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The EU Hears the Troubling Music

By **Brian Fabbri**

Visiting Senior Research Fellow, CAMRI & President, FABBRI Global Economics

2019 markets seem schizophrenic

There appears to be a curious disconnect in the financial markets. Market participants believe that the fears of global economic slowing that surfaced at the beginning of 2019 would convince the Federal Reserve to abandon its desire to raise its official rate this year. Consequently, the Fed funds future rate has no implied hikes for the next 12 months. They were correct: the FOMC decided to pause and remain patient until new data discloses whether the economic threats manifest themselves later this year. In spite of these economic worries, stock prices in the US and abroad continue to appreciate.

The ECB follows the leader

Careful observation over the past two decades reveals that policy actions taken by the European Central Bank (ECB) usually follow decisions made by the Federal Reserve with a lag of six months, or so. Once again, the ECB this year has reversed a recent decision to end its highly accommodative monetary policy stance which they announced late last year. This March the ECB decided that it would continue its highly stimulatory support of the EU financial markets. This follows a similar about face made by the Federal Reserve just months earlier when they too recognized the growing risks to the US economy.

The ECB officials recognized that the EU economy is presently struggling, and that it is subject to a black swan-type risk at the end of March, if Brexit inadvertently occurs. The central bank said on March 7th that it would keep interest rates on hold at least until the end of this year and extend its program of cheap loans to banks. Thus far, they have held back on a new commitment to purchase sovereign bonds from member countries.

Moreover, the ECB stated that it was unlikely that they would achieve their 2% inflation target in 2019. This later statement probably was made to cover themselves for reversing their previous decision to end market support and begin raising their official rate. Harmonized inflation for the EU is presently running at a pace of 1.5%, and it is projected to decelerate slightly through the remainder of this year.

Macroeconomic policy is running out of ammunition

In the years following the great recession in the EU, monetary policy was the only resource that EU officials used to combat the devastating economic impacts from that long, grim recession. Fiscal policy was, if anything, procyclical during the entire recovery period.

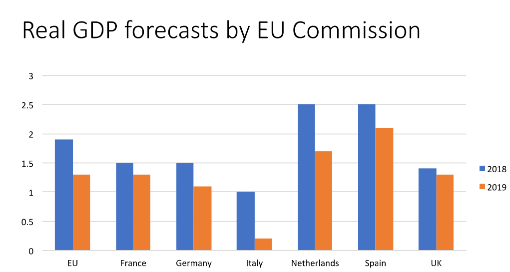
Now, the ECB is virtually out of ammunition. Its interest rates are already at rock bottom and its bond-buying program cannot easily be expanded because its holdings of German government bonds are close to legal limits. It can continue to make low interest rate loans to commercial banks, but it cannot make businesses borrow.

What about fiscal policy?

In other advanced economies governments frequently resort to fiscal policy to resolve economic cyclicality. In many cases, governments have abused their power over fiscal policy and either created too many worthless pork barrel schemes or increased public debt to threatening levels. In the EU neither was the case: instead, they focused on fiscal prudence and restrictive budget discipline during the crisis, which prolonged the misery, maintained unemployment at unhealthy levels, and tacitly contributed to the inevitable political proliferation of populism. For most of the past decade the EU was intent upon exerting maximum fiscal discipline on the countries whose budget deficits swelled during the crisis years.

Now, perhaps because the outlook for EU economic growth is distressingly dismal and with several dark holes to skirt by (China's apparently broader economic slowdown, US tariffs, and Brexit), the EU leadership is thinking about altering the stance of fiscal policy from restraint to mild stimulus.

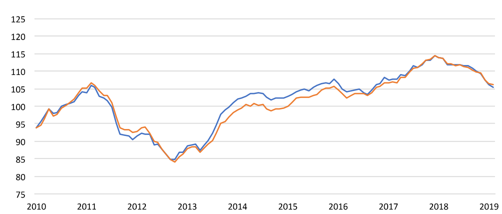
The EU Commission's sour forecast



In February the EU commission revised down their EU forecast significantly. The commission predicts that the 19-nation euro-area economy will expand by 1.3% this year down from 1.9% growth projected in November 2018. For 2020, it predicts growth of 1.6%, down from 1.7% forecast earlier. Downward revisions for growth in 2019 were sizeable for Germany, Italy, and the Netherlands. The gloomier forecasts reflect more pronounced weakness in the region, which stumbled at the end of 2018 as political instability continued to depress Italian economic activity, violent protests in France impaired output, and Germany's car industry struggled to rebound from changes in regulation.

Sentiment is depressing the EU forecast

Economic Sentiment Index for EU Area*



* EU Commission

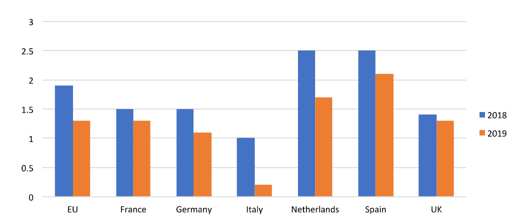
The EU downgraded its previous forecast for 2019 EU growth because it's Economic Sentiment Indicator (ESI) has decreased markedly in recent months. The drop-in business confidence in December, January and February was broad-based across countries and sectors, except construction. In addition, the euro area Flash Composite Output Purchasing Managers' Index (PMI) fell in January 2019 to 50.7. Since its peak in January 2018, the PMI Index has fallen 8 points, and is now at a 5½ year low. While PMI weakened across countries, both January's and December's readings were strongly influenced by the fall of the composite PMI in France, which was linked to the disruptions to business and travel arising from the 'yellow vests' protests.

It could be worse

Global trade uncertainty and a sharper-than-expected slowdown in China also pose external risks to the economic outlook. The possibility of a disruptive Brexit creates additional uncertainty. The commission then added this caveat to their forecast: "in light of the process of withdrawal of the UK from the EU, projections for 2019 and 2020 are based on a purely technical assumption of status quo in terms of trading patterns between the EU27 and the UK". While completely reasonable it implies a very large downside risk to their forecast.

The biggest members are sinking

Real GDP forecasts by EU Commission



Germany suffered a contraction in economic activity in the second half of 2018 and, as a major exporter of capital goods, continuing deceleration in industrial activity in China will remain a weight on its growth in 2019. Downside risks are related to weaker than anticipated growth in foreign trade, muted investment, poorer business and consumer confidence.

In France, the government's fiscal response to the ongoing street protests is expected to raise their debt ratio by around 0.4% of GDP and not advance economic activity significantly. The risks are concentrated with the persistent weakness of consumer confidence, which if depressed further would cause lower-than-projected private consumption growth.

Italy's low rate of trend growth (just 0.3% annualized since the euro's inception) is projected to remain at the same rate by the EU commission. Inadequate trend growth has been the major driver of its rising public debt-to-GDP ratio, and this debt ratio will only be exacerbated by the new budget resolution the new Italian government sent to the European Commission.

The latest ECB forecast contributes to the gloom

Then, one month after the EU commission's bleak forecast the ECB followed with an even more wretched one. The ECB stated that "Real GDP growth remained unexpectedly sluggish in the fourth quarter of 2018, and recent indicators point to substantially weaker than previously expected activity in the first half of 2019". "The broad-based worsening of economic sentiment indicators across countries and sectors in recent months suggests that more persistent adverse factors have also been at play and that the underlying cyclical momentum is somewhat weaker than previously assessed."

Consequently, they predicted that real GDP growth is projected to increase from 1.1% in 2019 to 1.6% in 2020 and 1.5% in 2021. Compared with the December 2018 projections, real GDP growth for 2019 has been revised down by 0.6 percentage point. And importantly HICP inflation is expected to continue to decrease in the course of 2019.

EU Fiscal policy is not an adequate weapon

Fiscal policy has never been the EU's strength. Indeed, it is their primary weakness and it has prevented the EU from managing their 19-member economy efficiently. Since there is no unified budget, the EU Commission has only the summation of the member countries' budgets to assess from a policy point of view. This aggregate budget bears little resemblance to a potent macro policy tool.

Nevertheless, for the first time in a decade fiscal policy in the euro area is expected to loosen this year. The extent of easing is small and its composition is not best suited to stimulate much growth. The plans now being discussed at the EU Commission point toward a wider aggregate deficit in 2019, of 0.8% of GDP.

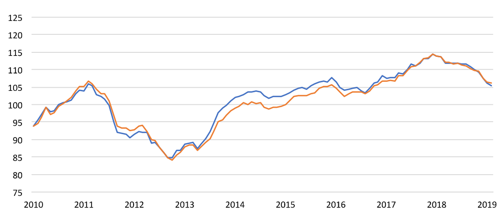
The euro area fiscal stance is presently assessed to have been broadly neutral in 2018 and it is now projected to loosen from 2019 onwards. The fiscal policy stance is measured as the change in the cyclically-adjusted primary balance net of government support to the financial sector.

In 2019, the main contribution to the looser fiscal stance being currently discussed stems from cuts to direct taxes and social security contributions, as well as higher government expenditure in some countries. This common budget would at least aim to encourage public investment and structural reform.

Public investment in the euro area has yet to recover from the deep cuts that were mandated during the crisis years. Because of the fiscal austerity directed by the EU Commission during the 'great recession' public investment's share in euro-zone GDP remains lower than it was in 2007.

One big caveat for fiscal policy

Economic Sentiment Index for EU Area*



* EU Commission

One important caveat to consider is the past record of the EU commission, which reveals that discussions rarely correspond with action. Therefore, whatever the present desire of finance ministers at the EU meeting is, they will have to overcome the insistence of northerners, who loathe the idea of fiscal transfers to the supposedly profligate south. Consequently, fiscal policy has not and probably cannot be used to stabilize the economy in rough times.

Conclusion: The EU is on a road to nowhere

All official euro area wide harmonized sentiment indicators are headed south. The deteriorating public confidence in the euro area economy has captured the attention of policy makers both at the ECB and at the EU Commission. This unfortunate economic situation is coming at a time when macro policy makers have sparse resources and political will to overcome the inevitable economic deterioration that is presently occurring before them.

The imposition of tariffs by the US and even the threat of them can only depress business confidence further. Uncertainty surrounding the Brexit leaves another huge hole in the official forecasts as their depressing forecasts have all assumed a status quo with regard to Brexit. Furthermore, there is increasing evidence (although not from official statistics) that China's economic slowdown is gathering pace. The Chinese government recently announced additional macro policy measures to stimulate economic growth. This could only reflect deeper concern among Chinese policy makers about the actual status of the Chinese economy. Because China is the second most important export market for the EU's goods, weaker than presently expected economic growth in China will probably catapult the EU into recession before the end of 2019.

For more information, please contact
camri@nus.edu.sg

	KEY INDICATORS TABLE (AS OF 28 FEBRUARY 2019)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	2784.49	3.21%	3.21%	4.67%	4.67%	3MO LIBOR	2.62	29.64
FTSE	7074.73	2.30%	3.43%	2.10%	-1.74%	10YR UST	2.72	-5.09
NIKKEI	21385.16	3.02%	0.70%	-1.16%	-5.24%	10YR BUND	0.18	-72.15
HANG SENG	28633.18	2.71%	2.67%	-3.85%	-4.14%	10YR SPG	1.17	-23.73
STI	3212.69	0.77%	0.35%	-5.31%	-7.31%	10YR SGS	2.26	-5.62
EUR	1.14	-0.67%		-6.75%		US ISM	54.20	-10.71
YEN	111.39	2.30%		4.42%		EU PMI	49.30	-15.87
CMCI	1244.57	2.66%		-2.28%		JP TANKAN	16.00	0.00
Oil	57.22	6.38%		-7.17%		CHINA IP	5.70	-8.06

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency