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Economic Bulletin

THE EXISTENTIAL CHALLENGES LOOMING FOR THE EU

Image Credit: istock/CIL868

- If taken at face value, the European Commission appears confident in its Brexit negotiating position. Yet the EU faces numerous existential challenges.

- Economic: An Italian sovereign default has increased in likelihood over the past year and the IMF still refuses to contribute to Greece's bailout until debt relief is agreed.

- Unemployment: It is highly questionable as to whether high unemployment can be indefinitely sustained in weaker Euro economies. Over 60% of 16-34 year olds in Greece, Italy, Spain and France would be willing to join a large scale uprising against their governments.

- Fiscal Union: Moves to fiscal union are likely to be unpopular in donor countries and may in any case fail. Fiscal transfers in Italy over the past 60 years have failed to reduce the wealth gap between North and South.

- Immigration: The loss of control of Europe's external border has caused increasing tensions, with the Visegrad group refusing refugee quotas. The EU has launched infringement proceedings against Hungry and President Macron has called for sanctions against Poland.

- Euroscepticism: Eurosceptism is spreading like wildfire across Europe. The man tipped to be next European President claims this poses an existential threat to the EU.

- A "no deal" scenario with Britain is likely to exacerbate the EU's existential challenges, rather than reduce them.

1. INTRODUCTION

At the start of the general election campaigning period, it was leaked to the Continental press that President of the European Commission Jean-Claude Juncker called Theresa May deluded and said that it was "more likely than not" that Brexit talks would fail. The former French President François Hollande was also disparaging towards the UK's position, calling for the UK to "pay the price" for its decision to leave the EU.

These pronouncements, if taken at face value, suggest that the elites in the European Union are confident in the strength of their negotiating position. Indeed, there are many opponents of Brexit in the UK that would support this view.

Donald Rumsfeld once famously said that "there are known knowns, known unknowns and unknown unknowns". The 'known knowns' in this context actually suggest that there may, in fact, be significant trouble ahead for the EU.

So, while newspaper headlines will no doubt focus on trouble ahead for the UK – both before and after the general election – here are some of the existential challenges that loom for the EU in the upcoming years.

2. THE ECONOMIC PROBLEMS: TROUBLE SPOTS

2.1 Instability in Italy

The news on 2 May that Italy's troubled flagship airline Alitalia had gone into administration is symptomatic of wider problems in the Italian economy. Italy's debt pile stands at over 130% of GDP, its economic growth has been effectively stagnant since the onset of the 2007-08 Financial Crisis and its GDP per capita has actually fallen over the last 18 years, according to Bloomberg calculations. This trend of negative growth in GDP capita has not even been observed in Greece.

Of course, the Italian banking system remains one of the Eurozone's major weak spots. Italian banks have suffered around €360 billion in non-performing loans, which is approximately a third of the Eurozone's total. The European Central Bank's last stress test on Italian banks has also raised major concerns about Banca Monte dei Paschi di Siene (MPS), which obtained a negative result in the adverse scenario. Moreover, Italian bank stocks have plummeted over the past year, with recent estimates showing Carige down 22.8% and UniCredit down 49.3% this year.

Italian five year credit default swaps (CDS) – which measure expectations of a sovereign default – have seen steady growth this year, ending up at $161.2 (see Figure 1). This suggests that investors deem that an Italian sovereign default has increased in likelihood. For the purposes of comparison, the UK's five year CDS has fallen over the year, ending up at just $28.1 (see Figure 2).

As the Eurozone's third largest economy, instability in Italy has the potential to cause real trouble for the single currency area.

Figure 1: Italian CDS over the past year

Figure 2: UK CDS over the past year

Source: Bourse link link

2.2 The Greek Sovereign Debt Crisis

The Greek debt crisis is still a major potential source of instability for the Eurozone. With a debt to GDP ratio of nearly 180%, Greece's fiscal position is widely viewed as unsustainable.

On 2 May, it was reported that Eurozone lenders had agreed on a further set of austerity measures to release additional bailout funds, which will now need to be approved by the Greek Parliament. Previous rounds of austerity would suggest, however, that this is far from the end of the Greek crisis. In 2016, the Institute for Regulatory Policy claimed that 90% of Greece's fiscal consolidation came from higher taxes against just 10% from spending cuts, leading to the measures inevitably being recessionary in nature. It was also claimed that compliance with structural reforms to boost competitiveness stood at a mere 15%.

Then there is also the thorny issue of debt relief. The International Monetary Fund (IMF) is still refusing to put in any of its resources into a bailout agreement until there is a credible debt relief plan for Greece. The IMF's rules on conditionality mean that is can only provide loans to countries that are capable of repaying.

Debt relief for Greece is a very contentious issue, with Greece's European creditors suspending debt relief measures after the Greek Government engaged in unauthorised spending in December 2016. The German Government has been very resistant to any debt relief, particularly in an election year when Angela Merkel is already facing a number of domestic political challenges. Regardless of considerations related to the electoral cycle, this will no doubt be a difficult sell to the populations of creditor countries.

3. ECONOMIC PROBLEMS: MEDIUM TO LONG TERM ISSUES

3.1 Chronic youth unemployment

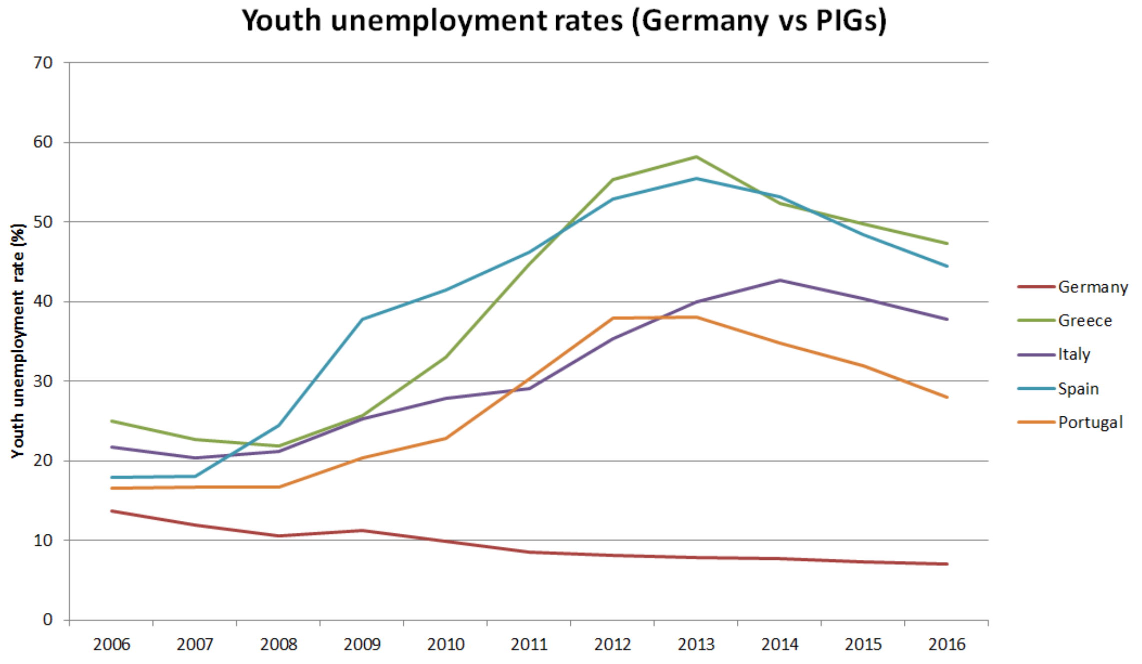
In the absence of currency devaluation options, many euro area countries attempting to regain cost competitiveness have had to rely on internal devaluation (in other words, wage and price containment). According to the European Commission's own analysis, this policy has limitations and downsides in terms of increased unemployment and social hardship.

In a recent interview, the former Governor of the Bank of England Mervyn King argued that this is the biggest stumbling block in the operation of the monetary union. He said that is was questionable *"whether people are willing to tolerate very low growth and high unemployment indefinitely remains to be seen".*

There is also, of course, the problem of mass social unrest arising from persistently high youth unemployment rates. Interestingly, more than 60% of 18 to 34 year olds surveyed in Greece, Italy, Spain and France would be willing to join a large-scale uprising against their Governments, according to a recent survey (see Figure 4).

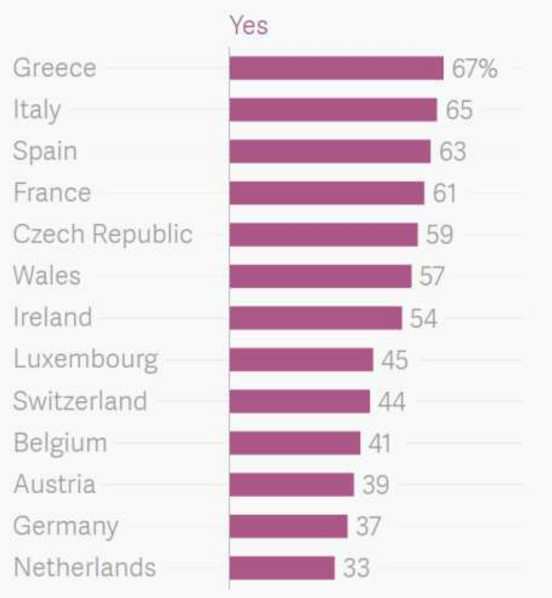
Mervyn King: *"I think the biggest stumbling block here is the operation of the monetary union in Europe…Whether people are willing to tolerate very low growth and high unemployment indefinitely remains to be seen".*

Figure 3: Youth unemployment rates in Germany and the PIGs



Source: OECD

Figure 4: Would you join a large-scale uprising against the Government (18-34 year olds)



Source: Quartz link

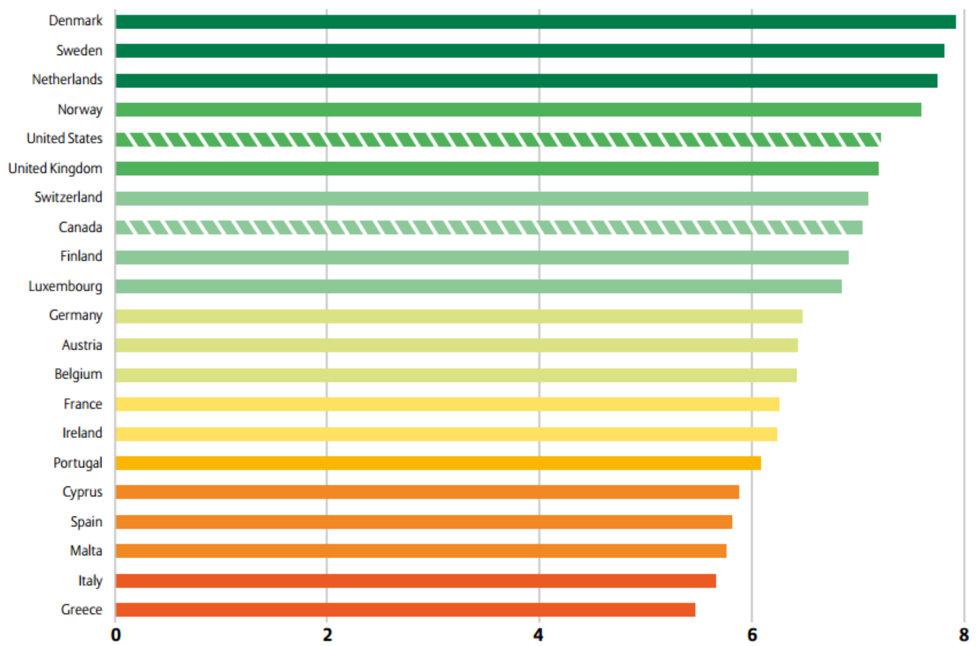
3.2 The Need for Fiscal Union and Fiscal Transfers

Table 1: Competitiveness of Eurozone countries (world rankings 2016)

Country	Ranking	Score
The Netherlands	4	5.57
Germany	5	5.57
Finland	10	5.44
Belgium	17	5.25
Austria	19	5.22
Luxembourg	20	5.2
France	21	5.2
Ireland	23	5.18
Estonia	30	4.78
Spain	32	4.68
Lithuania	35	4.6
Malta	40	4.52
Italy	44	4.5
Portugal	46	4.48
Latvia	49	4.45
Slovenia	56	4.39
Slovakia	65	4.28
Cyprus	83	4.04
Greece	86	4

Source: Global Competitiveness Index link

Figure 5: Pension sustainability index for Western Europe (2016)



Source: Allianz link

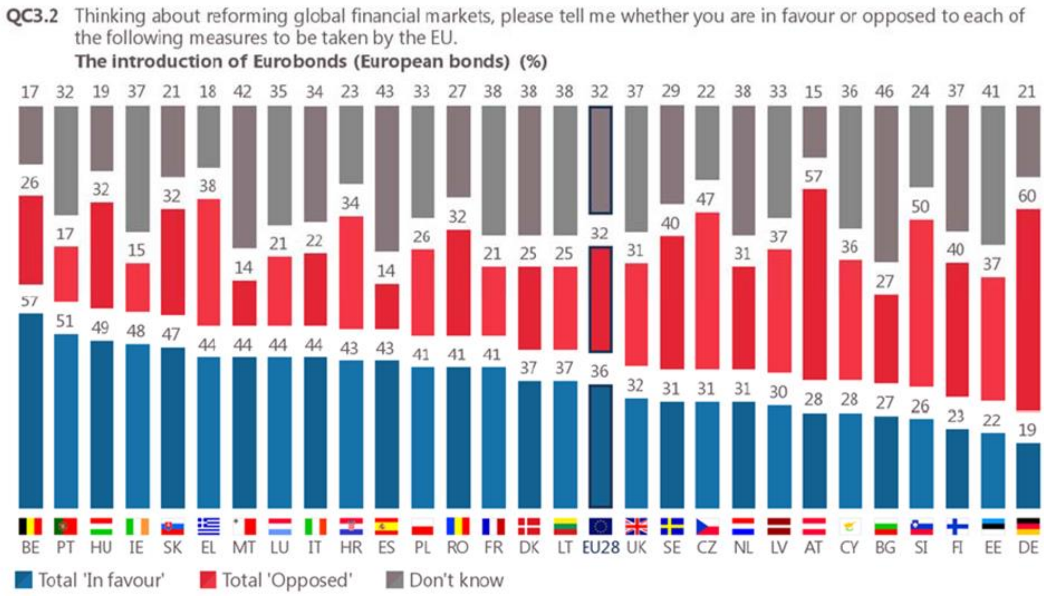
The competitiveness gap between various Eurozone countries is enormous (see Table 1). For example, the Netherlands is judged as the 4th most competitive country in the world against Greece's ranking of 86th, according to the Global Competitiveness Index (2016-17). There are also major discrepancies in terms of sustainability. While the Netherlands and Germany have relatively sustainable pension provision, the PIGS countries' pension systems are deemed inadequate (see Figure 5).

It is commonly argued that this divergence in competitiveness requires short-term monetary easing and a long-term fiscal transfer mechanism, which is often loosely referred to as a "fiscal union". Indeed, Emmanuel Macron has claimed that fiscal transfers between member states are necessary.

There are strong arguments in favour of a fiscal union. The ongoing European debt crisis provides frequent evidence that monetary union requires a fiscal union of sorts, and without it the Euro will always be vulnerable to asymmetric shocks. However, there are issues with a fiscal union.

Fiscal transfers no doubt face considerable resistance from the electorates of donor countries. The introduction of Eurobonds, which is effectively a mechanism of pooling economic risk across the Eurozone, have been hugely unpopular in Germany along with some Eastern European countries such as Estonia, Slovakia and the Czech Republic (see Figure 6).

Figure 6: Views on the introduction of Eurobonds across EU member states (Spring 2016)



Source: Eurobarometer

Fiscal union may even make the EU's problems worse. A former IMF chief has warned that fiscal union could simply mask the fundamental competitiveness problems of struggling member states. Italy's experience highlights how fiscal union may, in fact, be counterproductive. More than 60 years ago, GDP per capita in the South was half that in the North of the country. Despite fiscal transfers, this discrepancy remains as it was, according to the well-respected economist Alberto Mingardi. Fiscal transfers ended up being channelled into dubious projects and public sector employment grew.

4. DEMOGRAPHY AND STRUCTURAL REFORMS

The EU's old age dependency ratio is expected to increase from 28.8% to 49.4% by 2050, according to Eurostat. Average fertility rates in the EU stand at 1.58 compared to 1.8 in the UK, meaning that the UK's demographic problems will be far less pronounced than those of the EU.

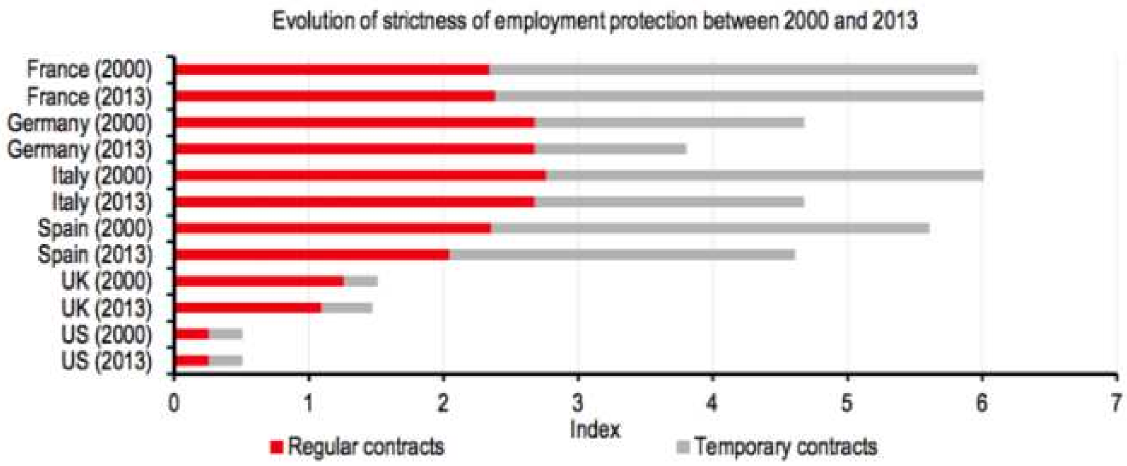
It is highly questionable as to whether mass immigration can solve the EU's demographic problem. The problem of ageing is a global phenomenon, with two thirds of countries now have childbearing rates below replacement level. High levels of immigration are also very unpopular in many member states (see next section).

EU member states will therefore need to embark on major structural reforms to embrace the upcoming trends. However, the necessary structural reforms required will face major political opposition. This is particularly the case in France, which has the most stringent level of employment protection of any advanced economy (see Figure 7). While President Macron has pledged to implement labour reforms, he will no doubt face tough resistance from a powerful coalition of interests.

Boosting labour participation rates will also be required to address the problem of ageing. Yet problems associated with the single currency will make increasing labour participation rates difficult to achieve in many Eurozone countries.

It remains to be seen whether the EU will be able to solve problems arising from its demographic projections.

Figure 7: France's employment protection compared to other developed nations

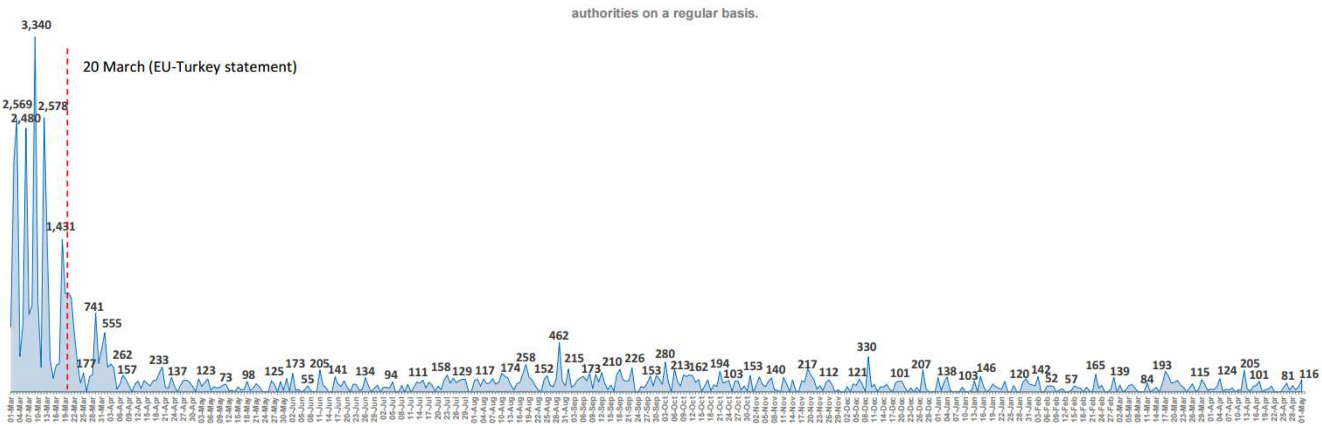


Source: HSBC link

5. **<u>IMMIGRATION</u>**

5.1 The European Union's external border

<u>Figure 8: Estimated Daily Arrivals since EU-Turkey Statement (March 2016 – May 2017)</u>



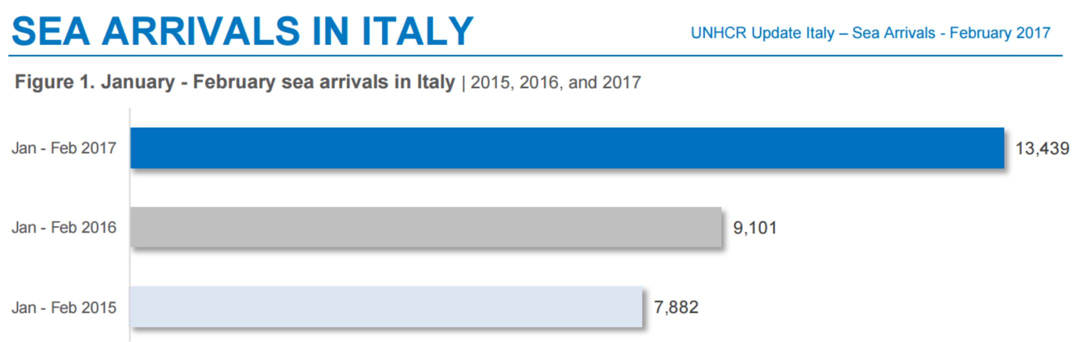
Source: UNHCR <u>link</u>

In 2015 the European Union effectively lost control of its external border. At its peak in October 2015, there were 6,000 undocumented crossings into Greece every day. The situation was brought under control by the EU-Turkey migrant deal, which has led to arrivals falling to a snail's pace (see Figure 8). From Jan – May 2017, there have only been just over 5,000 arrivals in Greece, according to the UNHCR's <u>latest dataset</u>.

However, this agreement is now at risk due to President Tayyip Erdogan's success in the Turkish referendum earlier this year. Erdogan's increasingly authoritarian stance led the European Parliament to hold a vote on freezing talks on EU membership for Turkey. In response, Erdogan <u>warned</u> that he will let hundreds of thousands of migrants travel to Europe if pushed by the EU, opening up the real risk of a fresh migrant crisis in Greece.

Moreover, the undocumented arrivals are still continuing at an unprecedented rate into Italy. In fact, the arrivals this year are higher than the equivalent figures for 2015 and 2016 (see Figure 9). A permanent solution to the European migrant crisis is still lacking.

Figure 9: Sea arrivals in Italy (Jan-Feb in 2015, 2016 and 2017)



Source: UNHCR link

5.2 Political discontent from porous external borders

> **Emmanuel Macron:** "You cannot have a European Union which argues over every single decimal place on the issue of budgets with each country, and which, when you have an EU member which acts like Poland or Hungary on issues linked to universities and learning, or refugees, or fundamental values, decides to do nothing."

The loss of control of the EU's external border has intensified public concern about immigration policy. According to Eurobarometer, immigration is now viewed as the largest problem facing the EU and is at its second highest level that has ever been recorded. This has been a major factor behind the rise of populist movements across Europe.

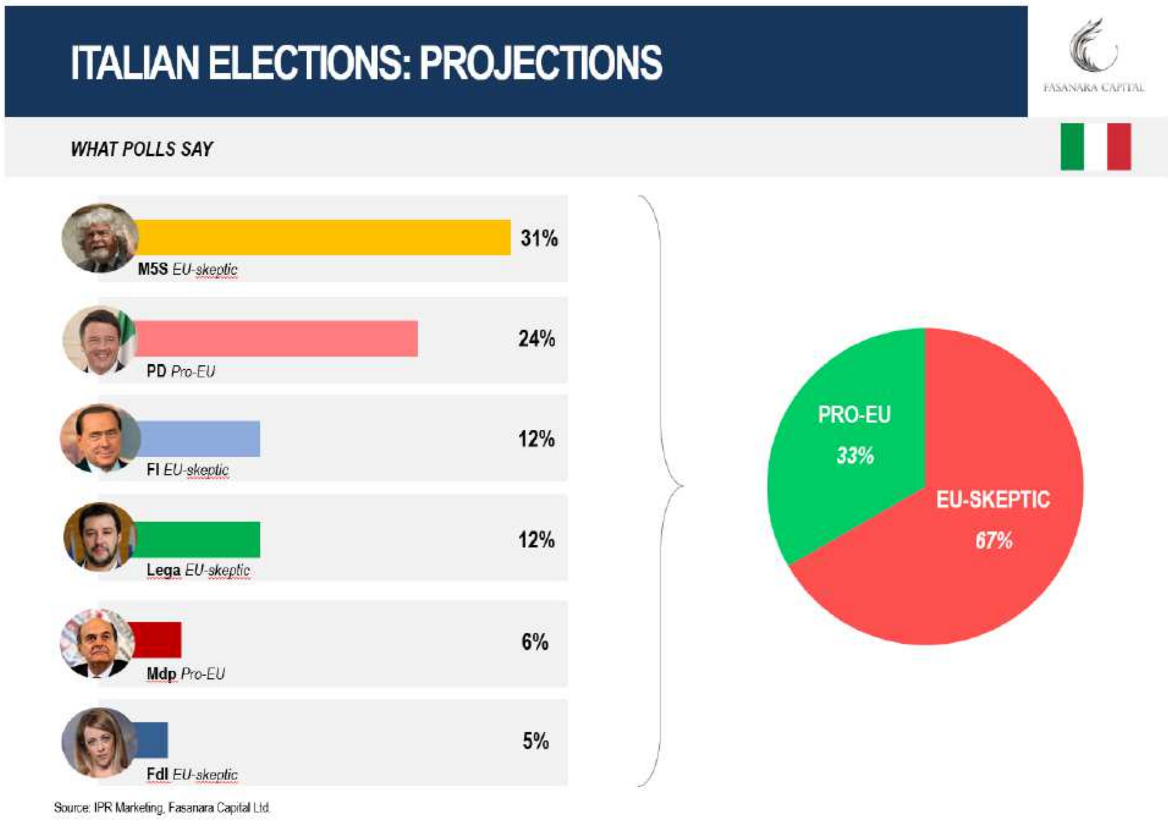
The 'open door' policy pursued by Angela Merkel has also created enormous tensions with the Visegrad group of countries (Poland, Czech Republic, Slovakia and Hungary). In November 2016, the Visegrad group ratified their refusal to accept EU refugee quotas. This, among other factors, has led to recrimination from many EU and European leaders. The EU has formally launched infringement proceedings against Hungary and President Emmanuel Macron has previously said that he would seek sanctions against Poland.

6. THE POLITICAL FALLOUT – EUROSCEPTICISM ACROSS THE CONTINENT

Far from Euroscepticism being simply a British phenomenon, all of these factors are leading to an explosion of anti-EU sentiment on the continent. In fact, rising Eurosceptism poses an existential threat to the EU, according to Jyrki Katainen who is poised to become the next European President.

Pew Research suggests that the EU now has a higher unfavourability rating in France than it does in the UK. Populist, anti-EU movements are spreading like wildfire across the EU. The Five Star movement in Italy is regularly topping the polls. Even in historically liberal Sweden, the hard Right Sweden Democrats recently received poll numbers close to 25% - double their showing at the 2014 general election.

Figure 10: Italian election projections



Source: Fasanara Capital

7. CONCLUSION: WHAT DOES ALL OF THIS MEAN?

Many might argue that these existential threats make it more likely that the EU will insist on giving the UK a bad Brexit settlement to dissuade other member states from leaving the bloc. Indeed, in the short term, senior EU officials and European politicians are likely to take this view, demanding that the so-called 'divorce bill' is agreed before post-Brexit trade negotiations can be agreed.

Yanis Varoufakis, Greece's former finance minister, has gone as far as to say that there 'will be no Brexit negotiations, make no mistake', citing the experience of Greece. The position of the UK in relation to the EU is not, however, comparable to Greece's negotiations with the Troika.

While Greece was dependent on bailout funds from the EU, the EU is seeking to obtain contributions from the UK. Incidentally, there is no legal obligation for the UK to pay what the EU is demanding (although the Government has, quite rightly, stated that it will meet any legal obligations that the UK has). Both net contributor and net receiving countries will be keen for a deal to be agreed that softens the blow from the UK ceasing its full net contributions. The UK's security and defence capabilities are also required by many European countries, and the trading relationship between the UK and the EU is far more substantial than that of Greece and the EU.

In summary, the EU has far more to lose from a "no deal" with the UK compared to a "no deal" with Greece. Moreover, in the longer term, it is likely to become clear that a "no deal" scenario with the UK would likely exacerbate many of the EU's existential challenges, rather than reduce the risks associated with them. A "no deal" scenario would have consequences for the EU's financial stability and would significantly ration resources, not to mention have a huge impact on many of its exporting industries. It would also impact some EU countries far more than others, which could lead to increasing tensions within the bloc. This will give the European Union as much of an incentive to come to a reasonable accommodation on the Brexit talks as it does for the UK.

There has been much scepticism about Britain's negotiating hand, both in the continental press and the British press. Yet, there appears to be far less scrutiny about the EU's negotiating position, which faces, perhaps, long-term ineradicable existential challenges. The European Commission has currently set out a clear negotiating position, but how well this stands up to its inherent long-term tensions remains to be seen. The opposite is true for the UK Government, which will – in all likelihood – benefit from an increased majority after 8 June.

It is therefore mistaken to take the EU's negotiating position at face value while criticising the UK's position as being weak and vulnerable. The EU's existential challenges illustrate that both sides have a lot to lose from an acrimonious divorce.

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Notes:

- Daniel Mahoney is Head of Economic Research at the Centre for Policy Studies. Tim Knox is Director of the Centre for Policy Studies.
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