Challenges Facing Europe Today

Europe continues its two-steps-forward, one-step-back progress towards a full exit of the sovereign debt crisis. Market spreads have compressed significantly and countries are facing low to non-existent refinancing risks. Eurozone growth continues to be sluggish and the European Central Bank (ECB) is under pressure to address the low inflation and “strong” currency scenario currently facing the economic area. Additionally, political pressures are starting to mount in response to continued austerity measures and high unemployment. Recent changes in administrations in France and Italy have again raised the general debate on the balance between cultivating sustained growth and reforming the economy through austerity measures. Europe’s countries must again decide how they will interact with each other while conducting themselves under the Growth and Stability Pact (the Pact). These structures and relationships are immature and need to be seasoned and reworked to appropriately address the challenges of the region. Low growth and continued austerity have placed the majority of European leaders under pressure from their electorates, especially given the European Parliamentary elections in late May. With this in mind, there is likely to be significant amount of push and pull between sovereign governments and the European Commission around new budgets and deficit targets. This dynamic should not be viewed negatively, but as part of the natural maturing process of the new institutions and structures. The governments of member states and the European Commission will find the space within the Pact to be more flexible around targets and more accountable when times are good. Full compliance should be viewed less as a destination and more of a journey; increasing progress towards meeting the targets should be sufficient to keep markets on side and an environment conducive to growth.

Reform and Growth

From a national perspective, the new governments of France and Italy have brought new promises of reform and growth. In France, devastating losses at local elections in March at the hands of right and centre right parties, prompted President Hollande to dismiss his cabinet, install new leadership and circle the wagons. With three years left of his term, President Hollande’s popularity is at an all-time low and he has not been able to deliver on any of his proposed reforms, despite the former strength of the socialist party in parliament. His new Prime Minister, Manuel Valls, hails from the more business-friendly part of the socialist party and immediately set about strengthening the administration’s resolve to carry through with Hollande’s Responsibility Pact and additional tax cuts. These tax cuts could be a significant step towards helping France increase competitiveness and could contribute to job growth. Yet they are currently unfunded and would make France’s other pledges to address its deficit and meet a 3% of GDP target for its deficit in 2015 difficult, despite the extension from the original 2014 target. Prime Minister Valls articulated a popular view in France that the government was not going to kowtow to EU austerity demands at the expense of growth. However, the administration lacks a core group of supporters in parliament and will likely find any new reforms difficult to pass. France should focus on delivering on the reforms and
building a more productive dialogue with the EU Commission. President Hollande has a very poor record of reform implementation and cannot expect the EU Commission to, again, meet the country halfway on the deficit target if France does not make the journey itself.

**Seeking Fiscal Expansion**

Prime Minister Matteo Renzi of Italy is discovering a similar phenomenon and, while he has a better reputation as a reformer, Italy has a poor track record of conducting reform without external pressure. Backed by rival parties as well as his own, the young mayor from Florence came to power at the end of February on a platform of significant reform. He has made some progress with tax breaks for lower earners and tackled the first step of electoral reform. He has also joined Prime Minister Valls in pushing back against the European Commission and the Pact and has called for room to support growth through fiscal expansion. In the recent budget and financial forecasts for 2014-18, Italy sticks mainly to its budget deficit targets in the short term, but it is hard to accept their aggressive growth numbers and progress on the deficit in the medium term. Italy will hold the presidency for the EU in the latter half of 2014 and has made it very clear that they will be working towards relaxing of the Pact during its presidency.

**Moving Forward**

During the height of the European sovereign debt crisis, authorities made multiple attempts at creating institutions and backstops before the ECB and the EU Commission were able to finally draw a line under market pressures in 2012. Now, under more normal circumstances, the national governments and the EU Commission must continue the work they did under extreme pressure, working to shape how they will use the rules to promote countercyclical fiscal policy. France and Italy are not alone in debate on how to balance reform and nurture growth. The Netherlands has delayed its compliance with the deficit rule in order to protect its nascent growth, whilst Spain received some reprieve from fiscal targets after its demonstrated commitment to reform plans. Even though Germany and Finland have criticised other countries for fiscal slippage, Germany itself backtracked on pension reform, creating unfunded liabilities as soon as 2018. The countries and the European Commission should not be so flexible or lackadaisical that they find themselves breaking all targets and parameters established to avoid a repeat of the crisis. There has to be a continued appreciation for the need to foster growth through appropriate structural reforms and accountability. It is a tall order to ask politicians to think about the long term and make painful political choices, which is why the region needs the European Commission and some oversight. There will be push and pull between these entities and between administrations and their electorates. However, as long as the general momentum is forward towards greater integration, stability and growth, the market is willing to support these measures and spreads are likely to stay range bound.

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