

## ANDBANK RESEARCH

Global Economics &  
Markets

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## Working paper - 71

### ***Eurozone - Debate on the state of the nation***

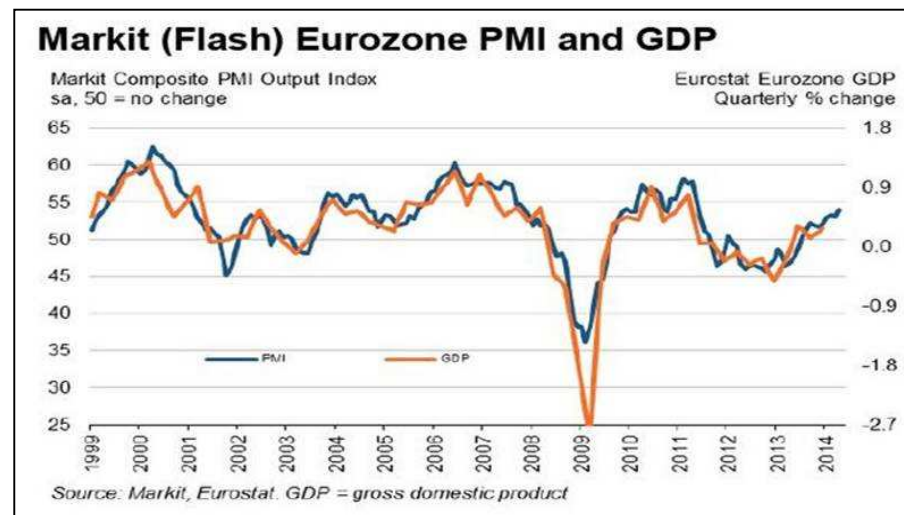
*(Activity, Inflation, ECB policy, Lending conditions, Banking, Politics & Financial markets).*

May 13, 2014

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Private Bankers

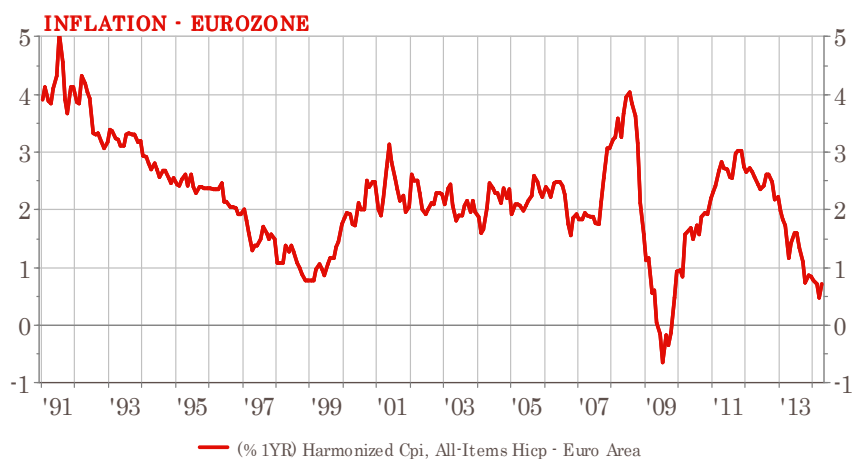
## Activity – Figures show that volumes are expanding

- Eurozone PMI Composite Output Index at 54.0 vs prior 53.1 (35-month high).
- Eurozone PMI Services Activity Index at 53.1 vs prior 52.2 (34-month high).
- Eurozone PMI Manufacturing Output Index at 56.5 vs prior 55.6 (3-month high).
- All eight national readings are in expansionary territory for the first time since November 2007. The recovery in the Eurozone is broadening.
- The EC kept unchanged its GDP forecast for 2014 (+1.4%), while lowered the outlook for 2015 (from +1.8% to +1.7%).
- It highlighted that (1) domestic demand will be a key driver for growth as real incomes benefit from lower inflation while activity and labor market will stabilize. (2) It also noted that the contribution of net exports is expected to diminish.



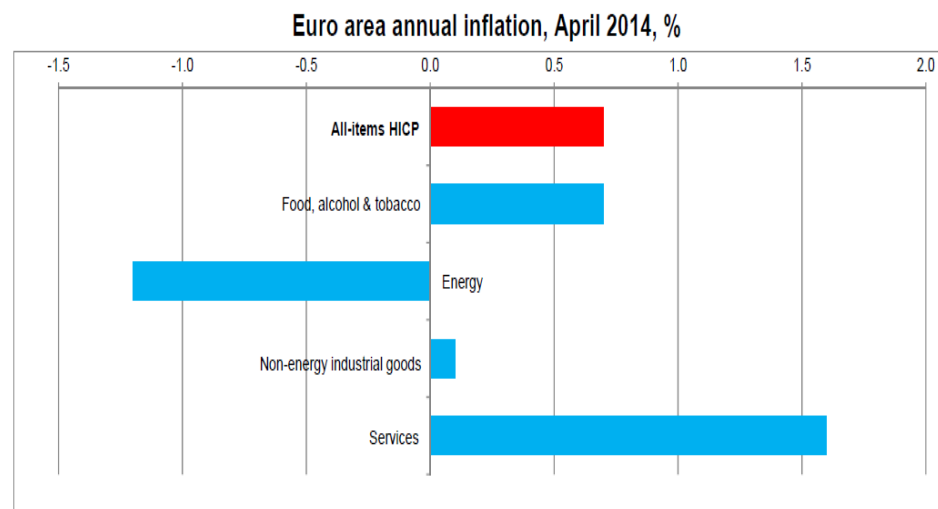
## Inflation – The breakdown shows that trend is weakening

- Eurozone April flash CPI came in at +0.7% y/y vs prior +0.5%. Recall that ECB President Draghi said CPI would pick up after the March reading was distorted by an energy drag and seasonal effects.
- The breakdown shows that the trend is still weakening.
- The EC cut the outlook for inflation:
  - ✓ In 2014 the ECB cut the CPI to +0.8% (from +1.0%)
  - ✓ In 2015 the outlook was also lowered, to +1.2% (from +1.3%).
- The ECB also noted that inflation could come in lower than expected.



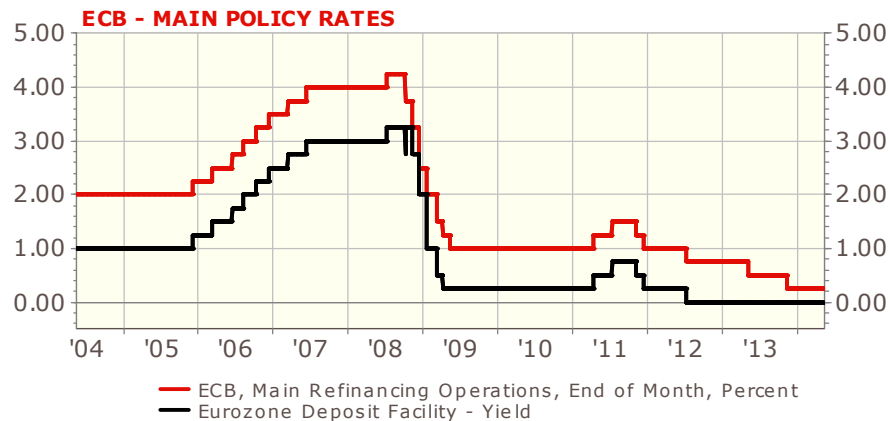
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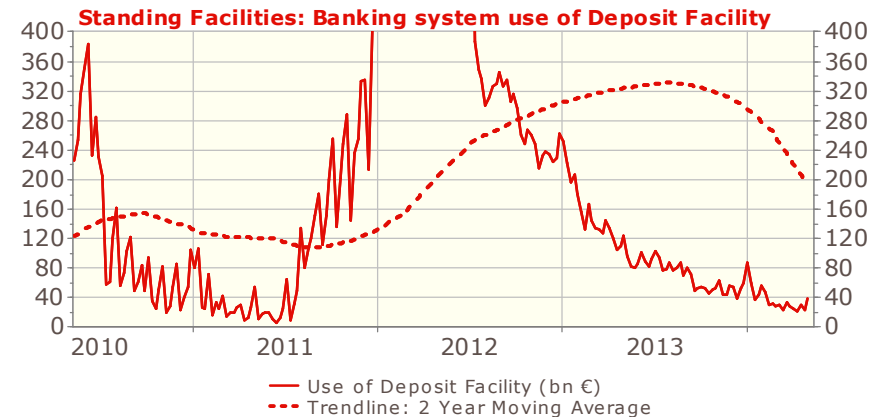
## ECB policy – Very limited actions available

- Draghi would have designed a two-step strategy on monetary policy. According to sources, if low inflation and the strength in the euro persist, the ECB will:
  1. cut rates by 10 bps to 0.15%
  2. ... and will put in place negative deposit rates (although this will not have a big impact, since the use of the Deposit facility is now very low. See the second chart)
- The ECB would only study asset purchases as a step of last resort if (1) trend in inflation and the currency does not significantly change, and (2) the expansion in activity clearly lose momentum. And this would only take place after the AQR in Autumn.
- In the meantime, we believe that Draghi will keep a dovish stance for a long time, leaving the door open for more policy easing and, of course, always **looking set** to push ahead with measures that could range from rate cuts to liquidity injections or asset purchases. (We consider this latest action as highly unlikely in a low-speed but broad based recovery environment).



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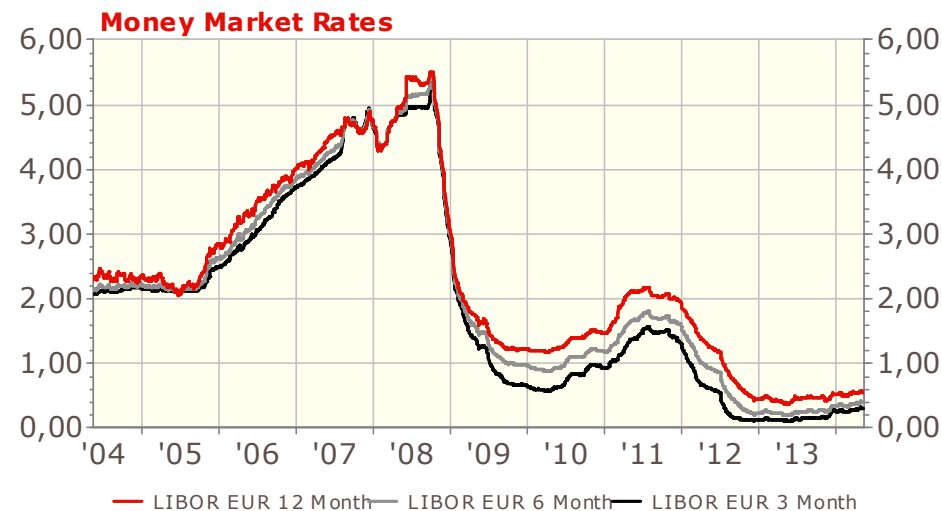


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## Money market conditions – Tighter but no need for concern

- Banks were focused on cleaning up balance sheets and this fuelled a fall in the amount of spare cash in the financial system, pushing up money market rates.
- Excess liquidity in the system fell to around €86B on the first week of May (the lowest level since the ECB offered LTROs in December 2011).
- The EONIA overnight money market rates hit 0.38% during the first week of May (the highest level since 2011 with the exception of two liquidity-tight days), although this tightness eased after the ECB carried out a liquidity operation.
- Draghi also stressed that banks are adapting to lower levels of liquidity in the system without the help of the ECB. As such, he noted that there is no need for concern, as banks are going back to trading on the market rather than relying on the ECB.



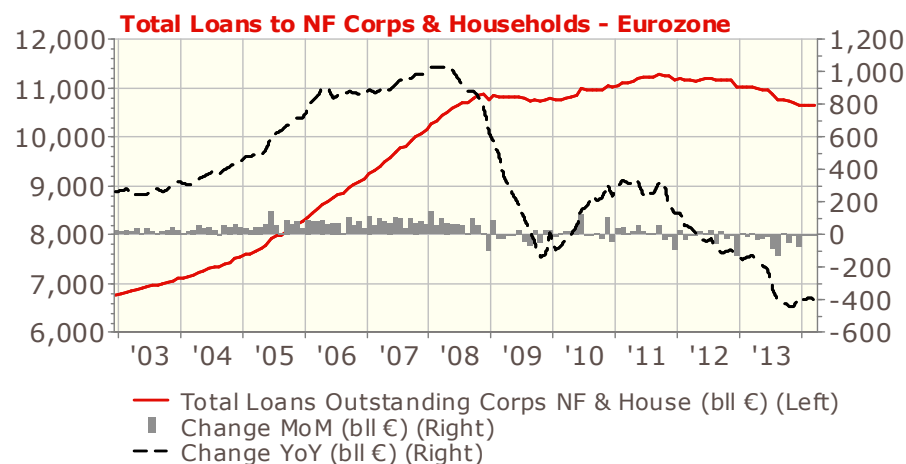
— LIBOR EUR 12 Month — LIBOR EUR 6 Month — LIBOR EUR 3 Month

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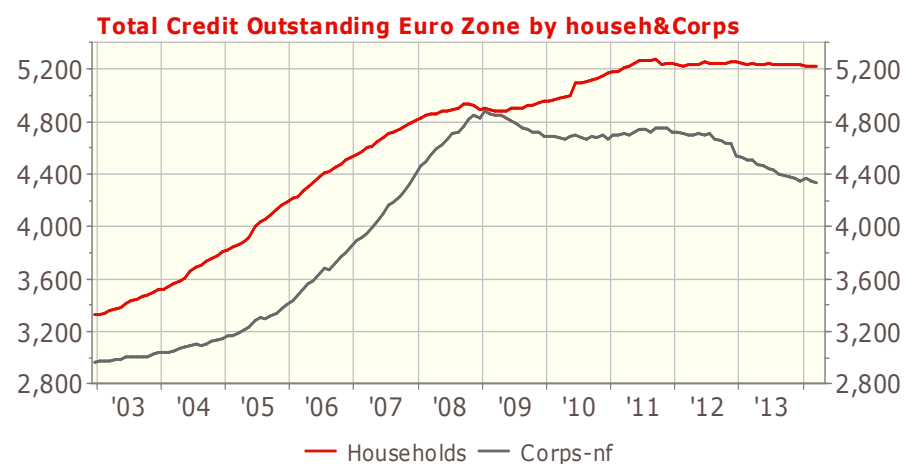
## Lending conditions – Stabilizing and being offset by other borrowing alternatives

- The SMEs reported less of a deterioration in the availability of credit, while credit standards are broadly unchanged.
- Although corps are still clearly deleveraging (see chart 2), banks expect an increase in loan demand in 2H and also anticipate an easing up in corporate loan standards.
- Financing conditions for SMEs continue to differ significantly across the Eurozone, still being in general more difficult for SMEs than those of larger companies.
- HY bond market is emerging as a stable alternative to banking loans. European companies have put €15bn in HY debt during 1Q2014 (vs €9.6bn for all 2013). The cost of using HY bonds compares favorably with other borrowing alternatives



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## The Financial Markets – Demand persists for euro-denominated assets.

### *The advantages:*

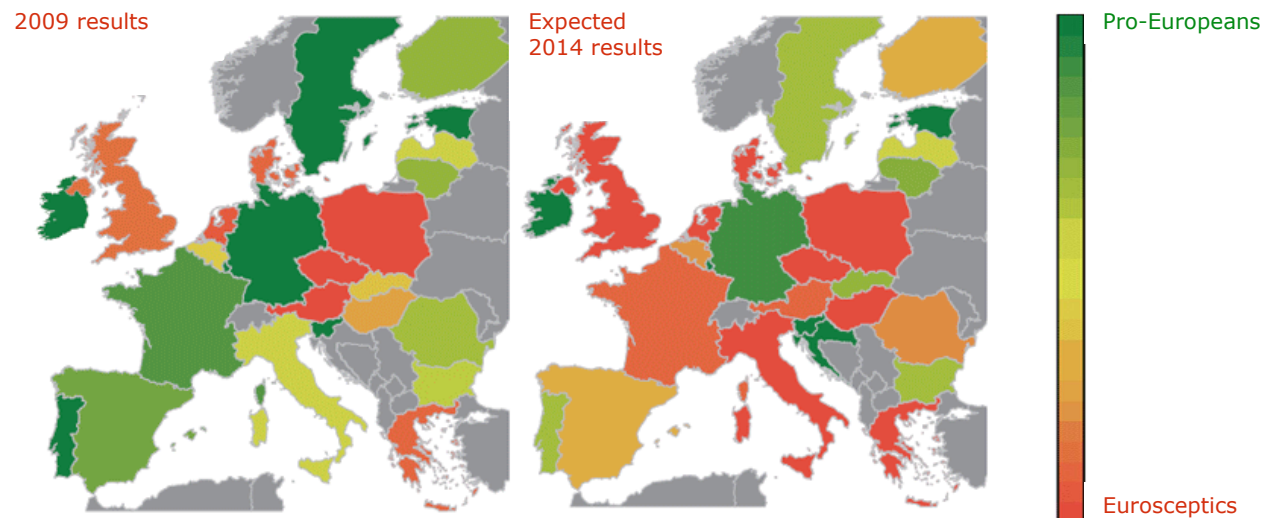
- Demand for Peripheral debt persists, and flows into EZ debt have mirrored outflows from emerging markets.
- 10 year yields on French and Austrian bonds hit the lowest in a year, while rates in all peripherals hit all-time record lows.
- The appetite for European assets would be creating a kind of virtuous cycle (WSJ): The rally is (1) accelerating the clean-up of the banking system, (2) improving credit conditions and (3) encouraging households to start spending again.
- Rating upgrades boost bond rally. A number of countries and companies have benefited from rating upgrades in a move that can exacerbate the trend (for first time since 2007, upgrades outpace downgrades). Why is this important? Rating agencies have always been pro-cyclical, exacerbating tensions and also contributing to the improvement in sentiment with a series of upgrades.
- Peripheral debt would be showing signs of behaving more like a safe haven trade (something good if the recent performance actually responds to an increased fiscal & banking integration that closes the national government's metrics to those of Germany).
- European banks funding costs are also at four-year lows, after a decline of 20% during Q1. Data from Dealogic showed that banks have taken full advantage of this situation, increasing bond issuance by 52% to \$148.4B compared with the same period in 2013, with banks from the periphery accounting for 45% of the Eurozone issuance..

### *The disadvantages:*

- In our view, the recent rally does not tell the whole story, since an estimated €160bn has fled Russia to Eurozone markets.
- The risks may lie in that the rally could dampen the much needed reform progress due to the reduced market pressure. If the result of all this is a break in the reformists process then neither the economic nor the banking union would be robust enough to withstand another market assault.

## Politics – Eurosceptics and populists could reach new heights in the coming European parliamentary elections

- In the EU's five biggest economies the pessimism is felt by voters in the run-up to the European Parliament elections. This sense of frustration is expected to propel euro-sceptic and populist parties to new heights in the coming European elections.
- France: Two-thirds of voters believe the economy is worse than it was a year ago.
- Spain one-third of voters polled feel the economy is worse than a year ago, with 43% saying it was no better.
- In Italy, corruption scandals could fuel voter anger. Seven officials connected with Expo 2015 Milan were arrested last week on charges of bribery and manipulating public tenders has caused anger. The scandal could affect both the left and right while giving a lift to the anti-establishment and anti EU party "5-Star Movement".
- In Greece, the far-right Golden Dawn party can run in the European elections despite calls to ban it as its leader waits in jail for membership of a criminal organization. Recent reports point that the party is expected to perform well and could even obtain the third place.





## National Particularities – What unites us and divides us

### France:

- ✓ French PM Manuel Valls said that France will push for action to lower the value of the euro after the European parliamentary elections. He also added that growth initiatives must be matched by more active monetary policy.
- ✓ French Montebourg (Economy Minister) said the Euro level is an issue for political authorities, that have the right to assess the right level. Chancellor Merkel's spokesman said the euro is not an issue for politicians.
- ✓ French lawmakers approve multi-year deficit reduction plan meeting the targets imposed by Brussels. The 2015-2017 Stability Program will now be submitted for approval to the European Commission.
- ✓ Hollande said he will push ahead with his plan to cut public spending and grant tax cuts for business as "the only way to boost jobs"

### Italy:

- ✓ Finance Minister Padoan criticizes the EU for paying only lip service to the need for more growth and jobs. He defends a balanced recovery through a higher inflation and a weaker Euro. He added that Italy would use its six-month EU presidency from July to complete this process. We do not believe Italy will succeed (as it did not Greece) in implementing such policies.
- ✓ Italian statistics office sees Real GDP growing +0.6% in 2014, +1% in 2015 and +1.4% in 2016
- ✓ Renzi wins confidence vote over his plan to ease rules for companies that hire temporary. This is part of his broader plan to overhaul labor regulations.

### Spain:

- ✓ Bad debt as a proportion of overall credit dropped to 13.5% and 13.4% in January and February, respectively, versus a peak of 13.6% at the end of last year.
- ✓ The government is preparing a plan to boost jobs by 370k by 2016. The general secretary of industry will launch this plan with a budget of around €1bn.

### Portugal:

- ✓ Portugal is to exit its three-year €78B bailout without an emergency backstop. The troika has urged Lisbon to consider a line of credit as an emergency safety net, but the government is convinced it doesn't need assistance after its recent auction success.
- ✓ Portuguese government outlined new reforms in its strategic budget. It included an increase in VAT by 0.25% from 23% to 23.25% and a 0.2% rise in social security contributions by workers from 11% to 11.2% as of 1-1-15

## National Particularities – What unites us and divides us

### Greece:

- ✓ The government is anticipating a fiscal gap of just €1.9B in 2015-2016, which is less than half of what its creditors had expected, around €3.9B, and is still targeted in the European Commission Report. Finance Ministry insists that the gap can be eliminated under certain conditions (maturity extension and lower rates of bilateral loans).
- ✓ Greek privatization drive accelerates as Greece's return to bond market and signs of an economic revival is fueling a pick-up in investor's demand for public assets. This higher interest is giving the Hellenic Republic Asset Development Fund more options to raise cash and cut debt.
- ✓ Samaras has proposed a series of far-reaching constitutional changes, including the reduction of deputies in Parliament and boosting the powers of the president.
- ✓ GDP growth contracted for the 23rd consecutive month by -1.5% y/y in Q1. The government takes it as a sign that Greece is on course to see growth this year for the first time since 1H2008.

### Germany:

- ✓ Labor market strength continues: The number of unemployed fell by 25.0K (vs consensus of -10.0K, and prior figure of -14K). The March unemployment rate was unchanged at 6.7%. The outlook remains robust.
- ✓ German factory orders came at +2.8% m/m in March (much higher than prior +0.9%), although the numbers were distorted by the timing of Easter.
- ✓ The German March trade balance came in lower at €14.8B vs prior €15.8B. The narrower surplus came from a downturn in imports and exports, with falls of 0.9% m/m and 1.8% m/m respectively. This was the second consecutive fall in exports and the largest drop in ten months.
- ✓ Growth could fall on tougher Russian sanctions: A report in German magazine Stern said that German growth could be reduced by 0.9% this year and 0.3% in 2015 if the EU imposes tougher sanctions against Russia. It cited the German section of a European Commission study in which confidential scenarios for all 28 EU member states were prepared as the bloc debates how to respond if pro-Russian separatists prevent Ukraine from holding free presidential elections on 25-May.
- ✓ German Finance Minister says that excess liquidity must be reduced to prevent the next bubble. He said that the Euro region is on the right track but that rescue-program countries, although having met big reforms, must stick with the reforms commitments.

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