

Jefferies European Economic Outlook

Can the ECB and the BoE wrestle back control of monetary policy? Whoever replaces Draghi, direction of next steps hangs in the balance

- In a performance that summed-up his term at the ECB, Draghi delivered something for everyone at the June press conference. The ECB's overall stance remains cautious, reflecting uncertainties over the state of the domestic economy, uncomfortably low inflation and global trade tensions. In response, Draghi reiterated that the ECB has plenty left in its arsenal to support the economy if it becomes necessary, including restarting QE and cutting rates.
- At the same time, the ECB's task of setting policy to reflect the needs of the euro area is being made harder by the US Fed's dithering over its direction of travel, and the markets projecting its expectations of imminent rate cuts in the US onto the European yield curve (a frustration shared by the Bank of England). Therefore, it was significant that when all was said and done, the measures announced in June were less dovish than some had expected, with Draghi pushing back against the speculation that the ECB was preparing to take further easing steps.
- As the clock ticks down on his time as the ECB President, however, increasingly, attention is turning to life after Mario Draghi. The European Elections didn't produce the political earthquake some had feared, nonetheless, the two main political parties did significantly worse than in 2014, and the next step in the process is to choose who will replace Jean-Claude Juncker as the President of the European Commission. The frontrunner for the job under the process of Spitzenkandidat is the German politician Manfred Weber. But if he is asked to step aside in the coming weeks in favour of another candidate (as suggested by Emmanuel Macron), then Angela Merkel could focus on the top ECB job and the nomination of Jens Weidmann.
- Bundesbank President Weidmann – who has a reputation as a policy hawk and someone who in the past has been sceptical about the merits of QE and negative interest rates – would be a more controversial appointment than Benoit Coeure, Olli Rehn, or Francois Villeroy. However, in terms of the bigger picture, there is too much focus on the individual personalities. Over the coming year, no matter who is in charge, the ECB is likely to undertake a review of its remit and its policy tools. Understandably, the markets will be more anxious if this process is led by Weidmann as opposed to some of the other candidates on the radar, but it's naive to think that the next eight years of ECB presidency will look anything like the past eight years. Following years of firefighting, the ECB is hoping to move onto a new phase with emergency policy measures starting to be phased out.

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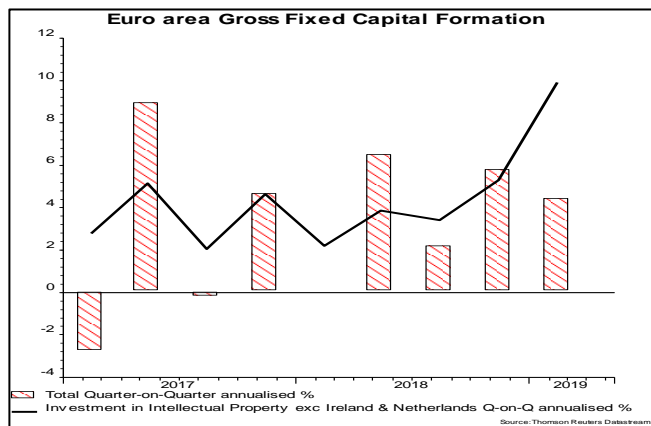
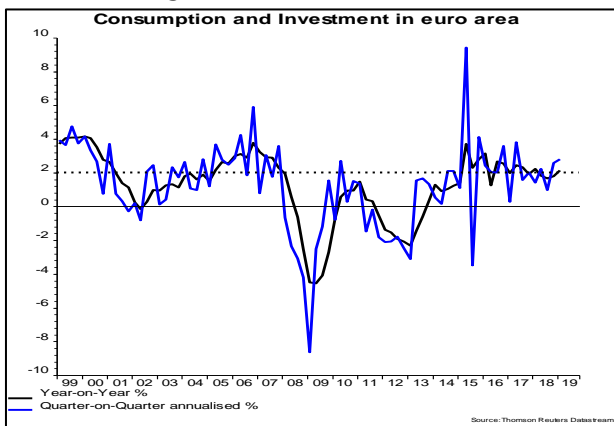
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Jefferies Fixed Income

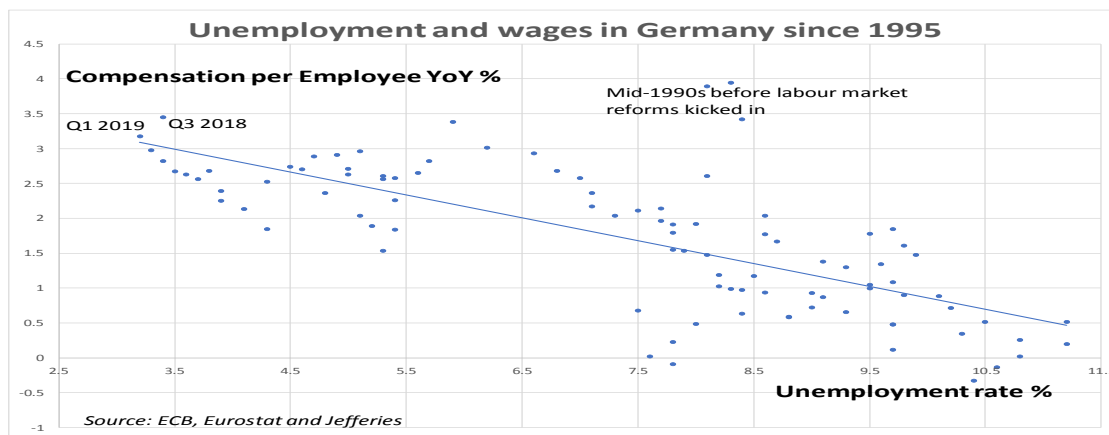
- At the moment there is widespread scepticism that the ECB would ever be in a position to hike rates or to start unwinding QE. But away from the hysteria surrounding inflation expectations and weak manufacturing PMIs, the ECB is nudging the markets to start focusing on a broader set of economic variables. Inflation dynamics should not be judged narrowly by the latest core inflation print, but by a wider basket of indicators including what's happening to unemployment and wages, profit margins and the GDP deflator, super-core inflation and the weight of HICP items in deflation. Similarly, while manufacturing sector output and global trade matter, what happens to euro area services matters even more. And while the markets are hung up on the US-China trade tensions, alongside, there should be at least some recognition that the EU could see some benefits from associated trade diversion.
- As the latest GDP figures showed (0.4% QoQ in Q1), there is more life in the euro area economy than is commonly recognised. Q2 growth is likely to be slower (with the Bundesbank pencilling a small decline in German GDP on the quarter), so perceptions will get worse before they get better. And when it comes to market developments, one troubling parallel is how events unfolded after the Asian financial crisis of 1997 and Russian default of 1998, when confidence about recovery also evaporated, bond yields fell, and policy rates were cut. Our strong call at the time was that the economy would continue to sail on through. This is precisely what happened, but of course the policy easing helped stoke the excesses that directly led to the TMT bubble bursting.
- In the UK, all attention remains on the corrosiveness of Brexit. Having disposed of Theresa May, the Conservative party is in the process of electing a new leader and by end-July the country should have a new Prime Minister. What will not change, however, is the Parliamentary arithmetic, with the majority of MPs opposed to a No Deal Brexit, or in fact to any form of Brexit presented to them in the run up to the original 29 March departure date.
- Will the new Prime Minister be able to renegotiate a deal with the EU and steer his/her version of Brexit through Parliament before 31 October? Extremely unlikely, with another extension almost inevitable, although the decision could come very late in the day, with the Parliament potentially on the brink of a no-confidence vote in the government. As this mess unfolds, the calls for another referendum and a new General Election will grow even louder, although neither would be expected to produce a decisive outcome, with the electorate as divided (and in some ways arguably more) now, as in 2016 or in 2017. Against this backdrop, the BoE will be on standby to adjust policy in either direction; but if an orderly Brexit can somehow be delivered or, more likely, Brexit is delayed into next year, the MPC has a bias to tighten policy and, as in summer 2017, could surprise the markets with its resolve.

Market underestimating risk of rate rises

Economic fundamentals still point to EU GDP growth surprising on the upside, despite increasing concerns that, along with rising trade tensions, Europe’s recovery is rolling over. Real GDP printed a solid 0.4% in the first quarter (1.6% annualized), up from 0.1% in Q3 2018 and the 0.2% of Q4 2018, underpinned by the on-going strength of fixed capital formation (including the hard to measure, investment in intellectual property), and on-going resilience of consumption. Employment printed 0.3% again in the euro area, as well as in Germany. Compensation per employee paused for breath in Q1, but the ECB’s measure of negotiated wages is also now growing over 2%, up decisively from two years ago, and the labour market continues to tighten.

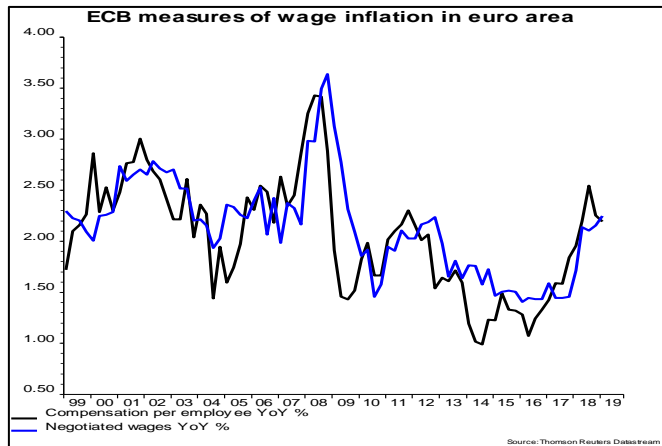


Indeed, compensation per employee in Germany posted over a 3% rise in the year to the first quarter, effectively the fastest growth in wages in the euro area’s largest economy since EMU commenced. Compensation per employee in Germany was growing at a slightly faster rate in the mid-1990s. But that was before labour market reforms kicked in, when the German unemployment rate was almost 8.5%. Now we have German wage growth of over 3% again, but with an unemployment rate of only 3.2% (below 2% in some regions). And, as with the rest of the euro area we have a recovery that is much more based around the service sector, and domestic demand. Moreover, although one should be careful pushing the argument too far, Germany and the EU more generally could benefit from trade diversion, away from China-US, and more towards the EU-China and EU-US.



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The flip-side of rising wages, has been a squeeze in profit margins, as measured here by the ratio of the gross operating surplus (pre-tax trading profits) of non-financial corporations to the gross value added (effectively turnover) of the same universe of companies. Nowhere can this be seen more clearly at a macro level than in Germany. This partly explains the slow response of core inflation to a pick-up in wages. However, just because prices have yet to really respond at a macro level does not mean to say that they won't. As we continue to highlight, a deep dive of the HICP data shows an increasing proportion of the euro area's inflation basket seeing price rises of above 1% and above 2%, and a smaller proportion of the basket seeing price rises of less than 1%, or outright price declines. And, in Germany super-core inflation continues to run above the rest, and the GDP deflator is growing at more than 2% year-on-year.



Certainly, from the ECB's point of view, the decisive pick-up in wages will give them more confidence on a policy relevant time horizon (2-3 years) they will eventually come close to hitting their target.

Meanwhile, in line with what we have seen in other economies, the service sector has become increasingly important at driving Europe's recovery. That is not the say world trade in goods and manufacturing no longer matters. In 2017, the year when world trade in goods kicked in, growing by almost 4.5%, euro area GDP grew by over 2.5%, compared to 2% in 2015 and 1.9% in 2016. Then, as the world trade cycle rolled last year, euro area GDP still posted almost a 2% rise in 2018, despite the sharp slowdown of the second half.

Household income growth (of approaching of 4% in nominal terms) is not the only thing that has been underpinning the euro area's recovery to date. Bank lending has also picked up, and picked up significantly in some cases, especially if one looks at the trend since the introduction of the TLTROs in June 2014. Importantly, we have yet to see the corporate sector swing into deficit, something that would normally occur as the business cycle matures. Indeed, running into the financial crisis of 2007 and 2008, the euro area's corporate sector had consistently been running a deficit of approaching 3% of GDP. In some country's cases their corporate sector deficits were, at the peak, running well over 10% of GDP, the counterpart of current account deficits of roughly similar magnitudes. Only in EMU could this have happened. A stand-alone sovereign would have been

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GLOBAL FIXED INCOME

Bank lending in the euro area since the introduction of the TLTROs IN 2014

Year-on-Year %	Euro area	Germany	France	Italy	Spain	Netherlands	Belgium	Austria	Ireland	Finland	Portugal	Greece	Slovakia	Luxembourg	Slovenia	Lithuania	Latvia	Estonia	Cyprus	Malta
Non-financial corporations																				
Jun-14 TLTRO-1	-2.3	0.6	1.6	-3.5	-9.4	-2.1	-1.2	0.3	-9.0	5.2	-7.3	-5.0	2.4	-0.3	-14.5	5.1	-3.7	5.6	-2.7	-5.2
Mar-16 TLTRO-2	0.9	2.8	4.4	-1.4	-1.9	-2.5	4.5	1.4	-4.6	4.5	-2.5	-5.9	3.1	13.2	-8.3	8.9	1.0	8.6	-1.7	-0.9
Apr-19	2.7	7.6	6.8	-7.7	-1.1	-1.3	7.9	9.4	-0.7	9.0	-0.3	1.0	6.4	4.1	2.4	1.0	5.9	7.5	1.7	-1.3
<i>of which:</i>																				
Adjusted for sales and securitisations																				
Jun-14 TLTRO-1	-2.5	-1.5	1.4	-3.4	-8.9	-1.7	-0.5	0.3	-5.0	5.2	-5.4	-4.6	2.4	-0.3	-9.7	-0.4	-3.7	5.6	-2.7	-5.2
Mar-16 TLTRO-2	1.4	2.0	4.4	0.1	-2.1	-1.8	5.7	1.4	-2.8	4.5	-1.9	-1.0	3.6	13.2	-8.3	7.5	1.0	8.6	0.7	-0.4
Apr-19	3.9	6.6	6.9	-0.5	-1.3	-1.1	8.8	8.3	3.5	8.9	0.9	2.5	6.5	4.2	2.4	1.0	5.9	4.0	4.7	-0.1
House purchase																				
Jun-14 TLTRO-1	-0.4	2.1	-1.9	-1.1	-3.9	-0.4	13.1	3.3	-1.9	1.8	-3.5	-3.6	12.9	6.1	1.0	1.3	-4.2	2.0	-4.1	7.7
Mar-16 TLTRO-2	2.3	3.7	3.3	0.6	-4.0	7.2	9.8	4.6	-3.4	2.5	-3.6	-3.4	13.4	6.3	2.3	6.3	-2.6	4.5	-2.8	8.0
Apr-19	3.5	4.7	6.5	1.6	-0.9	0.3	6.0	4.6	3.5	1.9	0.6	-3.0	10.9	7.6	4.9	9.1	1.9	7.3	-0.2	9.7
Consumer credit																				
Jun-14 TLTRO-1	-1.5	0.9	-2.4	-2.3	-0.9	-7.8	-2.0	-2.9	-8.4	3.8	-3.3	-3.0	12.6	5.3	-8.1	0.2	-5.9	1.4	-8.3	2.0
Mar-16 TLTRO-2	4.9	4.1	3.4	16.4	11.7	-8.3	-0.7	-2.6	-0.1	3.9	3.5	-1.1	13.5	2.2	-0.5	8.1	9.7	9.4	-0.6	1.8
Apr-19	5.9	5.2	5.0	9.0	12.1	-5.5	0.5	0.8	4.3	3.9	8.1	-2.0	3.9	11.4	12.8	7.0	7.9	10.6	-1.1	9.0

Source: ECB and Jefferies

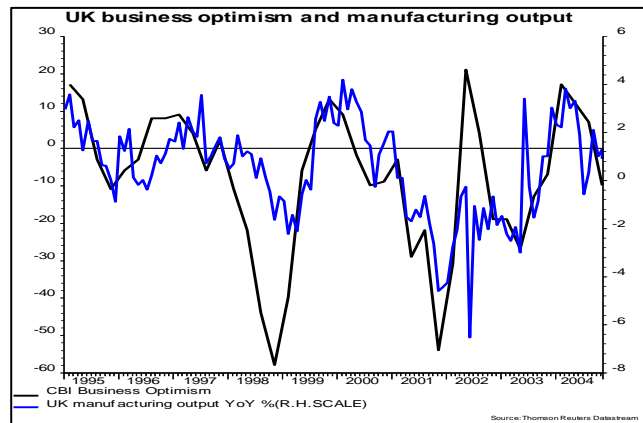
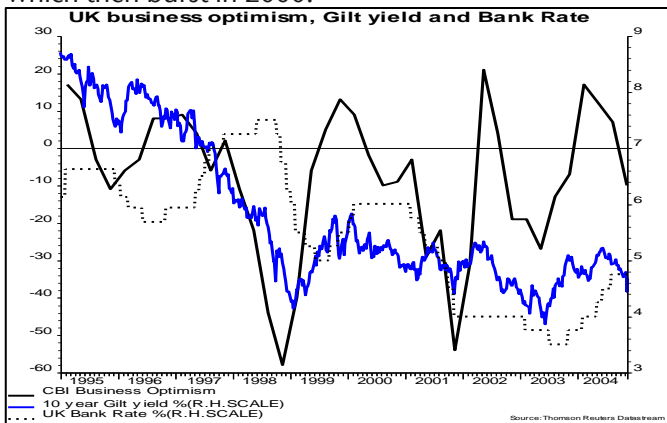
Non-Financial Corporations in euro area																				
Gross Value Added (Turnover) Year-on-Year %																				
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
Euro area	6.0	6.1	3.2	2.4	4.1	3.6	5.4	6.9	2.9	-4.8	2.8	3.3	0.2	1.4	2.8	4.5	3.7	4.2	3.6	
Germany	4.5	4.4	1.2	0.2	3.0	1.6	5.2	6.2	1.4	-6.1	6.5	5.4	1.6	2.3	5.0	4.7	4.4	3.9	3.3	
Rest of euro area	6.7	6.9	4.2	3.4	4.6	4.5	5.4	7.2	3.5	-4.2	1.3	2.5	-0.5	1.0	1.8	4.5	3.3	4.4	3.7	
Compensation of Employees Year-on-Year %																				
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
Euro area	5.9	4.5	3.2	2.7	2.9	3.2	4.8	5.4	4.8	-1.8	1.8	3.2	1.5	0.9	2.6	3.3	3.2	4.4	4.7	
Germany	4.6	1.4	0.2	0.1	0.5	0.1	2.4	3.5	4.2	-1.0	4.0	5.4	4.7	2.8	4.5	4.6	3.8	4.8	5.0	
Rest of euro area	6.6	6.1	4.7	3.8	4.0	4.5	5.7	6.2	5.0	-2.1	0.9	2.2	0.1	0.1	1.8	2.7	3.0	4.2	4.5	
Gross Operating Surplus (Pre-tax trading profits) Year-on-Year %																				
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
Euro area	6.1	8.4	8.4	3.0	2.1	5.7	4.0	6.7	8.8	0.1	-8.8	3.3	-2.2	2.2	3.2	7.1	4.6	3.8	2.1	
Germany	4.1	8.6	8.6	2.4	0.0	6.3	4.0	9.0	9.0	-1.7	-11.9	5.1	-2.8	1.7	5.6	4.7	5.5	2.6	1.0	
Rest of euro area	7.0	8.3	8.3	3.4	3.1	5.4	4.0	5.7	8.7	1.0	-7.4	2.4	-2.0	2.4	2.0	8.3	4.1	4.4	2.6	
Profit Margins (Gross Operating Surplus/Gross Value Added) %																				
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Euro area	39.6	39.6	40.5	40.4	40.3	40.9	41.0	41.5	42.3	41.1	39.4	40.2	40.1	39.2	39.5	39.7	40.6	41.0	40.8	40.2
Germany	39.8	39.6	41.2	41.6	41.6	42.9	43.9	45.4	46.6	45.2	42.4	43.7	43.5	41.6	41.4	41.6	41.6	42.1	41.5	40.6
Rest of euro area	39.5	39.6	40.1	39.8	39.7	40.0	39.8	39.9	40.4	39.5	38.2	38.7	38.7	38.1	38.6	38.7	40.2	40.5	40.5	40.0
Gross Fixed Capital Formation (Investment) Year-on-Year %																				
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
Euro area	8.9	3.3	-1.2	1.1	4.3	6.0	8.5	10.0	0.7	-14.9	3.0	6.9	-0.2	-0.6	4.1	8.5	5.9	3.0	5.7	
Germany	7.1	-1.4	-7.3	-1.4	2.2	2.5	8.8	8.5	2.9	-14.4	6.5	9.1	-0.3	0.3	7.3	4.5	4.1	4.2	4.9	
Rest of euro area	9.8	5.5	1.4	2.1	5.2	7.4	8.4	10.5	0.0	-15.0	1.8	6.1	-0.2	-0.9	2.9	10.1	6.6	2.5	5.9	
Net Lending/Borrowing % GDP																				
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Euro area	-1.8	-3.4	-1.6	0.3	-0.2	0.0	-0.5	-1.7	-2.3	-2.6	1.1	0.8	-0.5	0.0	0.8	1.1	1.2	1.5	1.2	0.7
Germany	-3.5	-6.2	-1.6	0.5	0.0	1.7	0.9	0.4	0.2	-1.1	2.0	2.4	1.5	2.6	2.7	2.9	3.8	3.5	2.6	1.4
Rest of euro area	-1.1	-2.3	-1.6	0.2	-0.2	-0.6	-1.0	-2.5	-3.2	-3.2	0.8	0.2	-1.3	-1.1	0.0	0.4	0.2	0.7	0.6	0.5

Source: Eurostat and Jefferies

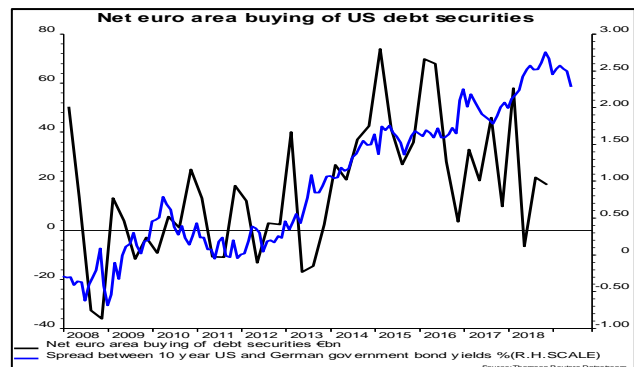
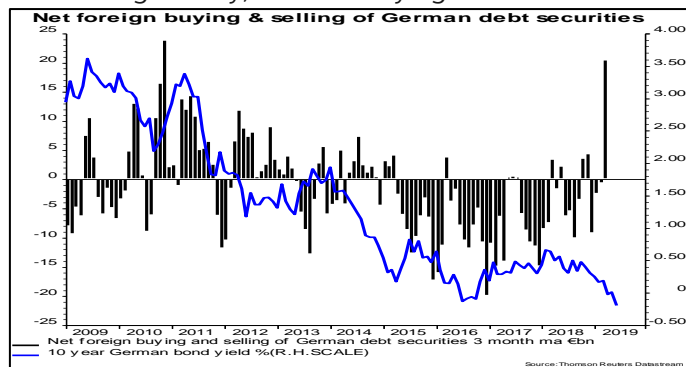
forced to slam on the brakes, a long time before these imbalances became so large, probably as their currency came under pressure. But, inside EMU cross-border capital flows and mispricing of risk continued until the financial crisis hit.

There is now much more focus of avoiding the worst of the financial excesses of that period, and renewed debate of how to increase the euro's role as an international currency. Potentially, this could include the introduction of a euro T-bill. But, in the interim, as the TLTRO-3 comes on stream we could see the corporate sector swinging back into deficit, further boosting spending, along with a continued pick-up in residential and commercial real estate.

Arguably, there are some parallels with the Asian financial crisis of 1997 and Russian default of 1998 when confidence in the recovery evaporated. Indeed, measures of business confidence, such as the very well respected CBI Industrial Trends survey in the UK, collapsed, to readings only normally seen in recessions. Our big call at the time was to suggest that economic growth in economies like the UK would continue pretty much as before. This is broadly what happened. But the policy easing that followed the collapse seen in confidence directly helped contribute to the tech bubble, which then burst in 2000.



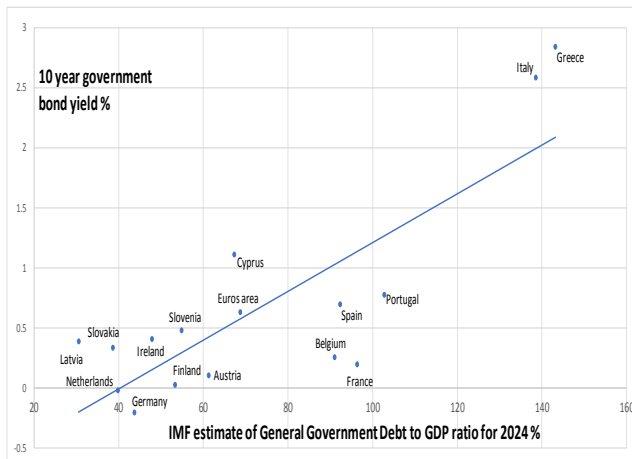
One thing that certainly surprised us was the significant net foreign buying of euro area debt securities in the first quarter of this year, particularly Germany, as outright QE came to an end. But, as we also highlight later in this note, this is not just a story of investors from outside the euro area allocating more cash to euro area bonds. We can infer from the ECB data that as QE came to an end, more capital has been put to work in the euro area more generally, with net buying from other euro area countries.



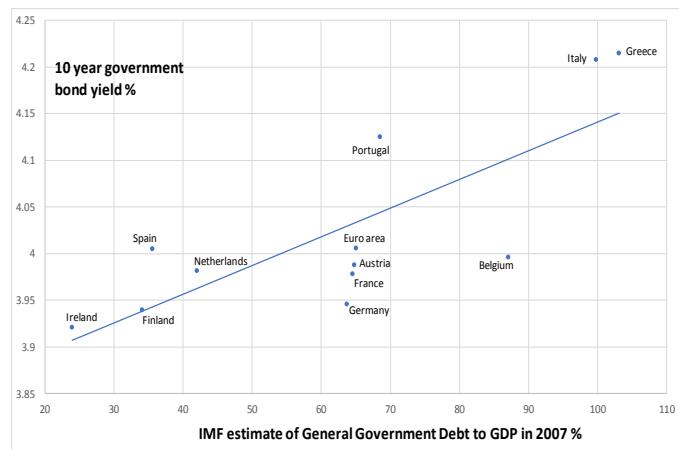
As was the case prior to the financial crisis there remains a relatively good relationship between outstanding government debt dynamics and the spread of sovereign bond yields inside EMU. On this metric Greece and Italy remain the outliers. All very helpful, but this still does not tell us going forwards, what should represent the exact distribution of spreads.

Government debt and bond spreads inside EMU

Today



In 2007

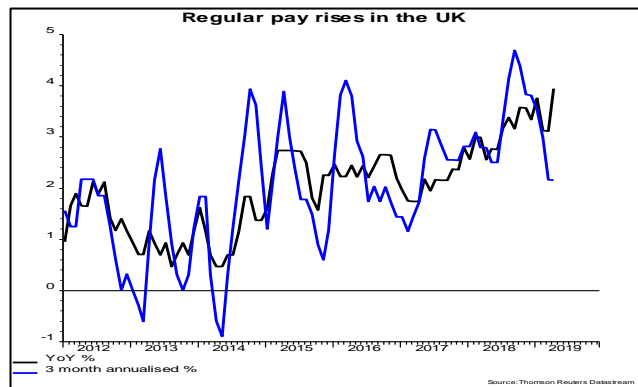
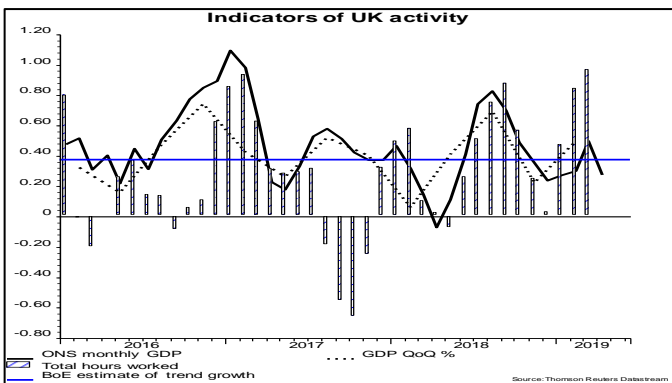


However, if we are right about the economic recovery surprising on the upside, then capital flows may well change significantly and could fundamentally reverse. For one thing, there remains a relatively close relationship between economic surprises and net foreign buying and selling of euro area equities.

Complicating the picture of course, is Brexit. 31 October is not just the date in theory when the UK is supposed to leave the EU; it also marks the end of Mario Draghi’s ECB Presidency. Much could pivot on who replaces him, even if the ECB undertakes a wide-ranging review of its monetary and macroprudential policies, regardless of his successor. Indeed, with Philip Lane in the chair as ECB Chief Economist there is likely to be more focus on macroprudential policies and one should forget his proposal last year for a euro-wide safe asset.

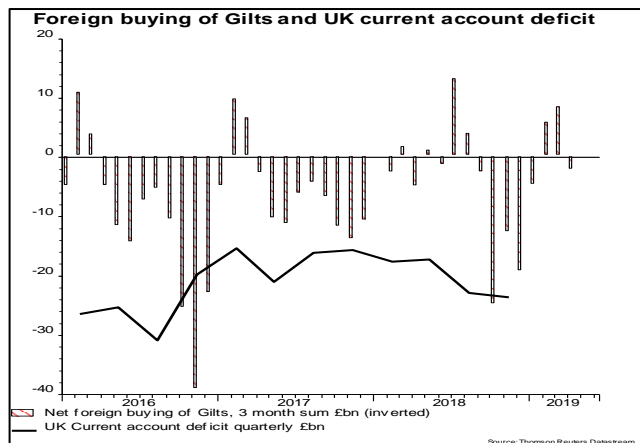
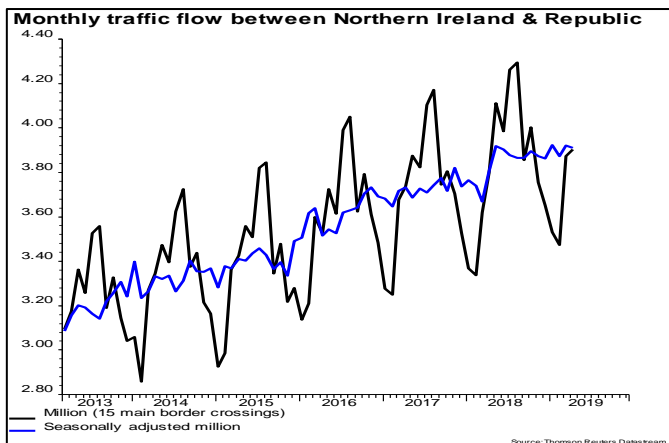
Turning to the UK, the BoE’s clear guidance at the time of the May Inflation Report was that the market was, on a 3-year view, not pricing in enough for interest rate rises. Indeed, based on what the market was pricing in for interest rates, the BoE saw a significant overshoot of inflation relative to target. In some ways, more importantly, on a 3-year view the BoE put excess demand at 1% of GDP; begging the question why they didn’t raise rates then? This compares with the time when they first raised rates in this cycle (November 2017) when they only had the output gap as having closed over the policy relevant time horizon, and August 2018, the second time they raised rates, when excess demand on a 3-year view was put at 0.5% of GDP. There are parallels with the weeks leading up to the November 2017 UK rate decision, when the market had put the odds of a rate rise as very low, despite the BoE consistently stepping up the rhetoric.

True, UK GDP fell by almost 0.5% in April, having effectively flatlined in March, but this followed a stronger than expected 0.5% GDP print in Q1, production shutdowns being brought forward and is consistent with the stockpiling ahead of the 29 March Brexit deadline being unwound. According to the BoE this might be a common theme across other EU economies as well, perhaps partly explaining the weakness of some IP data in April. Moreover, latest labour market statistics show, in a world where UK investment spend has been put on hold, total hours worked continuing to rise, along with regular pay picking up year-on-year. As BoE External MPC Member Michael Saunders highlighted in his last speech *“I want to stress that the MPC does not have to necessarily have to keep rates on hold until all Brexit uncertainties are resolved.”*



At the time of writing we do not know who the next Prime Minister of the UK will be, nor how serious they might be in running towards a No Deal scenario. There is an argument that government and business may be less well prepared for a No Deal than on 29 March (see [here](#)), partly a product of churn at the more senior levels of the civil service. One thing is clear, the Irish border issue is not going away (see chart).

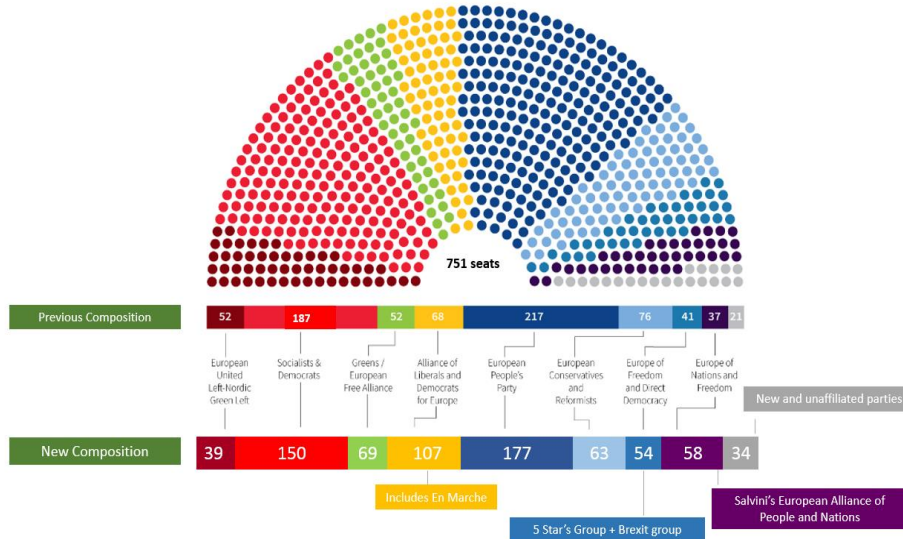
We would also stress the importance of net foreign buying of the UK gilt market in helping finance the UK current account deficit (last put at 4.4% of GDP), along with significant UK net selling of foreign equities in 2018. In a No Deal scenario the BoE has been quite clear in its guidance; one cannot simply assume a rerun of what happened in 2016, the BoE may actually raise rates, it all depends. However, before we get there, we are likely to see a vote of No Confidence in the government and political risk spiking. What happens next is almost anyone’s guess.



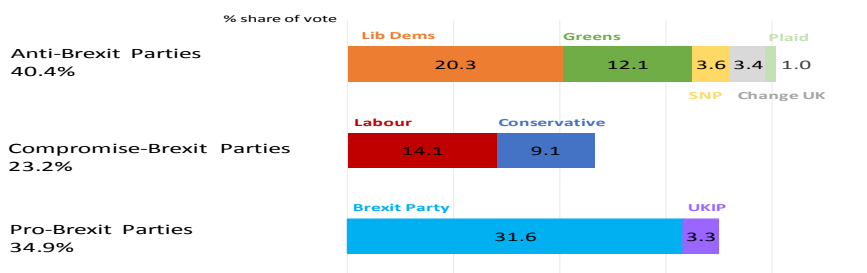
European Election and ECB Presidency

The European Parliament elections failed to deliver the political earthquake that some had feared, but with no clear winners, the political landscape in Europe is changing – something that became quickly apparent in the early discussions over the allocation of top jobs in the EU. In terms of the broad themes, the Greens, the Liberals and populist parties all picked up voter support and, depending on the country, that initially became the focus of attention. In Germany, the Greens outperformed expectations; in France, Macron’s En Marche coalition came a close second to Marine Le Pen’s RN but performed better than expected; in Italy, the main story is the surge in support for LN, fuelling speculation of an early general election. Meanwhile, in the UK, the performance of the Brexit Party was the most eye-catching result and yet, when compared with the aggregate vote of the parties running on a strong pro-EU message, as in the 2016 referendum itself, little separates the two sides (see second chart below). One encouraging development was improved voter engagement, with sharply increased participation in Germany, France, Spain and Poland, and the overall level of voter turnout hitting the highest level since 1994. In aggregate, while there may not have been an obvious set of winners, the losers – in the UK and across the EU – were the main centre-right and centre-left parties. For the first time in history, the EPP and the S&D will combine to hold less than a majority of seats in Parliament.

Composition of EU Parliament: current vs projected



UK's 2019 EU Election results



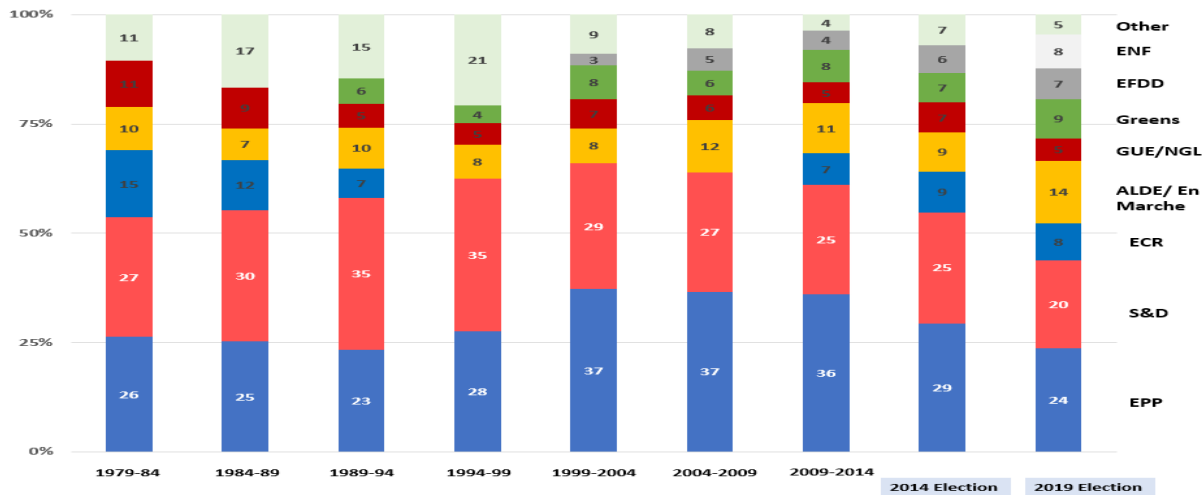
Source: European Parliament and Jefferies International

Jefferies Fixed Income

Voter turnout: EU Parliament vs last main national elections

	European Elections					Last Presidential or Parliamentary Elections
	1999	2004	2009	2014	2019	
Germany	45	43	43	48	61	76
France	47	43	41	42	50	75
UK	24	39	35	36	37	69
Italy	70	72	65	57	55	73
Spain	63	45	45	44	64	74
Poland			25	24	46	55
Romania		29	28	32	51	64
Netherlands	30	39	37	37	42	82
Belgium*	91	91	90	90	88	89
Czech Rep		28	28	18	29	62
Greece*	70	63	53	60	58	64
Hungary		39	36	29	43	70
Portugal	40	39	37	34	31	56
Sweden	39	38	46	51	53	87
Austria	49	42	46	45	59	80
Bulgaria			39	36	31	56
Denmark	50	48	60	56	66	86
Slovakia		17	20	13	23	60
Finland	30	39	39	39	41	69
Ireland	50	59	59	52	49	65
Croatia				25	30	59
Lithuania		48	21	47	53	51
Latvia		41	54	30	34	55
Slovenia		28	28	25	28	53
Estonia		27	44	37	38	64
Cyprus*		73	59	44	45	74
Luxembourg*	87	91	91	86	84	90
Malta		82	79	75	73	92
EU	50	45	43	43	51	

Seat shares in past EU Parliament elections and after this election



Source: European Parliament and Jefferies International

Now, attention turns to the top jobs across the EU institutions and, as seemed likely would happen, the German and the French governments are at odds with regards to how these should be allocated. The immediate question is who should replace Jean-Claude Juncker as the President of the European Commission. Fundamentally, the disagreement pins the EU Parliament against the Council (the leaders of the 28 member states), with Emmanuel Macron arguing that the Council that should have control over the appointment, while the Parliament is trying to assert its supremacy.

Jefferies Fixed Income

For example, in the current context, should the ECB respond to sharply lower market inflation expectations, or ignore them?; should it keep its “below, but close to, 2%” inflation target or adjust it, and if it to be adjusted, then in what direction?; if there is a need to provide more stimulus, does the ECB have the room to expand QE, or is the 33% limit on its sovereign bond holdings really a binding constraint beyond which it will stray into the murky waters of monetary financing?; or what if the ECB kept the 33% limit, but adjusted its guidance to say that QE reinvestments will carry on for the next 5 years, or what if they said reinvestment will carry on for the next 25 years; should the ECB move on to target nominal GDP rather than inflation?; should it try to make up for a persistent undershoot of inflation in recent years by aiming for a period of inflation overshooting the target for a time.

These questions, amongst many others, will need to be addressed whoever ends up replacing Draghi. And while the markets will certainly be more anxious if the review process is led by Weidmann as opposed to some of the other candidates on the radar, it’s naive to think that the next eight years of ECB presidency will look anything like the past eight years.

In terms of the timing, as a reasonable guess, the allocation of the main jobs in the EU, including the one at the ECB, could begin at the European Council Summit taking place on 20-21 June. In the meantime, all eyes remain on the future of Manfred Weber.

Draghi's balancing act offers something for everyone

In a performance that sums-up his term at the ECB, Draghi delivered something for everyone at the June press conference. As expected, the overall message was not fundamentally different from the meetings earlier in the year: the recovery is fragile and the risks around the outlook are high, low inflation is a worry, and the euro area continues to require a substantial degree of policy accommodation. In fact, much of the latest press conference was spent by Draghi reiterating that the ECB still has plenty left in its arsenal to support the economy if it becomes necessary. From introducing tiering and cutting rates further to restarting QE, every option has been discussed and remains on the table. And yet, when all was said and done, the measures announced in June were clearly less dovish than some had expected, with Draghi firmly pushing back against the market's speculation that the ECB was preparing to take further easing steps.

In terms of meaningful actions taken, the ECB's new forecasts, its forward guidance and the conditions of the new TLTRO appear to be designed almost as a direct challenge to the markets which have become entirely preoccupied with the idea that the global economy is on a brink of a recession. Much will clearly depend on whether the US-China dispute escalates from here, and the ECB may yet reverse course. But, at the moment, rather than panicked, the ECB appears almost bemused that market sentiment and perceptions of where rates could go from here seem to be driven by a single issue of a trade dispute which doesn't directly involve the euro area.

As an acknowledgment of the fact that risks around the outlook remain elevated and are unlikely to dissipate quickly (Draghi made the point that while in March there was some hope the US/China and Brexit could be resolved quickly, this is not the most likely outcome anymore), the ECB amended its forward guidance and extended the time horizon for interest rates to remain at their present level "through the first half of 2020". The key takeaway here, of course, is that this wording directly pushes against the prospect of rates being cut over this period, which is what the markets were starting to price in. Mid-2020 also provides Draghi's successor with a Goldilocks (not too long, not too short) period before further changes to guidance may need to be announced. Unless there is big shift in the ECB's thinking (and it is forced to cut rates this year after all), the Governing Council could now sit on its hands for the next six months until the new President steps in and chairs the December meeting.

In terms of the forecasts, as expected, 2019 GDP numbers were bumped up a touch on the back of better than expected growth in Q1; while core inflation numbers for this year were revised down. More importantly, however, the ECB left its 2020 and 2021 core inflation forecasts unchanged. This is an important development as far as the new ECB Chief

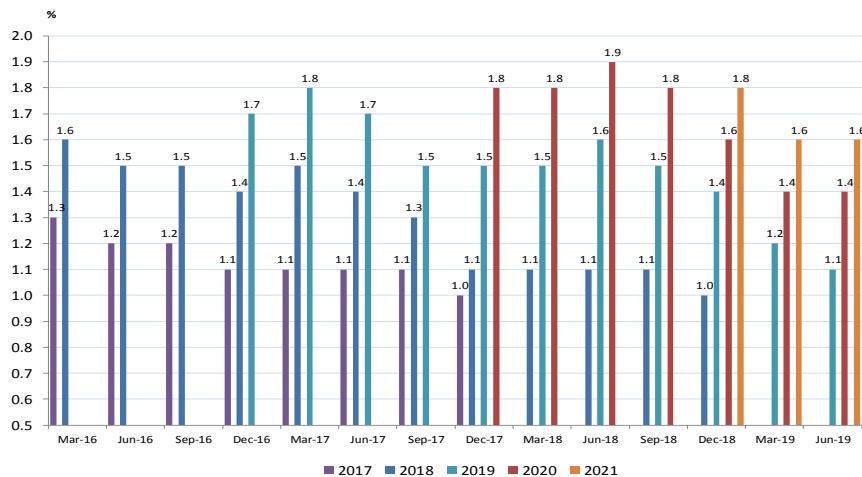
Jefferies Fixed Income

Economist Philip Lane putting down a marker: the markets should pay less attention to its own measures of inflation expectations, and more attention to the fundamentals such as falling unemployment, stronger wage growth, as well as broader measures of inflation such as the GDP deflator. For instance, the recently published Q1 data showed that, in aggregate, euro area GDP deflator had now risen by 0.4% QoQ in each of the last four quarters - this compares to readings of 0.2%-0.3% in the previous three plus years. Also, in Q1, both the French and the Italian GDP deflator printed the strongest reading since 2015. And the German GDP deflator is now at over 2% YoY for the first time since Q1 2015. This will not be on the market's radar but will matter to the Governing Council and help give it confidence that inflationary pressures in the economy are building.

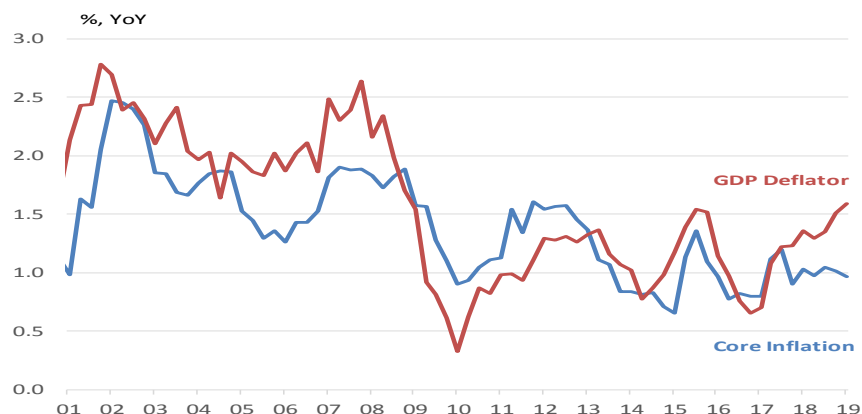
ECB's new quarterly forecasts

GDP		2019 Range	Mid-point	2020 Range	Mid-point	2021 Range	Mid-point
	Dec-17	0.9% - 2.9%	1.9%	0.6% - 2.8%	1.7%		
	Mar-18	0.9% - 2.9%	1.9%	0.7% - 2.7%	1.7%		
	Jun-18	0.9% - 2.9%	1.9%	0.6% - 2.8%	1.7%		
	Sep-18	1.0% - 2.6%	1.8%	0.6% - 2.8%	1.7%		
	Dec-18	1.1% - 2.3%	1.7%	0.8% - 2.6%	1.7%	0.5% - 2.5%	1.5%
	Mar-19	0.7% - 1.5%	1.1%	0.7% - 2.5%	1.6%	0.5% - 2.5%	1.5%
	Jun-19	0.9% - 1.5%	1.2%	0.5% - 2.3%	1.4%	0.4% - 2.4%	1.4%
HICP Inflation							
	Dec-17	0.7% - 2.3%	1.5%	0.8% - 2.6%	1.7%		
	Mar-18	0.6% - 2.2%	1.4%	0.8% - 2.6%	1.7%		
	Jun-18	1.0% - 2.4%	1.7%	0.9% - 2.5%	1.7%		
	Sep-18	1.0% - 2.3%	1.7%	0.9% - 2.5%	1.7%		
	Dec-18	1.1% - 2.1%	1.6%	0.9% - 2.5%	1.7%	0.9% - 2.7%	1.8%
	Mar-19	0.9% - 1.5%	1.2%	0.8% - 2.2%	1.5%	0.8% - 2.4%	1.6%

Core inflation forecasts unchanged in 2020 and 2021



Euro area core inflation and GDP deflator



Source: ECB and Jefferies International

With regards to the new TLTRO, the ECB delivered exactly what it said it would deliver earlier in the year – offering banks loans on less generous terms than in 2016. A 10bp increase in the rate it will potentially charge on the TLTRO-III loans is immaterial, but the signalling effect this provides should not be overlooked. This a modest tightening in policy (although the ECB will dispute this), at a time when the markets were becoming convinced the ECB is on the verge of moving in the opposite direction.

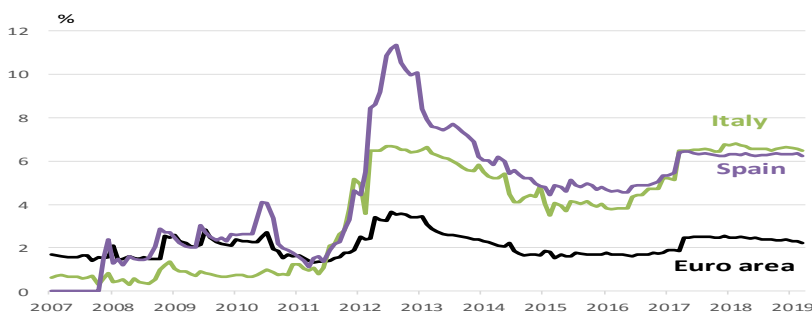
However, in terms of how much the banks will ultimately end up borrowing from the ECB compared to the current take up (see data below on how much they currently borrow through LTROs and MROs) and at what rate, we won't know for some time.

Eurosystem assets (LTRO+MRO loans) and liabilities (bank deposits with the National Central Banks)

NCBs' Assets																											Change since QE	
	Dec-11	Dec-12	Dec-13	Dec-14	Jan-15	Feb-15	Mar-15	Dec-15	Dec-16	Dec-17	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	Nov-18	Dec-18	Jan-19	Feb-19	Mar-19	Apr-19	May-19	started
Germany	56	73	52	66	43	37	37	57	66	93	93	93	93	93	93	93	92	92	89	88	88	88	88	88	88	87	86	49
France	218	234	127	138	138	126	128	140	107	149	163	168	156	166	162	149	157	154	150	150	154	112	112	112	112	112	112	-14
Italy	210	272	236	195	163	141	166	158	204	252	251	250	250	248	247	245	245	243	243	244	244	244	243	243	243	243	239	98
Spain	132	357	207	141	141	132	124	133	151	173	172	171	171	171	171	169	169	170	169	169	170	169	167	167	167	167	167	35
Netherlands	10	27	11	14	13	13	13	16	19	32	31	32	32	31	31	30	30	30	30	30	31	31	30	28	28	28	28	15
Belgium	40	40	16	12	9	6	7	8	14	24	24	24	24	24	24	24	24	23	23	23	23	23	23	23	23	23	23	16
Austria	16	18	8	14	14	14	14	16	13	22	21	21	21	21	21	21	22	21	21	22	21	23	22	23	20	20	20	6
Greece (including ELA)	77	121	73	56	87	104	108	108	67	34	29	26	25	22	21	16	13	13	12	13	12	11	10	9	8	8	-96	
Portugal	46	53	48	31	28	28	28	26	22	22	22	22	22	22	22	20	20	20	19	19	19	19	19	19	19	19	-9	
Ireland	151	111	37	21	19	19	20	10	7	7	7	7	7	7	7	5	5	5	3	3	3	3	3	3	3	3	-16	
Eurosystem total	643	1114	717	592	580	489	538	558	595	764	763	762	762	762	759	758	743	743	732	733	733	733	730	729	729	725	719	230

Monetary Financial Institutions deposits with the National Central Banks (€, bn)																										Change since QE		
NCBs' Liabilities	Dec-11	Dec-12	Dec-13	Dec-14	Jan-15	Feb-15	Mar-15	Dec-15	Dec-16	Dec-17	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	Nov-18	Dec-18	Jan-19	Feb-19	Mar-19	Apr-19	May-19	started
Germany	229	300	142	90	76	77	116	209	411	610	630	639	633	635	673	653	618	661	644	621	658	594	607	640	640	663	687	610
France	176	195	112	113	73	77	120	222	339	501	482	468	415	415	445	434	462	502	449	502	490	514	525	525	470	484	407	
Italy	34	28	21	15	18	10	13	24	72	143	139	119	117	129	89	86	70	68	91	97	89	89	63	91	91	100	83	
Spain	51	72	31	18	12	9	12	28	55	114	96	84	105	106	108	111	111	124	114	114	120	128	130	116	116	111	120	111
Netherlands	176	158	75	51	27	42	40	115	172	171	235	238	221	253	246	198	257	256	225	215	216	179	205	205	205	185	199	157
Belgium	23	20	14	11	8	10	10	25	51	65	89	94	89	98	99	92	95	96	102	112	115	60	102	95	95	78	112	102
Austria	55	63	54	43	46	46	48	52	59	48	48	48	48	48	48	48	48	48	48	48	48	48	48	45	45	39	50	4
Finland	72	64	28	15	13	14	21	45	47	77	102	110	97	103	97	93	97	88	99	85	87	75	97	105	105	107	89	75
Ireland	6	4	4	4	3	3	4	11	19	23	18	18	25	25	24	27	23	24	23	24	21	23	21	22	22	23	20	
Luxembourg	51	39	25	17	17	14	19	57	97	103	106	103	108	118	112	138	126	122	131	133	126	120	128	127	127	123	130	116
Eurosystem total	681	940	443	300	264	272	357	768	1313	1961	1998	1959	1926	1984	1968	1955	1950	1979	1951	1997	1986	1913	2015	2021	2021	1948	2038	1766

LTRO+MRO loans as share of banks assets in Italy and Spain



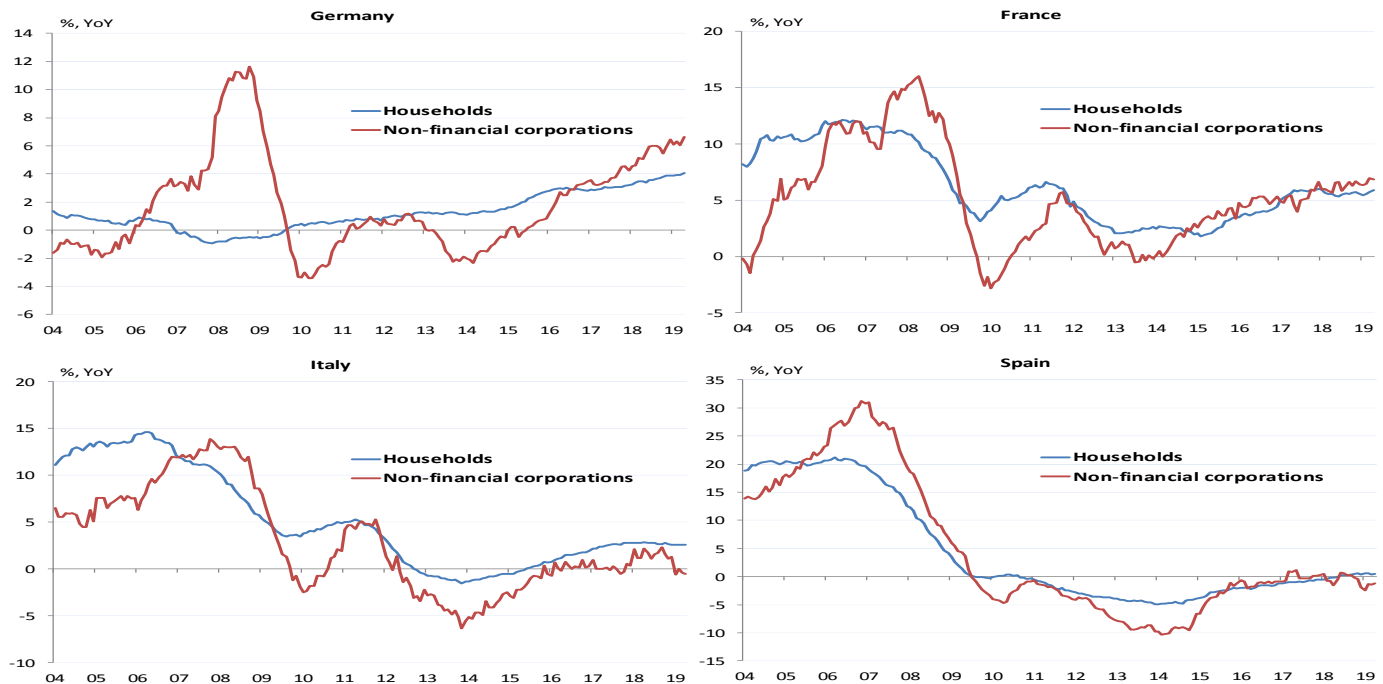
Source: ECB and Jefferies International

For point of reference, it is worth noting that the banks who participated in the TLTRO-II ended-up borrowing from the ECB at a weighted average interest rate of -0.365%. Thus, while some banks borrowed at a rate of -0.40%, others couldn't get to that level because they didn't hit their lending targets. Similarly, when it comes to judging the generosity of the ECB's new programme, much will depend on the lending targets that the banks will be asked to meet.

The broad terms of the ECB’s new offer are very similar to those given in 2016, and state that, “Counterparties will receive the maximum rate reduction if they exceed their benchmark stock of eligible loans by 2.5% as at 31 March 2021. Below this limit, the size of the decrease in the interest rate will be graduated linearly depending on the percentage by which a counterparty exceeds its benchmark stock of eligible loans. For counterparties that exhibited positive eligible net lending in the 12-month period to 31 March 2019, the benchmark net lending is set at zero. For counterparties that exhibited negative eligible net lending in the 12-month period to 31 March 2019, the benchmark net lending is equal to the eligible net lending in that period.”

Importantly, however, as the charts below show, lending growth across the euro area in 2018 was substantially stronger than in 2015. Therefore, some banks may find it harder to exceed their benchmarks than the last time around.

Bank lending growth across the euro area



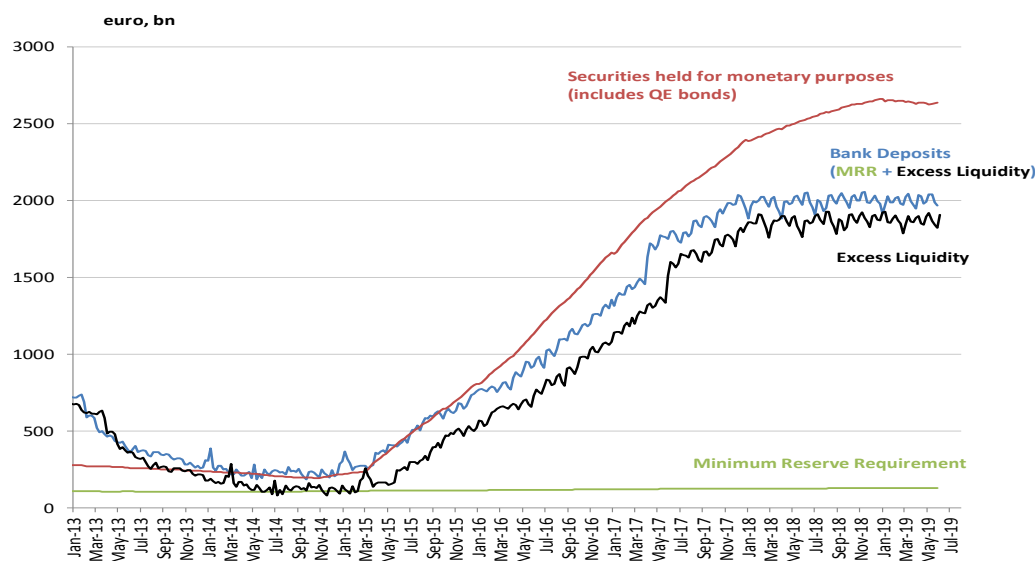
Source: ECB and Jefferies International

With regards to the idea of potentially tiering the deposit rate as a way of mitigating some of the effect of negative interest rates on banks, for now, the Governing Council is holding off. It did push out its interest rate guidance from end-2019 to mid-2020, however, the ECB kept the language that “interest rates to remain at the present levels”, whereas it could have opened the door to tiering by saying something along the lines of “interest rate to remain at present or lower levels”. This could be an important amendment to keep an eye on in the coming months.

Jefferies Fixed Income

In terms of how tiering could be structured and what it would achieve, the table below shows how it could be structured around the Minimum Reserve Requirement that the banks currently hold with their National Central Banks (if the ECB decided not to apply the -0.40% rate on, say, 10 times the MRR amount) and how much it would benefit the individual banking systems in the euro area. The main beneficiaries would be the banks in Germany, France, the Netherlands, Belgium and Finland; whereas the banks in Italy – where deposits with the National Central Bank are relatively small – would see a smaller benefit. If tiering were to be introduced, it would be seen as not just a reflection of a lower-for-longer stance, but also a steer that the main deposit rate has further to fall.

QE and ECB’s excess liquidity



What the ECB could achieve if it based tiering around banks’

Minimum Reserve Requirement deposits

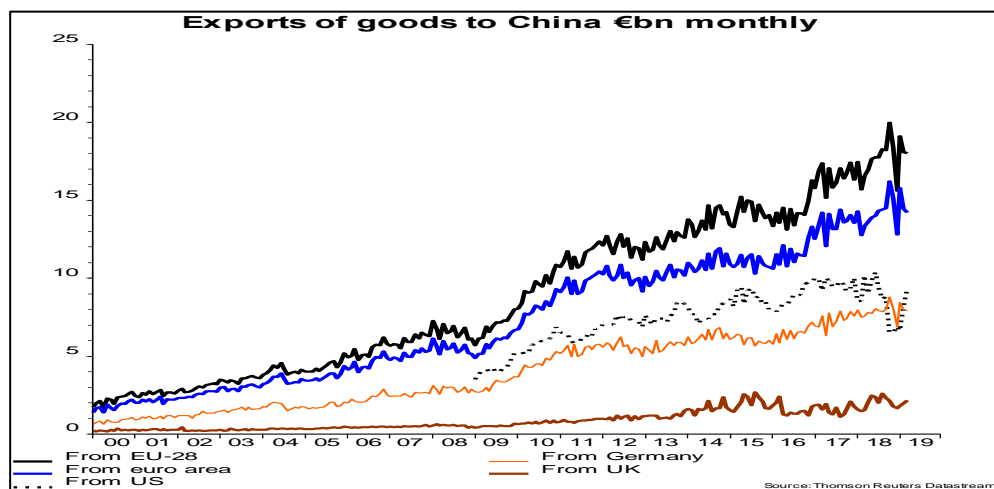
	Total Deposits with domestic NCBs (euro, bn)	Annual cost of minus 0.4% Deposit Rate (euro, bn)	Minimum Reserve Requirement (MRR) (euro, bn)	Benefit to banks when Tiered Deposit Rate is offered at 0% on MRR / or 10x MRR	
				on MRR (euro, mn)	10 times MRR (euro, mn)
Germany	687	2.61	35.6	142	1424
France	484	1.84	22.7	91	908
Italy	93	0.33	11.5	46	373
Spain	120	0.43	12.8	51	512
Netherlands	199	0.80			
Belgium	112	0.45			
Austria	50	0.19	3.9	16	156
Finland	89	0.34	2.9	11	114
Ireland	23	0.09			
Luxembourg	130	0.48	10.1	40	404
Eurosystem total	2038	7.64	128	512	5120

Source: ECB and Jefferies International

Trade wars versus Trade diversion: Benefiting the EU?

To be clear, we are not advocating tariffs as the way forwards. This is very different to the 19th century when, following the industrial revolution, many of today's developed economies took advantage of substantial tariffs to further consolidate their position and take market share (see Ha-Joon Chang's "*Kicking away the ladder*"). It is just that they create winners amongst the losers, with both the ECB and the UN recently suggesting that the EU, the biggest trading bloc globally, could benefit from trade diversion. This seems to have been lost amongst all the negativity surrounding the subject, especially important if the ECB has a different read on the challenges than many other commentators and market participants.

But we start with the latest data releases. These suggest a still relatively robust economy more generally, with euro area nominal household income growth of around 4% (employment growth of 1.3%, and compensation per employee growth of over 2%), with output gains led by the service sector. Outside the euro area Poland grew by 4.7% in the year to the first quarter, Romania by 5.1% and Hungary by 5.2%. True, there remains significant divergence in the growth rates of the euro area and many of the countries in its immediate orbit. But, nominal household income growth of around 4% and the service sector output printing gains of still close to 2% strongly suggests that all the recession talk of only a few weeks ago was completely misplaced. It should also cast further doubts on the ability of surveys to correctly read the ups and downs of the economic cycle since the financial crisis.



So, what of trade wars and trade diversion?

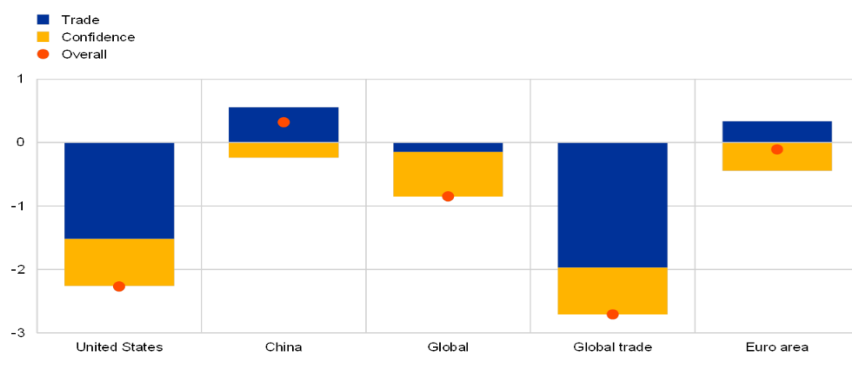
For starters, we would highly recommend taking a look at the ECB's "*The economic implications of rising protectionism: a euro area and global perspective*" from only last month, see [here](#).

Jefferies Fixed Income

In particular, this contained the estimates below, showing the US coming off a lot worse than China, but also the euro area. Much depends on how much diversion there is, away from the US & China, to the EU & China, and the EU & the US. Trade is not a zero sum game, & operates through complicated global supply chains, which given their complexity we actually know little about. Also, much will ultimately depend on whether, after China, the US administration’s focus switches more to the EU & the impact may, depending on the eventual tariffs and trade restrictions imposed, very much be non-linear and unpredictable.

Estimated impact of an escalation in trade tensions – first-year effects

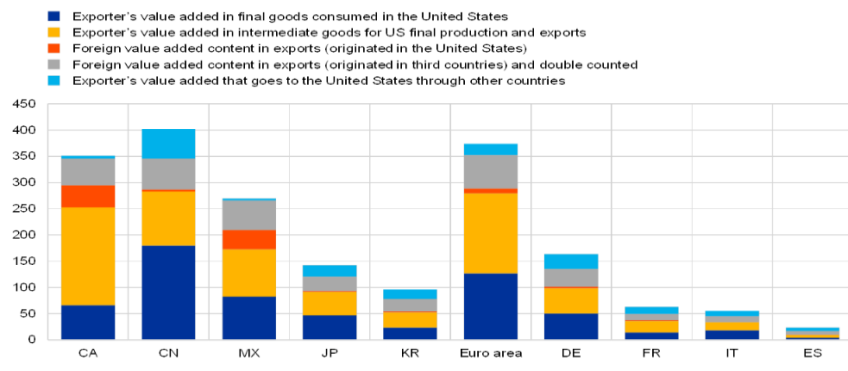
(GDP response, deviation from baseline levels; percentages)



Source: ECB calculations.
Notes: The results are a combination of the direct trade effects derived from the GIMF model and the confidence effects modelled using the ECB’s global model.

Production chain linkages in exports to the United States

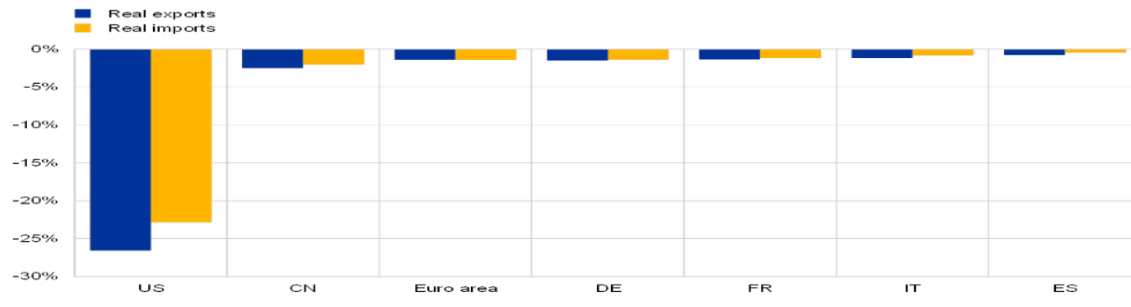
(USD billions)



Sources: World Input-Output Database (2016 release), Wang, Z., Wei, S.J. and Zhu, K., (2013), “Quantifying International Production Sharing at the Bilateral and Sector Levels”, *NBER Working Papers*, No 19677, National Bureau of Economic Research, November 2013, and ECB staff calculations.

Estimated impact of an escalation in trade tensions on trade – long-term effects

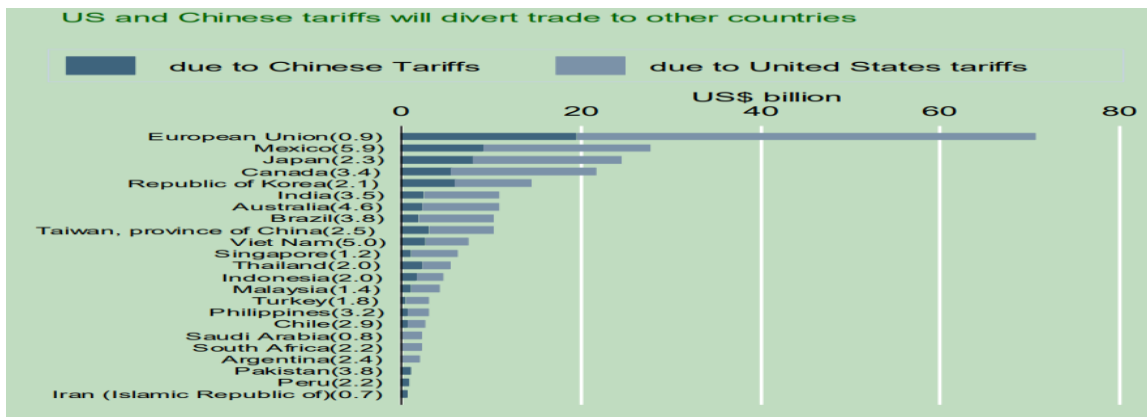
(deviations from current real trade as a percentage)



Sources: World Input-Output Database (2016 release) and ECB staff calculations.
 Notes: Changes in total real exports and imports have been aggregated from changes in sector-level real bilateral trade by using shares of corresponding nominal values. Nominal bilateral sector-level trade changes have been deflated by the respective price changes. The euro area includes both intra- and extra-euro area trade. CN is used as an abbreviation for China.

Source: Non-financial corporations (NFCs) in the Dow Jones Euro Stoxx 300 index.
 Notes: The sample consists of NFCs in the Dow Jones Euro Stoxx 300 index and varies over time owing to data availability. The measure shown is the year-on-year percentage change in investment-to-total-asset ratio, defined as the ratio of capital expenditure to total assets. NFCs are grouped on the basis of whether they are positively (blue) or negatively (yellow) affected by the threat of tariffs in the simulations.

However, the ECB’s analysis - please also see charts above – concurs with an earlier study by the UN that argued that the EU was set to benefit most through trade diversion, both directly (see chart below) and through supply chains. Note this study was from February “Trade Wars: The Pain and the Gain” see [here](#).



Source: UNCTAD secretariat calculations.

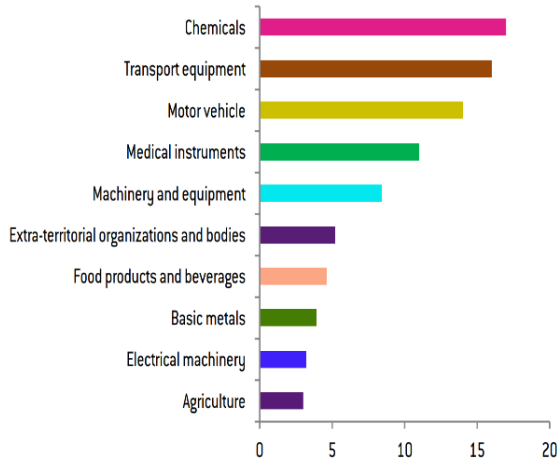
The ECB study also suggested that the escalation in trade tensions had already had an impact on the investment decisions of firms, with firms potentially positively impacted by tariffs pushing ahead with investment. The Brussels based think-tank Bruegel has also written on the subject, partly examining how politically the EU should best position itself to take advantage of the current situation but also to minimize the potential downside risk. In a recent report “Europe in the midst of China-US strategic economic competition: What are the European Union’s options?” they, for example, showed how China’s top imports by sector from the US were

Jefferies Fixed Income

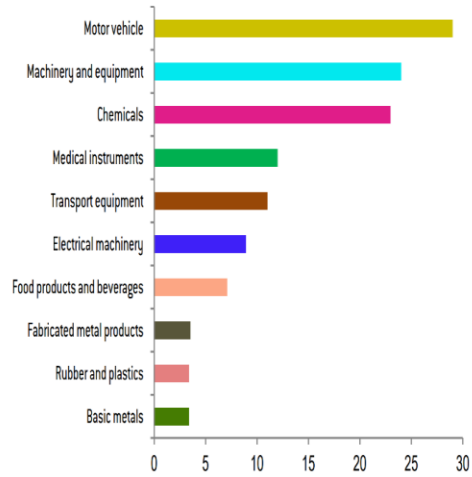
similar to those from the EU and estimated potential trade gains for the EU with China as well as with the US see [here](#), and charts below.

China's top 10 imports(\$ billions)

From the US in 2016



From the EU-5 in 2016

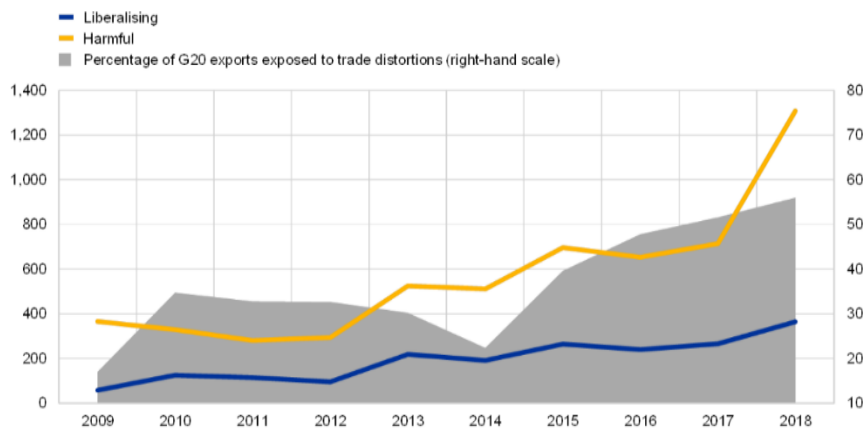


Source: Alicia Garcia Herrero, Bruegel Working Paper April 2019

In broad-brush terms, the Bruegel analysis is consistent with the earlier UN study. In round numbers, depending on what exactly happens, trade division could be equivalent to around 1% of EU GDP (the EU-28 is almost

[New trade measures announced](#)

(left-hand scale: number; right-hand scale: percentages)



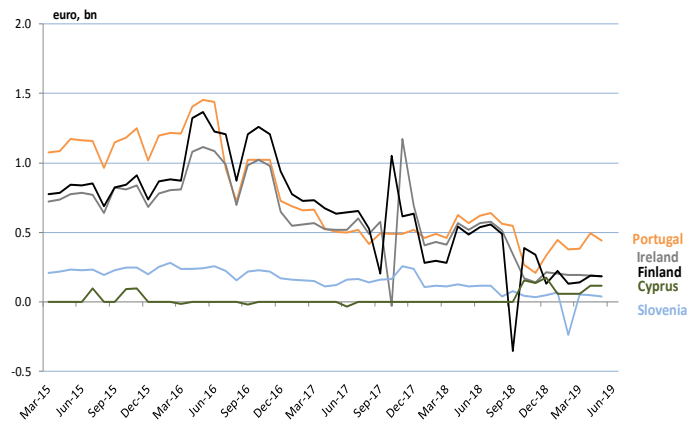
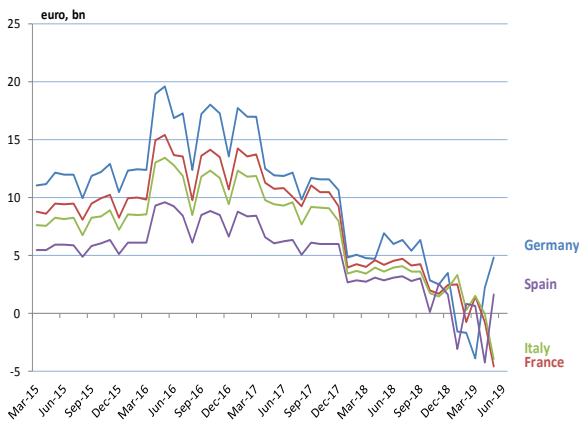
Source: Global Trade Alert database.

a \$20 trillion economy). Clearly, the eventual impact on GDP could be very different, especially in a world of heightened uncertainty and the risk of a hard Brexit. But it is important to recognize that the ECB's view of the current situation may be very different to many other commentators, and market participants, who may be looking at things very much through the prism of the US.

QE reinvestments and capital key

One market related topic which is not getting enough attention in our view is the ECB's reinvestment policies. As the first set of charts below shows, while officially QE has come to an end at the end of last year, through the first five months of the year holdings of sovereign debt are still rising in some countries (Portugal) and appear to be falling in others (Spain). In some instances the explanation is fairly simple – these movements are primarily down to the fact that the National Central Banks are smoothing their reinvestment purchases throughout the year. So, on our estimates (see tables below) the Bank of Spain might have had in the region of €11bn in bonds to reinvest between January and April, but it reinvested only perhaps €7-8bn so far.

Net monthly PSPP flows by country



Government bond redemptions & estimated PSPP reinvestments

Government bond redemptions													
euro, bn	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Redemptions in 2019
Germany	24	16	13	16	-	13	24	-	13	16	-	13	148
France	-	11	-	29	17	-	12	-	-	42	22	-	133
Italy	-	23	24	11	28	-	-	15	41	27	12	15	195
Spain	18	-	-	22	-	-	21	-	-	21	10	-	92
Netherlands	15	-	-	-	-	-	14	-	-	-	-	-	29
Belgium	-	-	10	-	-	-	-	-	12	-	-	-	22
Austria	-	-	11	-	-	7	-	-	-	7	-	-	26
Portugal	-	-	-	-	-	9	-	-	-	-	-	-	9
Finland	-	-	-	-	-	-	5	-	-	-	-	-	5
Ireland	-	-	-	-	-	7	-	-	-	6	-	-	13
Total	57	50	58	78	44	36	76	15	65	119	44	28	671
Our estimate of gov't bond PSPP redemptions to approximately match ECB data													
euro, bn	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Redemptions in 2019
Germany	6	4	4	4	-	4	6	-	4	4	-	4	40
France	-	3	-	7	4	-	3	-	-	10	5	-	31
Italy	-	4	4	2	5	-	-	3	8	5	2	3	36
Spain	5	-	-	6	-	-	5	-	-	6	3	-	24
Netherlands	4	-	-	-	-	-	4	-	-	-	-	-	8
Belgium	-	-	2	-	-	-	-	-	2	-	-	-	4
Austria	-	-	3	-	-	2	-	-	-	2	-	-	7
Portugal	-	-	-	-	-	2	-	-	-	-	-	-	2
Finland	-	-	-	-	-	-	1	-	-	-	-	-	1
Ireland	-	-	-	-	-	1	-	-	-	1	-	-	3
Total estimated gov't bond redemptions	15	11	13	19	9	9	20	3	13	28	10	6	156
ECB PSPP redemptions (including SSA and non-sovereign debt)	21	9	11	21	15	7	17	5	10	29	13	9	167

Source: ECB and Jefferies International

Jefferies Fixed Income

The markets may not have taken great notice of these developments, but any overbuying/underbuying done so far is actually part of a bigger story related to the ECB's capital key weights. Take the example of Italy for instance. As the table below shows, as of end of May, there was around €366bn of Italian government debt being held in the PSPP portfolio, when the amount that 'should' be held to match the capital key is around €342bn. Going forward, therefore, only a proportion of future redemptions will be reinvested back into the market. And so, while Italy has effectively enjoyed disproportionately strong support from the PSPP reinvestment operations in the first few months of the year, this will not last. On the flip side, as we continue to highlight, is the case of Portugal. In the first five months of the year, average monthly buying of paper there was €428mn, compared to €480mn in 2018, and so from the market's perspective QE there carries on as before. Also, using Portugal as a potential guide, it seems that the ECB is aiming to close the gap between actual PSPP holdings and holdings implied by the capital key (which are still around €8.5bn higher) in about two years. This timeline becomes important not only for Portugal, but of course also for Italy and Spain where holdings within the PSPP will end up being adjusted lower more rapidly than may be commonly realised.

PSPP purchases and deviations from 2019 capital key

	Actual purchases (euro, bn)	Implied by capital key weighting excluding Greece (euro, bn)	Difference: actual vs implied (euro, bn)
Germany	518	532	-13.6
France	418	411	6.8
Italy	366	342	24.6
Spain	257	242	15.1
Netherlands	115	118	-3.2
Belgium	74	73	0.4
Greece	0	50	
Austria	59	59	0.0
Portugal	39	47	-8.4
Finland	34	37	-2.8
Ireland	31	34	-2.9
Slovakia	12	23	-11.3
Slovenia	8	10	-1.8
Cyprus	1	4	-3.2

Source: ECB and Jefferies International

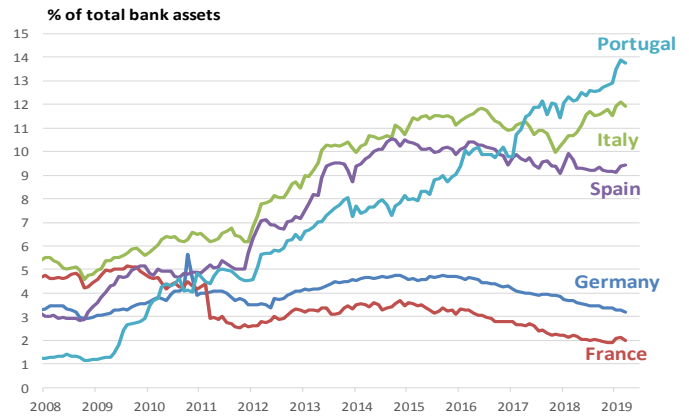
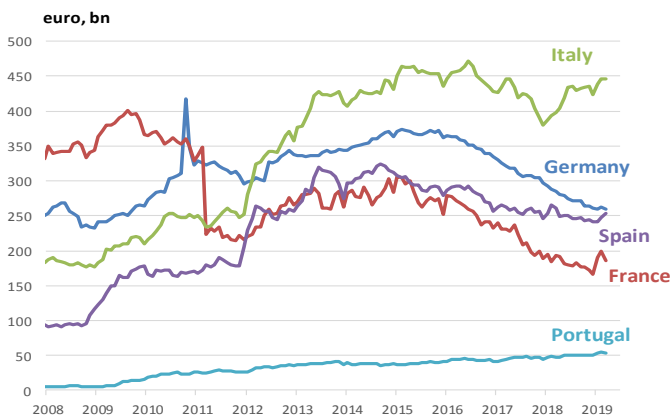
As far as the latest data on the holdings of sovereign debt by domestic banks is concerned, the charts on the next page highlight that as a proportion of total assets, in Italy and in Portugal, these are close to record levels. In part, however, this reflects the fact that other assets such as loans to non-financial corporations are still declining in these economies; while on a more positive note, customer deposits there continue to grow. In other words, it shouldn't really be a surprise that in parts of the euro area where demand for credit is soft, sovereign debt is a sensible alternative investment.

Monthly change in holdings of domestic government debt by euro area banks

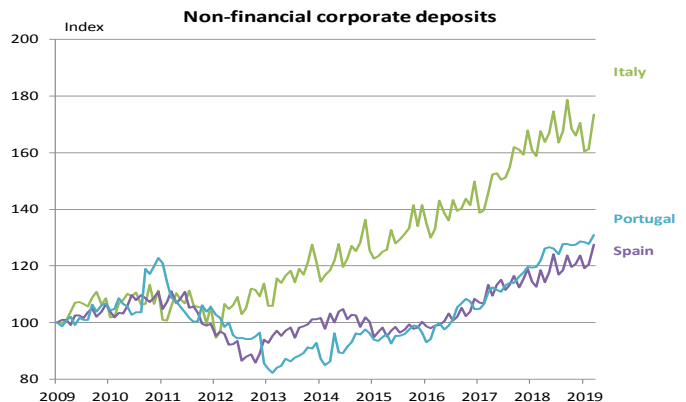
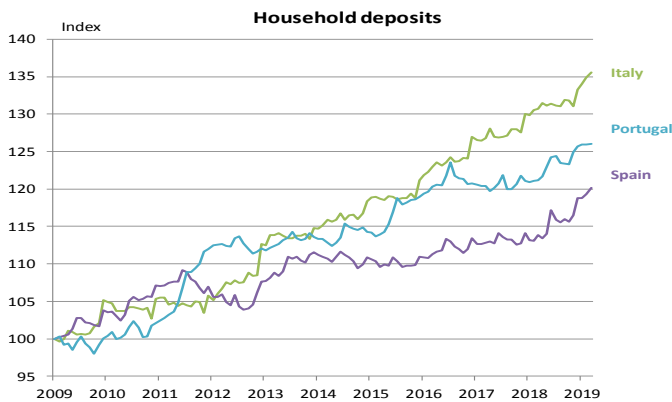
Italy												Spain											
euro, bn												euro, bn											
euro, bn	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	euro, bn	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Jan	7	5	3	23	18	-6	13	6	8	10	11	Jan	6	-7	-2	22	5	16	-1	6	0	2	1
Feb	4	7	-7	23	4	7	4	11	4	3	7	Feb	7	-3	3	15	8	-3	-7	2	5	9	6
Mar	16	7	-9	24	12	1	-7	-7	9	-2	-3	Mar	6	7	4	15	16	2	-1	4	-4	-7	6
Apr	1	8	2	6	8	8	0	6	3	3	7	Apr	8	4	-2	0	-7	-1	-8	1	-4	-12	-10
May	6	13	6	12	19	-3	3	3	-10	28		May	2	5	4	0	19	4	0	-5	-2	8	
Jun	4	4	7	5	11	-6	-5	5	-20	14		Jun	8	3	10	0	17	-3	2	3	-1	0	
Jul	2	-1	11	2	-6	-3	-4	-2	4	4		Jul	-4	-9	-1	-7	-5	-5	-12	-8	-1	-4	
Aug	1	-5	4	-6	-2	2	-1	-13	-2	0		Aug	1	-2	-8	-4	-4	4	1	-4	2	1	
Sep	8	-1	0	6	-2	-4	-4	-6	-5	0		Sep	8	5	-3	8	-1	2	5	-5	2	1	
Oct	1	0	0	10	-1	20	1	-1	-15	7		Oct	4	1	0	-4	-10	-4	-2	-6	1	-5	
Nov	-3	5	1	2	1	-6	1	-5	-16	3		Nov	4	6	3	5	-11	-6	-1	-2	-3	1	
Dec	-6	-4	-2	-13	-16	-11	-17	-12	-10	-17		Dec	3	0	23	-4	-20	-5	-7	-12	-8	0	

Germany												France											
euro, bn												euro, bn											
euro, bn	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	euro, bn	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Jan	6	4	1	4	-4	-2	2	0	-5	-3	0	Jan	4	-3	0	3	9	5	8	16	-1	10	16
Feb	-1	3	-2	2	1	1	3	0	-5	-3	-2	Feb	6	2	12	9	10	7	0	4	-2	-11	5
Mar	1	5	-1	3	0	0	-2	-3	0	-3	-1	Mar	6	1	2	4	-2	-1	-6	-6	3	4	-9
Apr	6	2	2	0	0	1	0	-2	-3	-3	-4	Apr	1	-4	2	-3	0	-1	0	-2	0	0	-1
May	2	4	1	-3	-5	2	-5	-3	2	-2		May	2	2	-2	3	5	4	0	-2	3	-5	
Jun	3	16	-3	8	2	2	-1	-4	-6	-3		Jun	5	5	8	7	-4	-5	-1	-2	-6	-3	
Jul	1	0	-3	2	3	3	3	2	-4	-1		Jul	0	-2	-8	-5	-21	-10	-5	-10	-8	-2	
Aug	-1	2	-3	2	1	1	4	-4	2	-2		Aug	5	-3	5	1	-1	3	8	-2	2	2	
Sep	5	0	-1	3	-1	1	0	-2	-1	0		Sep	-1	3	2	10	-3	8	-7	-10	0	-6	
Oct	4	105	0	3	3	2	-1	-4	-1	-5		Oct	-5	4	1	5	6	0	-2	4	-6	1	
Nov	2	-65	2	7	2	0	3	0	0	0		Nov	-2	0	4	-3	1	6	0	-1	6	0	
Dec	-1	-21	-8	-8	0	-8	-5	-3	-7	-2		Dec	-11	-12	2	-3	-2	-6	-10	4	-3	-7	

Holdings of government debt by euro area banks (in €bn and as % of total assets)



Bank deposit growth in Italy, Spain and Portugal



Source: ECB and Jefferies International

Time to strengthen the international role of the euro

Which brings us to recent calls for “*Strengthening the international role of the euro: European and international perspectives*” at a meeting in Brussels a few weeks ago (see [here](#)). This follows a key-note speech by Benoit Coeure examining the monetary policy implications for the ECB, if the euro was to take on a greater role, globally (see [here](#)).

The next table on shows how the net external position of the euro area has changed since the ECB started doing outright QE. And, remember that this occurred with the euro area running a substantial current account surplus, in contrast to the US and the UK. QE did lead to the euro area’s holdings of foreign debt rising from 36% of GDP at the end of 2014 to 43% at the end of 2018 (outright QE was conducted between 2015 & 2018), whilst foreign holdings of euro area debt fell from 50% of euro area GDP to 41%. However, this was offset by almost a corresponding rise in the foreign holdings of euro area equities and their direct investments in the euro area, which went slightly into reverse in 2018 as questions over the euro area recovery began to mount. True, compared to the beginning of QE, the euro area has more assets internationally, which going forwards it can draw an income from. And, since end 2014, the net external position of the euro area has improved by almost €800bn. However, this is not the UK of the early part of the last century which had a substantial pool of external assets, with sterling the reserve currency.

What may surprise many commentators is the relatively upbeat nature of some of the papers that were presented in Brussels. For example, even though only around 20% of international official reserves are held in euro-denominated assets (a figure lower than had been hoped at the start of EMU twenty years ago and down from the peaks of over 25%), the currency was viewed as “*widely accepted and used in international payments, almost at par with the USD and increasing.*” Contrary to what is often suggested, global trade invoicing was put by the ECB at 40% in the EUR, 40% in the USD, with only slightly less SWIFT payments in the EUR than the USD. However, there was little doubting that the euro area had lost significant ground in foreign-currency bond issuance and central bank reserve holdings, a development partly blamed on the earlier financial crisis, but also importantly, less financial integration.

12 June 2019

Jefferies Fixed Income

Change in euro area's net external position since the beginning of QE in 2015

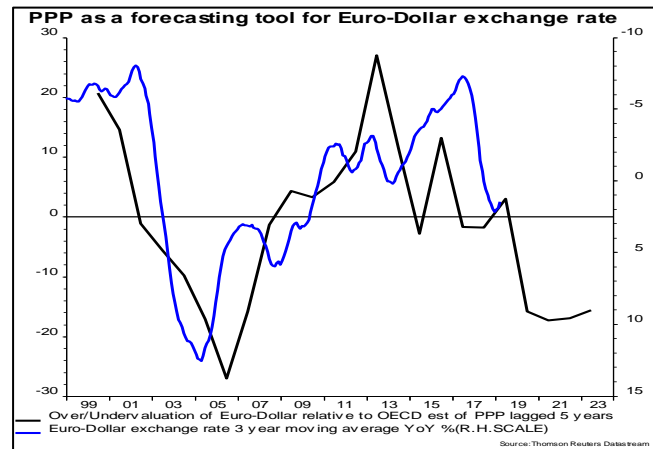
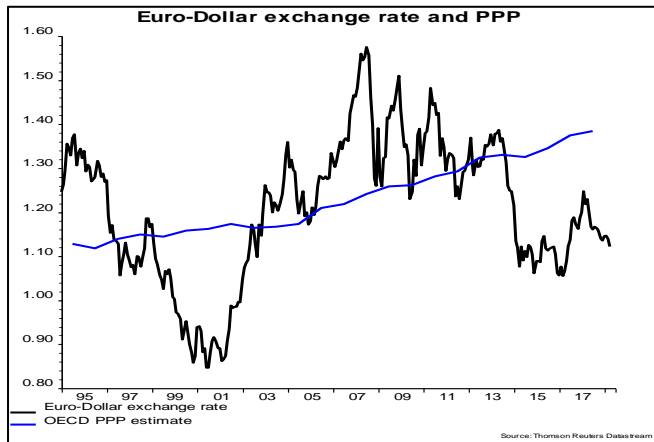
	End-2014		End-2015		End-2016		End-2017		End-2018	
	Euro billions	% GDP	Euro bns	% GDP	Euro bns	% GDP	Euro bns	% GDP	Euro bns	% GDP
Net	-1226	-12	-1220	-11	-789	-7	-794	-7	-437	-4
<i>of which:</i>										
Direct Investment	1812	18	2019	19	2165	20	1830	16	1785	15
Portfolio equity	-1856	-18	-2250	-21	-2290	-21	-2450	-22	-2299	-20
Portfolio debt	-1413	-14	-1190	-11	-555	-5	39	0	342	3
Other Investment	-318	-3	-396	-4	-756	-7	-827	-7	-906	-8
Assets	20796	202	23260	218	24654	225	24985	220	25023	216
<i>of which:</i>										
Direct Investment	8871	86	10575	99	11161	102	10814	95	10563	91
Portfolio equity	2854	28	3056	29	3236	30	3639	32	3435	30
Portfolio debt	3742	36	4191	39	4661	43	4912	43	5032	43
Financial derivatives	-64	-1	-46	0	-62	-1	-56	0	-79	-1
Other Investment	4781	46	4840	45	4950	45	5006	44	5354	46
Reserve assets	612	6	644	6	708	6	670	6	719	6
Liabilities	22022	214	24481	230	25444	233	25778	227	25461	220
<i>of which:</i>										
Direct Investment	7059	69	8556	80	8996	82	8984	79	8777	76
Portfolio equity	4709	46	5307	50	5526	51	6089	54	5733	50
Portfolio debt	5155	50	5382	51	5216	48	4873	43	4691	41
Other Investment	5099	50	5236	49	5706	52	5832	51	6260	54
Gross External Debt	12692	123	13738	129	14171	130	13935	122	14185	123

Source: ECB and Jefferies

Greater reserve currency status for the EUR would be viewed as validation in the EMU project itself, as well as bringing potential benefits in the form of lower financing, transaction & hedging costs, seigniorage and greater monetary policy autonomy, reducing exchange rate pass-through to prices, such that domestically generated inflation becomes more important. And, a common theme now is to question why, as a €300bn annual energy importer, the euro area was still being invoiced in the USD & not in the euro. Fundamental analysis suggests that the euro is certainly undervalued, consistent with the current account surplus that it has been running (see charts).

Moreover, in line with analysis done in the 1970s after the break-up of Bretton Woods, under or over valuation of the euro on Purchasing Power Parity (PPP) tends to lead moves in the exchange rate by between 5-7 years. The relationship is far from perfect and comes with caveats, but this supports the view of a stronger euro area in the years ahead. This might be given a further boost if more economies in the EU-ex UK, that are currently outside the euro, join the single currency bloc. This might act as a further spur to internal growth dynamics, and a reduced role for extra-euro area trade in driving GDP. For such a large bloc of countries linked by a single currency, the euro area is unusually open, in terms of its extra-area trade in goods and services as a share of GDP. As of Q4 2018, this stood at almost 55% in the euro area, effectively double that of the US & almost as high as the UK, making the euro area by far the biggest trading bloc, globally. Coeure suggested that, because of this, the positive spillovers from a

weaker euro to global trade could be greater than seen with a weaker USD, if more trade & credit was denominated in the euro.



GLOBAL FIXED INCOME

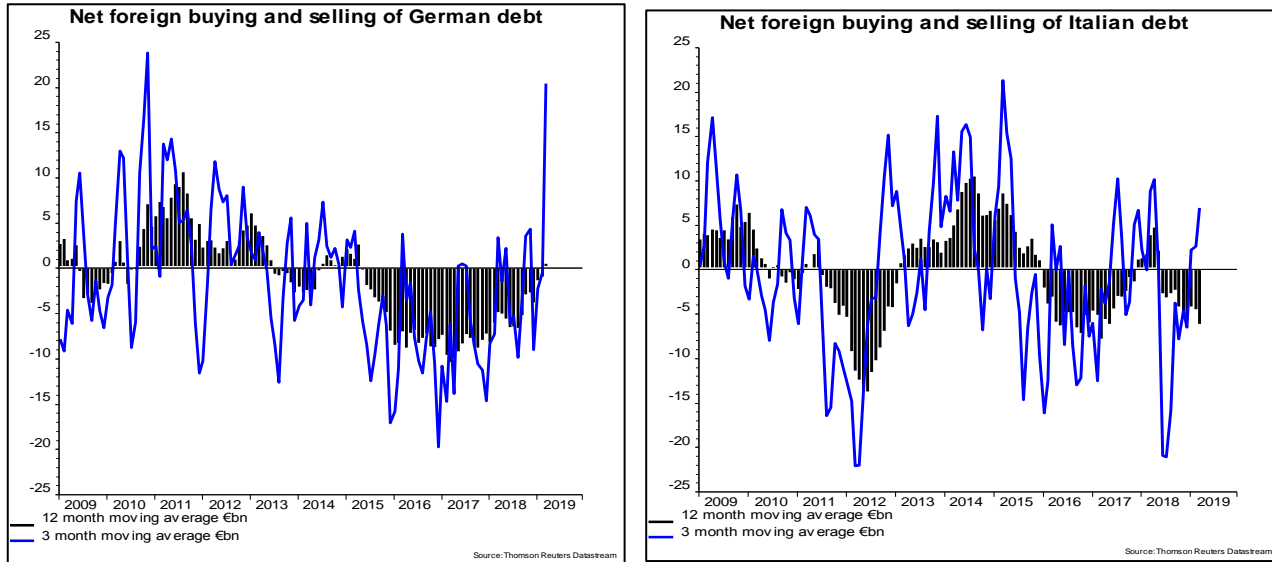
Which brings us to renewed interest in Graham Bishop’s proposal for the introduction of a euro-T bill (see [here](#)). The proposal here is “for a common institution created by participating Eurozone states to purchase the under-two year debt issuance of those states.” Arguably, this would be a far more significant development than the introduction of the TLTRO-3 in September, especially if Italian banks were to simply take use of an additional TLTRO to acquire more sovereign paper. In fact, ECB data on the issuance of very short-term debt suggests that it is much more skewed towards countries like Italy, than Germany. Government debt issuance of less than one-year maturity represents 5.7% of GDP in both Italy and Spain, and 6.8% in Portugal. In all three cases banks holdings of sovereign paper are very high. The equivalent figure for France is also 5.7%, for Greece 8.1%, but for Germany only 1.9% (see table). Taking the first step towards a common bond market in the euro area at the very short end of the curve would reduce fragmentation in the system and increase the demand for euro wide assets. In risk-off phases, spreads would be less likely to widen out significantly. Less financial fragmentation would also likely increase capital flows inside the system and lead to a better allocation of resources. With all change at the ECB and Brexit still looming, will 2020 also see the EU taking further steps to complete the EMU project, along the way increasing the role of the euro as an international currency?

Outstanding short-term government debt, Q4 2018

	Euro area	Germany	France	Italy	Spain	Neth	Belgium	Austria	Ireland	Finland	Portugal	Greece	Slovakia	Lux	Slovenia	Lithunina	Latvia	Cyprus	Malta
Outstanding government debt securities																			
Euro billions	8209.5	1589.7	1984.1	1997.6	1049.5	313.3	414.1	250.7	140.9	106	173.9	74.8	38.4	8.3	28.1	13.7	9.1	12.1	5.2
% GDP	71	46.9	84.5	113.9	86.9	40.5	91.9	64.9	44.2	45.4	86.2	40.5	42.6	1.4	61.1	30.2	30.7	58.2	42.5
Up to 1 year, Short-term																			
Euro billions	478	64	141.6	68.9	68.9	19.5	32.9	5	3.5	2	13.7	15	0.8	0	0.6	0	0	0.3	0.3
% GDP	4.1	1.9	6	5.7	5.7	2.5	7.3	1.3	1.1	0.8	6.8	8.1	0.9	0	1.3	0	0	1.3	2.8
Up to 1 year, Long-term																			
Euro billions	820	210.1	161.6	109.8	109.8	29.6	18.4	18.5	13.1	10.3	9.6	8.7	1.6	0.2	1.7	2.4	0.8	2	0.4
% GDP	7.1	6.2	6.9	9.1	9.1	3.8	4.1	4.8	4.1	4.4	4.8	4.7	1.7	0.3	3.8	5.3	2.6	9.6	3.2
Source: ECB																			

As QE came to an end, more capital being put to work in the euro area

As QE came to an end, so we have seen very strong net foreign buying of euro area debt (see charts below).



At the same time, the euro area's outsized current account surplus is now down from the peak, being 2.8% of GDP in the 12 months March, compared to the 3.3% recorded in the 12 months ending March 2018. A breakdown reveals this to largely be due to a pick-up in the imports of goods (which rose from 17.2% of GDP in the 12 months ending March 2018, to 18%), consistent with the recovery in the underlying economy, as well as the rise that we have seen in the euro on a trade weighted basis.

Between 2014 and 2018 net debt outflows from the euro totalled almost €2.1 trillion, much of it destined to the US credit markets, and to a lesser extent, the UK. During the period, net euro area buying of debt securities internationally totalled almost €1.7 trillion, net foreign selling of euro area debt securities, €386bn. Net foreign selling of German debt securities totalled €297bn; net foreign selling of Italian debt securities was particularly aggressive in 2016 and 2018, €72.3bn and €67.8bn, respectively.

However, following QE coming to an end, net foreign buying of German debt securities totalled €61bn in the first quarter of this year, €41.3bn in the case of France, €20.5bn Italy, €18.1bn Belgium, Luxembourg €18bn, €17.1bn Finland, €10bn the Netherlands, Greece €5.8bn and €4.8bn Portugal. And, in the first two months of the year, net buying of Spanish debt securities totalled €13.4bn (in the case of Spain, the March data has yet to be published). Note, that when it comes to the individual country data, net foreign buying and selling of debt securities can include the buying and selling by other euro area countries.

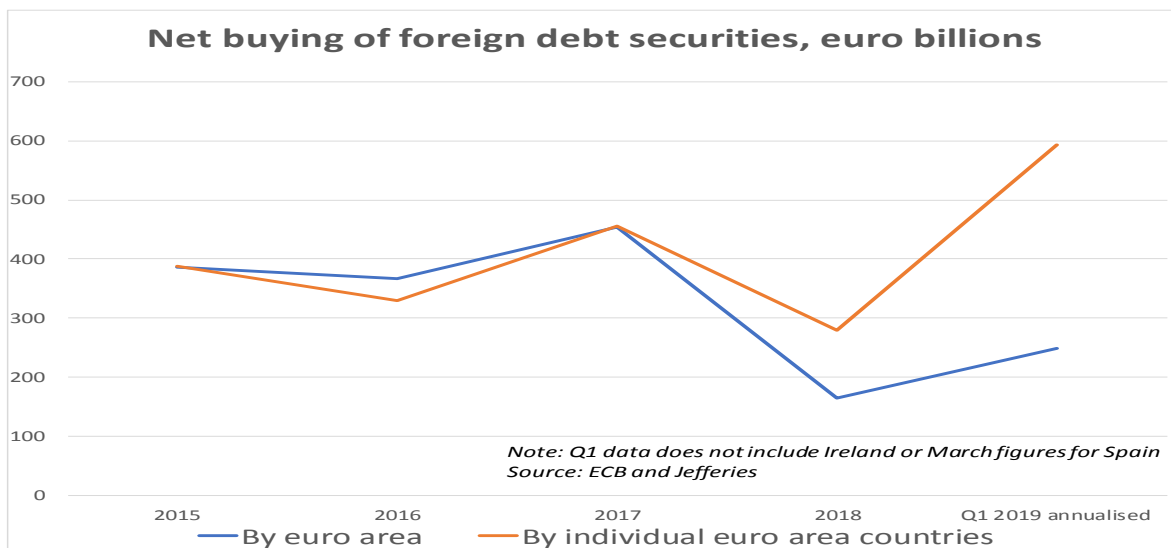
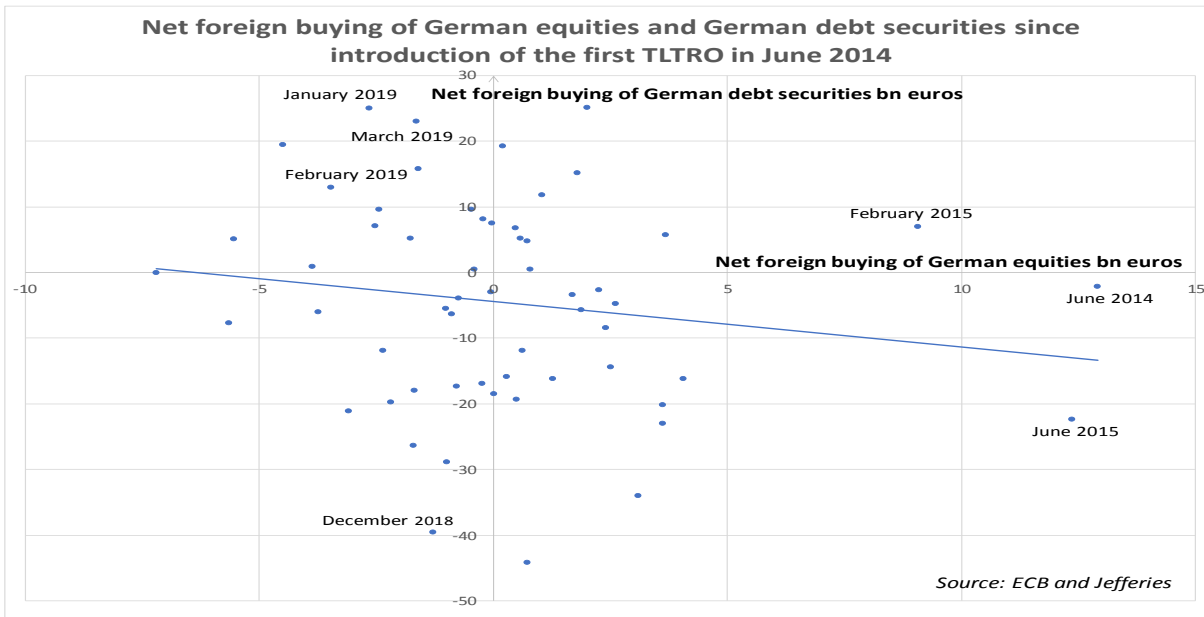
Selected portfolio and direct investment flows between euro area and rest of the world																					
Euro billions	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Q1 2019
Net debt outflows from euro area	-52.9	-133.2	59.3	-91.8	-21.6	-46.8	-1.9	-95.4	-24.0	-246.2	-211.0	7.1	-144.8	-35.3	-15.5	203.9	389.5	553.2	584.8	352.5	-60.3
<i>of which:</i>																					
Net euro area buying of foreign debt securities	148.0	111.5	182.8	137.7	203.3	238.8	282.4	365.0	377.7	97.7	51.7	60.6	-0.6	137.3	95.8	324.3	386.8	367.0	454.5	165.0	62.3
Net foreign buying of euro area debt securities	200.9	244.7	123.5	229.4	224.8	285.6	284.3	460.4	401.7	343.9	262.7	53.5	144.2	172.5	111.3	120.4	-2.7	-186.2	-130.2	-187.5	122.5
Net equity outflows from euro area	81.2	234.2	-132.4	-46.2	-32.8	2.5	-103.9	-89.6	-100.8	97.7	-42.2	-68.4	-130.6	-102.4	-111.3	-147.2	-217.2	-92.4	-287.8	-138.5	4.4
<i>of which:</i>																					
Net euro area buying of foreign equities	166.4	286.3	101.4	39.0	78.0	106.4	134.7	156.1	62.8	-90.4	73.0	78.2	-59.0	58.6	171.0	150.1	15.5	19.7	198.5	19.0	-6.1
Net foreign buying of euro area equities	85.2	52.1	233.8	85.2	110.7	103.9	238.5	245.8	163.6	-188.1	115.2	146.7	71.7	161.0	282.2	297.3	232.6	112.1	486.3	157.5	-10.5
Net direct outflows from euro area	107.7	14.0	109.7	-22.6	9.6	78.8	203.5	158.9	89.1	221.7	28.6	62.0	89.7	45.8	10.2	52.0	160.9	186.9	78.5	52.6	16.4
<i>of which:</i>																					
Net euro area direct investment abroad		523.3	382.5	191.1	153.5	166.8	382.9	448.9	579.7	379.6	261.1	353.3	476.1	541.7	591.9	201.8	1083.1	541.4	435.4	-220.2	37.1
Net foreign direct investment in euro area		509.3	272.9	213.6	143.9	88.0	179.3	289.9	490.6	158.0	232.5	291.3	386.4	495.8	581.8	149.8	922.2	354.6	356.8	-272.9	20.7
Net external lending of euro area MFIs excluding Eurosystem	-179.6	-164	-4.3	140	15.4	8.6	-91.6	31.3	-90.6	137.2	-73.2	44.8	346	94.6	288.5	99.3	-124.4	-123.7	144.1	95.8	-33.1

Source: ECB and Jefferies

Of course, the first quarter saw a further fall in yields. To further put this all in context, the scatter diagram on page 30 shows net foreign buying and selling of German debt securities and German equities since the introduction of the first TLTRO in June 2014. January, February and March of this year very much look like the aberrations, but then for most of the period shown here the Bundesbank, as the biggest buyer in the QE programme, lifted a lot of bonds from investors internationally.

One question now is that if we are right about the euro area economy surprising on the upside, will we see renewed net foreign buying of euro area equities? 2017, in particular, saw €486.3bn net foreign buying of euro area equities. The first quarter of this year did see €10.5bn of net foreign selling of euro area equities, but this disguises the fact that March saw €32.3bn of net foreign buying, the biggest net foreign buying of euro area equities since June 2018. And, historically there has been a correlation between economic surprises and net foreign buying and selling of euro area equities.

Finally, one can infer from all the data on net foreign buying and selling of individual countries' debt securities, compared to figures for the euro area overall, that capital flows have increased inside the euro area itself. This is even true without the Q1 data for Ireland or the March figures for Spain. For example, net foreign buying of debt securities by euro area countries that have published data totalled €593bn annualised in Q1, compared to €249bn for the euro area overall (see chart). This is very different to 2015-2017, in particular, when the figures were virtually the same, but also 2018. From our perspective, evidence of renewed intra-EMU capital flows is a good sign, further consistent with things normalizing.



12 June 2019

Jefferies Fixed Income

GLOBAL FIXED INCOME

Net buying and selling of euro area debt securities, both with the rest of the world and within the euro area																					
Euro billions	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Q1 2019
Net German buying of debt securities outside Germany	95.3	68.4	93.6	51.4	50.2	100.2	142.1	139.6	127.5	10.4	70.7	147.8	20.1	73.2	85.6	96.7	69.0	42.3	42.1	40.0	24.7
Net foreign buying of German debt securities	139.7	74.8	68.9	114.9	79.1	125.8	157.9	116.6	244.6	58.3	-19.9	53.9	57.5	55.6	-32.4	14.4	-83.5	-94.9	-87.5	-45.8	61.0
Net French buying of debt securities outside France										58.3	49.5	-43.1	-127.4	-59.3	12.7	58.4	42.9	19.2	5.2	62.2	52.2
Net foreign buying of French debt securities										134.2	267.1	90.5	67.1	-7.8	77.6	79.7	-5.5	1.4	18.9	25.9	41.3
Net Italian buying of debt securities outside Italy										13.5	26.8	-8.4	-30.4	-75.9	-26.2	23.3	36.5	30.7	29.6	16.9	2.4
Net foreign buying of Italian debt securities										26.2	63.6	-13.8	-49.2	-51.7	22.2	78.4	11.8	-72.3	13.1	-67.8	20.5
Net Spanish buying of debt securities outside Spain																-31	13.8	30.7	27	30.2	40.8
Net foreign buying of Spanish debt securities																27.1	32.5	42.3	-23.7	36.5	47
Net Dutch buying of debt securities outside the Netherlands						-4.2	9.6	-7.7	-6.5	-0.1	-3.7	10.3	4.4	0.5	-7.4	13.1	11.1	5.1	-22.2	5.1	15.1
Net foreign buying of Dutch debt securities						-5.5	11.6	-12.8	-18.4	0.1	2.0	30.7	12.3	-3.6	-22.5	38.1	42.3	4.4	-38.4	11.9	10.0
Net Belgium buying of debt securities outside Belgium										21.5	-11.8	-3.9	2.6	-42.8	-19.2	2.6	-3.5	5.8	3.5	5.9	2.7
Net foreign buying of Belgium debt securities										26.5	18.8	-16.4	-17.0	14.0	23.9	30.3	17.9	33.7	-1.5	2.1	18.1
Net Irish buying of debt securities outside Ireland										50.2	-8.8	-39.5	8.9	61.5	32.1	98.6	92.6	112.7	159.2	78.6	
Net foreign buying of Irish debt securities										-10.7	2.1	-39.4	-31.8	-9.3	-11.4	18.0	48.7	-41.6	3.0	11.0	
Net Finnish buying of debt securities outside Finland																	-0.7	-2.5	-1.9	-3.0	-4.6
Net foreign buying of Finnish debt securities																	1.5	6.0	13.1	16.3	17.1
Net Portuguese buying of debt securities outside Portugal	4.2	3.9	7.7	6.7	18.4	9.6	14.5	3.3	6.2	12.7	15.3	2.6	-20.2	-9.8	-2.6	3.5	-1.9	1.2	15.2	6.2	0.4
Net foreign buying of Portuguese debt securities	8.8	3.4	10.7	8.2	5.3	6.1	11.1	7.1	17.8	21.3	28.3	-7.5	-21.6	-32.1	-4.2	6.9	1.2	-13.2	8.9	-1.5	4.8
Net Greek buying of debt securities outside Greece										2.3	7.4	-14.1	-4.8	57.1	-1.5	7.6	0.3	9.6	-18.2	1.5	-0.9
Net foreign buying of Greek debt securities										19.9	31.1	-33.0	-23.7	-41.8	-10.0	-6.4	-7.7	-3.1	0.3	1.5	5.8
Net Slovakian buying of debt securities outside Slovakia										1.5	2.8	2.5	1.8	-4.2	-0.3	0.7	-1.5	3.6	2.3	4.0	0.1
Net foreign buying of Slovakian debt securities										1.1	0.9	4.0	1.5	4.5	6.9	3.3	-2.4	0.5	2.6	1.0	0.7
Net Luxembourg buying of debt securities outside Luxembourg				-3.2	39.3	33.2	114.4	59.8	89.9	-61.9	106.9	53.7	-14.6	97.6	76.9	141.7	110.4	68.1	201.2	23.6	57.7
Net foreign buying of Luxembourg debt securities				30.2	25.0	14.1	31.9	23.8	20.1	1.5	29.6	-13.8	10.7	222.8	48.5	43.7	61.6	54.7	15.7	-23.1	1.8
Net Slovenian buying of debt securities outside Slovenia									2.4	0.1	-0.1	0.2	0.1	-0.2	-0.5	0.3	1.9	2.2	2.5	0.4	0.3
Net foreign buying of Slovenian debt securities									0.9	0.8	4.5	2.2	1.7	-0.5	3.6	4.3	-1.0	-3.1	-0.2	-0.8	-0.2
Rest of the euro area net buying of debt securities elsewhere										-0.6	2.8	3.6	2.6	2.9	3.0	7.1	-0.7	4.8	7.1	-3.2	-0.5
Non-euro area net buying of the rest of the euro area										0.1	0.7	1.5	1.4	3.2	-0.4	3.2	0.0	0.5	1.8	0.3	0.9

Source: ECB and Jefferies

(*) Spanish numbers are only for first two months of this year

Note: Net buying and selling of a country's bond markets

includes net buying and selling from elsewhere in the euro area.

For example, French buying of Germany and Italian selling of Spain

On inflation, markets increasing at odds with the ECB

While there is nothing in the latest set of inflation figures that should have come as a surprise – the monthly releases continue to be swung around by the base effects related to the timing of Easter in 2018 compared to 2019 – with inflation and inflation expectations both uncomfortably low, and the US Fed making the ECB's job harder by dithering over the direction of policy, the markets are increasingly looking for the ECB to deliver more than just words and set out a roadmap of how it may respond if global activity stalls and euro area growth falls short of expectations.

Monthly rises in euro area core inflation

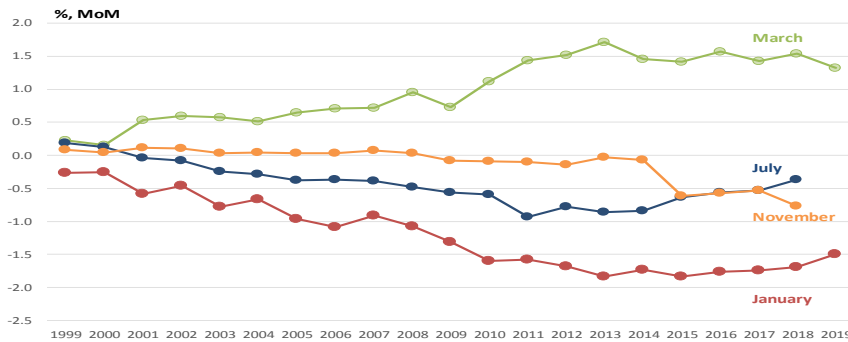
Year	Easter Sunday	% MoM change in core inflation index			
		February	March	April	May
2007	8 April	0.39	0.72	0.52	0.18
2008	23 March	0.41	0.96	0.17	0.26
2009	12 April	0.49	0.72	0.49	0.03
2010	4 April	0.44	1.12	0.21	0.11
2011	24 April	0.35	1.43	0.51	-0.02
2012	8 April	0.36	1.52	0.47	-0.01
2013	31 March	0.31	1.72	-0.03	0.19
2014	20 April	0.47	1.45	0.25	-0.13
2015	5 April	0.52	1.41	0.53	0.22
2016	27 March	0.40	1.57	0.22	0.30
2017	16 April	0.37	1.43	0.78	-0.04
2018	1 April	0.40	1.54	0.40	0.46
2019	21 April	0.27	1.32	0.92	-0.04

Source: Eurostat and Jefferies International

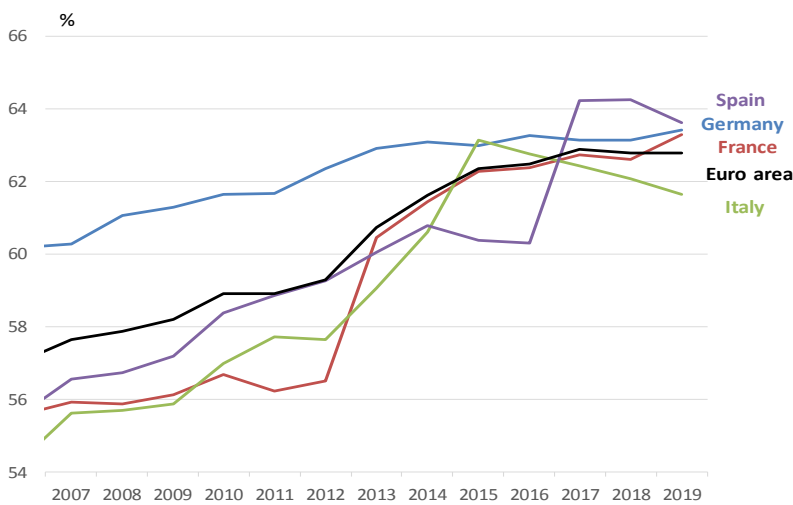
As we've written about in the past, inflation dynamics are impacted by a multitude of factors, and how central bankers read and respond to the data will also vary. Some things the ECB will view as irrelevant, such as distortions generated by the timing of Easter holidays, or the change in the way that 'package holidays' are priced, or the change to when the usual seasonal sales take place throughout the year. Other things the ECB will take on board – such as the growing popularity of online shopping or the ageing of the labour force – but will have no way of counteracting. Other trends, however, will carry more weight and will affect the ECB's actions.

For instance, when euro area core inflation dropped below 1% two days before the June meeting, the markets viewed that as very important (it really wasn't). Yet when the ECB highlights that the GDP deflator in the euro area is printing at much healthier levels than core inflation, or that profit margins have been squeezed over the last few years but should bounce back, or that super-core inflation is at higher levels than core inflation, that is generally ignored by the markets and viewed as the ECB finding another way to justify its inability to hit the inflation target. This is an example of the markets regularly focusing on the wrong things.

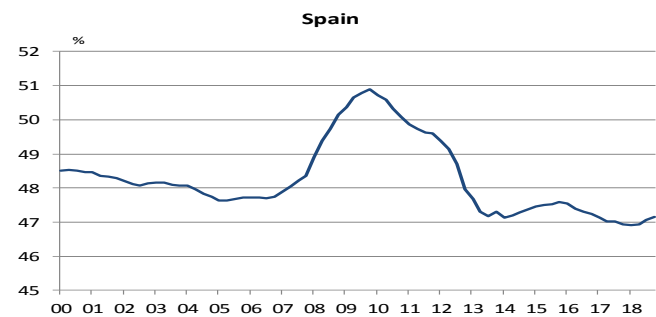
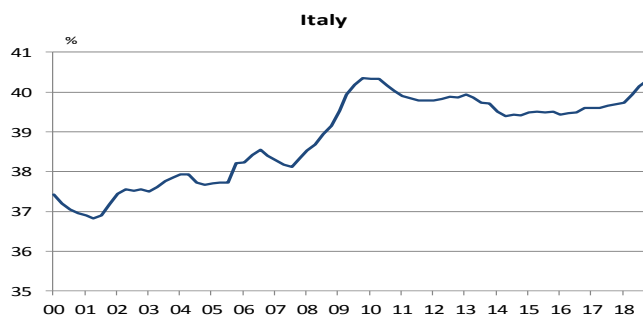
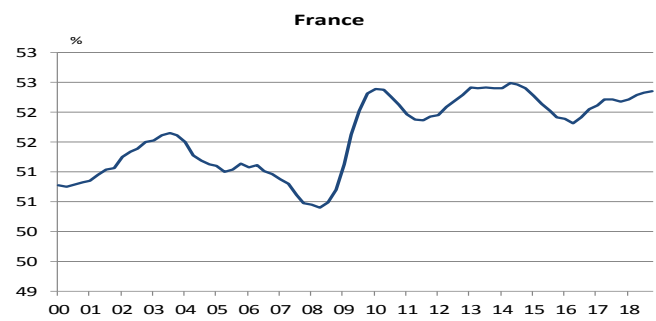
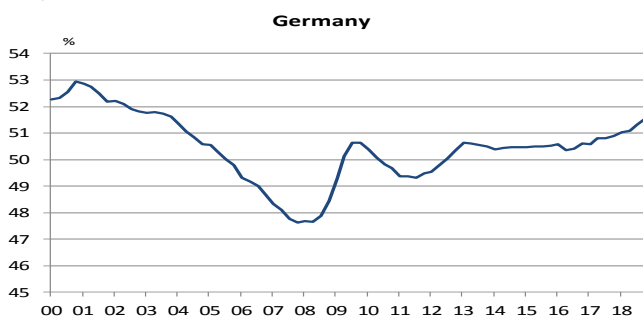
Changing pattern of price changes in the euro area: monthly change in core inflation by month over the past 20 years



Weight of services in the core inflation basket



Labour shares of GDP (compensation of employees/nominal GDP)

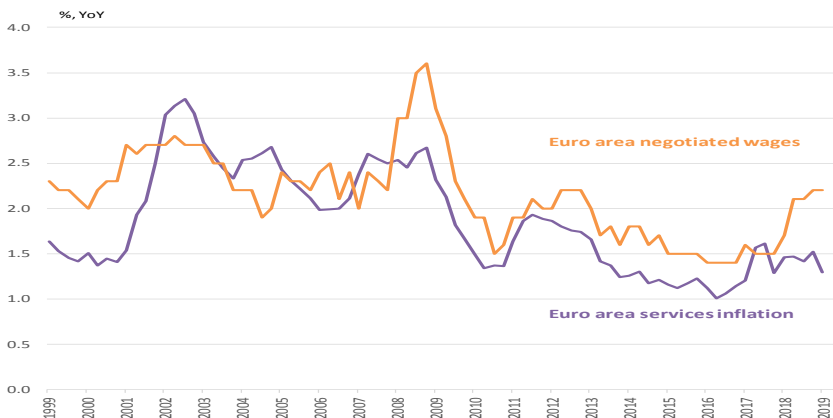


Source: Eurostat and Jefferies International

Jefferies Fixed Income

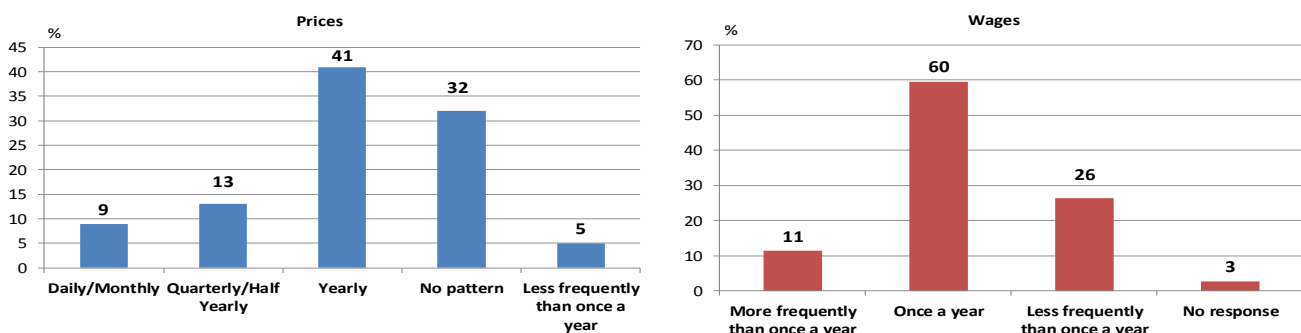
On this topic, Benoit Coeure’s recent speech focused on the growing importance of services as opposed to manufacturing as a driver of euro area growth. This may not necessarily be news to economists, but the markets are not on the same page, and still pay too much attention to what happens to the surveys of manufacturing as opposed to the surveys of services. (Surely, Markit should give it some thought to publishing Services PMIs first, and manufacturing PMIs two days later, rather than the other way around). Similarly, Coeure highlights the growing importance of the consumption of services in the HICP inflation basket (see second chart on the previous page), and essentially expands on Draghi point that this shift is likely to help explain why a recovery in euro area inflation may be slow to materialise. In simplest terms, prices of goods and services in the euro area have always been sticky (see second chart below), and stickier in services than in goods. But at the moment, in services, changes take place even less frequently than in the past. The argument therefore goes that as the economy recovers, the labour market and wages respond first (which they’ve done), but the move in prices comes through with a longer lag than in the past.

Euro area wage growth and services inflation



Source: Eurostat and Jefferies International

Frequency of price and wage changes in the euro area

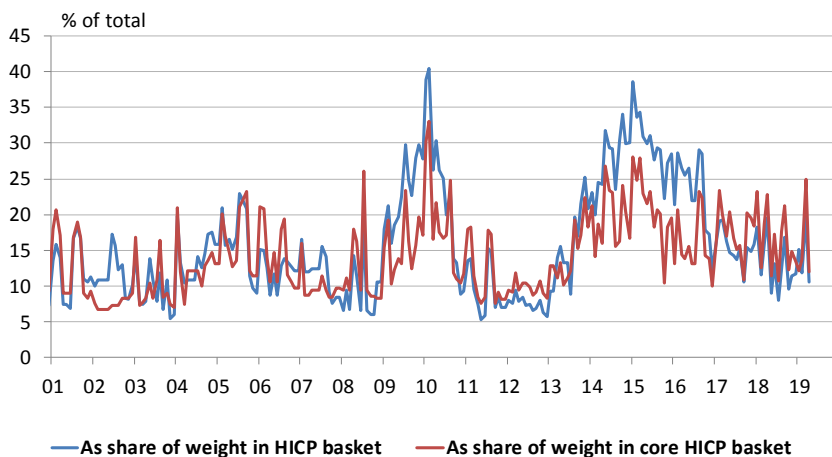


Source: ECB

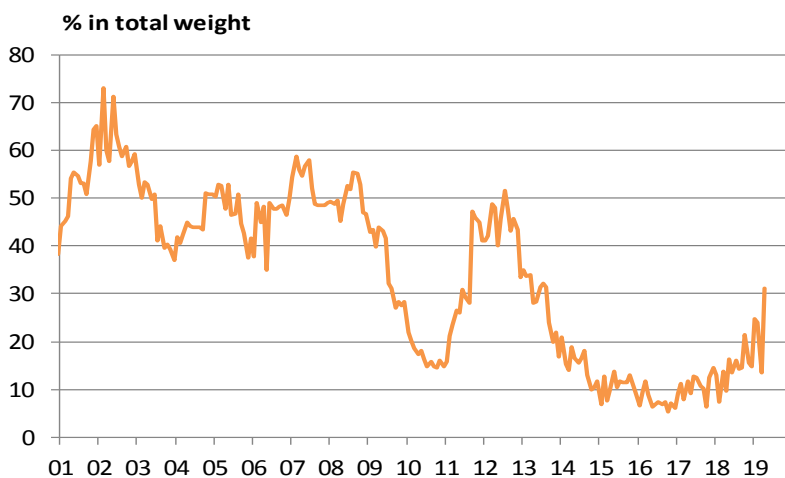
Finally, the charts below highlight our Deflation Monitor analysis. As a reminder, we calculate the inflation rates of the 94 components of the euro area HICP basket and the 73 components within the core HICP measure, and then track whether more or less of the basket is in deflation. We calculate two measures: the first, is the weight of items in deflation in the *total* HICP basket; and the second, the weight of items in deflation in the *core* part of the HICP basket (to strip away the movement of volatile food and energy components).

The key result for the month of April is that the proportion of the euro area HICP basket in deflation dropped to 11% from 20%. In terms of specifically the core portion of the inflation basket, the share in deflation fell to 12% from 25%. Also, the proportion of the core inflation basket where prices are rising by more than 2% per year currently stands at 31%. This is the highest reading since 2013. Although, as mentioned earlier, it should decline in May.

Share of euro area HICP basket in deflation



Share of euro area core HICP basket where inflation is above 2%



Source: Jefferies International

The labour market gains momentum

The ECB remains cautious on the outlook for the euro area economy, but there are also grounds for optimism, particularly the improving trends in the labour market. As the tables below highlight, there is little recognition for instance, that when it comes to wages (first table below) and disposable incomes (second table), in almost every single euro area country, the household sector is experiencing its strongest period of growth for a decade.

Growth in compensation per employee

%, YoY	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Germany	1.0	0.9	2.1	0.2	2.6	3.0	2.5	1.8	2.8	2.7	2.2	2.6	3.0
France	3.2	2.5	2.6	1.6	2.9	2.3	2.2	1.8	1.2	1.1	0.8	1.9	1.8
Italy	2.2	2.2	2.8	0.5	2.3	1.0	-1.1	0.8	0.2	1.0	0.5	0.1	2.0
Spain	3.3	4.6	6.7	4.5	0.2	0.7	-1.4	0.3	0.1	1.4	-0.2	0.6	1.4
Netherlands	1.4	2.8	4.0	2.5	0.7	1.9	2.0	1.8	1.6	-0.3	1.7	1.2	2.2
Belgium	3.6	3.5	3.7	1.1	1.4	3.1	3.2	2.6	0.9	0.0	0.5	1.9	2.0
Austria	3.1	3.0	3.3	1.6	1.1	2.1	2.7	2.2	1.9	1.9	2.4	1.5	2.5
Ireland	4.4	5.8	3.9	-1.1	-2.0	0.3	1.0	-0.5	0.6	2.6	2.1	0.9	2.9
Portugal	1.8	3.5	2.6	2.4	2.1	-1.8	-3.1	3.6	-1.8	0.4	1.7	1.6	2.0
Greece	3.1	4.6	3.7	3.1	-2.0	-3.8	-3.0	-7.5	-2.0	-2.4	-0.9	0.5	1.3
Euro area	2.3	2.6	3.4	1.6	2.0	2.0	1.5	1.5	1.3	1.4	1.2	1.6	2.2

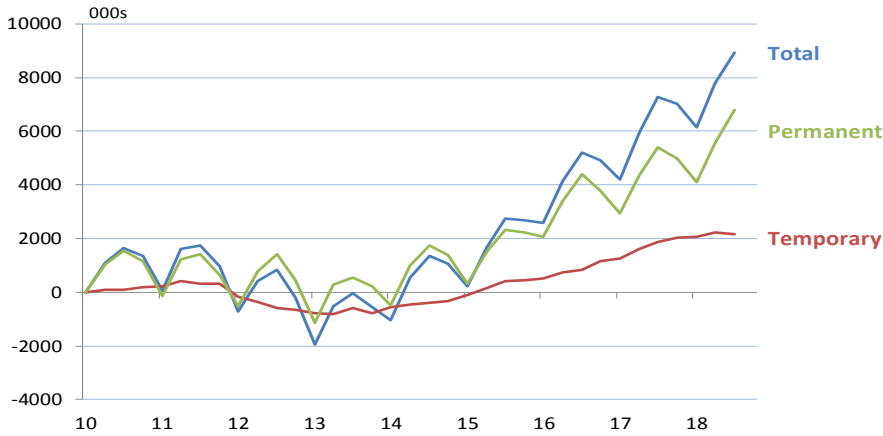
Household nominal disposable income growth

%, YoY	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Germany	2.2	2.0	2.5	-0.8	2.4	3.1	2.6	1.6	2.6	2.6	3.0	3.5	3.4
France	5.1	5.3	3.4	0.2	2.8	2.0	1.1	-0.4	1.3	1.2	1.7	2.6	2.7
Italy	3.7	3.7	1.8	-2.3	-0.1	2.6	-2.7	0.4	0.7	1.4	1.3	1.7	1.9
Spain	5.8	4.0	5.4	1.9	-1.5	0.8	-3.4	-0.9	1.1	2.3	1.8	1.6	3.2
Netherlands	4.5	4.1	3.3	-0.1	1.5	2.2	0.8	1.0	2.4	1.8	2.5	2.6	4.5
Belgium	5.4	5.0	5.6	1.7	0.7	2.0	1.9	1.2	1.2	0.8	3.0	3.3	2.6
Austria	4.7	4.7	3.1	0.2	0.9	2.7	3.9	0.3	2.8	1.3	3.8	2.2	4.4
Ireland	7.7	8.3	6.3	-6.9	-3.5	-4.6	3.2	0.0	1.7	4.8	5.1	5.8	5.3
Portugal	3.7	4.8	4.0	-0.4	2.8	-3.7	-3.6	-0.2	-0.2	3.4	3.2	3.3	3.7
Greece	9.1	6.7	5.5	1.8	-7.8	-8.6	-8.5	-8.6	-0.8	-3.5	-2.3	1.1	3.4
Euro Area	4.3	4.0	3.4	-0.5	1.0	1.9	0.3	0.4	1.6	1.9	2.2	2.8	3.3

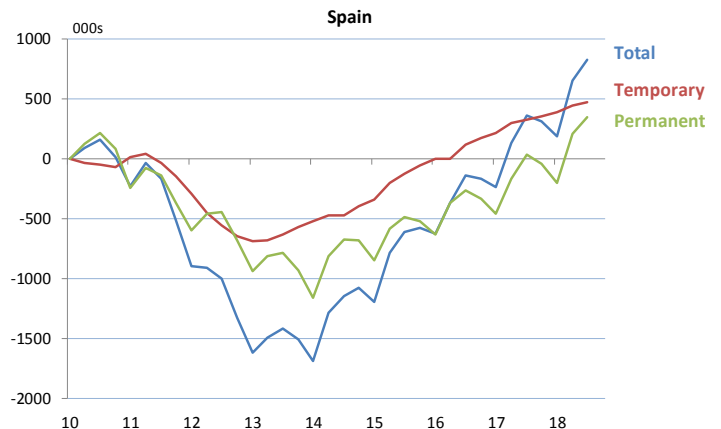
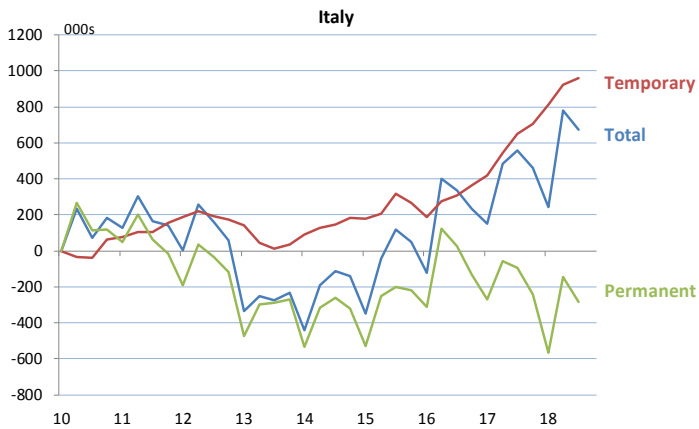
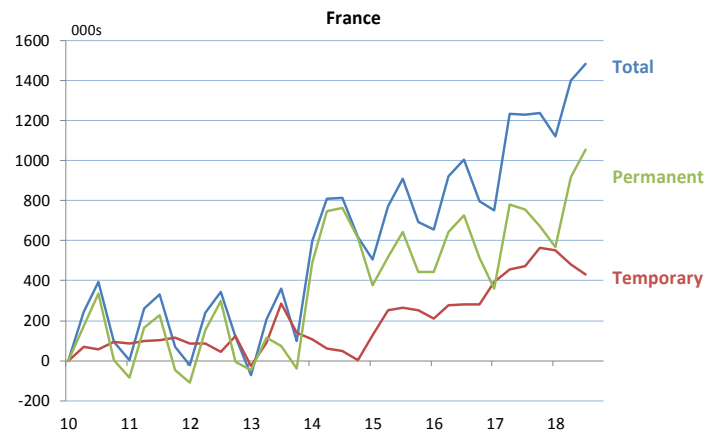
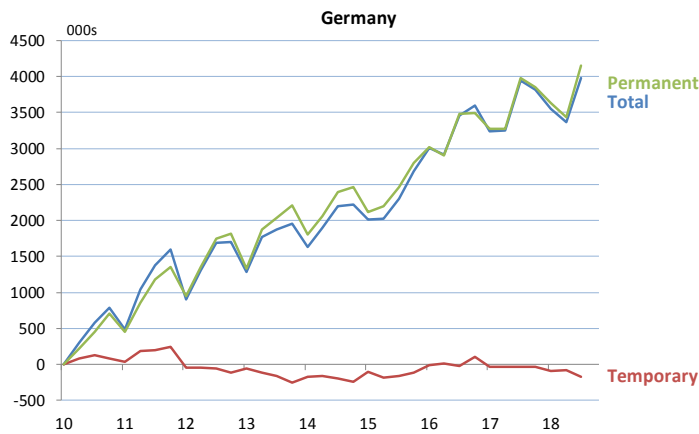
Source: Eurostat and Jefferies International

In addition to the outperformance in wage growth, another positive 'surprise' has been the rebalancing from temporary to permanent employment. As the graphs below highlight, Italy bucks the trend, but there has been a surge in permanent jobs in France and in Spain over the past year.

**Euro area employment growth since the start of 2010
(cumulative, permanent vs temporary contracts)**



**Country employment growth since the start of 2010
(cumulative, permanent vs temporary contracts)**



Source: Eurostat and Jefferies International

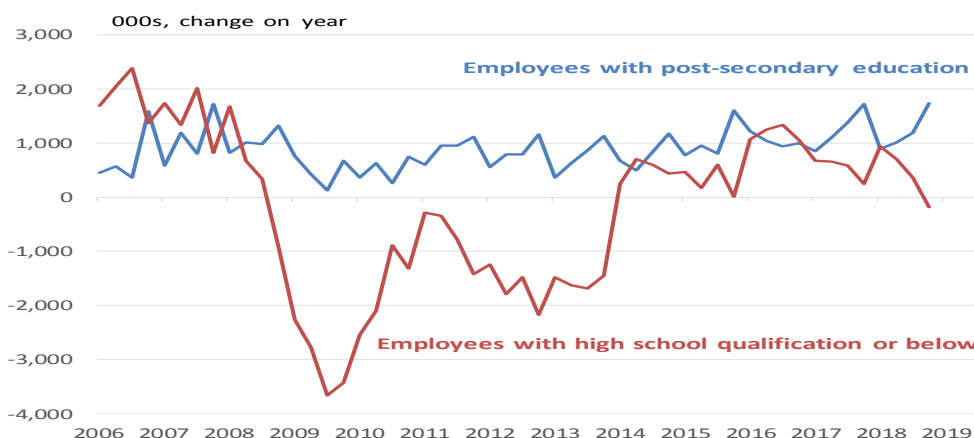
Jefferies Fixed Income

Likewise, looking at employment growth over the past year, in Italy, the majority of new jobs created have been on a part-time basis. But in Germany, France and Spain, the overwhelming majority of recently created jobs has been in full-time employment – something that wasn’t happening a few years ago. Finally, in terms of anecdotal evidence, as the chart below shows, the last year was also unusual because the majority of newly created jobs have gone to those with a higher level of education – something that at the margin may have contributed to increased job churn and put additional pressure on wage growth across the euro area.

Employment growth in 2018 by age group

000s	Aged from 15 to 50		Of which		Aged from 50 to 64		Of which		Aged 65 years +		Of which		Total	Of which	
	Full-time	Part-time	Full-time	Part-time	Full-time	Part-time	Full-time	Part-time	Full-time	Part-time	Full-time	Part-time			
Euro Area	264	489	-225	1,349	1,085	264	204	95	109	1,817	1,670	148			
Germany	-225	-29	-196	391	272	119	67	18	48	233	261	-29			
France	98	112	-13	43	73	-31	6	9	-3	147	193	-47			
Italy	-163	-112	-51	227	135	93	23	8	15	87	30	57			
Spain	256	212	44	289	253	37	21	12	9	566	477	89			
Netherlands	102	50	52	82	39	43	22	9	13	206	98	108			
Belgium	47	52	-5	49	34	15	-1	-1	-1	94	84	10			
Austria	6	38	-33	40	21	19	10	3	7	56	63	-7			
Ireland	29	29	1	21	22	-1	0	-3	3	51	48	2			
Finland	34	32	3	17	3	15	3	0	3	55	35	21			
Portugal	12	23	-12	35	52	-17	32	19	13	78	94	-16			
Greece	1	0	1	90	96	-7	7	5	2	98	101	-3			
Slovakia	30	52	-22	15	27	-12	4	4	0	49	83	-34			
Slovenia	1	7	-6	13	16	-3	-2	0	-2	12	22	-10			
UK	99	177	-76	230	144	82	106	85	23	435	406	29			

Euro area employment growth by level of educational attainment

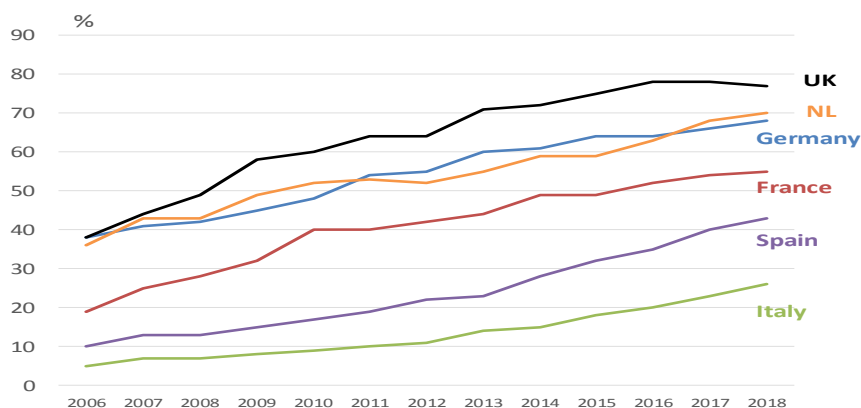


Source: Eurostat and Jefferies International

The 'Amazon effect' on European inflation: just getting started or over already?

Online shopping, and e-commerce more generally, continue to grow in importance for the global economy. In the euro area, consumers and businesses have generally been playing catch-up with the experience of the US and the UK; but in a number of euro area countries online shopping is becoming the norm, and as this shift takes place, its effect on prices and inflation becomes a topic which grows in importance. Globally, over the recent years, the rising popularity of using the internet to shop for goods and services has coincided with softer than expected inflation outturns, something which, intuitively, should not be viewed as a coincidence. Traditional brick-and-mortar retailers carry overhead costs, and if these costs can be reduced through fewer physical shops and fewer staff, some of this saving should be passed on to consumers via lower prices. The effect on prices also comes through competition: the internet makes it easier for consumers to compare prices, and on like-for-like branded items retailers are generally forced to charge the same price as their competitors, which puts a squeeze on margins. Retailers are also forced into a single-pricing structure, whereby even across extremely large geographical areas (the US) and irrespective of shipping costs, retailers are charging consumers the same price, irrespective of whether they are buying in store or online, and whether they are buying in NY or in Houston (roughly the same distance as Frankfurt to Athens). This means that margins can be squeezed even when e-commerce penetration appears to be relatively low – everyone, in every location is in competition, and mindful of over-charging. Initially, therefore, as an economy shifts to a paradigm where online shopping becomes sufficiently commonplace, margins, prices and inflation are under pressure – this seems fairly uncontroversial. But what happens once a new equilibrium is reached; indeed, may we already be seeing some evidence that when it comes to its dampening effects on inflation the importance of growth in online shopping has already peaked? Also, what specific challenges does the ECB face around how the internet is used and how prices are set across the euro area?

Share of individuals making an online purchase in the last 3 months

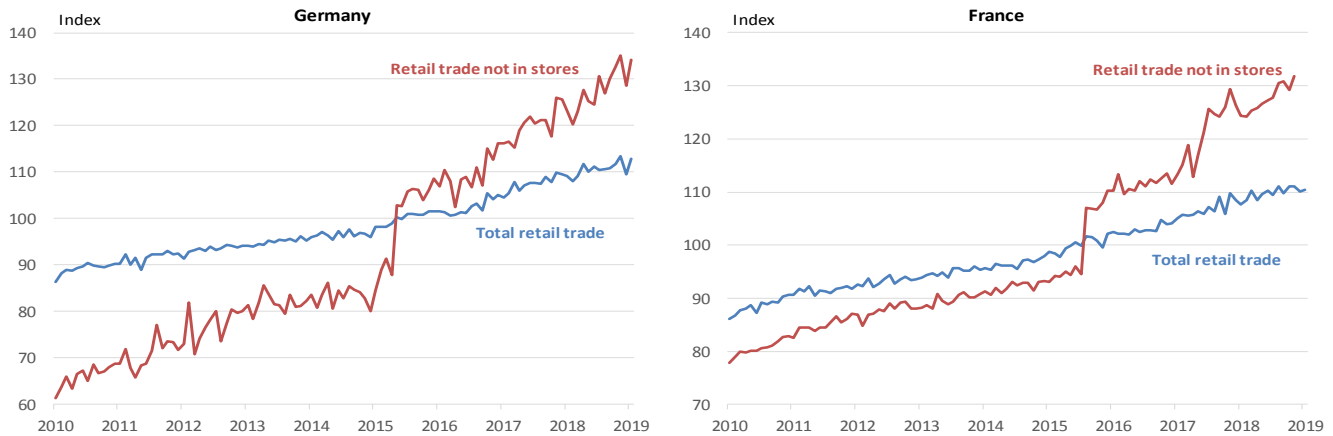


Source: Eurostat and Jefferies International

Jefferies Fixed Income

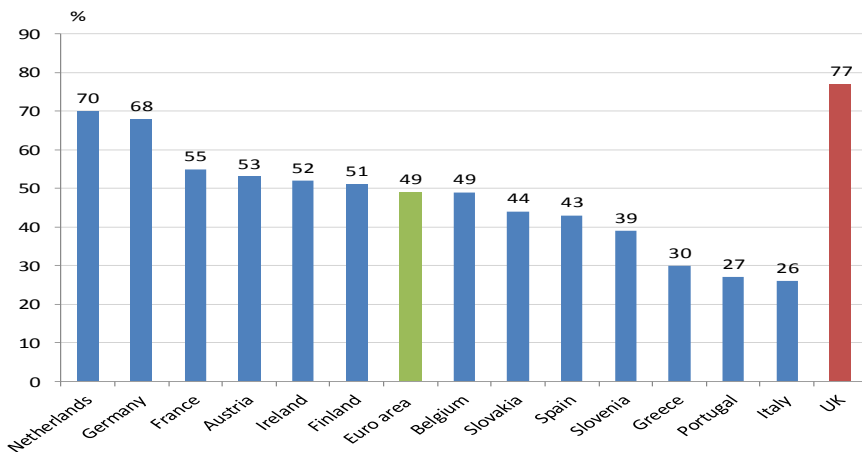
In terms of the background statistics, the starting position is that it’s hard to get an accurate picture of how much euro area consumers really engage in online shopping. For instance, when it comes to official retail sales data, Eurostat keeps track of “retail not in stores, stalls and markets” – which gives some indication of how fast online retail is growing (see charts below). But this does not pick up on what happens to supermarkets and traditional brick-and-mortar retailers who do more and more of their business through online orders. So, in terms of the data which can be compared across euro area countries, the focus is primarily on the surveys which track measures such as proportion of individuals who say they engage in online shopping (as seen in the front-page chart, and the last chart below). In terms of what consumers are reporting, the Netherlands and Germany are ahead of the pack when it comes to shopping online (with levels of participation similar to those in the UK), while shoppers in Italy, Portugal and Greece report that they use the internet for shopping significantly less.

Growth in distance retailing (retailing not done in stores) in Germany and France



Source: Banque de France, Eurostat and Jefferies International

Use of internet for shopping in 2018: share of individuals making an online purchase in the last 3 months

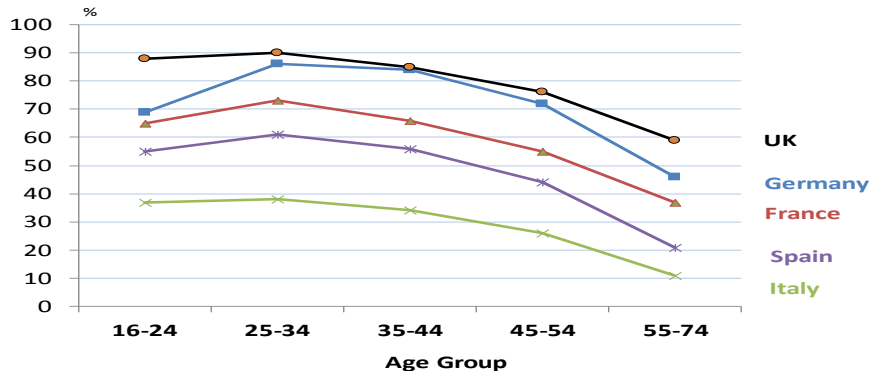


Source: Eurostat and Jefferies International

Jefferies Fixed Income

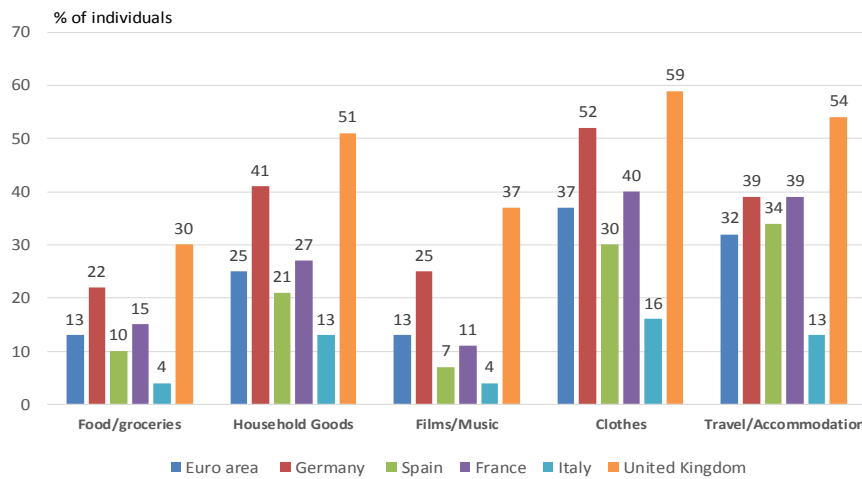
By age group, the surveys show what one would expect: 1) younger people are more regular online shopper than older people, and 2) country differences in terms of online shopping preferences are narrower amongst younger than older age groups. In terms of what European shoppers say they regularly buy on-line, at the top of the list are clothes, travel and holiday accommodation, household goods, and books; while towards the bottom is food.

Share of individuals making an on-line purchase in the last 3 months: by age group



Source: Eurostat and Jefferies International

Share of individuals making an on-line purchase in the last 3 months: by category of consumption



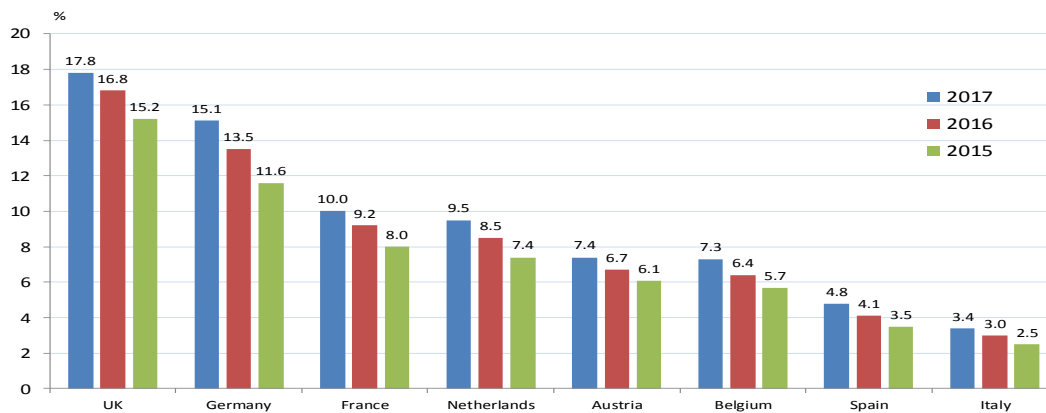
Source: Eurostat and Jefferies International

Moving on from the surveys to the ‘hard’ data, the table on the next page is one of the few cross-country comparisons we’ve seen which shows the importance of online for total retail sales. The numbers which we can verify are those for the UK, which broadly match the figures reported by the ONS; for everyone else, however, the levels should be treated as an indication, rather than as an official statistic. (In our conversation with Eurostat, they confirmed that they do not measure online retail sales, and if any such data is collected it falls to the individual national statistical offices to do so – in which case cross-country comparisons come with limitations.)

Jefferies Fixed Income

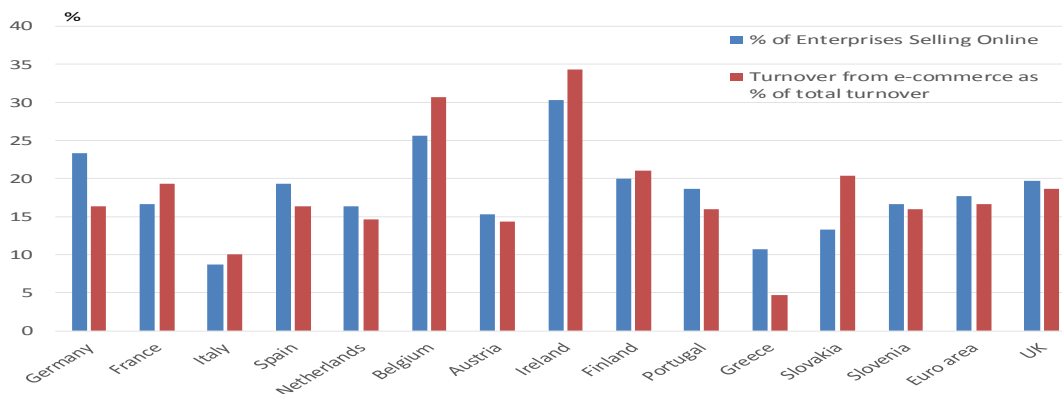
However, helpfully, Eurostat do publish country data on how much turnover is generated through e-commerce more broadly – this includes companies selling directly to consumers online and business-to-business orders taking place electronically. Again, these figures should be treated with some caution (as one example, in Germany, turnover from e-commerce as a share of total turnover fell from 21% to 14% in 2018 – not something that can be easily explained). But a couple of observations stand out: 1) On this measure at least, there has not actually been some relentless climb in importance of e-commerce for European companies. In fact, in most countries, there has been little change in terms of the share of turnover generated through e-commerce since around 2015 (only France has seen its importance climb further in recent years). And, 2) The degree to which businesses rely on e-commerce varies significantly less across the euro area than the difference between the preference of consumers for online shopping. For instance, consumers in the Netherlands appear to embrace online shopping significantly more than consumers in Spain. And yet, Spanish companies generate a larger portion of their turnover from e-commerce. This suggests perhaps that while consumers in some countries are slow to switch to online shopping, businesses are adopting technological change significantly quicker, and in a more synchronised way across the region – perhaps partly due to multinationals adopting the same business practices across different locations.

Online retail sales as share of total retail



Source: eMarketer

How much businesses rely on e-commerce: levels in 2018



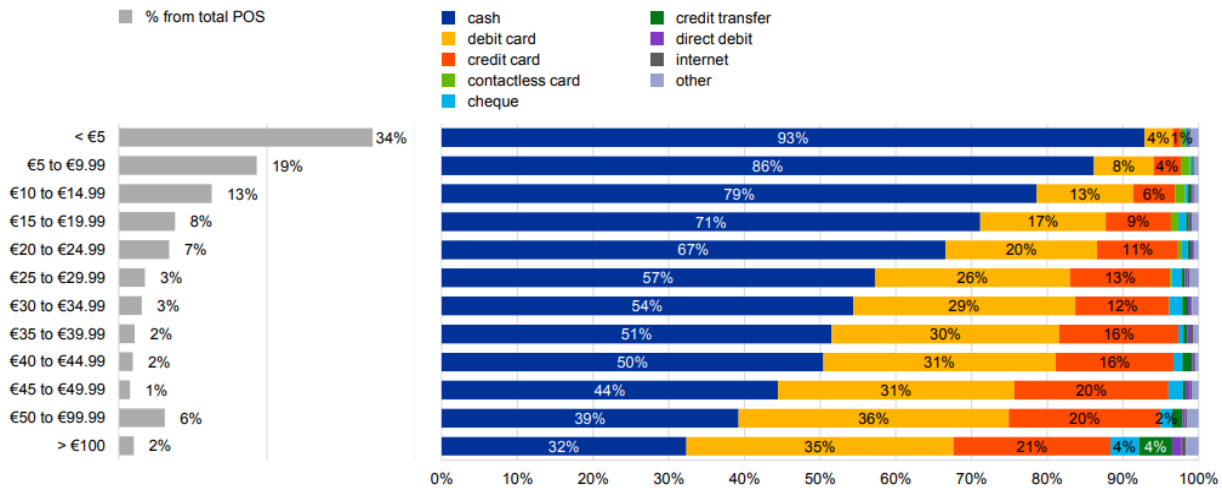
Source: Eurostat and Jefferies International

Jefferies Fixed Income

Turning back to consumer preferences in the euro area, what is it that gets in the way of some individuals becoming more enthusiastic online shoppers? One factor, perhaps, is that for many cash is still by far their preferred method of paying. The first chart below shows for instance that 93% of transactions under €5, and 86% of transactions of between €5 and €10, are still made in cash. In fact, on average, a person in the euro area carries on them €65 in cash, and for older people, that rises to €84. (A survey of colleagues sitting around us on the same pod puts the equivalent figure at £10, with 5 out of 6 having an App for instant cash transfers). For individual countries, Germans hold the most cash on them (see bottom chart below); but in terms of its usage, cash is more important in Italy, Spain, Austria and Greece; while consumers in the Netherlands, Finland and the Baltic states rely much more on card payments (see charts on the next page). The strong attachment to cash seems to be an important obstacle to greater proliferation of online shopping, particularly for older Europeans.

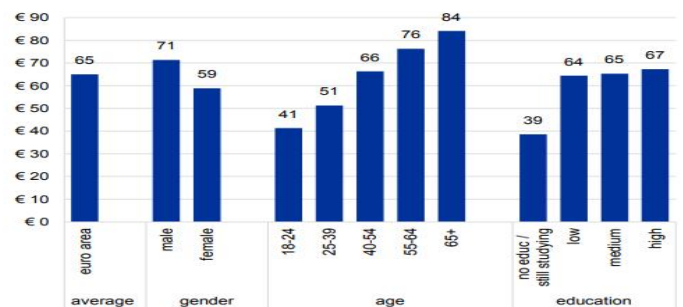
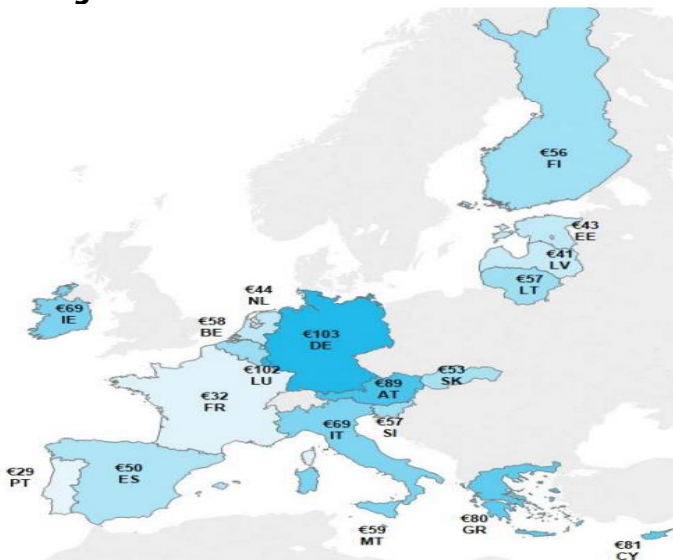
Use of payment instruments at points of sale (POS)

(number of transactions)



Source: ECB, Deutsche Bundesbank and DNB

Average amount of cash in wallet

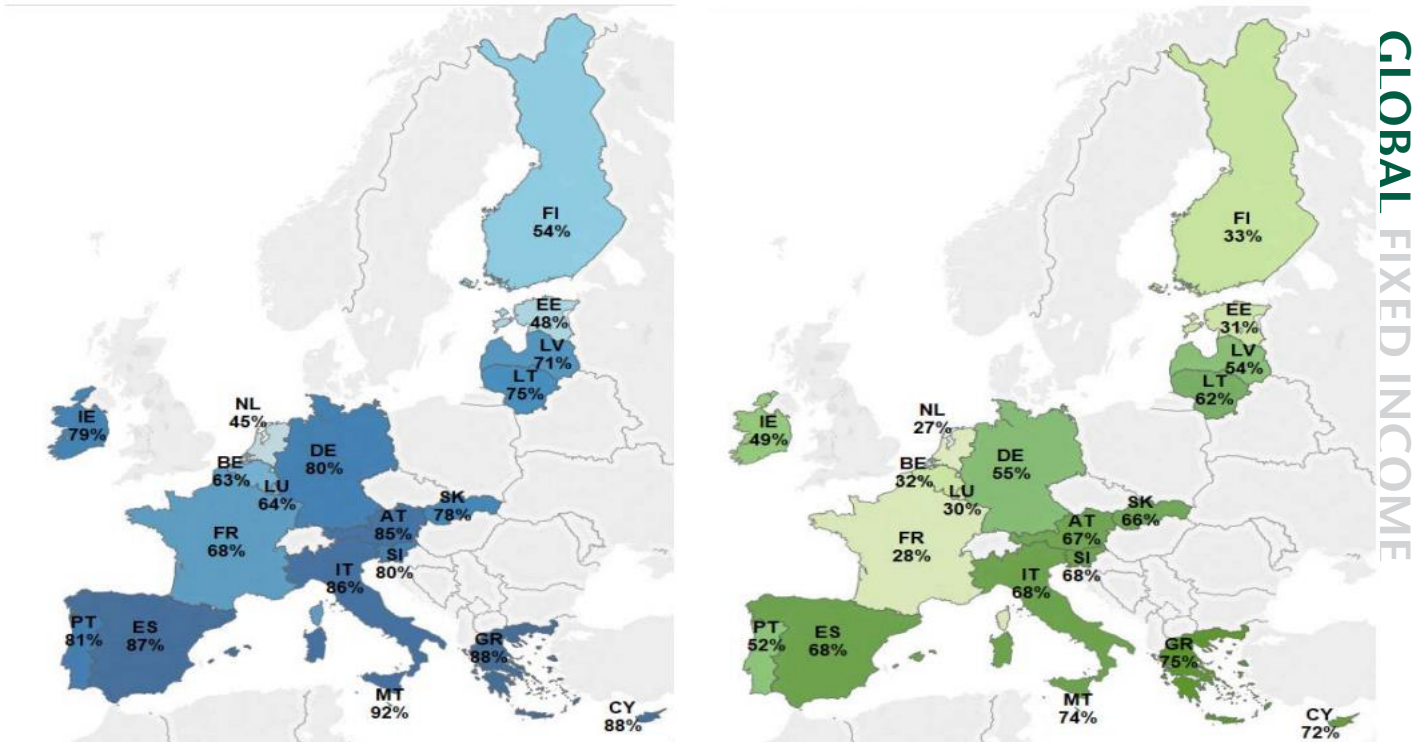


Source: ECB, Deutsche Bundesbank and DNB

Share of cash transactions per country at points of sale

(number of transactions)

(value of transactions)



Source: ECB, Deutsche Bundesbank and DNB

Irrespective of age and whether people feel safe paying for goods and services online with debit and credit cards, shopping online for some things – food being the primary example – may always have limited appeal. As responses below indicate, for many consumers there is simply no substitute to being in the store and picking out the items you want. Again, no surprise there, one could be expected to be more cautious about buying things online that you cannot see, cannot judge their quality because they are not branded and which you cannot easily return. Others undoubtedly simply enjoy going into a shop rather than viewing it as a chore (perhaps as a peaceful hour away from the rest of the family).

What reservations consumers have about food shopping online?
% of respondents

	Germany	UK	France
Like to handle goods physically	70.6%	68.1%	67.3%
Last-minute timing doesn't allow	48.3%	7.5%	13.9%
Delivery costs	45.4%	33.8%	22.7%
Don't trust people to pick the best/freshest items	33.4%	50.8%	32.7%
Delivery delay concerns	28.2%	11.5%	7.1%
Not available where I live	10.8%	1.3%	13.3%
Concerned about missing items	9.9%	22.1%	12.0%
Security concerns	9.6%	8.3%	9.4%
Difficult to find items I want	5.2%	7.1%	12.0%

Note: ages 18+ who have never shopped digitally for groceries

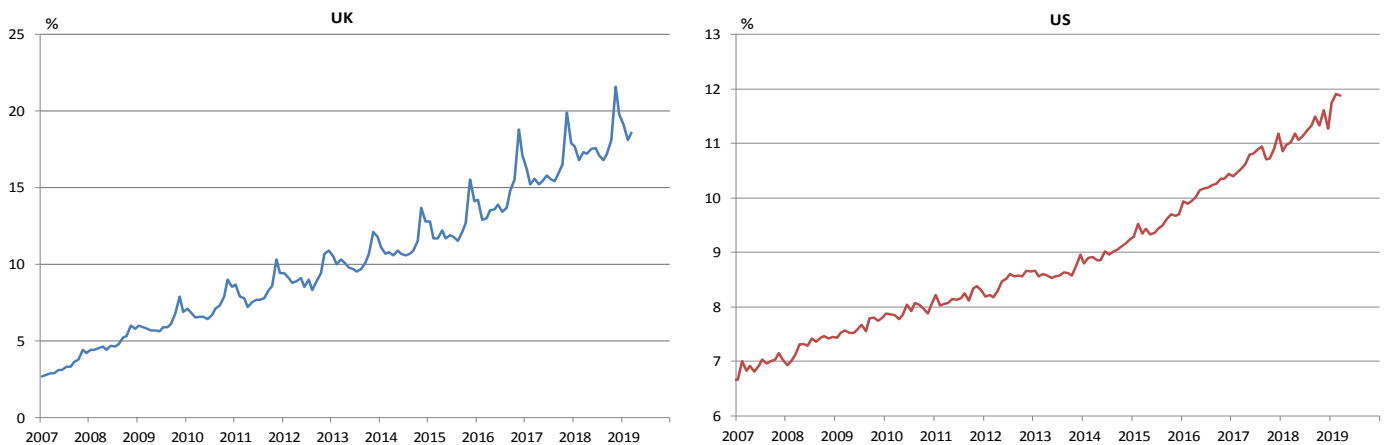
Source: eMarketer.com

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Again, this anecdotal evidence appears to be reflected in the hard data, so where as in the UK and the US online shopping represents around 19% and 12% of total retail sales respectively, in terms of shopping for food, the figure in the UK currently stands at under 6%, while in the US, one estimate puts the current figure at less than 2%. (To put things into context, sales in so-called ‘predominantly food stores’ accounts for around 45% of total UK retail sales).

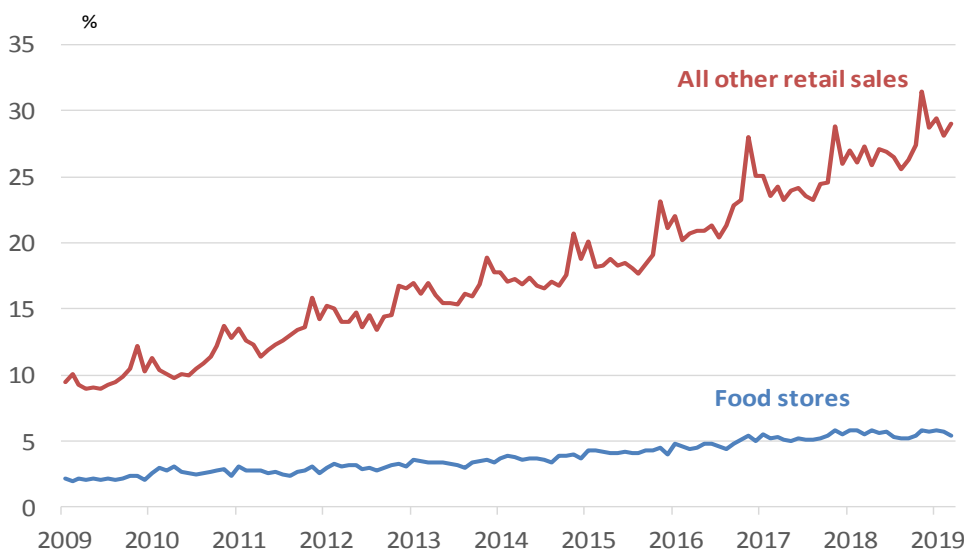
So is there perhaps a natural limit to how common online shopping becomes? For some categories of consumption, the answer is probably yes. For instance, in the comparatively internet-savvy UK, the share of food bought online has basically stayed unchanged for the last couple of years (see second chart below), so consumers are going online more and more to buy things, but they have not embraced buying food.

Online retailing as % of total retail sales



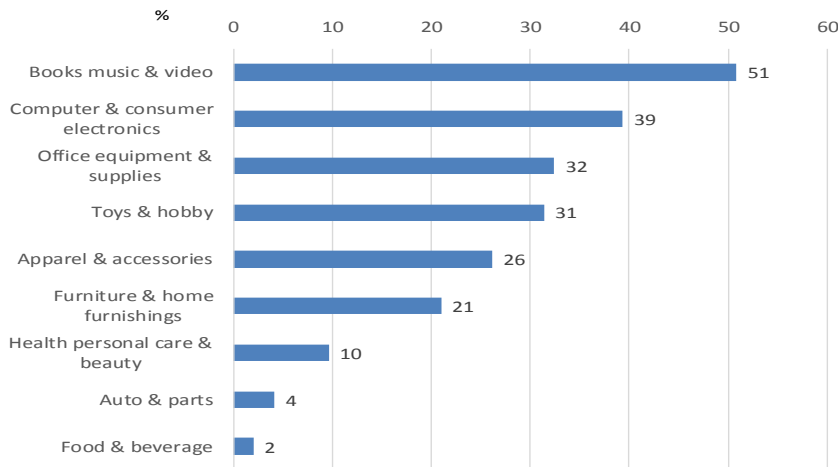
Source: ONS, BLS and Jefferies International

Share of UK retail sales done on-line: food vs the rest



Source: ONS and Jefferies International

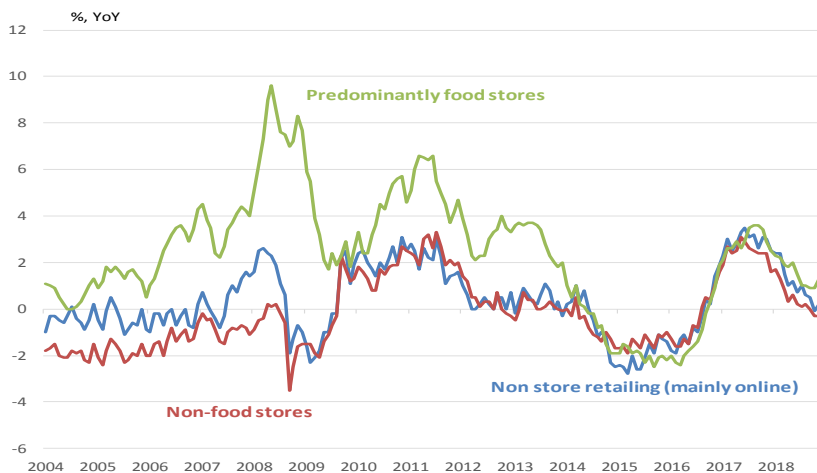
Ecommerce penetration as % total US retail sales by product category



Source: eMarketer

Turning now to implications, what are some ideas for policymakers to explore when it comes to the effects of online shopping? One interesting strand to consider is whether there are limits to which any further rise in the popularity of online shopping will make a difference to inflation. For instance, in the UK, five years ago, non-food retailers were running significantly lower rates of inflation than traditional stores, helping to push down on the overall rates of inflation in the economy. However, perhaps, as online shopping hit a critical threshold and price comparison become pervasive, the inflation rates between the two categories of shops converge. There are certain to be other contributing factors such as the emergence of challenger discount supermarkets. But there is an argument that perhaps only a small share of consumers need to start shopping online to raise competition and for there to be downward pressure on prices for everyone; but, down the line, it probably doesn't make much difference whether its 20% of all sales that are done online or 30% – the marginal effect in terms of dampening inflation is then very minimal.

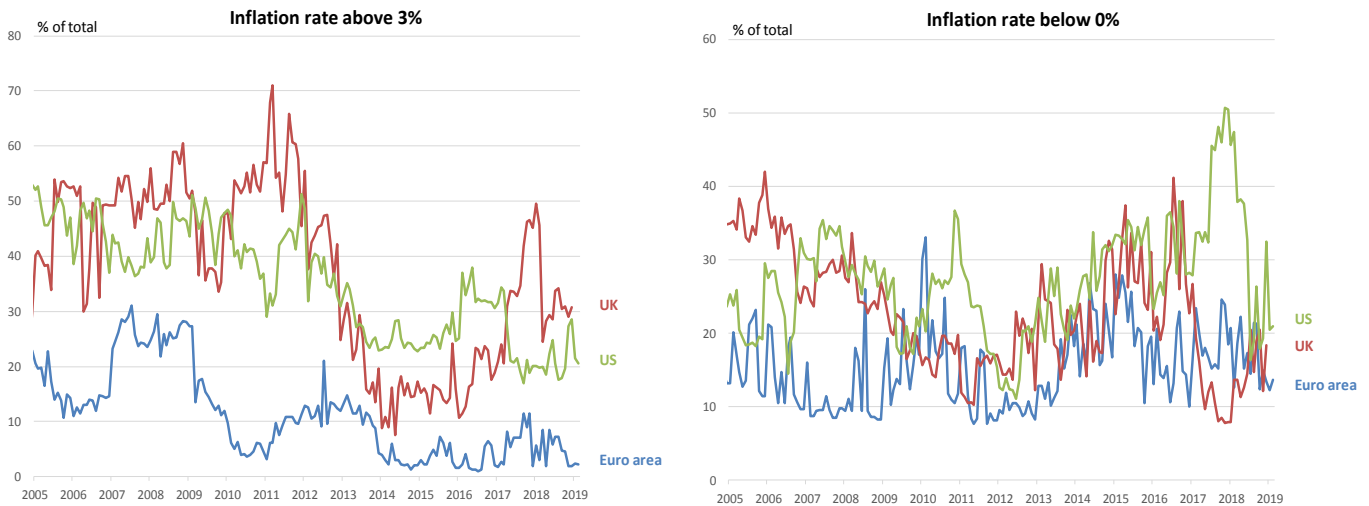
UK CPI inflation by category of retail



Source: ONS and Jefferies International

Indeed, looking at some of the hard data, our own Deflation Monitor analysis for example suggests that if one is looking to explain what’s really changed in the global inflation dynamics over the past five years, it is not the fact the retailers have been aggressively cutting prices (the weight of items in core HICP/CPI baskets in the US, the Euro area, and the UK where prices are falling year on year is basically the same as it was ten years ago – see chart on the right below), but rather perhaps that they are cautious about raising prices too aggressively – the weight of items in core HICP/CPI baskets where prices are rising at over 3% on year are much lower than they’ve been traditionally. In a world where the Google price-comparison function immediately exposes you as being too expensive, it’s unsurprising that retailers may be more cautious than in the past about putting up prices to widen their margins.

Share of core inflation baskets where prices are rising at more than 3% YoY and below 0%



Source: Jefferies International

Another interesting topic for further analysis comes from US academics who suggest that greater proliferation of online shopping has an impact on how all retailers (traditional brick-and-mortar and online only) set their prices. The results are summed up in the table below and suggest that prices are now being changed much more frequently than they were a decade ago; while at the same time price changes, on average, somewhat smaller in size than in the past.

Behaviour of regular prices in large US retailers

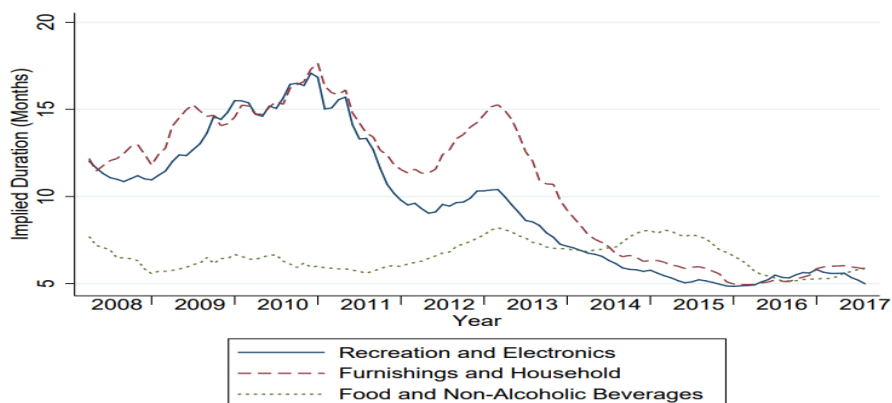
	Period Averages		
	2008-2010	2011-2013	2014-2017
Frequency of Price Changes (%)	15.43	22.39	27.39
Implied Duration (months)	6.48	4.47	3.65
Frequency of Price Increases (%)	6.89	10.27	12.49
Frequency of Price Decreases (%)	8.94	12.12	14.96
Absolute Size of Price Changes (%)	17.45	16.24	15.02
Size of Price Increases (%)	18.3	17.09	15.42
Size of Price Decreases (%)	-16.79	-14.71	-14.02
Share of Price Changes under 1pc	6.59	5.23	8.01
Sales as Share of Price Changes (%)	4.02	3.98	3.29

Source: Alberto Cavallo, “More Amazon Effects: Online Competition and Pricing Behaviours”, August 2018

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Monthly implied duration of regular price changes by sector in the US



Source: Alberto Cavallo, “More Amazon Effects: Online Competition and Pricing Behaviours”, August 2018

One important implication in terms of impact on inflation is that in a world where everyone watches and knows each other’s prices the response to any external shock (a higher oil price, fall in the exchange rate) is potentially more synchronised. In the context of the euro area, there are several other ideas to consider. For example, individual country inflation dynamics are significantly less synchronised than may be commonly believed. For instance, the table below shows the average move in the core HICP index for the Big-4 euro area countries over the past five years and it highlights that prices do not move in step throughout the year. Seasonal sales take place at slightly different times, and retailers even in bordering countries do not appear to follow each other’s practices. Now, the obvious question is what happens to these country differences as sales are increasingly driven by activity on blockbuster events such as Black Friday and Amazon Prime Day? Logically, one should see country inflation releases across the euro area become much more synchronised, and taking it a step further, perhaps even lead to greater synchronisation between inflation rates in the euro area, the US and the UK.

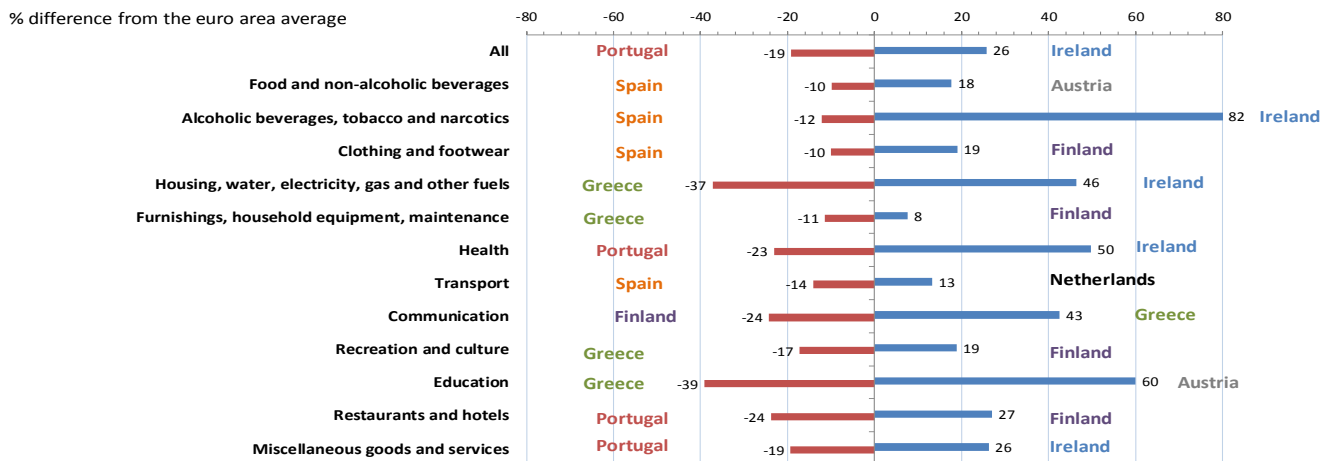
Monthly changes in core inflation by country

	Average monthly change in the core HICP index: 5-year average 2014-2018				
	Euro area	Germany	France	Italy	Spain
Jan	-1.8	-1.3	-1.1	-3.0	-2.7
Feb	0.4	0.7	0.5	-0.3	0.0
Mar	1.5	0.8	1.0	3.1	2.5
Apr	0.4	0.2	0.1	0.9	0.9
May	0.2	0.4	0.1	0.0	0.2
Jun	0.1	0.2	0.1	0.2	0.0
Jul	-0.6	0.8	-0.4	-2.4	-2.0
Aug	0.3	0.1	0.7	-0.1	0.1
Sep	0.4	-0.2	-0.5	2.5	1.0
Oct	0.0	-0.1	-0.1	0.1	0.4
Nov	-0.5	-1.1	-0.2	-0.5	0.2
Dec	0.4	0.7	0.4	0.3	-0.1

Source: Eurostat and Jefferies International

Before we get there, however, one hurdle that will need to be overcome is what happens to the difference in the level of prices across the euro area. We will write on this topic in more detail later in the year, but as an example, on the latest measure, the differences in the cost of many goods and services across the euro area remains high. The chart below shows how prices compare across the largest euro area countries; and while, as expected, price differences are largest in the cost of various services, large price differences continue to exist in the cost of goods such as clothes and household items. Retailers of course are legally obliged to charge the same price to shoppers in every euro area country, so price transparency which comes with online shopping should help narrow these differences. But what price convergence means in practice is that the relatively 'expensive' and the relatively 'cheap' countries will run different rates of inflation in order that prices reach a single equilibrium level. After that happens, inflation rates should then converge.

Dispersion of prices across the largest euro area countries: most and least expensive places to purchase goods and services



Source: Eurostat and Jefferies International

Overall, it's the statement of the blindingly obvious that the impact of internet shopping on euro area inflation is multi-layered. Up to a point, growing popularity of online shopping will increase competition and push down on inflation. But countries with big shares of online shoppers (such as the UK or Germany) may at some point feel no further impact on inflation from more people using buying goods and services on the internet – and perhaps that point has already been reached. On the flip side, cultural preferences may always keep some consumers in some euro area countries from shopping online, but those economies may still see lower inflation because: a) domestic retailers are nonetheless affected by increased threat from online competition, or b) pan-European retailers, are setting prices for the euro area as an entire region. Also, as mentioned, while it is reasonable to assume that, over time, euro area countries should see more synchronised rates of inflation, it is not immediately consistent with the idea that the level of prices (for branded goods at least) across the region should be converging toward a single price point, and price discovery related to online shopping should be accelerating this process.

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Finally, the tables below maybe give a glimmer of what may be on the horizon and offer some industry statistics on the global reach of Amazon and the popularity of its Prime service (with its free, and mostly one-day, shipping) across Europe. For economists, clearly, this will continue to be a fascinating subject to continue exploring.

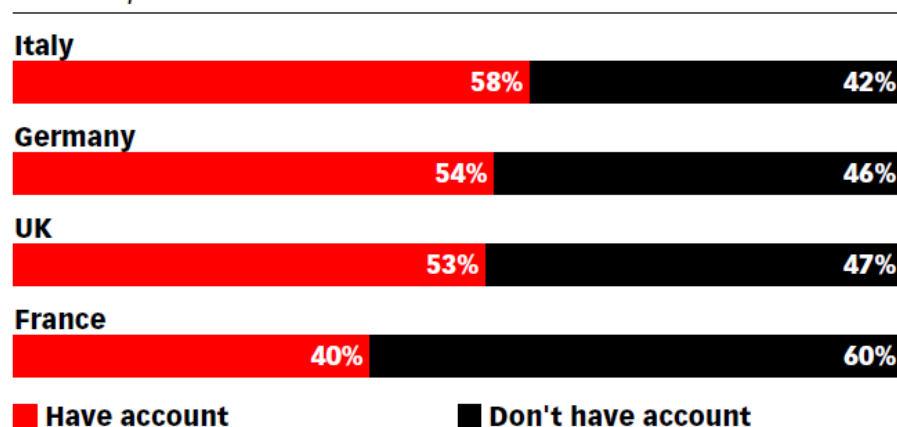
% of internet users who regularly Amazon.com or Amazon app % reach

	2017	2018
Argentina	3.5%	5.0%
Australia	7.7%	8.0%
Brazil	3.3%	5.7%
Canada	29.3%	46.9%
China	0.3%	0.4%
France	7.4%	14.6%
Germany	11.6%	21.5%
Hong Kong	4.4%	4.3%
India	9.9%	16.5%
Indonesia	2.2%	1.6%
Italy	17.5%	36.1%
Japan	4.7%	7.8%
Malaysia	4.2%	5.2%
Mexico	4.7%	7.9%
Spain*	12.6%	29.2%
UK*	33.7%	40.8%
US*	63.1%	72.2%

Source: eMarketer.com

% of internet users who have an Amazon Prime account (July 2018)

% of respondents



Source: eMarketer.com

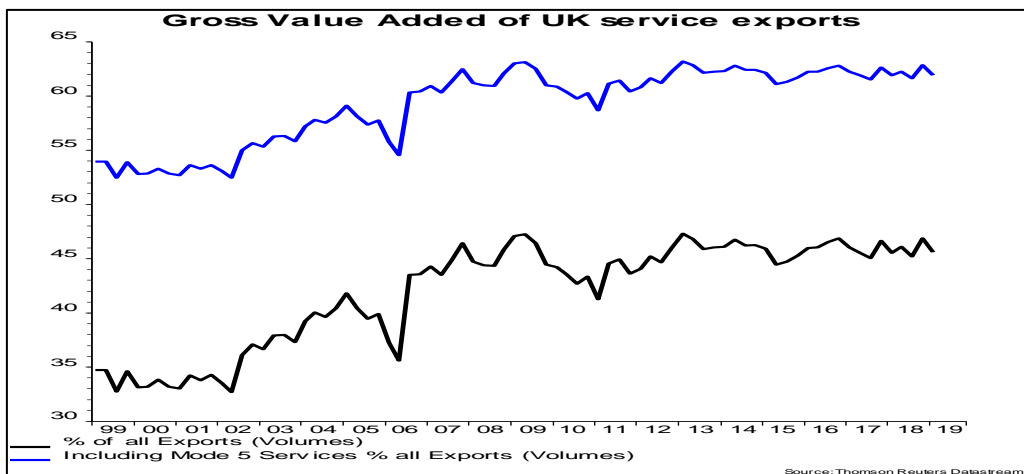
Brexit: Outside the single market level of trade restrictions with the EU for services will be key

When it comes to Brexit, one of our key themes is that, with or without the UK, the economic geography of the EU is set to change, driving capital flows. Much of this would focus on services, a sector that continues to take the back seat in Brexit discussions, despite being highly dependent on regulatory approval and access for trade. Most commentators – even those arguing for a WTO Brexit – recognize the importance of services for the UK economy. However, there seems to be a common misperception that, almost whatever happens, service access will carry on pretty much as before, with the focus instead on manufacturing. This is not at all clear.

Recent weeks saw key-note speeches from the ECB's Benoit Couere, arguing that services were the most important driver of growth in the euro area (something that is still not appreciated by financial markets) and the BoE's Jonathan Haskel, highlighting that spending on intangibles was now more important than investment in fixed assets, but under-recorded in the National Accounts, and even more so in quoted company accounts.

When thinking about services it is often suggested, especially amongst those that work in finance, that services are all about finance. However, UK exports of financial services represent just over 20% of all UK exports of services, even excluding so-called Mode 5 services. Mode-5 services are the embedded services in an export of a UK manufactured good. These include the intellectual property, the research and development, the embedded software, the financing and after sales servicing that goes with the product. Often these Mode 5 services are the more high-value added part of the production chain. They are more important than the exports of UK financial services, being put at around 30% of the value of UK manufactured exports, or around £70bn (as shown in the chart).

But, arguably part of the explanation for the Brexit discussions to largely ignore services, including the importance of services for the Irish border issue, is this misperception that service exports in large part comprise financial services – a sector that is hardly popular after the financial crisis.



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To help put all this in context the table below shows ONS estimates of UK exports for services in 2018, broken down by sector. We have compared exports to the EU-27 with the US as well as the figures overall. UK exports of services totalled £283.4bn last year, or 13.4% of GDP (this does not include any Mode 5 service sector exports). Of this, UK exports of financial services was 21.7% of the total, or £61.4bn. Combined, transportation and travel were bigger (£69.1bn, or 24.4% of the total), as was other business services (£81.3bn, or 28.7% of the total). Other business service exports include legal, accounting, management consultancy (£32.6bn or 11.5%) and technical services (£40.8bn, or 14.4%). And, then there is intellectual property (£17.1bn, or 6%) and telecommunications, computer and information services (£20.8bn, or 7.3%).

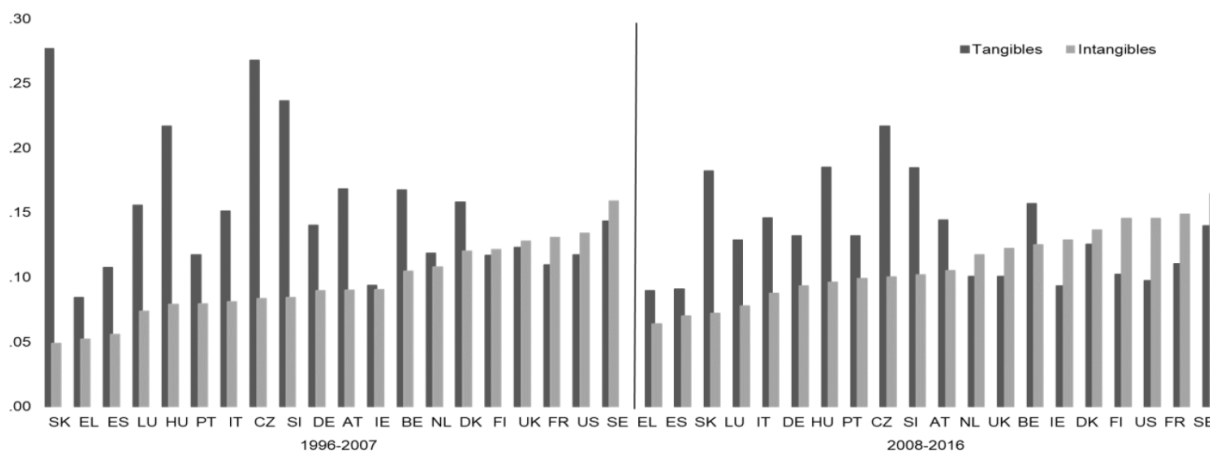
UK export of services in 2018, broken down by sector

	EU-27		US		Total	
	£bn	% Total	£bn	% Total	£bn	% Total
Total Services	116.7		63.2		283.4	
Transportation	13.1	11.2	5.5	8.7	30.2	10.7
<i>of which:</i>						
Sea Transportation	2.7	2.3	2.0	3.1	8.1	2.9
Air Transportation	9.6	8.3	3.0	4.8	18.8	6.6
Travel	17.1	14.7	4.8	7.7	38.9	13.7
<i>of which:</i>						
Business Travel	2.4	2.1	0.7	1.1	5.5	2.0
Personal Travel	14.7	12.6	4.2	6.6	33.3	11.8
Construction	1.0	0.9		0.0	2.0	0.7
Insurance and Pension provision	6.3	5.4	4.8	7.6	19.6	6.9
Financial services	26.7	22.9	14.6	23.1	61.4	21.7
Intellectual Property	6.0	5.2	3.4	5.3	17.1	6.0
Telecommunications, computer and information services	9.2	7.9	3.7	5.8	20.8	7.3
<i>of which:</i>						
Telecommunications	2.6	2.2	0.6	1.0	5.7	2.0
Computer services	5.6	4.8	1.6	2.5	10.6	3.7
Information services	1.1	0.9	1.5	2.4	4.4	1.6
Other business services	32.2	27.6	24.2	38.2	81.3	28.7
<i>of which:</i>						
Research and Development	2.3	2.0	4.0	6.4	7.9	2.8
Legal, Accounting, Management Consultancy and Public Relations	8.3	7.1	10.5	16.5	32.6	11.5
Advertising, Market Research	4.6	4.0	0.7	1.0	7.2	2.5
Technical, including Architecture, Engineering and Scientific	16.9	14.5	9.7	15.3	40.8	14.4

Source: ONS and Jefferies

What the breakdown highlights is that, compared with exports to the US, UK service exports to the EU-27 punch above their weight in areas like transportation and travel (to be expected), telecommunications, computer and information services. They are relatively similar in finance, intellectual property and technical services including architecture, engineering and scientific, but that as a destination for UK exports, the US wins out in areas like research and development, legal, accounting, management consultancy and public relations. Presumably, UK tourism earnings will not change much post-Brexit and to the extent that legal services benefit from the widespread use of UK Law nothing much may change there either, but what is not clear is the extent to which as things stand the advantage UK other business services enjoys is a product of the UK currently having full access to the EU single market – the biggest and most comprehensive single market for services globally, for the world’s biggest trading bloc.

Intangible and tangible shares of output (Jonathan Haskel)



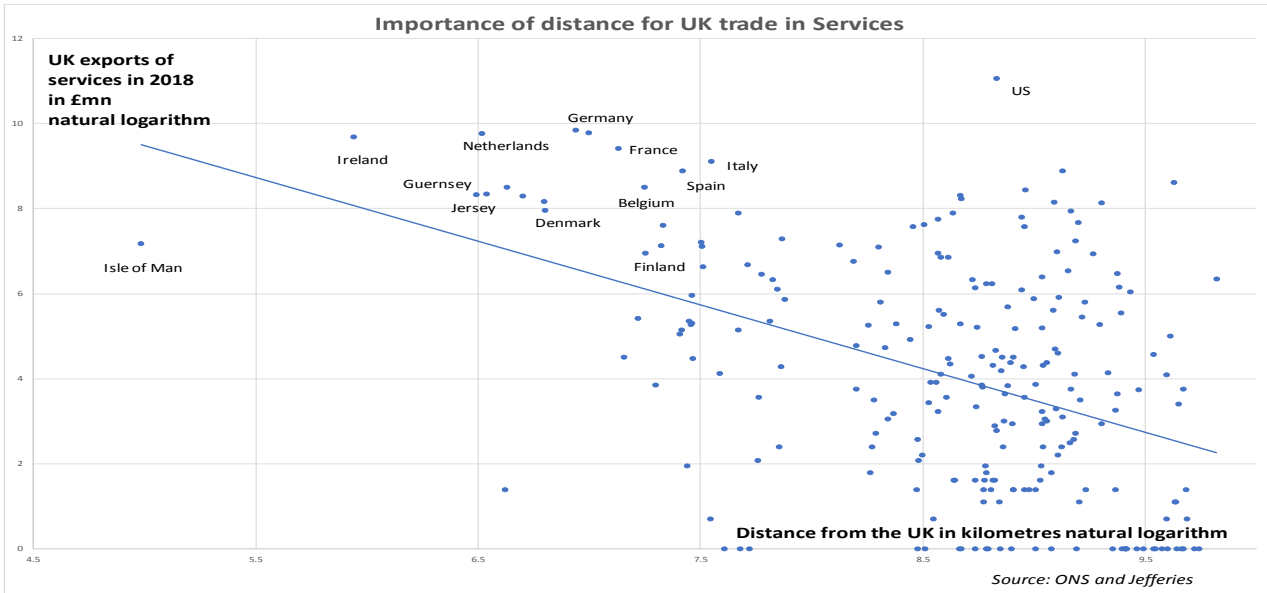
Note: GDP is adjusted to include intangibles. Country abbreviations are as follows: Austria (AT), Belgium (BE), Czech Republic (CZ), Germany (DE), Greece (EL), (GR), Denmark (DK), Hungary (HU), Spain (ES), Finland (FI), France (FR), Ireland (IE), Italy (IT), Luxembourg (LU), Netherlands (NL), Portugal (PT), Slovenia (SI), Slovakia (SK), Sweden (SE), United Kingdom (UK), United States (US).
Source: Authors' elaboration of data from INTAN-Invest@2018.

To further illustrate the level of detail of the data, the tables on pages 54 and 55 show UK exports of imports of services at the country level. One can see the importance of the EU-27, alongside the Crown dependencies (Guernsey, Jersey, the Isle of Man), the US (£63.2bn of UK exports of services in 2018, compared to £116.7bn for the EU-27), Switzerland (£12.3bn), Japan (£7.3bn), Australia (£5.5bn), China (£4.6bn), Canada (£4.1bn), the United Arab Emirates (£3.8bn), Singapore and South Korea (both £3.4bn), Norway (£2.9bn), Hong Kong (£2.9bn), Gibraltar and Russia (both £2.7bn) and Saudi Arabia (£2.3bn). According to the ONS, the UK runs a larger trade surplus with the US, than the EU-27 (£32.8bn, compared to £29.4bn), precisely because UK trade in services with the EU-27 is much more two-way (UK imports of services from the EU-27 was put at £87.3bn last year). Other countries that the UK runs a large trade surplus in services with include Switzerland (£7.9bn), China (£3.1bn), South Korea (£2.8bn), Australia (£2.9bn), Guernsey (£2.9bn), Canada and Kuwait (both £2bn), Gibraltar, Japan, Russia and Saudi Arabia (all £1.9bn).

Jefferies Fixed Income

What is very apparent, as we have shown before, is the importance of distance for UK trade in services. This can be seen very clearly from the chart below. Geographically, the closer the country, the more trade in services that the UK does with that country.

Services cannot defy gravity either: The importance of distance for UK export of services in 2018



UK trade in services with the rest of the EU, £bn

Exports of services	2016	2017	2018	Imports of services	2016	2017	2018	Trade Balance in services	2016	2017	2018
European Union (EU27)				European Union (EU27)				European Union (EU27)			
Austria	1.0	1.2	1.2	Austria	1.3	1.0	1.2	Austria	-0.3	0.2	0.0
Belgium	4.3	5.2	4.9	Belgium	2.5	2.4	2.5	Belgium	1.8	2.8	2.4
Bulgaria	0.5	0.5	0.6	Bulgaria	0.5	0.6	0.7	Bulgaria	0.0	-0.1	-0.1
Croatia	0.2	0.2	0.2	Croatia	0.5	0.6	0.7	Croatia	-0.3	-0.4	-0.5
Cyprus	0.8	0.8	0.9	Cyprus	1.1	1.2	1.2	Cyprus	-0.3	-0.4	-0.4
Czech Republic	1.0	1.0	1.0	Czech Republic	0.7	0.8	0.9	Czech Republic	0.3	0.3	0.1
Denmark	3.6	3.6	4.0	Denmark	1.2	1.3	1.3	Denmark	2.3	2.3	2.8
Estonia	0.1	0.1	0.1	Estonia	0.0	0.1	0.1	Estonia	0.0	0.0	0.0
Finland	1.2	1.2	1.2	Finland	0.5	0.4	0.5	Finland	0.7	0.9	0.7
France	15.7	16.8	17.6	France	12.3	13.0	14.6	France	3.4	3.8	3.0
Germany	17.4	19.2	18.9	Germany	9.0	9.7	9.4	Germany	8.4	9.4	9.5
Greece	1.3	1.4	1.5	Greece	2.9	2.9	3.1	Greece	-1.6	-1.4	-1.6
Hungary	0.7	0.8	0.8	Hungary	0.6	0.8	0.9	Hungary	0.0	-0.1	-0.2
Ireland	12.4	16.3	16.1	Ireland	7.3	7.5	7.8	Ireland	5.1	8.9	8.3
Italy	9.1	8.9	9.0	Italy	5.5	5.3	5.6	Italy	3.5	3.6	3.4
Latvia	0.1	0.1	0.2	Latvia	0.2	0.1	0.2	Latvia	0.0	0.0	0.0
Lithuania	0.2	0.2	0.2	Lithuania	0.3	0.3	0.4	Lithuania	-0.1	-0.1	-0.2
Luxembourg	3.0	3.1	3.5	Luxembourg	2.1	2.4	2.7	Luxembourg	0.9	0.7	0.8
Malta	0.8	0.9	0.4	Malta	0.8	0.6	0.6	Malta	0.0	0.2	-0.2
Netherlands	14.9	16.5	17.5	Netherlands	6.3	6.6	6.9	Netherlands	8.7	9.9	10.6
Poland	1.8	2.1	2.0	Poland	2.1	2.5	2.6	Poland	-0.3	-0.4	-0.6
Portugal	1.3	1.3	1.4	Portugal	2.7	2.7	2.9	Portugal	-1.4	-1.3	-1.5
Romania	0.8	0.7	0.8	Romania	0.8	1.0	1.1	Romania	0.0	-0.2	-0.3
Slovakia	0.3	0.3	0.4	Slovakia	0.2	0.3	0.4	Slovakia	0.2	0.1	0.0
Slovenia	0.1	0.2	0.2	Slovenia	0.1	0.1	0.1	Slovenia	0.1	0.1	0.1
Spain	6.5	6.9	7.3	Spain	13.8	14.9	15.7	Spain	-7.2	-8.0	-8.4
Sweden	5.0	5.0	4.9	Sweden	1.9	2.4	3.3	Sweden	3.1	2.6	1.6
European Central Bank (ECB)	0.0	0.0	0.0	European Central Bank (ECB)	0.0	0.0	0.0	European Central Bank (ECB)	0.0	0.0	0.0
European Union Institutions (excl. ECB and ESM)	0.0	0.1	0.0	European Union Institutions (excl. ECB and ESM)	0.0	0.0	0.0	European Union Institutions (excl. ECB and ESM)	0.0	0.1	0.0
Total EU27	104.0	114.9	116.7	Total EU27	77.0	81.5	87.3	Total EU27	27.1	33.4	29.4

Source: ONS and Jefferies

12 June 2019

Jefferies Fixed Income

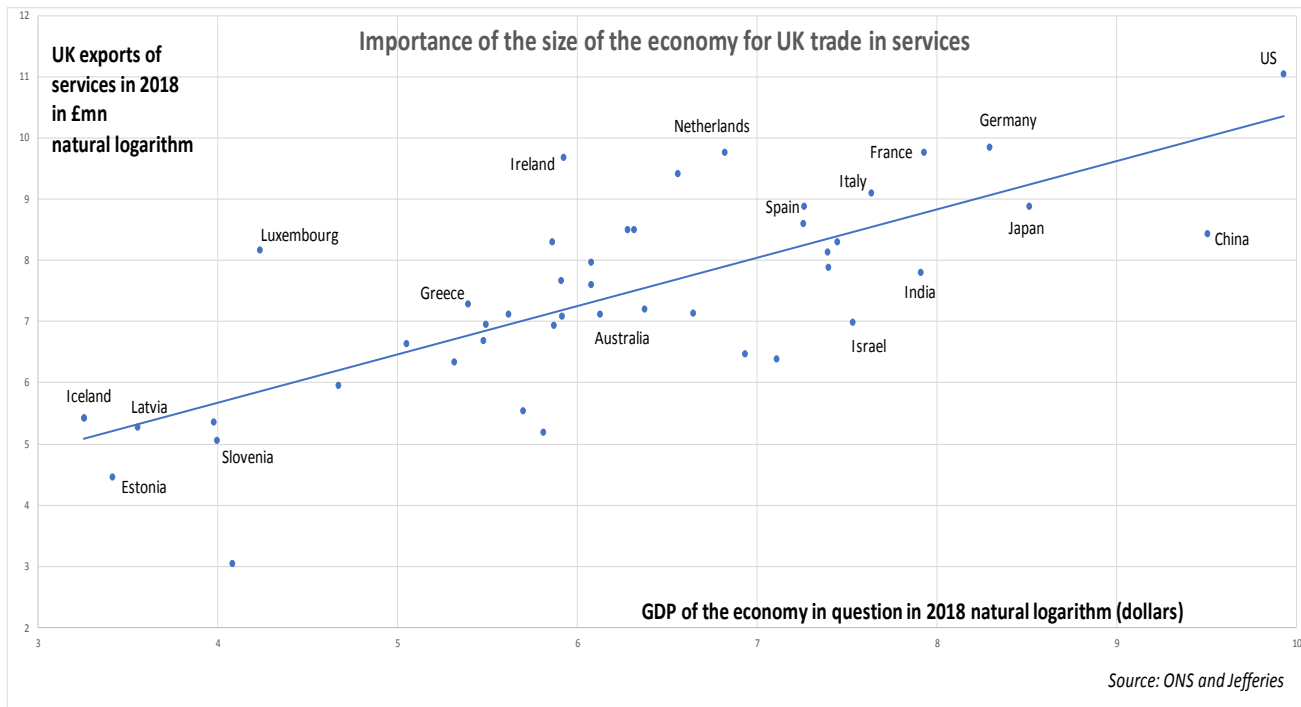
GLOBAL FIXED INCOME

UK trade in services with the rest of the world, £bn

Exports of services	2016	2017	2018	Imports of services	2016	2017	2018	Trade Balance in services	2016	2017	2018
Extra EU27 (Rest of World)				Extra EU27 (Rest of World)				Extra EU27 (Rest of World)			
Australia	5.0	5.6	5.5	Australia	2.5	2.8	2.6	Australia	2.5	2.8	2.9
Barbados	0.1	0.1	0.5	Barbados	0.2	0.3	0.5	Barbados	-0.1	-0.2	0.0
Bermuda	1.3	1.3	0.9	Bermuda	1.0	1.9	1.3	Bermuda	0.3	-0.6	-0.4
Brazil	1.1	1.2	1.1	Brazil	0.5	0.6	0.6	Brazil	0.6	0.5	0.4
British Virgin Islands	0.8	0.5	0.5	British Virgin Islands	0.1	0.1	0.0	British Virgin Islands	0.7	0.5	0.5
Canada	4.0	4.3	4.1	Canada	1.7	2.1	2.0	Canada	2.3	2.3	2.0
Cayman Islands	1.8	1.9	1.9	Cayman Islands	0.3	0.2	0.3	Cayman Islands	1.5	1.7	1.7
China	3.9	4.1	4.6	China	1.8	1.5	1.5	China	2.2	2.6	3.1
Egypt	0.8	0.7	0.7	Egypt	0.8	0.4	0.4	Egypt	0.0	0.3	0.3
FYR Macedonia	0.5	0.2	0.6	FYR Macedonia	0.7	0.3	0.4	FYR Macedonia	-0.2	-0.1	0.2
Gibraltar	3.1	3.6	2.7	Gibraltar	1.1	1.1	0.8	Gibraltar	2.0	2.5	1.9
Guernsey	7.0	4.3	4.1	Guernsey	1.8	2.2	1.2	Guernsey	5.2	2.0	2.9
Hong Kong	2.7	3.1	2.8	Hong Kong	2.0	1.9	2.5	Hong Kong	0.6	1.2	0.3
Iceland	0.2	0.3	0.2	Iceland	0.3	0.5	0.6	Iceland	-0.1	-0.2	-0.3
India	2.2	2.2	2.5	India	3.1	3.7	4.8	India	-0.9	-1.5	-2.3
Indonesia	0.4	0.5	0.6	Indonesia	0.3	0.3	0.3	Indonesia	0.1	0.3	0.4
Isle of Man	1.3	0.9	1.3	Isle of Man	0.4	0.3	0.3	Isle of Man	1.0	0.6	1.0
Israel	1.0	1.2	1.2	Israel	0.5	0.5	0.7	Israel	0.5	0.6	0.5
Japan	6.9	6.9	7.3	Japan	3.7	4.5	5.3	Japan	3.2	2.3	1.9
Jersey	5.2	4.0	4.2	Jersey	3.4	3.4	4.6	Jersey	1.8	0.6	-0.4
Kazakhstan	2.2	1.7	2.0	Kazakhstan	0.1	0.1	0.2	Kazakhstan	2.1	1.6	1.7
Kuwait	1.2	1.6	2.0	Kuwait	0.0	0.1	0.1	Kuwait	1.2	1.6	2.0
Malaysia	0.8	1.0	1.0	Malaysia	0.7	0.4	0.4	Malaysia	0.1	0.6	0.6
Mauritius	0.2	0.3	0.3	Mauritius	0.3	0.4	0.5	Mauritius	-0.1	-0.1	-0.2
Mexico	0.6	0.6	0.6	Mexico	0.8	0.9	1.0	Mexico	-0.2	-0.3	-0.4
Moldova	0.0	0.0	0.0	Moldova	0.2	0.2	0.5	Moldova	-0.2	-0.2	-0.5
Morocco	0.4	0.4	0.4	Morocco	0.6	0.5	0.5	Morocco	-0.2	-0.1	-0.2
New Zealand	0.6	0.6	0.6	New Zealand	0.4	0.5	0.5	New Zealand	0.3	0.0	0.1
Nigeria	1.0	1.0	1.1	Nigeria	0.3	0.4	0.4	Nigeria	0.6	0.6	0.7
Norway	2.8	2.7	2.9	Norway	1.2	1.4	1.5	Norway	1.7	1.2	1.3
Oman	1.0	1.4	0.6	Oman	0.1	0.1	0.1	Oman	0.9	1.4	0.5
Pakistan	0.4	0.5	0.5	Pakistan	0.6	0.6	0.7	Pakistan	-0.2	-0.2	-0.2
Philippines	0.2	0.2	0.2	Philippines	0.5	0.4	0.5	Philippines	-0.3	-0.2	-0.3
Qatar	1.1	0.8	0.9	Qatar	0.2	0.2	0.2	Qatar	1.0	0.6	0.8
Russia	2.4	2.8	2.7	Russia	0.7	0.7	0.8	Russia	1.7	2.1	1.9
Saudi Arabia	2.0	2.4	2.3	Saudi Arabia	0.7	0.3	0.4	Saudi Arabia	1.3	2.1	1.9
Singapore	3.1	3.4	3.4	Singapore	2.1	1.8	2.0	Singapore	1.0	1.6	1.4
South Korea	1.5	2.6	3.4	South Korea	0.6	0.5	0.6	South Korea	1.0	2.1	2.8
Switzerland	11.9	12.5	12.3	Switzerland	4.2	4.2	4.4	Switzerland	7.7	8.3	7.9
Taiwan	0.9	0.8	1.4	Taiwan	0.2	0.2	0.3	Taiwan	0.7	0.6	1.1
Thailand	0.4	0.6	0.7	Thailand	1.2	1.0	1.0	Thailand	-0.7	-0.4	-0.3
Turkey	1.5	1.2	1.3	Turkey	1.4	1.5	1.7	Turkey	0.1	-0.3	-0.4
United Arab Emirates	3.6	3.3	3.8	United Arab Emirates	2.2	2.1	2.6	United Arab Emirates	1.4	1.2	1.1
United States inc Puerto Rico	53.7	62.4	63.2	United States inc Puerto Rico	28.0	29.7	30.4	United States inc Puerto Rico	25.7	32.6	32.8
Rest	11.1	12.2	11.8	Rest	6.2	7.2	6.9	Rest	4.8	5.0	4.9
Total Extra EU27 (Rest of World)	153.9	163.9	166.7	Total Extra EU27 (Rest of World)	79.2	84.2	89.0	Total Extra EU27 (Rest of World)	74.7	79.7	77.7
Source: ONS and Jefferies											

Of course, a gravity model of trade would suggest that it is not just distance that matters for exports and imports of services. The size of the economy in question also matters. This is confirmed in the chart below, with the US seen to be punching above its weight, and China growing in importance.

Services cannot defy gravity either: The importance of size of economy for UK export of services in 2018



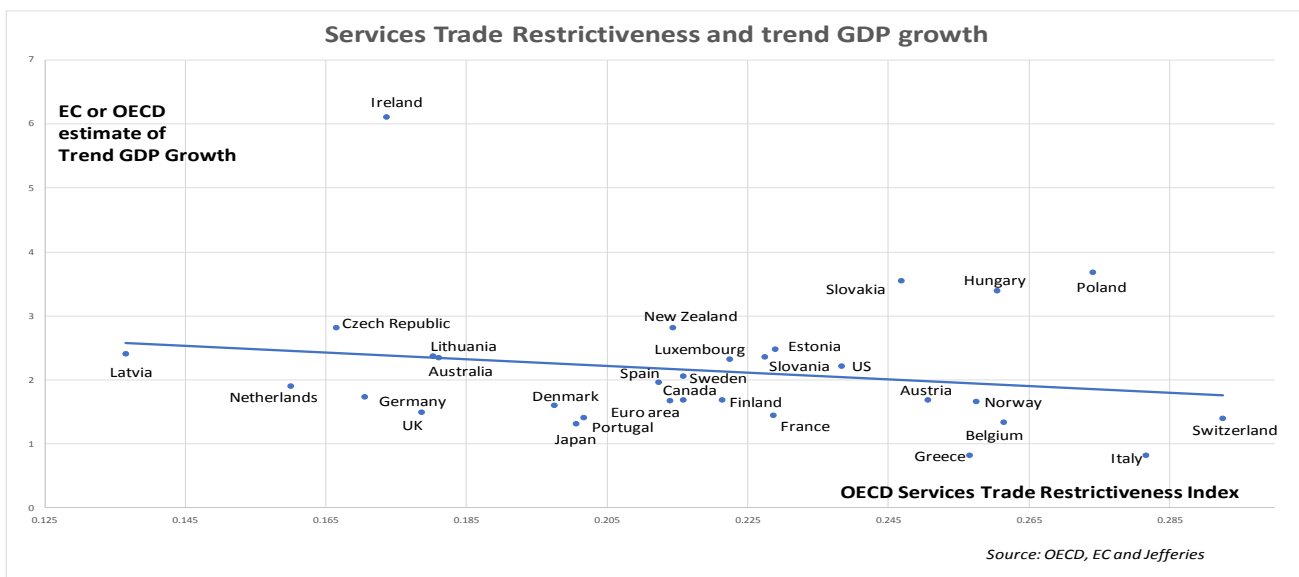
Importance of barriers to trade in services

If that was it, then UK trade in services with the rest of the EU and the rest of the world would simply be a function of distance and the size of the economy in question. However, we know the reality is more complex.

The OECD recently updated its database on trade restrictiveness for services by country. The important thing to recognize is that when it comes to service sector trade, it is regulatory issues and access that can be key. Either you have it, or you haven't. Either you need a license to operate or you don't. If you don't you may be able to work around it; either you must set up a separately capitalized office, staffed with individuals with the relevant qualifications or you don't; in financial services, for example, equivalence is not the same as mutual recognition; the devil really is in the detail. Put simply, as part of the EU single market an architecture practice can be based in London, staffed with Italians and Brits, and bid for public sector contacts across the EU. Going forwards, that may not be the case. Regulation may force it to open another office in the EU-27, and for some of the Brits an additional qualification may be needed, in order to be professionally recognized.

Many companies may be able to work around the problem, but for others it may be an additional cost too far. Moreover, one thing is clear. In this example, this is not financial services, where balance sheet carries counterparty and systematic risk. In this example, it would be quite understandable if other EU countries were keen to “capture” as much of this high-value added business as possible. Whole ecosystems which have grown up around the companies concerned, could overtime slowly begin to unravel. That is the risk. The OECD measure of trade restrictiveness for services looks at 22 sectors, comprising all OECD countries, Brazil, the People’s Republic of China, Costa Rica, India, Indonesia, Malaysia, the Russian Federation and South Africa, countries and sectors representing over 80% of all trade in services. We have shown before the relationship between the OECD’s measure of trade restrictiveness for services and estimates of trend growth. The more open the economy for services, the higher the trend growth (see chart).

Composite indices are put together for all countries, examining a wide range of issues, including foreign equity restrictions, legal and commercial restrictions, licensing requirements, broadcasting restrictions, composition, nationality and qualifications of managers, directors and other professionals, landing, transit, chartering and access rights, data, ecommerce and internet banking restrictions, services restricted to local monopolies, restrictions on numbers of licenses, foreign suppliers being discriminated on taxation or subsidy grounds, other restrictions on how the procurement process works, national standards that deviate from other countries, deviations from international standards including accountancy rules, restrictions on writing insurance contracts or holding foreign deposits, restrictions of foreigners on copywrite grounds, local contact for film and media rights or local nationals, restrictions on raising capital, inability to seek redress for discrimination, regulation on fees or pricing for foreign competition, regulation on number of products a foreign competitor can offer, duration of visas, or limit on number of visas offered, enforcement rights for intellectual property.



The list goes on, but hopefully this helps illustrate the complexity of the issue and how in theory and practice foreign competitors can be discriminated against. Altogether, the OECD has examined almost 350 different ways the 22 individual sectors can be discriminated against or access denied. The OECD has then distilled all of this into a single service sector trade restrictiveness measure for each country. None of this is perfect, BUT again giving the level of detail the OECD has gone to, very helpful for analysis and as the OECD argue, in future trade negotiations. Indeed, most commentators would accept that in boosting growth and potentially reducing current account imbalances, the focus should be far more on liberalising service sector trade, a point that Mark Carney keeps making.

The importance of trade restrictiveness in services for the UK: EU27 versus the rest



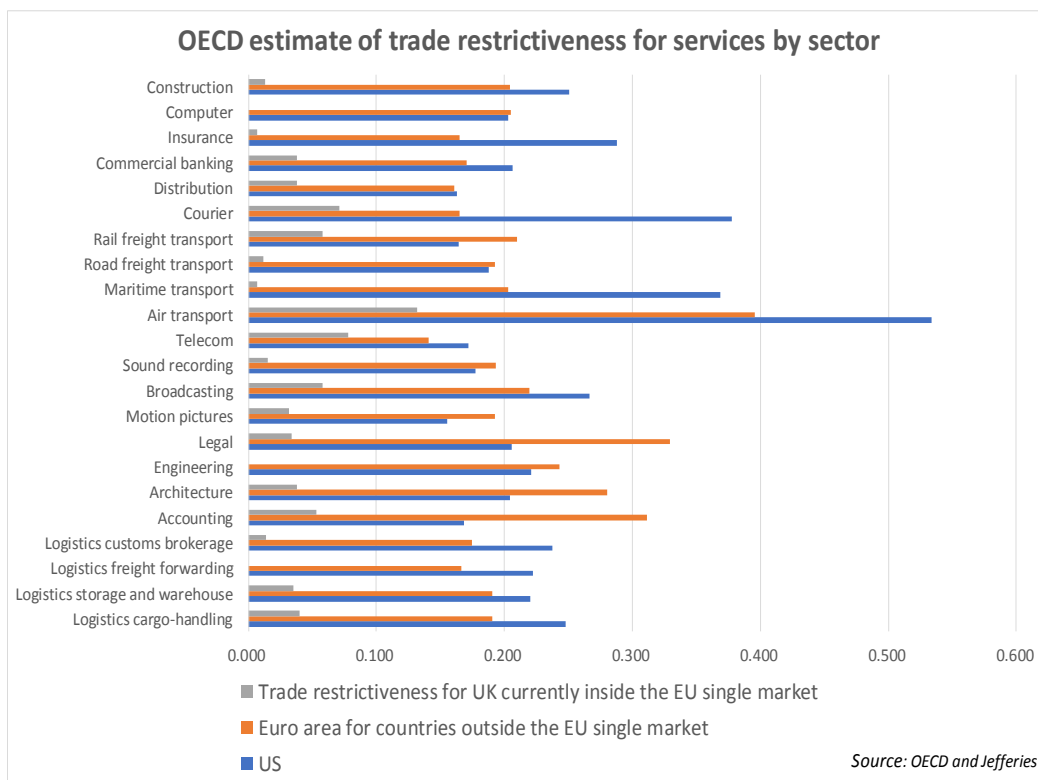
Importantly, the chart above suggests a relationship between the level of trade restrictiveness for a UK service based company exporting into other countries, and how much trade the UK does with that country in question. The greater the restrictiveness (represented by a higher number on the X-axis in the chart above), the less the UK exports to that country, it is as simple as that.

As far as the UK is concerned the starting point is that the country is inside the EU single market for services, where trade restrictiveness is almost zero. This doesn't get around the problem of say, home bias, language or internet usage being important for driving trade in services as well, but it is important to recognize that on the OECD figures the UK is proposing to leave the biggest single market in services there is, where the UK enjoys a

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comparative advantage in. Trade restrictions in the US are in comparison significantly higher. Indeed, access to US markets can be further complicated by the fact that regulation for an individual sector can be set at the state, rather than a federal level. Going forwards, UK trade negotiators need to be very aware of this issue when doing trade deals with the US in services. Indeed, according to the OECD, the UK ease of doing business in Australia and Japan in services is easier than in the US.

To further help put this in context, the chart below compares trade competitiveness by sector for a UK service based company currently operating in the EU-27 (close to zero), compared to the US and compared to what could happen outside the single market. In some cases, trade competitiveness for companies trying to do business say in the euro area when based outside the EU is more difficult than when doing business in the relatively highly regulated and closed, US economy. Sectors here include importantly for the UK, legal services, engineering, architecture and accounting. These services are part of other business services, where UK exports to the EU-27 totalled £32.2bn last year, or 1.5% of GDP.



To add some more rigour to this whole issue we ran a regression for the 23 countries in question (counting the EU as a single bloc), regressing the logarithm of UK exports of services in 2018 against the logarithm of the distance of the country from the UK, the logarithm of the size of the country and the OECD's measure of trade restrictiveness.

Although clearly simplistic; language, currency, internet usage, educational attainment, historic ties along with other factors could all likely play roles as well, the regression came with a R-bar squared of 0.82, with all explanatory variables correctly signed and statistically significant with a T-statistic of more than 1.96.

$$\begin{aligned} \text{Logarithm UK Exports of Services} = & 7.71 - 0.67 * \text{Logarithm Distance} \\ & + 0.98 * \text{Logarithm Size} - 3.71 * \text{Trade Restrictiveness} \end{aligned}$$

Based on this, what might appear to be a relatively small increase in the trade restrictiveness of services as the UK leaves the single market could reduce UK exports of services (worth £283.4bn last year) by as much as 20% - 3.71 times a 0.05 increase in overall trade restrictiveness on the OECD measure, based on the assumption tourism does not become any more restrictive with the EU, and that in most other areas trade restrictiveness rises towards that of Australia. If trade restrictiveness for UK services with the EU approached that seen with the US, everything being equal, we could be looking at a hit of 35%. All such estimates come with a large margin of error around them (nothing is ever equal), but the point remains that there are bound to be negative consequences of the UK leaving globally the largest single market for services.

As a third country, service sector trade restrictiveness with the EU-27 would certainly rise. The question is by much.

And, when it comes to future trade agreements as things stand with Brexit, the UK is giving up a degree of access for some of its most important sectors to its most important market, the EU. The whole discussion to date has been more on ensuring no hard border for Ireland in the case of manufactured goods and agriculture. From a position of weakness, the UK will then be trying to ensure it has as much access as possible for services but is unlikely to come close to gaining the access it currently has. We should also not be surprised if other countries start taking more of an interest in the embedded services in manufactured goods (Mode 5 services) in trade negotiations, especially given their growing importance. Clearly, it would not necessarily be in the EU-27's interest given the amount of services it exports to the UK (£87.3bn according to the ONS data in 2018) to shut the door entirely. But this would all be part of a likely on-going series of negotiations as the EU-27 acts in its own self-interest. Moreover, this all potentially matters as far as the Irish border is concerned, not that you would know that from the on-going discussions. It is not just physical goods and live-stock that go North-South of the border, but service sector providers (say, an electrician).

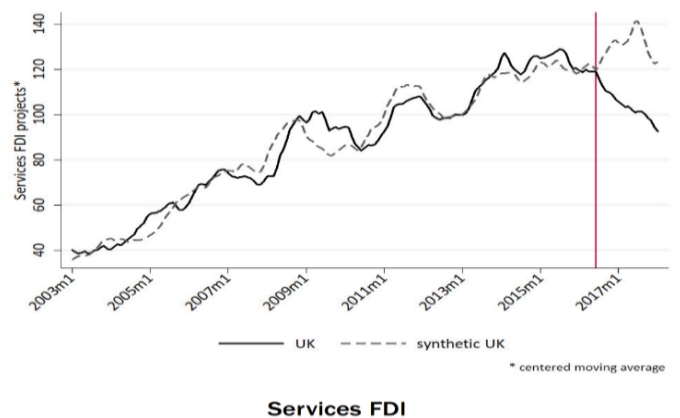
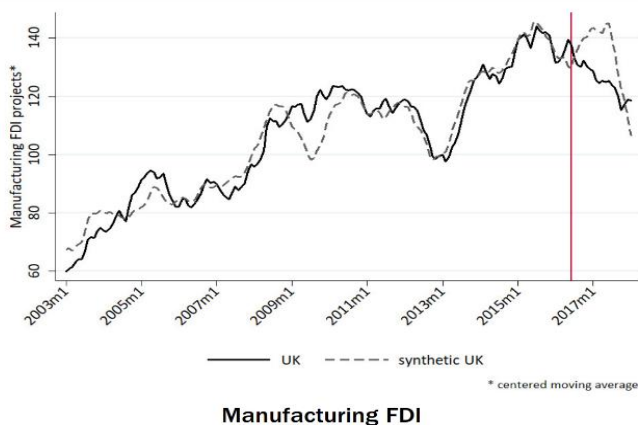
Jefferies Fixed Income

Finally, is there anything the OECD database can say about the different compositions of UK exports of services to the EU-27, compared to the US? As the table on page 52 highlighted, UK exports of services to the EU-27 are more skewed towards transportation and travel (11.2% and 14.7% of the total, respectively), than UK exports of services to the US (8.7% and 7.7%, respectively). Financial service exports in aggregate are not so different (22.9% to the EU-27 compared to the 23.1% to the US).

Where UK exports of services to the US punch above its weight is in other business services, including research and development (6.4% weight to the US, compared to 2% to the EU-27), and legal, accounting and management consultancy (16.5% weight to the US, compared to 7.1% to the EU-27), illustrating that in some high-value added sectors UK service based companies can still make a lot of headway in the US. However, this might partly reflect the UK acting as a hub for US corporate activity in Europe more generally, helped by clear expertise in these areas, multinational companies (included those based in Ireland), a common language, the rule of UK law and of course complete access to the EU single market. As with the car sector, as the UK leaves the EU some of this business may over time migrate to the continent, for access.

Finally, this is all very consistent with the academic evidence suggesting that this is already happening via foreign direct investment flows. When it comes to manufacturing companies it is more difficult to rip up production lines, but since the 2016 EU referendum the evidence suggests that FDI into UK services is falling short of expectations, and UK FDI to the rest of the EU in services is proving higher than expected. As things stand, this could become a growing theme.

Foreign Direct Investment into UK since EU referendum

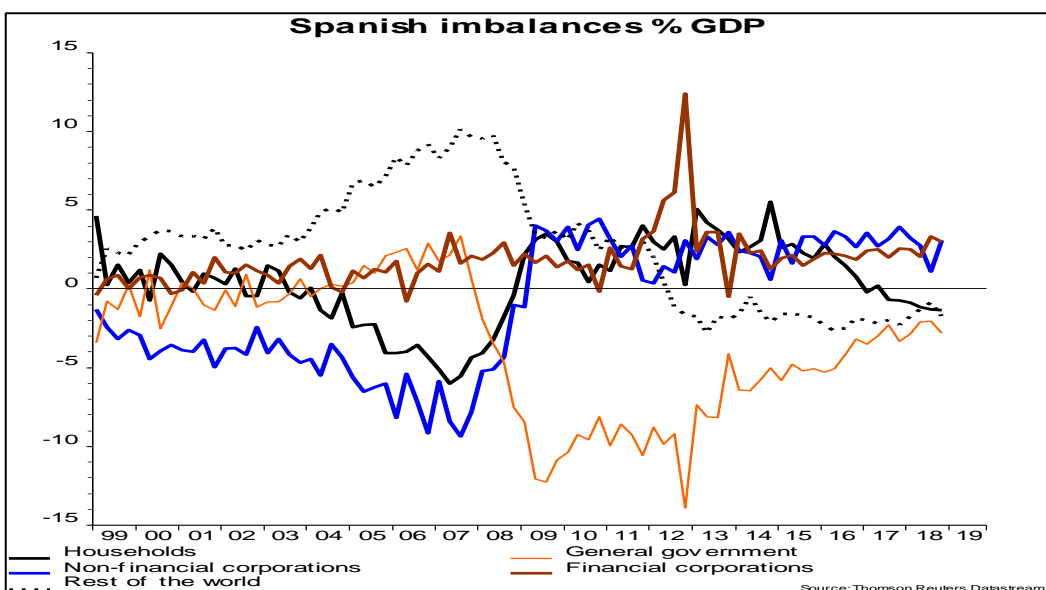


Source: UK Trade Policy Observatory, University of Sussex

Spanish imbalances can get a lot bigger from here, further underpinning growth

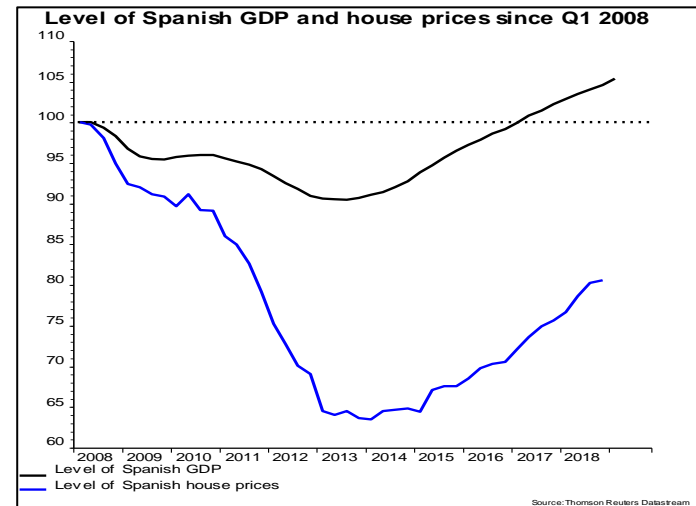
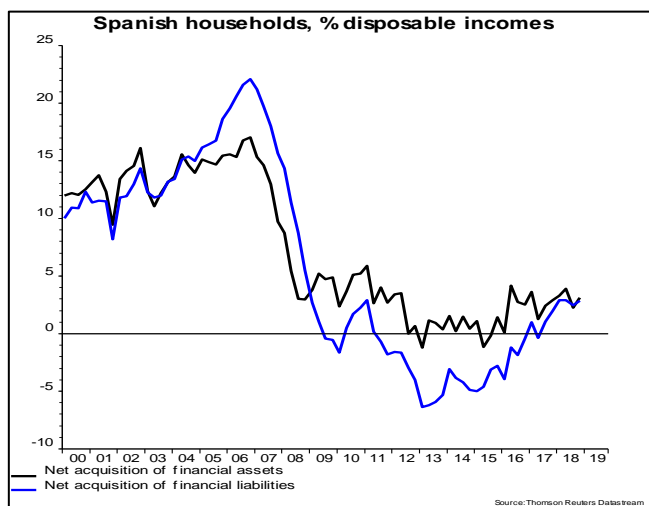
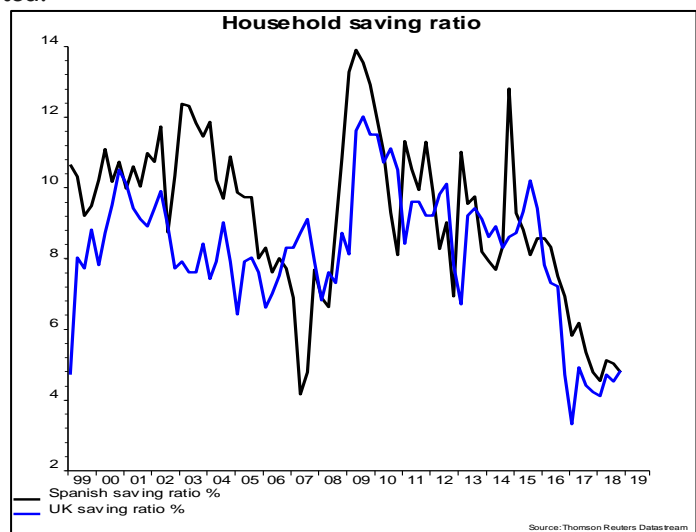
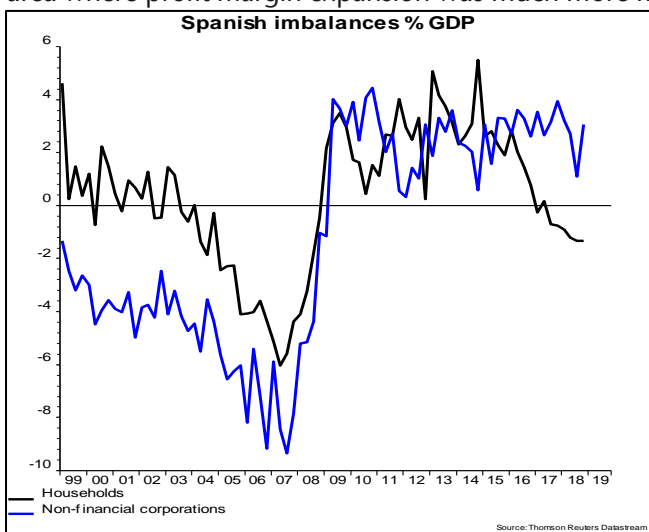
One of the major advantages of covering the euro area is the level of detail at a country level. This includes financial flows tracking the degree to which imbalances are building up within the region. Along the way growing imbalances can help further underpin growth, possibly as we saw before the financial crisis, for a long time. But, as the events of the last few years clearly illustrate, at some point they could be a trigger for a major downturn, made worse by the inability of the region to quickly adjust to cushion the hit and provide the foundations for recovery. Much to the frustration of many, several years on from the financial crisis there remains an inadequate focus on macroprudential policies and despite repeated calls to the contrary, the onus of adjustment remains much more on the deficit, than surplus countries.

Which brings us to Spain. The key reason for our bearishness on Spain prior to the financial crisis was the size of the imbalances that had built up. For economies like the UK and US, history shows that a corporate sector deficit of around 3% of GDP could be a trigger for recession. A corporate sector deficit of around 3% of GDP would warn of irrational exuberance and over optimism towards the peak of the economic cycle leading to over-investment and lending, and a significant misallocation of resources which the subsequent downturn then exposes. But, with little in the way of checks and balances inside EMU, Spain's corporate sector deficit hit 9.4% of GDP in Q3 2007, with the household sector the quarter before running a deficit of 6.1% of GDP. Such deficits had never been seen for a relatively large, developed, economy. Indeed, at the time official statisticians put Spain's corporate sector deficit at almost 15% of GDP, a fact ignored by many in the markets at the time, with risk underpriced and spreads wafer-thin. What is the situation today? As of Q4 2018, Spain's corporate sector was running a surplus of 3% of GDP, households a deficit of 1.4%.



The move by the Spanish household sector into deficit had been one of the reasons how Spanish GDP had been able to record such robust GDP growth since Q3 2014, averaging 0.75% a quarter. It had also been associated with a significant decline in the household saving ratio, from a peak of 13.9% in Q2 2009 to 4.8% in Q4 2018, with the sharpest decline recorded between Q4 2014 and Q1 2017. What is most striking is the very close correlation there has been between the Spanish and UK household saving ratios (see second chart below). Of course, this does not imply that there is any relationship between the two saving ratios, just that they have closely tracked each other in recent years. A further breakdown in the Spanish Financial Accounts suggest that this move into deficit by the household sector and sharp decline in the saving ratio is much more a story of Spanish households no longer paying down debt. Nevertheless, this is a key reason why Spanish GDP growth has consistently been so robust.

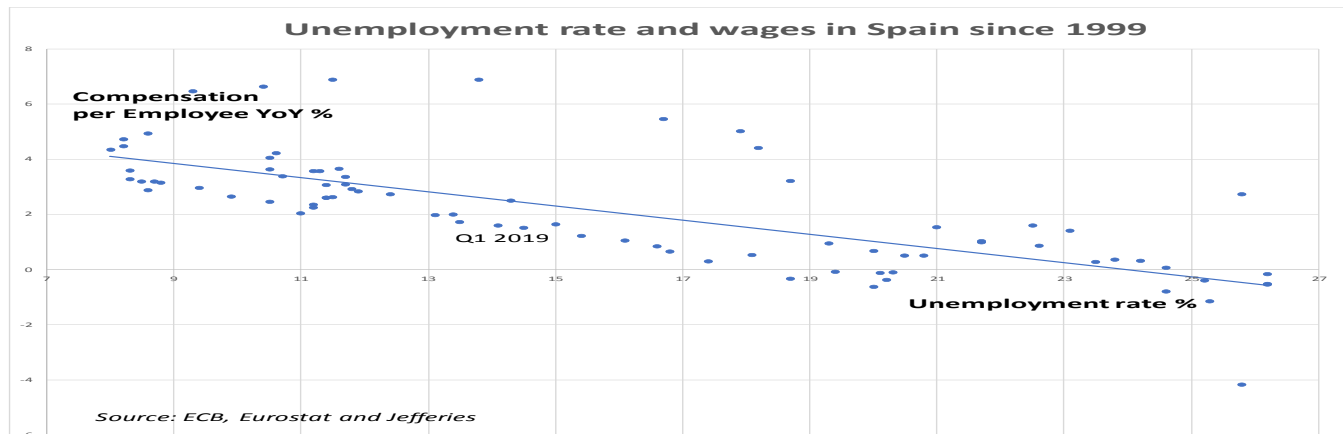
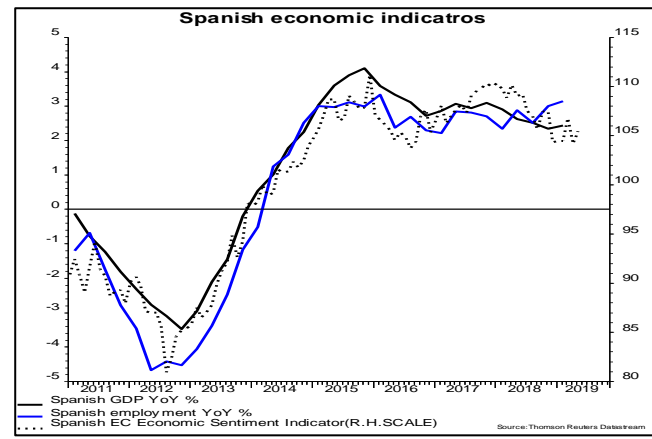
The other defining feature of the Spanish recovery had been the significant increase in profit margins at a macro level, as measured by the ratio of the gross operating surplus (pre-tax trading profits) of non-financial corporations to the gross value added (turnover) of the same universe of companies. When recession hit this was standing at 38.3%, but rose to a recent peak of 43.7%, in contrast to what was seen in the rest of the euro area where profit margin expansion was much more muted.



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But this was on the back of substantial cuts in Spanish employment. Now, we have reached the point where wages in Spain are beginning to accelerate again. Overall compensation per employee grew by 1.6% in the year to Q1 2019, a lower figure than seen in the rest of the euro area, but nonetheless an improvement from the figures of close to 0% recorded in 2017. Arguably, this is completely consistent with the tightening seen in the Spanish labour market (see scatter diagram). At the margin this might squeeze profit margins, but the bigger story will be if, as the economy continues to improve, the corporate sector goes back into deficit again, with companies seeing more reason to invest. Q4 2018 did see what could have been another turn in the corporate profit cycle. Finally, when it comes to Spain there has been a lot less disconnect between the survey evidence and hard data. The same cannot be said of many other economies.



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