CER Bulletin

Issue 96 | June/July 2014

Business as usual is not acceptable

By Charles Grant

The eurozone economy needs a kick-start

By Christian Odendahl and Simon Tilford

Will Europe scratch Japan's back?

By Rem Korteweg

CENTRE FOR EUROPEAN REFORM

Business as usual is not acceptable

by Charles Grant

In Britain, Denmark, France and Greece, anti-establishment parties won the most votes. But the European elections were less of an earthquake than some have proclaimed. Only about 150 of the 751 MEPs elected are hostile to the EU. The moderate parties will collaborate to ensure that the Parliament does its job of passing laws. Indirectly, however, the elections will have big consequences for the EU – particularly through their impact on national politics in countries like Britain and France.

In Britain, despite UKIP's victorious score of 27 per cent, David Cameron's Conservatives, on 24 per cent, look somewhat stronger than the opposition Labour Party, on 25 per cent. This is because British governments usually regain support in the run-up to a general election (the next one is due in May 2015). Many UKIP voters – having made their protest – are likely to return to the Conservatives, to keep Labour out. Cameron will also profit from the economic recovery. Labour could still win the next election, but the chances of a Cameron victory – bringing about the in-out EU referendum that he has promised for 2017 – have grown.

Marine Le Pen's Front National won 25 per cent in France, humiliating François Hollande's Socialists, who scored just 14 per cent. The French political system is drifting in a eurosceptic direction. Never popular in France, 'Brussels' will be bashed more often. Nicolas Sarkozy, the former Gaullist president, has called for the Schengen agreement on passport-free travel to be suspended and for half the EU's powers to be repatriated. The Gaullist movement's old wounds over Europe are reopening (in recent years the pro-EU wing has predominated). The left wing of the governing Socialists, who dislike the EU for its economic liberalism, is emboldened: it will try to stop Hollande pushing through the market-friendly reforms that would strengthen the economy.

An introverted France, riven by arguments over Europe, and weakened by a sluggish economy, will be unable to rebalance the currently uneven Franco-German relationship. Germany's strong economic performance, the high electoral scores of its governing parties and Chancellor Angela Merkel's personal authority will all reinforce German leadership of the EU.

Britain's waning influence, a consequence of its possible departure, is one reason for German dominance. But Italy, seldom an influential EU country on account of its weak governments and stagnant economy, now has a chance to become more assertive. The 41 per cent won by Prime Minister Matteo Renzi's Democratic Party may give him the credibility to push through badly-needed reforms at home – and to work with France and others to soften austerity in the eurozone.

Poland's imprint on the EU has been growing, partly through its teaming up with Germany and France in the 'Weimar triangle'. This trio has helped to lead the EU's response to the Ukraine crisis, and has also made a difference in discussions on energy and defence. Both Prime Minister Donald Tusk's governing centre-right party, and the mildly eurosceptic opposition, performed well in the elections, which will do nothing to diminish Poland's clout.

Even before the elections, the chances of a new EU treaty in the next few years were slim. But the surge of support for anti-establishment parties have made a new treaty even less likely. The French government is not alone in believing that a new treaty giving more powers to the EU could not be ratified – by parliamentary vote or referendum – in several member-states. Those who believe that a healthy euro requires a significant centralisation of economic decision-making, and thus a major new treaty, will be disappointed. If and when the euro needs a fix, it will be done without treaty change or through small treaties, which may not involve the whole EU, such as the recently negotiated agreement on a bank resolution fund. Germany would like some small treaty changes but is in no hurry. It understands that most EU governments are opposed.

That is a problem for Cameron. His plans to renegotiate the terms of British membership assume that the euro's problems will require a new EU treaty and thus a British signature, enabling the UK to extract concessions from its partners. Yet there is scant chance of a new treaty in time for Cameron's 2017 deadline. In fact most of the ideas for EU reform that he has floated could be adopted within the current treaties. But many Conservatives expect the repatriation of powers through treaty change, and he needs to lower their expectations.

In one respect, the European elections may help Cameron. When he says that the EU is in urgent need of reform, more of his fellow leaders are likely to agree. It is hard for them to defend business as usual. France, which has hitherto shown little interest in helping Britain reform the EU, may think again, particularly on issues like cutting red tape. British, German and Dutch efforts to reinforce subsidiarity, through enabling national parliaments to question Commission proposals, may gather support. And Cameron's desire to curb the right of EU migrants to welfare benefits resonates in many northern member-states, where hostility to immigration has boosted support for populists.

"The European Council should choose a heavyweight president who can communicate well, with economic experience."

A lot of governments will agree with Cameron and Merkel that the new European Commission, due to take office on November 1st, should focus on growth and employment – for example by negotiating more trade deals, extending the single market and investing in infrastructure and innovation. But the Commission will have to grapple with a paradox: Europe's poor economic performance has nourished the anti-establishment parties, yet some key measures that would improve that performance, notably those involving liberalisation, are opposed by most populists. That is why the Commission needs vigorous leaders who can not only set out a clear agenda for boosting growth, competition and innovation at EU and national levels, but also explain why change is needed and ensure help for those who may be disadvantaged.

The Commission needs a tough and effective president who can shake up the institution as well as work with both national governments and the Parliament. Therefore EU leaders should scrap the idea of designated candidates for the presidency – promoted by the Parliament and the pan-European political parties – which, if adopted, would result in a weak president. Jean-Claude Juncker, a former Luxembourg prime minister, is the designated candidate of the centre-right European Peoples Party. Now that the EPP has won the largest number of MEPs, the Parliament demands that he be anointed.

The European Council should resist this parliamentary power-grab. Juncker is a business-as-usual candidate, scarcely known outside Brussels, who wants more powers for the EU but has never talked seriously of EU reform. The treaties say the European Council should take into account the election results when choosing the president. That probably means they should appoint someone from the EPP. They should go for a heavyweight who can communicate well, ideally with economic expertise. Christine Lagarde, the French managing director of the IMF, is one potential president who would fit the bill.

Charles Grant
Director, CER

CENTRE FOR EUROPEAN REFORM

The eurozone economy needs a kick-start

by Christian Odendahl & Simon Tilford

With Greek banks raising €8.5 billion worth of equity from investors, Italian government bond yields touching all-time lows, and the German economy growing at an annualised 3.3 per cent in the first quarter of 2014, the eurozone appears to have finally overcome the crisis. Despite such positive news, there is ample reason for caution about the outlook for the currency union. Unless eurozone policy-makers do more to bolster demand and target structural reforms on product as well as labour markets, optimism is likely to prove short-lived.

Eurozone optimists usually base their case on a subset of the following seven arguments. First, the world economy is bound to grow faster: the IMF estimates that world growth will be 3.6 per cent in 2014, up from 3 per cent in 2013. This should raise demand for European exporters.

Second, confidence is returning to businesses and consumers in Europe. According to survey evidence both are above their long-term averages, with consumer confidence back at 2006 levels.

Third, prices and wages in southern economies have fallen relative to those in the eurozone 'core', compensating for some of the exuberance before the crisis and slowly making firms and workers competitive on European and world markets.

Fourth, reforms to the structure and institutions of some eurozone economies will have a positive impact on economic growth. For example, most countries have improved their rankings in the World Bank's Ease of Doing Business Index, and labour markets have become more flexible, according to the OECD.

Fifth, after years of low investment and consumption, consumer goods (for example, cars and fridges) and machinery equipment need replacing. This pent-up demand will give impetus to the eurozone economy.

Sixth, the largest economy, Germany, is on course to grow robustly. With record employment, relatively low debt levels and long anticipated increases in real wages, domestic demand will help to rebalance the eurozone economy, and push up German prices and wages compared to those in periphery countries.

Finally, the eurozone financial sector is being repaired. The ECB is currently inspecting the banks' balance sheets, forcing them to realise losses and raise capital. This will make room for new loans to businesses, softening the credit crunch in the most affected countries such as Italy and Greece and allowing for new investment. A common rule book for future bank rescues should also reduce uncertainty around European banks by making plain what bank investors have to lose in case of a crisis.

Unfortunately, these seven reasons for optimism are matched by just as many reasons for pessimism about the outlook for the eurozone. First, a growing world economy is certainly a welcome source of demand for European producers. But the rising export dependence of the eurozone means that any hiccup in the world economy – perhaps as a result of a sharp slowdown in China – will have stronger effects on the eurozone recovery than if the recovery were more balanced.

Second, while overall confidence is improving, it is volatile and uneven: consumer confidence, for example, is weak in France but high in Germany, and Italian firms' optimism is muted. What is more, hard data are following such survey evidence less closely than in the past – positive sentiment might not be a precursor to stronger consumption and investment.

Third, the adjustment in relative prices and wages is being undertaken under the pressure of very high unemployment. Since jobless workers and those suffering pay freezes are unlikely to consume more, such adjustment has negative side-effects which in the short run exceed the gains from increased export competitiveness. Moreover, persistently high unemployment continues to erode skills and therefore productivity.

Fourth, the structural reforms have so far focussed on labour market liberalisation rather than opening up product markets, which are more important for productivity gains. The 'competitiveness' of a country, properly defined, is not just about relative price competition but about investment, innovation and genuine productivity growth. If the eurozone continues to focus on 'price competitiveness' rather than productivity gains, the recovery will remain anaemic: wage cuts hurt demand, while lack of investment and loss of skills damage growth potential.

Fifth, inflation is very low across the eurozone but especially so in countries that are most in trouble. This makes real interest rates – interest rates corrected for inflation – highest in Italy, Spain and Greece, and lowest in Germany and Austria, which is the opposite of what is needed. Such inverted real interest rates are a natural feature of a monetary union, but hold back the needed recovery in investment in the depressed economies. Low inflation also makes it harder to reduce debt burdens (both private and public), thus extending the period in which households and firms cut back on spending, in turn hurting demand and the economy.

Sixth, the German economy is currently strong but unlikely to grow fast enough to provide the demand stimulus needed in southern Europe. The good first quarter was an outlier reflecting the impact of a mild winter. Investment is held back by a lack of competition in many service sectors, uncertainty about energy prices and weak public spending on infrastructure. Another problem is that German exporters are reluctant to raise wages as a lack of demand from Europe is hurting their business; and German consumers are only slowly becoming more confident about spending.

Finally, the financial sector is still fragmented along national borders, despite progress on the banking union. Since further institutional progress is unlikely, this fragmentation will persist and make divergent real interest rates worse: Italian banks and companies will still have to pay more to investors for the mere fact of being in Italy.

In summary, the positive trends in borrowing costs and consumer and business confidence have not so far been reflected in hard data: the eurozone economy is barely growing, unemployment remains near record levels and deflationary pressures are strong. The reason is that most economies suffer from a lack of demand: households and governments are cutting back spending, firms are hardly investing and the world will only buy so much of what Europe produces. At the same time, Germany will not grow fast enough to help its eurozone peers out of their malaise.

If the eurozone is to grow as strongly as it should, given the depth of the slump, policy-makers need to do more to support demand. The ECB should deploy all available tools aggressively to lift the expectations of consumers and investors, and weaken the euro. Fiscal policy should be supportive of growth, particularly in countries that can easily afford it, like Germany – which needs to invest more in research, education and infrastructure for its own sake. Finally, structural reforms need to be targeted at boosting competition in product markets and productivity, not just at lowering wages. This entails taking on powerful vested interests in the service sector, especially the professions. Unfortunately, progress on all three fronts is slow, despite the ECB's latest efforts suggesting that much of the current euro optimism is misplaced.

Christian Odendahl
Chief economist, CER

Simon Tilford
Deputy director, CER

Will Europe scratch Japan's back?

by Rem Korteweg

What do 'little green men' in eastern Ukraine and an oil rig in the South China Sea have in common? To Japanese politicians and officials, they are the copy-cat tactics of two major powers challenging the status quo in their neighbourhood. Tokyo says Russian and Chinese behaviour is similar and that democracies, including in Europe, must club together. But Europe is too pre-occupied with the Ukraine crisis and the aftermath of the European elections to take such a global view.

When in May a Chinese oil company sent an oil rig into waters claimed by Vietnam, it was the latest in a series of provocations in the contested maritime zone. Tokyo likens Chinese assertiveness in the South China Sea to Beijing's bellicose attitude towards the Senkakus, an island group in the East China Sea controlled by Japan, but which China claims under the name Diaoyu. Chinese merchant vessels, fishermen and aircraft regularly cross into Japanese waters and airspace, increasing the risk of a serious conflict. The Japanese government is struggling to develop a strategy for dealing with such non-military provocations, which it describes as the 'grey zone' between peace and war. They see an equivalent with the pro-Russian militants, who wear uniforms without insignias, who have destabilised parts of eastern Ukraine. Japanese officials warn that Russia's annexation of Crimea could embolden China.

The Japanese government does not want to be alone in responding to China's assertiveness. It hopes South-East Asian countries will overcome their differences and push back against Chinese bullying, but ultimately Japan counts on the West; particularly the US, but Europe's support would be welcome too. The Ukraine crisis coincided with Prime Minister Shinzo Abe's visit to six European countries, the EU and NATO, where Abe drew parallels between Russian and Chinese revisionist behaviour.

The struggling economies of Europe and Japan both depend to some extent on their large, difficult neighbours. Europe imports Russian oil and gas, and exports manufactured goods in return; Japan relies on China both as a market and a source of high-tech components. But here the similarities end. In Europe, there is little support for sacrificing economic relationships to punish Russia. In Japan, the government wants to reduce its vulnerability to China by deepening trade ties with others. This is why Abe strongly backs the US-led negotiations for a 'transpacific partnership' and an EU-Japan free trade agreement. The EU and its member-states often overlook the geopolitical significance of such trade deals.

China's actions have also convinced Japan to strengthen its military – and reinterpret its pacifist constitution – while in Europe a post-Ukraine defence renaissance is uncertain. Many in the EU believe that Russian encroachment will stop at the EU's borders, but the Japanese fear their territory is not safe from China's ambitions.

An increasingly impatient Japan doubts Europe's geopolitical resolve. Shigeru Ishiba, number two in Japan's ruling party, asked what signal Western indecision following Syria's chemical weapons attack in August 2013 sent to Moscow. Japanese officials also note Russia's violation of the 1994 Budapest memorandum, guaranteeing Ukraine's territorial integrity, and question whether the West has gone soft on defending the international rule of law. The EU's half-hearted effort to prevent Russia from destabilising Ukraine makes Japan uncertain that it could count on Europe's support in the event of a crisis with China. Japan worries that the EU is too focused on its own problems, handicapped by rising isolationist populism, and willing to sacrifice its values for economic gain.

EU countries should not forget that Japan helps to defend European security interests, and hopes – at least implicitly – for reciprocity. Tokyo contributes to counter-piracy efforts in East Africa and enforces sanctions against Iran. It funds development initiatives in the Palestinian territories and Afghanistan; an anti-terrorism programme in the Sahel; relief operations in Syria; and the destruction of Syria's chemical weapons. Like other members of the G7, it has imposed sanctions against Russia; a move that Russian president Vladimir Putin has called surprising. It could be costly for Tokyo: Japan hopes to make progress on resolving its territorial dispute with Russia over the Kurile islands, seized by the Soviet Union at the end of the Second World War; and to buy more Russian gas, to compensate for Japan's energy shortfall following the Fukushima nuclear disaster. Tokyo now also faces a possible Sino-Russian rapprochement, after Beijing and Moscow signed a major gas deal on May 22nd.

European leaders declare that "geopolitics is back", but EU member-states show little interest in committing more to East Asian security. For many, East Asia is a place to talk business, not hard security. Germany, for instance, has close trade ties with Beijing and prefers to avoid controversy, and the EU confines itself to bland statements of concern over security developments in the region. France and Britain, Europe's two most capable countries, could do more. Unfortunately, London is handicapped by its tricky relationship with the EU and Paris is burdened by its economic woes and deeply committed in the Sahel. But Europe must take Japanese worries more seriously. At the very least, it should see that allowing borders in Europe to be changed through coercion sets a bad precedent for East Asia.

Rem Korteweg
Senior research fellow, CER

CER in the press

New York Times
1st June 2014
"In the UK, the recession has given an added piquancy to anti-immigrant backlash," John Springford [of the CER] said. "When people's prospects are being squeezed, migrants are an easy culprit."

Financieel Dagblad
7th April 2014
"The problems of Eastern European states that are most dependent on Russian gas will not [only] be solved by importing more LNG", said Rem Korteweg of the CER, a think-tank in London.

The Express
10th April 2014
"Britain within the EU but not in the euro is not a problem – if we stay in the EU but resist getting involved in further integration with the eurozone, that is fine – but if we were to leave, the City would over time be vulnerable to regulatory attacks" said Simon Tilford of the CER.

Financial Times
8th May 2014
The CER has concluded that if Britain left the EU, banks would shift some of their activities to elsewhere in the EU. "The remaining member states would insist that Britain sign up to many [financial] rules, in exchange for more limited access to European markets than it currently enjoys."

The Wall Street Journal
15th May 2014
"We're seeing a cyclical pickup in activity, but it's anaemic given the depth of the slump," said Simon Tilford, deputy director of the CER in London. "Typically, you'd expect faster growth in the aftermath of such a recession."

The Telegraph
19th May 2014
"The reality is that China now holds the whip hand [on the gas deal with Russia] and they will drive a very hard bargain. For them this is just commerce," said Ian Bond, from the Centre for European Reform.

The Guardian
18th May 2014
The euro could be reformed along the lines proposed by Charles Grant, of the CER. This would involve throttling back on austerity, creating a banking union, structural reform in countries such as Italy to make them more competitive, rejigging the German economy to make it less export-focused, and a partial debt amnesty.

Recent events

Sir Andrew Wood

May 20th
Roundtable launch of CER policy brief 'The EU and Russia: Uncommon spaces', London
With Sir Andrew Wood

April 9th
Breakfast on 'What priorities for EU energy policy in 2014?', Brussels
With Dominique Ristori

Dominique Ristori

Jonathan Faull

April 7th
Dinner on 'The future of Europe's single market', London
With Jonathan Faull

March 12th
Roundtable on 'The UK-EU relationship' and 'The future of Ukraine', London
With Carl Bildt

Carl Bildt

Forthcoming publications

The economic consequences of leaving the EU – The final report of the CER commission on the UK and the EU single market

How to finish the euro house
Philippe Legrain

Why Europe needs a security strategy for the Asia-Pacific region
Rem Korteweg

Ten things everyone needs to know about the European Court of Justice
Hugo Brady

To read all of our recent publications please visit our website.

For further information please visit
www.cer.org.uk