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THE END OF EUROPE (AS WE KNOW IT)?

By Dan Steinbock

As the Eurozone is amid secular stagnation, its old fiscal, monetary and banking challenges are escalating, along with new threats, including the Brexit, demise of Schengen, anti-EU opposition and geopolitical friction. According to Dan Steinbock, Brussels can no longer avoid hard political decisions for or against an integrated Europe, with or without the euro.

Since 2010, European leaders have been deferring the hard decisions. Occasionally, there have been political reasons for delays. Yet, times of crises cry for leadership.

Economically, procrastination has sustained the semblance of continuity in the short-term. Politically, it has maintained the status quo of "integration without common institutions", which is unsustainable. Strategically, it has resulted in misguided military policies that threaten to undermine what is left of the unity of the region.

Time is out and delays are no longer an option.

From cyclical contraction to secular stagnation

The numbers are not encouraging. While the Eurozone (EZ) is amid a fragile cyclical rebound, it is barely breathing as quarterly real GDP growth is at barely 0.3% and inflation close to zero. After half a decade of economic pain, the region will struggle for 1.5% growth. In the coming decade, that will slow close to 1%.

When the global financial crisis hit Europe, its core economies – Germany, France, the UK and Italy – relied on relatively generous social models for cushion, but structural challenges were deferred. In spring 2010, the European sovereign debt crisis was still seen as a liquidity issue and a banking crisis. As Brussels launched its €770 billion "shock and awe" rescue package, it was expected to stabilise the EZ.

However, Brussels and the core economies failed to provide adequate fiscal adjustment, which made mass unemployment a lot worse and continues to penalise confidence, demand and investment. Today, unemployment has decreased to 10.3% in the EZ (and to 8.9% in the EU, respectively). But underemployment remains prohibitively high and youth unemployment amounts to 23% in the EZ and is far higher in crisis countries, such as Greece (48%), Spain (45%) and Italy (39%). In the future, Europe must cope with a 'lost generation.'

Initially, the small crisis economies (Greece, Portugal) were seen as "exceptions" because they were each less than 3% of the Eurozone GDP. As the crisis spread to Italy and Spain and the ailing economies accounted for almost 30% of the EZ economy, bailout packages were no longer a viable option. But while the urgency for structural reforms has increased dramatically, they continue to be deferred.

How has deleveraging succeeded? Well, it hasn´t, despite the rhetoric of austerity. As percentage of the EZ GDP, general government gross debt soared from 70% to 93% in 2013. It remains at threat levels in Greece (169%) and Portugal (130%) and excessively high in Italy (135%) and France (135%), even Spain (98%).

If Brussels had faced head-on its threats – fiscal, monetary, liquidity, banking and competitiveness challenges – in 2010, it would have been better positioned to do so. The EU was still stronger economically, more united politically and wary strategically. Now that it must face still new challenges, it is weaker economically, polarised politically and assertive strategically. And that does not bode well for the future.

New threats

The "Brexit"

In February, Prime Minister David Cameron struck a deal with EU ministers on revised terms for UK membership in the EU. The British referendum on whether to stay in the EU or to Brexit will be held on June 23. In media, the EU issue has been overwhelmed by domestic politics over the post-Cameron future. When London's Mayor Boris Johnson gave his support to the Leave vote, he became Tory activists' favorite to lead the Conservative party. Meanwhile, the UK pound plunged to a seven-year low against the dollar. If the Brexit advances, this is just taste of things to come. Even if the surprise resignation of Cameron's Work and Pensions Secretary Iain Duncan Smith may have had more to do with his personal ambitions than anti-EU position, it did deal another major blow to Cameron.

British EU-critics argue that the UK is suffering from Brussels's excessive business regulations and bailouts of financially fragile countries. In contrast, EU-supporters believe the UK benefits greatly from the ease of business to the huge EU market, the flow of young migrants to counter-balance the UK's greying population and EU's contribution to national security.

Cameron's revised EU deal won adjustments to block security-risk migrants, limits of welfare benefits to EU migrant workers, and reimbursement for British contributions on future Eurozone bailouts. The negotiated economic benefits will also allow London to block amendments to new regulations. Last year the UK also won a court case against the ECB, which would have limited the clearing of EZ transactions to within the EZ (a disadvantage to British banks over German and French rivals.

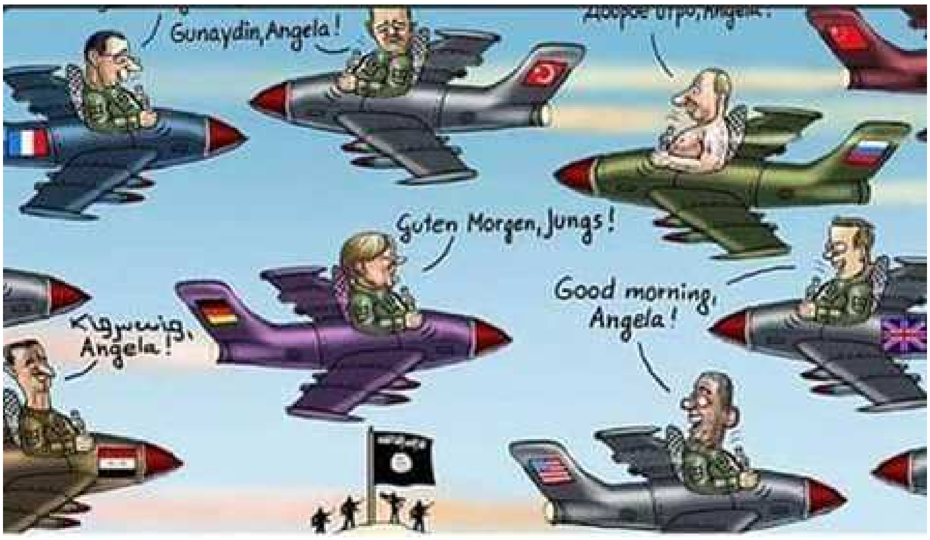
Despite close polls, these positives will be used as evidence that the UK and the City can thrive only with the EU. But with the British referendum, Cameron opened the Pandora’s Box not just for a potential Brexit but to a major shakeup of the EU with the loss of a core economy, a major budget contributor, global financial hub and a defense dynamo. That has potential for a series of negative feedbacks within the EU.

Demise of Schengen

While it took 25 years to consolidate the Schengen agreement, which abolished the EU’s internal borders, the treaty has been severely compromised by a refugee crisis in less than a year. Its reassessment began amid the 2015 influx of some 1.2 million migrants, many of them from Syria. The re-think intensified after the Islamic State’s (IS) terror attack in Paris. As EU states began to re-impose temporary border controls, the EC proposed a major amendment to Schengen. As the refugee crisis has escalated, divisions among EU member states have intensified along the migrant routes causing a virtual domino effect.

After record number of migrants flooded southern Germany from Hungary, via Austria, Germany re-imposed its border controls with Austria. Austria began to limit road and rail traffic on its border with Hungary, which built a fence on its border with Serbia, as even Denmark and Sweden started to step up controls to reduce migrant inflows. When Copenhagen adopted the notorious “jewelry” bill to seize asylum seekers' assets to cover their expenses, all gloves were off. Yet, member states may reinstate internal border controls for up to two years in “exceptional circumstances.”

As borders are closing within the Fortress Europe, the migrant bottlenecks – especially the Aegean Sea between Greece and Turkey – are at a boiling point, as



reflected by EC President Donald Tusk's recent plea: "Do not come to Europe! Do not risk your lives and your money!" It was a day when the founders of the EU turned in their graves. The old pretense of open and multicultural, democratic and peaceful Europe was gone. Instead, the new plan would see refugees being forcefully shipped back from Europe across straits patrolled by NATO warships, with Greece as its halfway house and Turkey as its waiting room.

Anti-EU opposition

According to an EC report, the reintroduction of border controls within the Schengen area could reduce EU economic output by €500 billion to €1.4 trillion. In 2010, these arguments could still have shaped the debate. But today, it is the *non*-economic

fears, political divisions, ethnic and religious anxieties that dominate the headlines. As a result, the support for Merkel and the EU's remaining integrationists is weakening across the region. As long as the migration crisis will linger, it fuels the rise of the anti-EU opposition across old party lines.

Chancellor Merkel has warned that border controls have potential to fragment the EU "into small states" that are not equipped to cope with a globalised world. Indeed, with its more than 500 million people, a truly integrated Europe could absorb even 2-3 million refugees. In the short term, that would cause a modest increase in GDP growth – particularly in main destination countries (Germany, Sweden, Austria) – and energise the region's stagnating economy and greying demographics. The medium-term growth effect would depend on the refugees' integration into the labor market.

However, in the absence of common institutions, the influx of immigrants into Europe is undermining the Schengen, disintegrating the EU, inflating differences among member states and boosting the support of euro-skeptical opposition parties from Heinz-Christian Strache's right-wing Freedom Party of Austria and Czech President

Milos Zeman to Marine Le Pen's Front National in France and the increasingly xenophobic Alternative for Germany (AfD). Indecision virtually ensures mounting support for radicalisation and anti-EU views. In German regional elections, the AfD eroded the power of the Christian Democratic and Social Democratic coalition, while unleashing a debate within the former whether Merkel will be a liability in the 2017 federal elections. In Eastern Europe and Balkans, Schengen is already largely history as fences prevail among most states.

Yet, labeling all the opposition parties as "populist" or worse will not mitigate the reality of the issues they address, including unemployment, income inequality, and the fear of foreigners. If the moderate middle fails to lead out from economic stagnation, the not-so-moderate groups will always offer a way.

Geopolitical friction

In March 2014, Washington and Brussels initiated sanctions against Russia in response to developments in Crimea and Eastern Ukraine. Since then, the hope has been that sanctions and the Ukraine crisis would quash President Putin's politics and boost Ukraine's economy. In reality, Ukraine has been pushed to a default, while the sanctions have united Russians behind Putin whose popularity rating remains 83%.

Critics of the sanctions argue that the ultimate US/EU objective is not to encourage pro-market policies in Russia but to clip Russia's economic future in a new Cold War. Meanwhile, sanctions have deepened stagnation in Europe, and reduced the impact of euro economies' fiscal policies and the effectiveness of the ECB's quantitative easing (QE). The repercussions are reflected in diminished global growth.

The showdown with Russia and Ukraine is also a reflection of Europe's increasing assertiveness, which has been prominent particularly in the EU members'

interventions amid the ‘Arab Spring.’ In the early 2000s, President George W. Bush’s White House believed that the War in Iraq would achieve a virtuous domino effect in the region, supplanting “authoritarian tyrants” with “genuine democracies.” In the early 2010s, France, Britain and the NATO seized the opportunity for regime change in Europe’s southern periphery. It was these years of misguided policies in the Middle East and North Africa, coupled with the unwillingness to cooperate with Putin’s Russia that amplified destabilisation across the region and the very refugee crisis that Brussels would now like to contain to its periphery (Greece, Turkey).

Eclipse of monetary effect

Currently, the prime reason for the semblance of stability in Europe is the ECB, which - after the disastrous rate hikes of Jean-Claude Trichet - opted for US-style non-traditional monetary policies. Since fall 2011, an elusive calm has been sustained by Mario Draghi’s pledge to defend the euro “at any cost,” record-low interest rates and rounds of quantitative easing. Yet, realities are different, as evidenced by the euro's drastic 23% plunge from $1.45 in fall 2008 to $1.13.

Recently, the ECB launched a relatively large easing package, cutting all policy rates and further expanding QE to €80 billion per month. Yet, markets were no longer that impressed. Just as the Fed’s Bernanke a while ago, Draghi has been forced to acknowledge that even non-traditional monetary policies cannot overcome structural challenges. That’s the job of fiscal policy, which would require the kind of common institutions that Brussels lacks. As a result, economic uncertainty, political divisions, and strategic friction are likely to be reinforced by increasing market pessimism as the ECB has few alternatives but to continue to exhaust its policy tools.

Recently Eurozone banks have also been hit by a slate of shocks, while equity sell-off has sparked concerns about their profitability. In Italy, non-performing-loans (NPLs) have soared, which has resulted in efforts to “resolve” some local banks. French banks are suffering from the ECB’s squeezed rates. In Germany, Deutsche Bank suffered a loss of €6.8 billion in 2015, after scandals and lawsuits, while the

Since 2010, Dr. Dan Steinbock has argued that Brussels has systematically under-estimated the long-term threats implied by secular stagnation. With the onset of the European crisis in 2010, he argued – against the conventional wisdom – that the liquidity packages were inadequate and only a part of the problem.

Instead of stabilisation, he projected destabilisation and street protests across the Eurozone. When the bailouts of the small EZ countries began, he said they were inadequate and that the crisis would spread to larger member states, such as Italy, Spain, and France.

In the absence of effective political leadership, he now believes that Europe will have to face its future economically weaker, politically divisive and strategically vulnerable.

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regional state-owned *Landesbanken* are coping with adverse markets. With heavy debt burden, Spanish banks' NPLs remain at elevated levels.

As the EZ banks grow more fragile, they are less likely to support the ECB's monetary easing in the real economy. By the same token, a systemic banking crisis, coupled with political repercussions, can no longer be excluded.

Changing sovereign risks

The erosion of Europe is not inevitable. Currently, financial and monetary conditions in the Eurozone actually reflect a slight improvement suggesting that the region is still on a rebound. However, economic indicators suggest that growth is slowing, as a result of the region's new threats and the weight of the old ones.

If the ECB's policy tools continue to soften, banking system remains fragile and Brussels cannot defuse the new threats, Europe's sovereign creditworthiness could face substantial downside risks – despite half a century of integration.

A Brexit alone could spark a downgrade to the UK, while providing another push for independence movements from Scotland to Catalonia. Such moves would shift

spotlight on the fragile sovereigns in Western Europe's southern periphery, force new scrutiny of indebted core economies (France, Spain) and increase scrutiny of several EU members in Central and Eastern Europe (CEE), which currently benefit from the EU's enhanced creditworthiness. Of the 19 Eurozone sovereigns, 16 are investment grade today, while three remain speculative grade (Portugal, Greece, Cyprus) and two have negative outlooks (France, Finland). With a major shakeup, downside risks would increase significantly for those with speculative grade and negative outlooks, while investment grade positions would begin to soften.

If the migration crisis has inflamed the Brexit debate and is fueling Schengen's erosion, anti-EU opposition and geopolitical friction, is it likely to de-escalate in the foreseeable future? Well, as Merkel's support is eroding in Germany, the chancellor has sought an agreement with Turkey, which is already hosting 2.7 million refugees from the 5-year-old Syrian civil war. Recently the EU and Turkey reached an agreement that will force asylum seekers (of whom 40% are children) who take clandestine routes to be sent back. In exchange, Turkey will receive €6.6 billion in aid, visa-free access for its citizens in the Schengen zone and the eventual resumption of talks on its EU membership. The deal has been denounced as impractical, legally suspect, hard to enforce and inhuman.

In the short-term, coordinated immigration policies could actually provide a temporary boost in several EU economies, while alleviating the adverse impact of aging populations over time. In the medium-term, more conciliatory policies with Russia and Ukraine, Syria and the Middle East would go a long way to defuse tensions. But in the absence of credible, coordinated and medium-term immigration policies, uncontrolled immigration is likely to continue to undermine Schengen, boost anti-EU forces, and contribute to further geopolitical friction within and around Europe's periphery – especially in Greece, which is amid its Great Depression and Turkey that's amid multiple frictions internally and externally.

What if these are the “good years”

While Europe's growth potential has been significantly diminished in the past half a decade, it is supported by record-low policy rates, rounds of QE, the collapse of oil prices and cheaper euro. It is thus tempting to ask: If these truly are the “good years" of the rebound, how will Europe cope with the “bad years” in the future?

What the European economy needs is more fiscal accommodation and investment to translate lingering growth to structural recovery. Yet, only structural reform efforts have the potential to solidify the future of Europe; with or without the euro. In the medium-term, the region's economic uncertainty continues to be fueled by the spluttering US recovery, Japan’s contraction and China’s deceleration.

In a very long-term perspective, what we are witnessing is the steady erosion of Europe’s economic power, political clout and strategic weight. Today, Europe still accounts for about 24% in the world economy. As long-term projections suggest, that share is likely to halve by 2050, in part because of the region’s secular stagnation and because of the relatively faster growth of emerging economies.

However, the erosion of Europe in the world economy can be accelerated or decelerated. The past half a decade shows the potential of deceleration, which has pushed Europe to the brink. In the coming months, the challenge is to halt and reverse that trajectory. The longer procrastination prevails in Brussels and the core member states, the harder will be the challenge.

About the Author

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