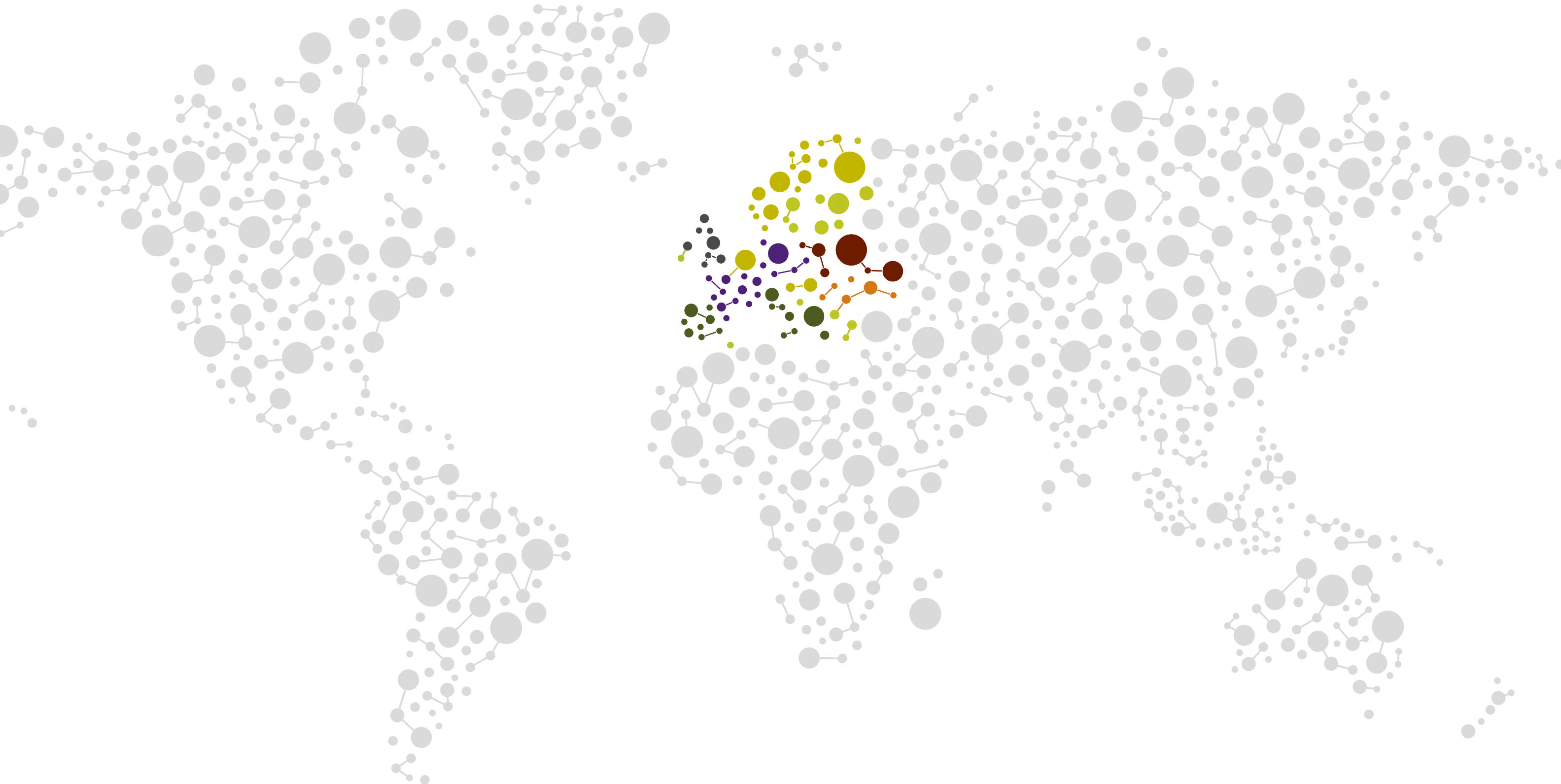
Europe in the Global Economy

Global Counsel



Looking beyond the "year of delivery"

A distinctive feature of President Juncker's "political" European Commission was a single set of collective top-down priorities, rather than a stitching together of the agendas of individual commissioners. In 2014, this meant a focus on economic reforms to restore growth lost during the 2008 financial crisis: a digital single market, a capital markets union and an investment plan for Europe. Events inevitably challenged this strategy — an unprecedented refugee crisis, Brexit, the emergence of new security threats — but it proved more resilient than many expected at the outset of the "last chance" Commission.

The 2019-2024 Commission will inherit some unfinished business. But the issue of a "Europe that protects" has undeniably driven politics in many member states since 2016 and will require a response from the incoming leadership. The proactive agenda will be occupied by questions of border security, defence and strengthening the 'rules-based system' — code for a tough line on trade with the United States, controls on inward investment from China and making EU spending conditional on respect for "European values".

There will also be increased pressure to balance economic reform with fairness and redistribution. Competitiveness is a mainstream concept in Brussels, codified in strategies such as Global Europe and the Lisbon Agenda, implemented via regulatory reform, the European semester and spending on research and infrastructure. "Fairness" is harder to define and target at EU level, with steps to address tax avoidance the main tangible recent examples. Distribution is no less difficult. But an EP election campaign shaped by the Five Star Movement in Italy, Die Linke in Germany or Podemos in Spain will nevertheless put these issues on the table for an incoming Commission.

As Brussels prepares for this new policy cycle, Global Counsel's Europe team examines here how the EU might balance the need for growth with pressure for fairness and solidarity, and where these choices will affect the business environment via legislation and spending choices. They will determine how the next generation of EU leaders approach policy challenges such as the decarbonisation of industry and harnessing the power of artificial intelligence. We also examine the persistent dividing lines within the Council and look ahead at the potential composition of the next European Parliament.

Tom White
Head of Europe

Bridging the Council divides: the future of the eurozone

A decade after the sovereign debt crisis, the eurozone is still subject to structural weaknesses and a widening political divide between north and south. Efforts made towards financial stability have been relatively successful — a centralised, more proactive monetary policy, a single rulebook for bank supervision and resolution and a European Stability Mechanism to facilitate economic recovery. Commitment to the EU also currently outweighs anti-euro sentiment, even when it comes to populist Italy. But Europe has a way to go before achieving full financial integration and its ability to withstand future shocks remains uncertain. Severe public debt levels in countries such as Greece, Italy and Portugal weigh heavy on citizens in the form of public spending cuts and stubborn unemployment. The loss of fiscal sovereignty, compounded by years-long austerity policies, has generated resentment in southern Europe at the perception that little solidarity has been shown by northern counterparts.

The incoming Commission will attempt to facilitate a new bargain that cuts through entrenched "creditor" and "debtor" positions. Sustainability of the eurozone relies on carrying out the final stage of risk sharing, if only to bolster confidence across Europe as a whole, rather than in select member states. However, northern and southern Europe often see the solidarity question differently. This comes down to the manner in which EU eurozone policy is decided and the political space for these decisions, rather than how member states feel about the "rules" themselves. The north views alignment within the eurozone as a precursor to sharing risk and assurance for the eurozone's future stability. The south sees the sharing of risk as an essential component of alignment and which can help remedy competitiveness imbalances between member states, achieving the very stability sought by the north.

The result is deepening mistrust on both sides and suspicion of Franco-German attempts to develop a solution for all. France and Germany's Meseberg Declaration seeks a balance between accelerating bank risk reduction while putting forward the possibility of a common eurozone budget. But any budget proposal for the eurozone is vulnerable to a northern-Baltic alliance determined to be more than levers in a Franco-German machine, though some may be amenable so long as fiscal convergence is avoided (e.g. Ireland, Luxembourg). The political shift in Italy represents growing discontent at the reluctance to relax fiscal rules that goes well beyond fringe populist movements, but pro-European countries such as Spain — which greatly reduced its public debt — can serve as a political counterbalance. How to get beyond this messy stalemate is not clear — but it is likely to involve a wider bargain in areas such as migration, defence and trade. Failure to resolve it also risks holding back the EU in these very areas.

Carmen Bell
Practice Lead — EU Institutions & Policy

A fragmented response to Meseberg

Signed 19 June 2018 Meseberg Declaration

Signed 22 June 2018 'Hanseatic' letter criticising Meseberg

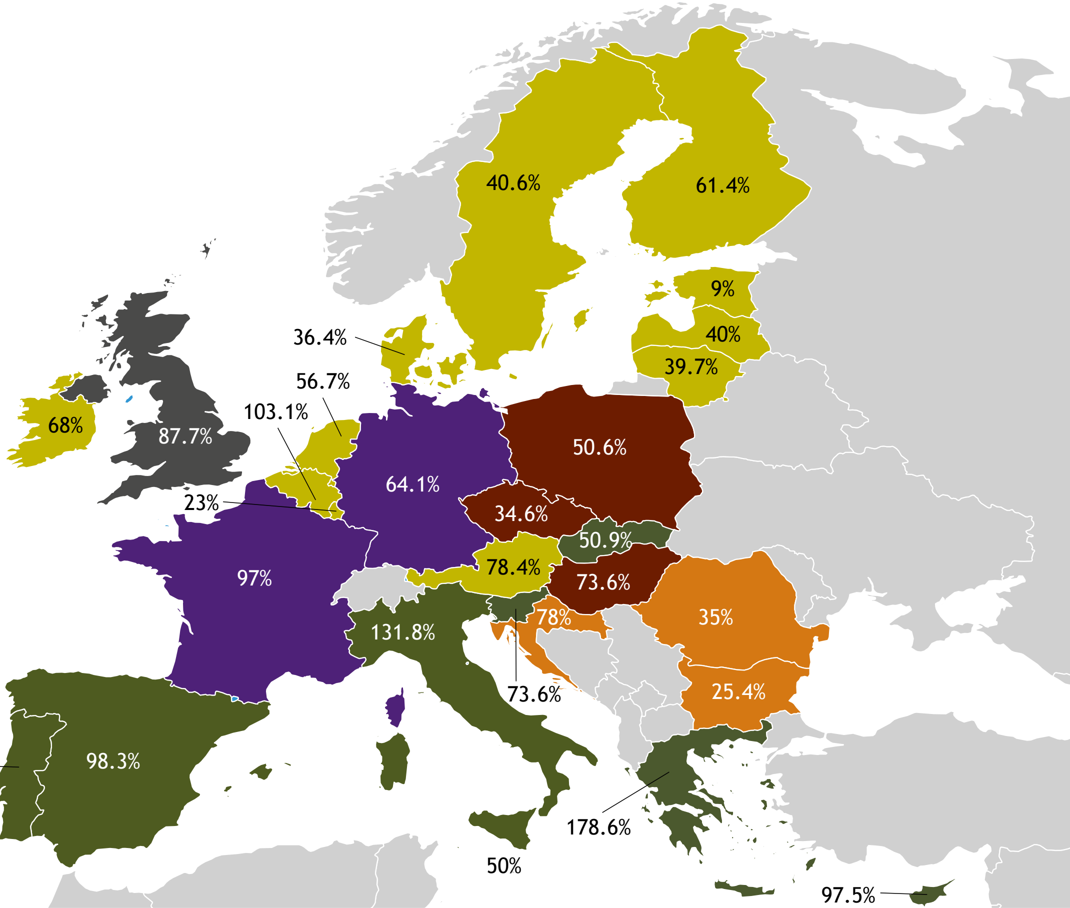
Advocates for more risk-sharing than Meseberg

Committed to eurozone accession

Current government publicly opposes joining eurozone

No position

% = debt / GDP ratio



Sources: GC analysis, Eurostat

Bridging the Council divides: east and west

The strategic, security and economic case for the 2005-2013 programme of enlargement remains clear but is under significant strain from perceived divergence of values. Countries that have joined the EU since 2004 provide EU economic growth potential, play a crucial role in external borders protection and serve as competitive places to source supply chains within the single market. But this may be coming at a price that is often too high for the 'old' members — compromised liberal values and assertive attitude to budget allocation, reluctance to tow a German line on migration and even scepticism of the quality of western European products placed on eastern European markets.

The crucial issue for the EU eastern members is maintaining sovereignty while western capitals see a failure to show solidarity and unity. The sharp focus on the attempts to defeat western European populism over the last three years has often meant a failure to note the strength of its eastern variants and their demand for greater sovereignty. The 'new' member states instinctively object to the prospect of being pushed to the EU periphery, two decades after their accession by a Franco-German led eurozone, or the concept of 'multi-speed' Europe advocated by large western European states. Meanwhile, the western members see inconsistent commitment to joining the single currency, reluctance to burden-sharing on refugees and a stubborn resistance to reflect on the future of subsidies and transfers.

A more equitable distribution of EU agencies and top jobs to newer member states may be part of the Brussels response, but it risks missing the point. To be sure, alienation from Brussels institutions is exacerbated by dominance of western Europeans in formal and informal positions of power. Council president, Donald Tusk, remains an exception — and not an advertisement for Polish influence in Brussels as far as many Polish Eurosceptics are concerned. A Commission president from the east may be able to reduce the divides and will be an attractive presentational fix for many in 2019. But the problem of building a genuine new east-west consensus runs much deeper than that.

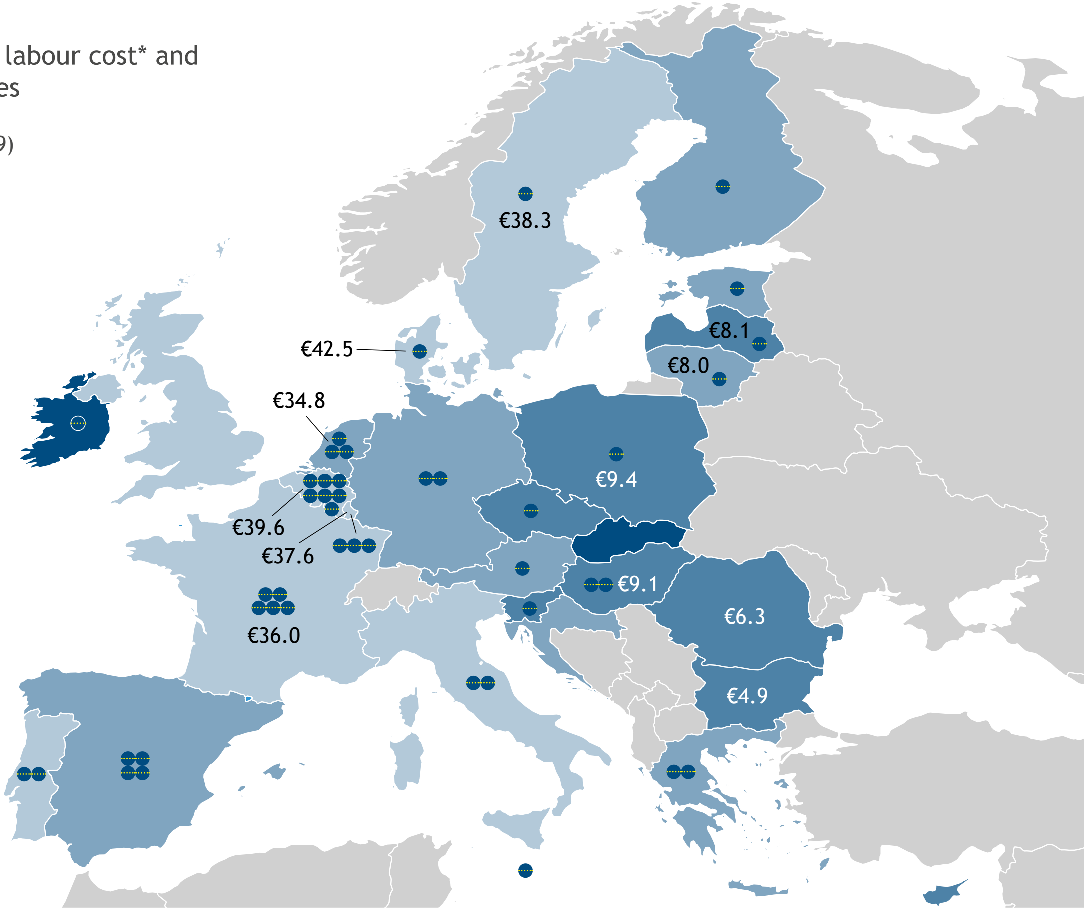
Alexander Smotrov
Practice Lead — Russia, CIS & CEE

East and west: growth rates and EU governance

Economic growth, hourly labour cost* and distribution of EU agencies

Economic growth forecast (2019)

- > 4%
- 3-4%
- 2-3%
- 1-2%



* Hourly labour cost for six highest and six lowest MS (2017); dots represent the post-Brexit number of EU agencies per MS. Sources: European Commission, Eurostat

Long term consensus on energy policy must survive short term challenges

A draft 2050 Climate Strategy will provide a contested inheritance for the next political cycle and will set the platform for future EU international leadership. The European Council has triggered the next round of negotiations on EU climate policy by asking the Commission to put forward a 2050 Climate Strategy before the 2019 election. This will put into practice the Paris Agreement commitment of decreasing emissions to 80-95% below 1990 levels by 2050. It will also feed into the EU's energy and climate policy agenda towards 2030, incorporating advances and cost reductions in renewable technologies, updating the Commission's work on transport and heating and cooling, while also attempting to keep less ambitious (and more financially stretched) member states on board.

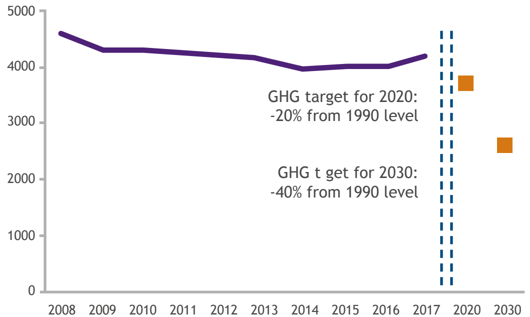
The end game of the Clean Energy Package is a reminder of unresolved tensions between member states and competing economic interests. There are signs that the strategy will land in an increasingly polarised Council. Elections in France, Italy and Spain have provided new impetus to climate action in the last eighteen months. The Five Star Movement and the Spanish socialists played an important last-minute role raising ambition on the energy efficiency and renewable energy directives, reflecting a desire to restart investment in their renewables sectors. However, the Polish and Hungarian governments continue to view decarbonisation both as an economic challenge and as a battleground in their contested relationships with Brussels. Meanwhile, Brexit will remove a key ambitious climate policy advocate from the Council.

A useful release valve for internal tensions will be a continued push for action by non-EU countries. Commissioner Miguel Arias Cañete has been a forceful advocate for climate action abroad, for example co-hosting the 2017 joint ministerial on Climate Action with China and Canada. This has increased his domestic credibility and fed into success securing agreements on new EU 2030 targets for renewable energy (up from 27% to 32%), energy efficiency (up from 27% to 32.5%), effectively putting the EU on course for a 45% reduction in emissions by 2030; although, for now, the EU target remains at 40%. As he looks ahead to translating this into a new EU commitment for COP24 in Katowice, Cañete's success, or otherwise, will in part depend on his ability to show that EU leadership yields results in other states too. This will require member states to mobilise their own alliances internationally.

Andrea Ninomiya
Senior Associate

EU greenhouse gas emissions still have a long way to fall...

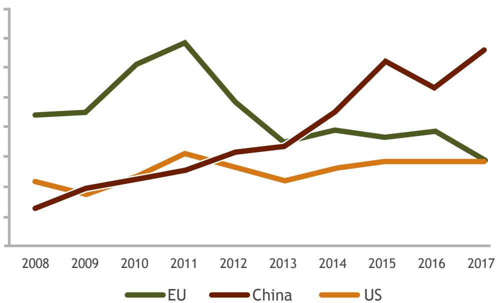
EU GHG emissions over time (MtCO2e)



Source: BP Statistical Review of World Energy

... while the EU is taking a declining share of the renewables investment

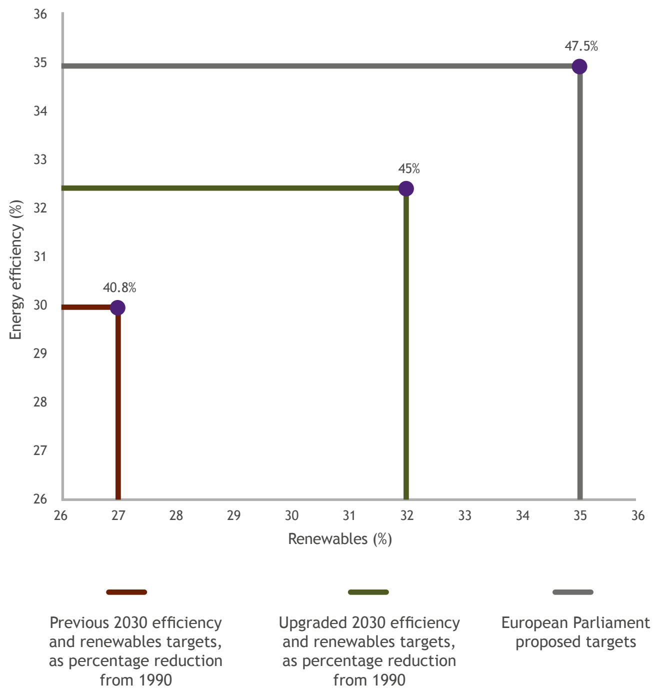
Annual new investment in renewables ($bn)



Source: Bloomberg New Energy Finance

Rising ambition ... but how far will the EU go?

Projections for effective 2030 emissions reductions, derived from increased energy efficiency and renewables targets (%)



Source: European Commission

Capital markets and investing in Europe's future

The capital markets union (CMU) initiative demonstrates the difficulty and the necessity of diversifying dependence on bank finance in the EU. The Juncker Commission asked not what the EU should do to financial services, but what financial services could do for the EU. This led to new EIB-run investment funds, initiatives to tackle cross-border fundraising barriers and proposals for more portable investment products and harmonised insolvency proceedings. These have had mixed success. Funding programmes for start-ups and SMEs could provide enough 'proof of concept' to ensure the CMU agenda continues. But a lack of financial infrastructure in several countries and continued reluctance by regulators to embrace cross-border investment, means political will is required if the CMU is to become more than just a catch-all label for a disparate set of initiatives.

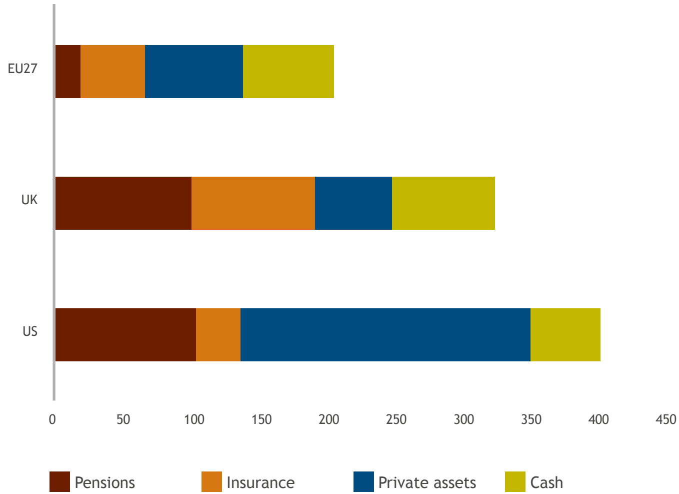
Moving beyond the Juncker Commission's headline objective of "more investment" may mean making judgements about what kind of investment is preferable. With the economy in a healthier state, politicians may feel they have more scope to direct capital in favoured directions. This has begun with schemes to encourage long-term infrastructure investment and regulatory reliefs to incentivise funding of SMEs. The next call will be to mobilise capital for sustainability objectives. Here, the current Commission has effectively ducked the difficult decision: agreeing at this stage only to classify what counts as "green" and what does not. It will be for its successor to decide whether to incentivise such investments or punish "brown", and whether that is best achieved by mandatory regulation or by behavioural nudges. That may mean a trade-off between higher immediate economic growth and something slower but ultimately more sustainable. High level rhetoric may favour the latter, but an increasingly cut-throat global economy may mean increased pressure to opt for the former.

Losing the EU's largest capital market and a dissenting voice on harmonisation could make agreement more straightforward, but this is not guaranteed. Some will see Brexit as an opportunity to push ahead with a more centralised, federalist vision of EU capital markets and their regulatory framework. But the UK was never the only member state resistant to this: Ireland and Luxembourg remain wary, given the specialised nature of their domestic markets, while Poland and Hungary (and now Italy) are resistant to "more Europe" in general. If a top-down approach to market liberalisation proves politically challenging, the next Commission may look either at bottom-up initiatives – such as the regional capital markets union launched in the Baltics – or parallel measures, like the creation of a pan-European personal pensions product, to make the case for cross-border finance on a commercial, rather than political basis.

Adam Terry
Practice Lead – Financial Services

CMU sought to make EU capital markets rival the US, but Brexit removes its largest, most mature capital market

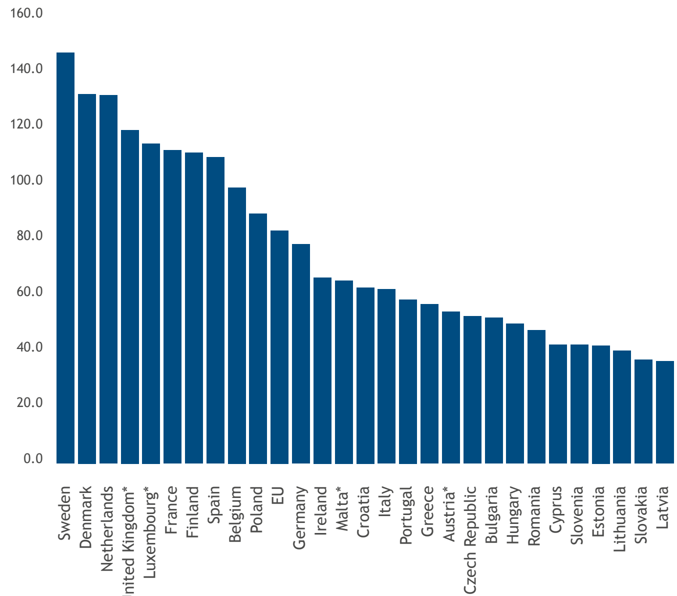
The value of pools of capital as a percentage of GDP in the EU and US in 2015



Source: New Financial

The challenge is made harder by the variation between member states

Stock market capitalisation as a percentage of GDP in 2017



Source: CEIC
*2016 data

A single market for artificial intelligence

After years of angst about the impact of artificial intelligence (AI) on labour markets, global competition and member state pressure has driven the EU to encourage it through legislation. Despite prominent examples of AI development in Paris and other cities, the platform revolution in Europe has been dominated by American tech companies and Asian software companies. China and US start-ups, for example, comprised 87% of equity funding to AI start-ups globally in 2017. Attempts at European responses through public funding have been complicated by competition between member states to attract inward investment, resulting in a slew of fragmented national strategies. France will allocate €1.5 billion for AI development over the next five years while the UK has committed to a package of up to €1.08 billion of support for the sector. Finland has also launched its own strategy, with Germany to soon follow.

Constrained financial firepower at EU level will mean the next Commission focussing on the power of the single market and its legislative prerogatives to strengthen global competitiveness. The "Digital Europe" programme seeks to build the market for the internet of things, by allocating €2.5 billion in funding for AI. However, this proposal encapsulates many of the limitations of Commission policymaking — high on ambition and intent but low on concrete actions, as €2.5 billion pales in comparison to the levels of funding in either China or the US. Addressing divergent rules between EU member states may be a more productive focus. The Commission's AI Strategy has already sought to address the risk of divergence in liability rules for innovative products such as autonomous vehicles, and the incoming Commissioner can be expected to build on this with a more proactive approach to setting EU wide standards.

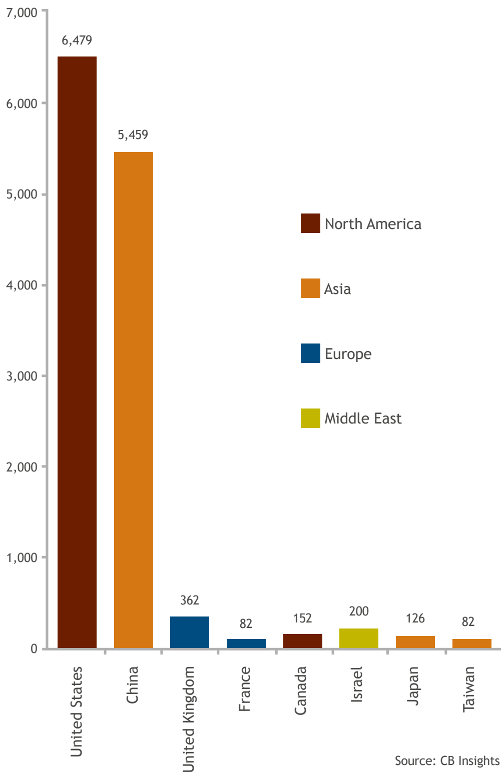
Even where internal agreement can be reached, successfully asserting global standards will be more difficult, and will depend on overtaking other countries through rapid innovation. EU attempts to repeat the success of its world-leading industrial standards in the online world have failed by being late to the development of new markets. The challenge will therefore be to introduce flexibility in regulation that permits innovation while also reassuring citizens about privacy and data protection. The Commission's new high-level expert group on AI is charged with setting out policy recommendations. However, this can be expected to stir up a debate over the balance between the EU's desire to set the world's standard for data privacy and protection — as touted via the General Data Protection Regulation — and its ambitions for global competitiveness in AI.

Franck Thomas
Senior Associate

EU investment in AI is thinly spread and low by international standards

European policy on AI is being driven by fear of being left behind by US and Asian competition

Total funding of the 100 most promising AI start-ups in 2017 (US$m)



Source: CB Insights

The European response is complicated by competition between member states to attract inward investment

Country	Funding	Priorities
France March 2018	€1.5 bn public funding over 5 years	• R&D • Open data
Germany due autumn 2018	N/A	• R&D and innovation • Skills • Internet of things
United Kingdom April 2018	£950m public and private funding	• Skills • Digital and data infrastructure • R&D and innovation • Investment incentives
Italy March 2018	No specific budget	• AI in public administration

Redefining EU interests in international trade

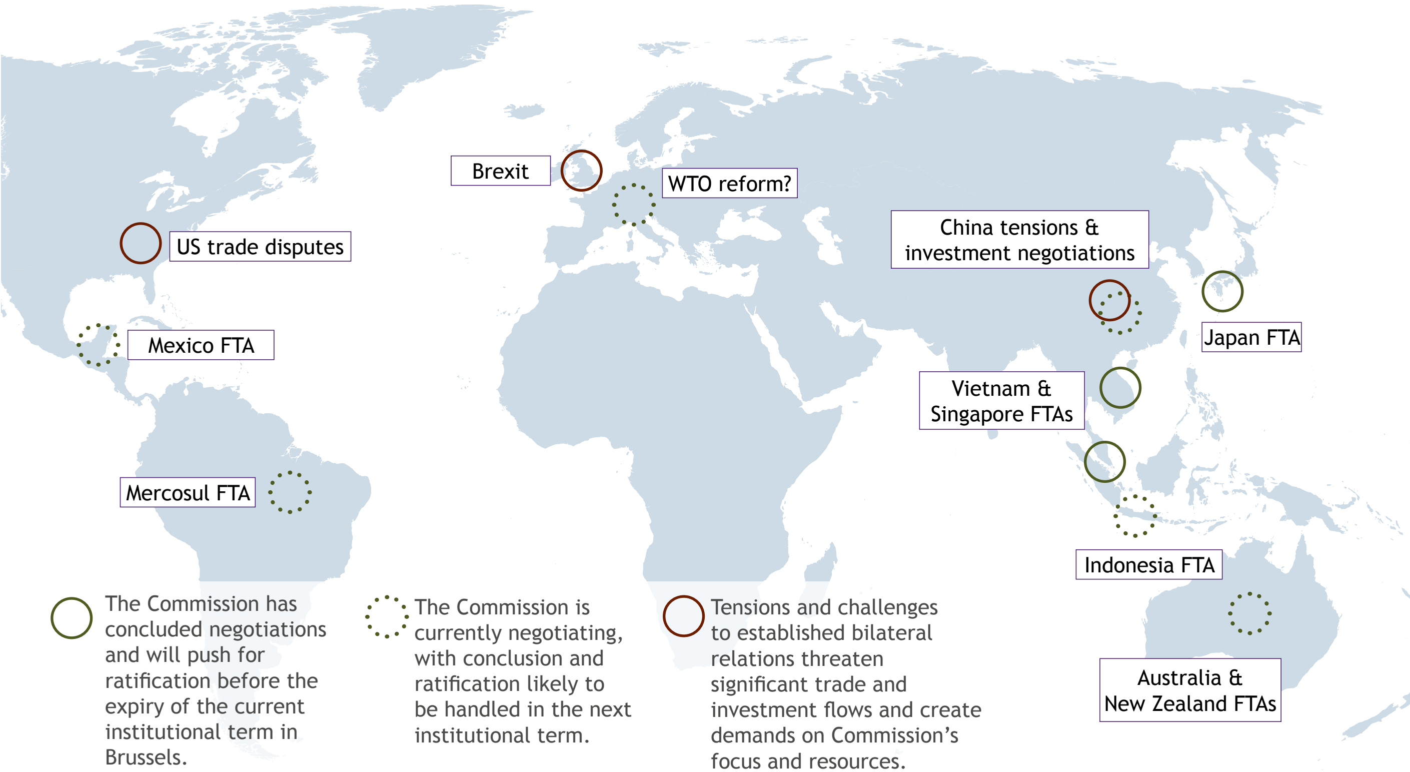
The next European Commission will inherit a trade policy agenda strained by disillusion about globalisation at home and protectionist measures abroad. The incoming trade commissioner will be expected to defend further trade liberalisation, while forging a new consensus between member states on trade defence and retaliation measures. The European Parliament will also ensure they enter negotiations with third countries, seeking more extensive assurances about social and environmental protection. But in a world where other markets do not share these objectives — or do not like to see them treated as EU demands — the EU may have to pay a price for them and standing firm could come at the cost of market access aims. This has important implications for a full docket of free trade negotiations, including a future EU-UK trade settlement, as well as the EU's approach towards an increasingly unpredictable US trade policy.

Commitment to the EU's global role in market liberalisation will also be challenged by a sharper sense of producer interests. Until now, European protectionist voices have mostly been reflected in a defensive agenda, primarily blocking the Transatlantic Trade and Investment Partnership and delaying ratification of the EU-Canada agreement. Both of those dossiers initially reflected an entrenched belief in the overall economic benefits of liberalisation within the Commission and centrist political groups in the parliament, but their focus on consumer and importer interests may struggle in the face of producer and exporter-focussed approaches now setting the agenda in both the US and China. This will initially be manifested in pressure on the next Commission to more aggressively tackle "unfair trade practices" with trade partners, but also in more explicit pressure to act unilaterally to protect European strengths in new technologies and value-adding employment, and to tie EU openness to direct 'reciprocity' from trading partners. Areas such as investment screening and trade defence will be in focus.

The reform of the World Trade Organisation is a possible route to a new consensus on trade, but not an easy one. Over 10 years since the collapse of the WTO Doha Round negotiations, reform and modernisation of the WTO is often seen as a possible solution to mitigating trade tensions between the US, the EU and China. France has formally called upon these countries, as well as Japan, to update the WTO rulebook on a range of politically sensitive issues, including subsidies, intellectual property and social and environmental standards. The EU can be expected to lead such a push and hand such a mandate to its next trade commissioner, but it is less clear how enthusiastically others will follow. In any case, the glacial pace of WTO evolution could easily absorb policy-making and negotiating energy for years — with uncertain results.

Daniel Capparelli
Practice Lead — Trade Policy

Opportunities in Asia could be overshadowed by potential deliberalisation in EU27's largest markets



A far less consensual European Parliament will take office in 2019

If Eurosceptic parties can translate national successes into representation in the EU legislature, the pro-EU majority will come under strain. Eurosceptic parties are currently present in four political groups: the European People's Party with Hungary's Fidesz; the Europe of Freedom and Democracy with Italy's 5 Star Movement; the European Conservatives and Reformists with Poland's Law and Justice; and Europe of Nations and Freedoms with France's National Front, now called Rassemblement National. Recent election results in Italy, Germany, Austria and the Netherlands have seen increased representation of far-right or other Eurosceptic parties. These remain rooted in national politics, with little organisation at European level in comparison with the established EPP, Social Democrats and Liberals. However, speculation is growing that a new group — formal or informal — could bring these national parties together, potentially around a platform of immigration control, although their main driving force is likely to remain blocking rather than starting initiatives.

Further pressure on the centrist consensus of recent decades is the collapse of support for traditional centre-left parties. The centre-left has declined across the European Union, scoring less than 10% in the last Polish election and less than 25% in countries where social democrats recently governed, such as the Netherlands, France, Germany and Italy, while the new PSOE government in Spain is a vulnerable minority administration. The causes of this are complex, but many of these parties' leaders are concluding they must move further to the left to re-engage with their traditional voter bases. For the S&D group there is a real risk of losing their traditional share of top jobs in the next European Parliament to more Eurosceptic rivals.

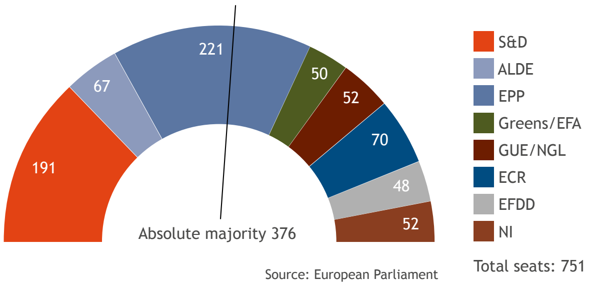
The biggest unknown remains whether President Macron can replicate his electoral success in France at EU level. Macron has kept Brussels institutions guessing since his rise to power in May 2017 about whether his En Marche movement might align with ALDE, a liberal grouping that shares many of his views. However, En Marche is now working on an election platform with Spain's Ciudadanos, with the intention of building a larger pan-European movement outside the traditional party structures. This gives some hope to pro-Europeans about maintaining a pro-European majority in the European Parliament. This, however, is to ignore one of the main lessons of Macron's success in France: it seems equally likely that any new centrist movement draws supporters away from the two main parties, rather than weakening the extremist parties.

Ana Martínez
Senior Associate

A smaller parliament in 2019 may diminish the in-built mainstream majority

The 2014 election delivered a reduced but substantial majority for centrist parties

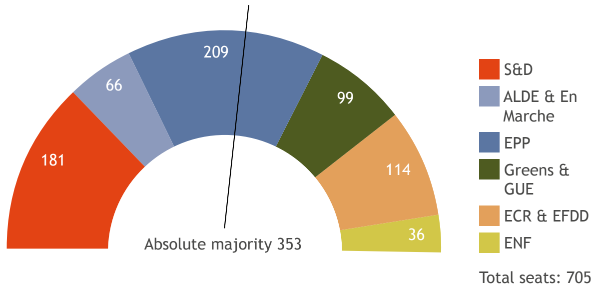
2014 European Parliament election result



Source: European Parliament

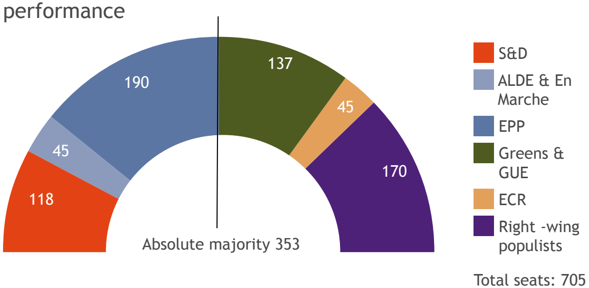
A repeat performance in 2019 is unlikely…

2019 European Parliament composition with 2014 vote share



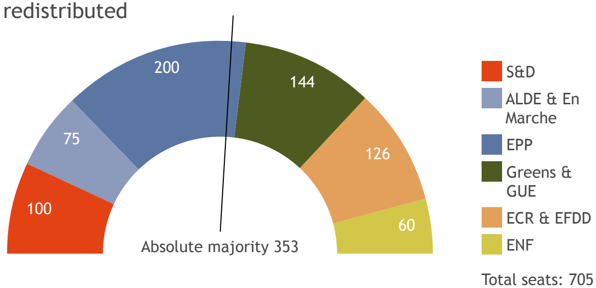
… if parties of the right translate strong national performances to EU level…

2019 European Parliament composition with strong far-right performance



… and/or if the centre left cannot reverse recent declines.

2019 European Parliament composition with S&D MEPs redistributed



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Global Counsel advisers in Brussels and London, and our wider network of former policymakers in EU capitals, represent experience in every area of public policy and political communications. With sector specialisms including manufacturing, energy, financial services, technology, media and telecommunications, our practice leads combine decades of experience working with the European Commission, European Parliament and member states in the EU Council.

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