



Summary

European union

Deepening EMU: the necessity is proportional to the challenge

European Commission releases reflection paper on deepening EMU. The necessity of the task seems proportional to the challenge of achieving it.

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Market overview

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Also in



Slowing momentum

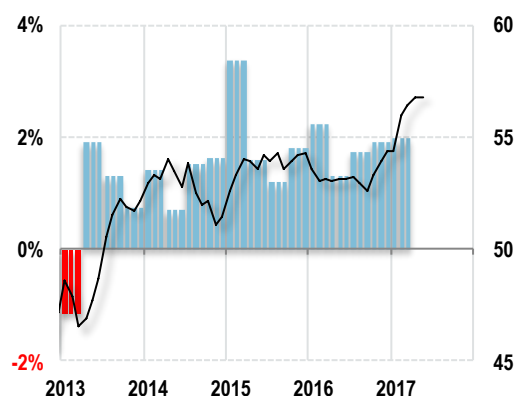
■ The increase in cyclical indicators has slowed recently, and sometimes even gone in reverse ■ Such a loss of momentum is unsurprising

Defining momentum as the difference between the change of a variable over a shorter time period with its change over a longer period provides interesting reading for the past 18 months. After a strong acceleration in the second half of 2016, there are increasing signs of a somewhat slowing momentum. This is particularly visible in 'soft' data (surveys of companies and households), which doesn't come as a surprise: typically, participants are asked whether they are feeling more or less confident than before, which makes the surveys by construction particularly sensitive to changes in sentiment. In addition, in the current upswing, surveys have tended to paint a brighter picture than the 'hard' data (activity, spending). Other factors which spring to mind are the decline of commodity prices, which could end up weighing on commodity exporting countries, and which in turn seems to be correlated with softer data from China, despite strong first quarter GDP growth. A disappointing start of the year in the US may also have played a role. A somewhat slower momentum is also visible in the euro area and in the US (certain investment intentions surveys). This should however not preclude the major economies from delivering robust growth. Indeed, looking at the levels of survey indicators (purchasing managers, consumer and business confidence), rather than their change, the conclusion is that historically they have corresponded with a healthy pace of growth. This bodes well for the remainder of the year.

EURO AREA, GROWTH VS BUSINESS SURVEYS

■ GDP Growth, q/q, annualized [LHS]

— PMI composite index [RHS]



Sources: Eurostat, Markit

THE WEEK ON THE MARKETS

Week 26-5 17 > 1-6-17

↘ CAC 40	5 337	► 5 319	-0.3 %
↗ S&P 500	2 416	► 2 430	+0.6 %
↗ Volatility (VIX)	9.8	► 9.9	+0.1 %
↗ Euribor 3M (%)	-0.33	► -0.33	+0.0 bp
↗ Libor 3M (%)	1.20	► 1.21	+0.8 bp
↘ OAT 10y (%)	0.76	► 0.74	-2.5 bp
↘ Bund 10y (%)	0.33	► 0.31	-2.9 bp
↘ US Tr. 10y (%)	2.25	► 2.22	-3.3 bp
↗ Euro vs dollar	1.12	► 1.12	+0.4 %
↘ Gold (ounce, \$)	1 268	► 1 264	-0.3 %
↘ Oil (Brent, \$)	51.5	► 51.3	-0.3 %

Source: Thomson Reuters



European Union

Deepening EMU: the necessity is proportional to the challenge

- European Commission releases reflection paper on deepening EMU. This can be considered as a follow-up of the Five Presidents' report of 2015.
- Deepening is necessary to complement monetary policy in stabilising the business cycle and to foster potential GDP growth.
- More ambitious ideas (euro area Treasury and budget) are up for consideration at a later stage, which illustrates the challenge and complexity of the process.

The European Commission released a reflection paper this week on deepening the EMU. The intention of the paper is to stimulate the debate by listing different options and possibilities and to help build a consensus. It is timely. Although support for the common currency is back at the highest level since 2004 (at 72 % of euro citizens)¹, EMU has become a subject of intense political debate in some countries and the report sets out a number of guiding principles: *"Completing the Economic and Monetary Union is not an end in itself but is needed to provide jobs, growth, social fairness, economic convergence and financial stability. Responsibility and solidarity, risk reduction and risk-sharing will have to go hand in hand. The Economic and Monetary Union should remain open to all EU Member States, and the decision-making process must become more transparent and democratically accountable."*²

There is a risk of a feeling of déjà vu considering that the necessity was already emphasized in the Five Presidents Report of 2015: *"Europe's Economic and Monetary Union (EMU) today is like a house that was built over decades but only partially finished. When the storm hit, its walls and roof had to be stabilised quickly. It is now high time to reinforce its foundations and turn it into what EMU was meant to be: a place of prosperity based on balanced economic growth and price stability, a competitive social market economy, aiming at full employment and social progress. To achieve this, we will need to take further steps to complete EMU."*³

To continue the weather metaphor, today the sky is blue but this means the time is ripe to prepare for the next storm, whenever that comes. This preparation is necessary because structural divergence in the euro area remains huge (differences in unemployment, youth unemployment, public and private sector debt, potential GDP growth, etc), which implies that the sensitivity of member countries to euro area wide shocks greatly differs. As a consequence, in the weaker members, downturns could trigger negative feedback loops (via rising risk premia, i.e. widening of sovereign bond spreads) which would make things worse, all the more so if ECB policy rates would still be very low and/or the size of its balance

sheet large because this would limit its policy leeway. Structural policy is generally used as the common denominator to address these issues. The ECB has been consistently vocal about this need. Mario Draghi, in his introductory speech at the annual ECB conference in Sintra said back in 2015 *"In every press conference since I became ECB President, I have ended the introductory statement with a call to accelerate structural reforms in Europe. The same message was also conveyed repeatedly by my predecessors, in three quarters of all press conferences since the introduction of the euro."*⁴ Structural reforms and monetary policy are complementary. Whereas the latter will seek to soften the impact of downturns thereby avoiding the development of a vicious circle via negative second round effects, the former will focus on reducing the sensitivity to shocks, via increased flexibility (thereby reducing the need for aggressive monetary easing) and a higher potential GDP growth. Such a higher growth rate would mean that in case of a shock, the risk that the economy would reach its stall speed is reduced⁵.

In addition to boosting the resistance to downturns, deepening EMU also entails *broadening* the toolkit for macroeconomic stabilisation policy. The real difficulty is how this ambitious goal can be achieved? Since the sovereign crisis, the ECB has basically made up for the gaps in the euro area construction. Its leeway to fight a new recession, when it comes, has been curtailed by the extent of the effort it needed to undertake (negative deposit rate, extension of its balance sheet). Deploying policy coordination to avoid a new crisis is a laudable ambition⁶ but recessions can also originate abroad which begs the question of how to increase the potential of macroeconomic stabilization using fiscal policy. However and unsurprisingly, based on the Five Presidents' report and the reflection paper, this seems like a distant prospect and in the short run the emphasis will be put on private risk-sharing through *"integrated financial and capital markets (Capital Markets Union) in combination with common backstops, i.e. a last-resort financial safety net, to the Banking Union. In the medium term, as economic structures converge towards the best standards in Europe, public risk-sharing should be enhanced through a mechanism of fiscal stabilisation for the euro area as a whole."*⁷ In that respect, the reflection paper mentions the idea of a euro area Treasury possibly with a euro area budget although the reference to *"could be considered at a later stage"* brings a necessary sense of realism. To conclude, in deepening the EMU the necessity of the task seems proportional to the challenge of achieving it. A stepwise approach looks like the recommended one.

¹ European Commission (2017), Commission sets out possible ways forward for the deepening of Europe's Economic and Monetary Union, Brussels, 31 May 2017, Press release

² European Commission (2017)

³ European Commission (2015), Completing Europe's Economic and Monetary Union, Report by: Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz, June 2015

⁴ Structural reforms, inflation and monetary policy, Introductory speech by Mario Draghi, Inflation and unemployment in Europe, ECB Conference proceedings, 21-23 May 2015 - Sintra, Portugal

⁵ The concept of stall speed has often been used in the US in the earlier phase of the recovery after the Great Recession. In a slow growth environment, minor economic headwinds could have a disproportionate effect (e.g. via reduced corporate investment) causing the economic engine to stall.

⁶ This refers to the process of limiting the budget deficit and reducing public sector debt to GDP levels so as to avoid that market concerns about government finances sustainability would trigger a downturn.

⁷ European Commission (2015)



Markets overview

The essentials

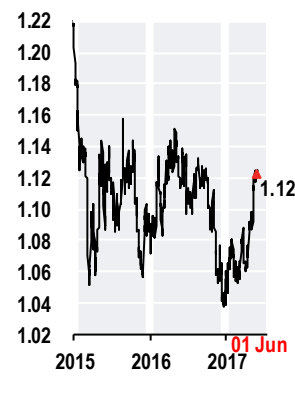
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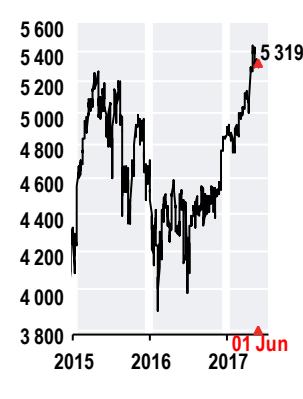
10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



Money & Bond Markets

Interest Rates	highest' 17	lowest' 17
€ ECB	0.00 at 02/01	0.00 at 02/01
Eonia	-0.36 at 04/01	-0.37 at 16/05
Euribor 3M	-0.33 at 02/01	-0.33 at 10/04
Euribor 12M	-0.13 at 02/01	-0.13 at 29/05
\$ FED	1.00 at 16/03	0.75 at 02/01
Libor 3M	1.21 at 31/05	1.00 at 02/01
Libor 12M	1.72 at 15/03	1.68 at 06/01
£ BoE	0.25 at 02/01	0.25 at 02/01
Libor 3M	0.29 at 05/01	0.29 at 31/05
Libor 12M	0.63 at 09/01	0.63 at 31/05

At 1-6-17

Yield (%)	highest' 17	lowest' 17
€ AVG 5-7y	0.28 at 17/03	0.23 at 02/01
Bund 2y	-0.76 at 25/01	-0.96 at 24/02
Bund 10y	0.31 at 10/03	0.09 at 02/01
OAT 10y	0.74 at 06/02	0.67 at 02/01
Corp. BBB	1.35 at 01/02	1.33 at 29/05
\$ Treas. 2y	1.30 at 14/03	1.14 at 24/02
Treas. 10y	2.22 at 13/03	2.18 at 18/04
Corp. BBB	3.54 at 14/03	3.51 at 31/05
£ Treas. 2y	0.09 at 06/01	0.01 at 28/02
Treas. 10y	1.00 at 26/01	0.93 at 30/05

At 1-6-17

10y bond yield & spreads

6.22%	Greece	591 pb
2.99%	Portugal	268 pb
2.25%	Italy	194 pb
1.55%	Spain	124 pb
0.78%	Ireland	47 pb
0.74%	France	43 pb
0.66%	Belgium	35 pb
0.52%	Netherlands	21 pb
0.50%	Austria	19 pb
0.36%	Finland	5 pb
0.31%	Germany	

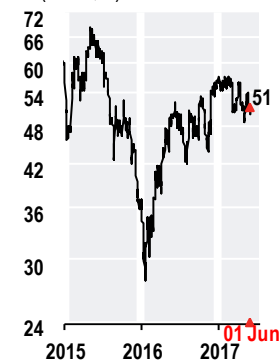
Commodities

Spot price in dollars	lowest' 17	2017(€)
Oil, Brent	51 at 08/05	-14.9%
Gold (ounce)	1 156 at 03/01	+2.6%
Metals, LMEX	2 639 at 03/01	-2.5%
Copper (ton)	5 462 at 08/05	-3.5%
CRB Foods	325 at 24/04	-3.7%
wheat (ton)	146 at 24/04	-1.6%
Corn (ton)	130 at 23/03	-3.3%

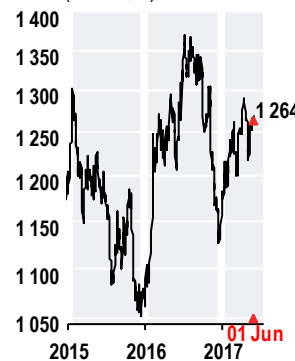
At 1-6-17

Variations

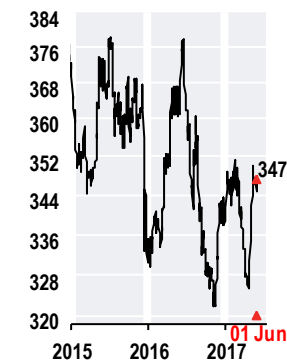
Oil (Brent, \$)



Gold (Ounce, \$)



CRB Foods



Exchange Rates

€ =	highest' 17	lowest' 17	2017
USD	1.12 at 22/05	1.04 at 03/01	+6.4%
GBP	0.87 at 16/01	0.84 at 19/04	+1.9%
CHF	1.09 at 10/05	1.06 at 08/02	+1.5%
JPY	124.88 at 25/05	115.57 at 17/04	+1.5%
AUD	1.52 at 01/06	1.37 at 23/02	+4.4%
CNY	7.75 at 22/05	7.22 at 03/01	+4.2%
BRL	3.70 at 22/05	3.24 at 15/02	+5.6%
RUB	64.95 at 31/01	59.66 at 17/04	-1.6%
INR	73.32 at 31/01	68.18 at 07/04	+1.2%

At 1-6-17

Variations

Equity indices

Index	highest' 17	lowest' 17	2017	2017(€)
CAC 40	5 319 at 05/05	4 749 at 31/01	+9.4%	+9.4%
S&P500	2 430 at 01/06	2 239 at 02/01	+8.5%	+2.0%
DAX	12 665 at 15/05	11 510 at 06/02	+10.3%	+10.3%
Nikkei	19 860 at 11/05	18 336 at 14/04	+3.9%	+2.4%
China*	72 at 29/05	59 at 02/01	+23.2%	+15.4%
India*	540 at 16/05	445 at 03/01	+15.0%	+13.6%
Brazil*	1 727 at 22/02	1 654 at 02/01	+2.5%	-2.9%
Russia*	531 at 03/01	531 at 01/06	-17.3%	-17.2%

At 1-6-17

Variations

* MSCI index



Economic forecasts

	GDP Growth			Inflation			Current Account / GDP			Gen. Govt. Balance / GDP		
%	2016	2017 e	2018 e	2016	2017 e	2018 e	2016	2017 e	2018 e	2016	2017 e	2018 e
Advanced	1.6	2.0	2.1	0.8	2.0	1.9						
United States	1.6	2.1	2.6	1.3	2.1	2.5	-2.6	-2.9	-3.5	-3.4	-4.2	-5.0
Japan	1.0	1.4	1.0	-0.1	0.6	0.7	3.8	4.0	4.4	-4.7	-4.4	-4.1
U. Kingdom	1.8	1.8	1.1	0.6	2.6	2.6	-4.4	-3.4	-2.5	-3.0	-2.7	-3.1
Euro Area	1.7	1.8	1.6	0.2	1.7	1.4	3.3	3.6	3.6	-1.7	-1.4	-1.2
Germany	1.8	1.8	2.0	0.4	0.4	2.0	8.3	8.1	8.2	0.6	0.7	0.6
France	1.1	1.3	1.5	0.3	1.2	1.0	-0.9	-1.1	-0.9	-3.4	-3.0	-2.7
Italy	1.2	0.6	0.6	-0.1	1.6	1.2	1.6	2.1	2.2	-2.4	-2.4	-2.5
Spain	3.2	2.6	2.0	-0.3	2.2	1.5	1.8	2.1	2.1	-4.6	-3.6	-3.0
Emerging	4.2	4.5	5.0	4.8	4.6	4.4						
China	6.7	6.6	6.4	2.0	1.8	2.3	1.9	1.6	1.4	-3.8	-3.5	-3.3
India	7.5	7.3	7.8	5.0	5.2	5.3	-1.1	-0.8	-1.7	-3.8	-3.5	-3.2
Brazil	-3.6	1.0	3.0	8.8	4.0	4.4	-1.2	-1.4	-2.1	-8.9	-9.6	-8.3
Russia	-0.6	1.2	2.0	7.1	4.2	4.3	1.9	3.4	3.2	-3.7	-2.7	-2.1
World	3.1	3.4	3.8	3.1	3.5	3.3						

Source : BNP Paribas Group Economic Research (e: estimates & forecasts)

Financial forecasts

Interest rates, %		2016				2017						
End period		Q1	Q2	Q3	Q4	Q1	Q2e	Q3e	Q4e	2016	2017e	2018e
US	Fed Funds	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.50	0.75	1.50	2.50
	10-year T-notes	1.79	1.49	1.61	2.45	2.40	3.00	3.25	3.00	2.45	3.00	3.25
EMU	Refinancing rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25
	10-year Bund	0.16	-0.13	-0.19	0.11	0.33	0.40	0.60	0.80	0.11	0.80	1.50
	10-year OAT	0.41	0.20	0.12	0.69	0.97	0.85	1.05	1.25	0.69	1.25	1.90
	10-year BTP	1.23	1.35	1.19	1.84	2.13	2.13	2.40	2.80	1.84	2.80	3.30
Japan	Overnight call rate	-0.00	-0.06	-0.06	-0.06	-0.06	-0.10	-0.10	-0.10	-0.06	-0.10	0.00
	3-month JPY Libor	0.10	0.06	0.06	0.06	0.06	0.00	0.00	0.00	0.06	0.00	0.00
	10-year JGB	-0.04	-0.23	-0.08	0.05	0.07	0.06	0.10	0.30	0.05	0.30	0.35

Exchange rates		2016				2017						
End period		Q1	Q2	Q3	Q4	Q1	Q2e	Q3e	Q4e	2016	2017e	2018e
USD	EUR / USD	1.14	1.11	1.12	1.05	1.07	1.10	1.07	1.04	1.05	1.04	1.10
	USD / JPY	112	103	101	117	111	115	117	120	117	120	130
EUR	EUR / GBP	0.79	0.83	0.87	0.85	0.86	0.84	0.82	0.80	0.85	0.80	0.85
	EUR / CHF	1.09	1.08	1.09	1.07	1.07	1.10	1.12	1.12	1.07	1.12	1.15
	EUR/JPY	128	114	114	123	119	127	125	125	123	125	143

Source : BNP Paribas Group Economic Research / GlobalMarkets (e: Estimates & forecasts)



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