The View

THE BULL CASE FOR EUROPE

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- **Volatile short-term macro confuses the long-term EA outlook**
- **The EA is losing competitiveness and its industrial base is under threat**
- **China turns from key export market into industrial rival (cars, chemicals)**
- **Higher energy costs, dependency on key raw materials and a complex system of subsidies put the EA at a disadvantage vs China and the US**
- **Thus, the old EA export-led growth model is dead, but this is good news**
- **The shift in the EA policy mix since Covid is profoundly positive**
- **Public investment and a tight job market strengthen domestic demand**
- **Crucially, many factors hint at a potential productivity revival (even in Italy)**
- **Market narratives about EA long-term growth seem overly pessimistic**
- **Beyond a cyclical slowdown, the glass is half full for the EA economy and assets**

Summary. Volatile short-term data are creating confusion about the outlook, muddying long-term narratives. Beyond the current uncertainties, investors are concerned about Euro Area (EA) structural growth trends and are rightly questioning the viability of the old EA (and German) export-led growth model. However, while the long tail of the energy crisis, the retreat of supply-chain globalization and rising geopolitical tensions are making the headlines, the shift in the EA policy mix in the wake of the pandemic could have profoundly positive effects on EA long-term growth and asset prices.

On the one hand, post-GFC insistence on balanced budgets and reliance on internal devaluations to boost external competitiveness are no longer options in a global economy that is being reshaped by the political imperative of technological decoupling from China and in which China itself is asserting its dominance in traditional EA export markets (cars, capital goods, high technologies). Moreover, because of the acceleration in the green transition, the EA's dependency on raw materials and key inputs for clean tech puts the bloc at a structural disadvantage, especially vis-à-vis China. Against the backdrop of easier-to-access US green subsidies (via the US Inflation Reduction Act) and the widening delta in US-EA energy prices, the EA faces growing challenges in retaining its powerful industrial base. Meanwhile, the cliff effects of adverse demographics are looming, putting further pressure on EA long-term growth.

On the other hand, the pandemic and its aftershocks were a watershed for fiscal and monetary policy in the EA, while domestic demand drivers are now structurally stronger. First, the need to accelerate the digital and green transition implies a more active fiscal policy targeting productive

investment areas. The EU Commission's proposal to update the EU fiscal framework still includes elements that could stifle growth as disbursements from the Next Generation EU fund stop in 2026, while the limited capacity of member states' governments to spend the funds efficiently could reduce spillover effects. However, it cannot be denied that the EA is now on a much better footing in terms of both investment and fiscal space than it has been since the GFC. Second, the robust recovery of labour markets from the pandemic and the prospect of more frequent labour supply shortages are likely to push up average wage growth even after the current phase of inflation. This would provide a more solid backdrop for real incomes and consumption. Third, beyond stronger aggregate demand, several factors point to the possibility of a productivity revival. New open-source digital technologies such as AI – with its low cost and easy accessibility – could compound the impact of the digitization of the economy and help boost productivity, including in the services sector. And a high-pressure economy, characterized by tight labour markets and higher wage growth, could finally push firms to increase capital investments, while empirical relationships show that historically such an environment also raises total factor productivity. Finally, a return to higher (more "normal") yields will increase the opportunity cost of lending to "zombie" companies – a major factor behind the widening gap in US-EA productivity since the GFC.

Moreover, beyond the cyclical slowdown globally and the rising risks that it entails, yield normalization is already encouraging the repatriation of some of those portfolio flows that left the EA amid the EA sovereign debt crisis. Meanwhile, the mere prospect of a rebalancing of the macro policy mix and its impact on growth drivers (from excessive reliance on exports to more robust domestic demand) over the next cycle are strong pointers to higher EA asset weights in long-term asset allocation globally.

In other words, don't fear the demise of the old, dysfunctional EA growth model. A rebalancing from foreign-demand dependency to stronger domestic-growth drivers with the potential for a productivity revival is very good news indeed for the EA economy and asset prices.

Don't miss the structural-growth-model-change 'forest' for the cyclical-data-volatility 'trees'

The macro outlook is more confusing than ever. The large shocks that have hit the Euro Area (EA) over the past three years (the Covid bombshell, the energy crisis and the invasion of Ukraine) combined with the long tail of their variegated ripple effects have distorted the normal functioning of the economy to such an extent and created so much volatility in cyclical data that the macro outlook is more confusing than ever and precise forecasts virtually impossible to make.

Last year, following the curtailment of Russian shipments to the EA, the spike in energy prices, led by natural gas, left investors fearing that rolling blackouts, large industrial output cuts and the hit on household real incomes would plunge Europe into a deep recession. But by mid-Q1 it had become clear that a mix of unseasonably warm weather, the rapid fuel substitution in manufacturing away from natural gas, efficiency energy savings across the industrial and household sectors and a strong fiscal response at both the EU and national level had prevented a serious real output contraction.

In fact, in Q1 the narrative of markets and forecasters on the EA rapidly shifted towards optimism, against the backdrop of sharply lower energy prices, easing supply bottlenecks and a more positive foreign-demand outlook – still resilient US consumption and a rebound in Chinese economic activity. This change in sentiment was reflected in survey data, with PMIs and Ifo

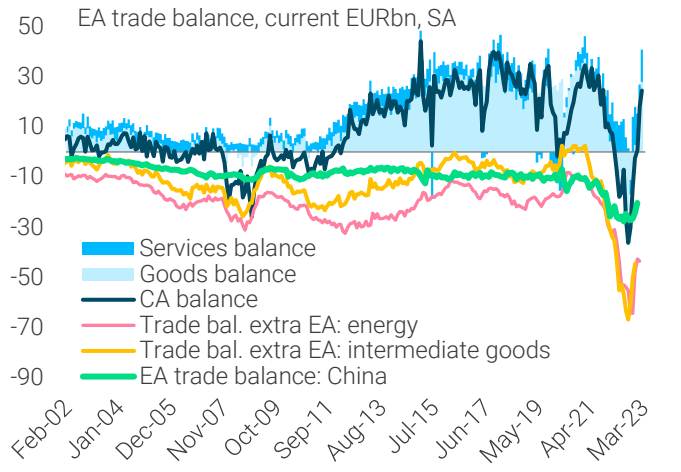
indicators rebounding, and in the marginal improvement in industrial production and export performance for January and February.

Anaemic growth remains the cyclical forecast for the EA in 2023. However, the underlying weakness in EA GDP details and the lack of meaningful macro catalysts for a genuine trend reversal have convinced us to keep our EA growth forecasts for this year well below consensus (0.6% versus around the 1% growth pencilled in by the EU Commission in its latest forecasts and by the ECB in its March projections). **As we have argued** (e.g., here, here and here), **the cyclical outlook for the EA remains anaemic growth that will be more or less indistinguishable from stagnation**. **The degree of stagnation will depend on three factors: (i)** the severity of the US slowdown/recession, which my colleague Steve Blitz expects to start by mid-year; **(ii)** the speed at which China's reopening momentum will fade in H2; and **(iii)** the emerging pressure of past and ongoing ECB tightening exerted on the real economy. **So far, this stance has been vindicated** by last week's final GDP data for Q1, which confirmed that EA real output contracted in 2022Q4 and 2023Q1, albeit only slightly.

The problem with the current extreme volatility in cyclical data is that it also distorted standard structural indicators, leaving investors and analysts struggling to make sense of the long-term prospects for the EA economy and industry. For example, such dynamics are evident in the EA trade balance, whose large surplus since the Global Financial Crisis (GFC) has become synonymous with EA export competitiveness. When the bloc was hit last year by a massive terms of trade shock, the trade balance plummeted into deficit for several months, driven mostly by a surge in the cost of energy and commodity imports exacerbated by euro weakness versus the dollar. Pundits did not miss the opportunity to warn against impending disaster, only to reverse their apocalyptic predictions a few weeks later as prices for energy and raw material abated, supply bottleneck eased, and the EA trade balance recovered (**Chart 1**).

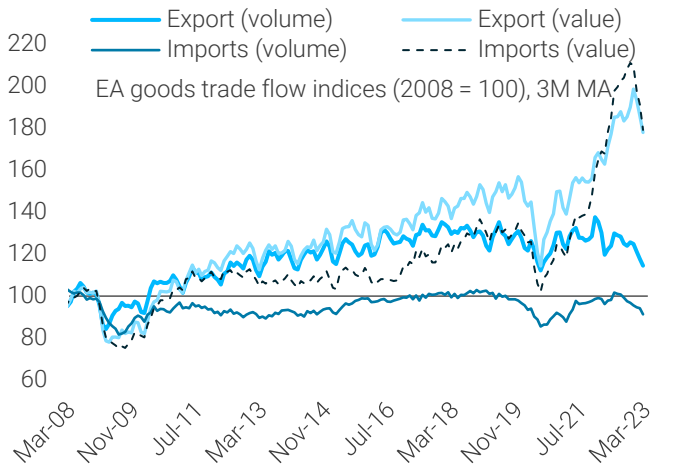
Does this mean it's back to business as usual for the EA? No, it doesn't. From a cyclical standpoint, as we explained, the Q1 rebound in the EA trade balance chimes with the marginal recovery in the output of industries most affected by energy costs (chemical, metals, food) and by supply-chain bottlenecks (cars). Expectations that a strong China reopening would boost EA exports played a role, too, buoying foreign manufacturing orders. However, the reality is that both factory orders and exports data clearly deteriorated in March, consistent with a return to the existing downward trends. Ultimately, the trade balance has also been boosted by imports falling faster than exports – both on a nominal and real basis (in line with the large fall in consumption

Chart 1: No, it's not back to business as usual



Sources: Eurostat, Datastream, TS Lombard.

Chart 2: Trade data resume downward trend



Sources: Eurostat, TS Lombard.

across the EA); and that is not something to write home about (**Chart 2**). Such developments are temporary and we should expect the trade surplus to stabilize at a somewhat smaller size. **From a structural standpoint**, while the most acute phase of the energy crisis is over, EA energy costs will remain higher than pre-Covid. Meanwhile, China's role as the world's manufacturing hub for green technologies – from electric vehicles (EVs) to batteries and solar panels – coupled with the strong EA push towards renewables and electric mobility implies a structural break in the EA goods trade balance going forward.

In other words, the ongoing wild macro crosscurrents imply that the cue for structural trends in EA long-term growth outlook can no longer be taken from single standard indicators. Rather, such analysis requires digging deeper into a constellation of factors that go well beyond the expected fallout from higher energy costs for industry, which is still grabbing the headlines. **In the rest of this View we take a comprehensive look at all structural drivers of EA growth and – what will perhaps be surprising to some – we find reason to be cautiously optimistic about the future.**

Less competitive and aging: the EA (and German) growth model is dead

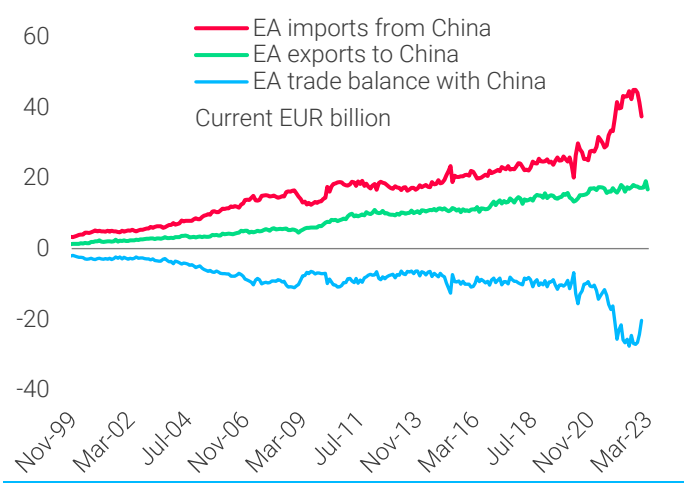
In the aftermath of the GFC and EA sovereign debt crisis, Germany's limited private and public debt overhang combined with its technological superiority in both complex capital goods production and the auto sector allowed the country to fast-track its post-GFC recovery and become the leading EA economy – setting an example for fiscally fragile southern EA countries struggling to deleverage and implement structural reforms. The German export-led growth model quickly became the economic policy benchmark for the entire bloc, fostering internal devaluations and greater reliance on external demand, especially from China.

But the preconditions for the viability of this growth model are no longer in place – not least a friendly Russia providing a relatively cheap energy source, weak domestic demand and political stability keeping a lid on the cost of labour and globalization allowing firms to tap into demand from vast Chinese markets. The invasion of Ukraine, rising inflation and nominal wages in the EA and increasing regionalization fuelled by geopolitical and technological rivalries are just some of the factors contributing to the change in the macro environment. If the demise of its export-led growth model poses risks for the entire EA, it is only natural that Germany is the first economy to be impacted and the one facing the biggest policy dilemma. Meanwhile, adverse demographics is

Chart 3: EA highly exposed to China

Sources: The Economist, TS Lombard.

Chart 4: EA imports from China surging



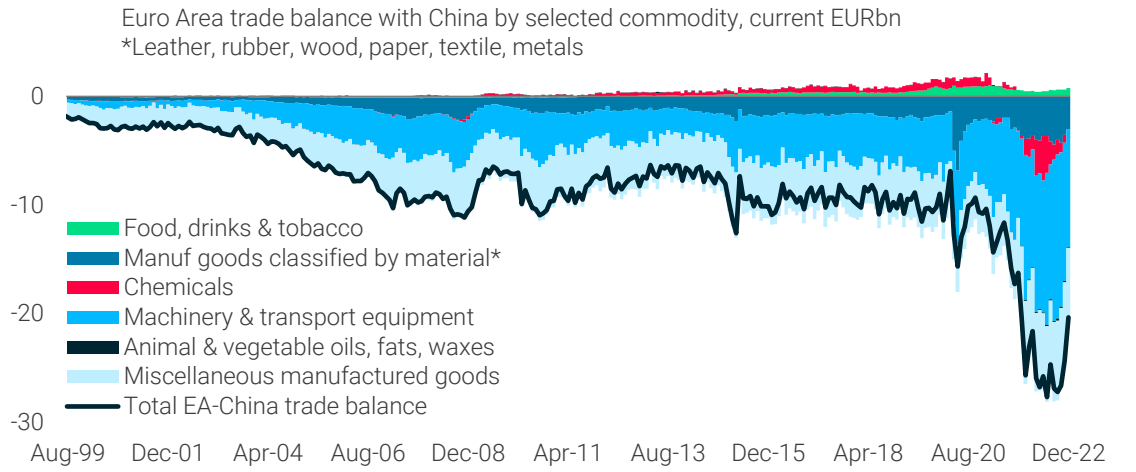
Sources: Eurostat, Datastream, TS Lombard.

starting to bite and cliff effects from the baby boomers retiring are now firmly within standard investment horizons.

The EA is losing competitiveness

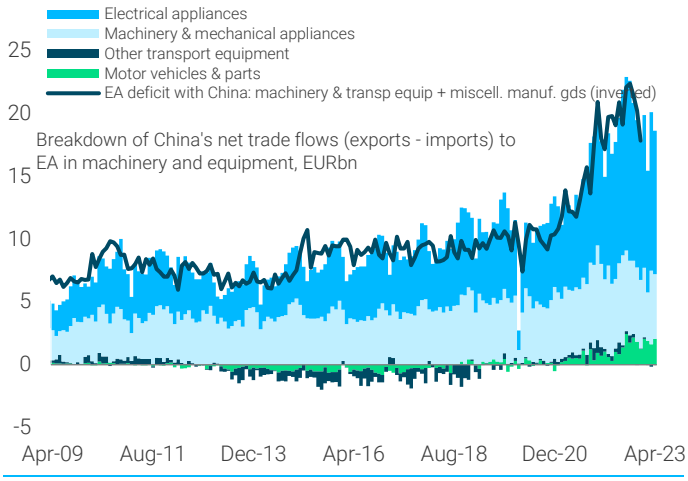
- **China: From key export market to industrial rival.** Post-GFC, amid the China boom on the back of monetary and fiscal stimulus, the EA (and especially Germany) benefitted from China's insatiable appetite for industrial equipment, cars and luxury goods. Over time, the EA's reliance grew to the point that China's export market became not only a key source of marginal growth for the bloc but also a significant risk exposure – both in aggregate and for individual companies (**Chart 3**). Germany is the most exposed economy by any measure, while Italy and Spain are at the bottom of the list, according to data from The Economist. The EA is much more exposed to China than either the US or the UK is. Moreover, sales of machinery to China account for more than one third of total EA exports to that country. If vehicles and parts (accounting for 16%) are included, then we get to half of all export flows from the EA to China.
  But tailwinds have now turned into headwinds. **First**, China's deleveraging policy since 2017 has ended the era of debt-fuelled booms, driven by industrial and real estate investment. **Second**, China's adoption of the "dual circulation strategy" and "Made in China 2025" targets for several sectors – including IT, transport and robotics – implies that increasing China's competitiveness in those very markets so far dominated by the EA has become a top policy objective. **Third**, the pandemic, the energy crisis and the Green Transition have all accelerated these developments, causing a sharp increase in EA imports from China and the widening of the EA's deficit (**Chart 4**). If the main factors behind the widening deficit in 2020 and 2021 were the global rush for China-made masks and protective medical gear followed by the scramble for commodities as well as intermediate and consumer manufactured goods, the energy crisis of 2022 exacerbated the situation, pushing the EA to cut domestic production of energy-intensive inputs, such as metals and especially chemicals, which led to massive import substitution. Since mid-2022, however, the strong EU impulse to speed up the Green Transition has even reversed some capital goods trade flows between EA and China. Thanks to its superiority in most green technologies – including EVs and batteries – and their supply chains, China is now running surpluses with the EA (**Chart 5**). And even if EA imports are now having a breather, the breakdown of imports of electrical appliances confirms that the Green Transition is already changing EA-China trade flows structurally. Virtually all growth in the

Chart 5: Imports of capital goods and chemicals drive EA deficit with China



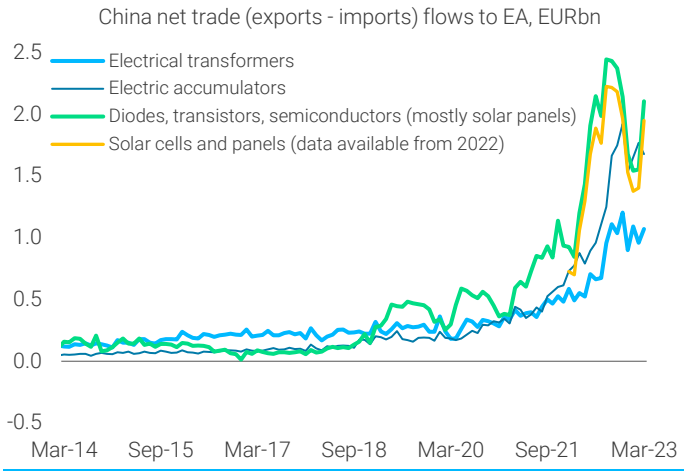
Sources: Eurostat, Datastream, TS Lombard.

Chart 6: China has become an industrial rival



Sources: China Customs, Eurostat, Datastream, TS Lombard.

Chart 7: The other side of the Green Transition



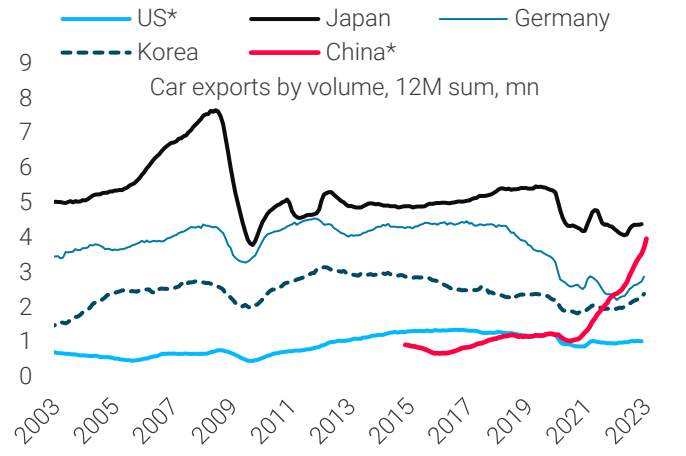
Sources: Eurostat, Datastream, TS Lombard.

EA trade deficit in this category comes from solar cells/panels, electrical accumulators (i.e., batteries) and electrical transformers (**Charts 6-7**).

The EU is ramping up public investment under the REPowerEU scheme to accelerate the domestic production of green tech and EVs; however, China has taken an early and significant lead in becoming an EV manufacturing superpower, mostly by having handed out large purchasing subsidies and tax breaks amounting to more than US$43bn between 2009 and 2022. As a result, China last year produced just under two-thirds of all global battery EVs, BYD has overtaken Volkswagen as the best-selling car brand in China, leveraging cheaper models with better connectivity, and the Middle Kingdom is becoming the largest car exporter globally (**Chart 8**). In other words, the combination of China's increased import substitution in manufacturing technology under the "dual circulation strategy" and the growing success of the Chinese auto sector have turned the EA's top export market into a fierce industrial rival globally.

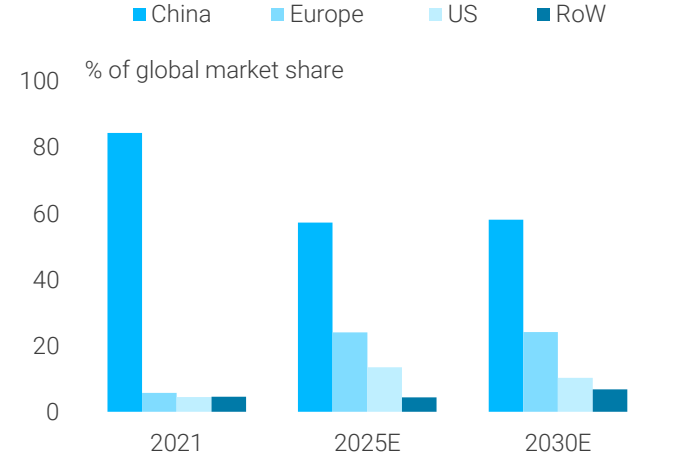
- **Regionalization amid growing raw material and input dependency.** With globalization now in retreat, Western governments are pushing firms to redesign supply chains in order to reduce dependency on individual countries –especially "unfriendly" ones such as Russia and China. According to a recent study by the ECB, the impact on EA growth of trade fragmentation owing to supply-chain "friend-shoring" is 1-2% of GDP, as rising imports within regional trade blocs do not fully compensate for the loss in trade flows

Chart 8: China EVs take over global car market



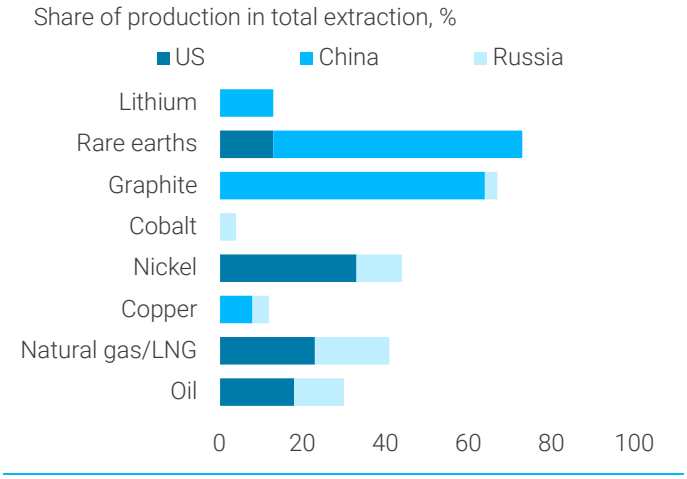
Sources: NBS, CEIC, TS Lombard. *includes some commercial vehicle.

Chart 9: China set to dominate the EV battery space



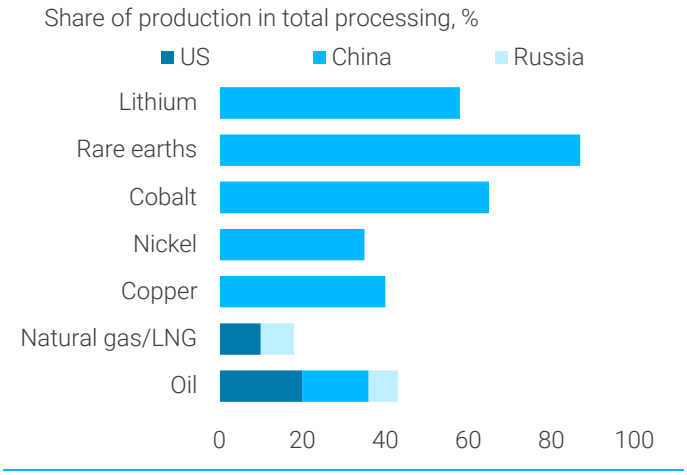
Sources: S&P Global Market Intelligence, TS Lombard.

Chart 10: China's stranglehold on critical inputs…



Sources: IEA, TS Lombard.

Chart 11: …spans extraction and processing



Sources: IEA, TS Lombard.

across blocs. However, the fundamental problem for the EA is that the Green Transition requires enormous quantities of raw materials, including rare earths, and intermediate inputs that are largely extracted and refined elsewhere. China, as explained above, has managed to secure for itself not only a strong lead on green technology but also a dominant position in the supply chain of the most critical raw materials for solar and wind energy infrastructure as well as for EV batteries. According to IEA's projections based on current policies, renewable generation capacity in the US, the EU and China is set to roughly double by 2030. Solar photovoltaics alone will account for 60% of all renewable capacity additions, with wind energy taking second place. China controls roughly 80% of the global solar-battery supply chain and provides 85% of components used by Europe's wind-turbine firms. Similarly, with RePowerEU in the EU and the Inflation Reduction Act (IRA) in the US further increasing incentives to speed up transport electrification and boost EV sales, forecasts suggest China is set to remain comfortably dominant in the EV battery market, with a global market share of just below 60% by 2030 (**Chart 9**).

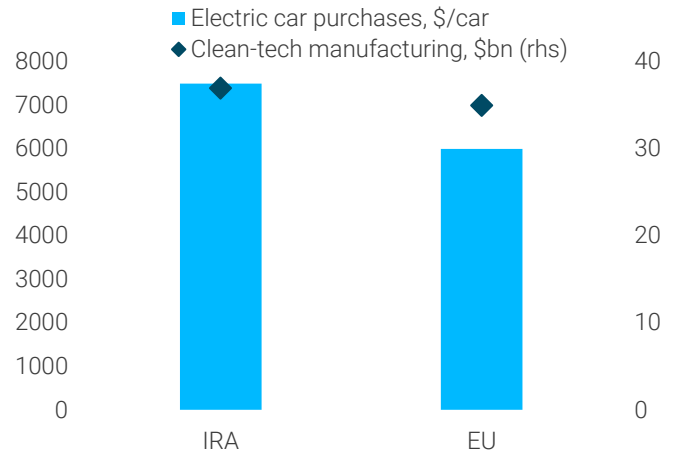
Crucially, China plays a key role in the supply chain of lithium, graphite, cobalt and nickel, all of which are the main inputs for batteries, EV motors and wind turbines (**Charts 10-11**). When China had no direct access to the mining stage of a mineral – as, for example, in the case of cobalt and nickel (the extraction of which is dominated by Congo and Indonesia, respectively) – aggressive diplomacy combined with generous investments in local businesses ensured de facto market control. The EU imports 98% of refined rare earths from China, while the US – once the leader in rare earths – now imports 80%, after ceding its supremacy in the 1990s mainly to outsource environmental pollution. Industry experts have estimated it could take the US up to 15 years to rebuild the US supply chain, implying there will be no "friendly" alternative for EA imports until towards end of the next decade. In sum, owing to current trends, it will be extremely challenging for the EA (and for the US) to compete in the renewable energy space.

- **Higher cost of energy and lower supply security.** Since mid-2021, the EA energy crisis has brought the issue of energy cost and supply security for EA firms back into focus. Unlike the US, which over the past decade has risen to become one of the largest oil and LNG exporters globally, the EA is one of the largest energy importers in the world. The result of this trade divergence has been a widening gap in energy costs across the Atlantic. Even before the energy crisis, the average cost of electricity for a German firm was around double of that of a US peer. In some energy- and capital-intensive sectors,

such as car manufacturing and chemicals, large EA industrial groups have long been redesigning their production footprint in order to benefit from the US' more secure and cheaper energy supply and to enjoy direct access to that country's large market. However, while the most acute phase of the energy crisis is now behind us, natural gas prices in Europe are still twice as high as their pre-crisis norm, while the US Henry Hub natural gas spot price benchmark traded at US$2.16/mmBtu in April, well below the pre-Covid average. Similarly, according to Volkswagen's CEO, electricity prices in the EA remain about double the €0.07/kWh level, which is where they should be to keep EA firms cost-competitive. €0.07/kWh is also a figure commonly referred to as the power cost that China guarantees its solar industry. In other words, the energy crisis has exacerbated the EA energy cost delta with other regions, while leaving the region highly dependent on the international LNG market for natural gas supplies. But beyond the energy crisis, it is the political push to accelerate the transition to renewables – whose output is intermittent and seasonal – that is making it harder for the EA to achieve energy security, as efficiency gains in large accumulators and mega-batteries are not yet within reach. What is more, the decision by the German government to press ahead this year with the decommissioning of the country's last two nuclear plants, increasing Germany's reliance on French electricity exports and putting further strain on the EA grid, is another main example of the side-effects of the transition. Volkswagen's decision to fast track the opening of a battery gigafactory in Canada while putting investment in Europe on hold is just one telling example of these dynamics. Of course, there are also counterexamples. When German Economy Minister Robert Habeck presented the controversial proposal to subsidize electricity at €0.06/kWh for a large part of German industry and leveraged the relaxation of EU state aid rules, Northvolt, Europe's main battery maker, announced it would proceed with plans to build its next factory in northern Germany. That said, as energy costs remain higher for longer, supply security poor and government subsidies relatively hard to get (see more below), European manufacturing companies with new capex to allocate have one more compelling reason to consider expanding investment overseas.

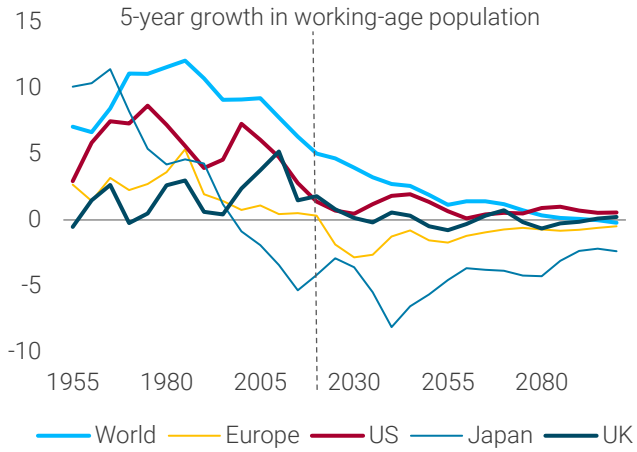
- **Inflation Reduction Act: The US take the lead in the subsidy race.** Besides having to face higher input costs and growing threats from industrial rivals, the EA's competitiveness has now come under heavy friendly fire. With the Inflation Reduction Act (IRA), the US has taken a strong lead in the subsidy race for green technologies and stepped up protectionism under the form of purchase subsidies conditional on local-content requirements (LCR) – prohibited by WTO regulation – and manufacturing subsidies that will have significant trade-distortive effects. In particular, EVs with final assembly in North America (US, Canada, Mexico) will benefit from significant consumer tax credits. As a study by Bruegel explains, "half of the tax credit is linked to the origin of batteries and the other half to that of raw materials used in the electric cars. To obtain either half, a minimum share of the value of battery components (presently 50 percent) or critical minerals (presently 40 percent) needs to come from the US or countries with which the US has a free trade agreement." Such thresholds will increase by about 10% per year. Similarly, renewable energy producers can claim subsidies if the steel and iron used to build energy plants is 100% US-made. Crucially, the US has no free trade agreement in place with the EU, which means that unless a loophole is found soon, EU exports will be at a great disadvantage. That said, according to Bruegel's calculations (which are subject to the usual caveats about the complexity of such a comparison), the

Chart 12: Quality > quantity applies to subsidies too



Sources: Bruegel, TS Lombard.

Chart 13: EU faces adverse demographics



Sources: UN, TS Lombard.

average US subsidy for EVs and green-tech manufacturing is not much higher than what the EU is dishing out (**Chart 12**), while on paper the EU is planning to provide much higher renewable energy subsidies: US$800bn between 2022 and 2031 versus US$208bn earmarked in the IRA. However, the key difference – even taking the results of this calculation at face value – is that US subsidies are very easy to tap as they are mostly tax credits. By contrast, EU subsidies tend to differ greatly across member states and to be dispersed among various EU programmes and entities (from the EU Innovation Fund to EIB loans for clean tech projects). This means that tapping EU subsidies requires dealing with a lot of bureaucracy, especially for green-tech manufacturing, and this is a non-trivial cost for companies. In sum, while the EU is working to make it easier for firms to benefit from all the incentives, the US retains the lead in the subsidy race for now, while threats to EU export competitiveness loom ever larger.

Adverse demographics will soon start to bite. Loss of export competitiveness is not the only thing threatening to slow down EA growth structurally over the next decade. Another key factor is a rapidly aging population. While adverse demographics is a longstanding issue for Europe, the cliff effect on the labour force of the retirement of large cohorts of baby boomers over the next 10 years is now firmly inside standard investment horizons. The rapid aging of the population is not simply a European phenomenon; in fact it is already affecting the global economy, including EMs and China, while the US is among the best-positioned DMs to withstand the impact (**Chart 13**). In Europe, rising life expectancy has bolstered population growth over the past two decades, although it has not been able to fully counterbalance the negative impact of low birth rates. Moreover, in the same period, the EA has experienced net immigration, which has contributed to stronger population growth in some countries (e.g., in Spain before the GFC and in Germany more recently). While concessions might soon be needed to counteract the negative demographic trends, policies fostering immigration into the EA are likely to remain politically toxic. For their part, Eurostat and the ECB calculate that the working-age population in the aggregate EA will shrink by about 5% over the next 10 years and by around 15% by 2070. Essentially, long-term growth is a function of the capital stock, depreciation, technology and labour supply growth (the interplay of working age population with participation rates), so adverse demographics – other things remaining constant – is a powerful drag on long-term growth. Similarly, an aging population is also associated in theory with lower demand for investment in housing and infrastructure and for credit (especially mortgages), which, in turn, implies lower demand for consumer durable goods and various commodities. What is more, higher dependency rates will

increase the burden on already fragile government budgets across the EA, claiming a higher share of GDP (e.g., pension expenditure, health care, etc.).

The bright side: The EA has a new policy mix, which can even revive productivity

Unsurprisingly, the combination of the energy crisis, rapidly growing geopolitical tensions between the West, Russia and China and the acceleration in supply-chain regionalization has captured investors and analysts' attention and cast a dim light on the future of the EA export-led growth model. Not all the effects from China "decoupling" need to be negative for the EA, as the region will also benefit from some "friend-shoring" investment. However, crucially, all this has overshadowed the structural changes that occurred since the Covid shock, which are bound to have profoundly positive implications for long-term EA growth and asset prices.

A shiny new policy mix and structurally stronger domestic demand drivers. It was not long ago that every economist and investor was lamenting EA aggregate demand depression, stagnant wage growth keeping a lid on consumption growth, the dearth of public investment, which, in turn, meant no favourable backdrop for private capex growth and, ultimately, the imbalance between the rigid EU fiscal framework and extreme monetary policy accommodation.

However, the pandemic and its aftershocks were a watershed for fiscal and monetary policy in the EA. The need to accelerate digital and green technology adoption has turbocharged public investment at the national and EU level, which has the potential to "crowd in" private capex (**Chart 14**). Meanwhile, the surge in inflation that accompanied the post-Covid reopening – largely as a result of the energy crisis, but also of rebounding demand meeting constrained supply in sectors most affected by the pandemic – and the robust recovery in labour markets since then have led to a complete U-turn in monetary policy strategy. The ECB quickly moved from fighting deflation to warning against 1970-style "wage-price spirals". Looking through short-term gyrations, if we are right about the medium-term global growth and inflation outlook, moderate real income gains and above-trend growth will allow DMs and the EA to tolerate higher (i.e., more "normal") interest rates in the next cycle than those that prevailed during the decade after the GFC.

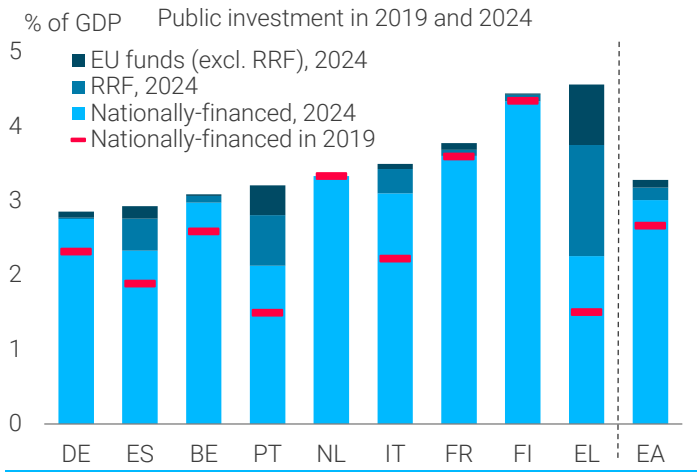
Crucially, the reversal of post-GFC trends can revive productivity – a turning point for structural EA growth. One of the key reasons why EA growth has structurally underperformed the US and other major DMs over the past 30 years is that productivity has been stagnating since at least the late 1990s, with very low growth in the EA periphery (especially Italy) disproportionately weighing on the aggregate. Indeed, following the GFC and EA sovereign crisis one of the main arguments in favour of forcing the adoption of an export-led growth model across the EA periphery was that international competition would discipline firms, reduce their costs and increase their productivity.

There are many micro-level reasons why the EA is a productivity laggard; for example, the small average size of EA firms, the still fragmented Single Market for services and the incomplete Capital Market Union, which make many firms unable to exploit economies of scale in full across the bloc, as well as bad management practices leading to suboptimal investment decisions, especially in IT capex. The macroeconomic environment – including overly restrictive fiscal policy, the lack of private investments and extremely accommodative monetary policy since the GFC – has only worsened the situation.

Four forces will foster EA productivity gains in the coming years:

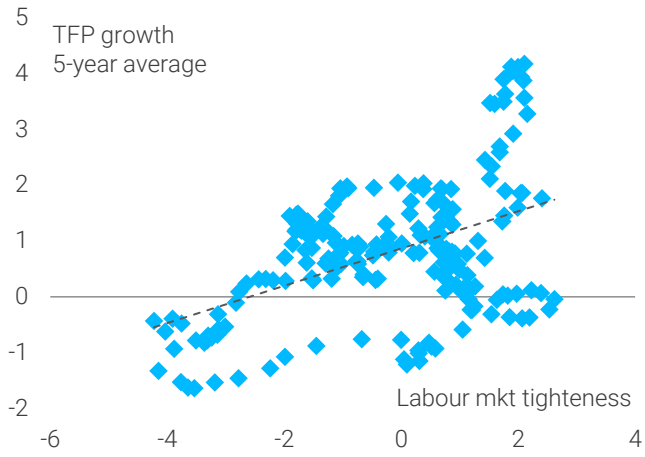
- **New public investment programmes target productivity.** The pandemic has brought about large investments in digital technology and new solutions to streamline traditional

Chart 14: Much improved public investment outlook



Sources: EU Commission, TS Lombard.

Chart 15: Even Italy gains from high pressure



Sources: OECD, TS Lombard estimate of TFP based on production.

operations. The Next Generation EU (NGEU) fund has been explicitly designed to fund investment and reforms aimed at boosting productivity, while new public investment programmes, especially at the EU level, broadly follow the same list of priorities; these include (i) upgrading digital telecommunication networks and digitizing public administration, (ii) upgrading the energy grid through sizable investment in renewables and accelerating large-scale deployment of EV charging infrastructure, (iii) upgrading the transport infrastructure, (iv) building and preserving human capital through education and vocational training to upskill/reskill and (v) funding tech R&D. To be sure, there is still massive uncertainty about the magnitude of the growth and employment multipliers associated with such a public-investment push and the actual productivity impact will also depend on the ability to "crowd in" private investment. Nonetheless, such plans are a very welcome step towards narrowing the enormous gap with the pre-2008 capex trend – a significant structural change compared with the past decade of misguided austerity.

- **New digital technology and AI leapfrogging potential.** The inability to embrace new digital technology and invest in IT capex has been a key factor constraining the productivity of EA firms for decades. New digital technologies, such as open-source AI applications, are already showing their significant productivity-enhancing capabilities in dealing with basic as well as sophisticated cognitive tasks. Crucially, several recent studies show sizable productivity gains in typical services sector tasks such as writing, software programming and even optimizing and supporting the work of call-centre operators. This is important especially because productivity and automation are generally lower in the services sector. EA firms – which tend to be infamous technological laggards– stand to be among the greatest beneficiaries from such technologies, as their relative accessibility and low costs would make it possible to leapfrog closer to the technological frontier. Finally, the demographic transition (see above) also implies that as older, less tech-savvy workers leave the workforce over the next decade, new workers will be more highly educated on average and have much higher digital skills, which can compound productivity gains.
- **A high-pressure economy.** As my colleague Dario Perkins has argued compellingly, the current high-pressure economy – reflationary by nature –creates a macro environment that is conducive to higher productivity. Long-term historical evidence shows that since the 1970s, policymakers in DMs have tended to be too pessimistic about the supply potential of the economy, underestimating slack. In a nutshell, scarce labour pushes firms to become more efficient, while higher wages are an incentive for worker performance. The positive correlation between various measures of labour market

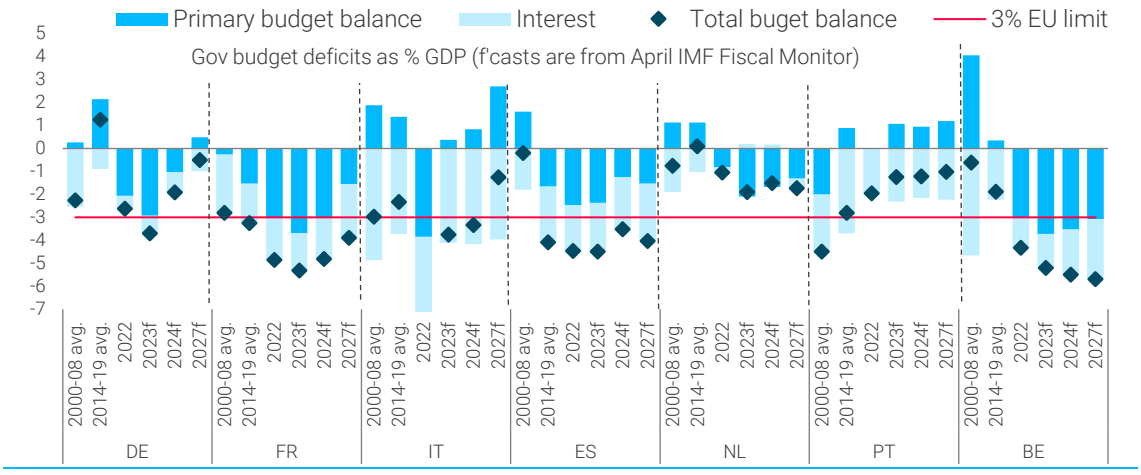
tightness and Total Factor Productivity (TFP) across DMs – including Italy – seems to imply just that (**Chart 15**).

- **Higher rates kill off 'zombies'.** Another key factor constraining EA aggregate productivity since the GFC has been the large number of "zombie" companies, i.e., non-productive, loss-making and highly indebted old incumbents that constitute a barrier to entry for younger and more productive firms. Zombie firms constitute a huge source of capital misallocation in the EA, which compounds – and partly contributes to perpetuating – the lack of "superstar" innovators, which have supported US productivity over the past decade. This is a well-known problem; and as we have written extensively in the past, monetary perma-accommodation in the post-GFC era allowed it to persist. In other words, if you think monetary policy is "long-term neutral" and has no impact on structural variables, think again. Years of extremely low interest rates and QE worldwide and in the EA are likely to have lowered the opportunity cost for banks of zombie lending, encouraging forbearance. Tighter monetary conditions in the next cycle will give us the chance to test the "zombie hypothesis" further and possibly help lift EA productivity.

Of course, there are several risks to this cautiously optimistic view, not least fiscal rules at the EU level that are still too rigid and the structural inability of governments to spend the allocated funds. The European Commission recently published a revised proposal to upgrade the hideously complex system of EU fiscal rules. There new framework is a clear improvement on the old one.

First, it is expected to do away with model-based fiscal measures such as cyclically adjusted budget deficits, whose calculations were based on unreliable output gaps, and to shift the focus to a single, more credible indicator that can be tracked in real time: a net expenditure path – basically the growth rate of government spending, netted out for factors such as interest rate payments and cyclical unemployment spending. Second, the system will be centred around a long-term debt-sustainability analysis. Third, countries with debt exceeding 60% of GDP will be required to negotiate a multi-year fiscal-structural plan with the Commission that ensures their net expenditure path is consistent with debt being put on a "plausibly downward path". The standard adjustment period is set to be four years, but an extension to seven years can be negotiated. However, both the 60% debt/GDP and 3% deficit/GDP parameters remain. In particular, deficits exceeding the 3% threshold are required to shrink by at least 0.5% of GDP annually. Another shortcoming of the new rules is that a structural investment carve-out is

Chart 16: EU fiscal rules improve but may still be too rigid in the long term



Sources: IMF, Datastream, TS Lombard.

missing – in other words, there is still no distinction between current expenditure and investments.

The Commission has also issued interim guidance for countries to draw up budgets before the rules are finally approved by the end of this year. We expect the debate to intensify this summer and autumn. Given current and forecasted level of nominal growth and the leeway granted under the adjustment periods, the new framework should not prove too onerous for high-debt countries in the short run. But in the long term, especially if EU large investment programmes are not made a permanent feature of the fiscal architecture beyond 2026 (when NGEU fund disbursements will end), these rules could come back to haunt the EA and severely constrain the fiscal space once again (**Chart 16**).

Beyond fiscal rules, another factor that could hold back spending, lower growth multipliers and reduce productivity spillovers is how efficiently national government administrations distribute the money. The track record of the EA bureaucracy, especially in the periphery, is not encouraging. Moreover, looking beyond the short term to a time when fiscal constraints could be biting once again, the need to make space for more unproductive but necessary spending – think greater military and pension expenditure – could pose additional challenges.

The bottom line and what this all means for EA assets. The threat posed to the old EA export-led growth model by deglobalization, higher input costs and greater competition from China and the US is both real and well understood. The EA is at a difficult crossroads. However, the upside of long-term structural changes in the fiscal-monetary policy mix is still overlooked and poorly reflected in asset prices – if at all. This is because such positive changes often take time for their effect on the economy to show and are difficult to estimate quantitatively. Productivity gains, especially those brought about by new technologies, are a classic example.

The post-GFC policy mix and macro environment in the EA – which was characterized by negative interest rates, depressed public and private investment, limited and unevenly distributed productivity gains and extreme dependency on external demand – is likely to prove an anomaly in historical terms. What is more, now that EA yields are significantly higher, the massive portfolio outflows that started with the EA sovereign crisis and ECB QE have stopped and may be reversing. In the fixed-income space, EA investors – think classic long-term debt investors, in particular, such as insurers and pension funds – are finally being offered a decent alternative to investing abroad. Generally, our analysis shows that better growth prospects than those in the past decade should drive a more broad-based rebalancing in long-term asset allocation towards EA assets, leading to an increase of their weight in global portfolios.

In sum, counter to prevailing gloomy marker narratives, we believe the glass for EA growth and asset prices over the next cycle is half full.

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