Prospects for the euro area ….short and long term?

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Vanguard

Outline

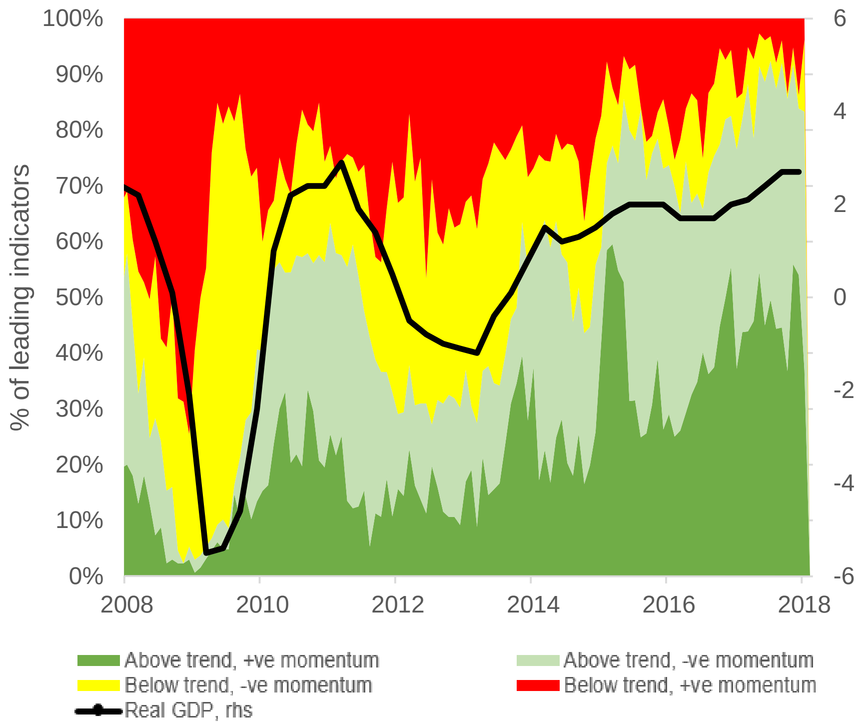
How will the euro area fare in the immediate future (6-24 months)?

How will the euro area fare in 5 to 30 years?

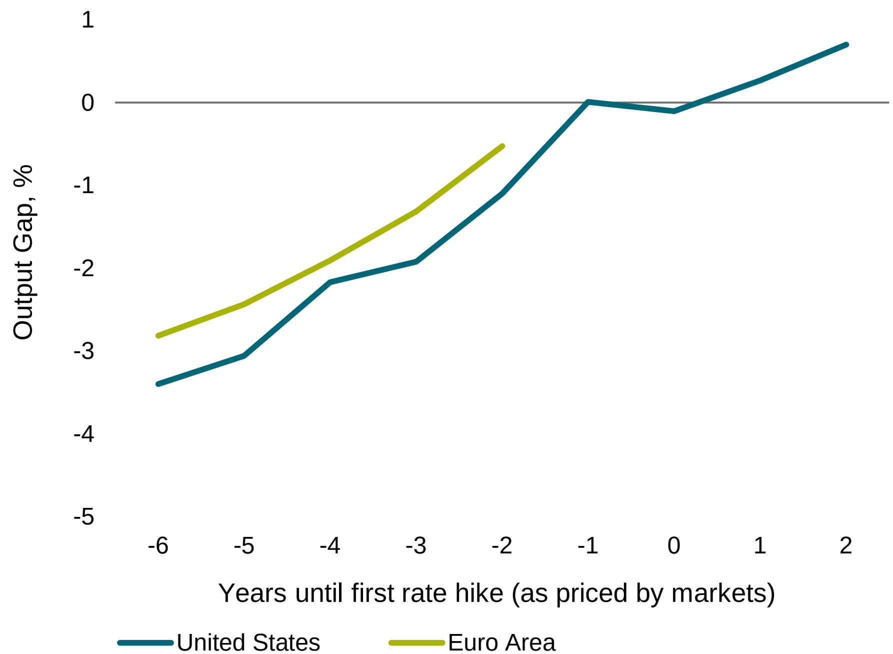
Short-term fate of the euro area

The euro area is having a second honeymoon

Dashboard of leading indicators



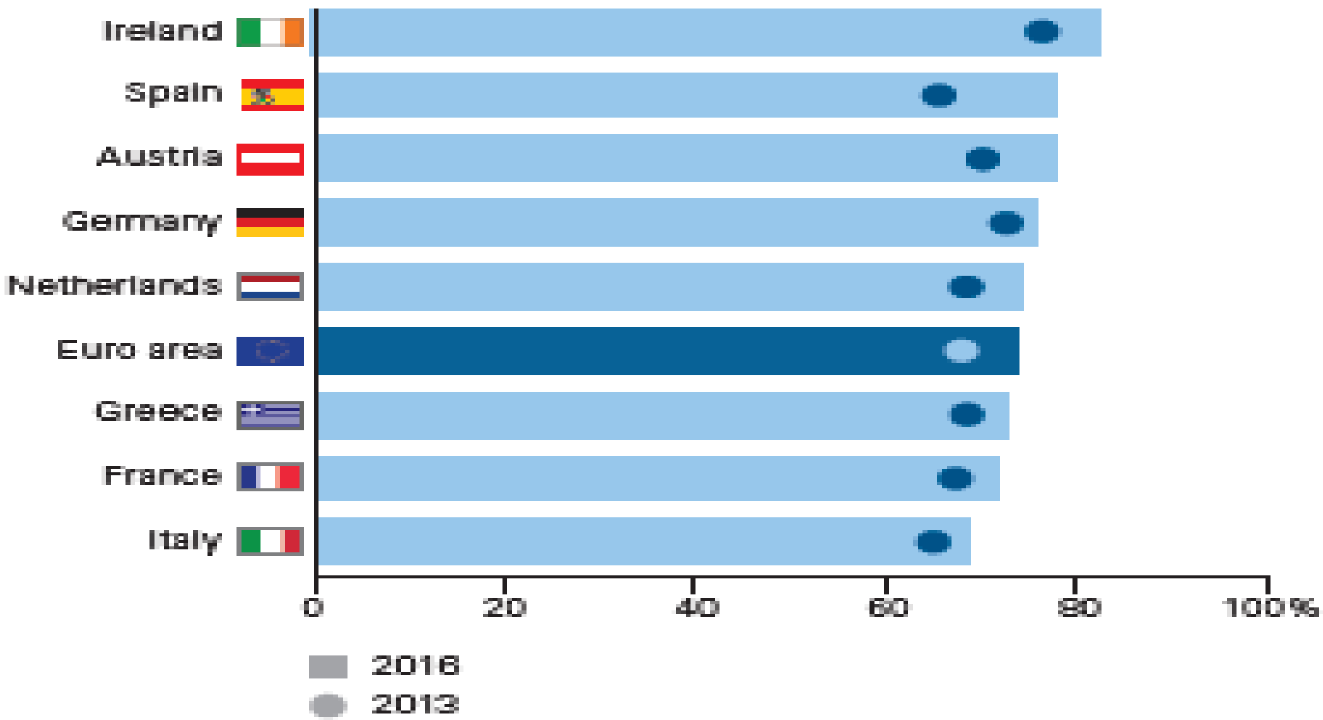
Output gap comparison



Source: Vanguard calculations, Macrobond and Bloomberg.
Notes (LHS): The distribution of growth outcomes is generated by bootstrapping the residuals from a regression based on a proprietary set of leading economic indicators and historical data, estimated from January 1998 to February 2018 and adjusting for the time-varying trend growth rate. Trend growth represents projected future estimated trend growth.
Notes (RHS) Tthe first post-crisis rate hike in the US was December 2015. In the euro area, the market has priced the first sovereign debt crisis hike in June 2019, based on Bloomberg data for overnight indexed swaps.

Anti-euro sentiment: is the tide turning?

Percentage of population in favour of a single currency—the euro

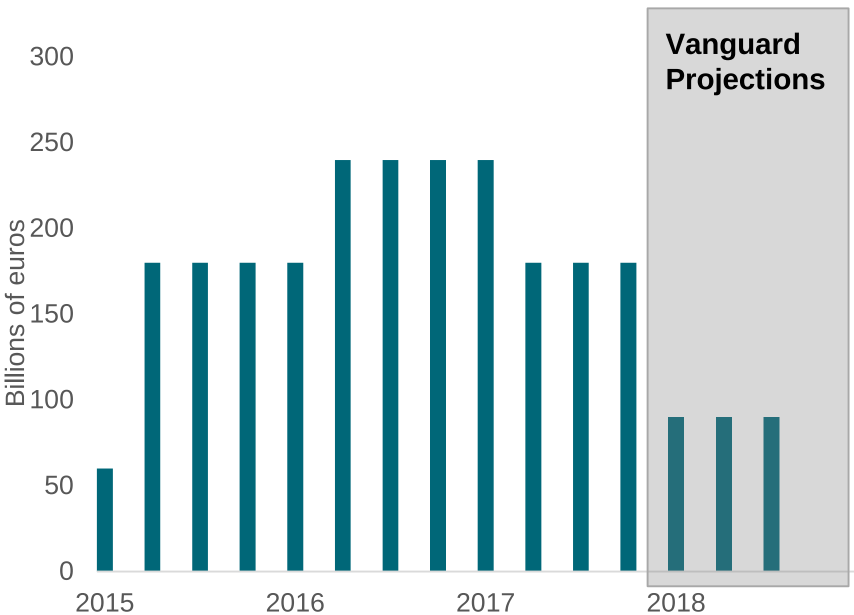


Source: Eurobarometer.

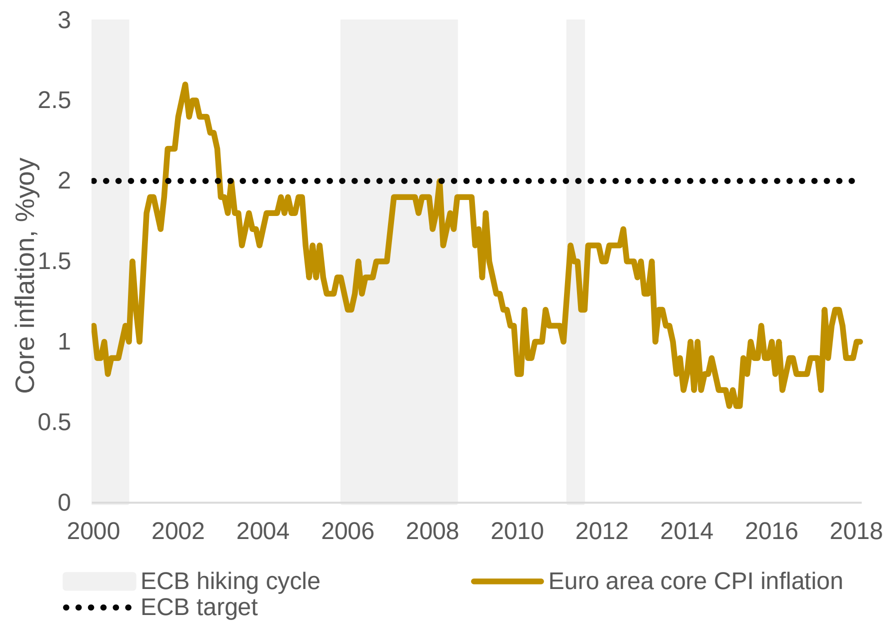
Despite low inflation, the ECB will terminate QE in 2018 and raise rates in 2019

ECB balance sheet

Rolling 3 month change



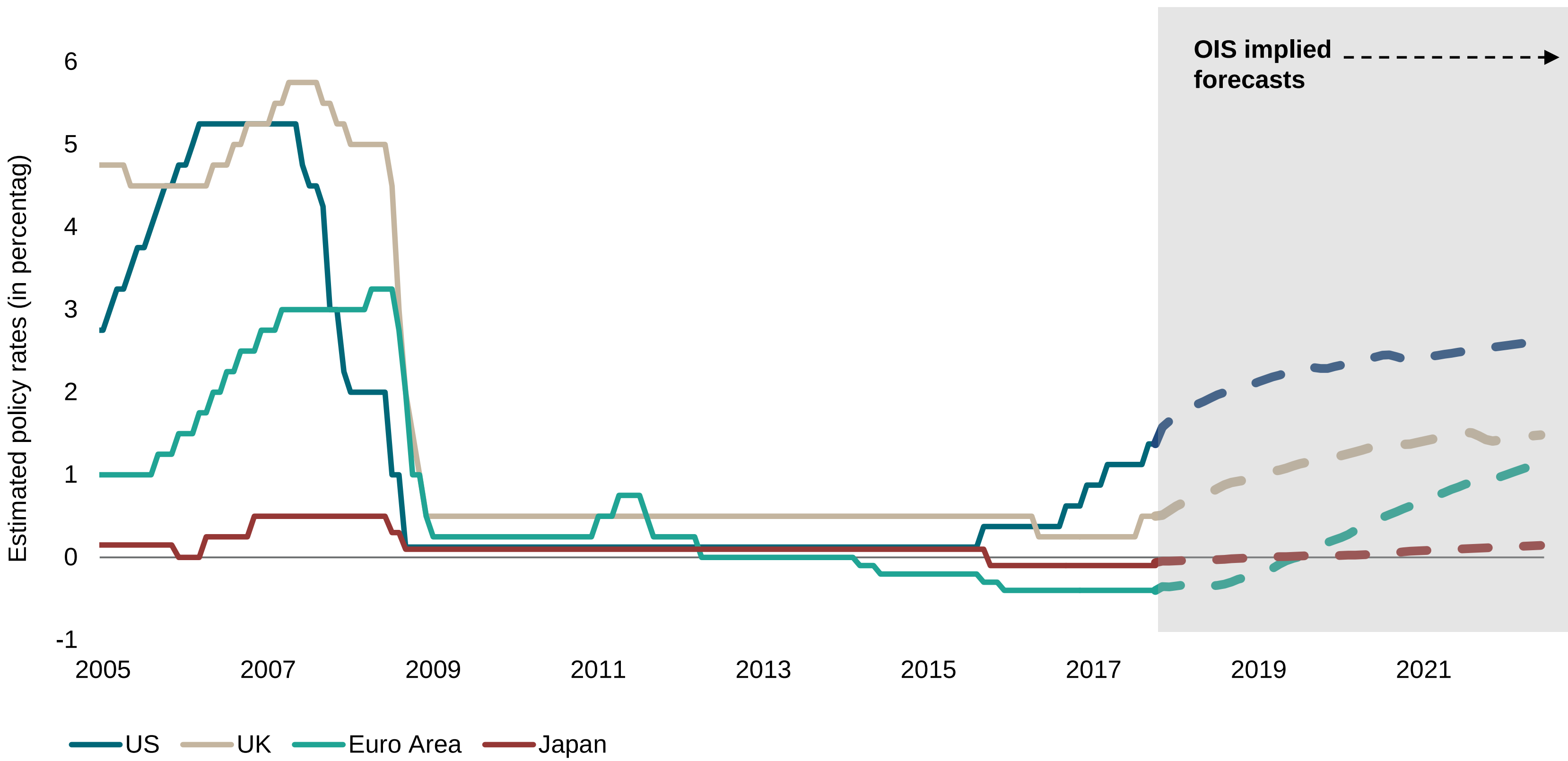
Core inflation



Source: Macrobond with forecasts from Vanguard. Shaded area represents Vanguard projections.

Interest rates have started to rise in the US and UK, but Japan and the euro area are yet to lift off

Interest rates



Source: Historical data from Bloomberg. Forecasts are Bloomberg data on overnight index swaps as at 28th of March 2018.

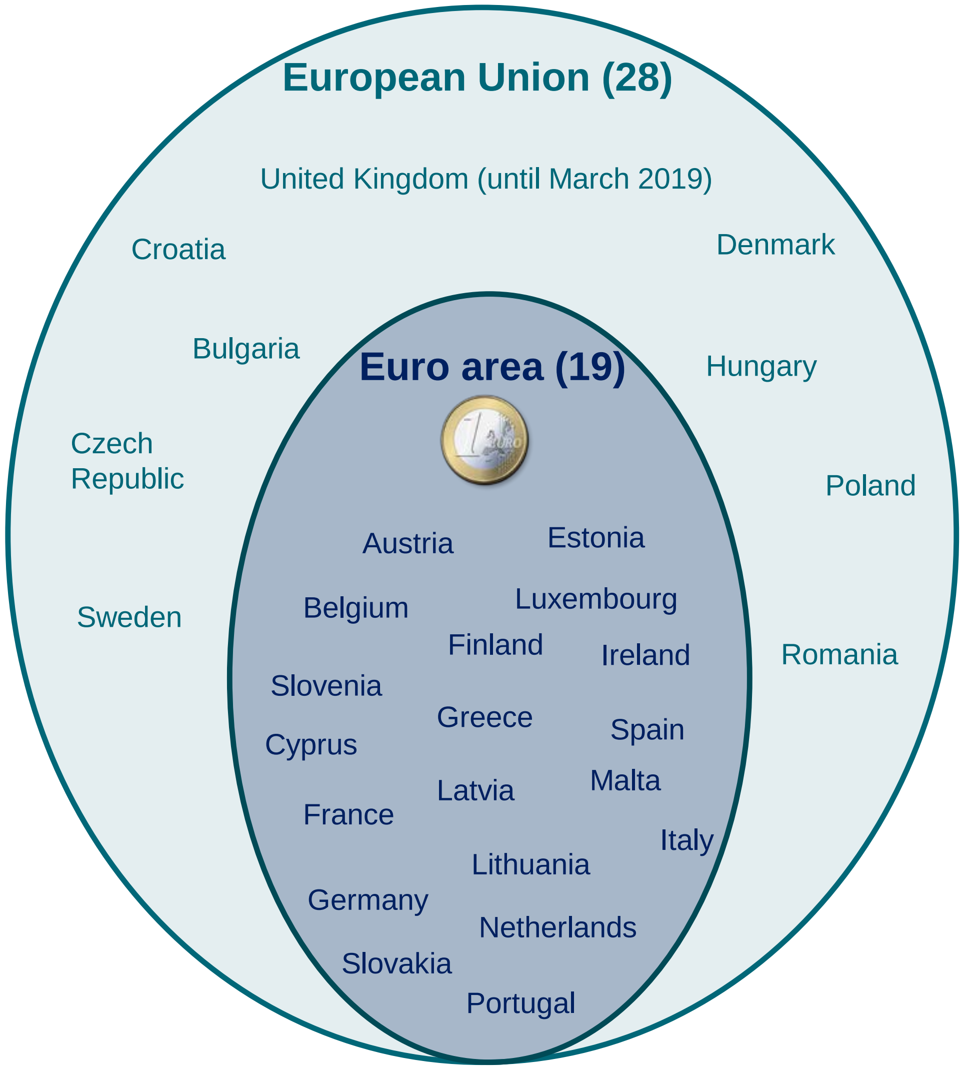
What type of Brexit?

5 scenarios

Crash Brexit	Hard Brexit	Compromise Brexit	Soft Brexit	No Brexit
10%	**20%**	**50%**	**5%**	**15%**
The UK fails to reach a deal and effectively falls out of the EU with no backstop. UK moves to WTO trade rules.	The UK leaves the EU Single Market and the Customs Union and reintroduces immigration controls.	The UK establishes a customs arrangement with the EU and leaves the Single Market.	The UK joins the European Economic Area and retains access to the EU Single Market and Customs Union.	Article 50 is revoked and Brexit does not take place

Long term fate of the euro area

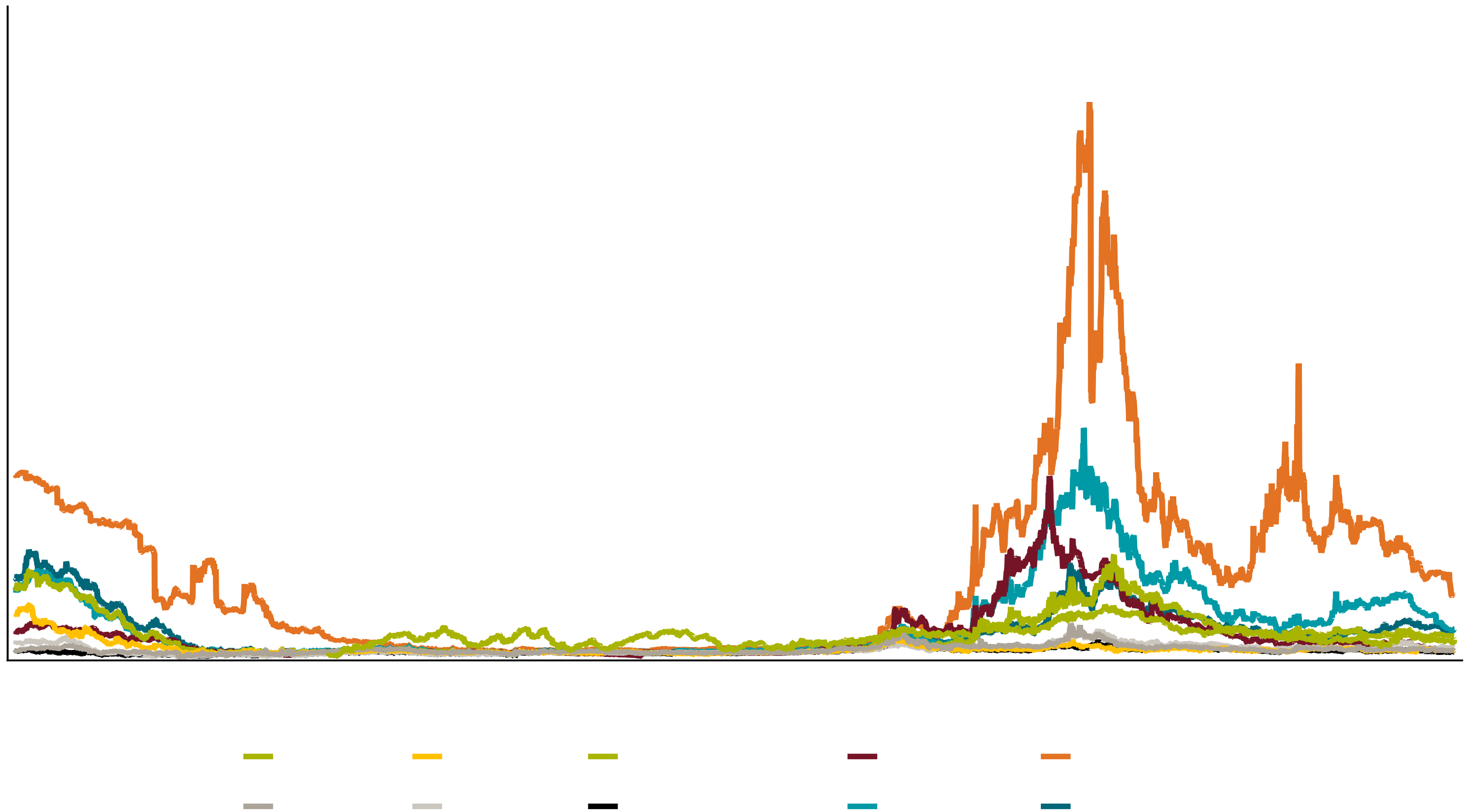
Composition of the European Union and the Euro area



Source: Vanguard

Sovereign spreads narrowed during the honeymoon years of the euro

Sovereign 10 year bond yield spreads to German bund



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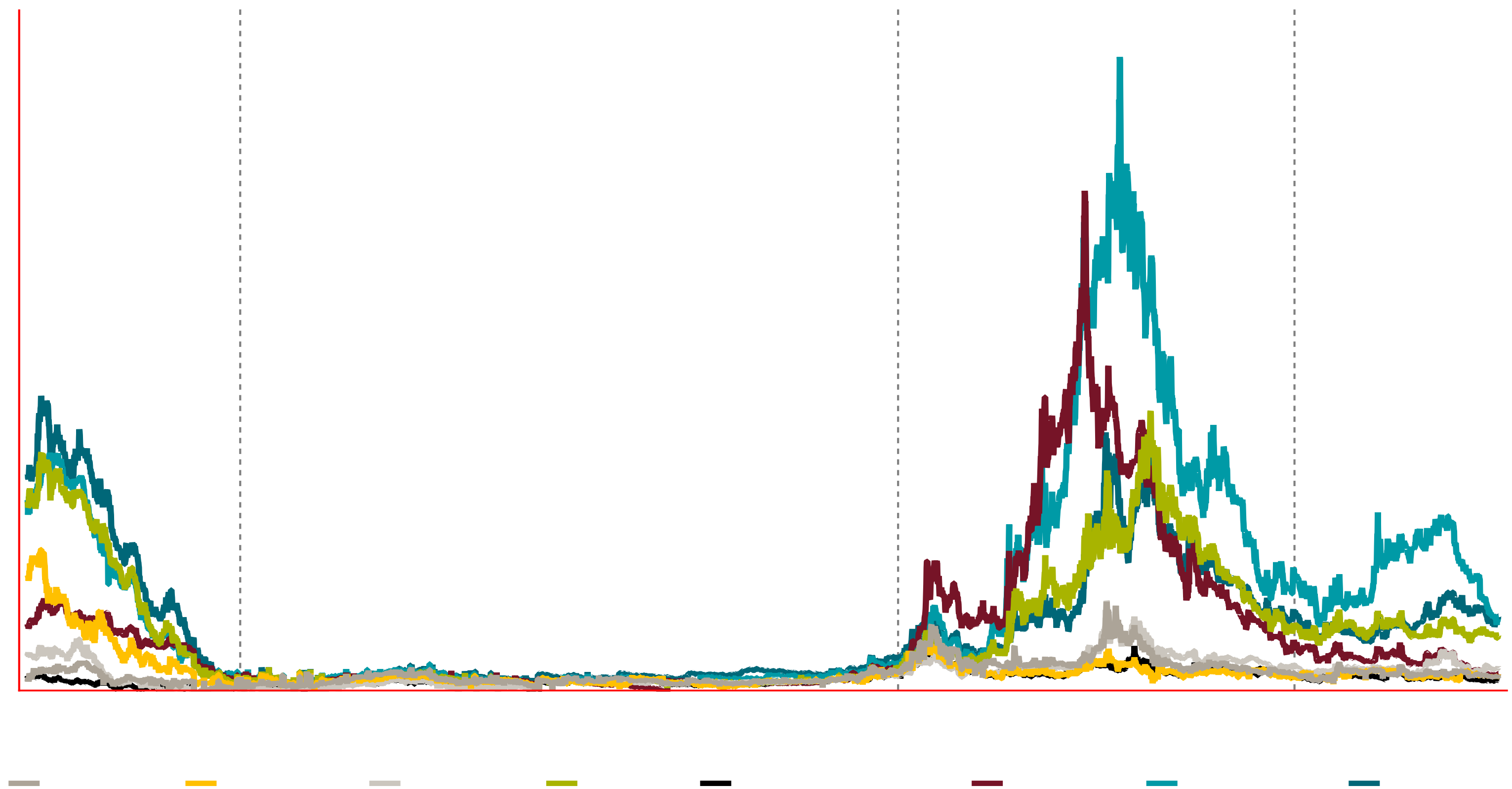
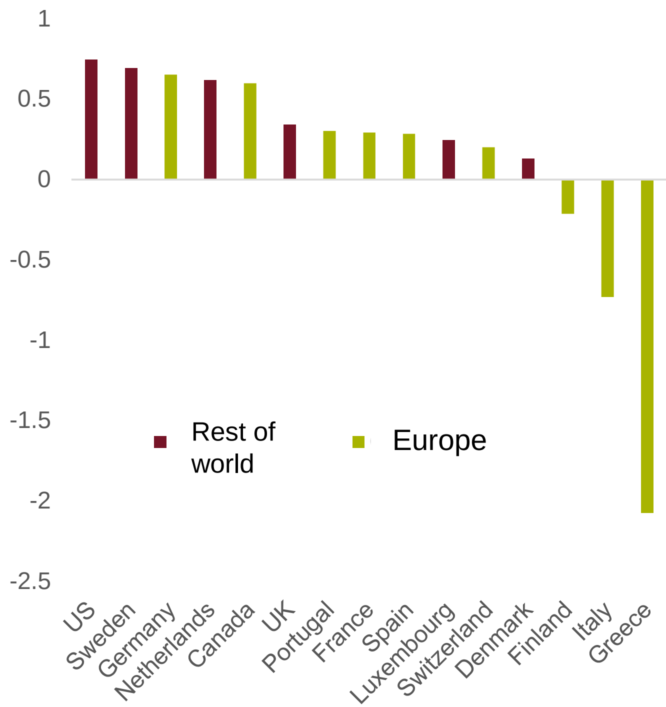


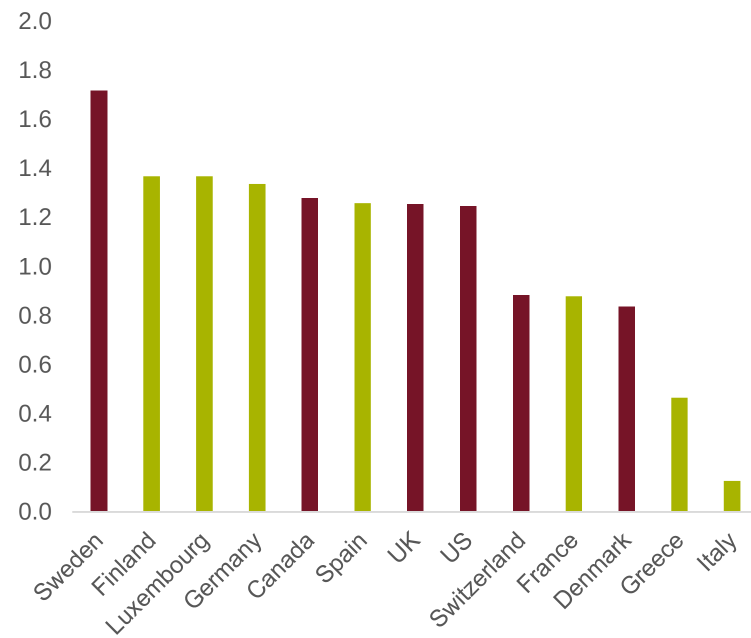
Post-crisis economic performance has been poor, relatively and in terms of divergence within the euro area… …differences less clear since the creation of the euro

Average annual GDP growth per capita

2008-2018

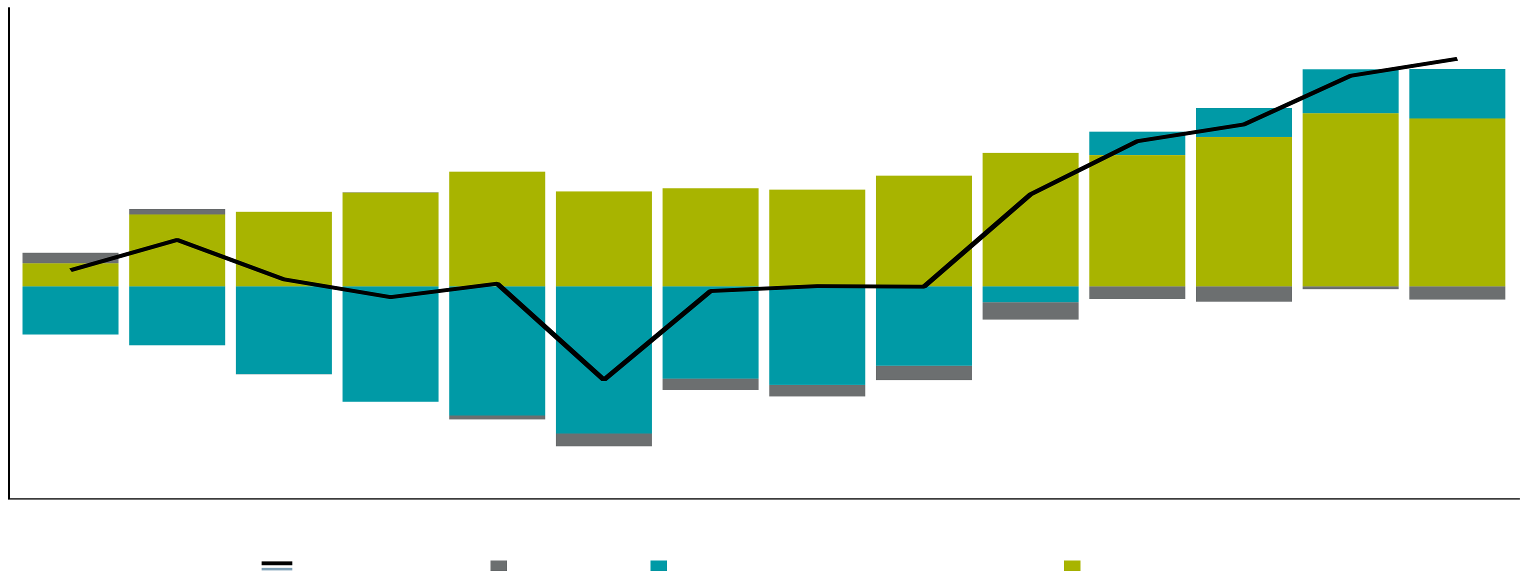


1999-2018



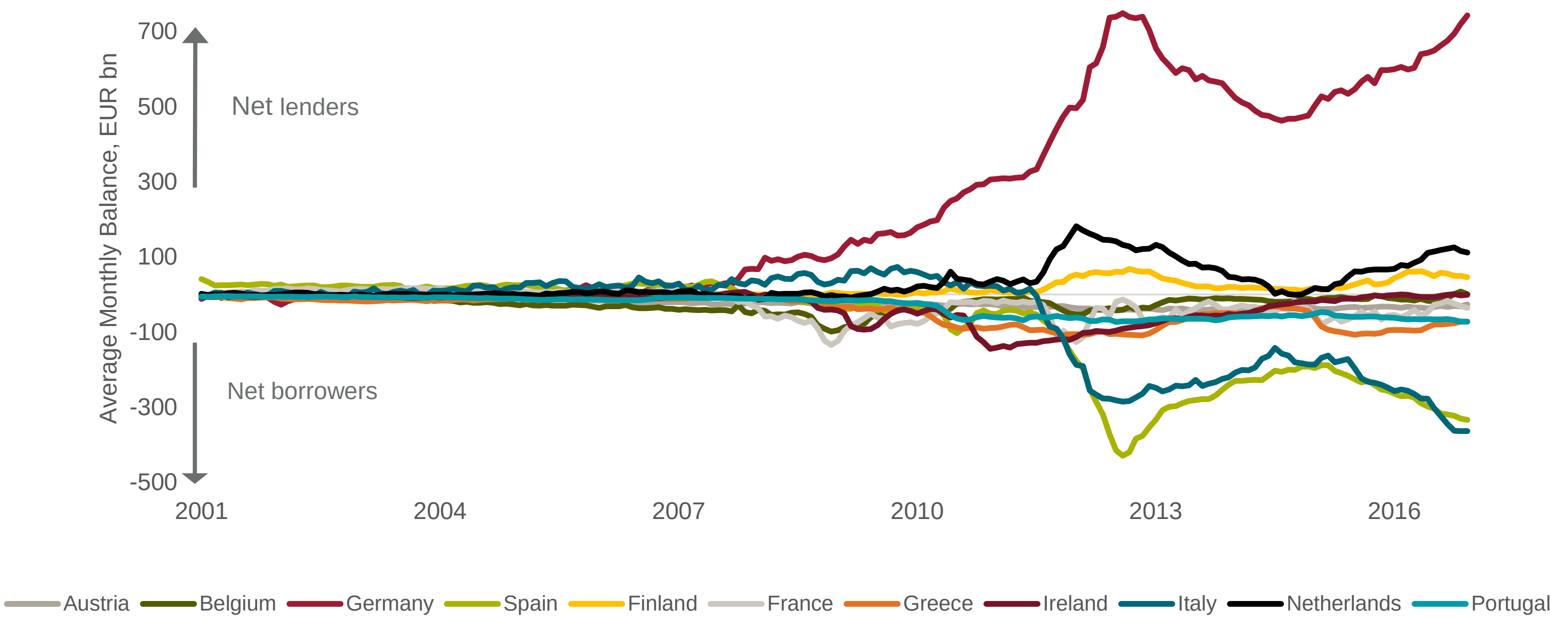
Large current account imbalances are symptoms of a flawed union

Euro area imbalances on current account (% of euro area GDP)



Financial claims within the euro area have ballooned

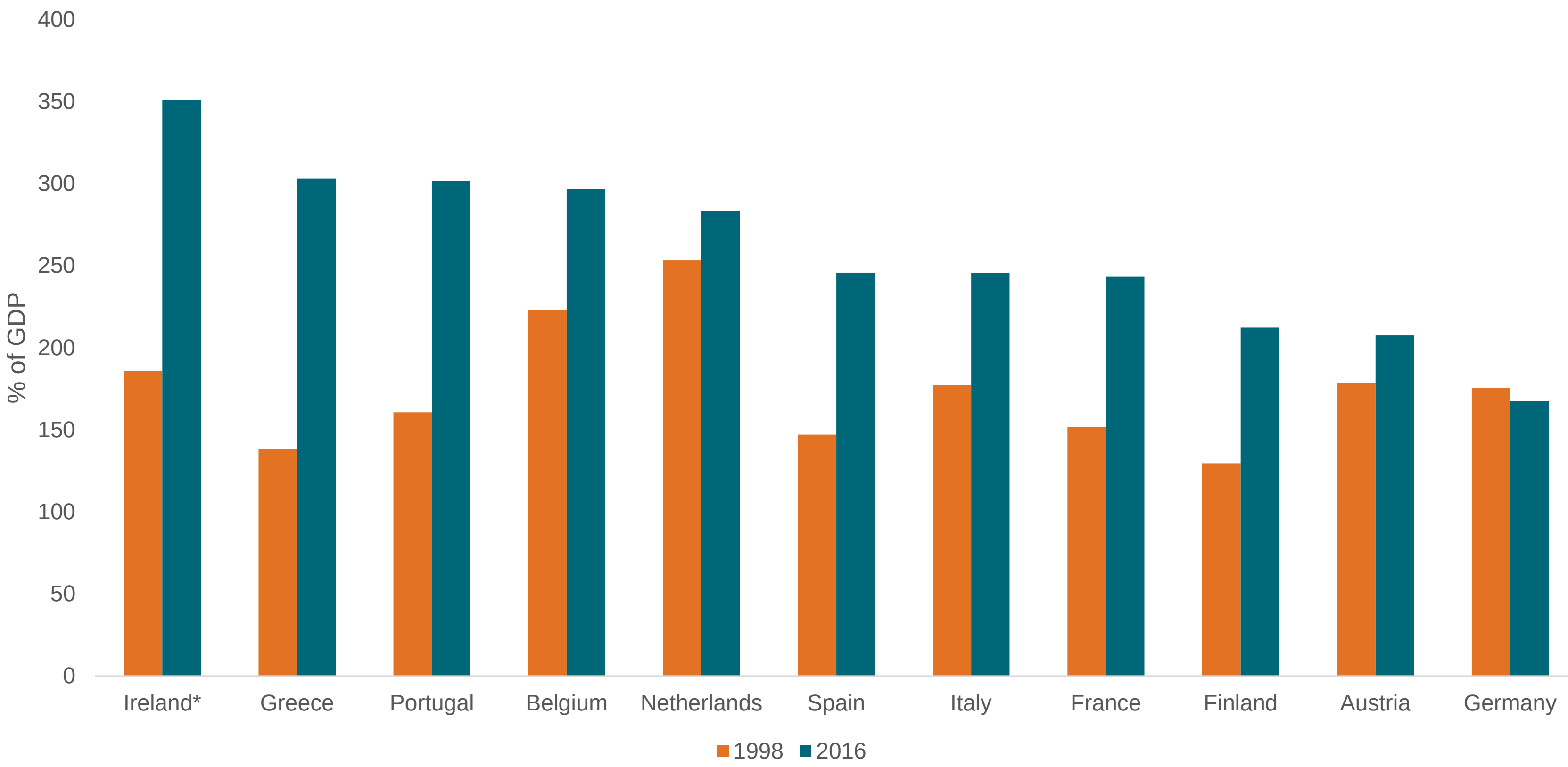
ECB Target2 Balances



Notes: Target2 is the real-time gross settlement system owned and operated by the eurosystem. Target stands for trans-European automated real-time gross settlement express transfer system. Target2 is the second generation of Target. It acts to balance out payment shortfalls and surpluses throughout the system, by transferring funds between respective national central banks as and when needed. A positive TARGET2 balances corresponds to a net claim vis-à-vis the ECB and a negative balance corresponds to a net liability.
Source: Eurostat, Macrobond

Debt levels have increased across most countries since the inception of the euro

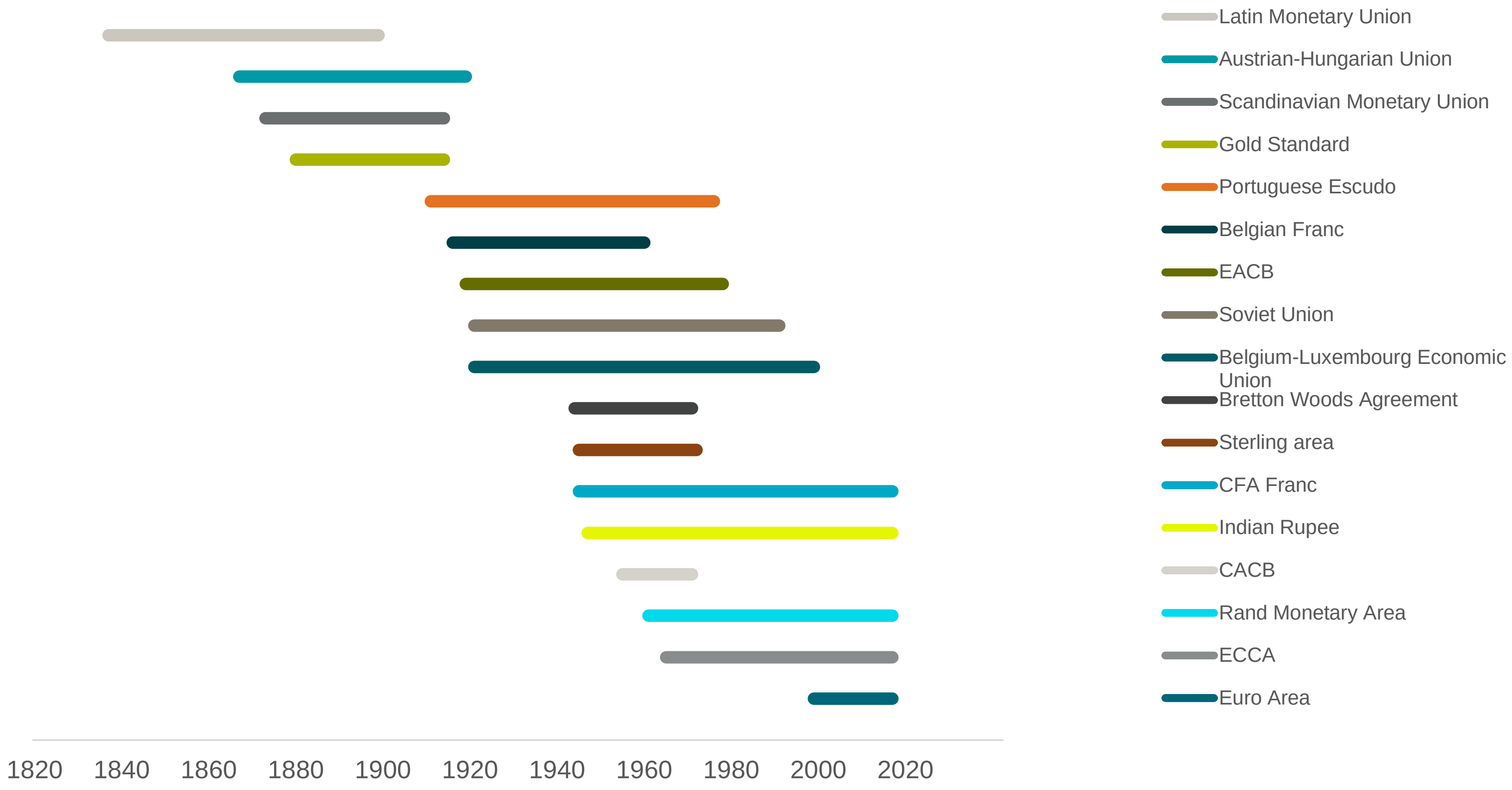
Total debt (% of GDP)



Source: Macrobond & BIS
*Ireland data for Households & NPISH + NFCs is from 2002 instead of 1998, because of lack of data availability.

What can past monetary unions teach us?

Timeline of historical monetary unions



The key ingredients for a successful union

		Number of member countries	Common Currency	Labour Mobility	Fiscal Union	Banking Union	Political Union
NATIONAL UNIONS	United States Dollar	1					
	Pound Sterling	1					
EXISTING	Euro Area	19					
	ECCA (East Caribbean Currency Authority)	11					
	Common Monetary Area - South Africa	5					
	CFA Franc	30					
DISBANDED	Soviet Union	15					
	Austro-Hungarian Krone	2					
	Belgium Luxembourg Economic Union	2					
	EACB (East African Currency Board)	6					
	CACB (Central Africa Currency Board)	3					
	Sterling Area	16					
	Portuguese escudo	7					
	Belgium	4					
	Indian rupee	13					
	Gold standard	43					
	Bretton Woods	11					
	Latin monetary union	4					
	Scandinavian Monetary Union	3					

	Common Currency	Labour Mobility	Fiscal Union	Banking Union	Political Union
	Same legal tender	Free movement of labour	Shared government budget	Shared oversight and resolution of banks	Full integration
	Currency board	Limited labour mobility	Some sharing of government budget	Some shared oversight and resolution of banks	Colonies
	Separate legal tender	No free movement of labour	Separate government budget	No shared oversight and resolution of banks	No history or integration

- The most successful unions have full integration (e.g. national unions such as USA, UK).
- The jury is out on whether monetary unions survive without full integration.
- Integration on its own does not ensure survival of a monetary union, political will is crucial.
- The pace of integration needs to be carefully considered. If integration occurs too rapidly then the political will to sustain the union could evaporate.

Flaws in the design must be addressed in the long term to prevent a breakup of the euro

Proposed reforms	Importance	Progress
Automatic budget stabilisers to increase public spending during downturns, and decrease public spending in upswings	Crucial	
Development of a **European rescue plan** to handle financial crises	Crucial	
Fiscal union with a new European treasury to direct fiscal policy	Very important	
Banking union with banking supervision, deposit insurance, common regulations, and a resolution procedure	Very important	
Restructuring of debts	Very important	
Mutualisation of debt (with the creation of Eurobonds)	Somewhat important	
Removal of barriers to labour mobility (portability of pensions, mutual recognition of credentials, receipt of social services)	Somewhat important	

Legend
Crucial = union cannot be sustained without this reform.
Very important = union can be sustained without this reform but instability is likely.
Somewhat important = union can be sustained without this reform with little instability.

	Complete
	Some progress
	No progress

Golidlocks approach to a sustainable euro area..
..not too slow..not too fast

Too slow: Lack of progress on necessary reforms make euro area vulnerable to next crisis

- Macron-Merkel axis lessens this risk

Too fast: Democratic buy-in for required increase in sovereignty-sharing is essential

- Brexit may heighten this risk..”concentric circles” in EU less necessary.

The fate of the euro over the next 5 years

~ 3 potential scenarios

No break-up

~95%

- No countries leave the union, however reform will be likely to appease member states

<u>Markets</u>

- Introduction of Eurobonds
- Collapse of sovereign spreads

Partial break-up

~5%

- Several small countries leave and the core currency block solidifies
- The fall out of a few small countries leaving would likely be manageable

<u>Markets</u>

- Widening of sovereign spreads
- Heightened market volatility in the short term

Full break-up

~0%

- The system dissolves and reverts to legacy currencies
- Major financial market disruption
- Potential bank losses from depreciation
- Redenomination risk

- <u>Markets</u>
- Heightened market volatility in the short term
- Re-emergence of national currencies and national bond markets
- Strong deutschemark, weak peripheral currencies
- Higher inflation in the periphery

The fate of the euro over the next 30 years

~ 3 potential scenarios

No break-up	Partial break-up	Full break-up
60-75%	**20-30%**	**5-10%**

What to watch? Key signals of progress

SCENARIO

SIGNAL	break-up	No break-up
Progress on reforms	No sign of commitment on fiscal or banking union, automatic stabilisers, or too big too fail	Measured progress towards fiscal and banking union, automatic stabilisers, and too big too fail
Current account imbalances	Sustained imbalances	Reduced imbalances
Opinion polls	Election of anti-euro political parties	Diminished popularity for anti-euro political parties
Unit labour costs and prices	Sustained imbalances	Cyclical convergence across the euro area (not necessarily in living standards_
Sovereign spreads	Sharp divergence of spreads between weak and strong countries	Stability of spreads between weak and strong countries

Investment risk information

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

Past performance is not a reliable indicator of future results.

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