

Research @ Citi Podcast, Episode 29: Europe's Historic Growth Model Shift

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Transcript:

Arnaud Marès (00:01)

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Elise Badoy (00:21)

Welcome to the Research @ Citi podcast. I'm your host, Elise Badoy, Head of Europe, UK, Middle East and Africa Research at Citi. I'm joined today by Arnaud Marès, we are recording from London and we are going to unpick the recent White House decisions. They obviously have immediate consequences for growth, inflation, and asset prices, which have been covered in Citi publications and calls, but they also have long-term consequences for our economies. This is really what we'd like to focus on on this podcast with Arnaud and especially for Europe. So Arnaud, how can we place the White House decisions on a longer-term perspective, please?

Arnaud Marès (01:02)

I think, Elise, you're asking exactly the right question because the decisions by the U.S. administration on tariffs are not just a short-term challenge for Europe. They represent a fundamental challenge to a growth model that for years now had been developed along mercantilist lines. By this, I mean a growth model driven by external demand. Europe is not the only part of the world that had moved in that direction, but the mantra for years had been to try to maximize extra demand by achieving maximum cost-competitiveness and effectively intentionally deliver a trade surplus, a current account surplus. That resulted in an economic model that first did bring down inflation rates because a trade surplus is an excess of supply over domestic demand. So it tends to bring down inflation, that brought down real rates because a current account surplus is an excess of savings over domestic investment, and therefore it does exert on the export a downward pressure on real rates. It also led the European economy to be relatively sensitive to the durations of other economies, in particular of the U.S. But what it did at the same time is that it created at least the perception, and probably the reality, of asymmetric benefits of globalization to the detriment of the U.S. and that certainly is the way it was perceived by the current U.S. administration and therefore it caused a backlash. So what is happening with tariffs is not just a near-term shock to demand or to prices, it is also a more fundamental question as to whether the growth model that Europe has had for quite a long time is sustainable.

Elise Badoy (02:54)

But obviously, those export-led growth models, are they sustainable in the face of increased resistance by the U.S.?

Arnaud Marès (03:01)

Not just in the face of increased resistance by the U.S., but also in the face of changes elsewhere. What happened for Germany in particular is that it was already facing some challenges because of China moving up the value chain and China becoming more a competitor than a client for Germany. And so if you have at the same time less ability to expose your supply to China and more resistance from the U.S., then you've got to find demand elsewhere. I think what has happened over a long period of time is that for quite many years, Germany was not that interested in European performance effectively because it's so—its demand is featured more elsewhere and in particular in China. But now that it finds it more difficult to capture demand, both in China and the U.S., its interests get more aligned with the rest of Europe. It is more interested in the domestic performance of itself — of course its own demand, but also its neighbors' because this is where the potential fallback demand lies. I insist on this because Germany is not just the largest economy in Europe. It is also in many ways the country that sets the tone in terms of the economic doctrine of Europe. So if you've got pressure from different sources that force it to rotate its business model, its growth model, this is quite significant.

Elise Badoy (04:30)

Unpicking this, essentially this shift in Germany towards placing more emphasis on domestic demand — that perspective — is that only what we expect or is it already almost happening?

Arnaud Marès (04:43)

So that is always a controversial point that we debate even internally. And what I would argue is that in fact, it was already taking place. So the pressure from the U.S., if you want, comes at a time when this was already momentum building. And you can see this in several ways. So first, you've got the relatively generous wage agreements which have been granted in Germany over the past couple of years. And the question is whether these relatively generous wage settlements were only the result of a tight labor market or it was something else. And I think it's disputable that it is just a consequence of the labor market being tight because the labor market had been tight historically in different periods in Germany and you had not seen anywhere close to the impact on wages that you have had. I think it's also it is not credible to think that we have had one inflation shock, arguably a very large inflation shock, and the natural inclination of Germans to try to prevent inflation has gone away, and suddenly the Germans would have entered into a form of wage pass-through. So I think a better and more credible explanation is that in fact, we were already seeing a shift in the consensus within the body politic in Germany, a recognition that to support the economy, you also needed to support domestic purchasing power — consumption. And therefore, that these wage increases represented already a form of rotation from an essential export-led model to a more demand-led model. You see that in a much less ambiguous way in the current fiscal plans of the German government, the review of the debt brake and on the institutional changes that now allow Germany to engage into more fiscal expansion than we have been used to. Certainly, it is a sign that goes in that direction. And I would say also that the security situation in Europe, and the recognition by many European governments that they will have to invest more in defense provides both a motive and an opportunity for the rotation of this business model because defense is a sector where it will be possible not just in Germany, but also in many other countries in Europe, to significantly increase domestic spending on a particular government-financed domestic— domestic spending. So I think we already have from multiple direction, signs that says rotation of the growth model is at play.

Elise Badoy (07:18)

And you've gone through some of the consequences already, perhaps around defense. Anything else maybe on the financial side or what do you think are the consequences of this rotation?

Arnaud Marès (07:27)

Yes. So the consequences I think important for us across all asset classes — equity, fixed income — I will start by the financial impact. As I mentioned earlier, the mercantilist growth model that were pursued in Europe, but also in many countries in Asia, is to a large extent responsible for the low-inflation environment that we had faced before the pandemic. So what you had is trade surpluses, and I would say intentional trade surpluses, that represented an excess of supply of domestic demand, or perhaps in Europe, a shortage of domestic demand relative to our supply capacity, and therefore were generating downward pressure on inflation and on inflation volatility. If we beef up domestic demand, that imbalance will go away and therefore we enter a world where inflation will be on the whole a bit less low. In the same way, the current account surpluses that we had, and we have to remember that after the euro crisis in 2011, almost all European countries trying to reduce vulnerabilities vis-à-vis the rest of the world tried to improve the external position and therefore did move into current account surpluses, resulting in the Euro area as a whole having a very quickly ballooning current account surplus. Those surpluses represented an excess of savings over domestic investment. Or in the same way, a shortage of investments related to excess savings capacity or therefore contributed to the fall in real rates across just not Europe, but also contributed to the fall around the world. And if you think about it, this is what the central banks were fighting against in 2010s. It's a set of policies that at the same time were pushing inflation down, but were also pushing real rates down and therefore made it harder for central banks to reflate the economy using conventional tools — so, interest rates. And this is how we ended up with negative interest rates, quantitative easing and other unconventional instruments. So if we have a rebalancing of the growth model in favor of more domestic demand, then this downward pressure on real rates also abates on the direction of travel, therefore, quite importantly is higher inflation volatility, higher inflation premium, higher real rates and generally steeper yield curve.

There is also an economic impact, and that economic impact is probably positive over the medium term. You have first the fact that if you have a growth model that is more reliant on domestic demand, you will be, by and large, less sensitive to what happened in other parts of the world. The usual phrase that people like to use is that when the U.S. sneezes Europe catches a cold, and that was logical in a world where first, growth was driven by credit cycles, which tended to be global in nature, but also where the export-led model of Europe means that the impulse that would cause inflation to cycle tended to come from abroad. With a rebalanced business model, European growth should be less sensitive to what happens elsewhere, and therefore you can have less synchroniz[ed] cycles across various economies. But you can also have higher growth not just because of— during the phase where we will have fiscal investment, whether it is in Germany in its infrastructure or across the continent on defense, that fiscal investment and fiscal expansion mechanically tends to raise growth. But also because you may possibly have higher multipliers of that investment if it is spent in defense and in infrastructure. In infrastructure, you can see the experience of NGEU, where money well spent does appear to be raising the potential of the countries that receive it the most, including Italy, Spain and others. In defense, there is growing academic evidence that to the extent that the money is spent on technology or on— or has a high content of research and development, in fact, it tends to raise growth not just in the short term, but also raise the

potential in the medium term. So that is, if you want to put this way, good investment. And therefore, I think that once this rebalancing is under way, it is reasonable to have a quite a positive view on European growth in the medium term, although I may add that it's extremely unusual for me to have a very positive view on Europe — I'm known to be a pessimist by nature — but in that case, I think that the case for Europe is reasonably robust.

Elise Badoy (12:15)

But surely there's a “but” because this is relatively— the outcome you describe is obviously that there has to be another side to it.

Arnaud Marès (12:22)

There is definitely another side of the coin, and that stems from the fact that much of the rebalancing of the public investment that I'm talking about is backloaded. In the case of infrastructure, almost by construction, large infrastructure projects are backloaded because you need first to define the project before the appropriation of money goes through public procurement, and then you have bottlenecks in the execution. That means that the delivery tends to be delayed. And we see this with the NGEU example that I mentioned just earlier is that Italy, other countries will benefit in 2025 and 2026 of the disbursement of monies which have been agreed some time ago. So there is a delay. In the case of defense, it may be even more pronounced because while there is a good case to make that there will be large European investment in defense for not just years but likely decades to come, it needs to be preceded by a definition of what is the new defense doctrine? What are the objectives? How is it going to be funded? And then you've got procurement, and then you can start to produce weapons or other equipment. So that backloading implies that while we may have tailwinds in the future, in the near term it produces headwinds. And that is because a reasonable expectation of more demand in the future and more debt — public debt — this reasonable expectation causes a tightening of financing conditions that exerts a negative impact on the borrowed today, and impact on investment. So you have to some extent a crowding out today of private investment by the realistic prospect of public investment tomorrow. And that creates a sort of J-curve where it's not that things have to get worse before they get better, it's that things get worse because they will get better. The prospect of an improvement causes these headwinds today.

Now this headwind adds to other headwinds that we have. We have an uncertainty shock, and you mentioned earlier the decisions taken by the White House. It does evidently create quite an unstable trade landscape for firms and I do not think we're going to get full clarity for some time as to what the final state of the world is. That uncertainty is not just fog. It is also information. That uncertainty doesn't just mean that we don't know what will happen. It means that we know that many firms will defer investment decision until they see clear, and that is a headwind for demand. And then we have the tariffs themselves, which do represent a negative demand shock independently of the response. And if you've got a strong response, then you're adding a negative supply shock to a negative demand shock. Effectively, you're taking growth further down. So I think the other side of the coin relative to my relatively rosy long-term view is that in the near term effectively, we're facing obstacles, downward pressure on demand. So we have a sort of J-curve where initially demand is way down, is dragged down, and then over time, we'll receive the support of the rotation of the shift of emphasis in policy that we mentioned.

Elise Badoy (15:45)

And so obviously we're lucky to have you, and the listeners all want to know perhaps what it means for monetary policy.

Arnaud Marès (15:52)

In principle, what it means for monetary policy is an overwhelming case for continuing to cut rates. One can very well understand that in the context of uncertainty that we are facing at the moment, central bankers want to be very prudent. Central bankers may reasonably want to get as much information as they can before they make decisions. But if you look at the overall picture that is emerging, if you look at the incremental information that has surfaced relative to the more recent monetary policy meetings — in particular, in the case of the ECB — I think that the case for continuing to cut rates is overwhelming. We have uncertainty causing a negative shock to demand. We've got a tightening of financing condition that is a drag on investment. We've got tariffs that even with retaliation constitutes a negative demand shock. We've got the acquisition of the euro, which all things equal does contribute to lower prices. We have likely diversion of trade from China into Europe, that will also increase or maintain the deflationary impulse that's currently coming from China. And finally, we have lower oil and gas prices that also contribute to bringing prices down.

And I do not think that the prospect of fiscal expansion, which as I say will be backloaded, is enough to counter the impact of all those factors I have just mentioned in the assessment of central banks. If the ECB was doing now, in view of all this information, a new projection, it would almost certainly lead to meaningfully lower growth projections and to some extent also, albeit more marginally, inflation projections. And therefore, in this context, I think it is reasonable to maintain the call that we have had for some time, which is that the ECB will continue to cut rates in forthcoming meetings, that the likelihood is that rates do fall below 2% before the end of the year. But I make a difference here between what I call the trough rate and the terminal rate. The trough rate is the lowest point that rates may achieve in this cycle, which I think should be at least as low if not lower than what we all thought a month ago. But the terminal rate, which is the average of policy rates over a long period of time, should realistically be higher. So for rates, you have exactly the same thing as what I described for growth and to some extent for inflation. It is a J-curve, where first things come down, but then over a long period, they will come up quite meaningfully.

Elise Badoy (18:33)

Arnaud, thank you very much for sharing your views. Now I'd like to thank our listeners as well for joining this episode of Research @ Citi, which was recorded on Thursday, April 3rd, 2025. I'm your host, Elise Badoy, and join us next time as we discuss how "Make America Healthy Again" affects the U.S. food and beverage industry.

[Disclaimer] (18:53)

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