The global economy: US and EU perspectives

Interest rates in the US and EU expansion issues to watch

Richard Bard and Peter Widmer

Richard Bard and Peter Widmer provided the Global Executive Forum with insights into the US and European economies and observations on where China, India and Russia go from here.

RICHARD BARD is founder and manager of Bard Capital, LLC, a private investment company. He is also chairman and CEO of privately owned WG Global, Inc., the leading global provider of surface preparation solutions and equipment to the automotive, aerospace and foundry industries. He has served as chairman of the board of the Federal Reserve Bank of Kansas City. Bard has an MBA in finance from Bernard M. Baruch College at the City University of New York and a BS in civil engineering from Pennsylvania State University. In 2001, Bard was selected by the CU Board of Regents to receive the degree of Doctor of Humane Letters.

Ben Bernanke, the nominee for Chairman of the Board of the Federal Reserve System, will have “a big challenge” when he steps into the large footprints left by retiring Chair Alan Greenspan, said Richard Bard in his address to the Global Executive Forum.

“To some degree Bernanke’s hands will be tied because the world is going to be watching every move he makes in his first two or three Fed meetings to see whether he’s soft on inflation or if he’s carrying forward the Greenspan era of gradual increases in rates,” said Bard.

“The Fed has been raising rates since June 2004 and in large part the tightening has not resulted in any real costs to the economy. But one can certainly make the argument now that we ought to stop.”

The fear of inflation drives interest rate decisions. “The Federal Reserve people are just inflation fighters. They hate inflation and our role as the Fed is to create a stable economy along with long-term economic growth (see sidebar). At the other end of the spectrum is the fear of deflation. Even as the Fed was lowering interest rates to spark the economy, there was a fear that deflation could be an unintended result.

“It was a real concern when the Fed funds rate was down to 1 percent. When there’s no more room to lower rates, you can’t spur the economy,” said Bard. “At 1 percent we were seriously worried about not having this important tool to impact the economy.”

As the economy started to pick up, “the issue became how to get back to neutral – a fund rate neither too high nor too low – without upsetting the recovery. We’re right at the cusp now and rates are starting to creep up a little bit. So far the recovery is pretty soft because of things like the cost of fuel, commodities, and the natural disasters that have hurt tourism.

Demand-driven inflation

Bard doesn’t see the necessity for increasing interest rates in this economy. “The only reason the Fed raises rates is to put a damper on demand. But what is the demand today that needs to be dampened? Is it new car sales? Is the auto industry taking off? I don’t think it’s housing anymore which has gone through its own cycle. Manufacturing isn’t robust and booming although it’s doing okay for once in a long time.
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“So what is so robust about the economy that we have to keep raising rates? I understand the notion that we need to get back to neutral but I think we’re about there. “Arguably, I think the pressure is going to be on Ben Bernanke to raise rates.”

The Federal Reserve System

The Federal Reserve System is the central bank of the United States, founded by Congress in 1913 to provide the nation with a safer, more flexible, more stable monetary and financial system. Over the years, its role in banking and the economy has expanded. Today, the Federal Reserve’s duties fall into four general areas:

- conducting the nation’s monetary policy by influencing the monetary and credit conditions in the economy;
- supervising and regulating banking institutions to ensure the safety and soundness of the nation’s banking and financial system and to protect the credit rights of consumers;
- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets;
- providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation’s payments system.

“It’s a quasi-government agency owned not by the government but by the 12 Federal Reserve banks that make up the system,” said Richard Bard.

– Federal Reserve Web site; Richard Bard

China and India

Bard referred to his own global business operations in making observations about foreign markets. “I have two manufacturing businesses that have facilities and sales offices throughout Europe and Asia. In India we have distributors and we’re looking at doing a joint venture in Mumbai.

“The growth in China is slowing and the demand for basic materials – copper, manganese, steel, petrochemicals – is not on an upward curve anymore. Even so, there are still huge opportunities in China. Forty-one nuclear energy plants are being built in China today and the forecast when they are done and operational is that they will supply only 2 percent of the energy for the country.

“In a lot of ways China is a terrible model. They are sucking up natural resources – fuel, oil, steel, etc. – to feed their growth. It’s a model that’s quite expensive to maintain. Imagine trying to become the biggest entity in the world based on making things cheap. You build a plant that makes little widgets that don’t have a lot of value but you’ve got to build a plant which requires costly energy.
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Compare that to the model for India which is based on low-cost technology and some smart people. India is a very elegant model.” Bard offered some comparative figures generated by the Fed relating to the current per capita GDP of the US, India and China: “US $35,000; India $450; China $860. By 2050, the Fed forecasts a rise in the per capita GDP of all three countries: US $72,000; China $8000; India $4800.”

(Don Stevens noted that the GDP per capita in Shanghai is close to $5000 “so they’re doing a lot better than the country as a whole. The story of these countries is going to be how many people join the mainstream.”)

As for Europe, Bard’s long-term view is very positive. “Russia represents the great opportunity for Europe. Everybody is opening offices in Moscow and other parts of Russia. The need for European technology and machinery is huge in the restructuring of the Russian economy.

“I think it’s only a matter of time that Europe will shed some of the malaise that has been there for the last several years. I think it’s going to be a good place to do business over time.

PETER WIDMER is financial advisor to a small number of wealthy European families. He previously was chairman of Julius Baer Investment Management Inc. and Member of the Executive Board of Julius Baer Holding in Zurich, responsible for the company’s institutional investment activities outside Switzerland. Prior to working for Julius Baer, Widmer was with Swiss Bank Corporation and London & Dominion Trust and Thomson-Schwab & Co. He holds the Commercial Diploma from the Swiss Business Association.

The summer of 2005 will not go down in history as one of Europe's brightest, said Peter Widmer in his address to the Global Executive Forum. “France and the Netherlands rejected the European Union constitution and this rejection paralyzed the EU and its workings throughout most of the summer.”

Also during the summer, there were political stalemates in key member countries: “In Germany, Chancellor Gerhard Schroeder resigned; in France President Jacques Chirac suffered heart problems, probably more serious than people realized; in the U.K. Prime Minister Tony Blair won a third mandate but without a majority, which weakens him; in Italy, Silvio Berlusconi was and is unpredictable.”

On the upside, “I think fresh blood and thinking are needed at the level of Europe’s heads of state and hopefully we will get it over the next couple of years.” In the meantime, the EU has embarked on a cleanup project to throw out 1500 pieces of obscure legislation over the next few months. There will also be a modernization of land use policies and the creation of uniform regulations to allow cross-border expansion. “All this is in recognition that current regulations hinder productivity,” said Widmer. “I think the momentum is gathering; business confidence actually has improved tremendously in Europe.

“The stock market is probably the best indication of this improved confidence. Year-to-date, stocks are up about 15 percent in local currency terms with their leading performers over 30 percent. The slow markets have been the U.K. with about 13 percent and Italy with less than 10 percent.
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Smooth integration

Central Europe is the star of the continent, with a pattern of solid growth. “Following 2004’s growth rate of 7 percent, 2005 is expected to come in at 5 percent, the seventh year of growth in this ex-communist block,” said Widmer. Despite the slowdown, he added, the growth is still good within the framework of Europe.

“But inflation has become a problem among the 10 new EU countries of Central Europe: Cyprus (Greek part), Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Several of the EU 10 will probably not qualify for the euro, Europe’s single currency, as early as they had hoped, sometime between 2007 and 2009.

Relatively low labor and production costs have drawn manufacturers to the region; “20 percent of cars produced in Europe are produced in these new countries, mostly in Slovakia. Capital investments are estimated to reach about $45 billion to $50 billion in 2005. And increasingly, the percentage of profits made there are being retained and reinvested.

“Slovenia is the wealthiest state with 80 percent of EU purchasing power. Poland is one of the weaker ones with only 45 percent. It’s a good area for investment. Widmer agreed with Richard Bard that the potential in Russia was good. “However, these new countries are scared. Russia is unpredictable under Putin. The political and economic future creates insecurity for investment. The free economy concept is in some danger, much more than it was a few years ago.”

Investors are doing well with stocks. “Stock markets in these Central European countries have been strong until recently when rising interest rates and inflation put a damper on stock prices. But Hungary is still up 42 percent this year. Russia is up over 60 percent. Currencies have been stable against the dollar. Hungary however had a setback because of severe balance of-payment issues.

Of all the foreign investors in these Central European countries, “the Austrian banks are most active in trying to participate in development projects. Erste Bank Austria now generates two-thirds of its business and profits outside of Austria.

“Bulgaria and Romania are on the chart for EU ascension in 2007. They’ll probably miss that date by at least one year,” said Widmer. “The EU considers their progress insufficient in tackling corruption and organized crime, improving the protection of intellectual property rights and establishing cultural safety standards.”

Turkey’s EU candidacy

Negotiations with Turkey have started and “they will probably take the better part of 10 years,” said Widmer. There are a lot of conditions Turkey must meet before the EU opens its doors.

“The EU is already applying pressure on Turkey to achieve reforms. Turkey now has two years to totally abolish torture in its prisons, guarantee religious freedoms to minorities and improve conditions for these minorities “And Turkey must come to terms with recognizing Cyprus, a EU member which is half Greek half Turkish. It’s a complicated issue.”
EU and Turkish officials are eager to proceed with negotiations. “The EU is Turkey’s largest trading partner, absorbing more than 50 percent of Turkish exports,” said Widmer. But resistance to some of the conditions that have been laid down is coming from Turkey’s state agencies. “They don’t like all this movement toward entrepreneurship.”

The profile of Turkey differs sharply from that of other EU members. “Never before has the EU taken in a new member whose economic status was so out of line with that of other members,” said Widmer. And Turkey’s large population is also a new challenge; currently the population is 90 million; projected to be more than 100 million by the time Turkey is accepted for membership.