

## In case you missed it: It's wait-and-see time

With much of the fate of the global economy and the likely direction of markets hanging on the outcome of this pivotal Trump-Xi meeting, we think things will get worse before they get better. Elsewhere, the EU is getting into a squabble of its own with none other than Switzerland. And come next week, it'll be OPEC members and Russia wrangling over oil cuts

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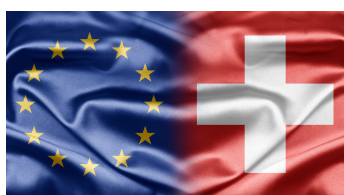
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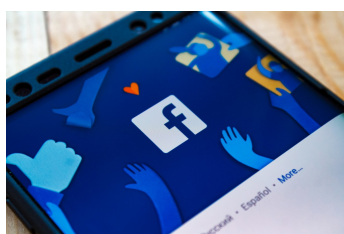
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By James Knightley

# G20: Trade war will get worse before it gets better

Resuming trade talks seems to be the best attainable result of the Trump-Xi meeting at the G20 summit. But even then, there are too many bridges to be crossed for a smooth path towards a deal. We think there will be another round of tariffs before the pain of the trade war forces both parties to strike a deal in the last quarter of this year



## Hopes for a deal

By describing his latest phone call with Xi as a “very good conversation”, President Trump has fuelled expectations that his meeting with Chinese counterpart Xi will lead to a cease-fire.

Where have we seen this before? In the run-up to the previous G20 summit in December 2018, Trump also tried his best to improve the negotiation climate after months of US tariff hikes and threats of more to come. Does this mean that the result will be the same as in December?

## Beijing won't acquiesce easily...

A cease-fire is certainly a possibility but this time it will be harder to get done. Just agreeing to resume negotiations is not enough anymore. The collapse of the trade talks at the start of May has changed things.

Although President Trump keeps saying that China is very keen to cut a deal, the US administration now knows that China is not prepared to strike a deal at any price. President Trump's negotiating

style is increasingly irritating Beijing. To get the trade talks going again, Trump will have to show that the US respects China. The President could do that by, for example, agreeing to reciprocity regarding penalties in case of non-compliance with a future deal.

That would also address the issue of the reliability of the US as a negotiating partner. Trump's actions toward Mexico earlier this month have given new meaning to the concept of 'negotiating in good faith'. Threatening Mexico with tariffs only weeks after the last loose ends of the USMCA trade deal were wrapped up will have given rise to doubts in Beijing about the value of a deal with the US.

## But Trump needs something to show voters

For the trade talks to start again, President Xi has to make concessions as well. He will have to assure Trump that China is willing to offer more in new negotiations than during the last round of trade talks. Without this, President Trump has nothing to show back home when he returns from the G20 summit.

But even if talks resume, the failure of the latest round of negotiations should suggest to investors that a cease-fire is not necessarily around the corner.

The breakdown in negotiations in May shows that China is no longer prepared to have the US dictating the content of a trade deal. For the first time, Beijing has publicly set its own conditions for a deal to be struck and it has ramped up patriotic communication through its state-controlled media, preparing the Chinese people for a war of attrition.

This shows the risk is increasing that Trump's negotiation strategy may fail. Thus far, the President has been relying on his usual way of deal-making. About this style he wrote in "the Art of the Deal": 'I aim high and then I just keep pushing, pushing and pushing to get what I am after'.

In his war on free trade, the pushing is being done by implementing tariff hikes and threatening to step that up if the other side does not give in to his demands. This has worked quite a few times with various countries. But China consciously chose to stand firm in the current conflict and accepts the price it has to pay: elevation of the US import tariff from 10% to 25% on US\$200 billion of its exports to the US.

We think that Trump will stick to this negotiating strategy for a little bit longer. Even if the leaders agree to resume negotiations this weekend and refrain from imposing further trade restrictions for as long as the talks are ongoing, we think that there are too many bridges to cross for a deal to be struck smoothly. Also in this case, this would lead to a tariff hike on all remaining imports from China. China, in turn, will respond as it has thus far: by retaliating.

## We expect a deal in 4Q

Failure to agree on the resumption of the negotiations during the G20 or failure to come to a deal after a new round of negotiations will inflict extra economic pain. This increases the willingness to make concessions and strike a deal on both sides. Let's not forget: both sides want a deal in the end. China can hurt the US economically but it knows that the US can hurt China even more. President Trump needs a deal to show the American people that he delivers on his promises to get better terms of trade for the US. He knows that this is best done without the US economy having to suffer from Chinese retaliation for an extended period of time. We expect a deal to be struck in the last quarter of this year.

So it is likely that China as well as the US are prepared to make concessions in the end. After all, this is what's happened in the renegotiation of Nafta. To strike a deal, Trump had to accept that Mexico and Canada would not agree to all of his original demands.

## Author

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## Watch: If there's no US-China trade deal, then what?

We're not expecting any breakthroughs at the G20 summit between Donald Trump and his Chinese counterpart Xi Jinping. ING's James Knightley says things could then go in one of two directions



### No deal likely at the G20

President Trump will meet his Chinese counterpart, Xi Jinping this weekend at the G20 summit in Osaka. We're not expecting any deal to be struck as far as the trade war's concerned.

[Watch video](#)

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# What will happen after Xi-Trump meeting in G20

China and the US have scheduled a sideline meeting at the G20 in late June. What will happen next?



Source: Shutterstock

Donald Trump, Xi Jinping. President Donald Trump, right, with China's President Xi Jinping, left

## China US meeting scheduled

Overnight, announcements from both China and the US have stated that the two Presidents will meet at the G20 summit in Osaka for "extended" meetings to discuss the ongoing trade conflict.

As we have claimed a few times in our notes, we do not believe that the meeting will deliver a trade deal, even if the meeting does take place. From the Chinese side, the discussion with US President Trump is expected only to exchange views on fundamental issues concerning the development of China-US relations.

## What will happen after Xi and Trump meet?

Reading carefully from the statement from China, we only expect that both sides will repeat their views on the already drafted terms. But it is difficult to see any concrete progress that would either lead to a deal or improve the current deadlock situation.

During the meeting, President Trump will probably leverage on recent weak China economic data to persuade President Xi to agree that a trade deal is in China's interests. President Xi may use this opportunity to show President Trump that as long as both sides keep talking it will be helpful for the US economy and therefore President Trump's election campaign.

As such we expect no real change following the G20 sideline meeting. The fact that both sides are talking should at least postpone thoughts of a further increase in tariffs, for a while at least, until either side comes up with different thoughts.

Preventing any meaningful all-encompassing trade deal, there are still some fairly substantial hurdles. One is reform of state-owned enterprises, which is related to a lot of laws in China and fundamentally an issue of the Chinese political and economic model - in a word, sovereignty. Technology will also be discussed, and we expect China will confirm that there are no security issues on Chinese-made technological equipment. Though we do not think the US will accept this claim.

So the news on the talks in Osaka is a short term positive for asset markets, but we believe any talks will change little unless either side makes some meaningful concessions, which we do not view as likely at this time.

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## Yuan has already reflected the good news

USD/CNY and USD/CNH have already appreciated from the range of around 6.93-6.934 at the end of the trading session on 18th June to around 6.90 level (as of writing) for both USD/CNY and USD/CNH.

Markets are reacting positively to the fact that at least both sides are willing to talk about trade, even if this is only likely to deliver a short-term boost.

The yuan appreciation matches our forecast of USD/CNY at 6.90 by the end of June 2019.

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## OPEC+: Vienna waits for you

The 1st and 2nd of July will see OPEC+ members meet in Vienna, where the main discussion will be whether the group extends its current production cuts into the second half of the year. We believe that broader macro uncertainty and concerns over demand will force OPEC+ to continue with the deal



The market is expected to be in peak surplus through the first quarter of 2026, so a pause makes sense, though its size remains uncertain

### Why is OPEC so afraid?

All was going to plan for OPEC+ earlier in the year, their production cut deal which was agreed at the end of last year had the desired impact of pushing prices higher. This was helped out by the fact that Saudi Arabia was cutting production by around 500Mbbls/d more than it agreed to over much of the deal, whilst exempt Iran continued to see flows edge lower as a result of sanctions. The expiration of waivers for buyers of Iranian crude oil only helped the market further.

However as we have moved through the year, the surprise breakdown of trade talks between China and the US, has re-ignited concerns over the impact trade tensions will have on the global economy, and as a result the knock on effect on oil demand growth. Furthermore the market has been too fixated on US inventory numbers, which have shown unusual builds over large parts of Q2, which is a reflection of prolonged refinery turnarounds, and unplanned outages. This is a trend we expect to reverse as we move through the summer months- we are already seeing run rates in the US recovering, and the EIA report this week showed the largest weekly fall in US crude oil

inventories since September 2016

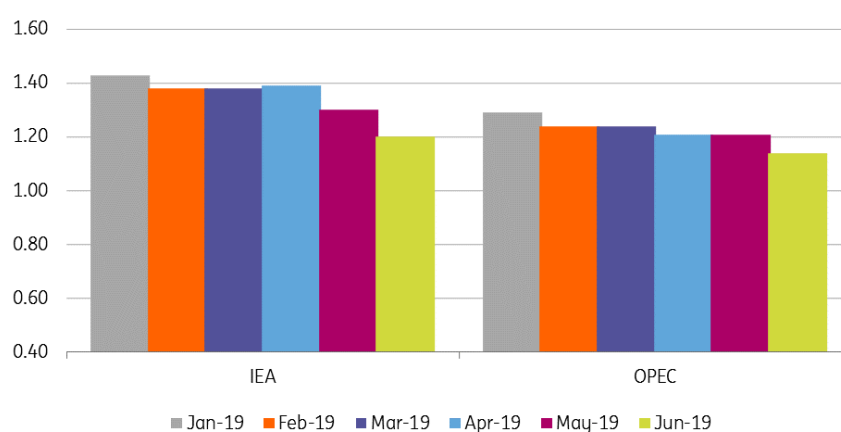
On the demand side, a number of agencies have slashed their demand growth forecasts for the year. The International Energy Agency are now forecasting that 2019 oil demand will grow by 1.2MMbbls/d over 2019, down from their forecast of 1.4MMbbls/d at the start of the year. A large part of this revision reflects weaker demand in the OECD over Q1, and in order to meet the IEA's demand growth estimate for the year, growth will have to pick up over 2H19- something that will likely be dependent on how quickly a resolution can be found with current trade talks.

The sell-off that we saw in May, has shown OPEC+ how vulnerable the market is at the moment, with participants clearly concerned about the macro picture. It is because of this vulnerability that we believe that OPEC+ will decide to extend the deal of cutting output by 1.2MMbbls/d over the second half of the year.

It is OPEC who have more to lose by not extending the deal, and this is evident through comments from a number of OPEC oil ministers in the lead up to the meeting, that they are confident that the deal will be extended. It comes down largely to fiscal breakeven oil prices- the Saudis have a breakeven price of around US\$85/bbl, and so they will be concerned about potentially a widening gap between this level and where the market trades.

A no deal scenario does mean the potential for further speculative liquidation. Speculators are already concerned about broader macro concerns, and so ending supply cuts would likely make them only shy further away from the market. The managed money net long in ICE Brent has fallen from over 400k lots in early May to almost 270k lots as of the 18th June, whilst for NYMEX WTI the managed money net long has fallen from 314k lots in late April to around 147k lots as of the 18th June. Although admittedly, given the more recent rally in the market over 2H June, with the rise in Middle East tensions, these positions are likely to be somewhat larger at the moment.

## Evolution of 2019 oil demand growth estimates (MMbbls/d)



Source: IEA, OPEC, ING Research

## Where's the fire, what's the hurry about?

As has become a common theme with OPEC+ meetings, there is always uncertainty around what Russia will do. They continue to take a more relaxed approach on whether the deal needs to be extended. Russia has a fiscal breakeven oil price below current levels, and so they are more comfortable with where the market is trading. The Russian energy minister just this week said that

it is still too early to comment on whether the deal will be extended or not, and that a large part will depend on the outcome of the G-20 summit, where trade talks will resume between Trump and Xi.

However we do believe that at the end of the day, Russia will continue with cuts, given the risk that the market falls to levels where they do not feel so comfortable in the event of no deal.

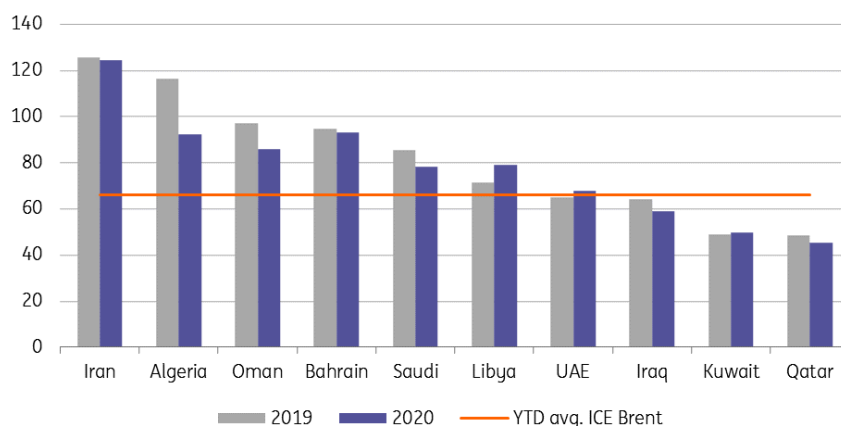
## Slow down, you're doing fine

We continue to hold a constructive view towards the oil market, assuming that OPEC+ extends the deal. We are forecasting that prices will firm from current levels, with ICE Brent averaging US\$69/bbl over Q3 and US\$73/bbl over Q4. Furthermore lingering tensions in the Middle East should continue to offer some support to the market.

We should see a seasonal pick-up in demand over Q3, and this combined with continued cuts from OPEC+ and further declines from exempt Venezuela and Iran should see a tightening in the global oil balance.

While prompt ICE Brent time spreads have come off from their recent highs-reflecting more of a normalisation in Druzhba pipeline flows, the Aug/Sep spread is still trading at a healthy US\$0.80/bbl, suggesting still a fairly tight prompt physical market. Meanwhile the forward curve continues to remain heavily backwardated.

## Fiscal breakeven oil price (US\$/bbl)



Source: IMF, Bloomberg, ING Research

## Author

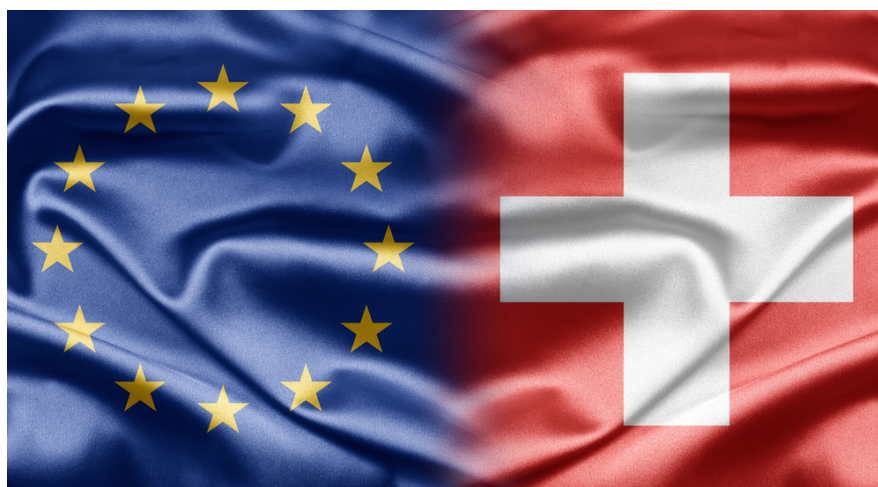
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## Swiss-EU relations strained

In Switzerland, negotiations for a framework agreement with the EU are completely blocked and the stock market equivalence granted by the EU to Switzerland is again at risk



Source: ING

Switzerland and the EU

### Negotiations at a stalemate

The months pass and nothing changes with regard to the negotiations between Switzerland and the EU for a framework agreement that will frame all relations between the two blocs in the future. Summing up the situation quickly: Switzerland is reluctant to approve the draft of the agreement negotiated for years with the EU. The EU is putting pressure on Switzerland so that the agreement can be signed quickly. The main means of pressure used by the EU is halting the stock market equivalence for the Swiss Stock Exchange, which is necessary for European traders to carry out their Swiss securities transactions directly on the Swiss market.

Since December 2017, obtaining the stock market equivalence is linked to progress in the negotiations on the framework agreement. Switzerland first obtained a temporary one-year extension of stock exchange equivalence. In December 2018, it received a further temporary extension of 6 months, until 30 June 2019 in order to set up consultations within the Swiss Confederation concerning the draft agreement. But since then, there has been almost no progress. The Swiss have asked the EU for "clarifications" this month in three areas - wage protection, state aid regulation and the definition of EU citizens' rights in Switzerland. If the EU was ready to give clarifications, it strongly insisted that there would be no renegotiations possible. Both sides are therefore encamped on their positions and an agreement before the end of the month seems completely impossible.

A European diplomat told Reuters on Friday that the European Commission will not propose to extend the equivalence regime.

This is perhaps a way to put pressure on Switzerland. Nonetheless, stock equivalence is more at risk than ever and without a new extension, the equivalence will expire automatically on 30 June.

## Life without stock exchange equivalence

Losing equivalence means that European traders would be forced to trade Swiss securities on European platforms rather than on Swiss stock exchanges. For the Zurich Stock Exchange, this would be a real problem because currently the majority of trading of the main Swiss shares is carried out by brokers based in the EU. In practice, a large part of the liquidity of Swiss shares would be migrated to the European stock exchanges and the Swiss stock market would see its volume of transactions drop drastically. The Swiss Finance Minister estimates that the volume of trading would decrease by 70% to 80% without equivalence. This situation could lead Swiss issuers to consider transferring their main listings to European regulated markets, thus distorting the position of the Swiss financial centre and impacting the entire Swiss economy.

To avoid a situation that is too catastrophic, Switzerland has already invented protective measures, which will be put in place if stock market equivalence stops. The law suspends the right of European stock exchanges to trade Swiss equities if equivalence is not granted. The goal is to still allow Swiss securities to be traded by European traders in Switzerland. Indeed, according to European law, when securities of Swiss companies are not traded on European stock exchanges, then European traders can trade Swiss securities in Switzerland without the need for equivalence (as there is no other means to exchange these securities). It is therefore a way to maintain a sufficient volume of transactions on the Swiss stock market and avoid a liquidity problem for Swiss companies. However, this does not solve the problem of European securities that can no longer be traded in Switzerland. But this problem is less important because the volume of European equities traded in Switzerland is quite low, especially compared to the volume of Swiss equities traded in the EU.

## Economic consequences

So, all in all, the loss of stock market equivalence would be compensated by the protective measures. However, the risk is that difficult negotiations between Switzerland and the EU and threats from both sides could leave long-term traces on the relationship between the two entities and on Switzerland's economic performance. In the eyes of the Swiss, the EU now appears uncompromising, which affects its image. The Swiss consider that they are "treated without dignity" by the EU. This could strengthen eurosceptics and the nationalist UDC party, who could win seats in parliament in the upcoming elections scheduled for October 2019.

In addition, the deterioration of relations makes the conclusion of an agreement more and more complicated. This could result in uncertainty and difficulties for Swiss companies trading goods and services with the EU. The EU is Switzerland's largest economic partner. 53% of Swiss exports are destined for the EU (18% for Germany), and 71% of Swiss imports come from the EU (28% from Germany). Switzerland is also a small open economy whose GDP growth depends heavily on foreign trade. Together the value of exports and imports represent more than 82% of the annual GDP of Switzerland. A deterioration of relations and a greater difficulty of trade with the EU, its main partner, would therefore be extremely damaging for the Swiss economy. Switzerland has nothing to gain from a battle with the EU.

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## The eurozone's Japanification - more to come

With the eurozone economy stuck in a low growth, low inflation and low rates environment, it's really hard not to make 'Japanification' comparisons. If we're honest, the eurozone is probably already in the thick of it, which means rates are likely to remain lower for longer and every new crisis or recession will bring the bloc closer to more Japanification



Haruhiko Kuroda, Governor of the Bank of Japan, left, talks to Mario Draghi, President of the ECB in 2015

### A brief history of Japan's lost decades – Japan's first crisis

The roots of Japan's subdued economic performance can be traced back as far as the late 1980s.

In September 1985, following the Plaza Accord – an agreement by Japan, the United States, France, West Germany and the UK to depreciate the US dollar against the Japanese yen and the German Deutsche mark, the Japanese yen appreciated sharply. Being highly export-oriented, Japan's exports and GDP growth dropped considerably in 1986. Because of the deteriorating economy, to stop speculative capital inflows and limit the yen's appreciation, the Bank of Japan

lowered interest rates from 5% to 2.5% between January 1986 and February 1987. Furthermore, fiscal packages were compiled in September 1985 and May 1987 to support the economy. Although the economy rebounded significantly in the second quarter of 1987, the central bank kept its policy rate at 2.5% until May 1989.

Fuelled by a mixture of declining lending standards, financial regulation in the years before, low interest rates, cheap money and the belief, that the only way was up, Japanese stock and real estate prices grew at a staggering speed towards the end of 1986 and until 1990, pushing the Nikkei index from 13,000 points to an all-time high of 39,000 points in December 1989. [1]

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### *The lending standards of banks became more cautious*

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In May 1989, the central bank raised interest rates from 2.5% to 6% in just 16 months as it became concerned about asset price increases, banks' lending behaviour and upward pressure on prices. At the beginning of 1990, stock prices started to decline with the yen depreciating and long-term yields increasing. However, the BoJ kept raising rates until August 1990 – also in the wake of the Gulf war leading to an increase in oil prices. Subsequently, the lending standards of banks became more cautious, money supply growth decelerated sharply and the pace of economic growth started to slow.

When the stock market and real estate bubble started to burst in 1990 and 1991, the Japanese banking sector faced a pile of non-performing loans with Japan's corporate sector being characterised by excess debt. According to the IMF's systemic banking crises [database](#), Japan's non-performing loans (NPLs) peaked at 35% (of total loans) during the banking crisis - a level which neither Greece nor Italy reached during the European sovereign debt crisis. However, the magnitude was not immediately recognised and authorities were slow in reacting. Only in the second half of the 1990s, when large institutions started to fail, the full extent became visible. [2]

## **The Bank of Japan's courageous monetary policy**

Meanwhile, the Bank of Japan was quite brave with introducing new monetary policy measures beyond textbook knowledge. In October 1999, the interest rate was lowered to zero and ZIRP (zero interest rate policy) was born. Japan's central bank started to use quantitative easing policies, back in 2001, setting the outstanding balance of current accounts at the Bank as the operating target [3]. But the monetary stimulus didn't result in higher inflation as the authorities had waited too long before taking decisive action. Initially, the BoJ had raised rates during the burst instead of lowering them and it was only in 1999, a comprehensive disclosure requirement for bad loans was put in place.

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### *Japan's low inflation seems to be more structural*

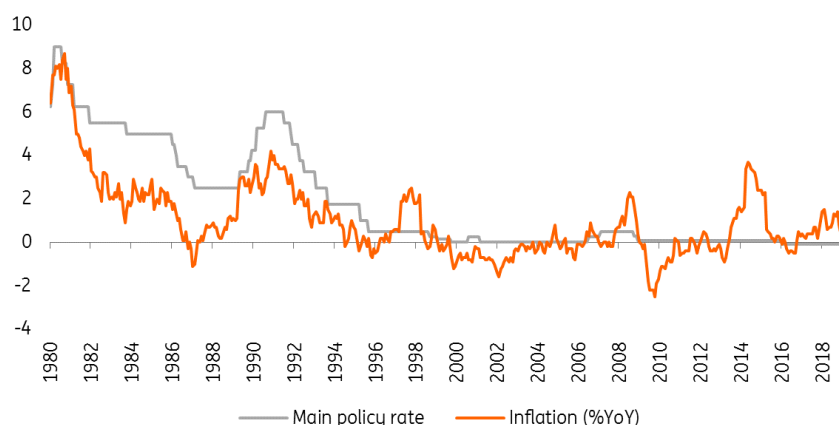
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Japan's low inflation seems to be more structural, causing low-interest rates, for which numerous factors can be cited. Research has identified factors like the “zero-lower bound on nominal interest rates, public attitudes toward the price level, central bank communication, weaker growth

expectations coupled with declining potential growth or the lower natural rate of interest, risk-averse banking behaviours, deregulation in the distribution chain and the rise of emerging economies” as possible factors depressing inflation.[4]

The Federal Reserve Bank of St. Louis (2018) adds to that technological progress, globalisation and demographic transitions [5]. Another factor weighing on inflation might actually be deleveraging. After the bursting of the bubble, the private sector deleveraged, cutting borrowing and spending.[6]

## Japan's main policy rate and inflation (%)



Source: Refinitiv, ING Economic & Financial Analysis

## Eurozone's lessons from Japan – the same causes or only similarities?

By now, an environment of low inflation has also reached the eurozone. It probably is structurally low inflation, driven by globalisation and digitalisation. However, the question is whether Japan-specific factors can help to explain the current low growth and low inflation situation or whether the eurozone and Japan are 'only' experiencing similar external factors.

Savings glut, central bank credibility, globalisation, the 1990s and 2000s saw a general decline in inflation and interest rate levels, which go beyond Japanification. But right now, the eurozone is showing similarities with Japan of the early 1990s. A financial crisis turns into an economic crisis, which then turns into a banking crisis, and finally into an existential crisis.

- **Leveraging and deleveraging:** In fact, the eurozone's development between 2009 and 2018 has a high degree of Japanification. Government debt increased by more than 25% GDP in Japan during the bust period of the 1990s while in the eurozone, on average it increased by some 20% of GDP. Credit to households on the back of loose monetary policies increased by 7% GDP in the eurozone and by around 9% in Japan. At the same time, however, credit to the corporate sector increased more significantly in the eurozone (+20% GDP) than in Japan (+6% GDP).
- **Central bank action:** The Bank of Japan and the European central bank behaved similarly during the crisis years. The BoJ didn't only cut rates to the zero-bound in 1999, it cut interest rates by 600bp in the 1990s while the ECB cut rates by 425 bp. However,

the ECB started to use its balance sheet extensively as a policy instrument earlier than the BoJ.

- **Financial sector:** Both Japanese and eurozone banks accumulated a huge pile of non-performing loans during the crisis years, with Japan's NPL ratio at 8.4% in 2001 and the eurozone's NPL ratio at 8.1% during the height of the sovereign debt crisis in 2012. In both countries, the financial sector had to be supported by large capital injections.
- **Demographic change:** An often-mentioned structural factor for the slowdown of Japan is ageing. In fact, Japan's working-age population (aged 15-64) has been on a declining trend since the mid-1990s, while the population as a whole started to decline from 2011 onwards. Although the eurozone still has some breathing room, the working-age population is also on a declining trend since 2009.

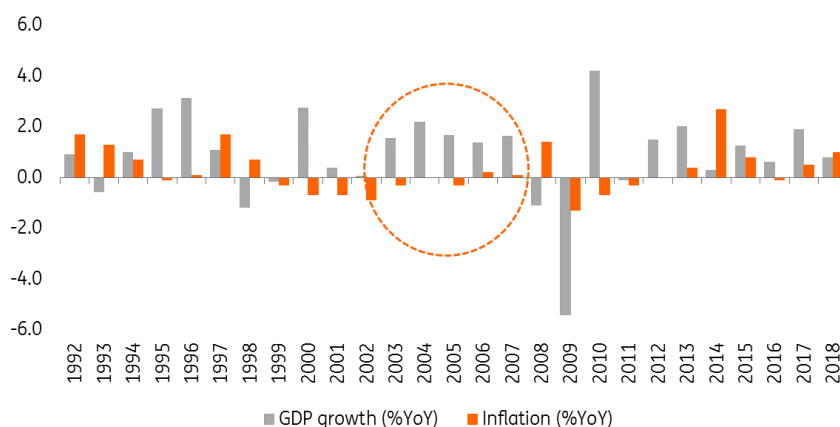
## So why should we care? Because of the next downturn...

While Japan's experiences in the 1990s were engraving, they are not enough to explain Japan's prolonged subdued economic growth environment up until today. Timing was not on its side.

The recovery of the Japanese economy was thrown back by three major events: the Asian crisis in 1997/1998, the dot-com bubble burst in 2000/2001 and finally and most importantly the global financial crisis of 2008/2009. Whenever it looked as if the Japanese economy had finally bottomed out, the next external shock came along. With the economy growing by 1.8% on average between 2003 and 2005, the Japanese central bank cautiously raised its main interest rate in July 2006 by 25 basis points to 50 basis points in September 2008.

But then, the financial crisis hit and the hiking cycle was over before it really began.

## GDP growth in Japan and inflation (%)



Source: Refinitiv, ING Economic & Financial Analysis

This is an important lesson for the Eurozone: the next crisis can always be just around the corner. Without a strong recovery, it is difficult to escape the low growth, low inflation and subsequently low rates environment. An economic upturn could quickly be over and monetary policy might not have enough ammunition up its sleeve, with interest rates remaining stuck at the zero lower bound for years to come.

Japan's central bank hasn't raised main interest rate more than 50 basis points for over 24 years

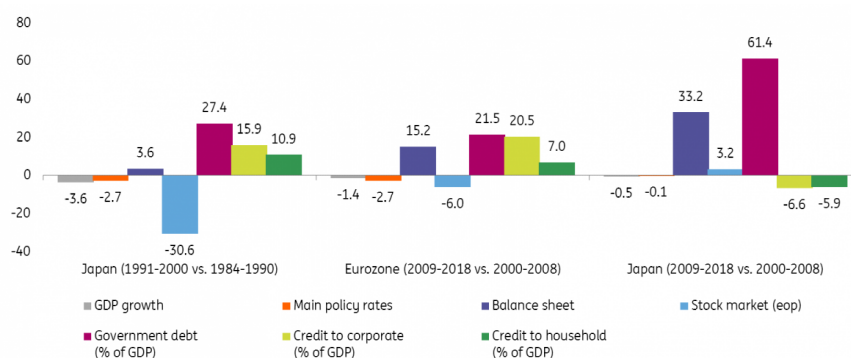
now and still has the largest central bank balance sheet measured as a percentage of GDP compared to the US and the eurozone. So, for the eurozone, the most important lesson is probably not so much the root cause of Japanification but the desperate attempts to get out it.

## What are the developments the Eurozone could be facing soon?

- **Deleveraging of the private sector:** Over the last ten years, the balance sheet problems of financial institutions and non-financial corporations have been one of the most important factors keeping the economy subdued for a long period of time, prolonging the subdued inflation environment [7]. Both credit to corporates and households have actually shrunk.
- **Ballooning of central bank balance sheet:** Over the last ten years, the balance sheet of the BoJ has increased by more than 75% of GDP. In the Eurozone, the ECB's balance sheet is currently some 18% of GDP bigger than in 2009.
- **Fiscal policy to the rescue:** Over the last ten years, Japanese government debt increased from 183% GDP in 2008 to 236% in 2018. The fiscal budget has been running deficits for 26 years, implementing countless fiscal packages to stimulate the economy.
- **Higher retirement ages:** While there has been a drop in the working age population of people aged 15 to 64, older employees and women have remained in or joined the workforce in Japan. Employment in Japan has actually been growing for seven years as the effective retirement age has moved up to close 70. Also, robotics and automation is well-advanced in Japan, keeping GDP per capita at high levels. All of this means that the expected wage-price spiral as a result of a shrinking labour force has never happened. Important lesson for the Eurozone: without these developments or measures, stagnation could easily turn into stagflation.[8]

## Economic developments in Japan and the Eurozone

(mean values over respective periods, %)



Source: Refinitiv, corporate and household credit data = BIS, government debt = Refinitiv/DG Ecfm Ameco.

### Why Japanification might be worse for the eurozone than for Japan

Having said all of this, Japanification doesn't have to be a bad thing, instead, it is rather a description of the state of an economy.

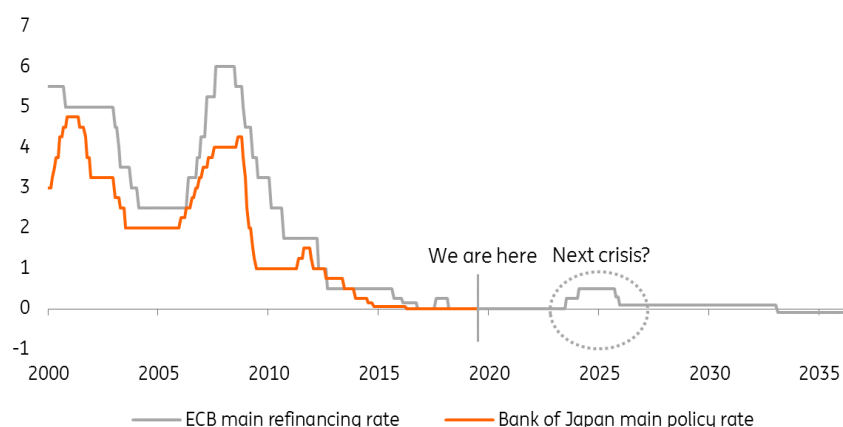
Despite Japan's prolonged period of subdued economic performance, the economy is still the third largest in terms of nominal GDP and is one of the most innovative and digitally

conscious economies in the world and thanks to the government's fiscal packages, Japan continues to enjoy a modern and well-maintained infrastructure. At the same time, however, Japan is also a relatively homogenous society.

On the contrary, in the heterogeneous eurozone, political tensions within and between countries might rise given differing interests, economic developments and the controversial use of fiscal policies among members, making forward-looking reforms more important than ever. Particularly, the discussion about the role of fiscal policy in attempts to stabilise or kick-start the economy clearly have the potential for greater conflicts in the eurozone than in Japan.

For the eurozone, the lessons from the future from Japanification are more important than the lessons from the past. The Japanese experiences show that it will be very hard to actually escape a low growth and low inflation environment without reverting to loose fiscal policies and policies aimed at increasing productivity growth. For the ECB, this means that even looking beyond the short-term horizon with economic and trade uncertainties, the possibility of Fed rate cuts and the ECB's easing bias, there will not be much room for rate hikes in the coming years.

## Main interest rates Eurozone Japan (%)



Source: Datastream, ING

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Article | 18 June 2019

## ECB president succession: Nationality matters...sometimes

Our analysis of eurozone central bankers' communication shows nationality matters, but not really in the ECB's board. And once the appointment is made, the national bias won't be as significant as many ECB watchers think these days



Source: Shutterstock

From L -H: Bundesbank President Jens Weidmann, former Governor of the Bank of Finland Erkki Liikanen and the Governor of the Bank of France Francois Villeroy de Galhau

When European leaders meet in Brussels this week, they won't only be discussing ways to further deepen the monetary union but also scratching their heads on how to best fill the top European jobs.

As [we've discussed](#) in detail before, an already complex musical chairs game has become even more convoluted as it also includes replacing the ECB president Mario Draghi. In the past, the ECB president was appointed in an exclusive process but due to the timing of Mario Draghi's term ending - 31 October, the position has been included in the bigger game. Nationalities, gender, political affiliations and previous jobs, everything matters.

As hard as it may be for market participants and ECB watchers to understand, leaders will first choose the next president of the European Commission before appointing Draghi's successor.

[Read our detailed report on ECB Musical Chairs](#)

## No real front runners as the presidency is part of horse trading

Given the deadlock in the talks up until now and particularly the increasing differences between France and Germany, chances have increased that this week's summit won't tell us 'who is who' in European politics.

We think it's very hard not seeing one of the Spitzenkandidaten as the next European Commission president. While the German politician Manfred Weber has the backing of the largest party in the European Parliament - the EPP, there is growing resistance against Weber. This could open the door for the Danish-born Competition Commissioner for the EU, Margrethe Vestager or the centre-left Dutch politician Frans Timmermans. If Weber doesn't get the job, chances of another German, Jens Weidmann, to take over Mario Draghi's seat increase.

In any case, while many observers believe this round of European musical chairs would bring both France and Germany a top job each, a scenario in which neither country gets one should no longer be excluded.

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*We think it's very hard not seeing one of the Spitzenkandidaten as the next European Commission president*

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Zooming in on the next ECB president, there is no real news on a front-runner. It still looks as if Draghi's successor will emerge from the group of Germany's Jens Weidmann, France's Francois Villeroy de Galhau or Finland's: Oli Rehn and Erkki Liikanen plus the outsider or compromise candidates including Klaas Knot, Ardo Hansson or Benoit Coeuré. While the European Treaties 'only' say that the ECB president (as well as all other Executive Board members) should have "recognised standing and professional experience in monetary or banking matters", it's hard to imagine any candidate without central bank experience.

[Watch our video on who'll be the next ECB president?](#)

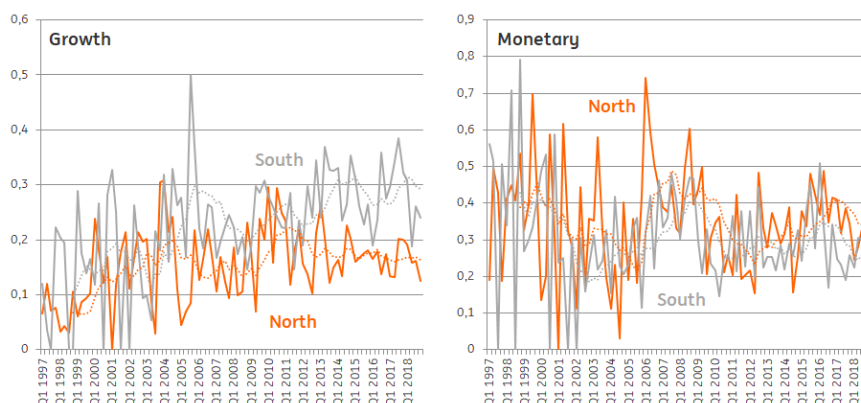
## Does nationality really matter?

Officially, nationality shouldn't matter. However, given that the Draghi-succession has now become part of the bigger European horse trading, nationality will matter.

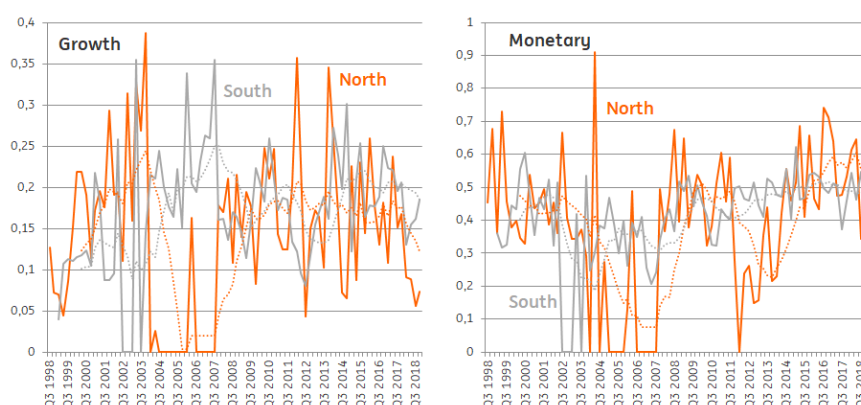
We all know of the prejudices about core European hawks and Southern European doves. To lift the issue of nationality out of the cocktail party sphere to a more analytical level, we find that there is indeed a significant difference in terms of topics that central bankers discuss. Southern European Governing Council members are much more concerned with growth-related issues, while Northern European Governing Council members have more of a tendency to discuss monetary issues like inflation and price stability.

However, surprisingly, this national bias tends to disappear in the ECB's Executive Board, as our analysis finds that ECB board members discuss less diverging themes based on their background.

## Governing council members see clear differences between South and North in terms of topical discussion in speeches



## ECB executive board members have less clear divisions in terms of themes discussed in speeches



### Leaving the national passport at the door

Even if the European musical chairs game currently looks set to continue after this week, giving all commentators more time and material to gossip and engage in tea-leaf-reading on who will get which job, the ECB presidency remains the most important nomination for markets.

*The results of our analysis give hope that even though nationality will matter during the appointment process, the national bias won't be as significant as many ECB watchers think these days*

Now that the ECB has moved towards a new easing bias, opening the door for rate cuts and other monetary action, any Draghi successor will not only be questioned and tested on “whatever it takes” but also on the continuation of the latest dovish shift. In this regards, we could see marginal differences between a more hawkish new president, let’s call him Jens Weidmann, and a more dovish president, let’s call him Benoit Coeure. This difference won't be apparent in the pace of normalisation but rather in the depth and determination of additional easing.

In the broader sense of things, the results of our analysis give hope that even though nationality will matter during the appointment process, the national bias won't be as significant as many ECB watchers think these days. Chances are much higher that the ECB president will be presidential, leaving his or her national passport behind at the security control of the EuroTower on 1 November this year.

## Footnote

Our analysis of the ECB speeches is done using word count methodology based on Ernst and Merola (2018).

The vertical axis depicts the relative intensity of the topic in speeches where one means all of the speech were about a single topic. The thematic categories “monetary” and “growth” consist of five keywords central to the themes (for growth: expansion, recovery, productivity, GDP and economic growth, for monetary: inflation, interest rates, money, assets and quantitative).

The country grouping north includes Germany, Netherlands, Luxembourg, Ireland, Finland, Estonia, Lithuania, Latvia, Slovakia and Austria. The country grouping south includes Italy, Spain, France, Belgium, Portugal, Greece, Slovenia, Malta and Cyprus.

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Article | 18 June 2019

## Facebook's Libra is here. Should you Like it?

After months of rumours, Facebook finally unveiled its digital currency plans - and they did not disappoint. The social media giant's plans are far-reaching and have already attracted some well-known partners to back it. Is Libra really the best of the libertarian cryptocurrency and traditional corporate worlds combined?



Source: Shutterstock

When the social media giant with close to 2.4 billion people using the platform each month, launches a new digital currency, there is reason to pay attention.

Facebook's Libra, clearly has the potential to quickly achieve vast scale, [setting it apart](#) from any other cryptocurrency and virtual or gaming currency around.

Facebook is well aware that in order for Libra to be successful, it needs to open it up, which is why it is seeking the support of other corporate backers and has announced that Libra will launch as an independent entity in 2020. Facebook apologises that the current state of technology doesn't allow a digital currency to be simultaneously scalable (process hundreds/thousands of transactions per second) and be fully decentralised - without [consuming half of the world's electricity](#). Indeed, technology hasn't yet made all this possible, but the status quo makes it very convenient for Facebook to launch Libra in a comfortable centralised way, whilst grabbing the world's attention

with the launch of a cryptocurrency on blockchain.

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*The value for Facebook is not in the Libra currency itself, the transaction data is the real treasure trove*

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From a technical perspective, the current centralised governance means using a blockchain architecture is unnecessary (to add to the confusion, Libra claims to be a blockchain without blocks). But if indeed, Libra is to make good on its promise to start moving towards decentralised governance in 2025, then it makes sense to start on a blockchain right away.

## How will Libra work?

The plan is for the Libra network to operate independently from Switzerland, but users will need a Libra 'wallet' to interact with it, and that wallet will be domestically regulated. Facebook is building the Calibra wallet, and contrary to Libra itself, Calibra will be wholly owned by Facebook. This makes sense: the value for Facebook is not in the Libra currency itself; the transaction data are the real treasure trove.

This data will be generated by the wallet app and Facebook claims it won't mingle transaction data with its other data without user consent. The Calibra app will probably make efforts to get this consent by offering superior functionality.

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*Libra takes us right back to the discussion that has been haunting cryptocurrency for years, is it a security or something else?*

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The biggest question right now is, how will regulators react? An e-money license (which Facebook already has in Europe) may not be enough for the Calibra app. Given that Libra is not denominated in domestic currency, but reflects a currency basket, it is probably more like security from a legal perspective. This takes us right back to the discussion that has been haunting cryptocurrency for years: is it a security or something else?

## What about central bank and regulators?

And there is more. The digital coin will be backed by a full reserve of low-risk safe assets, including government bonds. But the world's supply of safe assets is limited. Central bank buying government bonds has increased scarcity in various parts of the world including the eurozone. If Libra becomes successful, it could develop into a significant buyer of government securities, which could potentially further push interest rates into negative territory. Germany, Switzerland, take note.

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*Lawmakers and supervisors will have to decide quickly what Libra is, and how it is supposed to be regulated*

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For years, central banks have been deliberating about cryptocurrency and central bank digital currency (CBDC). But with the introduction of Libra, Facebook has now accelerated this discussion significantly. It might be prudent and wait for regulators to formulate their view, or it may take the US-based ride-hailing service Uber's approach and just launch, forcing regulators to respond ("shape a regulatory environment", [as they put it](#))

In any case, lawmakers and supervisors will have to decide quite quickly what Libra is, and how it should be regulated.

There are many more issues to think about. For example, the exchange rate risk users and businesses would face, how secondary market liquidity will hold in challenging times, and the impact all this would have on competition in various sectors.

While a lot remains unclear at this stage, Facebook has clearly started a new chapter on digital currencies. Over to policymakers for a response.

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Opinion | 25 June 2019

## Retail Think Tank: What is the true state of retail spending?

There has been a general understanding that the retail sector has been proportionally losing sales, and its share of consumers' disposable income, to the leisure sector. We examine the impact and assess how far this has held back the UK retail sector



Members of the Retail Think Tank acknowledge that there are a range of different data sources available to ascertain evidence about the shift in spend away from the retail sector. However, most data does suggest that households have indeed been moving towards spending more of their incomes on services, including property rentals and accommodation/travel services. That is not to say spending on "things" has actually fallen, it is more that the relative growth rates of spending on goods versus services has been widening significantly.

A number of different structural and societal factors have contributed to this diversion of consumer spend. Firstly, the RTT notes the increased popularity of online shopping, which as a service is improving in line with technology at an almost constant rate. Without doubt, this has impacted the size of retailers' share of the available spend.

Changes within society, and the values consumers hold, also contribute to the apparent shift in spend. Members of the RTT agree that more of 'the pie' is finding its way to the leisure sector, which can provide these consumers with the more experiential, and less tangible, gratification they are looking for.

Much like the rising popularity of travel has opened up retail opportunities at travel hubs, the ever-growing use of the internet has meant retailers are seeing the store as having uses beyond just

selling. Retailers are actively looking at ways to enhance their in-store offering to provide consumers with the experiential shopping experience that they believe this generation desires. However, RTT members do question the actual benefits that retailers are reaping by this switch, and if investment in this area is actually holding the retail sector back.

It is clear though that a shift in spend away from retailers has negatively impacted the sector. However, the RTT members hold that this alone is not to blame for the fragile position that many operators find themselves in today. External economic factors, political uncertainty, rising costs, a changing consumer mindset, an increased use of technology and the rise of the discounters, alongside this shift in spend towards the leisure sector are all working together to challenge the status quo of what it takes for a retailer to succeed in 2019.

[Download the RTT's latest whitepaper on their website here](#)

**ING's Chief International Economist, James Knightley, is a member of the RTT. Here are his thoughts:**

There is a hypothesis that since the global financial crisis, households have moved away from buying “things” to buying “experiences” and this structural shift in behaviour explains some of the pain being felt by retailers.

As an economist, my first port of call when looking at the shifts in relative spending is the consumer price inflation report. Here we can see a time series of the weights of different goods and services that a “typical” person in the UK spends their money on.

Since the late 1980s there has been a notable shift in spending behaviour from goods towards services. Back in 1988, goods accounted for 71% of the basket. Today, that's down to just 52%. This largely reflects the rising proportion of spending on housing rentals (owner occupied housing is not included) and an increase in the proportion of spending on “miscellaneous services” such as personal, legal, financial and social (including retirement) services.

Still, this shift has slowed markedly since the financial crisis. In 2007, goods accounted for 54.7% versus the 51.9% today. In terms of the big components, food, alcohol and tobacco dropped from 14.6% to 14%, primarily because of tobacco. Housing and utilities have risen from 11.5% to 13% reflecting rising rents as a proportion of household spending. Transport has held steady at just over 15% (rising use, but falling prices for airfares and taxis).

In terms of the specifics of “things” versus “experiences” there are some interesting shifts. Clothing and footwear is actually up from 6.2% to 6.7%, led more by the latter than the former. However audio visual has gone from 2.9% to 2%, furniture and household equipment has edged very marginally lower to 6.5% from 6.8%. Games, toys, garden and pets have held at 3.7%.

Spending on “major durables for recreation and culture” has increased from 0.9% to 1.7%, led by spending on camper vans and boats! This looks to be part of the shift to “experiences”. Package holidays have been one of the biggest movers, going from 2.9% to 4.3% of spending while accommodation services have increased from 1.9% to 2.6%. However there has been weakness in other “experiences”. For example, “catering services” dropped from 11.9% to 9.5% with restaurants, canteens and take-aways all seeing declines in relative spending.

In general, there does appear to have been a marginal shift towards “experiences” from “things”,

but it is quite tentative and there are clearly winners and losers within both groups. Given the relatively small changes in spending behaviour and the fact that the “pie” of consumer spending has got significantly bigger (consumer spending is up 14% in real terms and 46% in nominal terms since 2007) this cannot be attributed as the major factor holding back UK retail. The problem seems to lie more generally with other structural issues such as internet/rents/taxation/car parking and management.

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