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Euroglut: a new phase of global imbalances

This report argues that both "secular stagnation" and "normalization" are incomplete frameworks for understanding the post-crisis world. Instead, "Euroglut" – the global imbalance created by Europe's massive current account surplus will be the defining variable for the rest of this decade. Euroglut implies three things: a significantly weaker euro (we forecast 0.95 in EUR/USD by end-2017), low long-end yields and exceptionally flat global yield curves, and ongoing inflows into "good" EM assets. In other words, we expect Europe's huge excess savings combined with aggressive ECB easing to lead to some of the largest capital outflows in the history of financial markets.

Introducing Euroglut

The dust is settling on the Global Financial Crisis, and markets are now focusing on the future. One prominent line of thinking is that the new normal is "secular stagnation" - weak trend growth and very low neutral rates. Another view is that "normalization" is around the corner - growth will soon return, and policy will inevitably normalize faster, particularly in the US. In this piece, we argue that both the "normalization" and "secular stagnation" frameworks are incomplete. Instead, it is Europe's huge savings glut - what we call ***euroglut*** - that will drive global trends for the foreseeable future. While euroglut seems similar to "secular stagnation", the asset price conclusions are very different and far more powerful.

What is Euroglut?

Euroglut is a global imbalances problem. It refers to the lack of European domestic demand caused by the Eurozone crisis. The clearest evidence of Euroglut is Europe's high unemployment rate combined with a record current account surplus. Both are a reflection of the same problem: an excess of savings over investment opportunities. Euroglut is special for one and only reason: it is very, very big. At around 400bn USD each year, Europe's current account surplus is bigger than China's in the 2000s. If sustained, it would be the largest surplus ever generated in the history of global financial markets. This matters.

Domestic policy implications

A domestic implication of euroglut is that FX weakening will not be an effective policy response. Does the euro-area need an even bigger trade surplus? Europe faces a problem of domestic, not external demand. The global environment is hardly conducive to export-led growth either. Japan has engineered a close to 50% appreciation in USD/JPY yet exports have failed to recover.[1] This lack of FX responsiveness does not mean that the ECB doesn't care. Absent fiscal policy or other "animal spirit"-boosting initiatives, there is very little left for the central bank than to push yields and the currency lower. QE in Europe will be ineffective, but it will happen anyway - it is the only tool the ECB has to protect its mandate.

[1] Similar examples can be found elsewhere. The GBP trade-weighted index dropped 25% after the crisis yet the trade deficit has widened. Weak global growth may be the culprit

Global impact

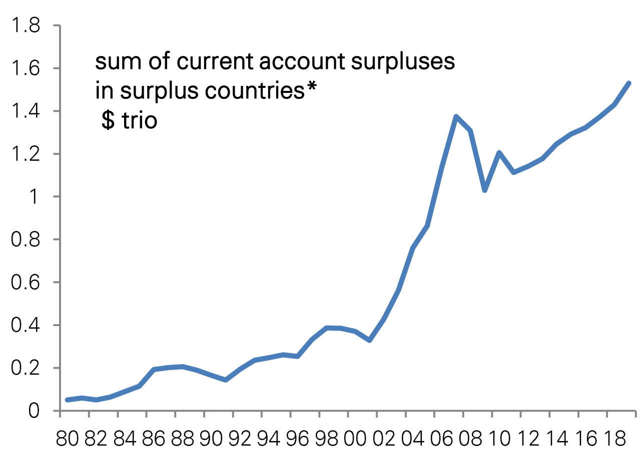
Euroglut means that as the world's biggest savers, Europeans will drive international capital flow trends for the rest of this decade. Europe will become the 21st century's largest capital exporter. This statement is close to an accounting identity - a surplus on the current account implies capital outflows elsewhere.[2] Our premise is that the next few years will mark the beginning of very large European purchases of foreign assets. The ECB plays a fundamental role here: by pushing down real yields and creating a domestic "asset shortage", it is incentivizing European reach for yield abroad.[3] Think about policy over the next few years: at least 500bn-1trio of excess cash will be sitting in European bank accounts "earning" a negative rate of 20bps. In the meantime, asset-purchases will drive yields down across the board – there will be nothing with yield left to buy. The asset implications are huge:

1. Currency weakness. As equity, fixed income and FDI outflows pick up, the euro should face broad-based weakening pressure. Our end-2017 forecast for EUR/USD is 95cents.

2. Very flat fixed income curves. What will Europeans buy? With the US Treasury - bund yield spread at record highs, US fixed income should be a primary beneficiary of European demand. "Secular stagnation" implies a low terminal Fed rate resulting in low long-end yields. "Euroglut" suggests that the level of neutral Fed funds doesn't matter. If there is sufficient demand for long-dated instruments, the US 10-yr yield could easily trade below terminal Fed funds. It happened during the 2000s "bond conundrum", it is even more likely now - global imbalances are bigger.

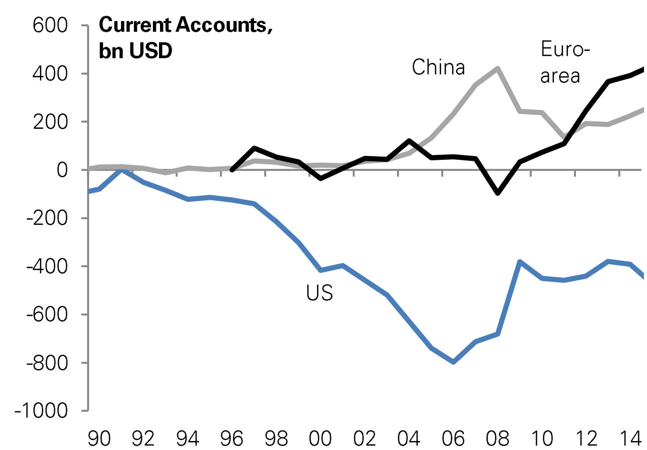
3. Good EM could survive. The Global Financial Crisis has seen a rotation of current account surpluses away from EM to Europe. At face value, this makes EM more vulnerable. But the sum of countries' current account surpluses is larger now than before 2008, so there is more spare capital around. European current account recycling should mean that the marginal demand for EM assets is likely to go up, not down.

Figure 1: Global Imbalances Bigger Now Than Pre-Crisis



*Source: Deutsche Bank; IMF *excludes top nine oil producers; values from 2014 onwards IMF forecasts*

Figure 2: "Euroglut" Is New Source of Global Imbalances



Source: Deutsche Bank; IMF

[2] Europe has been running a current account surplus over the last two years but also benefited from portfolio inflows as Eurozone risk premia normalized. This surplus was plugged by outflows in the "other investment" component of the balance of payments. This was mostly related to falling bank liabilities to foreigners. Even though banks reduced their foreign assets (deleveraging), their foreign liabilities dropped by more as foreigners reduced their euro loans and deposits.

[3] ECB policy is why Europe's current account surplus is so different from Japan's in the 1990s and 2000s. Back then, the BoJ wasn't easing as aggressively keeping liquidity tighter and real yields higher. Even so, it is worth remembering that even Japan experienced bouts of large capital outflows and yen weakening.

Beyond the Eurozone

Just like China's surplus drove most Asia policy in the 2000s, Euroglut will drive policy across Europe. Two economies are already imposing currency floors to fight off euro weakness (Switzerland and Czech Republic) and one more has imposed negative rates (Denmark). Scandinavia, Switzerland and the CE3 economies are likely to face continued pressure to ease more. All these countries are running current account surpluses, meaning the potential for European capital outflows is even larger. We could see an amplification of Euroglut: most of the European continent could end up with negative rates or FX managed-regimes.

Conclusion

"Secular stagnation" and "normalization" rely on views around trend growth but ignore global imbalances. It is these that remain the most important feature of the global financial system. Europe is the new China, and via large demand for foreign assets, it will play a dominant role in driving global asset price trends for the remainder of this decade.

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Appendix 1

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