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Hermes Investment Office

Ahead of the curve

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Euro-zone - time for Plan B...

- **The ECB's decision to extend, but taper, its QE does not herald an early tightening of policy. The main policy (deposit) rate is likely to stay negative in 2017, & the fiscal side should be activated.**
- **While helpful in addressing the symptom, deflation, Mr Draghi cannot alone be expected to solve the underlying problem - a monetary union devoid of economic union. This will take years.**
- **We update our *Competitiveness Analysis* to highlight the progress so far. Despite improvement at the euro-wide level, shifts in individual members' competitiveness are still too disparate.**
- **After a decade of deterioration, Italy & Spain's positions have improved significantly since austerity. But, while encouraging, it brings economic & social costs, with reform-fatigue building.**
- **So, with 2017 such a highly-charged political year in Europe, any contagion - unlike 2008 - is more likely to be political rather than financial. And, with the monetary engine already overloaded, it looks time to also crank up the fiscal side...**

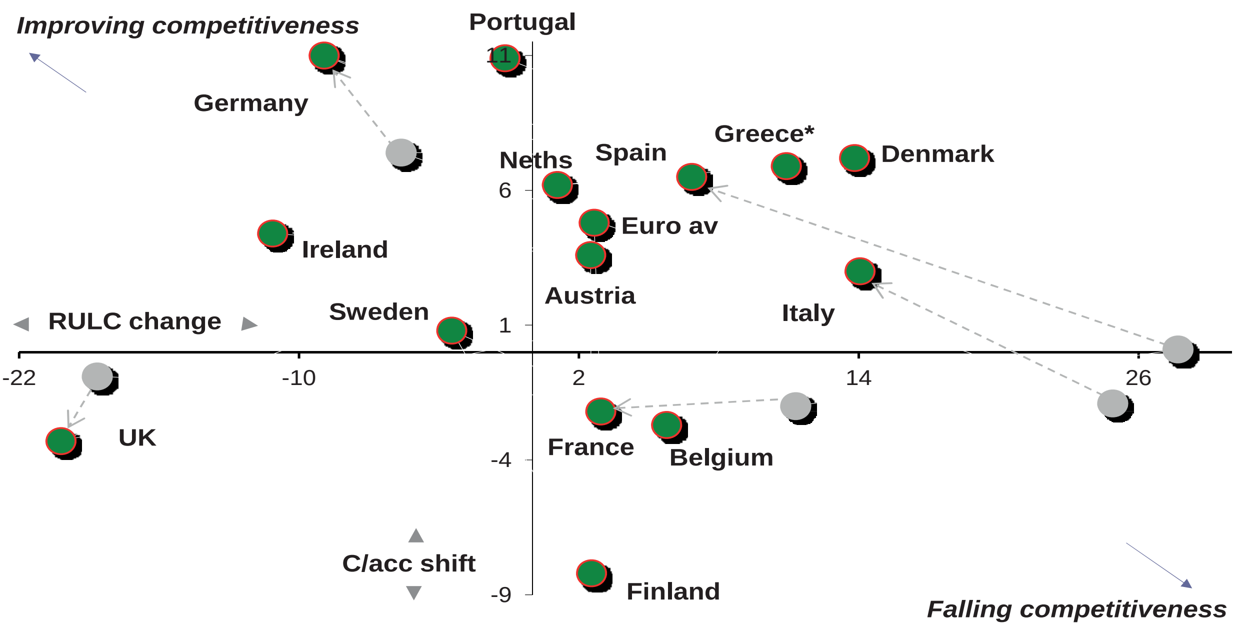
It always needed more than just QE...

"...political risks have increased considerably in almost all euro area countries" which threaten the fiscal and structural reforms needed for growth. This could *"contribute to contagion and refragmentation in the euro area"*. (ECB's Financial Stability Report, 24 May 2016)

The ECB's decision before Christmas to extend QE for another nine months to December 2017, though 'taper' from April its pace of monthly asset purchases does not herald an early tightening of economic policy. Quite the opposite, with the main policy (deposit) rate likely to stay negative in 2017, and the fiscal side activated.

First, tapering means *more* QE. And, even though president Draghi is closing the tap a notch in April, the ECB's liquidity 'sink' is still filling up. By tapering its monthly asset purchases from €80bn to €60bn, it's still looking to inject an extra €540bn in QE. **This easily surpasses the combined GDPs of Greece and Portugal. Second, central banks will from now on be able to buy at yield *lower* than the -0.4% deposit rate.**

Chart 1. The underlying problem - *individually*, competitiveness within the euro-zone is still too disparate...
Changes from 2000 to 2016 in a country's relative unit labour costs (RULC), vs current account shift as a % of GDP. Grey arrows denote shift since austerity started in 2010



Source: Hermes Investment Management, based on OECD data. (*NB: Greece is from 2001 when it joined the euro)

Third, the nuance is Draghi's growing encouragement of governments that have *"fiscal space"* to take the baton back from the ECB. A lesson from Japan is that QE provides cash to lend, but cannot force consumers and firms to borrow. The euro-zone thus looks halfway down the Japan route. It too may be running unconventionally loose monetary policy (QE and negative rates) to get its currency down, but has yet to let go of the fiscal reins.

2017's extra QE easily surpasses the combined GDPs of Greece & Portugal...

Yet, austerity has sliced the zone's budget deficit from 6¼% of GDP in 2009 to 2% - below the 3% Maastricht test for EMU. This makes it easier presentationally for fiscally-prudent Germany to 'turn a blind eye' to some profligacy by the higher-debt members seeking to maximise growth. With Greece losing a fifth of its real GDP since austerity and Italy/Spain running still elevated unemployment rates, reform fatigue - and populist parties - are building.

This gives added urgency to governments facing elections. 'Helicopter money' is considered a next step. This would go some way to aligning the zone and Japan with the faster-growing US and UK, whose net fiscal positions have loosened the most in the long run. Together with on-going monetary stimuli, this would raise the chance of keeping the euro down to avoid deflation. A hitch is the absence of a region-wide fiscal agency, which precludes a unified giveaway akin to the US's tax-rebates 'dropped' to consumers in 2001 and 2008.

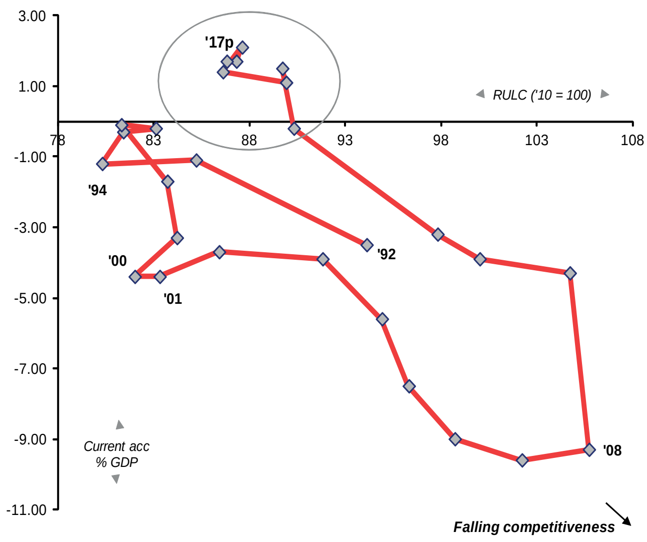
But, this could still be done nationally, perhaps in a coordinated way, supported by the ECB's bond buying. Given the ECB's concern expressed about *"political risks"* (reform-reluctant populist parties) potentially contributing *"to contagion and re-fragmentation"* of the zone, it should at this lower deficit ratio, be seen as the lesser of 'two evils'. **Reform pledges could even become back-end loaded to allow growth to breathe and avoid credit downgrades.**

So, while helpful in addressing the *symptom*, deflation, Mr Draghi cannot be expected to solve the underlying *problem* - a monetary union devoid of economic union. This will take years. With this in mind, we update our *Competitiveness Analysis* to show the progress so far. We use the OECD's estimates to the end of 2016 and projections to 2018 of a country's unit labour costs in tradeable goods, relative to its main trading partners' (RULC). The average is weighted, then indexed to a 2010 base year (=100). A rising index indicates a *de facto* real effective exchange rate appreciation and falling competitiveness. An index fall signifies the opposite. The results are in ***charts 1-4***.

First, as an amorphous bloc, the euro-zone is after six years of austerity regaining competitiveness lost since the euro. Only part of this can be laid at the weaker euro's door (-15% in trade-weighted terms). The zone's costs between 2000 and 2009 rose a net 21% relative to its trading partners. This compared with *falls* of 19% in both

Chart 3: Spain (and Italy's) competitiveness is improving rapidly...

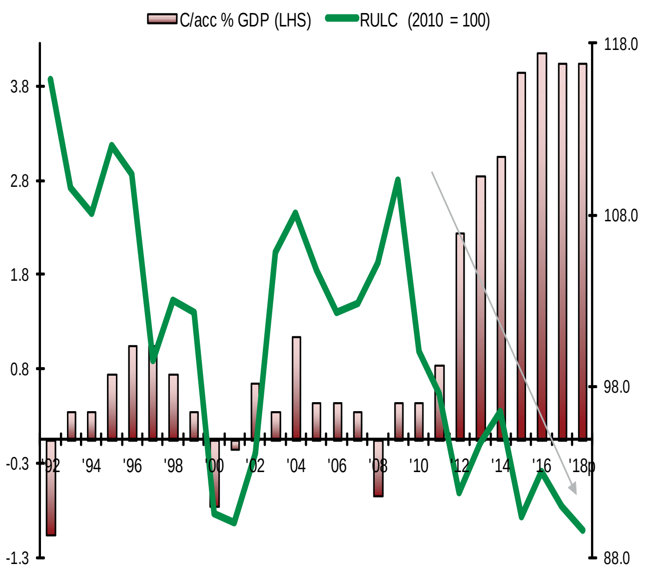
Relative unit labour costs (RULC), vs current account as % GDP. Years in bold



Source: Hermes Investment Management, based on OECD data

Chart 2. Even though *the bloc as a whole* is regaining competitiveness

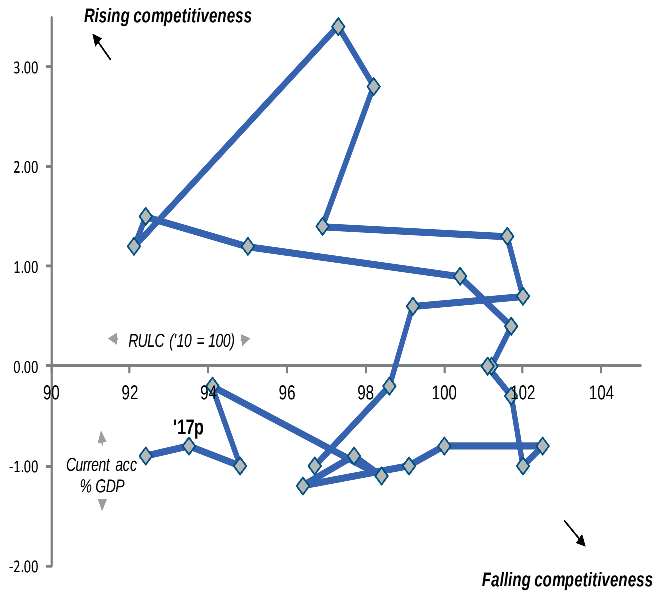
Euro-zone's relative unit labour costs (RULC), vs its current account as a % of GDP



Source: Hermes Investment Management, based on OECD data

Chart 4: But, France's position is still deteriorating

Relative unit labour costs (RULC), vs current account as % GDP. Years in bold



Source: Hermes Investment Management, based on OECD data the US and UK. Yet, since austerity started in 2010, its costs have fallen back 7%, beefing up a current account surplus helped by oil ***(chart 2)***. This beats a currency-induced rise of 20% in the US and the UK's 3% fall. If sustained, it suggests further relative gains in euro-zone exports.

Yet, despite this *overall* improvement, shifts in *individual* members' competitiveness are still too disparate. *Chart 1* shows the absolute competitiveness-shifts by country from 2000 to 2016. With the escape route of currency devaluation closed off, the deciding factor has been whether members undertake the internal, cost adjustment needed to boost competitiveness, thereby generating GDP and tax revenue.

The euro-zone's competitiveness gap is narrowing, but will take years to close...

On this basis, the biggest winners still include Germany, which is helpful given it accounts for about 30% of euro-zone GDP. Germany saw its unemployment rate rising from under 8% in 2001 to over 11% by 2005. But, this reaped dividends, and it has since translated cost control into substantial current account improvement.

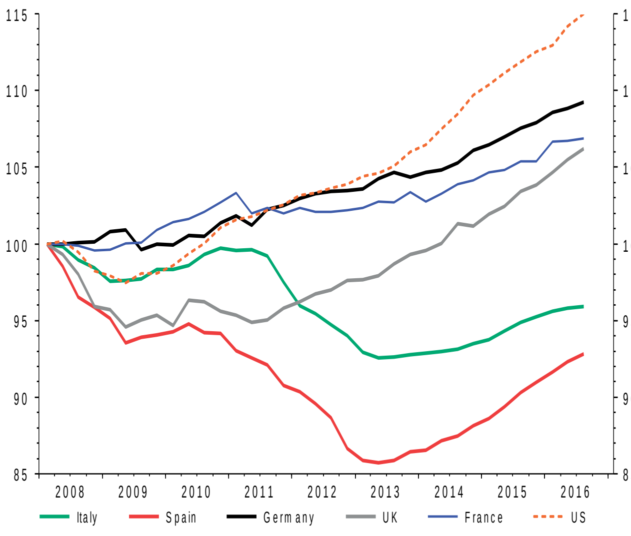
By contrast, most other members have experienced a deterioration. Because of its adjustment, Germany has managed to cut its RULC by 9%. But, countries on the right-hand side of ***chart 1*** saw theirs climb. Up to 2010, Spain and Italy's competitiveness deteriorated fastest. Ireland and Greece had to suffer deflation to 'improve' their position. **But, Spain and Italy's deterioration is now correcting, and their shortfall versus Germany reducing. This is shown by:**

- **the reducing cluster in *chart 1.*** We highlight the 2000-2010 period by the grey blobs, to highlight progress since austerity. The estimates to 2016 in green thus suggest improvement. **Outside the zone, the UK since 2000 has managed to outperform by virtue of sterling's 23% depreciation - a route cut off to euro-zone members; and**
- the improvement in Spain and Italy's individual profiles. ***Chart 3*** tracks Spain's which, after a decade of deterioration, has improved since 2010. Italy's has also improved significantly since austerity.

This raises hope that austerity is paying dividends, and suggests the narrowing in bond spreads after Draghi's *"whatever it takes"* pledge have initiated a tangible improvement. **But, while encouraging, it comes at significant economic and social cost, suggesting an additional stimulus is needed. First, lower trade flows and the drain on resources risk holding back the 'core' members.** Germany's competitiveness is improving, but may be tested if its euro peers (40% of Germany's exports) can't make up for a slower China/Russia *etc.*

Chart 5: Yet, Spain & Italy are between 'a rock and a hard place'

Real household consumption levels, re-based to Q1 2008 (=100)



Source: Thomson Reuters Datastream, based on national sources

Chart 6. The euro-zone's highly-charged political year

Key scheduled & expected political events in 2017

22 Jan	France - 1st round of Socialist primaries
29 Jan	France - 2nd round of Socialist primaries
12 Feb	Germany - Presidential election
15 Mar	**Netherlands - General election**
26-Mar	Germany - regional election in Saarland
(Mar/Apr	**UK triggers Article 50?)**
(Apr/May	UK council elections)
23 Apr	**France - 1st round of Presidential election**
7 May	**France - 2nd round of Presidential election**
7 May	Germany - regional election in Schleswig-Holstein
14 May	Germany - state election in North-Rhine Westphalia
June	France - Election of Lower House **Italy - likely General election**
Sept/Oct	**Germany - Federal election**

Source: Hermes Investment Management

Second, boosting competitiveness via austerity poses its own risks. The difficulty is raising competitiveness via productivity, rather than higher unemployment, falling wages and/or *slashing* taxes that governments can't afford. Though reaping the benefit now, deflationary Ireland in 2009-10 suffered the vicious circle of bloating real debt, lower ratings, higher funding costs and recession, exacerbating the deflation.

And, after impressive gains, there's a limit to how far Spain and Italy can reform, given male youth unemployment rates of 43% and 36%. Their real household spending are still 4-7% down on 2008, yet Germany's is 10% up ***(chart 5)***. Then there's Greece, whose deflation improved competitiveness, but exacerbated its real-debt dynamics. Without debt relief, its €86bn package is only a 'sticking plaster'. After losing 30% of real GDP since 2010, it too has reform fatigue.

So, tackling the *cause* of the problem always needed more than just QE. Its effectiveness hinges on capping long rates, helped by the ECB's latest commitment to buy bonds to a yield even *lower than* the deposit rate. This *should* ultimately stimulate consumption, with roughly two-thirds of euro-zone private borrowing (personal and corporate) long-rate, rather than short rate, driven. This is the mirror image of the UK.

Yet, euro-zone velocity (the ratio of nominal GDP to broad money supply) has no more than flatlined since 2008. The UK's by contrast has been rising, aided by its housing sector's more acute sensitivity to short rates. **And, despite an improving periphery, it will take years before the converging countries can reclaim GDP lost - with Italy and Greece's real GDP, on a net basis, still yet to rise with the euro.**

So, meanwhile, with 2017 being such a highly-charged political year in Europe *(chart 6)*, any contagion - unlike 2008 - is more likely to be political rather than financial. And, with the monetary engine already overloaded, it looks time to also crank up the fiscal side.

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