DBS Focus

G3 rates outlook for 2020: Part 2 (Eurozone)

Strategy/economics/fiscal/monetary/rates

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- *This is the **second of a three-part series** that explores how G3 rates will be impacted as policy makers tilt towards a more balanced monetary / fiscal mix*
- *Pressure for European economies to do more on the fiscal front is mounting as monetary policy gets exhausted*
- *Tax cuts in selected countries and green policies are steps in the right direction. However, the overall increase in fiscal stimuli is expected to be muted*
- *EUR interest rates are about appropriate after the recent rise / steepening moves. We prefer paying EUR interest rates swaps on dips*

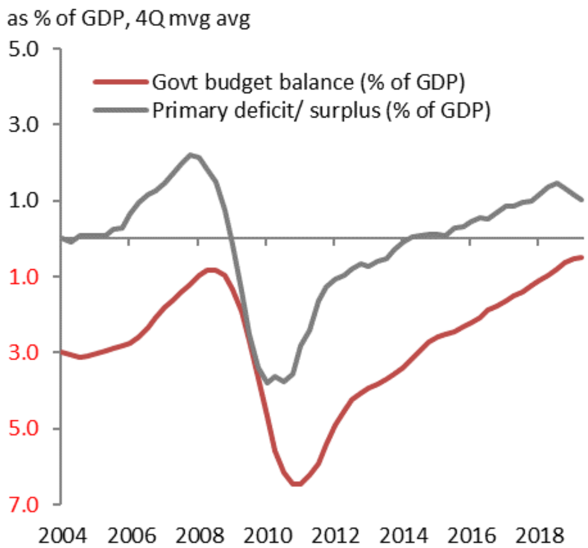
Eurozone: Modest fiscal support forthcoming

Seven years since the bloc faced a debt crisis, the ECB has called on national governments to play a dominant role in boosting growth, in turn lifting wages and in turn inflation. A prolonged period of dovish monetary policy has sharply lowered sovereign borrowing costs, creating space for fiscal support.

Pressure is, thereby, building on economies with the fiscal space to step up public spending.

In 2018, the aggregate public deficit of the EU and Eurozone was the lowest since 2000. Core-4 economies (Italy to a lesser extent) have improved their fiscal balance and debt levels, with German's balance back in black. Mindful of this space, Bundesbank President called on his political counterparts to review their commitment to a balanced federal budget, urging them to utilise the room to increase public investments.

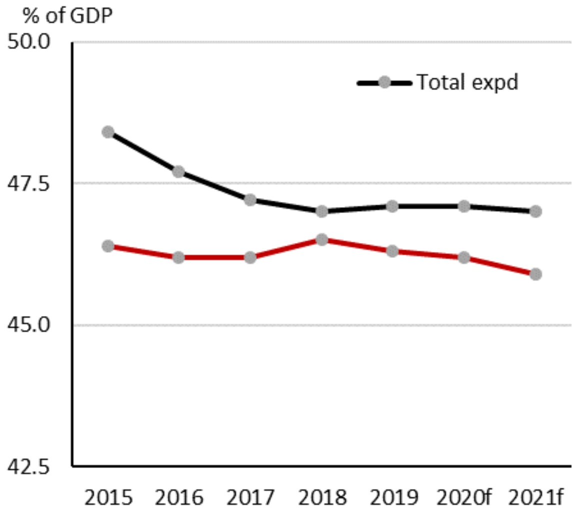
Fiscal balance on the mend



Few member countries have rolled out piecemeal steps. France and Netherlands announced tax cuts in 2H last year, while Germany came up with a ‘green package’, apart from other measures including an increase in child benefits.

A material increase in budget spending, however, is not evident in the bloc's official forecasts/ projections. Deficits are likely to increase slightly in 2019, due to a moderating revenue ratio on sub-potential growth and modestly loose discretionary fiscal policies in few member countries (case in point Portugal, Italy etc.). Expenditure as a % of GDP assumptions is steady at ~47%, while revenues slow. Within expenditure, investments and social payments as % of GDP is forecasted to rise, as noted by the European Commission. However, this will be offset by slowing interest payments, courtesy the accommodative monetary policy stance for the past five-six years. At the country-level, budgetary dynamics and scale of consolidation differ significantly.

Expenditure vs revenue mix in EZone



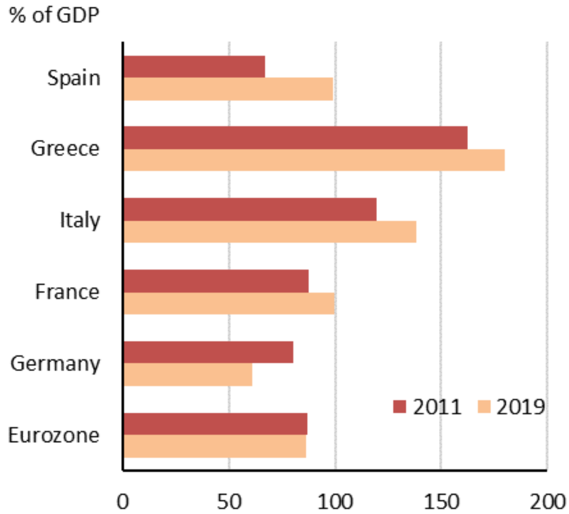
Source: European Commission, DBS

The eurozone deficit is slated to marginally weaken from -0.5% in 2018 to -0.7% in 2019 and 0.1ppt next two years (EC).

There is also little sign of a borrowing surge in 2020, with the German debt office expected to issue securities of aggregate EUR210bn this year, of which EUR148bn are bonds (nearly flat vs year before) and rest money market instruments. Green bonds could also be part of pool sold this year.

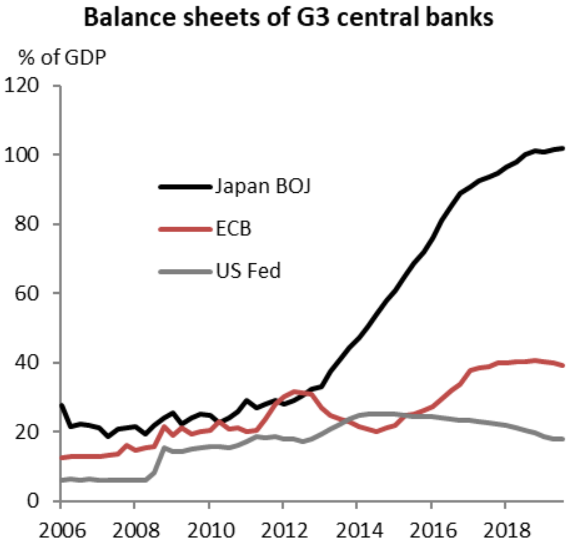
Most member countries have consolidated their debt ratios in the past four years. Slowing growth, however, lowers the scope for further sharp correction here on. Here too, countries face different scale of indebtedness. For e.g., notwithstanding recent consolidation, four member countries will still register debt levels of above 100% of GDP over the next two years.

Uneven improvement in debt levels



Source: Bloomberg, DBS

Demand for the sovereign papers has been underpinned by sustained asset purchases by the ECB, as well as the regional central banks. The ECB’s bond holdings topped 40% of GDP last year, above the US Fed, but modest compared >100% held by the BOJ (see chart above).



Source: Bloomberg, DBS

National governments, thereby, see limited need for large scale stimulus at this juncture. The European authorities also subject member countries to penalties who are seen in breach of thresholds, acting as a quasi-deterrent. Concurrently, if the stabilisation (albeit at weak levels) in growth indicators since late 2019 sustains, odds of fresh stimulus measures will fade.

Beyond the near-term, an overhaul of the fiscal framework is under consideration. Reigning EU fiscal rules, particularly the six pack and two pack legislations adopted in 2011-13 [1] will be under review. This will involve assessing EU fiscal rules on a more holistic basis, based on a) ensuring long-term sustainability of public finances; (2) stabilising of economic activity in a counter-cyclical fashion; and (3) improving the quality of public finances.

While the Maastricht Treaty introduced fiscal discipline, the framework overlooked the importance of macroeconomic imbalances as a source of fiscal risk, according to the European Fiscal Board. Such a review would provide a reprieve to governments that have been forced to adopt fiscal austerity during times of an economic crisis or recessionary conditions. Pro-cyclicality bias also implies that during phases of strong growth, fiscal positions will need to improve. **We see this framework review as a more medium-term agenda, rather than for the short-term, given varied political, economic and fiscal backdrop of the member countries.**

Implications for rates

We prefer paying EUR interest rate swaps on dips. Given the lack of immediate catalysts that could drive further curve steepening or much higher rates, we are reluctant to chase at current levels.

The EUR and German Bund curve has steepened significantly over the past few months as it became clear that a global recovery is taking hold. In the short end of the curve, rates also came under upward pressure as ECB policies have led to a steady rise in Euribor (they have technically raised rates when tiering was implemented in 2019).

With rate hike expectations not on the horizon and only modest fiscal easing upcoming, the supply / dynamics (with the ECB maintaining asset purchases) still point to generally depressed EUR rates.

Notes:

[1] European Fiscal Board: Assessment of EU fiscal rules - European Commission – Europa; September 2019

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).