In case you missed it: Divergence and divisions

The split among Europe's central banks was brought into sharper focus this week, as the Bank of England and Norges Bank kept the door open to rate hikes while the Swiss National Bank stuck to its dovish stance, in line with the ECB. In the eurozone itself, finance ministers at least attempted a show of unity, though cracks appeared here, too

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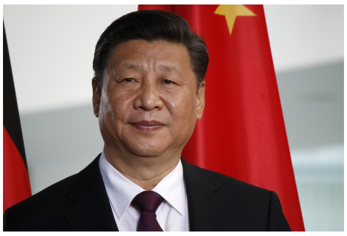

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Article | 22 June 2018

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Eurozone: Setting and showing limits to the French-German axis

Eurozone finance ministers tried to put up a brave front at last night's meeting in Luxembourg. But there was more disagreement than agreement on how...

Source: Shutterstock

The German Chancellor and French President, July 2017

It's been another typical European negotiation process. Months ago, with plenty of time to prepare for the June EU summit, there were still many diverging views, ranging from European dreams to simply saying “nein” to everything. At the start of this week, a compromise on further Eurozone reforms seemed to be in the making, with an agreement between France and Germany on credible proposals for the future of the eurozone. Last night’s eurogroup meeting, however, shows that next week’s European Summit of government leaders still has lots of unfinished work to do.

Good from the outside, disappointing from the inside

It felt almost as if we were back to euro crisis times when eurogroup president Mário Centeno talked to the press last night at 2.20am. This time around, however, eurozone finance ministers had good news to present. Not only the end of the Greek bailout programme but also progress on further reforms of the eurozone. At second glance, however, this good news remains mainly limited to Greece. The so-called agreement on further eurozone reforms leaves more questions than answers and it's very difficult to agree with Centeno’s statement that “the question is no longer if, or how we will complete the economic and monetary union. The question is when? And the answer we gave today is that we start now."

There seems little committed agreement on anything

In fact, reading between the lines, there seems to be very little committed agreement on anything. The only tangible decision taken was to make the European Stability Mechanism (which provides loans to EU area members facing financial distress) a financial backstop for bank resolutions. But there still seem to be diverging views on how to further strengthen the ESM- the term European Monetary Fund disappeared completely- and on the eurozone budget. Phrases like "going forward, in terms of deliverables, the eurogroup will prepare by the end of the year an outline of the key features of a strengthened ESM covering all the issues" are painful for eurozone veterans to hear.

Where do we stand on the most important issues?

1 Strengthening the ESM

The French-German proposal suggests a more technocrat approach to countries' emergency funding and an increased role in terms of monitoring. The idea here is to morph the ESM into an EMF. Both governments also put more emphasis on debt sustainability analysis for support to countries with upfront (automatic) debt restructuring. While other core eurozone countries have shown support for these ideas, southern economies have been more opposed. Italy, in particular, is less enthusiastic about the German proposals of reforming the ESM into an EMF and creating debt restructuring procedures. It believes the ESM works well and is worried about the stability on financial markets if private writedowns were automatically part of a debt restructuring process.

Our verdict: a stronger analytical role for the ESM looks feasible. Upfront or even automatic debt restructuring still lacks broad support.

2 Eurozone budget

The French-German proposal for a eurozone budget is similar to that of the European Commission for the 2020 budget. It's not a new stand-alone budget but a budget line dedicated to the eurozone as part of the multi-annual budget of the entire EU. One leg of the budget would be devoted to investments that are related to the structural improvement of the economy, specifically innovation and human capital. The other would be a macroeconomic stabilisation function that would not involve transfers. A financial transaction tax could be an important driver of the revenues related to the budget.

The question really is how large this budget will become. Here the differences between France and Germany remain quite large. French President Emmanuel Macron has said that he would love this to be a budget of several percentage points of GDP, which would be in the hundreds of billions of euros, while Merkel has indicated that she would like this to be in the "low double-digit billions".

Also interesting is the proposal for the European Unemployment Stabilisation Fund, which Germany has recently shown signs of warming to. While stopping short of a common unemployment insurance scheme, this proposal would allow national social-security systems to borrow during a crisis. This money would have to be paid back during the upturn following the crisis.

Last night's comment that "it is clear that our discussions are less advanced on possible fiscal instruments for convergence and stabilisation in the EMU" shows that the French-German ideas received very little support. The governments of the Netherlands and the Nordics are strongly opposed to new budget lines to stabilise economies, stating that sound fiscal policies would be sufficient to provide stabilisation during times of crisis.

Our verdict: Still a long way to go but a small budget line in the EU's multi-annual fiscal framework as a kind of "money for reforms" or conditional cross-border investments fund looks feasible.

3 Banking union

Here, the most important additional proposal to the already agreed upon measures by the French and German governments is that the ESM should be the backstop to the Single Resolution Fund. With last night's decision, there is now a deal. This should take the form of a credit line and would not be bigger than the current size of the SRF, which is now around €55 billion.

In terms of a European deposit insurance scheme (EDIS), the French-German proposal already showed that the ambition level has been lowered. Last night's meeting did not bring any change. A statement that "after the European Council in June, the work on a roadmap for beginning political discussions on EDIS could start" is not really promising.

Our verdict: Making the ESM a financial backstop for bank resolution is a done deal. EDIS is clearly on a backburner.

All this means that European leaders will still have lots of unfinished work when they meet on Thursday. On a positive note, at least there is some progress. On a more negative note, however, there still seems to be more disagreement than agreement and the rest of the eurozone countries have clearly shown the limits of the French-German axis.

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Germany: Merkel sunset postponed

The growing government crisis in Germany has been defused, temporarily. However, the fact that the interior minister has given the chancellor a kind of...

Source: Shutterstock

It is a normal political phenomenon that the longer a politician is in office, the higher the number of swan songs they will get. German Chancellor Angela Merkel has survived and managed several difficult situations during nearly 13 years in office. However, most of these crises were on the European stage. The current one is playing out on the domestic stage. And even worse, it is within her own coalition. The chancellor's political survival has never been more at risk than it is right now.

What is happening?

Merkel's problems stem directly from the refugee crisis, which has returned to the forefront of German politics. Scandals at regional offices of the Federal asylum agency, the murder of a 14-year old girl with an asylum seeker as a suspect and tough talk from Merkel's coalition partners, have dominated recent headlines. On the back of these tensions, a conflict between Merkel's CDU and the Bavarian CSU has heated up. The CSU wants German police to prevent refugees, who are registered in another EU country, from entering Germany. Merkel blocked its plans, arguing in favour of a European solution. This debate has led to a damaging fight that is out in the open between Merkel and her interior minister, the chairman of the CSU, Horst Seehofer.

On the one hand, Seehofer has threatened to issue an order to implement his will regardless of Merkel's objections. According to German law, ministers can introduce new policies in their respective domain, without the government's agreement. On the other, the Chancellor can fire ministers. So there is clear deadlock from political gambling by the CSU. At the moment, it is hard to see how exactly the CSU wants to solve the situation without any severe loss of face or a collapse of the government.

Today, both parties agreed on some kind of ceasefire. Merkel and Seehofer, in two separate statements, announced that Merkel would try to find a European solution at next week's European Summit, while Seehofer will prepare measures to prevent refugees from entering the German border until early July. But Chancellor Merkel also stated there was no deadline for a solution after the European summit, trying to play down that effectively Seehofer seems to have given her an ultimatum. In our view, this simply means that the conflict has only been postponed. European leaders are only likely to agree on common principles and intentions next week, not specific details.

Any upside?

The only upside of this severe political crisis in Germany could be that Merkel will now be forced to give away more than currently expected on other policy areas to the rest of Europe. Her domestic fragility could mean that she will be somewhat more willing to push on with eurozone reforms - even though it is questionable whether this would be in the CSU's interest.

Merkel's worst crisis ever

Merkel is currently going through the worst political crisis since she entered office almost 13 years ago. However, this doesn't necessarily mean that the government is about to collapse. The fact is that the CSU is playing a dangerous game and it's unlikely to benefit from a collapse of the government. It would backfire for the CSU during the Bavarian elections in October, because a possible splitting of CDU and CSU would bring the CDU to Bavaria, costing the CSU votes.

Nevertheless, political tensions remain, and a multitude of different scenarios look possible. These range from a muddling-through process, the CSU budging or a strengthened European Merkel, to a fall of the chancellor, a full collapse of the government and new elections. We will not speculate, but one thing is clear: hopes for a strong German government to lead further reforms in the eurozone have taken a severe hit.

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Snap | 21 June 2018

Bank of England keeps the door to an August hike firmly open

Despite a fairly mixed run of data, the Bank remains relaxed about the first quarter slowdown and is confident about wage growth. An August rate rise...

Source: Bank of England

The run of economic data since the May meeting has been pretty mixed, but the key message from the Bank of England (BoE) today is that they're comfortable things remain on track.

Importantly, the Bank remains just as confident that the economy is rebounding after the weak first quarter as it did back in May, pointing to the rebounding household activity as a key example.

An August rate hike is still more likely than not

Policymakers also remain upbeat about wage growth – a central part of the Bank's thinking on rate hikes – suggesting that the recent moderation we've seen in average earnings hasn't fazed the committee. The 3M/3M annualised rate of change in wage growth has slipped from around 3% at the turn of the year, to just under 2.5% now. But with Bank agents still pointing to faster pay hikes in response to skill shortages within the jobs market, the BoE noted "domestic costs pressures will continue to firm gradually".

To us, this all suggests that an August rate hike is still more likely than not. While the Bank hasn't offered any firm signals or commitments this time, the overall outlook and tone suggest they'd still like to raise rates if the data allows. It's also worth noting that one extra member – Chief Economist Andy Haldane – has joined two others in voting for an immediate rate hike.

But nothing is guaranteed - there's still plenty of data to come between now and August. Our main concern remains the retail sector, where ongoing consumer caution, higher wage costs and rising business rates still appear to be causing real difficulties. If further cracks begin to appear, then the Bank may be forced to puts its tightening plans on ice for a little while longer.

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Snap | 21 June 2018 Norway

Norges Bank confirms September rate hike

As expected, the Norwegian central bank reiterated its intention to raise interest rates in September. This shows the NB is on a more hawkish path than...

Norges Bank's policy statement today confirmed that "the key policy rate will most likely be raised in September 2018", a more explicit line than the previous intention to raise interest rates "after the summer".

The interest rate path now shows an average of 0.53% in 3Q, consistent with a September rate hike, and 0.76% in 4Q, indicating some chance of another hike already in December. Further out, the rate path shows an average of two hikes per year in 2019-21.

The NB's GDP and output gap forecasts are largely unchanged from March, while the headline inflation forecast has been revised up for 2018 but down in 2019, while the core inflation forecast is revised down throughout the forecast period. This is largely due to higher energy prices and some downside surprises in core inflation this spring.

The key factors driving the upward revision of the interest rate path are the higher oil price since March and the weaker-than-forecast krone exchange rate.

Today's announcement reinforces our view that the Norwegian central bank is in a more hawkish mode than its fellow central banks in western Europe. Importantly, today's announcement demonstrates clearly that the NB is not tied to the ECB's policy path in the way that the Riksbank and Swiss National Bank are: the ECB's dovish surprise last week has not led the NB to revise its stance.

It is also notable that weaker core inflation has not prompted the NB to revise its interest rate path lower (though it does push down on the NB's rate path calculation). This is in clear contrast to the Riksbank, which revised its rate path down in April after several months of negative surprises in core inflation.

So long as the recovery in the domestic economy stays on track and oil prices hold up, the NB is likely to remain in tightening mode. We fully expect the NB to deliver a hike in September and see the next hike after that most likely coming in March 2019.

This suggests further upside in NOK. The krone has strengthened materially on the back of the NB's announcement and EUR/NOK is currently testing the 9.40 level. While the krone is held back by the overall risk negative environment in the near term, the NB's stance is likely to provide a substantial tailwind.

More of the same from the Swiss central bank

As expected, the central bank left rates unchanged today and still believes the franc is "highly valued". Given that a strong appreciation of...

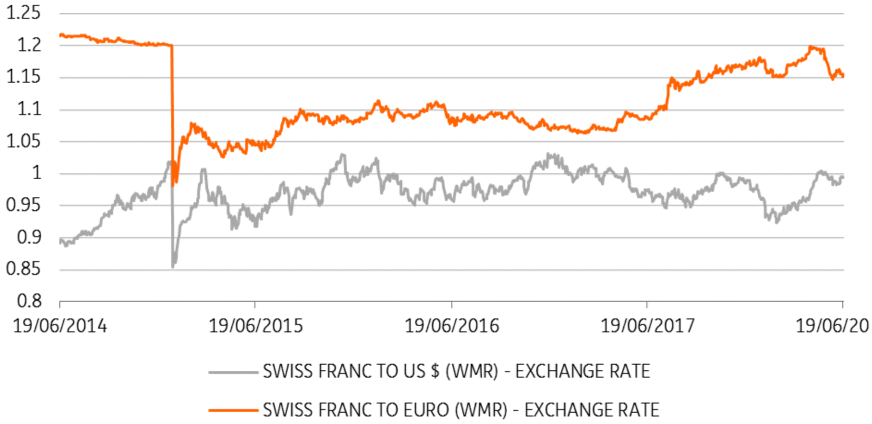
Source: Shutterstock

Nothing new for monetary policy

The target range for the three-month Libor was maintained between -1.25% and -0.25% and the interest rate on sight deposits with the Swiss National bank remains at -0.75%. Moreover, the central bank reiterated its willingness to intervene as required in foreign exchange markets to prevent an appreciation of the Swiss franc.

The Bank still believes the franc is "highly valued," noting its volatility over the past three months and saying it is still considered a safe-haven asset. Indeed, according to the SNB, political factors in the euro area are the main culprits for the recent appreciation of the franc.

Swiss franc has had a volatile ride during the past three months



Source: Thomson Reuters Datastream, ING Economic Research

More cautious assessment of global growth outlook

Even though the central bank still considers the global economy will continue to grow above its potential, the growth outlook is more cautious than it was in March. Trade tensions and political developments in certain countries are risks for the Swiss economy. Nonetheless, the assessment of the domestic growth outlook is still positive. The SNB noted that 1Q18 GDP growth was above its estimated potential and that overall capacity utilisation improved further. The SNB believes GDP growth will reach 2% in 2018.

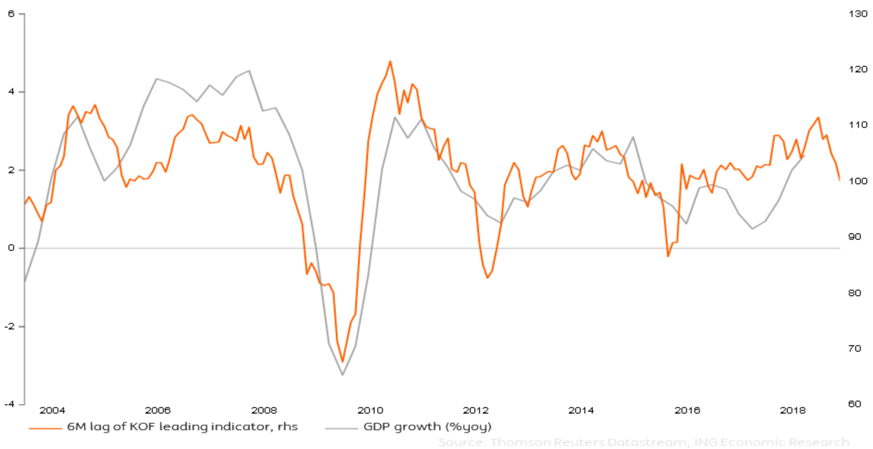
Given the increased risks and the decrease of the KOF-leading indicators, we have slightly revised our GDP forecast for 2018

On the domestic side, it noted imbalances on the mortgage and real estate markets persist. It remarked that real estate prices continue to rise and that "affordability risks for new mortgage loans in the residential investment property segment rose significantly last year."

We tend to agree that global risks have increased over the last few months and that can already be seen in the fall of Switzerland's leading indicator - the KOF Economic Barometer - from 108.3 in February to 100, its long-term average, in May.

Given the increased risks and the decrease of the KOF-leading indicators, we have slightly revised our GDP forecast for 2018. GDP grew at 0.6% quarter on quarter in 1Q18, and we revise our estimates to 2.2% on average in 2018 from the previous 2.3% estimate. We expect 2.0% growth in 2019 compared to 1.1% in 2017.

A falling leading indicator



Source: Thomson Reuters Datastream, ING Economic Research

Higher inflation, but only due to external factors

The central bank noted that inflation has increased during the past few months, reaching 1% year on year in May for the first time since March 2011. It could be considered a good sign as the country has been battling with deflation and low inflation for the past seven years. However, the spike was mostly a consequence of higher oil prices and temporary weakness of the franc in late April, which together increased import prices.

The SNB revised upwards its conditional inflation estimate (i.e. based on the assumption of no change in monetary policy) for 2018 to 0.9% from 0.6% in March. However, it didn't revise its forecast for 2019 (0.9%), recognising that higher inflation is due to temporary factors. Moreover, it revised its inflation forecast for 2020 downwards from 1.9% to 1.6% which signals a rather dovish monetary policy over the next years.

Looking ahead

We believe the SNB won't change its policy anytime soon.

Given the SNB's worst nightmare is a strong appreciation of the franc, we believe it will wait for the ECB to start raising rates. The ECB's announcement that it would stop bond buying in December isn't enough on its own to make the SNB change its policy.

Given the ECB is not expected to hike before the end of summer 2019, we think the Swiss National bank won't raise its rates before December 2019 either.

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Article | 22 June 2018 Greece

Smooth end to Greek debt programme

The deal reached overnight confirms a piecemeal approach to Greek debt relief. While concerns about the long-term sustainability of the country's debt...

Source: Shutterstock

Green light to late-August end of third Greek programme

By confirming that Greece has implemented all of the 88 prior actions under the fourth and final review, eurogroup chief Mario Centeno announced that Greece has successfully completed its ESM (Emergency Stability Mechanism) programme and that there will be no follow-up programme.

Yesterday's meeting was widely expected to disclose a new batch of medium-term debt relief measures to make Greek debt sustainable. These were indeed announced overnight, with a different mix from what the debate had suggested. The growth-related French mechanism was not part of the deal, nor was an explicit liability management exercise. Approved measures involve extensions of interest rates and maturities, medium-term measures, and the creation of a cash buffer. Amid the current, unstable political backdrop, the chances of building the necessary consensus on politically-binding and more ambitious debt relief measures were indeed slim.

Medium-term debt relief measures announced, with conditions attached

The first batch of debt relief, a 10-year extension of the EFSF (European Financial Stability Facility) interest and amortisation, will be delivered upfront. This should help Greece to smoothly return to market financing all along the Greek curve. A second batch of debt relief measures will be agreed upon, with conditions attached. These include the abolition of the step-up interest rate margin related to the debt buy-back tranche of the second Greek programme and SMP profits (Securities Markets Programme) from the ESM segregated account as well as the transfer of ANFA (Agreement on Net Financial Assets) and SMP income. They will be disbursed in semi-annual payments until 2022, subject to compliance with policy commitments and monitoring. The relevant monitoring will be run under the EU Commission's enhanced surveillance procedure to be activated in the next few weeks, which will produce quarterly reports.

Cash buffer set up, with possible flexible use

The eurogroup also mandated the ESM to disburse €15 billion to Greece as the last programme tranche. Some €5.5 billion of it will be placed into a segregated account and will be used for debt servicing. The remaining €9.5 billion will be disbursed to a dedicated account to set up cash buffers to be tapped for debt service in case they're needed. According to the eurogroup statement, Greece should exit its programme with a total cash buffer of €24.1 billion, deemed enough to cover Greece's financial needs for at least 22 months, a substantial backstop against potential short- to medium-term risks.

The use of the cash buffer was not made explicit in the official statement, but the national press conference of the Greek finance minister Euclid Tsakalotos added some useful information. In principle, the cash buffer should be used to manage the debt profile to reduce the burden of financing the Greek economy; as such this could include the possibility of buying back IMF or GLF (Greek Loan Facility) debt. We expect some this to materialise.

IMF to remain a technical partner

As expected, the IMF decided not to enter a stand-by arrangement but will remain involved in the post-programme surveillance framework with the eurozone institutions. The divergence on debt sustainability between the IMF and other lenders was apparently not bridged by the debt relief package approved yesterday. IMF managing director Christine Lagarde said the measures should ensure medium-term sustainability but reaffirmed that the IMF has reservations over the long term.

Need for long-term debt relief to be assessed in 2032

The need to take additional debt relief measures will be reassessed in 2032. Should an unexpectedly adverse scenario materialise by then, the eurogroup could put in place a further re-profiling, capping and deferral of interest rates of ESFS loans to create the conditions for Greece to meet the gross financial needs long-term benchmark (20% of GDP).

The Greek case should fade from the headlines for some time

The agreement on the completion of the Greek programme is certainly good news. To be sure, it does not bring a once-and-for-all solution to the Greek debt problem. But it should ensure an effective hedge against the resurgence of Greek risk for a number of years. The post-programme governance keeps a substantial degree of conditionality on the completion of planned reforms, and the Greek government's growth strategy seems to show a growing sense of ownership of realised and ongoing reforms. Fiscal targets remain ambitious, and the Greek commitment to keep the primary surplus at 3.5% of GDP until 2022, and, most notably, at 2.2% of GDP from 2023 to 2060, looks liable to future downward revisions. Still, the available cash buffer seems big enough to accommodate a gradual return of Greece to the market without excessive external pressure. A favourable environment for the Greek government to work hard at returning the country to a renewed, financially sound footing.

It's now time for the European institutions and political leaders to concentrate on the reform of the entire European project: creaks in the building need quick fixing, not only on the Greek side.

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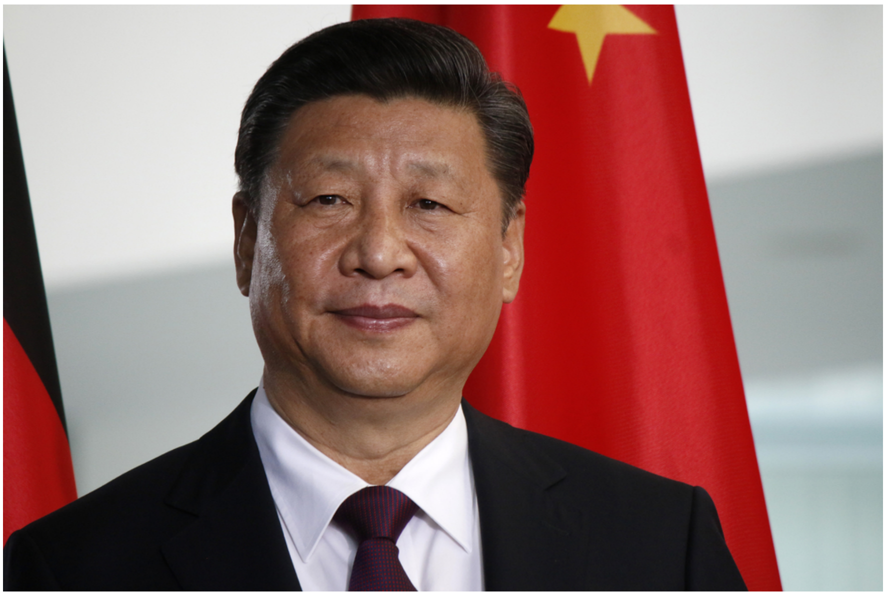
Article | 21 June 2018

China policies to cushion potential trade war impact

China has started pre-emptive measures to buffer the negative impacts of rising trade and investment tensions between China and the US



Source: Shutterstock

China adopts measures to soften the impact of a potential trade war

China will not passively sit back if a trade war is unleashed. Indeed, it is already implementing policies to temper any effect We look at some of the more important ones below.

Fiscal support on high-tech sector

Government expenditures on science and technology in China rose by 18.5% year-on-year, year-to-date in May, considerably faster than overall government spending growth of 8.1%.

This is a direct response to sanctions on a Chinese company operating in semiconductor and smartphone operating systems. China intends to invest in its own advanced technologies.

We expect fiscal spending in this sector to increase and be matched by rising funding from private companies to achieve President Xi Jinping's objective of a bigger domestic advanced technology sector.

Monetary policies to assist SMEs

SMEs will likely be hit hard by a trade-war. Consequently, the government has established an SME Working Committee to help small companies navigate through any trade storm.

Even before we see any tangible evidence of the damage the trade war is having, China's strategy is to put in place policies designed to cushion any negative trade spillovers.

At its meeting on 20 June, the central government emphasised lowering the interest costs of SMEs, and including some SME loans as collateral for the Medium Lending Facility (MLF), a loan taken by banks from the central bank.

The meeting also mentioned that targeted cuts in the reserve requirement ratio could help small and medium-sized enterprises.

We expect the central bank to implement the targeted RRR cut in July. And like the previous cut, any cash released could be used to repay high-cost MLF funds borrowed from the central bank. This could avoid cash released by RRR leaking into asset markets.

The reason we don't expect targeted RRR cuts in June is that it might confuse the market into thinking that the RRR cut was a measure to relieve quarter-end liquidity tightness. However, this is a longer-term policy tool, which should not be interpreted in this way.

Would a trade war stop reforms in China?

It really looks as if the central bank (PBoC) is loosening monetary policy to prepare for an escalating trade war and investment tension. But, at the same time, the PBoC is managing liquidity quite tightly to achieve financial deleveraging reform.

Could a trade war slow down or even stop the PBoC's financial deleveraging reform?

We don't believe that, at the current stage, the PBoC will slow its efforts to clamp down on shadow banking activity - the focus of financial deleveraging reform. But if a trade war escalates and weighs on investment, then the central bank may have to step back on reforms and focus instead on supporting the economy by loosening monetary policy.

Policies to ease inflows reducing yuan impact on outflows

During this period of escalating protectionism and rising investment tension between China and the US, the market usually reacts to bad news by causing the US dollar to appreciate against other major currencies. This would also tend to weaken the yuan against the dollar.

If the yuan maintains its weakening trend, this could lead to capital outflows. To avoid a repeat of the quick loss of foreign exchange reserves that occurred between mid-2014 and 2016, the central government has made it easier for foreign companies to do businesses in China.

For example, commencing from 1 July, foreign direct investment into China will follow a negative list control. So business areas not in the negative list could invest in China without restrictions.

Another example is the recent relaxation of QFII and RQFII outflow restrictions, which is to ease worries of foreign investors so that China can attract more inflows (you can read the note here).

We believe more measures to open up the market and attract inflows will be unveiled in the near future. This is important to offset outflows induced by an expected weaker yuan. Without more measures to attract inflows, the central bank could easily become trapped by a fall in foreign exchange reserves and may be forced to strengthen the yuan even if it's not in line with economic conditions.

We expect USDCNY to go to 6.60 by end of 2018 (our note on USDCNY forecast revision is here).

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