THE PANEL

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EUROPE'S GROWTH PROSPECTS: WHAT WILL 2016 BRING?

Roundtable

After a turbulent few years, Europe is facing political pressure over the Syrian refugee crisis, the prospect of a Brexit and further financial instability within the eurozone, with Greece never far from the news. Stefanie Linhardt speaks to seven economists about the region's prospects for the coming 12 months.

In its first few months, 2016 has already proven to be full of challenges, with equity markets sold off across the globe and China's intensifying economic slowdown sending stocks and indices tumbling. Couple that with Europe's very own issues regarding the Syrian migrant crisis, uncertainties over the future of the EU – with or without the UK – and the continued financial problems surrounding the eurozone, and 2016 is shaping up to be eventful. *The Banker* spoke to a panel of experts on just how significant the impact of these issues could be for Europe's economies.

WHAT WILL THE IMPACT BE ON EUROPE OF THE MIGRANT FLOWS FROM THE MIDDLE EAST?

George Magnus, associate, Oxford University's China Centre, and senior independent economic adviser, UBS: Immigration is the principal issue likely to challenge Europe's economies in 2016. [German chancellor] Angela Merkel said in 2015 that immigration – or at least the EU's response to it – would be a defining matter for Europe, and for European integration. We should not take her words lightly. That means all countries face a huge challenge, but we could single out Greece and Italy as the principal countries first on the itinerary of refugees and migrants; Germany and Sweden, which have already accepted a disproportionately high number of migrants and are facing an internal backlash on account of it; and the countries of the Balkans and eastern Europe, where there has been some combination of high migrant traffic and resistance to flows.

The economics of migrant flows into Europe are pretty simple. Over time, flows should be beneficial as they help to offset the stagnation or shrinkage of the working age population due to rapid societal ageing, and a rising old-age dependency ratio. Empirical evidence suggests the net financial costs to the public purse of net immigration are [beneficial] over time. There is also anecdotal evidence that migrants are prepared to do jobs for pay that existing citizens won't do or shun. Evidence as to whether migrants contribute to low pay is equivocal.

Colin Ellis, chief credit officer, EMEA, Moody's Investors Service: The short-term impact of migration is negative for the public finances in terms of increased spending, but relatively small. The longer term impact will depend on economic and social integration: the former to boost sustainable growth, and the latter to help contain any domestic political tensions.

Charles Collyns, managing director and chief economist, the Institute of International Finance: Migrant flows can actually be a net positive from an economic perspective. A country such as Germany will step up its public spending by as much as 0.75% of gross domestic product [GDP] to help absorb the refugees, who over time will also add to the supply of labour [which is] important with ageing populations.

But the social and political challenges are immense. There is a clear tension between the desire to do the right thing from a moral perspective and concern about the difficulties of integrating the newcomers into European societies and economies. Unless inflows are contained, these concerns may become overwhelming, leading to strains not just internally but also between countries with different perspectives and interests.

Debora Revoltella, chief economist, European Investment Bank Group: The huge numbers of asylum seekers and migrants that arrived in Europe in 2015 are likely to continue in the future due to the persistency of conflicts in neighbouring regions and the evolution of push and pull factors generating economic migration in other areas. This creates pressure on public finances, but also as we have seen in some corners, political tensions. The challenge to integrate such a large number of people into society is enormous and only very few countries in Europe have a successful past record on this.

It is worth remembering though that the total of non-EU born people living in the EU is 19.6 million, which as a 4% share of population is still three times smaller than in the US [with 13%].

There is a potential opportunity here. While unemployment in most EU countries is high overall, serious labour shortages concentrated in certain sectors are beginning to emerge, at least in some countries, sectors and occupations. Migration could play a role in reducing these shortages and thereby partially compensate for insufficient intra-EU mobility. It is clear that, at least on current demographic trends, sustained migration inflows in Europe are necessary for the smooth functioning of the economy. Nevertheless, the solution is not so straightforward. Policy-makers need to gain a better understanding of the changing nature of the labour market and the potential of migration to help overcome skill mismatches and to increase productivity.

Willem Buiter, chief global economist, Citigroup: If it is handled well – that is through a well-resourced common external border policy, financial burden sharing among the EU28 and an equitable, quota-based distribution of the new refugees/migrants, supported by effective co-operation with Turkey and Russia to reduce the flow of conflict-driven refugees – there could be two plusses.

First, a short-term Keynesian demand stimulus, say 0.4% to 0.5% of GDP annually with about 2 million net refugees/migrants arriving yearly for the next 25 years. Secondly, provided the new migrants are effectively integrated into the labour force and into the social and political life of their new home countries, a long-term positive supply shock, as the problem of an ageing and declining population would be postponed for at least a generation.

If the EU does not hang together on this issue, its member states will surely hang separately, and an unravelling of the EU becomes a distinct possibility over a horizon of two or three years.

ON CURRENT DEMOGRAPHIC TRENDS, SUSTAINED MIGRATION INFLOWS INTO EUROPE ARE NECESSARY FOR THE SMOOTH FUNCTIONING OF THE ECONOMY

Debora Revoltella

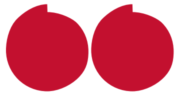
THE OTHER BIG TOPIC OF 2016 IS THE UK REFERENDUM ON EU MEMBERSHIP. IF THE BRITISH POPULATION WERE TO VOTE FOR AN EXIT FROM THE EU, WHERE WOULD THAT LEAVE THE COUNTRY?

Mr Collyns: A vote to leave the EU would have serious consequences for the UK economy. Important parts of the financial sector could leave London for locations still within the EU. Foreign investors seeking production platforms to supply EU markets could be attracted elsewhere, particularly until it becomes clear what new trade arrangements would be put in place. Financial markets would be disrupted and sterling would come under further downward pressure. The UK's capacity to influence key European decisions on trade and financial regulation would be substantially eroded. Overall, growth and employment would be damaged not just in a difficult transitional period but also more permanently.

Neil Williams, group chief economist, Hermes Investment Management: The only real precedent we have [of a country leaving the EU] is Greenland, whose 'soft' exit in 1985 left it as an associate member still subject to EU treaties. If the Brexit goes ahead, a similar result probably awaits the UK. Yet, for what it's worth, Greenland's negotiating process between referendum, sparked by home-rule and fishing rights, and departure took three years. So, a risk with the UK – much larger and, after 43 years, far more entwined in the European »

THE ISSUES

- THE IMPACT OF MIGRANT FLOWS
- CONSEQUENCES OF A BREXIT FOR BOTH THE UK AND EU
- THE EUROZONE CRISIS
- THE EUROPEAN POLITICAL SCENE



THE UNCERTAINTY ARISING FROM THE FORTHCOMING UK REFERENDUM ON THE EU IS ALREADY HAVING AN IMPACT ON STERLING ***David Riley***

project – is it would need even longer than this! This would make Brexit look like a long, drawn-out 'can of worms'.

David Riley, head of credit strategy, BlueBay Asset Management: The uncertainty arising from the forthcoming UK referendum on whether to stay or leave the EU is already having an impact on sterling, which has fallen by more than 7% against the euro since the beginning of December. The uncertainty generated by a pending and closely contested EU exit referendum could discourage consumption and investment spending and result in weaker growth in 2016 than currently forecast.

A vote in favour of exit from the EU would render the medium-term outlook highly uncertain and generate volatility in financial markets until businesses and investors have clarity on the terms of the UK's exit and its ongoing commercial and trading relationship with the EU. In my view, it is easier to identify the negative implications for the UK economy of leaving the EU than the benefits.

Mr Buiter: The UK would be in dire straits for years to come. First, there would be a period of at least two years during which there is great uncertainty about the terms for future relations with the UK, including access to the single market and passporting of financial institutions, that the EU27 would impose on the UK. This would depress investment significantly.

Second, the terms of the arrangement ultimately offered would be much worse than those enjoyed by Norway, Iceland or Switzerland. This is not because the EU27 want to punish the UK for having the temerity to exit from the club but '*pour décourager les autres*' – to prevent other EU member states from emulating the UK example.

Third, the UK would start to break up the day after the referendum comes down in favour of Brexit. First, Scotland will demand another referendum. With the prospect of continued EU membership and the easy adoption of the euro as Scotland's new currency, the Scots would vote to leave the UK. They could be followed with a lag by Wales and Northern Ireland. At that point it would make sense for Greater London, the area inside the M25, say, to secede from England, join the EU and adopt the euro.

Mr Magnus: The country will experience an intensive debate in months to come, much of it about economic issues which most voters will either not understand or care about. But economically speaking, the UK's economic position would be compromised, and importantly, that goes for the City of London too.

A full audit on the negatives would have to await the negotiated terms under which the UK would leave, but even before those are known, it is likely that the pound would come under pressure, foreign investors in UK financial and physical assets would very likely reconsider their strategies, and the UK might no longer be seen as the obvious springboard to the European continent. The UK would have to build new relationships in trade and commerce, and come to terms with the consequences of what would probably be new European Central Bank [ECB] and other European regulations governing the domicile of institutions choosing to make markets and transact in euro-denominated instruments.

HOW WOULD THE EU BE AFFECTED ECONOMICALLY AND POLITICALLY?

Mr Ellis: The economic impact on the EU would be small. But the political impact may be more profound. The UK is a large, rich economy that already has freedom from two main aspects of European integration; the single currency and the Schengen Area. If it can choose to leave despite those freedoms, other countries may increasingly adopt a more isolationist path.

Mr Riley: As the third biggest economy in Europe, a Brexit could prove a damaging loss for the EU economically as well as politically. In terms of the latter, the failure of the EU and the UK to reach an arrangement to keep the UK in will be viewed by the rest of the world as a sign that the faultlines in the 'European project' are becoming ever greater and potentially spur populist and 'eurosceptic' political parties across Europe. In the UK, the pressure for another referendum on independence for Scotland would also return to the political agenda.

Mr Buiter: The effect would be negative, but much less dramatic than the impact on the UK. Trade diversion policies would transfer much of the euro-related business currently conducted in the City of London to eurozone member states. The EU is already a political dwarf when it comes to 'hard power'. Without the UK it would also be severely diminished as a wielder of 'soft power'. The EU has

benefited from the more liberal/less dirigiste political culture of the UK, which would be sorely missed.

Mr Magnus: My own view about this is that what seems like a small island, esoteric matter could have regional consequences, if other countries in the EU with 'issues' vis-à-vis Brussels saw an opportunity to press their cases more firmly and or threaten to leave as well. There might well be economic consequences for the EU from losing a large member, especially if this entailed significant changes to the single market and to British involvement in European trade and commerce. Uncertainty, and what some might see as another example of 'EU disintegration risk', could have a deleterious impact on business confidence and investment on the part of both European companies and foreign investors.

■ IS THE EUROZONE CRISIS OVER?

Mr Ellis: No. Greece still faces a long and perilous path before it can genuinely stand on its own two feet. And other countries – notably Portugal – still face significant fiscal challenges. Recent political developments suggest that governments may increasingly challenge Brussels on 'orthodox' policies this year.

Neil Williams: Mario Draghi [president of the ECB] is doing a good job at addressing the symptom – deflation. But, he alone cannot be expected to snuff out the problem – a monetary union still devoid of economic union. My own 'competitiveness analysis' shows this will take years to solve. Germany remains the head-and-shoulders 'competitiveness winner' since the euro, with Italy and Spain making great strides to become 'more German' in this respect.

But others, such as France, are lagging and Greece's €86bn sticking plaster will come unstuck in 2016, with another debt restructuring needed. Thankfully for financial markets at least, four-fifths of that debt is held 'within the family', by the International Monetary Fund and the ECB rather than private participants.

Meantime, the ECB cannot rely on the US Federal Reserve's gentle tightening path to do the work for it. So, with few options available, expect further forays into the unconventional policy measures of 2014 and 2015. And bottom line: the absence of fiscal union – unlikely in 2016 or 2017 as it's hardly a vote winner in Germany – leaves Mr Draghi as the only 'government' the euro has!

Ms Revoltella: Through the exceptional ECB intervention, fragmentation of the euro area financial market has been substantially reduced. At the same time, the exceptional crisis response of the past few years has helped lay the foundations for much-needed institutional strengthening.

Particularly relevant are the efforts in the context of the banking union and capital market union. Single supervision for systemic banks is in place. A single resolution mechanism is agreed, as well as single resolution fund which allows for bridge financing by member states. The framework for deposit insurance should be a next step and the European Commission proposal is being discussed. Advancing those reforms and granting a proper separation of the sovereign/bank risk is crucial.

However, the long-term challenge is not only related to the financial sector. On the fiscal side, strengthening the European semester and the execution of the stability and growth pact is important. Countries also have to look at the long term, addressing the deep causes of low potential growth. More solidarity among eurozone countries should be associated with stronger efforts in terms of overall competitiveness and sustainability.

But there is one absolutely crucial issue. The challenges ahead for the euro area are acute and profound. At the same time, the political cohesion required to address them is sometimes being strained. Strong political leadership in the euro area is needed. It is interesting to see that during the eurozone crisis the most proactive policy originated from a non-political institution such as the ECB.

Mr Collyns: The critical phase of the eurozone crisis seems to be over. Even during the most extreme moments last summer, when it seemed that Greece could be forced out of the currency union, we saw very limited impact on broader market conditions given the firewalls that have been created to protect other countries from cross-border contagion, the ECB's commitment to quantitative easing, and reforms and policy adjustments being implemented elsewhere in the periphery. Today, Greece's economy is starting to turn around and other countries in the periphery are sharing in the broader expansion, especially Spain and Ireland, which have done much to achieve competitive economies.

But there are still chronic problems. Much work remains to be done to advance reform agendas in individual countries to ensure they can live within a currency »

RECENT POLITICAL DEVELOPMENTS SUGGEST THAT GOVERNMENTS MAY INCREASINGLY CHALLENGE BRUSSELS ON 'ORTHODOX' POLICIES THIS YEAR
Colin Ellis

OF COURSE THE CRISIS IS NOT OVER. NON-FINANCIAL SECTOR DEBT AS A SHARE OF GDP IS HIGHER TODAY THAN IT WAS AT THE BEGINNING OF THE GREAT FINANCIAL CRISIS

Willem Buiter

zone. The banking sector faces significant headwinds including asset quality risks, the decline of profitability, and the decline of valuations. And the broader financial architecture still needs to be completed, including, for example, steps towards banking union.

Political vulnerabilities are also a major challenge. Years of high unemployment and slow or negative income growth have led to rising populism and threats that the policies needed to sustain countries within the eurozone could be rolled back. The difficulties in dealing with the refugee crisis are exacerbating the political strains.

Mr Riley: While the acute short-term, life-threatening phase of the eurozone crisis is over, the long-term problems remain chronic. Progress is being made towards banking union – a necessary but not sufficient condition for a well-functioning economic and monetary union – but greater fiscal integration remains a distant prospect. The EU's struggle to develop a unified and coherent response to the migrant crisis is fuelling political fragmentation rather than unity across the continent.

Recent elections in Spain and Portugal have shown the political limits to the austerity-led policy response to the eurozone crisis but without offering a coherent alternative. Greece remains mired in recession and another destabilising stand-off between the Syriza-led Greek government and other member states – more nervous creditors than 'partners' – would not be a surprise. And after the ECB dampening the fire of the eurozone sovereign debt crisis, the ECB has also been left to clear up and generate growth. Yet Europe has demonstrated resilience and an ability to adapt and it will continue to do so, even if the catalyst for change will be periodic episodes of political and economic crises.

Mr Magnus: We can't say it's over until there is confidence that the path to economic recovery looks secure and/or that there is a satisfactory mechanism or mechanisms for addressing the large debt burden that will continue to afflict Greece and some other European countries. Greece still seems the country 'most likely to' fail, that is, to meet demanding economic targets, and to deliver hope to its citizens that there is a way out. The immigration crisis isn't making things any easier. A re-run of Grexit concerns at some point, even if not in 2016, seems quite likely. For the time being though, the eurozone economy is likely to continue on a path of modest expansion, and the Tsipras government is willing to go along with its creditors. We will have to refresh both these statements regularly, especially as and when a new economic downturn occurs.

Mr Buiter: Of course [the crisis is] not [over]. Non-financial sector debt as a share of GDP is higher today than it was at the beginning of the great financial crisis. The banking sector has too many small, inefficient banks and remains poorly capitalised. The separation of national sovereigns from 'their' banks has barely started. The sovereign risk spreads of Italy, Spain and Portugal are only contained because of the asset purchases of the ECB and the [maybe] mistaken belief in the private sector that if necessary the ECB would purchase the entire outstanding sovereign debt of a near-insolvent sovereign. A sustained increase in the growth rate of potential output in countries such as Italy is necessary to restore fiscal sustainability. A Grexit continues to be a material risk.

■ WHEN LOOKING AT GENERAL ECONOMIC OUTLOOKS, WHICH EUROPEAN COUNTRIES WILL BE THE ONES TO WATCH IN 2016? AND WHY?

Ms Revoltella: The political landscape was already pretty loaded in the autumn of 2015. In 2016, European economic growth could be stifled by very material political risks, as recorded by the most recent wave of Euro-barometer surveys: overall, euro area integrity can still not be seen as a given. While euro area institutional building has continued to move forward in 2015 in a way that should be commended, countries mired in deep recessions such as Greece and Finland may still contemplate domestic-focused policies, potentially raising uncertainty and instability.

The institutional tension arising between the regional government in Catalonia and the central government in Madrid, together with an overall strengthening of populist political movements across Europe, pose further political risks. Further negative developments in Ukraine's separatist crisis should also be watched carefully. And, of course, the UK referendum on EU membership is looming. It makes sense to be particularly aware of this complex constellation at a time when Europe is putting a great deal of effort into thinking about its future.

Mr Magnus: Other than the UK/Brexit debate, and Greece's capacity to cope with its own circumstances, the biggest concern I

have for this year is Germany, loosely, and Ms Merkel, specifically. She has come to be seen almost as the glue that keeps Europe together. She may be followed by a more than adequate replacement [or even have another shot at elections in 2017 herself], but losing her might be a shock that would not be easily absorbed.

Mr Williams: Despite China's slowdown, the likelihood that Greece will reappear on the radar, and further US Fed rate hikes to come, European growth should not be completely derailed. But, clearly, these are headwinds, and another reason for the ECB to keep pumping in cash and the US Fed and, ultimately, the Bank of England to take only the smallest baby steps to normalising rates.

After impressive gains, there may be a limit to how far Spain and Italy can reform, given male youth unemployment rates of 48% and 38%. Their real household spending is still 6% to 10% down on 2008, yet Germany's is 7% up. Then there's Greece, whose deflation improved competitiveness, but exacerbated its real-debt dynamics.

All this, and Japan's scary deflation precedent still in the background, leaves the ECB ready to act – whatever the US Fed's doing.

Mr Ellis: I will be looking closely at Italy, Sweden and – in the broader Europe, Middle East and Africa region – Turkey.

Italy has enacted several reforms, for instance to the pension system and the labour market. Further reforms are planned this year to the senate, which – together with electoral reforms already passed – could increase political stability and effectiveness. However, if structural reforms do not raise growth much above 1% on a sustained basis, Italy's gradual relative decline may continue.

In contrast, Sweden has seen healthy growth, declining unemployment and the public finances are very strong, relative to other European countries. The Riksbank took the bold step of launching quantitative easing [QE] and cutting policy rates [to below zero] to try to preserve the nominal anchor; as yet, the jury is still out as to whether this has had the desired effect.

Turkey continues to see growth despite substantial external vulnerabilities, notably a large current account deficit and high external debt. It has also recently been buffeted by significant geopolitical risks, which will continue to play an important role in the global economy, and the current refugee crisis. As such, Turkey is likely to be an important bellwether for the global economy: if it is able to enact economic reforms and steer a course towards calmer waters, that should give investors more confidence that global growth will be resilient.

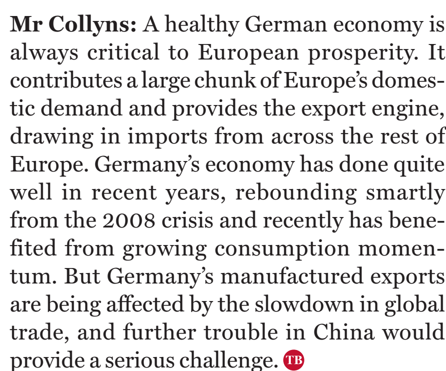
Mr Riley: Weak global demand and falling commodity prices have already prompted Mr Draghi to hint of more 'whatever it takes' monetary stimulus. The ECB is likely to delve deeper into negative interest rate territory and extend its bond-buying programme sooner rather than later. But even QE in economic and financial terms is subject to the law of diminishing returns and the spread of negative yielding debt distorts the capital allocation process. The danger is that further interest rate cuts and QE is simply perceived as currency manipulation and encourages a race to the bottom by global central banks.

We expect growth in both Germany and France to be slightly higher in 2016, about 1.5% to 1.75%, but further evidence that the recovery is broadening beyond the 'core' is key for investor confidence in its sustainability. And investors should not ignore the smaller but typically more dynamic economies of central and eastern Europe, such as Poland and Hungary.

Mr Buiter: Ireland will continue to outperform, with the only threat to an extended period of high growth being excessively procyclical fiscal policy. Italy must pass the constitutional reform in the referendum later this year. This is a necessary condition for the deep supply-side reforms required to raise the country's growth rate of potential output from its current level of about 0%. This in turn is a necessary condition for avoiding eventual sovereign debt restructuring.

Spain and Portugal: will there be a reversal of reforms? France: will growth continue to be so miserable that even tactical voting in the 2017 presidential elections will not suffice to prevent President Marine Le Pen from meeting with President Donald Trump?

Mr Collyns: A healthy German economy is always critical to European prosperity. It contributes a large chunk of Europe's domestic demand and provides the export engine, drawing in imports from across the rest of Europe. Germany's economy has done quite well in recent years, rebounding smartly from the 2008 crisis and recently has benefited from growing consumption momentum. But Germany's manufactured exports are being affected by the slowdown in global trade, and further trouble in China would provide a serious challenge.



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