In a world where politics and markets increasingly intersect, smart investors look beyond today’s economic data to analyze future market conditions. Nowhere are these issues more pressing than in Europe. To provide a snapshot of Europe’s current geopolitical and economic climate, we spoke to Ian Bremmer, President of Eurasia Group, and Ron Wexler of Citadel’s Global Equities group.

The views expressed in The Citadel Conversation reflect those of the individuals being interviewed. These perspectives are neither endorsed by Citadel nor reflect our view on investments.
What is the biggest concern for the investor looking at Europe?

**Ian:** Globally the world is becoming more equal, but within Europe life is becoming more unequal. The national identity in Europe is not “you can make it.” There is no European dream like there is an American dream. Instead, it is, “the government provides for all of these people, you will have a good life.” That model is failing. Clearly, that is the biggest issue.

For the last several years I have been more optimistic than most about Europe. I understood the economics were bad, but I believed the politics would not allow the Eurozone to implode. This year, we don’t have to worry about the Eurozone, but we certainly have to worry about geopolitics.

What are your specific geopolitical concerns?

**Ian:** The geopolitics of the world are making Europe much more fragile. The transatlantic relationship is less important than before. People say NATO is relevant, but NATO is only relevant to Poland, the Baltics and Germany, not to Spain or Italy.

The biggest threat, clearly, is Russia. And if it were not for the downing of the Malaysian Airlines flight, I believe the Europeans would have already split from the Americans on sanctions. We now see the French and other EU countries saying they want to reduce or remove sanctions if the cease-fire holds in eastern Ukraine. Not if Russia gives back Crimea or pulls their troops out, just if the cease-fire holds!

As the weather gets colder, gas becomes a big deal and the impact of sanctions starts biting other sectors. The Europeans will continue to back off a harder US line to avoid falling back into recession.

Let’s unpack this situation from an economic perspective. In terms of growth, what are the challenges to the European economy?

**Ron:** Ian did a great job painting the broad strokes on the political climate; I’ll try to do the same for the economy. There are three inter-related concerns.

The first concern is a lack of growth. To set the stage, consider two figures. First, the current level of activity in the Eurozone is €50 billion less than it was in 2008. And second, the unemployment rate has shot up from 7.2 percent to 11.5 percent. By comparison, in the US, real GDP has grown by over $1 trillion and the unemployment rate has fallen below 6 percent.

As we look forward, Europe faces a set of supply side challenges. On the demographic side of the equation, the working age population, which had been contributing 20-50 basis points to growth, is expected to start contracting by the end of the decade. The productivity side of the equation isn’t rosy either.

If you step back, there is a long list of improvements Europe could make: more privatization, more free trade agreements, more flexible labor markets, lower tax rates, fewer onerous regulations. But without these changes, it’s...
hard to get excited about growth in Europe.

The challenging growth environment creates the second concern: low inflation turns into deflation. Once deflation expectations become entrenched, economies have a tough time recovering. Deflationary expectations create further disincentives to spend. They also create a third challenge: fiscal sustainability.

Are you seeing this in Germany, which has been driving Europe's economy?

**Ron:** So there is no doubt that Germany has done better than most countries in the eurozone, however, on an absolute basis, the gains have been modest. The level of activity in Germany is only 3 percent higher than it was six years ago. There are several notable headwinds. First, there is a concern that Germans will ultimately need to pick up the tab for excesses created in the periphery down the road. At the margin, this increases the incentive to save and decreases the incentive to spend. As a result, you really aren’t seeing material gains in consumer spending, which represents 53 percent of GDP. Consumer spending is only growing about 1 percent per year. Moreover, trade, which had been contributing about 50 basis points to growth, appears to have stalled of late. There are certainly some pockets doing better than others, but in aggregate the gains have been modest.

**Ian,** if you listen to Ron the economic picture sounds pretty bleak. Is there, at least on the political front, a growth party across Europe that can help reignite the economy?

**Ian:** I’m fairly negative on Europe. There’s no question that lackluster growth has reduced the austerity rhetoric we have heard from Brussels and Berlin. That’s why you see Mario Draghi pushing interest rates down and why there’s so much talk about quantitative easing for 2015.

The austerity movement was a response to the economic crisis in Greece and the periphery. But looking forward we’re not close to another European crisis right now. Absent that, major reform will not happen.

In Europe, I am concerned about ISIS and the potential for more terror. I am concerned about the potential for violence from immigrant communities that are not integrated the way they are in the US. I have a lot of concerns about Europe, but none of them reach the crisis level that will motivate European governments to take the steps needed to restore growth.

What is the role of political uncertainty in Europe, and how will sanctions against Russia play out in the long term?

**Ian:** It’s very clear that the single winner of the Russia/Ukraine crisis is China. The Americans said to China, “You need to support the sanctions process to be a part of the international community.” The Chinese said, “We have no interest. We’ll get a better deal from the Russians.” The 30-year, $400 billion gas deal between China and Russia is, according to Putin, the biggest in the history of the post-Soviet Russian gas sector.
The fact the Russians decided to do this implies that Putin has made a strategic shift. He understands his relationship with the West – not just the US, but Europe – is broken. That is a horrifying prospect to many Europeans, but it is the reality. I do not believe that Russia is going to give back Ukraine. The impact on European economies will be long lasting in terms of trade, banking and real estate.

**Ron, what’s your perspective on Russia and political uncertainty in Europe?**

**Ron:** Well there’s no doubt that some of the weakness in Europe over the last three months can be traced back to heightened geopolitical uncertainty, but I can’t help but wonder whether we might be asking the wrong question. Instead of asking about the impact political uncertainty is having on Europe, I wonder why more investors aren’t asking what it means for Russia.

Russia, which was growing 5 percent not too long ago, is now barely growing and has around 8 percent inflation. Food import restrictions are going to add at least another percentage point to inflation. Moreover, most of the leading indicators suggest that growth is likely to continue hooking lower. The Russian equity market is down 25 percent year-to-date, the ruble is down 18 percent and capital is fleeing the country.

While there is no doubt Russia has a lot of leverage over Europe, it’s also worth pointing out that they don’t have limitless degrees of freedom. They have $420 billion in reserves and $730 billion in debt. And even though Europe is 6 times bigger than Russia in GDP terms, because Russia was growing 5 percent it had been contributing more to global output/demand than Europe since the financial crisis ended. A sharp slowdown in Russia is sure to have spillover effects for many multinationals.

**Ian:** Ron raises a great question. We have a lot of countries in Europe that get a majority of their gas from Russia. There is no technical infrastructure fix until at least 2017. That is a serious point of leverage. I think Europeans are unprepared to take any significant pain on these issues. As a result, the Europeans are starting to fragment. Again, I believe we are at the high water mark for sanctions right now, and I think the coalition will start weakening.

As far as the impact on the Russian economy, my understanding is that if oil goes under $97, the Russians will actually start taking money out of their national reserve fund.

Many Russians have been waiting 20 years for a leader to stand up to the West. Putin has finally done it. They believe the West has been happy to facilitate Russian decline. I think the Russians are prepared to take quite a bit of economic pain to ensure that a red line with the West is drawn. If Europe and Putin faced-off for 10 years, Putin would ultimately lose. But the Europeans will blink 20 times before Putin even considers it.

**What about hydraulic fracturing? Is there a chance this technology will make the Europeans look at their energy options in a new way?**

**Ian:** I think the policies they’re changing have more to do with building
infrastructure that will allow them to rely less on Russia for gas. On fracking, there’s a lot of local opposition, and I don’t see that changing.

**Ron:** The US Department of Energy recently gave final approval to LNG export terminals. I wonder what role the US has to play in terms of exporting gas or oil. Ian, is there a scenario where we change our energy policy to meet some of our geopolitical goals?

**Ian:** This is happening slowly, but I do see some appetite for it. Typically, you can only export natural gas if it’s considered as a bilateral Free Trade Agreement. There’s a big question whether this could happen with Japan under the Trans-Pacific Partnership. Just that relatively small issue has generated an enormous amount of lobbying between the White House and Congress. My sense is you’ll see slow, incremental movement, but I don’t believe that it will be a fix.

Moving back to economics, given what we’ve seen in the last few months, what do you think the conditions are in Europe for a new approach to QE or some kind of monetary stimulus?

**Ron:** In Europe, things are weak and there is a genuine concern that at some point you are going to see inflation turn to deflation. To prevent this from happening, the ECB is offering cheap long-term funding to banks and will also be buying private sector assets to lift their balance sheet by close to €1 trillion. The hope is that the latest set of stimulative measures will be enough to stem the slide in inflation and also incent the banks to lend more.

Will it work? The jury is still out. Keep in mind that Europe’s predicament is very different from the US. In the US, most corporate funding gets done via capital markets. When QE was announced, corporate spreads plummeted. Meanwhile, banks were in the process of being recapitalized. The direct impact on the US economy was meaningful.

In Europe, the banks are critically important for the transmission mechanism of monetary policy. Only 25 percent of funding is done in capital markets. If banks don’t lend, it seems unlikely that QE would have comparable effects on inflation expectations and growth prospects. In other words, for QE to be successful, banks need to be recapitalized. Structural reforms that stimulate the supply side would also be helpful.

**Are there other tools that can stimulate the economy?**

**Ian:** The US has many major geopolitical advantages over Europe. But we also have a huge governance advantage. When Washington does nothing, things still happen. Consider energy policy. Washington does nothing, but look at what happened with fracking in the states.

Europeans desperately need that. Yet they can’t get it. Not only is the central bureaucracy worse in Europe than the US, but you also do not have effective decentralization of powers.

In a world with more volatility, growth is less important because people are looking for stability. Having said that, Europeans are much more vulnerable to fat tail risks than Americans. That’s true on terrorism, the Middle East, and...
Russia. Those are the three significant fat tails we should have in our equation.

**Where do you see Germany both geopolitically and economically? Is there a new geopolitical trend in Germany?**

**Ian:** The Germans and the Japanese both believe they have to start playing a more normalized role. These countries were no longer combatants after WWII, and they are both thinking about becoming stronger international leaders. But it’s a very slow process.

The Germans are thinking about getting involved in security operations in Africa. They will play a role in terms of security infrastructure and engineering, but they’re not going to provide soldiers or peacekeepers. That’s interesting, but it’s far from saying Germany is going to start – like France – taking the lead in Mali, or pushing Americans to engage in Libya. If you look over the next few years, it’s hard to see Germany becoming the new voice of European security involvement globally.

I do think the German-Chinese relationship, what they call a strategic partnership, is one of the most interesting relationships in the world. The Chinese have historically preferred Germany over other Western countries, and the Germans conduct a lot of business with China. Unlike the US, the German perspective on China is that it’s exclusively a business relationship.

It may well be attractive to Germany to be more of a hedge between the dollar and the RMB as it starts internationalizing. It may be an exciting opportunity for Germany, but I wouldn’t bet on that because I don’t think the Germans are likely to take that big a leap.

**Ron:** I have one final question for Ian. What are two or three page 16 stories you watch out of the corner of your eye that keep you up at night?

**Ian:** One of my biggest concerns is that if sanctions continue against Russia, they will engage in cyber attacks on Western financial institutions. When they hit Estonia a few years ago, they brought down the central bank for quite a while. So far, the Russians have showed restraint primarily because of fear of retaliation. But the Europeans are vulnerable there.

Another concern is what happens if things suddenly go wrong with the economic transformation in China? If there are problems, China might have to play the nationalist card domestically. The fallout could prove substantial. If a big US multinational says they have to leave China because the competition is too tough, and they take a major stock beating as a consequence, the chance for a real anti-China backlash in the US is dangerous. No one is talking about that right now.