The Economist Intelligence Unit

EUROPE: OPEN FOR BUSINESS?

An overview of macroeconomic trends and business investment in Europe

A report by The Economist Intelligence Unit

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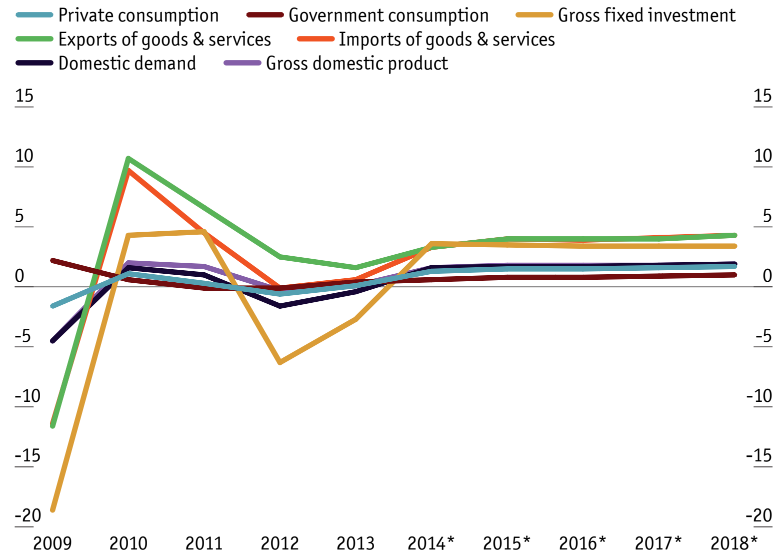
1 EUROPE'S FAST AND SLOW LANES

"Are we finished? The answer is no, we aren't finished here." That was the fighting talk from Mario Draghi, president of the European Central Bank (ECB), when in June 2014 he announced an unprecedented package of measures to avoid a deflationary spiral.

The double-dip recession Europe weathered between mid-2008 and the beginning of 2013 has left its economy fragmented and fragile. Ballooning budget deficits and worrisome sovereign debt levels have made fiscal discipline and structural reform a necessity in many European countries. Barring bright spots such as a resilient Germany, Europe's largest economy, and a resurgent UK, where economic prospects are looking healthier by the day, belt-tightening in Europe in the last few years has been a painful experience for many, highlighted by the fact that unemployment is hovering at around 11% across the EU28 group of nations. But is Europe on the whole about to turn a corner?

Growth forecasts for EU28

(% change per annum)



* Forecasts.
Source: The Economist Intelligence Unit.

Looking beyond the horizon

The contrasting fortunes of those European countries that are making a recovery and those still with their backs to the wall have given credence to the notion of a "two-speed Europe". It would be more apt, however, to speak of a five-speed European economy instead, ranging from contractions in 11 out of the 28 countries in 2013 to Latvia, Lithuania and Romania growing at more than 3%.

The recovery is likely to be stronger and more widespread in 2014. Poland and its smaller neighbours in eastern Europe will lead the pack with GDP growth of more than 3%. The recovery will stay relatively strong in the UK, Sweden and Germany, in part thanks to improved public consumption and business investment—with dynamic exports providing further stimulus in the latter two. Growth in France, Spain and Belgium will be soft to middling (between 1% and 1.5%), and only tentative in Finland, Italy, Greece and Slovenia (less than 1%).

By 2015 all EU28 economies should be growing again, with many of them registering GDP growth of between 1% and 3% (21 countries in 2015, as opposed to six in 2013). This is in marked contrast to the situation in 2013, when 19 European economies either shrank or expanded by less than 1% (see Tables 1 and 2).

Table 1: Growth rates in EU member states

Country	2013	2014*	2015
Belgium	0.2	1.4	1.6
Germany	0.4	1.8	2.0
Estonia	0.8	1.9	3.0
Ireland	-0.3	1.7	3.0
Greece	-3.9	0.6	2.9
Spain	-1.2	1.1	2.1
France	0.2	1.0	1.5
Italy	-1.9	0.6	1.2
Cyprus	-5.4	-4.8	0.9
Latvia	4.1	3.8	4.1
Luxembourg	2.1	2.6	2.7
Malta	2.4	2.3	2.3
Netherlands	-0.8	1.2	1.4
Austria	0.4	1.6	1.8
Portugal	-1.4	1.2	1.5
Slovenia	-1.1	0.8	1.4
Slovakia	0.9	2.2	3.1
Finland	-1.4	0.2	1.0
EU18	**-0.4**	**1.2**	**1.7**

Country	2013	2014*	2015
Bulgaria	0.9	1.7	2.0
Czech Republic	-0.9	2.0	2.4
Denmark	0.4	1.5	1.9
Croatia	-1.0	-0.6	0.7
Lithuania	3.3	3.3	3.7
Hungary	1.1	2.3	2.1
Poland	1.6	3.2	3.4
Romania	3.5	2.5	2.6
Sweden	1.5	2.8	3.0
UK	1.7	2.7	2.5
EU28	**0.1**	**1.6**	**2.0**
Memo items			
US	1.9	2.8	3.2
Japan	1.5	1.5	1.3

Source: European Commission, *European Economic Forecast Spring 2014*, European Economy 3/2014.
*Forecasts.

Table 2:
Five-speed Europe: Change in rates of growth for EU member states 2013-15

Growth rate	Negative	1% or less	1.1-2%	2.1-3%	3+%
2013	Ireland Greece Spain Italy Cyprus Netherlands Portugal Slovenia Finland Czech Rep. Croatia	Belgium Germany Estonia France Austria Slovakia Bulgaria Denmark	Hungary Poland Sweden UK	Luxembourg Malta	Latvia Lithuania Romania
2015		Finland Croatia Cyprus	Belgium Germany France Italy Netherlands Austria Portugal Slovenia Bulgaria Denmark	Luxembourg Malta Estonia Ireland Greece Spain Czech Rep. Hungary Romania Sweden UK	Latvia Lithuania Slovakia Poland

Sources: European Commission and The Economist Intelligence Unit.
*Forecasts.

Challenges persist

While improving economic prospects across the continent are a cause for optimism, a number of underlying challenges risk throwing the recovery off course. For one the impact of austerity by way of reduced public and private investment was such that average inflation in the euro zone during the first five months of 2014 fell below 0.5%, significantly short of the ECB's policy target of "near to, but below, 2%", raising the spectre of deflation, which can discourage household spending as consumers anticipate further price falls.

Moreover, lack of adequate access to credit for small and medium-sized businesses (SMEs) remains an issue, particularly for periphery economies, due to more stringent capital requirements and other regulatory changes for lenders. A recent paper from the IMF found that a high prevalence of SMEs, such as in Italy, Spain and Portugal, can have a detrimental effect on GDP growth when financial conditions are difficult.

Growing SMEs are therefore fundamental to economic recovery on the continent. They are also crucial to the prospects of large corporations in Europe. SMEs provide larger companies with access to specialised products and services; they commit resources to research and development (R&D) in specific areas that are often overlooked and they incubate talent and expertise that large corporations often tap into.

To address the risk of deflation and the shortage of credit, the ECB has been working on a series of stimulus measures. The latest set, announced in September 2014, includes a further reduction of the ECB's refinancing and deposit rates, respectively to 0.05% and -0.20%. Both are ten basis points lower than what had been agreed in June 2014, when the ECB became the first major central bank to set a negative deposit rate. The aim is to encourage commercial banks into lending more and stimulating demand; another factor that may also have played a role in the ECB's decision is the hope that lower interest rates tend to weaken the euro exchange rate, thus boosting exports.

Doing "whatever it takes"

The ECB's latest measures may mark a turning point for Europe's economy. But beyond euro zone and EU28-wide measures, there are a number of structural weaknesses within individual European economies that will have to be addressed at the national level.

France is a case in point. The country has so far shied away from any kind of deep restructuring of its economy, relying on continued growth in public spending and tax hikes to see it through the crisis. Government debt will peak at around 96% of GDP in 2015, according to Economist Intelligence Unit forecasts, with a real danger of investor sentiment turning sour if competitiveness fails to improve and public administration reform does not become a reality. The new prime minister, Manuel Valls, seems intent on doing what is necessary to make France competitive again by promising a freeze on tax rises, reducing the size of companies' social security contributions for employees and slimming down the public-sector budget. France's neighbours, Spain and Italy, have to make similar tough choices to address risks such as high rates of youth unemployment.

Despite its underlying challenges, however, Europe remains an attractive place to do business for several reasons. Will these be Europe's saving grace?

2 DOING BUSINESS IN EUROPE

Even amid the economic turmoil after the crisis, innovative European companies such as Skype were attracting the attention of suitors from far and wide. In 2011 the popular online voice and messaging service was bought by Microsoft for US$8.5bn—its largest acquisition to date. The US software company saw in Skype a significant source of innovation and growth; the economic uncertainty in Europe was no deal-breaker.

Spotting opportunity where others see risk is often a key to success in business, and a skill that a number of companies have put to good use with regard to Europe over the last few years. Like Microsoft, the cable company Liberty Global has been making big investments in Europe. In 2013 it even moved its headquarters from the US to London after its purchase of Virgin Media, a UK cable operator. “We started to focus on our core markets, and for us these are in Europe,” explains Jim Ryan, senior vice president and global strategy officer at Liberty Global. Over the last five years the company’s overriding strategy has been to concentrate its efforts in a few areas rather than spread itself thin. Previously active in 26 markets, the company is now present in just 14, of which 12 are in Europe.

For BT Global Services (BT Group’s global business-to-business arm), Europe is crucial too. “The UK and continental Europe are an extremely important part of our growth agenda,” says Tanuja Randery, president of strategy, marketing and transformation at the company. For some at least, then, the old continent’s still got it.

Europe’s crown jewels

Although Europe’s overall performance in the EIU’s business environment rankings has taken a knock since the onset of the global financial crisis, the high representation of west European countries in the top 20 is a testament to the continent’s enduring political stability, openness to global trade and broadly pro-market policies. A recent global survey carried out by EY, an auditing and consultancy firm, corroborates the importance of these qualities: 45% of the executives polled ranked Europe as their preferred investment destination, beating China (albeit by a small margin) for the first time since 2006. The study also found that when making decisions about where to establish new operations, executives seek above all else stability and transparency in the political, legal and regulatory environment—all of which Europe can offer.

For Liberty Global, Europe was an obvious choice for a number of reasons when it came to slimming down its global operations, explains Mr Ryan. First, European markets can offer relatively stable currencies and interest rates, which are crucial for companies that, like Liberty Global, have highly leveraged balance sheets. Second, the cost of debt is very attractive on the continent; coupled with merger and acquisition (M&A) opportunities, this has the potential to boost shareholder returns. Finally, Europe’s regulatory environment is stable and predictable, which cannot be said for many other parts of the world.

In speaking about the continent's strengths, Ms Randery instead focuses on developments in the digital economy, highlighting the availability of talent, skills and resources. Beyond that the continent's maturity and stability, despite the downturn, are key qualities, alongside the large financial services sector and the accessibility of financial capital.

Both Liberty Global and BT Global Services have managed to find the silver lining in the macroeconomic cloud that has been hanging over Europe. Liberty Global has tapped into decreasing household wealth by introducing a new offering that combines mobile, broadband and cable, thereby reducing the cost of its services. In BT's case, more and more of its clients continue to look for ways to improve efficiency, so they will seek outsourcing services to lower their costs and increase scale. "Despite the downturn, there are incredible pockets of opportunity," says Ms Randery, warning against writing off a country—or a continent—simply because it is not growing fast enough.

Nicolas Veron, senior fellow at the Brussels-based think-tank Bruegel, agrees: "There are assets in Europe. There are infrastructure and skilled people and, to the extent that reform creates a comparatively more favourable business climate, there really can be a pick-up of investment." The continent's high unemployment level has also created a pool of qualified, highly skilled workers at a cheap price, says Mr Veron, pointing to some investment projects in countries where there has been some wage adjustment.

The old continent's young competition

The macroeconomic clouds in Europe have not marked the end of business activity on the continent by any means, but Europe's largely saturated markets have faced more and more competition for investment from large-population, high-demand emerging markets, particularly the BRICs (Brazil, Russia, India and China). Nestlé, the Swiss beverage and food giant, is a good example. Although in 2013 it invested in manufacturing plants in Germany, Switzerland, Poland, Russia and France, Nestlé made larger investments in new factories in China, Vietnam and Malaysia.

The investment case for the BRICs and other emerging markets will continue to challenge that for Europe for some time, according to Meziane Lasfer, professor at London's Cass Business School. "It is a chicken-and-egg kind of problem," he adds. "If multinationals see that in Europe the growth rate is slow—there is a problem with unemployment, social problems, low demand—then they might think twice before investing in Europe." It seems, then, that the old continent will have to rely on its underlying qualities to strengthen its business case and win.

The return of M&A

Much of the renewed investor confidence in Europe can be seen in the revival of the M&A market. According to Mergermarket, an information and data service provider, in the first half of 2014 the value of European deals was the highest since the second half of 2008, with the pharma and telecoms sectors among the most active.

Europe has also seen a rise in the value of inbound deals (those initiated by companies outside of Europe), which hit US$147.3bn in the first half of 2014, a 47.4% increase compared with the same period last year. Chinese and Hong Kong companies have been particularly active in Germany; Prognos, a research firm, expects Chinese investment in Germany to hit US$2bn by 2020. North American companies also continue to display great confidence in Europe. In fact, the biggest European deal so far in 2014 involved Medtronic, a US medical device company, acquiring Covidien, an Irish-headquartered global healthcare company, for US$45.9bn.

Non-European companies attach great value to the well-established and respected brands that the continent has to offer and to the productivity and skills of its workforce. Having a base in one of the EU28 markets also provides businesses with easy access to consumers in any of the other economies in the Union.

Conclusion

The European macroeconomic recovery is far from bulletproof. Although all 28 EU member states are expected to grow in 2015, businesses will continue to have to grapple with a multi-speed European economy as countries such as Poland rush on ahead, while others, such as Italy and France, struggle to make any great strides. It will also take time before domestic demand and private investment bounce back completely, while the increasingly real threat of deflation in the euro zone will send shivers down politicians' spines. Reassuringly, the ECB is taking decisive action to avoid a deflationary spiral by improving liquidity to benefit the continent's SMEs. Europe's future also hinges on national governments and their willingness to push forward with painful and unpopular structural reforms; new leaders in both France and Italy are making a promising start on that front.

Despite the macroeconomic cloud that has been hanging over Europe since 2008, however, business confidence in the continent is rising again. Evidence of this is seen in the increasing inbound M&A activity and the stabilising yields on government bonds, especially in the periphery. Europe's underlying strengths, ranging from a skilled workforce to a strong infrastructure and from mature financial markets to political stability, have helped it maintain its importance and relevance in the global economy. These qualities have been largely immune to the economic downturn, and have helped Europe tell the world that the old continent is still open and attractive for business.

Business action points:

1. View Europe as a multi-speed economy to make it easier to spot areas of growth and opportunity across countries and industries

2. Consider Europe's strengths, such as a highly-skilled workforce and developed digital markets, alongside the continent's macroeconomic trends

3. Use changes in consumer spending and habits to reassess products and services offered, and develop new ones

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