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Europe policy overview

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Introduction

The economic situation in Europe has improved over the last years. Although the problems of the financial crises in Greece have not been completely solved, growth rates have increased in most countries. Average growth within the Eurozone reached 2.4 per cent in 2017. Countries like Spain, France and Germany with 3.1, 2.3 and 2.2 per cent have pushed economic development in Europe. On the other side, Italy and the UK reached lower growth rates of 1.5 and 1.7 per cent.

However, expectations for 2018 and especially 2019 are a little bit lower. Two per cent and 1.5 per cent can be expected for the Eurozone in 2018 and 2019. Growth in the UK will reach 1.5 per cent in 2019 after 1.2 per cent in 2018 – as long as an economic shock caused by a no-deal Brexit can be avoided, Italy will grow by only one per cent.

The economic consequences of Brexit for the EU and the UK on the one side and future fiscal policies of the populist government in Italy are the most significant internal risks for short-term economic development in Europe.

In Germany, GDP growth rates have been at or above potential growth for a number of years. However, the economy will expand by 1.2 per cent only in 2019 after 1.5 per cent in 2018 due to growing global risks like trade restrictions. Scarcity of qualified labour has emerged as a central obstacle for further investment and growth. Unemployment has shrunk from more than five million in 2005 to below 2.5 million in 2018. The high level of employment has become the main driver of domestic demand and therefore the current growth performance.

Brexit and trade restrictions

The German economy is one of the most open industrialised economies in the world. The business model of many successful companies is based on international trade. Large parts of the German Mittelstand are highly specialised in their respective niche which is only large enough to survive when the world is the market. These success stories are threatened by any attempts to increase trade barriers in the world.

Additional tariffs or other trade restrictions have been in place for a couple of years. Export restrictions for natural resources have been of significant concern for about five to 10 years. The British Brexit decision in the summer of 2016 and the election of an openly protectionist US president increased uncertainty regarding the future of world trade. Growing tensions and threats of massive import tariffs (e.g. on automobiles) reduced business confidence and reduced the short-term growth perspective for Germany.

After two years of negotiations, there was still no fixed agreement on the terms of Brexit as of mid-January. All extreme scenarios from a no-deal Brexit to a new referendum were still possibilities less than three months before the Brexit date at the end of March. Uncertainty became a major obstacle for investments in the UK. Companies with significant business in the UK have been prepared for the no-deal scenario as they had to face interference of supply chains at the harbours and other short-term consequences. A number of companies reacted by moving capacities to the continent or by stockpiling spare parts in order to keep production running. The long-term effects of Brexit will be significant and will probably be more harmful for the UK than for the EU. Growth perspectives and investment in the UK have already decreased significantly.

While Brexit negotiations were about keeping trade barriers as low as possible, Europe and especially Germany were faced with a US president who does not see international trade as mutually beneficial and therefore follows a protectionist agenda.

The threat of the US administration to introduce significant tariffs on manufactured goods from Europe has been put on hold after a meeting of the President of the European Commission, Jean-Claude Juncker, and US President Donald Trump.

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The deal between the President of the European Commission and the US President was a ceasefire that prevented an escalating trade war with tariffs on European cars and car parts on one side and retaliation measures on the other side. In this deal, Europe agreed to let more natural gas from the US into the EU and import more soybeans. US soybeans will find their way to Europe as prices dropped significantly due to Chinese tariffs introduced in response to protectionist measures in the US. As far as natural gas is concerned, there are plenty of unused LNG import capacities in Europe to progress more US gas and to distribute it within the EU.

There are no European trade restrictions, though. The first American natural gas arrived in Portugal in 2016. Whether imports from America can increase mainly depends on price developments. LNG shipping is more expensive than gas transport in an existing pipeline network, therefore US fracking gas has to be cheaper than gas produced in Russia. At the bottom line, gas trade is market based and not a political decision between leaders from the US and Europe. Again, this was a moderate concession, but politically valuable for the Trump administration.

The outcome of the ongoing negotiations about future trade relations is very unclear. The transatlantic trade relations are critically dependent on US domestic politics. Therefore the ceasefire could end from one day to another, which adds uncertainty to economic opportunities in the short and medium term.

Scarcity of qualified personnel and demographic change

The demographic development in Germany will lead to an ageing of the society, while the number of people living in Germany will be higher in the mid-2030s than it is today. The society will grow for the next few years, and then start shrinking in the 2020s. However, the ratio of working population to total population will continue to shrink as life expectancy will continue to grow.

Today, people receive payments from the public pension scheme for almost 20 years. In the 1960s, it was less than 10 years. The strong labour market performance helped to generate the necessary contributions to the pay-as-you-go pension scheme, but a longer working life has to be open for discussion if the level of pay-outs from the system is to remain stable and contributions not be increased drastically.

Political decision-making currently is hardly addressing the demographic challenges, although

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the baby-boomer generation will reach retirement age in the early 2020s. The strong labour market and record tax revenues make it difficult for political decision-makers to discuss reforms of the pension system. Instead, the last government introduced benefits for mothers with children born before 1992 – a second stage of this costly program has been announced.

Furthermore, employees who have worked for 45 years have the opportunity to choose early retirement without deductions. When this opportunity was introduced in 2014, companies lost well-qualified employees, who are difficult to replace.

Scarcity of qualified personnel has become a central obstacle for many companies in Germany and other European countries. This is true for computer experts or engineers, but also for qualified metal workers, lorry drivers, or geriatric nurses.

Surveys show that a shortage of qualified personnel is one of the most important reasons for not investing more, even if market opportunities are there.

The demographic development will make this problem more pressing. As a consequence, the GDP growth potential for Germany will shrink from 1.7 per cent in 2017 to 0.7 per cent in 2035. A combined strategy to increase labour supply and to increase investments and technical progress can bring growth back to previous levels.

However, a later retirement age, longer working hours, higher labour market participation of mothers and the elderly and increased productivity and innovation are not easy tasks to deliver. Digitalisation can bring some relief and should be seen as a positive development. And migration of qualified personnel is essential to close some of the gaps. After many years of discussion, the German government wants to decide on an immigration law which makes migration into the German labour market easier.

Migration and populist parties

Politically, migration from outside the EU is one the most discussed topics in Europe. This is not obvious as the number of refugees heading to Europe has shrunk drastically and is far below the levels of the refugee crisis in 2015. However, the unsolved distribution of migrants from Africa is a major challenge for the EU. Eastern European countries do not want to accept any migration, the current Italian government presses for a solution where refugees who cross the Mediterranean Sea do not stay in Italy. Europe must find a solution before the number of people asking for asylum may rise once again. In the meantime, many countries need foreign people with good qualifications to fill some of the job vacancies.

The ongoing discussions about migration and refugees help populist and right-wing parties in many European countries to succeed. In Hungary and Poland, these parties have formed government for several years now. Austria has a coalition with a right-wing party, while the Italian government consists of two populist parties. In Germany, a populist party won 12.6 per cent of the vote in the last general elections, but they are excluded from any coalition. There are similar movements in France, the Netherlands, Finland, Sweden and other countries.

The elections for the European Parliament in 2019 will show how strong the anti-European group in Parliament will be. However, with populist and right-wing governments in the European Council it has already become very complex to govern the EU and to solve the important problems from Brexit to trade and from financial stability to migration.