Conversation with Philipp Lotter

Philipp Lotter - Managing Director, Head of Global Ratings & Research, Moody's Investors Service
David Wright - President, EUROFI

David Wright

I am very pleased to welcome Philipp Lotter, who is the managing director and head of global ratings and research at Moody's Investors Service. Philipp, first of all, thank you for the support of Moody's of our work over many years. It is greatly appreciated. You have been at Moody's since 2003. You have had an immense amount of experience in the Far East, in Singapore and in Dubai, heading up various departments and offices in these regions. Now you are responsible for Moody's global ratings and research business, based in London, so you have a really crucial and very important role in European capital markets. Let us start off by asking you, Philipp, if I may, what are the big credit themes that you see today for this year.

Philipp Lotter

Thank you, David, and thank you, Didier and all the organisers, for what looks like another absolutely fantastic conference. As it has been mentioned before, the current environment is complex. Our job at Moody's is really to distil complexity into messages that I would not call simple, but clear. What we have attempted to do for our imminent credit outlook is to look at the four key themes that are going to drive credit and, by extension, the capital markets, not just in Europe but globally over the next year and probably beyond.

The first key theme is clearly the broader rate environment and the growth environment. We call it higher rates/lower growth. It is no surprise to anyone here that we have come off a period of unprecedented cheap money and are now in the midst and, as it looks like, the end phase of a really unprecedented correction and adjustment of financial and, to some extent, fiscal policies. That is going to remain a theme, certainly for most of this year, in that central banks are going to want to make sure that inflation is sustainably heading back towards their target corridors before they start loosening the monetary agenda.

I think that the markets have gotten a little bit ahead of themselves until very recently in talking about March rate cuts. We would be very surprised if we saw rate cuts in March. I think that even May might be a stretch. Ultimately, rates are going to come back down. We think that the Federal Reserve (FED) will go towards 4.25% or 4.5% by the end of this year, and the European Central Bank (ECB) likely towards 3.25% by the end of the year. We have certainly reached a peak, but not to the extent that inflation has returned comfortably back to sustainable levels. As we have seen, inflation is bumping up and down and, accordingly, markets and monetary policy will remain on edge until we have clarity.

I do also want to highlight, though, that one of the biggest fears throughout the decade of easy money was, 'How are we ever going to get back to some form of normality?'. The central banks have done a very good job of leading us through this period of monetary adjustment without, so far, having caused serious recessionary impacts across most of the developed economies. The resiliency of the markets and of economies is quite astounding. I know that some pessimism has been raised in the EU, and the EU is certainly performing below potential at the moment, but, even in the EU, we have had relatively strong economic resilience, as well as consumer and labour market resilience. Particularly in the US, resilience has been quite phenomenal. There will be continued volatility certainly over the course of this year.

Secondly, I want to touch upon the other three key considerations very briefly, because they are all very relevant to the discussions taking place over the next couple of days. The first one is structural shifts. Again, there are a number of challenges posed by climate change, technological advancement, and demographic and social pressures. We can already see the effects of climate change really starting to challenge business models and bringing costs and insurance premiums up. No matter where you stand in the debate, the tangible impact is already quite noticeable. Then, of course, you have social considerations that are posing risks. Something that, a year ago, no one was even talking about was Generative Artificial Intelligence (GenAI), which is now a popular topic and has already fundamentally changed the way people work and operate.

I want to mention the third key theme, which is reforms and regulations. That is all about how governments and policymakers are responding to some of these shifts. We have already seen tighter regulation in the US on the banking side following some bank failures there. We are seeing increased pressures to disclose sustainability metrics for climate risk. We have a huge transition financing gap, which is affecting all governments, but particularly those in frontier and emerging markets. The big question is, 'Who is going to fund it?'. That will be a question not just for the EU, but globally, for the foreseeable future.

The final key theme is politics – in particular geopolitics, geopolitical realignment and the polarisation that has come with that. Most of us in this room have heard this phenomenal figure that two-thirds of the democratic electorate are going to go to the polls this year. We have the EU parliamentary elections coming up in a couple of months. We have the presidential election in the US. This will likely bring about greater polarisation as well as more complex and more uncertain policymaking. That is something that the world and all of us are going to have to navigate quite carefully over the next couple of years.

David Wright

Thank you very much, Philipp. What about the euro area economy and recent downgrade forecasts by the Commission and the ECB? Could you steer us here?

Philipp Lotter

We heard the gentleman from the International Monetary Fund (IMF) earlier. We are not far off. We think that EU area growth will be 1.1% this year. Then, of course, you have a lot of the economic engines of EU growth – Germany, Italy and France – all performing at 0.8% or 0.7%, i.e. well below their potential.

The good news is that, as we start to see inflationary pressures ease and interest rates come down, that will also provide impetus to the EU economy. NextGenerationEU (NGEU) funds will start to support growth across the EU area. For next year, we are in the 1.7% camp, which is an improvement, but I would certainly argue that is still below potential and still below some of the larger competing economies around the world while being enough to maintain living standards across the EU. Then again, governments still have very limited fiscal space to respond to a lot of social pressures. Going back to my earlier point around polarisation and fiscal space, that is going to be a challenging conflict for some governments to manage.

David Wright

We heard on the previous panel a lot of talk of competitiveness, the single market, and people talking about Europe's economy falling behind the US since 2008. What do you think are the main reasons for this? Do you buy the thesis that Europe is sliding downwards compared to the US and China?

Philipp Lotter

I would not argue that it is sliding downwards, but there is certainly a gap, and that gap is not new. As the previous panel said, we have had that for over two decades. There are a number of reasons for that, and the previous panel was fantastic at spelling some of those reasons out, but I would like to focus on two in particular.

One is the demographic disadvantage of the EU. Our US colleagues all work a lot more. When they take a long weekend, they call it annual leave. That is something that has an impact on productivity. Their population growth is stronger and, generally, the demographic dividend that the US has over the EU is one that, again, is not new. I do not want to be all negative. There have been labour market reforms in the EU – and I want to highlight particular countries like Greece and Portugal, as well as France – which have boosted employment. Overall, however, this is still a structural disadvantage with which the EU will have to operate.

The second point that I want to mention, as mentioned in the previous panel, is capital markets and capital markets infrastructure. There is lower capital formation in the EU. There is a much more risk averse approach to early-stage investments. There is still a mismatch between funds and investments that need to be funded. Research and development (R&D) was mentioned earlier: in 2020, the EU invested 1.5% of GDP in R&D while in the US, it was 2.6%, and that is a big difference.

These are structural issues that are set to remain and not to change anytime soon. Coordination is key, and I am very much looking forward to seeing what Messrs Draghi and Letta come up with in their upcoming reports. A lot of these questions and topics require a fresh impetus and a fresh focus from policymakers.

David Wright

Europe has not sat back and done nothing. We had the NGEU programmes, which M. Nava was just talking about, and €850 billion of expenditure. Only 25% to 30% has been absorbed up to now. How do you look at this? Is this potentially a good medium-to-long-term driver or is it deficient in its structure?

Philipp Lotter

Again, I want to show some qualified optimism here, because the NGEU funding programme is a landmark and unique programme in mobilising funding across the EU, which should not be neglected and forgotten. However, you make exactly the right point. The complexity around NGEU, particularly versus the Inflation Reduction Act (IRA) in the US, makes it more difficult and less flexible. In the US, the IRA is very much targeted at the private sector. Accessing loan grants and guarantees is a relatively straightforward process. The fact that you have this direct access by the private sector makes it a much more easily accessible fund.

Again, we must not forget the breakthrough that was achieved. In fact, we recently upgraded some sovereigns in the EU, such as Cyprus, Portugal and Greece, which are all countries that we refer to quite explicitly as net beneficiaries of some of these investment funds to the extent that it has already had promising effects on credit profiles and, thus, ratings.

David Wright

As a final question, although we could go on a long time, looking forward and particularly looking at the capital markets and banking markets, what are the key drivers? What could really change the perception of Europe and the supply of capital? What would you do? What are the priorities? Given the theme of this conference, how do we drive this forward and be more successful?

Philipp Lotter

Again, it is simpler to answer than it is to execute, but it is all about new impetus, better integration and better coordination. What we need in the EU is more diversified funding sources, deeper credit markets, deeper fixed income markets, a greater EU fiscal capacity, and matching funding to much greater risk appetite. As mentioned earlier, savings are greater than investments, and that free flow of capital across EU member states is so important in facilitating these developments.

We have been talking about capital market and banking unions for many years, and we have made progress. The Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) are already two very important anchors of financial stability that exist today. Again, as mentioned earlier, we need the European deposit insurance scheme, which has made some progress but is still not where it needs to be. In order for it to be successful, you need central pooling of authority and centralisation across member states, although some progress has been made. Again, it goes back to fresh impetus and increased coordination.

The other thing that I just want to highlight around banking union is that, even if we did make progress on the capital markets side, there is still a lot of work that needs to be done on the banking side. There are still big differences in product features, in regulation and in insolvency laws, etc. There is still a mountain to climb and I am sure that we will be hearing a lot more of that over the next couple of days here in Ghent, but it has become very clear that the motivation for greater union, greater integration and greater alignment is just going to increase.

David Wright

I hope that you are right.

Philipp Lotter

Don't we all?

David Wright

Thank you very much for being with us. You are absolutely right that we need new impetus. We will get these very good reports, for sure, from Mario Draghi and Enrico Letta – and others, because there are others who are hardworking. The question then is the politics and the economics. I was going to ask you a left-field question. Do you think that we have won the economic arguments about integration at the European level? I am not so sure.

Philipp Lotter

Most people in this room will probably agree with the economic arguments. We still have to convince a lot of others outside of this room.

David Wright

Philipp, thank you very much, and thank you again for supporting us.