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Closing the Gap: Can Europe's Economy Finally Catch Up with the U.S.?

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What effect could politics have on transatlantic economic policies?

How do European and American recovery indicators compare?

The year 2016 has been characterized by growing uncertainty about the strength of the global economy: uncertainty about the ability of emerging markets—and especially China—to successfully address cyclical and structural weaknesses in their economies; uncertainty about the impact of the slowdown on advanced economies, namely the United States and Europe; and uncertainty about the impact of a weakening global economy on commodity prices. In its World Economic Outlook in Spring 2016, the International Monetary Fund (IMF) lamented that growth had been “too slow for too long,” saying “[...] persistent slow growth has scarring effects that themselves reduce potential output and with it, consumption and investment. Consecutive downgrades of future economic prospects carry the risk of a world economy that reaches stalling speed and falls into widespread secular stagnation.”¹

Indeed, that is what markets seemed to fear. Linking the sources of weakness, investors seemed to recognize a potentially negative feedback loop, compounded by the growing fear that major central banks, once relied on as “the only game in town,” may be losing their ability to respond to and contain the fallout of a suddenly cooling economy.

These fears continued to linger beneath the surface even when markets shook off some of those concerns and staged an impressive rally in early spring, reversing earlier losses. In fact, in what seems to have become a recurrent feature of more recent rallies, concerns and fears about the state of the global economy more generally, and in particular doubts about the robustness of the U.S. recovery, tend to stage sudden comebacks. This year is a perfect example of this pattern. As markets set their sights on the second half of the year, they will increasingly add a powerful, potentially very disruptive, element to an already combustible mix: politics.

The IMF notes, “In both the United States and Europe, the political discussion is turning increasingly inward. The causes are complex but certainly reflect growing income inequality as well as structural shifts, some connected with globalization, that are seen as having favored economic elites while leaving others behind. Fear of terrorism also plays a role. The result could be a turn toward more nationalistic policies, including protectionist ones.”²

In the U.S., the primary campaigns are throwing traditional assumptions about the November race out the window. Some pronouncements made by the presumptive Republican nominee could very well rattle markets, while the Democratic race continues as voters assess the trade and finance policies of the two candidates. Markets have not reacted yet, but that could change depending on how the race evolves in the coming months, especially once the two parties have officially selected their respective nominees in the summer.

At the same time, Europe could be deeply affected by a “No” vote in the upcoming British referendum on continued membership in the European Union. Thanks to the ongoing refugee crisis, the Schengen system of free travel in most EU countries has been suspended and populist political forces are trying to exploit fears. Furthermore, growth in the EU, and in particular the euro area, is still not strong enough to reduce unemployment substantially. In crisis-hit countries, even in those that are bouncing back, the parties and governments that were forced to implement “austerity” measures have been punished by voters.

These political factors make it potentially very difficult to achieve progress on the ambitious transatlantic agenda, including negotiations on the trade and investment partnership known as TTIP. The paradox is that while the U.S. and Europe confront similar challenges and seem to converge on so many different fronts, many of the responses offered to address those very issues could in fact move the transatlantic community farther apart, politically as well as economically.

The Macroeconomic Picture: Are the U.S. and Europe Converging After All?

The macroeconomic picture offers some interesting elements. The U.S. economy, credited with a more robust recovery and a vibrant and strong labor market, continues to grow at an annual rate close to 2 percent. The unemployment rate has fallen substantially to 5 percent, a level consistent with the definition of full employment—which means that the Federal Reserve (Fed) is at least fulfilling one of its two mandates. However, despite a tighter labor market and some wage gains, inflationary pressures have not yet materialized and labor force participation has been disappointing. The Fed remains cautious, noting improvements in the housing sector, increases in households’ real income, job gains, inflation remaining below the 2 percent goal, and high consumer sentiment. These improvements, however, are accompanied by “soft” business fixed investments and net exports, and have resulted partly from price decreases in energy and non-energy imports. As a result, the Fed expects that “with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market indicators will continue to strengthen.”³ However, some economists, most notably the former Secretary of the Treasury Lawrence Summers, have raised doubts about the nature of the recovery. They think that

the U.S. economy is stuck in secular stagnation, a prolonged period of low aggregate demand and therefore low growth.

The same would apply to Europe. For years, the widely-held assumption was that the EU, with its wide output gap, repeated bouts of disinflation, and a more vulnerable banking system, was condemned to remain stuck in much worse shape than the United States. While it is certainly true that Europe is still weaker than the U.S., the latest data does not seem to support the view that the gap is actually widening.

In its May 2016 bulletin the ECB paints a cautiously optimistic picture of the economy in the euro area, saying “The economic recovery in the euro area is continuing, driven by domestic demand, while foreign demand growth remains weak. Domestic demand continues to be supported by monetary policy measures. Their favorable impact on financing conditions, together with improvements in corporate profitability, is benefiting investment. Moreover, the accommodative monetary policy stance, continued employment gains resulting from past structural reforms and the still relatively low price of oil should provide ongoing support for households’ real disposable income and private consumption.” Still, it notes, “the economic recovery in the euro area is still dampened by the ongoing balance sheet adjustments in a number of sectors, the insufficient pace of implementation of structural reforms in some countries and subdued growth prospects in emerging markets. The risks to the euro area growth outlook remain tilted to the downside.”⁴

The EU Commission published its own forecast in May, lowering its growth estimates for the euro area for this year and next. Gross domestic product is expected to advance 1.6 percent in 2016 and 1.8 percent in 2017. The Commission also lowered its forecast for economic growth in the broader European Union, now expected to hit 1.8 percent this year (down from 1.9 percent) and 1.9 percent in 2017 (down from 2 percent). According to EU Commissioner for Economic and Financial Affairs Pierre Moscovici, “The recovery in the euro area remains uneven, both between member states and between the weakest and the strongest in society. That is unacceptable and requires determined action from governments, both individually and collectively.”⁵ Indeed, some countries stand out positively while others continue to struggle. Ireland is currently growing faster than China, while Greece’s economy continued to contract at the beginning of 2016, albeit at a slower pace.

The Diverging Financial Sector: Can Euro Area Banks Catch Up to Their American Peers?

Banks on both sides of the Atlantic have recently struggled with low profit margins and disappointing quarterly results. The reasons for the disappointing results are both structural and cyclical. Higher volatility in financial markets in the first months of the year had a negative impact on the investment banking

sector, with merger and acquisition activity as well as trading profits down. More importantly, banks are still operating in a world of low or even negative interest rates.

Today, 18 percent of the global economy finds itself in an environment of negative central bank policy rates. The proportion rises to 40 percent if countries with 0 percent to 1 percent rates are included. Very low rates put pressure on the business model of financial institutions by squeezing interest income. At the same time, the sector is still adjusting to post-crisis deleveraging in the economy and changes in the regulatory environment. This situation is in part due to what the former Fed chairman Ben Bernanke famously called a savings glut, i.e., rising net savings as aging populations plan for retirement, less public capital expenditure due to high public indebtedness, and a slowdown in productivity growth that has reduced the profitability of investment.

While both the U.S. and Europe suffer in a low interest rate environment, differences in the structure of the financial sector tend to exacerbate the impact. The European Union is still largely a bank-based economy: about three-quarters of the funding of the economy takes place thanks to traditional credit institutions and a mere one-quarter is channeled through capital markets. The opposite is true in the U.S. In fact, the U.S. is a capital markets-based economy and managed to rebound from the crisis much faster than Europe.

This is not the place to point out advantages or disadvantages of each system—they perform differently. But it is worth mentioning that U.S. banks underwent shock therapy in the early stages of the crisis and build capital buffers much faster than Europe. Facing a rapidly-fragmenting banking system—along national lines—the euro area realized late that it needed to overhaul its financial system, first by building a banking union and subsequently by trying to increase the role of capital markets, a project whose goal is to forge an EU-wide, well-integrated Capital Markets Union (CMU).

However, despite the introduction of a single supervisor and a single resolution system for failing banks, the completion of the so-called banking union very much remains a work in progress. This is not only because the biggest euro area banks are still learning to interact with a new European supervisor, but also because not all elements required for a fully functional, integrated banking union are in place. The single resolution fund has only started to receive the first installments—a small portion—of the necessary common funds that are needed to absorb the shock in case of multiple bank failures. The European deposit insurance scheme proposed in the autumn of 2015 by the European Commission that should protect European depositors in case of bank failures still needs approval from member states. Since a common deposit scheme mutualizes some risks among member states' banks, Germany and a few other countries are not willing to back the Commission's proposal, unless banks first drastically reduce

the risks on their books, including the gross exposure of banks to non-performing loans (NPLs), and limit the exposure to their domestic sovereign bonds. In other words, the German government insists on drastically de-risking the banking sector before agreeing to the European Deposit Insurance Scheme (EDIS), while the Commission is trying to convince member states to start sharing some of the risks earlier. The Brussels-based institution has concluded that in order to increase banks' resilience and capacity to lend, vulnerabilities in the banking sector can only be credibly reduced if member states share an increasing portion of risks.

Germany wants to see a strict sequence while the Commission would like to see a synchronized approach. The stalemate is having an impact on the banking system, as the German approach puts the onus on individual member states to put their banks "in order" before agreeing to any new form of mutualization of liabilities.

In fact, the consolidation in the European banking sector is making slow progress. So far it is a national affair. In Germany and Italy, two of the countries that are disproportionately overbanked, the process is not attracting many international investors. Bank mergers in Italy are a domestic affair, just as much as they are in Germany where a multitude of "Sparkassen" (savings banks) and "Landesbanken" (regional development banks) continue to struggle to adapt their business model to a low interest rate environment.

The over-reliance on banks has an impact on the transmission of monetary policies as well. Thus the ECB, when designing its policy mix, tries to keep an eye on the banks' well-being. The ECB needs credit institutions to effectively transmit monetary policy impulses to the real economy. It is too early to say whether the ECB is fully achieving its goals. However, it is clear that in order to close the remaining gap with the U.S. economy, Europe also needs a resilient and more diversified financial sector. America needed to repair and restore a broken system, but the building blocks were all in place. Europe, it seems, is going through a deeper, potentially transformational change. Whether it succeeds will ultimately also depend on its capacity to resist the temptations of limited, national solutions.

¹ International Monetary Fund, "World Economic Outlook: Too Slow for Too Long," *World Economic and Financial Surveys*, April 2016.

² *Ibid.*

³ Board of Governors of the Federal Reserve System, Press Release, 27 April 2016, <https://www.federalreserve.gov/newsevents/press/monetary/20160427a.htm>

⁴ European Central Bank, Economic Bulletin, Issue 3 (2016), <https://www.ecb.europa.eu/pub/pdf/ecbu/eb201603.en.pdf>

⁵ European Commission, "Spring 2016 Economic Forecast: Staying the course amid high risks," Press Release, 3 May 2016, http://europa.eu/rapid/press-release_IP-16-1613_en.htm.

As the American voters evaluate their choice for the White House on November 8, the debates over economic and foreign policy issues in the U.S. all through the campaign toward Election Day will reverberate well beyond the United States. This Issue Brief is part of AICGS' Annual Symposium in Germany, examining key issues at stake for the U.S. and Germany, including U.S. expectations of Germany and Europe; German and European expectations of the next President; chief economic challenges ahead on either side of the Atlantic; and areas of cooperation and conflict across the Atlantic in dealing with regional and global crises.

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