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WEEKLY ECONOMIC COMMENTARY

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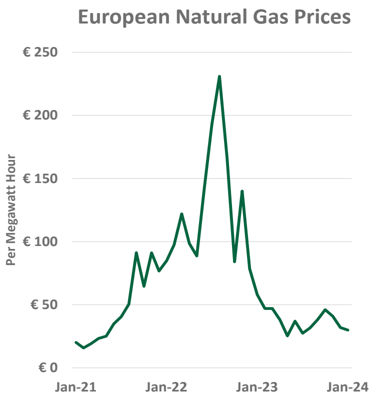
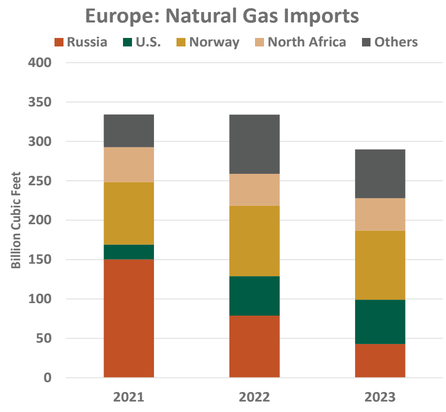
It seems to me that people often choose partners who have a completely different sense of temperature. One is usually too warm; the other, too cold. Wrestling over the thermostat is known to cause challenges for even the best relationships.

Europe has been wrestling with a thermostat challenge ever since the invasion of Ukraine two years ago. It hasn't been easy, but Europe has managed through two winters without Russian natural gas. The approach of spring should bring seasonal relief, but Europe is still seeking energy and security.

When Western countries sanctioned Russia for its aggression, Russia retaliated by restricting the supply of natural gas to other European countries. At first, key pipelines were taken down for "maintenance;" shortly thereafter, they were closed. In September of 2022, the NordStream pipeline was destroyed in an explosion. This sequence of events initiated a jump in energy prices and a scramble to be ready for winter 2022-23.





Sources: Bloomberg, European Commission

Matters could have been worse. In the decade prior to the hostilities, Europe had increased the fraction of its electricity derived from renewable sources from 18% to 32%. (This compares to about 25% in the United States.) Nonetheless, Europe generates about 20% of its power from natural gas-fired power plants, and about 30% of its homes are heated with that fuel. Securing replacement supply became an imperative.

Thankfully, Europe succeeded in getting enough natural gas into storage to be ready for seasonal demand. Purchases of liquified natural gas (LNG) from the United States, among others, helped considerably. Conservation measures reduced electricity usage by 10%, and a relatively mild winter limited heating needs. Coal-fired and nuclear power plants were used more heavily. The continent came through last winter with plenty in reserve.

The experience was an expensive one, though. Energy costs in the eurozone's consumer price index escalated by more than 40% during the first year of the war. Real income of households declined, hampering consumption. A number of countries enacted measures to buffer the blow felt by residents. While welcomed by the recipients, they weren't entirely popular with economists, who felt that support would dull incentives to conserve and diversify. The programs also added to public debt, the cost of which will be borne by businesses and households in the years ahead.

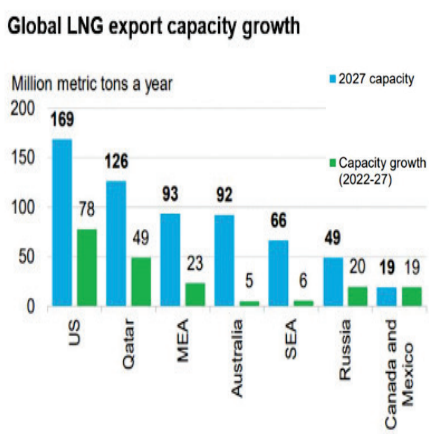
Rising input costs contributed to the struggles of Europe's industrial sector. Further, inflation in the euro area peaked at over 10%, prompting a series of interest rate increases from the European Central Bank. This combination of headwinds brought the region's economy to a standstill; prospects for this year are modest, at best.

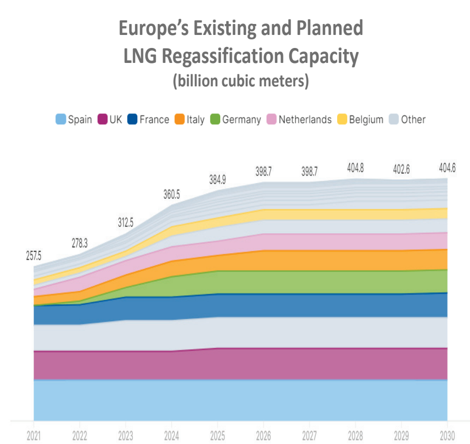
Europe's forced energy transition has come at a substantial cost.

The pipeline closures have proven costly to Russia, as well. Oil not sold to Western Europe has been diverted to India, China and other countries. But there are no customers who can fully replace European purchases of Russian natural gas. Exports have fallen by 40%, depriving Russia of a substantial source of revenue. Unfortunately, this deficit has yet to bring either side to the bargaining table.

There is a debate to be had about whether economic sanctions have been worthwhile. The costs to both sides have been significant, especially when lost trade between the two is factored in. Sanctions have a moral component that should not be underestimated, but the costs of weaponizing commerce may not produce sufficient geopolitical returns.

The most recent winter offered a repeat of the preceding one. Europe entered the season with plenty of gas in storage, and winter temperatures were the second highest in the last ten years. The slowing regional economy reduced demand for power, taking further pressure off prices. Homes remained warm, and European energy costs are now deflating.





Sources: Bloomberg NEF, Gas Infrastructure Europe, IEFA

Favorable supply and demand conditions have provided Europe some time to adapt more permanently to life without Russian fuel. European leaders are anxious to sustain progress towards their environmental goals; to that end, investments in alternative energy sources have accelerated. The continent is busily constructing new terminals to receive LNG, and exporters have moved to increase output. Production of LNG is expected to increase by 40% over the balance of this decade.

In January, however, President Biden announced a pause on pending LNG projects. Analysts saw two motivations for the move: one was that supporting dependence on natural gas might slow the transition to fuels that are more environmentally friendly. The second was economic: rising exports have increased natural gas prices in the United States and made them more volatile. The U.S. Energy Information Agency projects a 10% increase in domestic energy costs if LNG exports follow the planned path.

Europe has survived two winters without Russian gas, but there are many winters ahead.

For decades, domestic supplies of natural gas afforded the United States a substantial advantage. The fuel does not travel easily; pipelines must be carefully constructed, and transport by road, rail or sea requires liquification or compression. Investments made to facilitate a more global market have improved energy supply and security for Europe, at the expense of American users.

The current situation illustrates what economists have called the energy "trilemma," a state in which there are three goals but where only two can be achieved. The world wants cheap energy; it wants clean energy; and it wants to procure energy from reliable sources. Western countries have been seeking to balance these elements since the first Arab oil shocks sixty years ago. Some progress has been made, but much more is needed.

Europe's energy resilience over the past two years has been impressive, but the future remains uncertain. Downward pressure on thermostat settings and upward pressure on trade relations may not subside for a while.

Back In Time

The *Back To The Future* movie franchise introduced a mass audience to the complexities of time travel. Revisiting the series today also teaches us a lesson in how the world continually changes. Consider this scene from *Back To The Future III*, set in 1985, but with Doc Brown having just time-traveled from 1955:

> Young Doc: No wonder this circuit failed. It says "Made in Japan."
>
> Marty McFly: What do you mean, Doc? All the best stuff is made in Japan.
>
> Young Doc: Unbelievable.

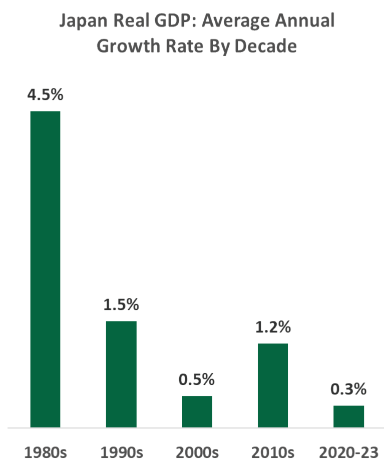
A viewer today may find Marty's enthusiasm from 1985 just as unbelievable as Doc did in the film. Just as the movie was released in 1990, Japan commenced one of the largest economic setbacks the world has ever seen. As one indication, Japan's leading equity index finally reached a new high last month, thirty-four years after the last one.

While Japan is coming out of a decades-long malaise, China is trying to avoid one. There are clear parallels between the two situations, but also some important differences.

First, a brief recap: Following World War II, Japan's government, manufacturers and banks collaborated to not merely rebuild the ravaged nation, but generate an economic boom. The United States was a crucial partner and sponsor, forging a new alliance with Japan in the Cold War. Japanese factory output progressed from inexpensive but unreliable goods to some of the highest-quality products in the world.

Good times never last forever, and this cycle peaked with an asset bubble that burst in late 1989. A stronger yen in the late 1980s made Japanese exports more expensive, just as other Asian nations emerged as competitors in key categories like steel, autos and consumer electronics. Japan once had 8 of the top 10 banks in the world, but credit problems (mostly related to inflated real estate) caused a crunch that hampered Japan's economy for a long time. Deflation set in and stayed, hindering consumption.

Social norms that developed in the growth cycle added to Japan's struggle to rebound. Japanese firms have maintained the expectation of lifetime employment. Decisions in those firms are made by those with the longest tenure, who may be the least open to new ideas. Entrepreneurship is limited, with large incumbents representing the majority of employment. Letting mature businesses lumber along is a costly strategy. While bankruptcies and layoffs are never pleasant to endure, they allow labor and capital to move where they are most productive.



Sources: Cabinet Office of Japan, Wall Street Journal, Haver Analytics

Japan's economy has languished for more than 30 years.

Demographics have been especially challenging. Long work hours and impaired economic prospects weighed on the nation's birth rate. Immigration to Japan is limited, offering few prospects for new arrivals to support the economy. Discouraged young workers often failed to launch careers at all, adding to stagnation.

After a slow start, Japanese policymakers sought to arrest the decline through public spending. The ratio of Japan's national debt to its gross domestic product (GDP) grew from 49% in 1989 to 199% in 2019. The government always had a reliable buyer of its debt: the Bank of Japan (BoJ) monetized the deficit by printing currency to purchase new Japanese Government Bond issuances. But the stimulus only maintained the status quo, and once the practice began, it was a hard habit to kick. The BoJ's overnight rate remains a moribund -0.1%, with governors fearful of impairing prospects with positive interest rates.

At long last, Japan seems to have ended its malaise. COVID disruptions played a part in the upward trend, as higher external demand for goods helped get the economy moving. A return to wage growth supported consumer spending. Moderate inflation should bring the BoJ out of its negative rate regime this year.

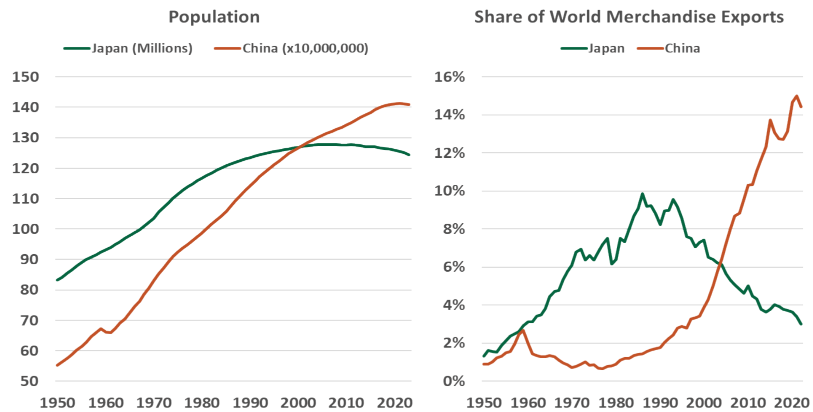
Japan's incredible boom and bust offer important lessons for other nations. China is chief among them. History may not repeat, but it often rhymes.

Both countries grew quickly on the back of state-sanctioned, debt-financed technological transformations, which led to a surge in exports. Both countries ascended when their populations were young, and began to struggle when collective aging gathered momentum. Both ascended quickly to global leadership, which attracted both acclaim and disdain around the world.

China's potential descent after decades of growth is a point of global concern. Foreign direct investment into China is falling; the pandemic illustrated the risk of concentrated production, and the Ukraine war illustrated the potential consequences of sanctions. China's low birth rate—a rescinded policy that has become a cultural norm—and limited immigration have brought about a population decline. China's equity markets are worried, falling off while indices in other markets ascend.

Both China and Japan borrowed heavily to finance their growth. Credit comes easy in thriving economies, but must be repaid even in sluggish circumstances. In both cases, leverage fueled excesses in property markets, which eventually cracked. Residents of both nations prioritize saving, making a shift toward domestic consumption a cultural challenge.

Is China headed for Japanification?



Sources: Japan Ministry of Internal Affairs and Communications, China National Bureau of Statistics, Haver Analytics, World Trade Organization

As it seeks to avoid "Japanification," China has one clear advantage: the ability to learn from Japan's struggles. Ben Bernanke, among others, has noted that Japan's policymakers did not do enough, or act early enough, to head off persistent deflation. So far, the response of China's government to its gathering challenge has been restrained. Fiscal stimulus has been minor, and the People's Bank of China has offered only modest accommodations. Depressions throughout history call for overwhelming policy responses; without them, only time (lots of it) can heal.

Macroeconomics is not a movie. Japanese policymakers cannot jump in a DeLorean and change decisions made thirty years before. While Japan's economic drama appears to be ending, China's could be beginning. Unlike the *Back To The Future* series, no one is eager to watch a sequel.

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