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THE EURO-AREA ECONOMIC OUTLOOK FOR NEXT YEAR

How Concerned Are Traders Of The HKSAR ?

When a country/company determines to buy itself out of a dire financial difficulty by the issuance of bonds, warrants or other negotiable securities, there is, more often than not, an equal (or greater) and opposite risk involved.

Recently, it has been reported that the Government of Italy has been talking to senior officials of certain banks with a view to the country, issuing its first, US dollar-denominated bond of the past eight years.

There is no secret to Italy’s financial problems, with its present public debt, being second only to that of Greece of just a few short years ago.

According to usually reliable sources, the Economic Ministry of Italy is negotiating with banks to nut out the details as to the best way forward in order to post collateral on derivative trades, linked to the issuance of proposed, new negotiable securities.

It is highly questionable that this plan will ameliorate the dire financial situation that has long been festering in the country’s economy; and, many people have suggested that the plan is akin to trying to put a Band-Aid over a deep slash of the country’s hypothetical carotid artery in the hope of stopping the bleeding.

When an individual/corporate entity/country borrows money by the issuance of negotiable securities, it is assumed by the party(ies), accepting the risk by purchasing the negotiable securities, that the money expended shall be repaid in accordance with the terms and conditions of the securities, typically with interest.

In the corporate world, overtrading has resulted in many a company, having to go belly up.

In the case of Italy, as at December 31, 2017, the country had 2.26 trillion euros in Government debt. That is about $HK20 trillion.

That amount of money is just about sufficient to purchase New Zealand, lock, stock and sheep, one might be tempted to state, facetiously.

In terms of ranking in the total World Merchandise Trade, Italy ranked 10th, representing 2.70 percent, about $US959 billion (about $HK7.48 trillion).

The Eurozone is a very important trading partner of the Hongkong Special Administrative Region (HKSAR) of the People's Republic of China (PRC): It ranked on the Number One slot, in fact.

Again, reverting to ranking in terms of Total Trade in the 2017 World Merchandise Trade, five Eurozone countries, with which the HKSAR considers them as important trading partners, represented about $US6.98 trillion (about $HK54.43 trillion).

The five Eurozone countries were:

Germany ($US2.62 trillion);

The Netherlands ($US1.23 trillion);

France ($US1.16 trillion);

Italy ($US959 billion); and,

Belgium ($US837 billion).

The HKSAR relies, heavily on the following industries for a large portion of its bread and butter:

Financial Services;

Tourism;

Trading; and,

Logistics.

The above-mentioned, four key industries have been the driving force for the territory’s economic growth, providing impetus to growth in other sectors of the economy, too, and in the creation of employment.

The Importance Of The Eurozone To The HKSAR

The Eurozone has now been growing, over the past five years; and, it is expected to continue to grow in the coming years.

Recently, however, there has been a number of growth hiccoughs, the situation in Italy, not being included as one of them.

In the third quarter of this year, the growth in the Eurozone has been only about 0.20 percent.

Questions have been raised as to whether or not the growth projections of the **E**uropean **C**entral **B**ank (**ECB**) will be sustained, as well as the ongoing convergence of inflation towards the objective of the ECB.

Questions have, also, been raised as to whether or not the present situation is but a flash in the pan or, alternatively, the beginning of an enduring deterioration in the growth outlook of the Eurozone.

It is quite normal for corrections to be made in any market – and the Eurozone is no exception to the rule because nothing is forever.

During the past 43 years, there have been five periods of rising **G**ross **D**omestic **P**roduct (**GDP**) – the total value of goods produced and services provided in a country, during one year – in the Eurozone.

The duration of the trough to the peak of these five periods was about 7.75 years. And, during those 7.75 years, the GDP increased by about 21 percent, on average.

Recently, the expansion in the Eurozone has been about 5.50 years, with GDP, being about 10 percent above the trough.

The decline in GDP, one might be inclined to state, has been very apparent.

For traders of the HKSAR, this situation might well be considered rather worrying.

Dr Mario Draghi, the President of the European Central Bank, at the Frankfurt European Banking Congress, stated on November 16, 2016:

> ‘*In light of this* (the decline in GDP, during the past 5.50 years)*, it is important to understand the sources of the growth slowdown we have witnessed this year. At present there are two main sources.*
>
> ‘*The first is one-off factors, which have clearly played an important role in the underperformance of growth since the start of the year. In the first half of 2018, weather, sickness and industrial action affected output in a number of countries. And in the third quarter, we saw a significant disruption of car production created by the introduction of new vehicle emissions standards on 1 September.*
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> ‘*Production slowed as carmakers tried to avoid building up inventory of untested models, which weighed heavily on economies with large automobile sectors, such as Germany. Indeed, the German economy actually contracted in the third quarter, removing at least 0.1 percentage points from quarterly euro area growth.*
>
> ‘*But this effect should be temporary. As the testing backlog clears, car production should return to normal by the end of the year and the effect on output should dissipate. The latest data already show production normalising.*
>
> ‘*The second source of the slowdown has been weaker trade growth, which is broader-based. Net exports contributed 1.4 percentage points to euro area growth in 2017, while so far this year they have removed 0.2 percentage points. World trade growth decelerated from 5.2% in 2017 to 4.6% in the first half of this year.*
>
> ‘*We are witnessing a long-term slowdown in world trade. Some of the factors that previously drove its rapid expansion, such as trade liberalisation and the creation of global value chains, have waned since the financial crisis. We are also witnessing a cyclical correction from the very strong trade growth recorded last year. Trade dynamics are now normalising as global growth retreats towards potential.*
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> ‘*Insofar as world trade stabilises at a lower level, its drag on growth could also be temporary. But there are two conditions that could make it longer-lasting.*
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> ‘*The first is if trade uncertainty rises and dampens euro area export performance, in particular owing to protectionism.*
>
> ‘*The preliminary trade agreement reached between the US, Canada and Mexico reduces some uncertainty, but other disputes remain. Some indicators suggest this is feeding into the trade outlook. The manufacturing PMI* (**P**urchasing **M**anagers' **I**ndices – economic indicators, derived from monthly surveys of private-sector companies) *for the euro area fell to a two-year low in October, with export-oriented economies recording particularly large drops. New export orders contracted for the first time since 2013.*

'*The second condition is if uncertainty about external demand spills over into domestic demand through confidence and investment channels.*

'*For now, there is little tangible evidence that the moderation in growth has affected business investment. But there is some evidence that those euro area firms that are most likely to be affected by proposed tariffs have reduced their rate of capital spending. Moreover, the slowdown in imports has particularly affected capital and intermediate goods, which might signal that firms are scaling back their investment decisions.*

'*So we need to monitor these trade risks very carefully over the coming months. However, we still see the overall risks to the growth outlook as broadly balanced, in large part because the underlying drivers of domestic demand remain in place.*

'*Most important is the virtuous circle between employment, labour income and consumption, which has been the motor of growth throughout the recovery. Various indicators suggest this cycle has not been disrupted by the loss of growth momentum this year.*

'*Employment growth remains relatively strong, even though the latest data suggest some slowdown. The contribution of labour income to household income growth in the first half of this year was the strongest in a decade. And consumer confidence remains above its long-run average in the euro area and across most economies. Perceptions about the general economic climate have declined somewhat this year, but consumers' assessments of their personal situation - which tend to be more correlated with consumption - have remained steady…*

'*Over the past five years, employment has increased by 9.5 million people, rising by 2.6 million in Germany, 2.1 million in Spain, 1 million in France and 1 million in Italy. This growth is similar to the five years before the crisis, when employment grew by 10 million people. In that period, however, close to 70% of employment growth was "prime age", meaning it came from the 25-54 age group. But since 2013 more than 70% of employment growth has come from those aged 55-74. This partly reflects the impact of past structural reforms, such as to pension systems.*

'*Indeed, the participation rate of people aged 55-74 has almost doubled, from around 20% in 1999 to 38% in 2017. The share of women in work has also risen by more than 10 percentage points since the start of EMU* (**E**conomic and **M**onetary **U**nion) *to almost 60% - its highest level ever. In addition, countries that have implemented structural reforms have in general seen a rise in labour demand in recent years compared with the pre-crisis period. Germany, Portugal and Spain are all good examples.*

'*The second consideration that points to the resilience of domestic demand is the strong link between consumption and job growth in the euro area. Consumption is much more conducive to jobs than exports, reflecting the higher labour-intensity of services, which are the bulk of consumers' expenditure. In contrast, exports have a higher manufacturing content and are less labour intensive. This is one reason why the labour market recovery was not affected by the contraction in world trade in 2015-16…*

'*The third consideration is the still very favourable financing conditions in the euro area, underpinned by our accommodative monetary policy.*

'The cost of bank borrowing for firms fell to record lows in the first half of this year across all large euro area economies, while the growth of loans to firms stood at its highest rate since 2012. The growth rate of loans to households is also the strongest since

2012, with consumer credit now acting as the most dynamic component, reflecting the ongoing strength of consumption. Household net worth remains at solid levels on the back of rising house prices and is adding to continued consumption growth.

'*But there are some risks to financing conditions as well.*

'*Lack of fiscal consolidation in high-debt countries increases their vulnerability to shocks, whether those shocks are autonomously produced by questioning the rules of EMU's architecture, or are imported through financial contagion. So far, the rise in sovereign spreads has been mostly restricted to the first case and contagion across countries has been limited.*

'*Such developments feed into tighter bank lending conditions for the real economy. To date, though some repricing in bank lending is happening where the rise in spreads has been more significant, overall bank funding costs remain near historical lows in all large countries, thanks to a steady deposit base.*

'*To protect their households and firms from rising interest rates, high-debt countries should not increase their debt even further and all countries should respect the rules of the Union.'*

But it is only too obvious that the Government of Italy is not listening to the sage words of Dr Mario Draghi and is forging ahead, hoping to buy itself out of its dire financial situation.

Could this be construed as '*overtrading*'?

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