Sunday Wrap

Happy Sunday – and happy Father's Day to all my fellow fathers in countries celebrating this very fine day today!

More seriously, as I noted last Sunday, in spite of the overall worrisome global economic outlook, there are some green shoots out there. Most recently, the May reading of our proprietary global leading indicator, published this past week, shows its strongest monthly increase in more than seven years, suggesting that growth in global trade may be back at around its annualized trend growth rate of 4%.

Our indicator, developed by my colleague Andreas Rees, comprises ten macroeconomic components from a wide range of countries and sectors, which are released early in the month. They include the global manufacturing PMI, the Ifo business expectations component, new-orders-to-inventories ratios from the US and eurozone, Singapore Electronics PMI as well as South Korean and Taiwanese exports. Our indicator is as statistically reliable as, e.g., the OECD's Composite Leading Indicator, but we have – and release - our readings a month earlier than the OECD.

The strong May reading was pretty broad-based across the ten components but driven particularly by very strong growth in Taiwanese and Korean exports (on a 3-months rolling basis, which is what we use in the indicator to detect turning points), partly as the recovery in the tech sector continues at a solid pace. Encouragingly for Europe and the broader world, it encourages the hope that even though the Chinese growth momentum eased a bit in May, their stimulus is boosting imports.

But as I also discussed last Sunday, investors are (rightly) getting increasingly focused on the generally elevated valuations of big parts of the risky assets universe at a time when the US seems to be heading towards a slowdown (if not a recession), and as US policies and trade tensions imply a risk of a more abrupt end to this very long expansion. As a result, investors are now searching for safe assets from where they can sit out the downturn that's (probably) emerging on the horizon. The effect on fixed income prices has been very visible in recent weeks, as you know.

But safe assets aren't what they used to be – and I'm not only talking about the fact that the US has as president a man who as a presumptive Republican nominee in May 2016, said that he, as president, "would borrow, knowing that if the economy crashed, you could make a deal [on treasury debt …and] … if the economy was good, it was good. So, therefore, you can't lose."

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Rather, today, I'll discuss the lack of a euro-denominated safe asset from a practical - markets – perspective, specifically:

- **The causes and effects of this bizarre state of affairs of the world's second most important currency not having an underlying safe asset, which contributes to the now record low – negative – yields.**

- **And I'll briefly reply to those who questioned my statement last Sunday that the euro has nothing to do with Italy's poor growth performance.**

1. The missing euro-denominated safe asset.

There are several reasons why the eurozone (like any other highly developed economy) needs a single "own-currency safe asset". It's needed to create a deep and integrated European financial market so euro-denominated assets can be priced consistently off a common "risk-free" yield curve, which, in turn, is a requirement for efficient capital allocation. It is also needed to reduce the home bias of banks' sovereign holdings – and to provide a safe harbor during downturns for pension funds, insurance companies and asset managers.

In every well-functioning economy, the "safe asset" is the liability of the central government (which has a monopoly on the right to tax and to write the laws of the land) and is backed by the monetary authority. These are incredibly important first-principles in a market economy, and – as I have been writing about on several occasions – I often worry about the apparent willingness of many well-meaning advisors and policymakers to compromise on these pillars of democratic market economies in their eagerness to fill the gaps in the eurozone construction.

There are several interesting proposals out there on how to create a safe euro-denominated asset without a central budget and common debt. The guiding idea behind all the proposals is to pool a segment of all eurozone countries' sovereign debt into a common instrument, and then enhance its quality by giving it senior status as well as regulatory preference for banks' balance sheets. My key concern about these "artificial constructions", or short-cuts if you will, is that to make it liquid and "safe" enough, it'll ruin national sovereign debt markets. And without a common fiscal capacity, well-functioning national sovereign debt markets will continue to be critical for (national) fiscal policies' ability to play their counter-cyclical role.

The present extreme situation in euro-denominated assets illustrates my point, as it reflects this "search for a safe euro-denominated asset", which just cannot be fulfilled at a time of increasing worry about the outlook. To be specific: As European pension funds, insurance companies and asset managers now (wisely) seek to reduce risk in their portfolios, what do they buy without locking in a negative carry and - almost certainly – negative income and wealth for their policy holders?

In reality, a currency can only have one safe asset, but let's be generous and assume that the sovereign debt of Germany, France, the Netherlands, Austria and Finland all qualify as euro-denominated safe assets for the marekt. (To be clear, I think they all do qualify, but this assumption means that we ignore the national biases, illustrated by e.g. Dutch pension funds being worried about e.g. "too much" exposure to the French government.) Yet, at EUR 4.2 trillion, these five countries' total tradable debt outstanding is only 35% of eurozone GDP, which is simply not enough to meet the demand for safe assets in a normal turndown in a highly developed, wealthy economy, like the eurozone. For the sake of comparison, the size of safe assets in the US is 73% of US GDP and in the UK 93% of GDP.

And as my colleague, Chiara Cremonesi, has argued, it gets worse because so much of the debt has been packed away in central banks, either as part of monetary policy objectives, or as foreign reserves in other central banks around the world.

The ECB (and the eurosystem) has “removed” typically 20%-30% of the eurozone national debt for (completely appropriate) monetary policy purposes, while the Fed holds only 11% of the US debt stock on its balance sheet (in the UK, the Bank of England holds 24%). On top of this, official creditors (i.e. the foreign reserves of central banks around the world) have not been helpful in this regard. While they have shifted their reserves out of euros (the euro share of their reserves has dropped to 20% from 24% in 2012), they have shifted towards the already scarce bunds. As a result, while the other four “safe euro assets” have 20%-30% of their securities stowed away in foreign central banks’ reserves, no less than 47% of German sovereign debt is held by foreign central banks. (Taxpayers around the world should be very unhappy with their central banks when they waste the country’s foreign reserves by investing in securities with negative yields! – and European taxpayers should be very unhappy with their finance ministries when they waste the opportunity to borrow at negative rates to build better schools and healthcare facilities, or invest in better infrastructure.)

Reflecting national fiscal priorities in the five “safe asset eurozone countries”, there is no real prospect of addressing the problem partly stemming from insufficient stocks of debt. These five countries’ net issuance this year is very limited (so the stock won’t increase much, if at all), and even the gross issuance ranges from just 3.5% of GDP in Germany to 5%-7% of GDP in the Netherlands, Austria and Finland to 13% of GDP in France, for a total of 7%-8% of total eurozone GDP. In contrast, the US will issue this year a whopping (and certainly excessive) 25% of GDP.

To be sure, these supply issues are not the only reason for the big chunk of eurozone safe assets, particularly bunds, now trading with negative yields, but it’s surely a contributing factor, and make no mistake about the major problem this causes not only for banks, but also for pension funds in the eurozone – and for their policy holders.

There are many reasons why Europe desperately needs a euro-denominated safe asset of a size and liquidity compatible with the size of the economy or, more specifically, the savings surplus of the eurozone, but one of them is the need for financial institutions to have a safe option for their investment, like in other big and highly developed economies, which does not carry a rate so low that it implies de facto insolvency for many pension funds. They can handle zero, or negative yields, for a year or two, but not for multiple years.

This calls for urgent policy action to help the ECB not being “the only game in town”, both via fiscal stimulus but also by getting the work under way to create a proper euro-denominated safe asset.

Meanwhile, what do pension funds, insurance companies and asset managers do to navigate this impossible terrain? Without a doubt, they hold more risky assets on their balance sheets than they would have done based on the economic outlook and relative prices, thereby taking risk they probably shouldn’t be taking.

For example, I have been stunned in recent months to hear how many Europeans have been buying US Treasuries and Gilts, unhedged, in their search for a safe asset that provides at least a bit of a positive yield. But is that the right motive for building open FX positions? – at a time of an increasingly dovish Fed and the prospect of Brexit under Boris Johnson? I think not.

Another example is this past week's solid demand for the new Italian 20-year bond in the midst of significant political, economic and budget uncertainties in Italy. There was demand for about EUR 24bn from which Rome picked EUR 6bn, which priced at a yield of 3.1%. Asset managers were allocated about half the issue, and an additional (relatively high) 12% went to the hedge fund community. Banks bought 30% of the issue. Italians bought 36% of the issue, while the remaining 64% went to foreigners (with almost 40% going to the US and UK, and only 2% to Asia.)

(The contrast to the Spanish 10-year issue - the same day - is quite stark, clearly reflecting the better Spanish economic story, as summarized in the next section: Spain saw demand of about EUR 30bn, and sold EUR 6bn at record low yields. But no less than 86% of the Spanish issue went to foreigners, of which 11% to Asia, and pension funds and insurance companies took a bigger share than they did of the Italian issue.)

That Italy can issue 20-year debt at 3.1% at a time when growth has vanished, and the government has re-invigorated its dispute with Brussels over fiscal policy, is quite impressive. It's also a reminder to all those arguing that the euro-system can be based on the discipline provided by markets, namely that this is unlikely to work.

Let me briefly illustrate why this strong demand for the 20-year is impressive: First, recall that the average cost of all Italian debt is 2.9% (2.6% for the marketable debt) and the average maturity is 6.8 years. So, issuing 20-year debt at 3.1% makes good sense for the treasury, and it illustrates the highly competent and professional management of Italian debt.

But, importantly, it leaves no fiscal space for the government, which is particularly noteworthy at this time. Assuming we agree that it should be a top priority for the Italian government to engineer a gradual decline in the debt/GDP ratio, consider this: Nominal GDP growth has been 2% on average over the past 20 years (although only 1.2% since 2010), so to just stabilize debt/GDP, when the borrowing cost is around 3%, will require a continuous primary fiscal surplus of at least 1.5% of GDP. Is that do-able? Yes, sure it is – although it's closer to 1% right now. But it leaves the government no room for fiscal easing (but plenty of room to reallocate revenues and expenditures towards more growth enhancing budget lines…)

Indeed, rather than fiscal easing, and in addition to reallocating budget items, the Italian government should consider ways of boosting real growth from the supply side, and as I postulated last Sunday, that has nothing to do with the euro – which leads me to the following:

2. Italy: Growth and the euro.

Last Sunday, I wrote, "The euro is not to blame for years of weak Italian growth – rather, it has delivered stability (and influence) to Italy". This triggered a few skeptical reactions, so let me briefly remind you of two statistical facts:

First, while we could always wish for more, average eurozone growth hasn't been bad since the introduction of the euro in 1999: Following an annual average underperformance in per capita growth of about 0.4pp, relative to the US, prior to the euro (1990-98), eurozone growth accelerated and matched that of the US between 1999 and 2007. During the financial crisis (2008-11), US real growth underperformed the eurozone, while the eurozone has underperformed the US since 2012 as we went through the extra-ordinary period of the sovereign crisis combined with fiscal austerity, and – more recently – the temporary boost to US growth of Trump's mega fiscal stimulus. Still, even during these past years of eurozone underperformance relative to the US, if you were to calculate the same number for only the "bottom 90% of the income distribution", we are broadly back at par.

Second, since this past week saw both the Italian and the Spanish debt issuance (and I happened to spend the week in Italy and Spain), let me decompose (courtesy of my colleague, our Spanish economist, Edoardo Campanella) the vast difference in growth performance between these two countries since the introduction of the euro, to illustrate where Italy's hurdle lies:

Since 1999, Italian real GDP has increased by a dismal (cumulative) 7.3%. This growth rate was generated primarily by a respectable 10pp increase in the participation rate, although a reduction in the number of hours worked deducted about 7 ½ pp from the cumulative growth rate. Productivity growth during these past 20 years contributed just 4pp to the overall GDP growth rate. (The residual is accounted for by a small increase in the employment rate and a marginal decline in the total working age population.)

In sharp contrast, Spain's rather impressive (cumulative) 34.9% real growth during these past 20 years was generated in broadly even measure by an increase in productivity (16pp), higher participation (15pp) and an increase in the working age population (13pp) – while enjoying an even greater reduction in average hours worked, deducting 8pp from the overall GDP growth.

To the Italian euro skeptics, I ask this question: What does the euro have to do with the overall stagnant working age population in Italy, the participation rate or the number of hours worked, which combine to explain the vast difference between Italian and Spanish growth? And if Spain could deliver 15% productivity growth over these past 20 years, why did Italy deliver only about 4%?

Our Chief Italian Economist, Loredana Federico, and I have written quite a bit about what Italy needs to do to generate stronger growth. It starts with incentives to raise – substantially – women's participation rate, which is now the lowest in the OECD, having fallen below Japan in recent years. But the Italian government also needs to address the fact that Italy ranks a troublesome 31 in the WEF's Global Competitiveness Index, well behind its Western European partners, and an even more troublesome 51 in the World Bank's "ease of doing business" index.

As I have argued many times before, the euro has been an incredible success by providing a truly single market to the participants, helping Germany and the Netherlands avoid the curse of an ever-appreciating currency, while providing critical stability (and unprecedented influence over monetary policy matters) to the periphery. But the euro is still a work-in-progress, and the institutions and infrastructures need to be completed. That'll take time – years, if not a few decades – and meanwhile, the ECB will have to continue to play its all-important role as the monetary underwriter of the project (like indeed central banks do in all other well-functioning economies.) To me, this is the most important aspect to appreciate when Mario Draghi's successor is being considered.

Tomorrow, I'll be heading to Sintra, Portugal, for the ECB's annual forum. This is always a great gathering. This year, the agenda includes sessions on the first 20 years of the euro as well as the future, including the issue of real convergence, demographic changes, migration and growth. It'll be interesting – and fun.

Best
Erik

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