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Europe is facing a perfect economic storm, says expert

US economist Robert Shapiro talks to Deutsche Welle about concerns over Europe's debt crisis and other economic challenges facing the US and the EU.

Robert Shapiro is an informal advisor to President Barack Obama, and served as undersecretary of commerce for economic affairs in President Bill Clinton's administration. He is co-founder of a private finance consultancy that specializes in a range of economic policy issues.

Deutsche Welle caught up with Shapiro in Washington at a time when Europe's debt crisis is shaking financial markets around the world.

Deutsche Welle: Have you bought any gold lately?

Robert Shapiro: (Laughs) No, I don't buy gold. I don't buy commodities. Commodities, particularly gold in this kind of period, are particularly volatile. I don't really bet in my investments - gold is a wager. Normally, gold responds to inflation rates. We don't see that inflation except in a couple of places. The notion now is that gold is a safe haven when the future value of a lot of currencies is more doubtful. But frankly, the dollar has been the great beneficiary of that, so no, I'm not interested in buying gold.

What would you tell Europeans, especially the Germans and the Swiss, who are buying a lot of gold because they're concerned that the European Central Bank's decision to buy bonds from European states could fuel inflation?

There is reason in strict economic terms to be concerned about inflation. And, of course, the Germans would be concerned about inflation - that's a kind of a national characteristic. However, there are potentially profoundly disinflationary forces also at play right now, and in particular, the potential impact of the sovereign debt crisis not only in Greece but also Spain and Italy and Ireland, and the measures which those and other countries are being forced to make not because of inflation but because of concerns about the capacity of their government to handle the debt. This fiscal crisis is what Europe needs to be concerned about, not inflation.

This fiscal crisis was utterly predictable. It was predicted by me and many others. A year and half ago, I said this would be a three-part crisis. First, you have the financial market crisis: all financial crises produce long and deep recessions. So the second crisis will be an economic crisis, the recessionary crisis. And the third crisis will be a fiscal crisis, which will reflect all the spending needed first to bail out the financial institutions and then to stimulate the economy from the deep recession.

What poses the greater risk for the US – the situation in Europe or the huge debt the US itself is accumulating?

They are on different time tracks. The US debt is fine in this period; our debt is equal to about 50 percent of GDP. Even if you include the debt held by our own government institutions like the Fed and our social security fund, it's still 60 percent of GDP. The US economy is fully able to accommodate that…There is general confidence that the US is a more productive economy than the major European economies. I don't know if that's always fair with respect to France, but it's fair with respect to everybody else. The US has the deepest capital markets in the world. Whenever there is trouble with the yen or with the euro, money flows to the US. In addition, of course, the dollar has value that other currencies don't have because it's

the reserve currency. So you can always count on the dollar. It's a safer harbor for investment than other currencies and particularly in this period when the euro is falling and consequently, the dollar is strengthening. This hurts our exports, obviously, which is a concern because a lot of us don't have a lot of faith in domestic demand in the US… but there is no short term debt problem for the US. There is a long term debt problem.

Fed Chairman Ben Bernanke has said that the "federal budget appears set to remain on an unsustainable path."

It is. What's unsustainable is not the financing of another trillion dollars in debt this year, or another trillion dollars in debt next year, but the market's view of a trillion dollars in debt the year after and the year after and the year after. Because debt is growing faster than GDP - significantly faster - that means that the debt burden is increasing every year, which means the financing burden is increasing every year. And that produces both inflationary pressures on the Fed and the prospect of higher interest rates… because you're not only financing the new debt every year, but you're refinancing debt. And investors can say at any time: ‘I just sold 10 million dollars' worth of treasuries. Now I'm taking that 10 million dollars and I am investing it in gold or euro bonds or whatever. There are infinite numbers of places to put money today. That's Bernanke's concern, that's everybody's concern.

Is there the necessity to act now?

There is a necessity to act within the next two years - that's my view…the pressure to take steps is really the combination of the fiscal overhang from the recession and the financial crisis combined with a new trajectory of spending, in particular in healthcare and pensions. This is something Europe is facing as well. Europe is facing it in a more serious way than the US because European demographics are worse. We have at least an expanding labor force to pay for it, though the numbers of elderly are expanding much faster than the labor force. In much of Europe, you've got stable or contracting labor forces paying for an elderly cohort that's growing just as fast as it is in the US. And, in addition, the pension systems in Europe are much more generous than the pension systems here. The European retirement systems are utterly unsustainable for the next decade. And almost no country except Ireland and Japan and England in the 1980s has shown the political capacity to address this. It's not there yet. It's not there in France or Germany or Italy. If you look at the long term structural issues, the Italian political economy is not sustainable for more than another couple of years.

So you are worried more about Europe than about the US?

Absolutely. I think Europe is facing what we call a perfect storm: three negative forces converging. It is a combination of unsustainable terms of the retirement provisions, the fiscal overhang from the financial crisis and the recession, and also the financial system overhang. And an underlying relative uncompetitiveness in a global economy. This has to do with European investment patterns – the fact that the big economies of Europe, in particular Germany and France, have not invested in the developing world. Their foreign direct investment is almost exclusively in Europe and the Unites States. They have very little presence in the fastest and most dynamic parts of the global economy; they are consequently under less competitive pressure to innovate; their investment is less effective. The result has been a sustained period of 15 years in which growth and productivity were significantly less in France than in the US. That has reopened the income gap between the US and Europe. Europe has always favored an approach to its economy, which puts greater emphasis on equality and less emphasis on entrepreneurship and growth than the US. That has a lot of positive effects, but it has economic costs particularly in a global economy.

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