Sunday Wrap

Happy Sunday,

This past week we learned that eurozone GDP expanded by 0.4% qoq during the first quarter of the year, or 1.5% annualized. This was a bit better than expected, but it was still only half the (also stronger than expected) growth rate of 3.2% in the US.

Of course, these are only preliminary estimates of GDP, and if history is any guide, then the eurozone number will end up being revised up by 0.15pp to 1.65%, while the US number will come down by 0.5pp to 2.7%, hence narrowing the gap slightly. If, furthermore, you consider that the US economy is still fueled by the biggest peace-time "top-of-the-cycle" fiscal expansion in history with huge public debt creation as a result, and that it's now been eight years with US nominal yields below US nominal GDP growth, which has fueled a substantial corporate debt expansion in the US (most of which has been used for stock buybacks, etc., rather than investment); frankly, I think I'll take the eurozone's 1.5% over the US 3.2%.

That said, it's not only in the US one could have wished for a more enlightened fiscal policy approach. Running huge fiscal deficits with full employment is surely irresponsible, but pursuing a constant fiscal tightening while suffering sizable output gaps, as has been the case in the eurozone since 2010, is hardly better – not least as the deficit reduction has been achieved, to a large extent, by killing investment.

In today's note, I'll discuss what the 1.5% annualized eurozone GDP growth in Q1 implies for policies:

- **I'll first argue that the 1.5% growth rate in Q1 is unlikely to be maintained during the next four quarters – because of global forces.**
- **While this implies a need for policy stimulus across the eurozone (to eliminate the output gap), and with the ECB running low on (politically acceptable) tools, fiscal policy must be used to some extent.**
- **More importantly, however, trend growth needs to be raised, which will require both national and pan-European initiatives.**

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1. The bounce-back in eurozone GDP growth, but probably not here to stay

The first estimate of eurozone GDP growth in Q1 was a decent 0.4% qoq, or annualized 1.5%. We know that Spain expanded by another impressive 2.9%, France and Austria by 1.2%, Italy 0.9% and Belgium by 0.7% (all annualized). The numbers for Germany, the Netherlands and most of the smaller countries will be released during the next couple of weeks.

Whether the better-than-expected Q1 number means that the weakness in H2 2018 was just a technical blip (as we originally thought), or whether Q1 was a one-off good number in a bad series, is too early to tell with certainty. That said, my sense is that the pretty sound underlying fundamentals, as well as the ongoing monetary stimulus and the bit of fiscal expansion in the pipeline, will fuel the Euro area economy through the spring and summer months, before global forces then drag us down for a few quarters.

I'll first note the three question marks with respect to the Q1 number discussed by my colleague, Marco Valli, in his note following the data release:

First, there are signs that the industrial sector contributed to the acceleration in growth in Q1, but the manufacturing PMI has continued to decline into contraction territory, opening a gap between soft and hard data. This gap will almost certainly narrow again in coming months, but will that happen (primarily) via a softening of the hard data for industrial activity, or by an improvement in the survey data? If Thursday's Italian manufacturing PMI is anything to go by (strong recovery to 49.1 from 47.4, driven mostly by export orders), then it'll be more of the latter than of the former.

Second, the weather was unusually nice (higher temperatures than normal) in Q1. On the one hand, this would have boosted construction output while, on the other hand, it would likely also have lowered energy consumption. So far, we don't know which one was the more important, and hence how this balance will wash out in Q2.

Third, new car registrations rose strongly in Q1 (+7% qoq), erasing part of the big technical (WLTP) Q4 drop (-11% qoq). On the one hand, one should expect this bounce to continue to make up for the entire Q4 2018 impact, but the latest monthly data on car registrations suggest that the recovery might have started to flatten out at the end of 1Q19.

But there are also two major global factors at play:

First, it's almost certain that global growth, including in the eurozone and in the US, was being boosted in Q1 by Chinese stimulus. As my colleague, Daniel Vernazza, has shown in our *Chart of the Week* (Chart of the Week – We are all dancing to the Chinese credit cycle), during the last ten years, the world has been dancing quite beautifully to the tune of the Chinese credit cycle: Whenever the Chinese ramp up credit growth, the global manufacturing PMI picks up with a lag of around nine months, so the latest upturn in China's credit cycle explains a fair part of these better Q1 numbers.

But while the effects of the Chinese stimulus are now coming through, there are indications out of Beijing that things may be shifting again. The large expansion in total social financing has kept money rates low, but as the PBoC shifted towards less expansion during April (by cutting some of its long-term funding to banks), both short and long rates have moved higher. Not surprisingly, the Chinese April PMI showed some cooling of the prevailing optimism.

Second, I keep worrying about the US (and not only because of its misguided president.) As noted above, the US economy is living on fiscal steroids these days, and the party will end at some point.

The timing of the slowdown is tough to pinpoint, of course, and Q1 was certainly a positive surprise (although volatile net exports and inventories accounted for more than half of growth); but on present information, I continue to think the US will see a couple of quarters next year with about zero growth – and I wouldn't be the least surprised if the slope starts in the present quarter. Wednesday's drop in the ISM manufacturing index to 52.8, the lowest since October 2016, could be a sign.

2. Policy stimulus across the eurozone is needed to eliminate the output gap, and the ECB cannot do it all

I accept the considerable uncertainty with respect to the size of output gaps (and I tip my hat to the IIF's Robin Brooks for his crusade against the way the shifting estimates have been used – inappropriately – to guide policies), but I think it's safe to say that the eurozone still suffers from a sizable output gap, regardless of its precise size. If you dispute this, you'll have to argue that the 7.7% unemployment rate represents a natural unemployment level, which, to me, would be an absurd argument (if not outright disrespectful to many of the unemployed).

So, with spare capacity, there is a strong argument for policy stimulus – and we are getting it, although primarily from the monetary side. The central European policy story during the past ten years has indeed been one of misguided fiscal policy.

The fiscal authorities have been too reluctant to participate in overall stimulus efforts for way too long. As a result, monetary policy has been over-burdened with severe consequences for a whole host of things, including income distribution (or burden sharing) between capital owners and non-capital owners, and for the profitability of the financial sector. In my assessment, this heavy skewing of the policy mix, as well as the composition of fiscal policy, has contributed substantially to the rise of populism and nationalism across Europe that, in turn, threatens further policy mistakes. (The handling of the refugee crisis and unregulated social media account for the rest of the reasons for the unfortunate emergence of the dreadful "politics of resentment".)

The good news is that things have begun to move on the fiscal front, although so far it is to provide tax relief and to boost public consumption, rather than for investment. In Germany, the fiscal impulse this year is close to 0.4% of GDP and, even more importantly, there is now a serious discussion in Berlin about the possible adjustment of the (highly inappropriate) debt brake. In France, the 2019 budget included a 0.2% of GDP expansion, and Macron's additional pledge this past week, including the EUR 5bn in tax breaks, add up to another 0.4% of GDP. In Italy, where the fiscal room is virtually non-existent, the 2019 budget still includes a 0.2% of GDP expansion. Other member states have introduced broadly similar changes.

Fiscal issues are complex, and I don't mean to suggest anything else, but I would suggest a two-pronged approach: First, all member states with fiscal room (which is virtually everyone apart from Italy) should introduce an immediate tax cut for the working poor, and second, a coordinated approach to adjust the overall fiscal composition to bring about a fairer and more growth-oriented policy … which I'll address in the next section.

My point is this: In spite of the decent Q1 GDP number, the eurozone continues to need more stimulus than it has seen in recent years, and fiscal policy needs to be used to take the pressure off an already over-extended monetary policy.

The good news is that the better growth numbers take a bit of pressure off the ECB to add further stimulus at this time, which means that they can focus their June meeting on the terms of the TLTRO, while postponing any decision on tiering of the depo rate.

3. Trend growth needs to be raised, which will require both national and pan-European initiatives

I have discussed the issue of trend growth before, but it can never be said enough: Europe desperately needs reforms to boost potential growth – and to make it more resilient. In this endeavor, nothing is more important than boosting investment, which will require two things: Raise public investment (by a lot!) and facilitate a smooth and proper allocation of the savings surplus across the eurozone, while creating incentives for more risk-taking by savers.

The bizarre developments in investment in the eurozone – and particularly the staggering deficiency of policy choices – is well illustrated in a simple chart published this past Monday by the ECB (in their quarterly "*Euro area economic and financial developments by institutional sector*", Chart 1 – the report is here: link).

The chart shows quarterly saving, net investment by sector, and net lending to the rest of the world in the eurozone. In a stunning display of irresponsible fiscal priorities, it shows that while corporations' non-financial investments (net) gradually increased since 2012 to now over EUR 300bn (in Q4) and households' non-financial investments also moved slightly higher, governments – which were, and continue to be, the single biggest beneficiary of the low yields generated by ECB policies – chose to keep their net investments unchanged, quarter by quarter, for the past six years! This is nothing less than stunning in this rapidly changing world: A policy of no net public investment to facilitate job creation or, more broadly, to prepare the next generation for the digital world.

Europe desperately needs to change its fiscal rules to be able to differentiate between public consumption and investment. Without a doubt, the complete killing off of net public investment in recent years is the result of a (partly misguided) obsession with the bottom line budget in an era of difficult political choices, not least to "pay off" pensioners. But it also reflects a strange vision of what is needed for the next generation.

The treaty says that the Commission should take into account whether a breach of the deficit or debt limits is caused by public spending or investment, but I don't recall ever having read a verdict on this separation. A version of the "Golden Rule" (investment to be treated differently than consumption) should definitely be applied and if you ask me, education (which is categorized as public consumption not investment) should get special treatment – and preference in the fiscal rules.

But there is also a need for a pan-European approach to expand investments, both by the official and private sectors. I have written before about the attractiveness of Banque de France Governor Villeroy de Galhau's call for an "Investment Union", now also endorsed by Bundesbank President Jens Weidmann.

Of course, for that to happen, we'll need clear-sighted leaders both in the capitals and appointed to the European Commission, Council and ECB. The European appointments will all be on the agenda as soon as we get through the European Parliament elections in three weeks; a topic I'll return to next Sunday.

Best,

Erik

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