THE RACE TO HEAD THE EUROPEAN CENTRAL BANK

While all eyes have been on Jerome Powell's inaugural year as chairman of the Federal Reserve, an equally important change at the helm is taking place in Europe. The European Central Bank's (ECB) top post is opening next year, and several economists and politicians are vying to succeed Mario Draghi. Not unlike the famed Sienese horserace—the Palio—this is a race in which competitors will be jockeying for position to win, whether for the sake of their own career ambitions or for their country's glory and influence. Some of the top minds in the European Union (EU) are saddling up for the 8-year term at the helm; meanwhile, their home countries must decide which positions of EU influence mean the most to them, potentially letting the ECB presidency slip away. As in the Palio, the outcome can be, and has been in the past, determined by intense politicking. Much like the recent appointment of Chairman Powell, the selection is one of great interest, as the policies he/she sets will have global ramifications.

The European Union is an economic and political union joined by the motto "United in diversity." Diverse it certainly is, with 28 independent countries and 23 official languages spoken. In addition to its cultural diversity, there is great economic dispersion as well. GDP growth ranges from 1% to 9% across the EU, and unemployment spans from 3% to 19%. The varied cultural landscape compounded with economic disparities makes it challenging to coalesce around common policies and leaders.

The ECB is the body of the EU that oversees the euro and implements monetary policy. The decisions of the European Central Bank directly affect 19 different European Union countries and indirectly impact the remaining 9 that are not part of the single currency market. Its primary mandate is price stability, and its main tool is setting interest rates for the Eurozone. The ECB, like the Fed, expanded its toolbox to address the aftermath of financial crises and later a European sovereign debt crisis. This led the ECB to take novel steps to decrease the lower bound of interest rates into negative territory and incept the asset purchase program to purchase debt from weaker EU countries.

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These policies provided liquidity to the markets and eased monetary conditions to spur growth.

Now after a decade of easy monetary policy, the ECB faces the same predicament as the Fed. Their focus now is to decrease the balance sheet and start raising interest rates without disturbing progress in stabilizing the euro (i.e., meeting the 2% inflation goal) or quenching economic growth. If the end result is a monetary policy misstep that sends the Eurozone into recession, investors could be caught in a substantial market sell-off.

ECB's Version of the Palio

A change of monetary policy leadership will occur on October 31, 2019, in the world's second largest economic area by GDP (behind the U.S. and slightly ahead of China). This will be the fourth ECB President since the executive board was instituted 20 years ago. The six executive board members, including the President, are elected to a non-renewable 8-year term. Each chosen central bank board member must be an EU national with banking or finance experience and must win over a majority of countries in the EU to take the position. Exhibit 1 compares the stringent ECB process of electing monetary policy officials to the Fed's process.

Exhibit 1

	ECB	FED
TERM	8 Years (non-renewable)	14 years (non-renewable); the Chair and Vice Chair are selected from the current members to serve for 4 years (renewable)
# OF MEMBERS	6 Executive Board; 15 total voting members (rotate monthly)	7 Board of Governors; 12 total voting members (rotate yearly)
NOMINATING PROCESS	Finance ministers of each country recommend to EU heads of state; EU parliament and governing council of ECB weigh in	Nominated by the President of the United States
APPROVAL PROCESS	Consensus vote taken of the EU heads of state (European Council). Candidate must win 75% of the votes (14/19 country votes) and those votes must represent >=65% of the EU population.	Confirmed by the Senate with a simple majority vote

Source: Highland Associates, ECB, Federal Reserve

Selection of ECB members involves as much politicking between countries as it does being qualified with relevant banking or finance experience. The EU factions are divided between the Northern and Southern countries. The Northern Countries tend to have lower debt levels and unemployment rates with higher inflation (see Exhibit 2). Like-minded countries tend to support each other's candidates to change policy in their favor. For example, Germany has led a vocal opposition campaign to subsidizing southern countries with the wealth of the north, which started in response to the sovereign debt crisis in 2012.

Exhibit 2

	COUNTRY	3-YEAR REAL GDP GROWTH (YOY)	CPI (YOY)	UNEMPLOYMENT RATE	DEBT AS % OF GDP	10 YEAR GOVERNMENT YIELDS
NORTH	AUSTRIA	2.3%	2.2%	7.0%	75.0%	0.7%
NORTH	BELGIUM	.04%	2.2%	6.0%	105.5%	0.9%
NORTH	FINLAND	2.3%	1.3%	7.5%	58.6%	0.6%
NORTH	GERMANY	2.1%	2.0%	3.4%	61.8%	0.5%
NORTH	IRELAND	9.7%	0.6%	5.6%	67.0%	1.0%
NORTH	NETHERLANDS	0.7%	2.3%	3.9%	54.0%	0.6%
SOUTH	FRANCE	1.6%	2.3%	9.1%	96.7%	0.8%
SOUTH	ITALY	1.2%	1.6%	10.4%	136.2%	2.8%
SOUTH	PORTUGAL	2.2%	1.2%	6.8%	123.2%	1.9%
SOUTH	SPAIN	3.2%	2.2%	15.1%	97.4%	1.5%
SOUTH	GREECE	0.6%	1.2%	6.8%	123.4%	4%

Source: Factset. Red indicates unhealthy economic levels; light green indicates at or near healthy economic levels; green indicates healthy economic levels.

Exhibit 3

PRESIDENT	TERM	COUNTRY	HIGHLIGHTS	INFLATION (CPI YOY)	ECONOMIC GROWTH (GDP YOY)	UNEMPLOYMENT	CURRENCY (EUR RELATIVE TO USD)	EQUITY MARKETS (MSCI EUROPE - TOTAL RETURN LOCAL CURRENCY)
WIM DUISENBERG	1998-2003	Netherlands	• Conditions during tenure: euro declined for first four years, slowdown in economic growth, low unemployment, and stable prices	• Average 1.9% • Range 1.3% - 3.1%	• Average 2.2% • Range 0.4% - 4.5%	• Average 9.1% • Range 9.1% - 10.5%	Strengthened 5.3%	Declined -13%
JEAN-CLAUDE TRICHET	2003-2011	France	• First half of tenure: strengthening euro, increasing inflation, low unemployment, and economic growth •Second half of tenure: global financial recession, European sovereign debt crisis, rising unemployment, and runaway inflation	• Average 2.0% • Range -0.7% - 4.1%	• Average 1.3% • Range -5.5% - 3.8%	• Average 9.0% • Range 7.3% - 10.5%	Strengthened 16.4%	Appreciated 42.4%
MARIO DRAGHI	2011-2019	Italy	• Took over in the midst of PIIGS debt crisis (Portugal, Italy, Ireland, Greece, Spain) • Known for pledge to “do whatever it takes” to preserve the Euro	• Average 1.1% • Range -0.6% - 3.0%	• Average 1.2% • Range -1.2% - 3.0%	• Average 10.6% • Range 8.2% - 12.1%	Weakened -15.6%	Appreciated 114.7%

Source: Highland Associates, ECB, Factset

Intrigue

The selection of ECB Presidents has historically been fraught with uncertainty and rife with backroom dealings. Like a Palio jockey taking a last-minute deal behind the starting line, the Dutchman Wim Duisenberg, the first ECB President, left the position 5 years into his term as part of a rumored “gentleman’s agreement” to make way for the second ECB President, Frenchman Jean-Claude Trichet. Trichet was only allowed to take the post after being cleared in a banking scandal investigation from his time as Treasurer. The baton was eventually passed 8 years later as the Italian Draghi quietly took the helm. The terms and notable achievements for each of the past ECB Presidents are highlighted in Exhibit 3.

Political Complications

In addition to the ECB President position, there are multiple top posts in the European Union opening, and concessions will have to be made by heads of state. Part of the economic and political union is coalescing around common leadership, which must reflect the diversity of its members. In maintaining a balance of power and influence, one country cannot dominate the leadership makeup of the EU, leading them to make tough decisions on which positions of power to pursue. In 2019, top political positions in the EU will become available including the following: President of the European Council (strategic body made up of heads of state of each EU member state) and all 28 member state Commissioners sitting on the European Commission (EU’s executive body responsible for proposing and implementing laws, monitoring treaties, and day-to-day tasks).

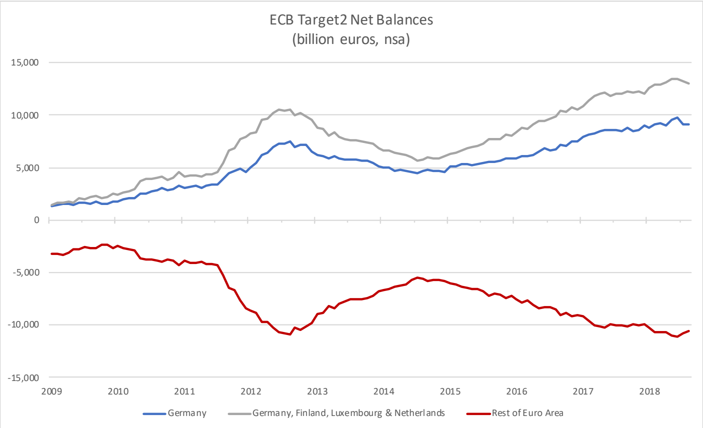
There are also additional positions on the ECB Executive Board to be filled. Peter Praet (Germany) rolls off in May 2019, followed by Draghi (Italy) in October 2019, and finally Benoit Coeure (France) in December 2019. This comes just after the Vice President position was filled by Luis Guindos (Spain) in June. Filling the number two spot with a Southern country leads many to speculate that a Northern country will claim the top spot to keep the “balance of power.” This leads us to believe that politics will trump continuity, and political agendas will distract from a pivotal monetary policy leadership shift.

Economic Complications

The stage is set for some tough choices on when and how to raise rates in the upcoming years, coupled with a phase-out of the ECB’s unprecedented asset purchase program. The ECB is well behind the Fed in its path for monetary policy, as they have instituted a negative interest rate path and are still weaning the economy off easy money. The ECB’s Quantitative Easing program is historic at 40% of EU GDP compared to the Fed’s purchases of 21% of U.S. GDP. What is of further concern is the skew in purchases toward lower-quality debt from the PIIGS (Portugal, Ireland, Italy, Greece, Spain) nations in a time of crisis. This has resulted in an imbalance where healthier Northern countries are essentially net buyers of weaker

Southern countries' debt, as seen in Exhibit 4. The Target2 net balances reflect cross-border payment flows of central bank money where Germany and Northern neighbors are net providers of liquidity (as indicated by surplus balances), while the rest of the Euro Area are creditors (as indicated by the liability). This leads to a divergence in policy priorities where Northern countries benefit from higher central bank interest rates and a stronger currency while Southern countries are hurt by higher borrowing costs.

Exhibit 4



Source: European Central Bank Statistical Data Warehouse; Yardeni

Jockeys & Odds

A Bloomberg Poll of 24 economists ranks the top three contenders neck-and-neck: Erkii Liikanen, Francois Villeroy de Galhau, and Philip Lane. Early leader Jens Weidmann (a German) has since fallen back in the polls.

Erkii Liikanen recently pulled from the pack as a somewhat neutral pick. The recently retired Finnish Central Bank Governor is known as a non-controversial pragmatist with a history in banking reform. He represents the north—a good counterbalance to the Spanish VP of the ECB—and has German support. As a close confidante of Draghi, we think this transition could yield more of the same. With lower inflation than the rest of their Northern neighbors and a track record of neutrality, Liikanen is the most likely candidate to gradually raise interest rates from today's negative interest rate policy. Finland's central bank has been vocal on the downside risks of the economy, so we wouldn't anticipate a hastening to end the accommodative stance of monetary policy.

Philip Lane is head of the Irish Central Bank and is known as a highly regarded economist. He was viewed favorably by the European Parliament for the VP spot but dropped out for Spain's Guindos, likely as a result of political haggling that ended in favor of Spain. Ireland is the only founding member of the EU to not hold a seat on the executive board. While it might seem obvious for Lane to finally lead Ireland to the ECB in this capacity, he is more likely to be selected for the May 2019 opening on the executive board taking over responsibility for economic projections and preparation of monetary policy decisions. Given his background, we would expect him to be gradual with raising rates and very data-dependent in his decision-making.

Francois Villeroy de Galhau, Governor of the Central Bank of France, should not be discounted. He is favored second in the Bloomberg poll, and if history has taught us anything, France won't go down without a good fight in negotiating EU leadership positions. Galhau has been supportive of stimulus and spent over a decade in banking, which may lead some to speculate his keen awareness of the effect low interest rates have on lenders. Based on recent comments, we believe Galhau is most focused on strengthening the economic union through shared investment across all countries. We believe he will likely look similar to Draghi in a gradual pace of normalizing monetary policy. However, he has indicated a desire to raise rates months (not years) after the central bank stops asset purchases.

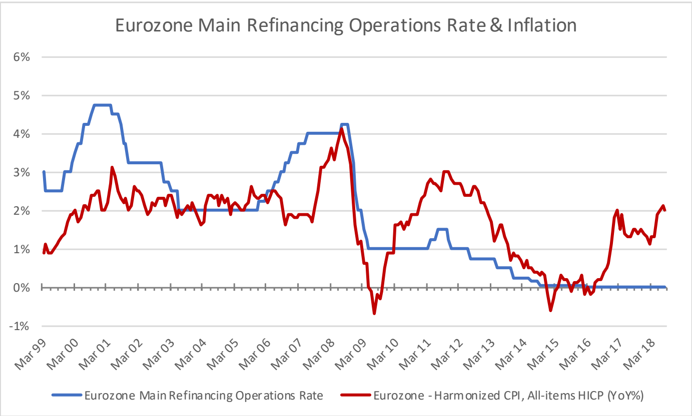
Jens Weidmann was an early contender before Merkel announced intentions to pursue a top EU political spot for Germany, perhaps conceding the ECB top spot. Germany is the largest and most populous economy in the EU and has yet to take the helm of the ECB. Southern states might find this a relief as Germany has historically taken a hardline in times of crisis—known to be critical of the bond buying during the sovereign debt crisis. While not a popular pick, it is not improbable for Weidmann to make a run at the post given his strong credentials as an economist, though his selection is unlikely. If he were to be selected, this would likely be the most hawkish selection for interest rates. Given Germany's low debt to GDP and strong economic standing, Weidmann would be most at risk to raise rates too quickly and/or too high in response to inflation.

Evolving Course Conditions

The economic backdrop echoes the past while presenting wholly new challenges. History reminds us that the ECB has historically pushed rates higher to combat inflation. Over the course of the past 20 years, there have been three periods of rate hiking cycles, two of which ended in recession. Most of this time, price stability presented a challenge, with only the early 2000s marked by "stable" inflation in a range of 1.5%-2.5% (the ECB's goal is slightly under 2%; see Exhibit 5).

This time is a little different. After close to 7 years of decline, inflation is back at the 2% goal and other signs of economic weakness are absent. Unemployment is in steep decline from all-time highs (though still higher than pre-2008 all-time lows). GDP growth remains strong. However, unlike in the U.S., the statistics for the Eurozone mask a deep divide in economic outlooks between the north and the south. This dichotomy drives a wedge between regional policymakers seeking to bolster their local, country-specific economies.

Exhibit 5



Source: Highland Associates, Factset

High-Stakes Outcomes

Given the uncertainty in Europe, it is hard to make a strong case for continued economic growth. The risks of political upheaval and monetary policy missteps are certainly heightened with the Brexit deadline of March 2019 approaching and with the ECB leadership change months later in October.

Highland feels this will not be as smooth a transition as we saw in Yellen's final year at the Fed. Political jockeying makes this outcome much more unclear and will certainly be an overhang for the next year as investors try to sort through the monetary policy implications. We feel the risks in this scenario are twofold: one, that the EU chooses a candidate who appeases the political forces rather than one who is the most capable, and second, that this candidate is unable to form consensus during a crisis, heightening the chance of a policy misstep. In our opinion the best possible outcome will be a quick consensus over the future leadership of monetary policy that yields consistency and high confidence with heads of EU member states. A gradual raising of interest rates would also be the best possible outcome for markets. As this translates to candidates, we see the most risk to markets coming from a Weidmann selection given his hawkish views. The least risk of a policy misstep would be from Liikanen, whose Finnish central bank has been a neutral pragmatist throughout the past decade. Consensus for the first ECB rate hike is at the end of 2019, coinciding with a new ECB President. With stakes this high for the fragile political and monetary union, this will be a race worth watching to the Fall 2019 finish line.

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