# Sunday Wrap

Happy Sunday,

First, from my café here in Berlin's Mitte, I wish France a happy Bastille Day. There is a lot to celebrate for the French at this time: The economy is ticking along quite nicely with domestic demand up 1.6% (annualized) in Q1, powered by stronger household consumption and business investment, which was, however, like elsewhere in Europe, partly offset by weaker external demand. The Gilets Jaunes' protests have basically ended with widely perceived high marks for Macron and his government for their handling of the crisis. And last week's selection of the new European leadership team marked an impressive return of French influence in Europe.

In today's note, I'll address the external threat to continued good European growth and the likely – versus desired - policy response, which will lead me to the promised (from last Sunday) "Part II" of the most important challenge facing Christine Lagarde when she takes over the leadership of the ECB on November 1.

**I'll divide my argument into the following three sections:**

- **The latest communication from the Fed and the ECB and why they are right that policy stimulus is appropriate.**

- **Yet, as the ECB is set to ease further, the negative side-effects for banks – thereby weakening the all-important transmission mechanism – will become increasingly problematic because of the complexity of designing appropriate mitigating measures.**

- **Therefore, a rethink of the policy imbalance is due. Christine Lagarde's key challenge will be to put her generalist (as opposed to monetary policy specific) experience, as well as her great standing among the political leaders, to good use in helping them formulate a more appropriate balance in the European policy agenda. I'll summarise what I think the agenda should look like.**

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## 1. The latest communication from the Fed and the ECB and why they are right to adjust policies on the back of the risks.

This past week, Fed Chairman Jay Powell all but confirmed that, although the last couple of months' message of huge negative risks have still not made it into the Fed's central scenario, these worries are now great enough to justify a rate cut, almost certainly as early as this month. In his testimonies, Powell worried about some foreign countries "appearing" to slow (which could have a negative effect on the US), and he was concerned about what he called unresolved policy issues, including trade, the debt ceiling and Brexit – in other words, the stuff that could more appropriately be called the "man-made misery."

He also indicated that the Fed folks now believe that a rate cut is warranted because they have re-estimated the neutral rate and found it to be lower than previously thought, so the policy stance is tighter than they thought. In my opinion, Fed policy decisions on the back of changing estimates of the neutral rate is about as problematic as the European Commission's reliance on their – also changing – estimates of output gaps, but I'll leave that for another day. If Powell needed a domestic excuse to cut rates, he could have taken a good look at my team's most recent "Chart of the Week", which illustrates why the US labor market is not as hot as it appears. In case you missed it, it's here: Chart of the Week: The US labor market is not "hot"

I heard some commentators suggest that this might just be a case of a single "insurance cut", but I don't buy it. One rate cut makes virtually no difference for the real economy and its full effect won't be visible for about a year. Moreover, while it is indeed unusual for a central bank to move predominantly on the fear of risks materializing, when a central bank turns, well, then it (usually) turns. So, in addition to the fully baked cut later this month, we think they'll do four more between September and next spring.

As I discussed after the ECB's Sintra forum two weeks ago, Draghi worries about the same risks that Powell worries about – and, I suspect, Draghi also worries about the Fed: How aggressive they may go, and what that'll mean for the exchange rate. Remember his reference to the greater pass-through now that the eurozone has negative rates! This past week, we then learned from the minutes from their June meeting that the Governing Council "broadly agreed" that these risks call for further stimulus.

That said, on Thursday, Benoit Coeure gave a very important speech in Frankfurt about inflation expectations and monetary policy. In a nutshell, Coeure questions (to put it mildly) the importance of markets-based inflation indications, particularly the 5y/5y. As you hopefully know from my earlier notes, I profoundly agree, but I recommend reading this excellent speech in full (it's here: Inflation expectations and the conduct of monetary policy ) - and when you have read it and thought about the great value it provides to those interested in monetary policy matters, then also take a moment to consider how many Executive Board members will be likely (able?) to deliver this type of thought leadership on monetary policy affairs after January 1. There'll be some, of course, but to get a rich understanding of these complex issues, we need more than a few on such matters…

As implied by Coeure, right now, the greatest risk to the outlook is indeed not deflation, but the directly man-made policy mess, from trade to Brexit. Either way, the Fed and the ECB are right to be worried about the outlook. As we in UniCredit Research have argued for quite a while, the US expansion is old and getting more fragile, and the damage done by Trump's trade policy (and the retaliation it triggers), along with the generally slowing momentum in China means that global growth almost certainly will be easing during the next 12-18 months, possibly significantly so. If in doubt, Tuesday's profit warning from BASF should serve as a stark reminder: BASF said that this year's earnings (before interest, tax and one-offs) would likely be down by about 30% from 2018. This is an important message: BASF is the world's second largest chemicals company with operations in more than 90 countries, so when they quote the lingering negative effects of trade issues as well as soft demand in several sectors, including autos, and particularly in China, we better take notice. And if you still doubt the immense harm done to the world by Trump, take a look at Friday's Chinese trade numbers: Imports from the US were down an eye watering 25.7% year-on-year during the first half of the year!

## 2. As the ECB eases further, the negative side-effects for banks – and therefore the transmission mechanism – will become increasingly problematic.

So here we are on the verge of another dose of monetary easing in the eurozone from a state of already negative rates and somewhat limited (presently politically acceptable) assets to buy. As Draghi said in Sintra, this means that the ECB will have to find new mitigating measures to cushion the banks, and hence the transmission mechanism, as we move deeper into negative territory – which ever so conveniently leads me to the promised Part II of the challenges facing Christine Lagarde as she prepares to take over at the ECB.

And I'm not talking about the technical details of tiering the depo rate or finding clever ways of making the TLTROs more attractive for banks; these are no more than leaves on the branches of the trees in the forest. Rather, to understand the key challenge facing Lagarde as she prepares to take over at the ECB, let's take a step backwards to get a proper view of the entire forest:

As the financial crisis hit, European banks (with the exception of French, Italian and the Nordic banks) were bailed out by their governments to the tune of 10%-15% of GDP. But while this life-support has been reversed to some (but far from full) extent as government shares were sold back to the market, fiscal austerity to the tune of a whopping 3.5pp of GDP (for the eurozone as a whole) followed during 2010-13, followed only last year by a marginal fiscal easing. As a result, monetary policy became "the only game in town", and when the required monetary easing to meet the ECB's inflation target far exceeded what could be achieved by the normal monetary policy arsenal, we got negative rates, QE to flatten the curves, etc.

This cocktail of monetary policy measures, along with a lot of well meant, but utterly uncoordinated (and probably excessive), regulations cut profits in banks to levels well below that of almost all other sectors. This drove capital allocation away from banks, thereby raising the cost of term financing. (One of the not-so-funny realities in the banking world these days is of the EIB inviting banks to co-finance projects with them, but stipulating a lending rate below the banks' on cost of funding – which really tells you a lot about a number of issues.) So, another form of "life-support" was provided, now in the form of term financing at low rates from the central bank because – for political reasons, and because of the continued lack of a proper banking union – bank closure, and cross-border mergers, which would help increase productivity in the sector, still seem to be virtually ruled out.

So, here we stand on the verge of another global downturn which, in my opinion, means that the single biggest question facing European policymakers, including the ECB, during the next couple of years will be how to deliver a more balanced and growth stimulating policy easing, while adjusting policies and regulation so that the financial sector gets a fair shot at getting back to a level of profitability where banks can get off their life-support, attract equity and long-term debt at a cost that will make a normal markets-based transmission of monetary policy to the real sector possible again.

In other words, in my assessment, following the financial crisis, European policymakers – collectively – overcooked the policy response in terms of putting way too much weight on monetary easing, while tying banks down with an uncoordinated (and excessive?) set of regulations, and moving the pan-European structural reforms, including full and proper banking and capital markets union, forward too slowly.

I'm not going to argue that further cost cutting and measures to boost productivity in banking are not needed, but I greatly worry when I hear the general sentiment in most central banks and among regulators that still after 1.2 million people have left the industry in Europe (about 25%) and cost/revenue ratios have fallen dramatically (apart from in Germany), that this is still where the key issue in bank profitability lies.

Other often heard advice from policymakers is that banks need to develop their fee policy. True, but there are also limits here, as illustrated most recently with Danske Bank being charged with overcharging its customers. Even Jesper Berg, the hugely experienced and highly regarded director general of the Danish Financial Supervisory Authority and an early advocate of fee-based banking, said that this case now "shows that the fee channel is also threatened" for banks dealing with negative rates. (The Bloomberg story and quote is here: Danske Bank Crisis Has a Warning for All Banks.)

So, let me remind you of the pickle the European banks have been put in – but, again, I'm not disputing the benefits to the economy of ECB policies and the spillover from better growth onto banks, and I'm not ignoring the (intentional) fact that there'll always be winners and losers as a result of policies; indeed, policy is about changing incentives…. (My colleague Marco Valli wrote a very good piece on this in May: It's here in case of interest: "Winners" and "losers" in the eurozone´s low interest rate environment

Consider this: Based on EBA data, my colleague Michael Teig has calculated that the "gross" negative effect of lower yields on banks' P&L since April 2016 is on the order of EUR 121bn, mostly due to the lower lending margins, yields on banks' investment in liquid assets and securities, but also including EUR 23bn in direct cost from the negative rates.

Then there are the harder-to-estimate positive effects on banks' balance sheets of the stronger growth of (on plausible ECB estimates) 0.3-0.4pp per year, of possibly EUR 10bn in quite direct effects. Of course, banks have also benefitted from the more indirect positive effects, e.g. the lower default rates that come with higher GDP growth, but it feels like a stretch to argue that these effects would amount to more than the "remaining" net cost of EUR110bn to make this entire package into a net positive. And as Michael has pointed out, if the cumulative net effect is on the order of EUR 110bn, it's been an annual average cost of EUR 32bn for the sector, which is approximately 20% of banks annual net profit of EUR 130bn (for banks included in the EBA risk dashboard sample.) Quite something…

To be sure, the counterfactual is always tricky to estimate, but it's hardly coincidental that while banks in the eurozone delivered a return on equity similar to the market up until 2008, they have underperformed sharply since then and are now, at 6.7%, the second worst performing sector (after Telecoms) with a RoE 2.5pp below the market average, in spite of massive layoffs, pay cuts, etc. But even if you dispute this, surely a banking system that has for more than ten years now been dependent on various forms of life support, first from governments and now from the central bank, cannot be an optimal setup for a market economy.

Yes, banks surely need to modernize further, not least in the digital sphere, but with the RoE below the cost of equity, and the prospect of a restoration of profitability to competitive levels still hazy in a world of further monetary easing and rising costs to deal with regulatory matters, where will the financing come from? Not surprisingly then, banks trade at a fraction of their book value. Strictly speaking, in such circumstances, a bank would be better off using available commercial funding to buy back its own shares than to lend the money to businesses at a time when growth is slowing.

Surely, this is not an optimal state of affairs! But, in my assessment, this is the web the European banking industry has been entangled in after the financial crisis. So, if I'm broadly right, how should policymakers deal with this dilemma at a time when a policy response to mounting global risks stimulus is needed?

## 3. A better balanced policy agenda:

I suggest the following five items for the policy agenda which should be implemented simultaneously:

First, the European Commission should, in coordination with the EIB, implement a massive investment program in digital infrastructure and university education across Europe, at least on the order of 1% of GDP.

Second, national governments should announce a coordinated fiscal expansion of 2%-3% of GDP in tax cuts for (primarily) youth employment, as well as spending on educational programs. To both the incoming Commission and to the national governments, I ask this: Can you really not find socially profitable investments even when your 10-year financing rate is negative? If you need ideas, ask! And if you worry about public sector debt levels, let me remind you that it's debt service ratios you need to focus on, and at these rate levels, they aren't very high… (and, if interest rates start to go up, guess what, it'll be because the economy is doing better and fiscal revenues will then recover as well!)

Third, rapid progress should be made towards completion of the banking union (ironing out national issues to make cross-border mergers possible is more important than EDIS) and a refocused capital markets union aimed at encouraging equity (in all its forms) over debt. This latter point should be accompanied by a revenue-neutral fiscal adjustment to shift tax incentives towards risk capital and away from debt.

Fourth, the ECB should gradually raise the depo rate to zero and start a QE program to broadly anchor the yield curves, both wrapped in detailed communication – a bold forward guidance, if you will - to explain that this is a coordinated policy move along with the fiscal and institutional story, and that it is not to be interpreted as the beginning of a tightening cycle. In return, banks' access to the ECB's lending facilities (or at least the cost of access) should be made conditional on developments in the individual bank's cost/revenue ratio, i.e. a tougher version of the leaning on banks to bring down their non-performing assets.

Fifth, an urgent study of the cumulative impact of all regulations hitting banks should be made to properly evaluate the effect on banks' profitability vs. increased safety (amazing that this has not already been done!)

So there you have it, Madame Lagarde. If you throw your considerable international standing and broad policy background at an agenda along these lines, I predict some very exciting years ahead in Europe – and a great place in history for you.

Best

Erik

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This report was completed and first published on 14 July 2019 at 13:31.

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