



The Eurozone's Illness is Serious But Not Fatal

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EXECUTIVE SUMMARY

Recent weak economic data from Germany has refocused attention on the Eurozone's continuing struggles and are part of the reasons the IMF has reduced its global growth forecast. The asset quality review and stress test for Eurozone banks conducted by the European Central Bank (ECB) and the European Banking Authority respectively, showing that 13 European banks are currently undercapitalized also did little to dispel pessimism about Europe's prospects. For many observers, these latest signs of weakness come as no surprise. The fundamental challenges posed by uniting countries with very different fiscal conditions under a single monetary policy remain and there is little sign of commitment to increase the political integration necessary for reform. On the contrary, renewed tensions have arisen between Germany and the ECB over extending its asset purchasing program to stimulate demand. We recently spoke with Holger Fahrinkrug, Chief Economist with Meriten Investment Management about the latest setbacks in the Eurozone and what they might mean for Germany, Europe and the global economy.

Does the recent run of bad economic news from Europe suggest the start of Eurozone crisis 2.0?

Things aren't getting better, but I wouldn't call it a crisis. We used the word "crisis" when Italian bond yields were heading for seven percent. Italian and Spanish bond yields today are about one third of that. The Eurozone economy is weak, but not outrageously weak. Many of those who call it a crisis were shocked by the recent weakness in Germany. However, in fact the German economy is just returning to its trend growth rate. They also point to low inflation that contributes to fears of deflation and to problems many countries have with public finances. If you look at all of those things together, you may have the seeds of a crisis, but I don't believe we're there now.

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Just saying the word “deflation” almost inevitably evokes Japan and its decade of economic stagnation. Are investors right to be concerned that something similar could happen in Europe?

There's certainly a risk that something like that might happen. In Japan, a huge bubble exploded in the 1980s and policy errors contributed to the mess.

Some countries such as Spain exhibit similarities to Japan. Like in Japan, in Spain, a property bubble exploded and took the banking sector down with it, but that's been partly resolved in Spain as the recent stress test shows. Reforms have taken place and unemployment appears to have peaked. Unlike Japan which suffered “lost decades,” what I call the “reform” countries of the Eurozone periphery should continue to improve and grow in the years ahead, although it will be a long process. Policymakers today have learned from Japan's example. Central banks in developed countries are more responsive now and have put quantitative easing in place, including that provided by the European Central Bank. It's too early to tell whether the ECB's quantitative easing policy will succeed because they've come late to the party.

But some observers claim that Germany's constitution requires the government to oppose the ECB's asset purchase policy. Do you expect this to happen?

I think those efforts are overdone and too late. The German government will certainly do nothing to stop the ECB's already announced asset purchases. It would probably have to challenge an attempt by the ECB to purchase sovereign bonds, however.

What is the significance of the ECB's bank stress test results?

The test results showed no major surprises in terms of the number of banks that are undercapitalized or the overall gap. This provided some reassurance regarding the robustness of the financial system. That said, there's no miracle to be expected in terms of the tests' impact on the real economy and on credit growth, which has been one of the major weaknesses in recent years.

While we wait for the periphery to grow, economic data suggests Germany is having trouble sustaining its own economic growth. Doesn't a slowdown in the country which many observers hope will play a lead role in stimulating growth across the Eurozone make a broad European recovery even more difficult?

The changing global perception of Germany is remarkable and doesn't always reflect reality. Right now, Germany is much better off than it was ten years ago. Unemployment is very low and earnings are rising, but there is little inflation. Public finances are in good shape. The trouble in my view is that expectations about what Germany can contribute to the global economy have become unrealistic. Germany used to be viewed as the sick man of Europe, then people began to call it the locomotive of Europe, so the perception went from unrealistically negative to unrealistically optimistic.

The reality is that German corporations have reformed themselves over the past ten years and the government has aided the process with labor market reforms. Germany now offers the same reform prescription to Greece, Ireland, Portugal and Spain. These countries have had support from the EU and from an improving global economy as they have made structural adjustments and are now much better positioned for future growth. The problem is that some other euro area countries have not reformed as much. France and Italy make up one third of the total Eurozone economy and have reformed far less than the reform countries. Downward revisions to German growth don't mean Germany is in trouble, but it no longer looks strong enough to pull Italy and France up and rescue the rest of the Eurozone.

Could the problems in Europe spill over and slow the US recovery?

That concern has already been expressed by the Fed and others. Surely, it has something to it. Since I do, however, believe that Europe will recover into 2015, albeit gradually, I do not believe that this is a very serious threat to the US economy which I view as being self-sustaining at this point.

Some observers have called on Germany to run budget deficits in order to spur aggregate demand and stimulate a European revival. Do you see any sign that there's political will to take that kind of step?

The current weak demand situation is a Eurozone situation, not just a German one and one of the Eurozone's key weaknesses is the lack of fiscal harmonization. Instead of focusing on this problem, most of the discussion is about public stimulus and how Germany could do things like increasing public spending on infrastructure. Germany won't do those things easily because they are not necessarily in its national interest.

Germany is at the top of the economic cycle and the country's leaders believe it should have a balanced budget at this time. The problem with this view is that it ignores the fact that Germany is no longer an independent nation, but rather a member of a currency union that needs a kind of fiscal burden sharing. I don't see a political willingness to work against that national interest, though, at least not yet. There may be some infrastructure spending at some point, but it won't be a big program.

The political tension you speak of between acting in an individual member state's national interest versus the interest of the Eurozone as a whole raises the fundamental question of whether the level of political integration in the Eurozone is sufficient to fix the problems it faces. Is it?

The asset quality review and bank stress tests are part of the banking union process in which the ECB is taking over supervisory responsibility for Eurozone banks, so we have seen progress in terms of Eurozone integration. Right now, though, political sentiment in most Eurozone countries is toward less integration, rather than more. The longer growth remains weak and unemployment high, the less interest there is in giving up more national autonomy to a union many believe hasn't delivered on its promises. It's a challenge for democratically elected governments to act against the immediate and often emotional responses of their voters. That electorate is also changing quickly and the share of the vote for non-euro parties in countries like France and Greece is rising. The crisis showed the weakness of the current system and the need to integrate much further, but the opposite is happening.

How should investors think about the latest European economic setbacks?

From a political or social standpoint, things can look bleak, but that doesn't necessarily imply bad news for investors. Investors shouldn't lose sight of the distinction between what's happening at the national or macro level and what takes place at the corporate or micro level, where many positive developments may take place. In my mind, there is also absolutely no chance we'll see tighter monetary policy, which should reassure investors. I don't see a brilliant future, but unlike in the US, I believe monetary policy in the EMU will remain very accommodative. There's lots of opportunity in this difficult environment, but it requires expertise and analysis to find. We're not in a normal business cycle so we're not going to see a normal rate cycle either.

Peripheral economies are improving in terms of their competitiveness and will benefit from domestic investment. We anticipate that they will create jobs in the future and that will help increase demand. The energy sector is also attracting a lot of investment as Germany looks for ways to bring down its very high electricity costs. If those efforts are successful, corporate energy users could see their profits improve as well. Consumer-related sectors will eventually experience catch-up effects, especially in the reform countries, though that may take longer to happen. Investors will need to be very precise in how they find the bright spots in Europe, but they will be there.

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