Sunday Wrap

Happy Sunday,

This is Marco Valli from Milan, the UniCredit Chief European Economist. Erik is busy this weekend, therefore I take the opportunity to share with you my thoughts on the following topics:

- Uncertainty rises as the trade war broadens to the tech sector. Financial conditions should be monitored carefully to gauge where growth is heading.
- The Fed is firmly in wait-and-see mode, while the ECB faces trade-offs when deciding on the pricing of TLTRO III.
- The importance of mutual trust for the next leg of eurozone integration.

1. Trade war broadens to the tech sector

The escalation of the US-China row continues with worrying developments. This past week, China announced its retaliation with new tariffs on a list of USD 60bn of US goods, while the US Commerce Department added that big Chinese tech company and 70 affiliates to its “Entity List”, de facto banning them from acquiring components and technology from US firms without the approval of the US government. This might have big implications for the business of this Chinese company and its large US suppliers. Separately, Trump signed an executive order that prevents US firms from using telecom equipment made by companies that are considered to pose a threat to US national security.

The broadening of the trade war to the technological sector makes it extremely difficult to gauge the implications for economic activity going forward. By now, we have become familiar with the estimates provided by a number of institutions (IMF, OECD etc.) that, under simplified assumptions, tried to model the economic impact of a trade war. But what could happen if we add tech protectionism and the risk of escalation there? I suppose very few people would have a reasonably clear idea.

The only good news of last week was the US move to ease tensions with Canada and Mexico by removing steel and aluminum tariffs, and the six-month delay of Trump’s decision on whether to impose tariffs on imported cars and car parts. The latter brought some temporary relief to financial markets where, however, sentiment remains fragile.

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I would like to believe that the strategy of buying time on car tariffs might signal increased doubts at the White House on what America could gain from taxing goods that contain 10-15% of US-originated input. Another possibility is that the US has doubts about the wisdom to clash with some key trading partners instead of having them as allies in some of the legitimate disputes with Beijing on fairer trade practices and treatment of intellectual property. Unfortunately, I suspect that none of these factors played a decisive role. It is more likely that the delayed decision on car tariffs mainly reflected the need for the US administration to avoid opening a second front while Trump is busy going after China. Therefore, the probability of tariffs eventually being imposed does not seem to be lower now than it was last week. The issue will likely come back once the US and China, hopefully, strike some sort of deal.

Given the complexity of the current situation, the main issue for us economists is not so much the direct effect of protectionist measures on global trade and GDP, but rather the broader impact on growth from heightened uncertainty, via the sentiment and financial markets channels. This needs to be monitored very closely going forward. Together with policy stimulus in China, the material easing in financial conditions that was triggered by the Fed's U-turn at the end of last year has been key for the recent green shoots in the global economy and the ensuing expectations for somewhat better growth in 2H19. The latest renewed tightening of financial conditions, mainly driven by lower equities prices, higher implied volatility and wider credit spreads, increases risks to this scenario.

For the time being, the damage appears to have been contained. In the eurozone, I estimate that only about 20% of the improvement in financial conditions from end-2018 has been reversed in the last two weeks. While heightened uncertainty can have spillover effects that go beyond those caught by financial conditions, the impact on growth should be manageable overall. The next round of eurozone PMIs will be published this coming week and it is probably too early for these surveys to reflect the recent spike in uncertainty, if anything because the PMIs tend to be less affected by animal spirits and psychological factors than other soft indicators. In this regard, the expectation component of the German Ifo would seem more vulnerable, even though it is possible that the relief for the delayed decision on car tariffs might temper the increased concerns related to the escalation of tensions between the US and China.

The bottom line is that financial conditions are one of the key gauges to look at when visibility is generally low. If tightening of conditions continues due to higher risk aversion in financial markets and, possibly, a stronger euro (CNY, under pressure after the latest US decisions, accounts for the largest weight in the basket of the trade-weighted EUR), it will be difficult to avoid negative implications for eurozone economic activity from the summer.

2. What this means for the Fed and the ECB

The intensification of protectionist tensions complicates the life of the main central banks, although to a varying extent. If not for the pain of being constantly under the pressure of Trump's tweets, the Fed is in the least problematic position. The long recovery that started in 2009 has made it possible to create some policy buffer and, in a context of still-solid GDP and employment growth amid low inflation and inflation expectations, their dual mandate allows them to wait and see. Judging from all the most recent statements, the Fed remains quite comfortable with its neutral bias on rates. This past week, in a Bloomberg interview, New York Fed President John Williams claimed "policy is in the right place".

However, things will probably start changing in about six months' time, when the fading boost from fiscal stimulus and slower job creation in a situation of full employment, combined with the drag from protectionist measures, are likely to expose the vulnerabilities of the US corporate sector and exert meaningful downward pressure on a very mature business cycle.

The market is now pricing in a first Fed cut by the end of 2019. Maybe this timing is a bit aggressive, but the direction of the next move is most likely right and the policy buffer they have built will turn out to be very useful. We think the Fed will cut rates three times in 2020, starting about a year from now. This time, fiscal policy is unlikely to come to the rescue given that room for maneuver has already been largely exhausted with a badly timed boost at the peak of the business cycle.

The ECB, which has a price mandate, is in a more difficult position due to inflation expectations hovering around record lows and much less policy leeway than the Fed. However, this is partly mitigated by the fact that in most eurozone countries fiscal policy has room to move countercyclically if needed.

When the Governing Council (GC) of the ECB meets next month, it will probably face broadly unchanged GDP forecasts, following a long series of downward revisions. This should ease some of the pressure and allow them to focus on the conditions of TLTRO III – pricing being the most important of them. The features of TLTRO III that have already been announced, namely the maturity and the variable-rate structure, are generally less favorable than those of TLTRO II. Therefore, I assume that the lowest possible rate paid by banks on TLTRO III will have to be higher than that on TLTRO II (the latter coincides with the deposit rate, i.e. -40bp). The main question is how much higher.

The price of TLTRO III will ultimately depend on the GC's assessment of the trade-off between: **1.** reducing banks' reliance on ECB funding and preserving ample monetary accommodation, and **2.** the intensity of stimulus injected with the upcoming decision and the scope to adapt TLTRO III conditions to possible changes in the macro and financial environment.

In the former trade-off, the GC will have to decide how appealing the facility should be, compared to market funding of similar maturity. If the benchmark is two-year funding via covered bonds and the ECB wants to secure a decent take-up, the spread on the MRO rate should be fixed in such way that the lowest rate on TLTRO III is allowed to decline into negative territory. If conditions are not sufficiently appealing and the take-up is low, the ECB's balance sheet would start shrinking in a year's time when the first TLTRO II expires. This would not be a problem per se, because lower central bank lending to banks would mainly reflect the normalization of the transmission mechanism of monetary policy. However, the ECB should ponder whether a reduction in the size of its balance sheet risks sending to financial markets an unwanted tightening signal.

The latter trade-off, between current stimulus and scope to do more at a later stage, reflects the GC's decision to consider TLTRO III as a flexible tool, whose terms – especially the distance between the facility's lowest possible rate and the deposit rate – can be revised if and when the outlook changes. If the GC were to adopt loose terms now in order to increase the take-up (for example by fixing the spread to the MRO rate in such way that the rate on TLTRO III can be as low as -30bp), it would reduce its room to make these terms more appealing in the future and deliver "stealth" easing if needed without having to cut the deposit rate further. This is an important factor to consider, especially if the GC is indeed split on tiering (with implications for the remaining policy space on rates) as some comments and headlines seem to suggest.

Overall, my gut feeling is that the GC might let the lowest possible rate of TLTRO III decline to zero or slightly below zero, say to -10/-15bp. Given that the transmission mechanism of monetary policy is still working well, the prospects of tiering remain uncertain and risks of deterioration of the outlook are non-negligible, keeping some easy-to-use powder dry would not be a bad idea, in my view.

Any meaningful discussion on tiering is going to be held at a later date, probably in September, when the ECB will likely have to revise further its rate guidance to delay the timing of the first increase in the deposit rate well into 2020. Barring very long negotiations for the presidency of the European Commission, by the time of the September ECB meeting we should know who will succeed Draghi at the helm of the central bank. The new president will have to shape and endorse the decisions on both guidance and tiering. While an extension of the rate guidance seems warranted under any new president, the fate of tiering is much more uncertain. Among the main contenders for Draghi's job, Villeroy de Galhau is the strongest supporter of measures that aim at mitigating the side effects of negative rates, while his fellow countryman Benoit Coeure and Buba's Jens Weidmann appear to be much less convinced (at least for now).

3. Mutual trust running low is the key hurdle to fixing the eurozone architecture

This week I attended the joint conference of the European Commission and the ECB on European financial integration and stability, which was held in Brussels. A good half of the program was dedicated to discussing the international role of the euro and possible strategies to enhance it. There are no shortcuts here, as strengthening the foundations of the common currency requires fixing its institutional architecture in a profound way. Therefore, while the tone of the discussion was generally constructive, the prevailing mood was one of caution, and rightly so given the big challenges posed by the next leg of eurozone integration.

Before I elaborate on these challenges, let me remind you that after only twenty years of life, the euro accounts for about 35-40% of total global trade invoicing and payments, very much in line with the share of the US dollar. By all means, these are very good results. The big difference with the greenback is in areas such as FX reserves, as well as debt and loan business, where the USD enjoys undisputed supremacy accounting for about 60% of the total, compared to only about 20% for the euro. Narrowing this gap should not be seen as a priority per se, but rather as the natural consequence of a process that tackles some of the most pressing structural weaknesses of the eurozone framework. In turn, this would convince markets to completely price out the risk of redenomination and/or sovereign debt restructuring that still weighs on the assets of some eurozone member countries.

Reflecting this situation, the eurozone and its currency are left facing a lack of large-enough pool of safe assets. A large stock of safe assets is important because it allows providing depth and liquidity to markets for euro-denominated securities, features that become especially relevant at times of market stress when investors' appetite for safe havens rises considerably. In the current environment of low ECB policy rates, a shrinking pool of highly rated assets and increased demand for them driven by regulatory requirements leave risk-averse investors with very few options, which basically consist of either paying the German government for the "privilege" to lend them money at maturities shorter than fifteen years, or diversifying away from the euro.

Erik has written a lot about UniCredit Research's skepticism that financial engineering – in the form of European Safe Bonds – might help find a solution to this problem. Therefore, if the eurozone wants to break the status quo, fix its structural deficiencies for good and, as a consequence, boost the intentional role of the euro, in my view, it faces only two possibilities (or a mix of both): enhancing macroeconomic and fiscal convergence across member countries, or making a bold move towards a union with common fiscal capacity to help smooth asymmetric shocks.

The current political landscape supports neither option. Salvini's recent statements about the need to breach deficit and debt rules to stimulate growth and employment are only the latest example of this. While these comments contain a good dose of pre-election hype, clearly they do not facilitate mutual trust among national governments, which is badly needed when it comes to laying the foundations of deeper integration.

To be clear, deepening eurozone integration requires efforts on all sides. Countries with the weakest potential growth and fiscal trajectories would probably need to blink first and in a way that reassures their peers about the sustainability of the improvement. Once these actions are implemented, they should be quickly followed by those of countries that are currently benefitting from good policies of the past, but should not count on this tailwind to last indefinitely. This involves an open-minded discussion about the appropriate domestic policies for jurisdictions running large current account surpluses. These national initiatives would need to be compounded at the eurozone/EU level with **1.** the implementation of a common budget for shared policies on immigration and security, with the idea of progressively extending its scope to investment in infrastructure projects that generate cross-border synergies and benefits, and **2.** a move to close tax loopholes within the EU that prevent European companies and governments from competing on a level playing field.

Once this virtuous progress gets started and mutual trust is progressively restored, other policy initiatives, including the completion of the banking union through a common deposit insurance scheme, will become much more realistic objectives.

But all this seems too ambitious for now. I head to next week's EP elections with the feeling that the eurozone's incomplete framework will remain such for some time, leaving once again on the shoulders of the ECB the burden of finding (new?) tools to stabilize financial markets when the next crisis hits.

Best

Marco

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Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: link

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