Rosa & Roubini
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MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
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Thomas Jefferson - Confederation
Alexander Hamilton – Federal State

EU: Is This A "Hamilton Moment", A "Jefferson Moment", Or Just The Usual Muddle Through?

We have been following the vicissitudes of the EU integration process for years now. To recap the milestones of our view, we have been saying that unless the EU changes tack, it will be very hard for the incomplete federalisation process of Europe to survive in a new world in which continental economies (the US, China, and India) will make the most relevant geo-strategic and economic decisions. Covid will make this new world come sooner than anticipated, even if the relative ranking of countries will be different than would have otherwise been the case .

The EU is currently an incomplete transfer union, in which resources (human, physical and financial capital) move from the periphery to the centre. The two main poles of attraction have been the UK (within the EU) and Germany (within the euro area). Somewhat ironically, one of the greatest beneficiaries of these influxes, namely the UK, has decided to leave, because the influx of migrants became politically unsustainable (or so the Leave campaign sold it as being). Brexit has proved us right, that the EU dis-integration process has begun.

The optimists believe that without the UK a more cohesive union will emerge, and therefore the integration process will finally be able to proceed. This is likely to be an over-estimate of what will actually take place. The presence of the UK was the *excuse* all other reluctant countries were using not to proceed further with the integration process. Was the UK blocking the completion of the euro-area banking union with the adoption of EDIS (the European Deposit Insurance Scheme)? Of course not. It was Germany that was doing so.

With the rise of populist parties in all major EU countries (Germany, France, Italy, Spain, and Poland) and also in smaller countries (Hungary, Czech Republic, etc,), it was clear that, a soon as any severe crisis would arrive, it would constitute an existential threat to the EU. And, at that point, the EU would reveal whether or not it was up to the game, by completing its integration process, or else accelerate the ongoing dis-integration process. The shock has now arrived, of course, with the Coronavirus. We wondered whether the EU would finally face its "Hamilton moment" (i.e. finish its integration process) or, instead, its "Jefferson moment" (return to some form of Confederation, with limited sharing of sovereignty).

Facing the abyss, France and Germany have tried to come up with a proposal to mitigate the devastating effects of Covid and lockdowns on the economy of the continent. In an interview, German Finance Minister Olaf Scholz has called it Europe's "Hamilton moment." We wish that was true. The proposal has merits, and is in line with our preview for how the EU would respond to the Covid crisis. But some of the details reveal that we are still quite far from any form of debt mutualisation, and the distrust that exists between the Northern "frugal four" (Finland, Denmark, Austria, Sweden) and the "profligate" Southern countries (Italy, Spain, Greece, etc.) remains high. We will see what the Commission proposal looks like on May 27, and what compromise the Council will be able to make in June and the following months.

Our suspicion is that we will merely witness another round of the eternal "muddle through" that seems to characterise recent European history. To some extent, this would be better than the immediate collapse of the EU project, as any such collapse would have enormous economic, social and political costs. On the other hand, we doubt that any "more of the same" approach will equip Europe to succeed in the post-Covid world.

Our Recent Publications

Oil Outlook 2020-21: Prices Expected To Stabilize, With The OPEC+ Deal Unlikely To Make Up For The Collapse In Global Demand, *By Nouriel Roubini, Alessandro Magnoli Bocchi, Brunello Rosa, Marco Lucchin, 15 May 2020*

GEOPOLITICAL CORNER: Beyond the Frenzy: A First Take on Donald Trump for the History Books, *Part 1—The Successes, by John C. Hulsman, 19 May 2020*

Looking Ahead

The Week Ahead: US GDP To Confirm Sharp Contraction, Germany's GDP Might Show A Slight Expansion

In the US, Q1-2020 GDP is forecasted to contract by -5% y-o-y, down from an initial estimate of -4.8%, as several states imposed strict lockdown measures - pushing millions of people out of work.

In the EZ, Germany's Q1-2020 GDP is expected to show an expansion of 0.3%, from an earlier estimate of -1.9% y-o-y (p: -0.1%).

In Japan, April retail trade is expected to further contract by -11.5% y-o-y (p: -4.7%), due to social distancing measures.

***The Quarter Ahead:* Geopolitical Tensions Remain Elevated, Debt To Rise**

Tensions due to mutual ***US-China*** blame over COVID-19 is threatening the 'Phase One' trade deal. The Trump administration accused the Chinese government of "making it impossible for US airlines to resume service to China".

In the EZ, the ECB is likely to increase its bond purchases and the EC will publish its proposal for a 'Collective EU fiscal response' to the crisis.

In the US, Fed Chair Powell said that the FOMC "has other tools available" to counteract the slowdown and "there is really no limit to what we can do."

In China, as the country faces its most severe economic downturn since the 1970s, the NPC: *i)* abandoned setting a GDP target for the first time in history; *ii)* announced a fiscal stimulus on par with that following the GFC; and *iii)* hinted to further rate declines and faster credit growth, while monetary policy is likely to remain more constrained than in 2009. As a result, China should recover faster than other major economies; yet, another wave of state-led investment could worsen the economy's structural challenges. Finally, the government is seeking to consolidating its power in Hong Kong.

Last Week's Review

Real Economy: Geopolitical Tensions Remain Elevated, Q1 GDP Forecasted To Contract Steeply

In the US, May's IHS Markit Composite PMI increased to 36.4 (p: 27.0) – highlighting the second-sharpest decline in business activity since 2009, as: *i)* Manufacturing PMI increased to 39.8 (c: 38.0; p: 36.1); and *ii)* Services PMI rose to 36.9 (c: 30; p: 26.7), showing weakness in domestic and foreign demand.

In the EZ, the IHS Markit Composite PMI rose to 30.5 in May (c: 24; p: 13.6) – pointing to the third sharpest private sector contraction since series began, as both manufacturing output and services activities shrank (Manufacturing PMI, a: 39.5; c: 38; p: 33.4; Services PMI, a: 28.7; c: 25; p: 12) - as social distancing and lockdown restrictions hit businesses. April's CPI inflation fell to 0.3% y-o-y (c: 0.4%; p: 0.4%), as energy prices remain low, while core-HICP inflation – ECB's preferred inflation gauge – remained unchanged at an eight-month low of 0.9% y-o-y.

In Japan, COVID-19 is depressing activity and demand. May's Jibun Bank Manufacturing PMI fell to 38. (p: 41.9), pointing to the steepest contraction in the sector since March 2009. As Q1-2020 GDP shrank by -0.9% q-o-q (c: -1.2%; p: -1.9%), the economy entered a recession for the first time since 2015. CPI in April inflation declined to 0.1% y-o-y (p: 0.4%), and core-CPI fell to 0.2% y-o-y (p: 0.6%) –well below BoJ's 2% target. During an emergency meeting the BoJ: 1) held its policy rate steady at -0.1%; and 2) launched a new lending program worth JPY 30 trillion (USD 279bn), to support small businesses hit by the COVID-19 pandemic.

In China, the PBoC kept its key policy rate unchanged at 3.85%; data suggested a mild economic recovery in April and May and policymakers adopted a 'wait-and-see approach'.

In Turkey, the CBT cut its policy rate by 50bps to 8.25% during its May meeting (c: 8.25%; p: 8.75%), in order to contain the economic downturn while maintaining a sustained disinflation process.

Financial Markets: Stocks Rose Driven By Re-Openings And Vaccine Trials; Bonds Flat; Oil Up

Market drivers: eased COVID-19 restrictions and optimism about upcoming vaccines boosted hopes about an economic recovery.

Stocks: w-o-w, global indies rose (MSCI ACWI, +3.3%, to 494), driven by the US (S&P 500, +3.2% to 2,955) and the EZ (Eurostoxx 50, +4.9% to 2,905). EMs rose (MSCI EMs, +3.2% to 930).

Bonds: w-o-w, returns rose slightly (BAML Global, +0.4% to 293.3); the yield on a 10y UST rose by 2bps to 0.66%. Volatility fell to 28.2 (p: 31.9), but remains above historical averages (52w: 22.0; 10y: 17.2).

FX: w-o-w, demand for USD weakened (DXY, -0.5% to 99.863), while demand for EUR and GBP strengthened (EUR/USD, +0.8% to 1.090; GBP/USD, +0.5% to 1.216). EM currencies remained flat (MSCI EM FX index, +0.3% to 1,567).

Commodities: oil prices rose (Brent, +8.1% to 35.1 USD/b; WTI, +13.0% to 33.3 USD/b), as supply is constrained and demand recovers. Gold kept its safe haven appeal (-0.4% to 1,741 USD/Oz.), driven by abundant liquidity of monetary and fiscal stimuli.

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The picture in the front page comes from this website

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Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*