EUROPE: NAVIGATING THE STORM

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Introduction

This is a difficult and uncertain time for Europe, as it is for much of the world.

Europe faces its own set of challenges in the current environment. But, its deeper problem is that the current economic crisis might combine with some of Europe's structural weaknesses to create a toxic long-term effect that drags it down. The risk is that this could happen precisely as other countries might emerge strengthened from this crisis in the long-term.

EU leaders need to make the right choices now in order to take advantage of the continuing potential for EU economic growth and strengthen their political influence over their own destinies.

1. Europe and the Economic Crisis

The financial crisis has spread gradually across Europe, to the point where overall EU growth is now predicted to slow into a recession for all or most of 2009 (IMF says – 0.5%).

What started in the UK as a spill-over of the sub-prime crisis from the United States into its own highly-leveraged economy has not been contained there. Almost all EU economies have now been hit one way or another.

Bank crises have hit the UK, Germany, Austria, Denmark, Hungary, Ireland, Slovakia and Slovenia. Spain's unemployment is expected to rise to 15% nest year on the back of a 0.9% decline in its GDP. Britain has already had 2 quarters of negative growth.

After initial divisions, European governments have responded well and pragmatically in their national and collective response to the crisis. Britain led the way with a dramatic decision to under-write the national banking sector and financial system with a £500 billion combination of purchases of major equity stakes in three of Britain's leading banks; huge lines of credit to back bank lending; and deposit guarantees.

Other EU countries have followed this lead with a similar combination of policies. Germany (€400 bn. to back bank loans plus €80 bn. "top-up" capital for them); France (€320 bn. and €40 bn.).

Equally remarkable at the political level, the members of the Eurozone coordinated with Britain (a non-Eurozone member) their collective response.

Interest rates have also been coordinated across the EU and with other international players.

There is now growing consensus that support for the financial sector and monetary policy (interest rate cuts) will not be enough to see Europe through the crisis. There is growing support for a set of Keynesian stimulus packages across the EU to avoid too steep a drop in economic activity.

In the meantime, the existence of the Eurozone has helped avoid competitive actions (such as devaluations between national EU economies) and has offered somewhat of a safe haven for the small EU economies, such as Ireland and the Netherlands, from the global economic and currency turmoil. Those outside the safe harbour – Denmark and Iceland, in particular – have suffered economically.

However, the decline in the value of the Euro (and the pound) relative to the US dollar may reflect market belief that the US has better potential for recovery than does the Eurozone or the UK.

Why is this so? What are the longer-term risks for Europe? What are some of the deeper, structural factors that will determine how it navigates its way though the current storm?

2. Europe's structural risks

- *Demographic change*

European nations are aging faster than any other major countries in the world, except Japan. By 2050, 7 of the 10 oldest countries in the world are projected to be European (including Spain, Italy and five from central and eastern Europe) with average ages over 50.

Although some progress has been made in recent years, few European nations have adapted their pension systems sufficiently to prepare for this reality. Budget deficits are likely to rise, constraining economic growth.

- *Unreformed welfare systems*

Overall, generous post-World War II social welfare contracts (ensuring generous protections for retirement, labour laws, healthcare and education) have still not been adapted to the more competitive realities of the 21st century. Examples include German and Italian retirement systems and French healthcare and education.

- *Low immigration rates*

With few exceptions (Britain and Spain, among them), immigration rates have not risen anywhere near the levels needed to compensate for societal aging, in terms of workers and payments into social security systems.

Large numbers of those Immigrants who do arrive find it difficult to integrate effectively into the national economies. This adds to welfare costs and contributes to rising social and political tensions (Italy and East Germany are examples).

- *An incomplete Single Market*

At the EU level, potential drivers of growth from the Single Market have come to a halt. Most importantly, barriers to the trade in services (which account for almost 70% of EU GDP) remain in place across the EU, whether in banking, transport, postal and communications services or professional services such as law and medicine. This could be a key area for productivity growth and new employment.

Most importantly, the lack of an integrated EU energy market creates vulnerabilities as well as price distortions and bottlenecks across the EU.

- *National economic divergence across Europe*

Complicating, Europe's response to the crisis, Eurozone and other EU economies enter the recession in different economic shape and with different strengths and weaknesses.

  - The Eurozone's major economy – Germany – still relies heavily on exports to drive its growth and is more vulnerable to external shocks than are other major economies.

  - Some countries (Italy, Belgium, and Hungary, among others) are carrying heavy government debt levels already and are not well-positioned to handle the costs of stimulus packages over time. Britain has relatively low debt, but very high government deficit forecasts (5%).

  - 10-year bond yield spreads over Germany have grown for some of the Eurozone's weakest countries – 150 basis points (Greece), 110 basis points (Italy), and 80 basis points (Portugal).

Despite the existence of the Eurozone, therefore, the European Central Bank and national EU governments will find it difficult to coordinate monetary and fiscal policies in ways that do not have divergent impacts in different EU economies.

- *Political divergences*

The failure to ratify the Lisbon Treaty which would introduce new institutional reforms for an enlarged EU, has not led to grid-lock in EU decision-making. But it does create a more fragile political context in which EU leaders must deal with the economic crisis and its after-effects.

There is a risk that long-standing protectionist sentiment in some EU countries (France and Italy, in particular) might undermine the future cohesiveness of Europe's response. France's national sovereign investment fund and Berlusconi's championing of state subsidies stand out as examples.

The transition to a new US president makes this more possible during an especially complex next few months. President Sarkozy, in particular, wants to seize the opportunity to impose EU-led change on the international financial system. There will be resistance to this not only in Washington, but also in other European capitals.

3. What are the positives and what will be the best steps to take to achieve a sustainable recovery?

It is important to note that, for all of its structural weaknesses (and other countries have their own!), the EU does have some inherent strengths and also scope for improvement.

It has a diverse and mature set of economies that can be competitive internationally if well-governed and motivated.

While its demography and aversion to immigration can hold it back, most EU countries have extensive room to achieve gains in productivity, through labour market reforms, raising levels of employment among women and older workers, and greater incorporation of ICT into their economic processes.

With stronger national economies, new benefits can be secured through a deepening of the Single Market, especially in the fields of services and energy.

If protectionist instincts can be held back in the near-term, then European countries can grow as magnets for foreign direct investment. At one level, this will be so that foreign companies can gain improved access to wealthy EU domestic economies.

Perhaps more important in motivating increased FDI into Europe, given that EU markets may not be as inherently dynamic as others, is the fact that European companies are strong in areas of design, technology and marketing which can be of added value to the emerging economies with large foreign exchange reserves that are now looking to expand their own international presence.

The EU also has scope to expand its own trade deals internationally, using the leverage of access to its large market.

Conclusion

Europe has some structural problems which may make it harder for it to emerge strongly from the current economic crisis.

On the other hand, it also has scope to improve its own economic performance and to remain an attractive destination for FDI as its own capacity for domestically-driven investment declines.

Whether the more optimistic or negative scenario plays out will depend on the decisions that EU leaders take over the next 3 – 6 months. They will need to use the current crisis to push forward reforms to make their own economies more competitive and to be open to well-regulated trade and investment which would have been necessary under any circumstances within the next five to ten years.