Europe Has a Supply Side *Problem*

In July, TIE *founder and editor David M. Smick sat down with Axel Weber, former Bundesbank president and chairman of the board of UBS.*

Smick: Who would have thought we'd be sitting here talking about French political instability and Italian debt instead of the problems in Spain, Portugal, and Greece? This is a crucial point for the eurozone. Is the goal of fiscal reform lost forever? Where is this all going?

Weber: I hope the eurozone will continue to explore possible ways to bring down debt. The old debt problems are still out there. The biggest problem of the eurozone—anemic growth—is still there. Without major reforms, eurozone economic growth will not improve in the medium to long term. The European Central Bank did a good job in suppressing tail risks, but maybe they did a too-good job. Governments lack the necessary incentives and market pressure to enact full-fledged reforms.

The ECB should allow for more pressure on governments by limiting the scope of its own action so that governments have to come in and supplement monetary policy with more prudent fiscal policy reforms that help lift the long-term growth potential. We knew problems existed in some peripheral countries such as Portugal and Spain. But problems have moved closer to the core, with anemic growth for more than a decade in countries such as Italy, where output is even below the level it dropped to at the beginning of the financial crisis. Actually, Italian GDP is back at the level of the year 2000.

Politicians may see the need for reforms but find it very hard to enact them. Thus, the ECB should keep the incentives in place for reform rather than buy time and allow politicians to postpone doing what is necessary.

Smick: According to the *Financial Times,* with the European Parliament becoming so powerful, we're in uncharted territory with

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the European fiscal situation. Are we in a dangerous situation?

Weber: "Uncharted territory" is too benign a term. We are going through a major crisis and are in a transition with heightened uncertainty. The European election has increased the centrifugal forces in Europe, since parties that are focused on national interests and national politics now control a larger share of the vote. Therefore, while the conservative parties still are the largest fraction, both social democratic and conservative groups amount to just about two-thirds of the vote. On some issues, only a grand coalition between them will be able to move Europe forward.

There is a weakness at the core of Europe.

The Commission is also in transition. We will only know later in the year who will hold office as the next commissioners.

So there is a weakness at the core of Europe. Of the three central powers in Europe—the Commission, the Parliament, and the ECB—at this stage the ECB is the only fully functioning European institution. We will likely come out of the process with a weaker European Parliament and Commission, with the ECB potentially continuing to be seen as the one institution that can change the fate of Europe.

At the core, European institutions are going to be weakened again over the next electoral cycle, and key decision powers will still rest with the European Council—the heads of state. That has the potential to distract European politics away from an integrated European agenda and toward an agenda driven by the issues of individual nations.

In the United Kingdom, we will even see a proposed referendum on membership in the European Union. That has repercussions on the room to maneuver for the British government, which additionally faces a referendum on Scotland's membership in the United Kingdom. This in turn limits the scope for Spain and other governments to move on concessions toward the United Kingdom.

We are in a fragile situation in the sense that the momentum towards a more integrated Europe is clearly undermined by these recent developments. There are more federalist dynamics now in Europe that will definitely gain traction and will make life difficult for at least two European institutions—the Commission and the European Parliament, let alone the European Council.

Smick: The Scottish referendum is an interesting development. Do you think there could be a corresponding bank-shot effect on Spain? Could a similar situation develop in that country with the Catalans or the Basques? The implications of such a development would be enormous.

Weber: There is definitely the risk that separatist movements which have existed in many nation-states in Europe could come to the fore if a given nation-state were seen to split. At the moment, it is hard to see how this can be done within the rules that Europe has given itself. But clearly it will be an issue in Spain and some other autonomous regions that are looking for more independence from central government.

The bigger challenge is dissolving the currency union that exists with the British pound. The Scottish referendum in itself is a challenge to the Conservative government in the United Kingdom. It limits the room to maneuver for the Conservatives. On the one side are the demands by the separatist movement in Scotland, and on the other the continental calls for more integration within the European Union. Most likely the United Kingdom will shift somewhat further from continental dynamics and try to find a middle ground.

It is the supply side of the economy that needs to be reinvigorated in Europe.

Europe is increasingly taking majority decisions. There were issues on which the United Kingdom was outvoted by continental European countries that have the euro as a common currency and need a different degree of integration among themselves. It will be very hard for the European Union to navigate between a more

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centralized currency union with more integration, and at the same time make exceptions for those countries that haven't got the euro and want less integration. Those countries want a Europe based more on free trade and on the free exchange of economic goods and services, but much less an integrated common market with a common currency.

Smick: Why do you think UK Prime Minister David Cameron was so determined to defeat Jean-Claude Juncker for the European Presidency? Is Britain now isolated while also feeling betrayed in this process?

Weber: What happened in Europe for the first time was that the outcome of the European election had a direct impact on the person chosen as head of the Commission. Such a commitment is not foreseen in the Treaty but was entered into by some of the European governments, including the German government. It was very hard for member governments to unanimously accept, however. At the same time it was very difficult for the European Council to pull back from its previous commitment to the Parliament that the parliamentary elections will be a deciding factor in who becomes head of the next Commission.

Again, this episode shows the constant struggle between European and national interests. This new arrangement has increased the impact of the parliamentary election on the Commission, and the executive branch of the European Union comes out of this weakened.

Smick: As you know, there is an ongoing a debate between economists who called for more expansionary policy after the 2008 financial crisis versus the British government which enacted austerity measures. The UK Conservative government now boasts that Britain is the fastest growing economy in Europe thanks to these fiscal reforms. The other side counters that the fast growth can be attributed to the low level the economy reached after the crisis. Was the British policy successful, or just a bounce from an incredibly low level also heavily dependent now on what could be another housing bubble?

Weber: In my view, the British government has rightly, in a frontloaded fashion, consolidated the budget through tough fiscal measures and now is reaping some of the rewards of both the economic turnaround and the lower funding costs for government. Don't forget that part of the story has very little to do with fiscal policy and is more related to monetary policy and a weaker UK pound. And the UK economy is profiting again from a rebound in the housing market and from a regained dynamic in the city of London. UK home prices have stabilized and are rising again largely because of the very low interest rate environment.

What the United Kingdom did is in my view a good recipe. They combined a more restrictive fiscal policy with a looser monetary policy during the transition, where the looser monetary policy provided some room for fiscal policy to make the turnaround. Now, as fiscal policy tightening becomes less pronounced, monetary policy is becoming too loose but rightly so has signaled future tightening. The United Kingdom enjoys a more favorable macro environment due to this textbook response to the financial crisis. The burden of stabilizing the housing and financial markets typically lies more with the central bank. The Bank of England responded by lowering interest rates and easing monetary policy. The United Kingdom today is doing well because they had a well-sequenced restrictive fiscal policy along with expansionary monetary policy. Now, as their economy responds favorably, they can reduce the amount of fiscal consolidation and monetary stimulus.

Smick: ECB President Mario Draghi has promised to do "whatever it takes" to save the euro, including perhaps quantitative easing by the end of the year if not before. Why is the euro still relatively strong? Is it the eurozone carry trade? One explanation in the financial markets is that Draghi may talk like a dove, but he has Germany standing behind him holding a club and saying don't go too far. By contrast, Federal Reserve Chair Janet Yellen faces little in the way of a restraining element at a time when the Fed's balance sheet has expanded four-fold When if ever do you expect the euro to weaken?

Weber: The ECB is managing tail risks; they are not fine-tuning the economy. In a normal environment, a forward-looking assessment of monetary policy announcements on both sides of the Atlantic would lead you to perceive a weaker euro as a result of the now divergent future paths of monetary policy. The Fed is tapering and before the end of the year will end purchases of U.S. Treasury bonds. They most likely will have started tightening monetary

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policy by the middle of next year. There is a discussion of whether the recent inflation readings, the lack of slack in the economy, and tighter labor markets might not warrant an earlier move by monetary policy. If anything, the Fed should have a strong tightening bias. While it has not yet embarked on tightening action, tightening in my view is on the horizon and needed sooner rather than later.

The opposite is true for the eurozone, where the ECB has clearly communicated an easing bias. The ECB has eased somewhat with the recent announcement of no longer absorbing liquidity, and with interest rates on deposits in negative territory and the announcement of targeted LTROs. Purchases of asset-backed securities, for example, have also been put on the agenda. In a normal environment, these actions would weaken the euro relative to the dollar. But since action is not imminent, two important flow effects relative to these announcement effects still dominate.

First, the Fed's balance sheet is still expanding and the ECB's balance sheet still contracting, as it has been for the past two years. As banks retire some of the LTROs and with more LTRO retirement coming in December 2014 and spring 2015, another €500 billion of LTROs will run out and need to be prolonged. Some of the action the ECB has taken can actually be seen more as preventing a further reduction in its balance sheet, but it hasn't yet and is unlikely to produce a pronounced expansion of the balance sheet.

The second flow effect is that the eurozone as a whole has moved from having a current account deficit to having a current account surplus. In a typical macro context, it is hard to imagine a currency weakening under a current account surplus. But fast-forward by another year, as tightening and easing policies are being implemented by the Fed side and the ECB respectively, and the exchange rate of the euro is likely to weaken further.

Smick: Can you make a case that quantitative easing can be successful in a macro sense in the European economy? If so, what exactly does the central bank actually buy?

Weber: If you refer to quantitative easing programs such as purchases of corporate bonds or covered bonds, the Bundesbank has in the past supported such covered bond purchase programs which were part of the ECB's nonstandard monetary policy response to the crisis. The problem in the eurozone was that such covered bonds were issued only in some countries, so the program impacted only those countries, including Germany, France, and Italy.

Going forward, the asset-backed securities program the ECB has talked about will lend support to asset-backed securities over other securities. The ECB will act as a quasi market-maker for asset-backed securities aiming at incentivizing banks to securitize some of their credit exposures in order to enter into new lending activity. In fact, the ECB has announced that they might become an ultimate buyer of such plain vanilla asset-backed securities products in the hope that this will increase the likelihood that private-sector participants will also become buyers of these securities. I do see some merit in this market-making function for corporate bonds and covered bonds. And since the eurozone is a bank-based system, not a capital market-based system like the United States, the likely impact will differ from that in the United States.

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I currently see no merits for the ECB in buying European sovereign debt. The Fed has historically embarked on a policy where it buys the safest asset in the economy, U.S. Treasuries—every asset is priced off these. In Europe, the only equivalent asset is the bund. I don't see the ECB embarking on a policy where they would buy vast amounts of bunds. I also do not expect purchases of a broader definition of debt, such as a GDP-weighted index of European debt. In Europe such action is a long way off and only likely to be taken if everything else has failed. Such action is controversial since not all citizens in Europe would support it equally. The ECB has not ruled out that it might take such ultimate action, but I think the hurdle for this is pretty high.

Smick: Some analysts think Fed Chair Janet Yellen is a little behind the curve in raising rates. At one point she talked lightly about the "noisy" inflation data, which upset some hawks. Inflation looks like the last thing the industrialized world has to worry about. There appears to be enormous slack in the labor markets, but perhaps less slack, with today's historically low rates of labor participation. What if these workers never come back even with the economy improving? Could there then be less slack than we thought, with all the ramifications that might suggest?

Weber: In some of the more recent U.S. data, you see some acceleration of price trends such as in the CPI inflation averaged over the last three months—it stands at more than 3 percent annualized. Price increases have accelerated over the recent quarter. The risk is that with tighter labor markets this feeds into wage price dynamics and has second round effects.

The problem the Fed faces is that reading the data for this year is going to be more difficult because of a very negative first quarter impacted by adverse weather conditions, which has a mechanical impact on the average GDP growth rate for this year. The acceleration of GDP growth in the second quarter and beyond will make these data more difficult to read since this pattern will be outside the usual seasonally adjusted quarterly pattern. There is going to be some added noise in the data.

Smick: How do you gauge the tightness of U.S. labor markets?

Weber: Labor markets look tighter now. But a big issue in the United States over the last two years is the very clear negative trend in participation rates. Against such a drop in participation rates, the implications of a given unemployment number or a given number of increases in jobs is going to differ from historical patterns. Therefore, the labor market might be less tight than is signaled by the increase in the number of jobs.

Taking into account this falling participation rate, U.S. unemployment figures don't look as good. But if people dropping out of the labor market do not re-enter, there is a greater potential for the current improvement in the economy to impact on wage dynamics and for price increases and wage increases to feed on one another going forward.

Smick: Around the world, a process of gradual deglobalization appears to be underway. Global growth since 2010 has seen a significant decline, along with global trade and cross-border capital flows. Japan suddenly has a current account deficit for the first time since the late 1970s. The great mystery is China, which seems highly vulnerable to this pullback in trade and growth. Are you worried about China?

Weber: If you take the five years leading up to 2007 as the point of reference, then there is much less globalization today relative to then. But the five years leading up to 2007 showed a degree of globalization that we hadn't seen in the previous twenty-five years. And it was probably unsustainable to begin with.

The emergence of new economies cannot be reversed. China twenty years ago accounted for 10 percent of global economic growth. Ten years ago it was 20 percent. Now it's 30 percent. One-third of global growth originates from China. The Chinese economy is just half the size of the U.S. economy, but even with the U.S. economy growing at around 3 percent and China growing at 7 percent, the Chinese contribution to global growth is still bigger than that of the United States. That didn't used to be the case. So China is a factor to reckon with going forward.

Actually, if you look at the acceleration of global growth in the last year, the biggest contribution comes from Europe. Europe has gone from -0.4 percent growth last year to around 1 percent growth this year, and that's the biggest acceleration of growth at the global level.

Everyone should embark on the kind of reforms that Germany did.

Robust globalization is still intact. One of the big mistakes many people made before the financial crisis was to believe in the decoupling of growth between the major regions. I think what we're seeing now is countries are more than ever coupled to each other, and it is a byproduct of globalization.

If you want to get growth projections right for the future, China will play a bigger role than in the past. At this point, I don't see a deglobalization. I see a deceleration of the speed of globalization—more than was anticipated—but the degree of globalization will not fall below current levels. There's not a lot of momentum going forward and there are some centrifugal forces that are a challenge to globalization, but I don't think globalization will go in reverse.

Smick: China has moved from a heavily export-dependent economy to an investment-dependent economy, financed by a shadow financial system that's now the size of the U.S. financial system. A lot of that Hong Kong cheap credit to those shadow banks has dried up in recent months. China claims to have created 322 Manhattans in the last decade or so—an extraordinary amount of infrastructure and real estate spending. But does China have a cash flow problem? Empty buildings produce no cash flow and certainly infrastructure spending doesn't. At present the carry trade and the shadow financial system have helped China roll over a lot of loans, but is the system too strained? Are you worried

that China might represent the next unsustainable investment scenario? Why should we believe the Chinese can hold this together?

Weber: As you said, the Chinese economy has turned away from being an export-driven economy with over-investment in export capacity. Investment is now more focused on growing the domestic economy, and eventually China will rebalance to a more consumption- and less investment-driven economy. Our projections at UBS still estimate China's growth at just above 7 percent, so our main working hypothesis is a normalization of growth from levels that were double-digit with some volatility to being on a lower growth trajectory at around 7 percent. There is a residual risk that growth will slow beyond that, but we see that risk as pretty small.

What you are likely to see is more stimulus. The Chinese authorities are trying to proactively manage the problems in the housing market and around shadow banks. Many of these shadow banking products have been distributed through banking channels. In trying to stabilize that market, the banks will play a key role. Banks have an interest in stabilizing the shadow banking system, and the central bank will honor this by supporting the medium-term profitability of the banks. I think we're going to see a pretty orderly process.

Smick: China has the ultimate shock absorber: a mountain of excess reserves, including a lot of U.S. Treasury securities. If necessary, won't they use these reserves to save the shadow system?

Weber: True. The Chinese financial system has a high ability to absorb losses. The Chinese policy agenda includes opening up the economy and internationalizing the RMB, which clearly is at the forefront of negotiations between the Chinese central bank and their European/U.S. peers. In London, Frankfurt, and Zurich they're talking about RMB trading in Europe, and also in New York. There is very little risk that the Chinese authorities will let problems in the shadow banking sector derail that long-term agenda of opening up Chinese financial markets and internationalizing the currency. But it will be a controlled process and it will take time. There is very little room for negative surprises, and since China is a centrally controlled economy, authorities will use those controls in order to make sure the transition is smooth and orderly.

Robust globalization is still intact. Countries are more than ever coupled to each other.

Smick: You once commented that Europe is at risk of committing energy suicide. What's your sense now that the Middle East seems to be sinking into sectarian violence? Does it trouble you that the United States meanwhile is moving toward energy independence, particularly because of its ample natural gas reserves? Is Europe going to be caught if the Middle East remains unstable for a protracted period? German industry's energy costs are already significantly higher than American industry's energy costs.

Weber: Europe is embarking on an idiosyncratic energy policy that has put renewable resources for energy at the core of the future energy mix, and de-emphasized fossil, nuclear, and other forms of energy that were part of the historic energy mix. Europe's energy future depends on continued access to importable resources of energy and all domestic energy resources. This is clearly impacted by the recent geopolitical tensions in the Middle East, in the Ukraine, and around Russia. Europe is too dependent on the market for Russian energy and gas, as the recent sanctions talks have revealed. I don't see a big change in Europe's energy policy going forward, but there are signs of more flexibility in Germany recently regarding the time horizon for changing the energy mix between fossil, nuclear, and renewable energy.

Smick: Reducing carbon emissions may be a worthy goal, but it seems absurd to think we are going to reach it in the near term.

Weber: The shift in the energy balance is increasingly driving new technological developments in many areas. Take, for example, the European car manufacturers. They have assumed the challenge of producing hybrid cars and electric cars. But again, energy has to come from somewhere—a balanced mix between fossil, nuclear, and renewable sources of energy is the best way forward.

Smick: I didn't understand why the Merkel government announced it would shut down Germany's nuclear power plants by 2022. Nobody wants a future

of nuclear power, especially after seeing the disaster at Fukushima. On the other hand, nuclear power accounts for perhaps one-fifth of Germany's electricity supply.

Weber: The problem with closing nuclear facilities is that the investment horizon for many of these power plants is more than two decades. If policymakers commit to phasing out nuclear power over decades, an orderly transition in the investment cycle of many of the European power plants is possible. But a very short-dated turnaround makes a large part of the existing inventory of such plants obsolete. While I think diversifying away from nuclear and fossil energy and into renewable energy is the right policy, it will take many years. A front-loaded transition carries a high price with increased dependence on others to provide the needed energy sources. At the moment, with high geopolitical tensions and Europe's strong dependence on Russian energy, such a policy is not the best choice.

Smick: Technology historically has solved most of the world's difficult problems. While technological innovation is hard to predict, until now new technology has always appeared when needed. Will technology save Europe's bacon?

Weber: Investing in energy efficiency is clearly helping, but it's a medium-term project. At UBS, we are providing investment in renewable forms of energy and offering sustainable investment funds. We sell funds to domestic investors that contribute to energy efficiency. For example, investors can choose financial products that facilitate more energy-efficient buildings. There are many opportunities where banks can play roles in promoting energy efficiency.

Smick: One final question. Suppose Chancellor Merkel called you up and asked your suggestions for raising Europe's dismally low economic growth rate. What would you tell her?

Weber: First, there is no silver bullet, not one single thing that Europe can do to regain growth. If it were that easy, it would have been done long ago. Europe needs a coherent strategy, which it currently lacks. At the moment, the European recovery and stabilization agenda is too heavily relying on the ECB taking an over-proportional responsibility in stabilizing the situation and producing stimulus that helps the turnaround. There is too little action and support by governments for increasing long-term growth. Political support for growth-enhancing reforms is very hard to muster, as we saw in Germany with Chancellor Schröder. While there are uncertain long-term benefits, there are visible short-term costs to such reforms. In a difficult political situation, decision makers focus too much on the short-term costs and too little on the long-term benefits of economic reforms.

There is no silver bullet, not one single thing that Europe can do to regain growth. If it were that easy, it would have been done long ago.

What's needed is an all-encompassing agenda that has teeth. Policymakers need to make sure that social security systems are adapted to the new reality of an aging society. Government expenditure needs to be brought down in line with that new reality, too. Only when we deal with the aging issue we will actually get a favorable growth trajectory in Europe.

In the early 2000s, Germany was in pretty much the same situation as parts of Europe are now—the sick man of Europe with very anemic growth. There were many other economies that grew much faster. To me this suggests that everyone should embark on the kind of reforms that Germany did at that time. After a couple of years of difficult transition, such reforms will improve the situation of the economy.

It is the supply side of the economy that needs to be reinvigorated in Europe. In the United States, growth is driven by a turnaround in the supply side, including factors such as a stronger energy balance, the ready availability of capital combined with a higher capital intensity, favorable labor market dynamics, and a more positive demographic outlook on the pension and aging issue. The United States is the technological leader of the industrial world. U.S. inventions drive economic growth. These underlying supply factors come straight from a textbook production function—technology, labor, capital, and energy—and provide a favorable outlook for growth in the United States, a better growth outlook than in Europe. ◆