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The future of Europe

Grant Thornton International Business Report 2013

Welcome to the second edition of our 'Future of Europe' series, which draws both on data from leading economic forecasting houses, and on 3,100 interviews conducted with senior executives from in and around Europe as part of our International Business Report (IBR).

The report deals with three distinct aspects of the ongoing sovereign debt crisis: the stagnation of Europe's economies, the closer integration suggested as a means to mitigating uncertainty and what this means for the future expansion of Europe.

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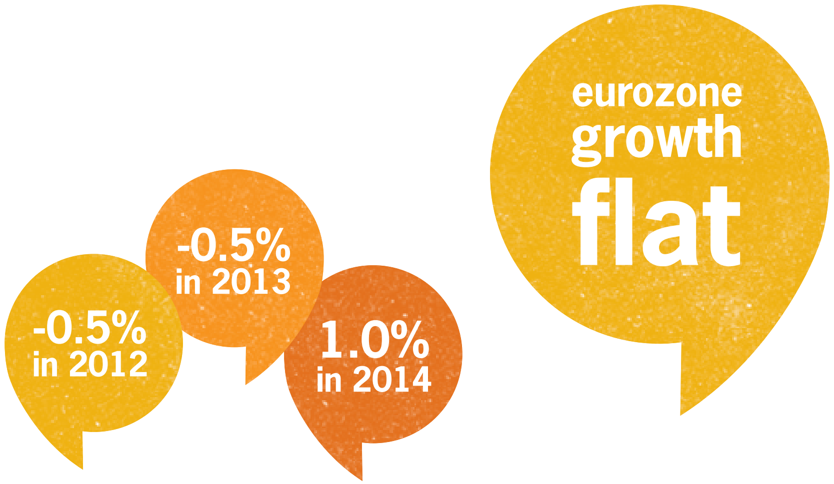
Introduction

The future of Europe remains delicately poised. Whilst the feeling at the 2013 World Economic Forum in Davos was that the worst of the crisis was over, growth prospects for 2013 look very weak. The European Central Bank (ECB) is forecasting a contraction of -0.5% across the eurozone in 2013 – with only mild improvements expected in 2014. Even the mighty German economy, previously relatively insulated from the crisis, posted a contraction of 0.6% in the final three months of 2012, pulling full year growth down to just 0.7%. France did not even manage that, with growth flat in 2012.



2012 did bring some cheer for European leaders, with the completion of the biggest sovereign debt restructuring in history in March: 86% of investors holding private Greek debt agreed to join a write-off deal, lowering the country's debt burden by some €105 billion or just over half the country's private debt. However, doubts about the Spanish banking sector were finally realised in early June with the government requesting a loan of up to €100bn from the European Stability Facility to recapitalise its banks. With investors wobbling, borrowing costs, especially in Southern Europe, began to climb back to unsustainable levels. It took an announcement on 26 July, by Mario Draghi, President of the ECB, that he would do "whatever it takes to preserve the euro" to restore an element of calm to the markets.

The ECB's proposed 'outright monetary transactions' (bond purchases in secondary markets) aimed to cut the borrowing costs of debt-burdened eurozone members. Whilst no government requested a bailout which would trigger these transactions, just having the mechanism in place seemed to placate bond markets. At the turn of the year all eyes were on the fiscal cliff negotiations across the Atlantic, whilst focus in Europe shifted to aligning the growth with austerity.

But a raft of bad economic data in January 2013 was followed by a worrying stalemate in Italy's election which left former comedian and anti-austerity campaigner, Beppe Grillo, as the potential 'kingmaker'. More recently, the travails of the second smallest member of the eurozone, Cyprus – which accounts for just 0.5% of currency area GDP – has reignited the crisis. The plan proposed forcibly buying troubled banks shares with up to 9.9% of savers' deposits but was unanimously defeated by the Cypriot parliament. Under a revised bailout deal, one of the two banks in trouble is being wound down with heavy losses inflicted on large depositors of both. The impact on the wider economy could be severe and contagion to other economies with unstable banking sectors are a major risk.

Report highlights

94% want to save euro

Europe's economies are stagnating: economic and business growth prospects are weak and unemployment rates are set to remain high; rising business investment offers some hope.

Support inside the euro remains strong: 94% of eurozone business leaders want to see the euro survive and just 6% want their economy to exit; 78% view joining the single currency as positive, up from 71% in 2012.

Eurozone members are open to further integration: 66% want to see further economic integration, with 40% open to more political union; a further 65% show support for eurobonds, although this drops to just 32% in Germany.

Less appetite for a 'Grexit': the proportion of eurozone members wanting to see economies leave the euro has fallen from 24% in 2012 to 17% this year.

Potential entrants remain keen to join: more than 50% of business leaders in Denmark, Latvia, Lithuania and Poland want to join the euro; although majorities in Denmark and Poland do not see it happening until 2018 at the earliest.

Eurosceptic nations wary of further EU integration: more than half of businesses in Sweden and the UK do not want to see any further integration and one in ten think the euro should break up.

Neighbouring markets see declining value in improving ties: 52% of EU neighbouring economies believe further integration would be an advantage, down from 62% in 2012; increased opportunity for exports is seen as the key benefit; one in five would like their economy to eventually join the euro.

65% open to debt mutualisation

Weak growth prospects

Integration to sharpen divides

Power of single market declining

Grexit chances fading

Stagnation

GDP forecasts

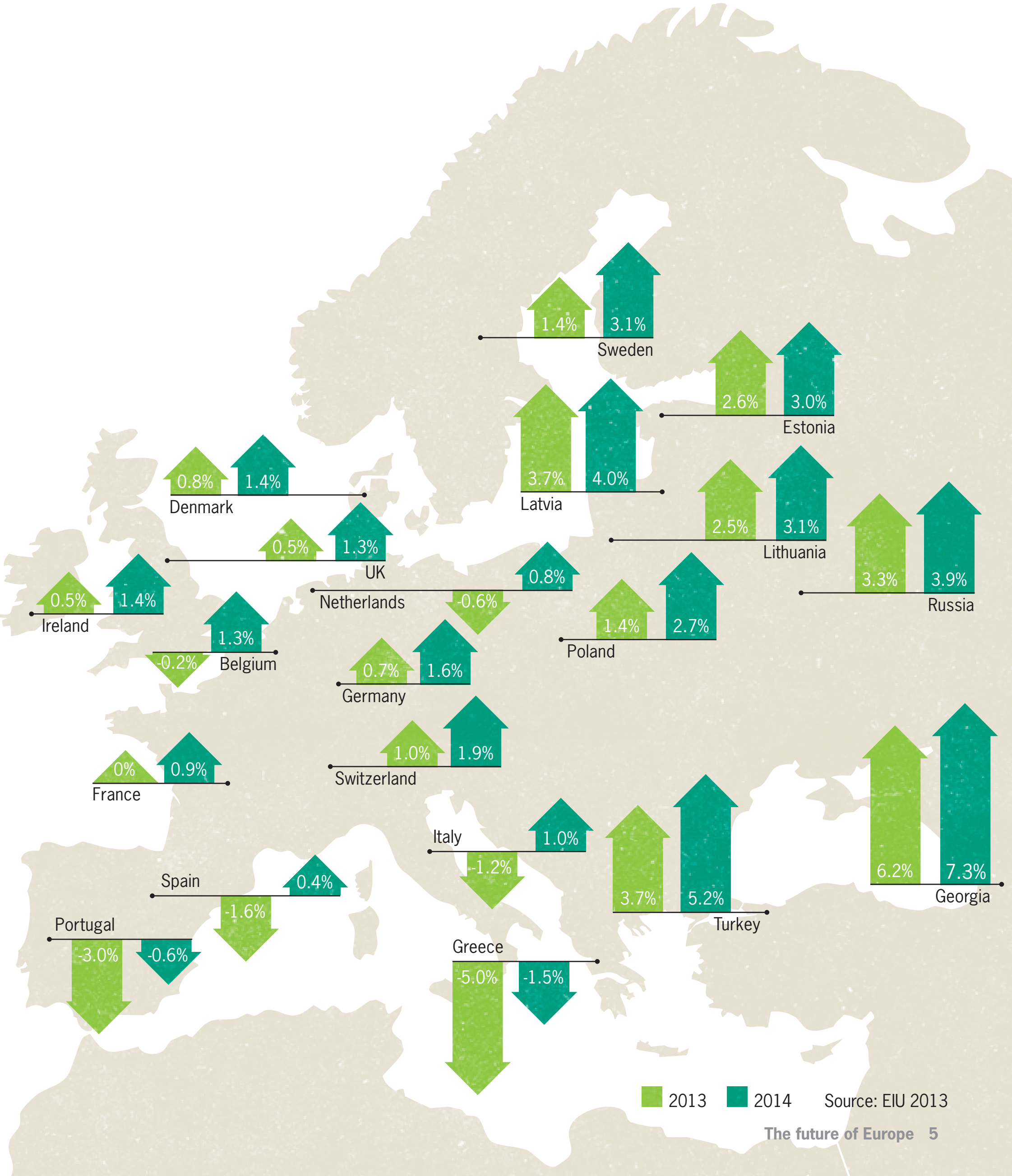
Growth prospects in Europe look tepid at best. A mild contraction is expected for the eurozone as a whole in 2013 – output is expected to shrink in all the troubled Southern European economies: Greece (-5.0%), Portugal (-3.0%), Spain (-1.6%) and Italy (-1.2%). Growth in France is expected to be flat for the second year in succession whilst the German economy is forecast to expand by just 0.7%, slower than 2012.

Many of the more indebted nations want to relax agreed budget deficit targets in the face of the strong economic headwinds, but Germany has promised to balance its budget by cutting net borrowing to a 40-year low, citing the low ECB interest rates as stimulus enough. Conversely, France expects to overshoot the agreed deficit target of 3% this year, an announcement which drew a sharp rebuke from the Bundesbank.

Prospects for older EU members outside the single currency are not much brighter. UK output is expected to climb by just 0.5% in 2013 meaning the economy remains more than three percentage points smaller than before the financial crisis. Growth rates in Sweden (1.4%) and Denmark (0.8%) are not expected to be much faster.

Growth rates are slightly elevated in Eastern Europe, but Poland's economy has slowed markedly and is expected to post expansion of just 1.4% in 2013. Latvia (3.7%), Estonia (2.6%) – which joined the euro in 2011 – and Lithuania (2.5%) have brighter forecasts but remain largely dependent on regional growth.

Outside the EU, forecast levels of expansion are more impressive. Economic output in Turkey is expected to grow by 3.7% this year, accelerating to 5.2% in 2014. Growth in Russia is forecast at 3.3% in 2013, climbing to 3.9% in 2014, but Georgia leads the way with output forecast to expand by 6.2% this year and 7.3% next.



Debt

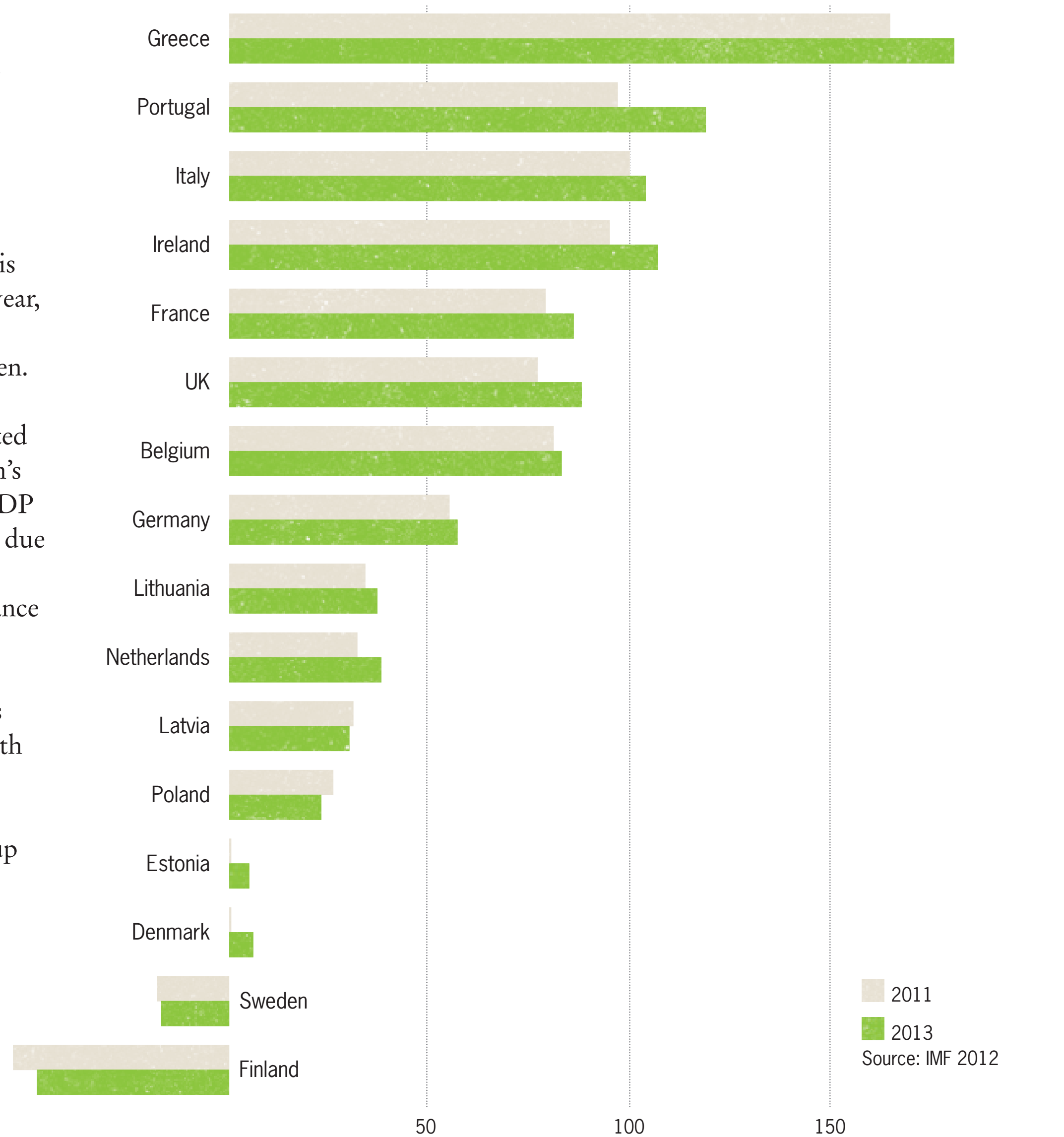
The concern for Europe is that these low growth rates are running tangentially to huge fiscal austerity programmes which are shrinking levels of government spending across the continent in a concerted effort to lower levels of sovereign debt. However, slow growth and elevated levels of unemployment, are weighing down on tax receipts whilst pushing benefits payments up.

As the IMF points out in a new paper, because those countries introducing the heaviest austerity programmes are starting from a relatively high level of debt and the negative impacts of the cuts they are making is large, rather than decline, debt to GDP ratios actually look set to rise for some time.

The net government debt of Greece is expected to reach 181% of GDP this year, up from 165% in 2011, despite the 'haircut' private bondholders have taken. The debts of Portugal (119%), Ireland (107%) and Italy (104%) are all expected to continue climbing over 100%. Spain's debt is expected to climb to 84% of GDP this year, up from 57% in 2011 largely due to bailing out its indebted banks and regional governments. Meanwhile, France and the UK have both lost their AAA credit ratings as stagnant economies hamper efforts to bring budget deficits under control. The governments of both countries are enjoying record low borrowing costs, but should the yield demanded by investors begin to pick up again, debt servicing would become a major issue.

IMF, 2013: 'The Challenge of Debt Reduction during Fiscal Consolidation'

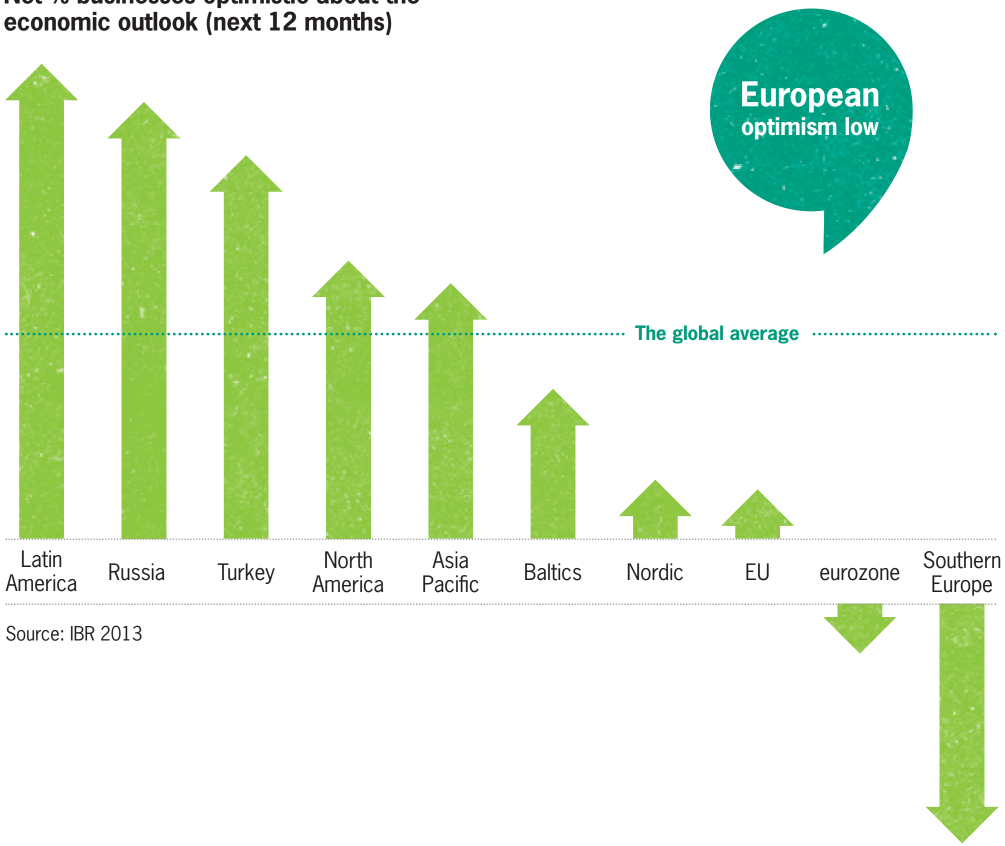
Net government debt as % GDP



Business confidence

A lack of confidence is evident in business expectations for growth in their own operations over the coming months. Just 14% of eurozone businesses and 22% of those in the EU expect profits to go up over the next 12 months, well below the global average (39%). Whilst business leaders in Estonia (44%), Latvia, the UK (both 40%) and Germany (36%) are more bullish, a majority of those in Southern Europe actually expect profits to decline (-6%).

Net % businesses optimistic about the economic outlook (next 12 months)



Source: IBR 2013

Fears over the eurozone continue to dampen business sentiment throughout the region. Optimism for the year ahead amongst EU business leaders in Q1-2013 stood at just 2%, well below the global average (27%). Whilst this represents a significant uptick from Q4-2012 (-17%), led by a rebound in Germany (21% to 42%), European figures are well below other regions of the world – particularly Latin America (58%) but also North America (32%) and EU neighbours such as Russia (53%) and Turkey (46%). Whilst the Southern European states of Italy, Greece and Spain are suffering (-27%), it is French business leaders who sit bottom of the global optimism table (-50%).

Concerns around business growth mean the job markets in many European countries remains depressed, further weighing on consumer spending. In February this year, eurozone unemployment reached 12.0% – a record high – and 10.9% across the EU. The problems in Greece (27%) and Spain (26%) are even more severe with the proportion of young people unemployed rising to more than one in two in these economies, compared with 23.6% across the EU. The lack of employment opportunities risks creating a 'lost generation' according to the EU employment commissioner.

Unfortunately, business leaders in Europe do not appear to be opening their doors to the hordes of people in search of a job. Just net 6% of EU businesses expect to hire staff over the next 12 months, falling to 2% across the eurozone. German and UK business leaders (both 18%) are more likely to hire staff over the next 12 months but those in Southern Europe expect further contractions (-8%). This contrasts sharply with Turkey where 54% of businesses expect to grow their workforces.

With governments and households cutting back, and exports to other European countries naturally weak, there is hope that business investment can help provide a boost to the region's stagnating economies. Encouragingly, the proportion of EU businesses expecting to increase investment in plant & machinery over the next 12 months jumped to 44% in Q1-2013, up from 26% in Q4-2012 – the highest since Q4-2010. Similar jumps were observed in the eurozone (22% to 38%) and Southern Europe (12% to 40%) over the last quarter. Indeed, businesses in Lithuania (66%), Ireland (50%), Poland (46%) and Italy (44%) show some of the most positive investment sentiment globally.

† Daily Telegraph, 2013: 'Italy's economy shrinks as EU leader warns of lost generation'

Integration

Against this uncertain backdrop, there have been calls, especially from German Chancellor Angela Merkel, for greater European integration. She argues that the eurozone needs greater political union to run alongside the economic and monetary union already in place. Francois Hollande, President of the other bloc heavyweight, France, is more cautious and wants to safeguard national sovereignty and control over its own budget.

66% want further economic integration

40% want further political integration

Overall, 89% of eurozone business leaders want to see further European integration of some sort, led by Spain (98%), Finland (97%), Italy and France (both 95%). The outlier is Ireland, where close to one in three (30%) business leaders do not want to see any further integration.

Given their respective leaders' standpoints it is perhaps unsurprising to see German and French business leaders' opinions differ significantly on the idea of further integration. Whilst 61% of German businesses are open to more political integration, just 35% of their French peers agree. Spanish (61%) and Belgian (45%) businesses are also interested in moving towards greater political union.

Whilst greater political integration is favoured by just 40% of eurozone business leaders, the possibility of further economic union has the backing of a strong majority (66%). Business leaders in Spain (80%), Finland (79%), the Netherlands (77%) and Germany (76%) are all open to more economic integration. Businesses in Ireland (50%) and Italy (56%) are the least keen.

The first steps towards a eurozone banking union were agreed in late 2012 in a deal that will see the ECB supervise around 200 of the region's biggest banks from March 2014. The deal gives the ECB powers to close down eurozone banks that break rules and is expected, in time, to allow the EU's main rescue fund to directly bail out struggling banks.

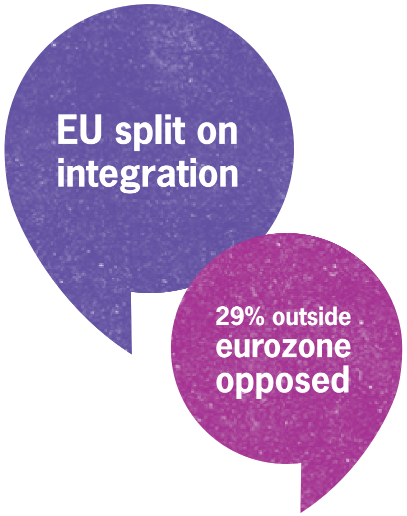
There are already fears, however, that the proposed 'resolution fund' will be watered down – or at least parked until the German elections in September – as it represents the first step towards debt mutualisation. German businesses are particularly against the idea of pooling eurozone debt through eurobonds: just 10% say they definitely support the idea with 62% opposed. The majority of business leaders from other relatively debt-free economies, Estonia (56%) and Finland (50%), are also opposed. Conversely, some of those business leaders in the eye of the eurozone storm – Spain (82%), Greece (69%) and Ireland (63%) – are, perhaps unsurprisingly, more eager to see debts pooled.

Integration could cause friction

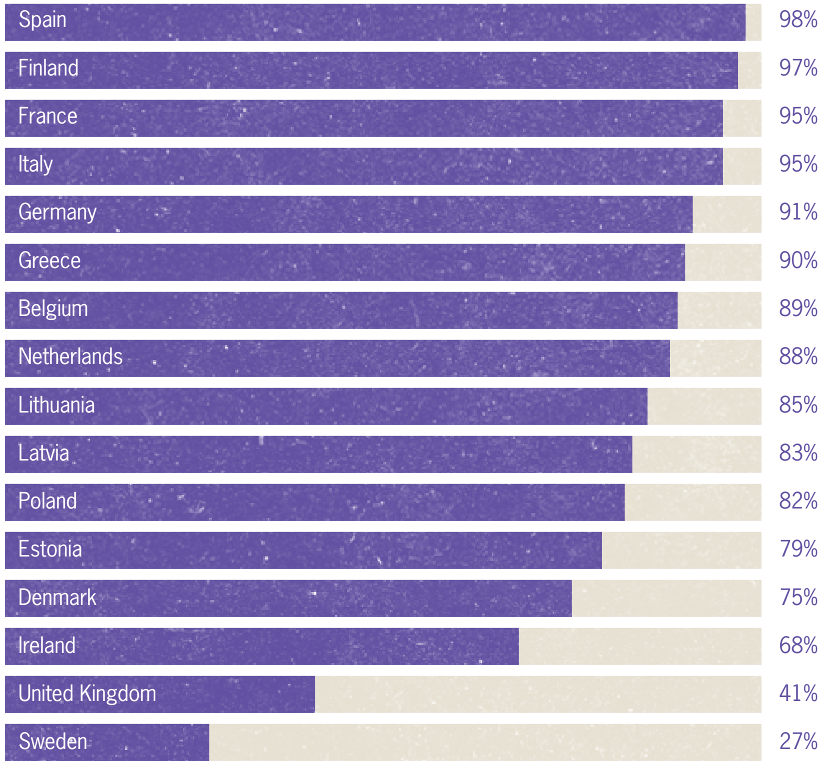
Outside the eurozone, there is much more scepticism about further integration: 29% of other EU business leaders are opposed, led by Sweden and the UK (both 55%).

Support for political union is way down at 14% across these economies, but 32% favour greater economic integration led by Poland (54%), Lithuania (40%), Denmark (37%) and Latvia (34%).

The results draw into sharper focus the fears that the ultimate impact of the eurozone crisis will be the creation of a two-tiered European system where the 17 eurozone 'ins' make decisions excluding the 10 'outs'. Splits have already developed, normally centring around the UK. In late 2011, UK Prime Minister, David Cameron, vetoed a new intergovernmental treaty to put strict caps on government spending and borrowing being written into EU treaties. However, all other EU members – excluding the Czech Republic – pressed ahead and signed the Fiscal Compact in early 2012. Indeed, the UK's relationship with Europe has become so strained that Mr Cameron has promised to hold a referendum on EU membership by 2017 if returned to power after the next election.



% of businesses open to further European integration



Source: IBR 2013

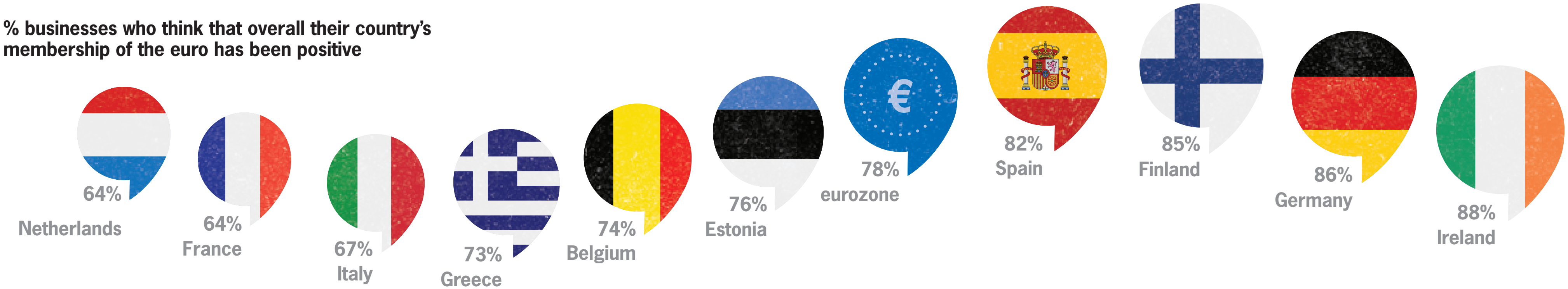
Expansion

At a time of such uncertainty in Europe, it would be understandable if countries both inside and outside the EU had shelved plans for further enlargement. No country has joined since Bulgaria and Romania acceded in 2007 but on 1 July 2013 Croatia will join and other nations – such as Iceland, Montenegro and Turkey – remain in negotiations. The eurozone itself may grow: Latvia has applied to become the 18th member of the euro whilst Denmark and Lithuania are part of the ERM-II mechanism (although the former has a formal opt-out).

Support for the euro to survive remains strong within the currency bloc – 94% of business leaders want to see the euro survive, up from 92% in 2012. Just 6% want their economy to leave, led by Italy (10%) although even here exit sentiment has declined over the past 12 months (down from 16%).

Moreover, 78% of business leaders are now positive about the overall impact of joining the single currency, up from 71% in 2012. Business leaders in Ireland (88%), Germany (86%) and Finland (85%) are most positive about the overall impact of joining the euro; peers in France, the Netherlands (both 64%) and Italy (67%) are much less positive – below Greece (73%) and Spain (82%).

% businesses who think that overall their country's membership of the euro has been positive



Source: IBR 2013

Growing the eurozone

euro adoption appeal fades

Sentiment around expansion has, however, sharpened amongst eurozone businesses over the past 12 months. When asked whether they would like to see the euro survive, 38% said yes, and that it should keep expanding, up from 31% in 2012.

However, 39% said yes, but that no more countries should join in the near future, up from 37% 12 months previously.

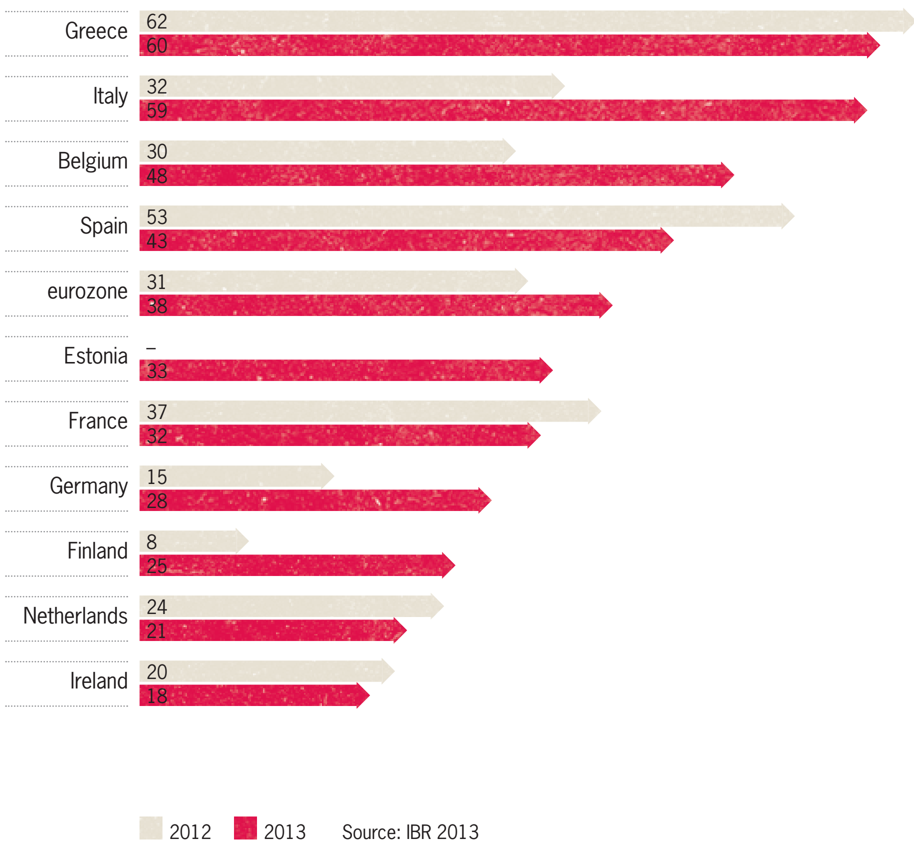
Businesses in troubled Southern Europe are amongst the most eager to see the euro expand. Greece (60%), Italy (59%) and Spain (43%) are all willing to welcome new entrants, as is Belgium (48%). At the other end of the spectrum, just 18% of business leaders in Ireland – which is rapidly assuming Latvia's role as the 'poster boy' for austerity – agree. The remaining AAA-rated eurozone economies of Germany (28%), Finland (25%) and the Netherlands (21%) are also less eager to see further expansion, although attitudes have softened considerably in both Germany (15% in 2012) and Finland (8%) over the past 12 months.

Together with Ireland (68%), the Netherlands (52%) and Germany (44%), business leaders in France (46%) are most strongly opposed to more countries joining the euro in the near future.

EU business leaders outside the single currency are also slightly more enthusiastic about the existing eurozone: 82% now want to see the euro survive, up from 79% 12 months ago. However, their enthusiasm does not stretch to adoption by their own economies. 85% of UK business leaders do not want to join the euro, up from 83% in 2012. There have also been ever sharper upswings in negative sentiment in Sweden (58% to 69%), Poland (28% to 39%) and Denmark (32% to 37%).

Whilst 71% of Latvia's business leaders expect to join the euro in 2014, 43% in neighbouring Lithuania do not see it happening until 2016 at the earliest. Danish and Polish businesses are less convinced: 49% and 45% respectively do not think they will before 2018. In Denmark the proportion of business leaders who think their country will never join increased from 26% to 39% over the past 12 months, a swing matched by Sweden (38% to 50%).

% businesses who want to see euro survive and continue to expand

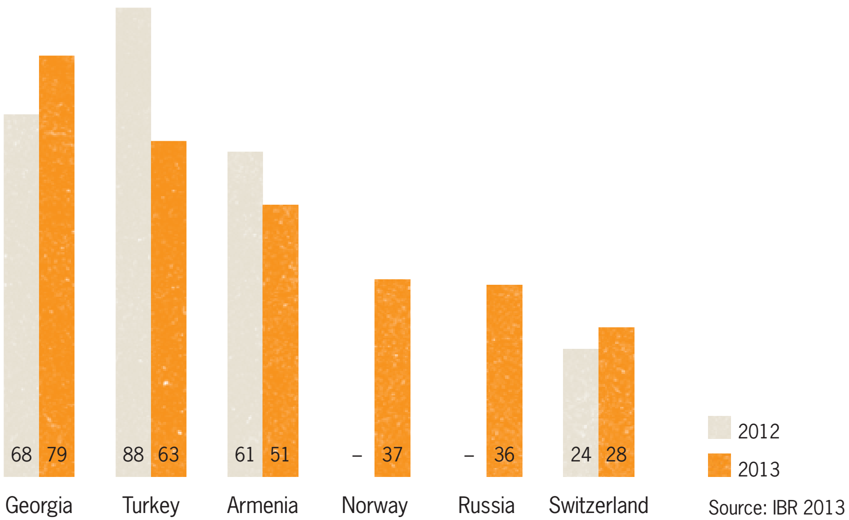


Fading appeal of the EU

Outside the EU, there is evidence of the declining importance of the trading bloc. In 2012, 62% of business leaders believed improving ties with the EU would be of benefit to their operations but that proportion fell to 52% this year.

The biggest decline in perceived importance of the EU was observed in fast-growing Turkey (88% to 63%). Just over a third of businesses in Norway (37%) and Russia (36%) believe further integration of their countries' economies with Europe would be an advantage for their companies.

% businesses who believe integration between their country and EU would be positive for their operations



Source: IBR 2013

Businesses in Turkey see the increased market for exports (56%) as the biggest advantage of further integration with the EU, although with membership negotiations seemingly stuck, trade with the Middle East has soared. Over the past decade, Turkey's exports to post-conflict Iraq have grown by 25% a year, making it the country's second largest market after Germany. Businesses in Armenia (46%) and Georgia (32%) also view the size of the single market as a potential advantage for their business.

For businesses in Russia, whose government enjoys somewhat fractious relations with the EU, leading to visa difficulties and import tariffs, the key advantage of further integration would be a decrease in bureaucracy (38%). For those in Norway, which sits in the European Economic Area but does not benefit from the free movement of labour, the key advantage would be easier access to qualified personnel from other countries (32%).

Whilst any of these nations would have to join the EU before they could adopt the single currency, it is interesting to note that even with the eurozone crisis ongoing, one in five business leaders would like their economy to eventually adopt the euro. Business leaders in Georgia (35%), Armenia (31%) and Turkey (26%) are most keen. However, whilst sentiment in Georgia (18% in 2012) has risen over the past 12 months, it has fallen in Turkey (from 32%), perhaps reflecting the former's desire to move away from Russian influence and the latter's pivot towards the faster-growing and increasingly open markets of the Middle East.

IBR 2013 methodology

The Grant Thornton International Business Report (IBR) is a quarterly survey of approximately 3,500 senior executives in listed and privately-held businesses all over the world. Launched in 1992 in nine European countries the report now surveys more than 13,000 businesses leaders in 44 economies on an annual basis, providing insights on the economic and commercial issues affecting companies globally.

The data in this report are drawn from 3,100 interviews with chief executive officers, managing directors, chairmen and other senior decision-makers from all industry sectors, conducted between November 2012 and February 2013. The economies and total interviews included in this report are listed below:

	Number of interviews	Countries interviewed
eurozone	1,250	Belgium, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Spain
Other EU	1,150	Denmark, Latvia, Lithuania Poland, Sweden, United Kingdom
European neighbours	700	Armenia, Georgia, Norway, Russia, Switzerland, Turkey

To find out more about IBR, please visit: www.internationalbusinessreport.com.

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United States
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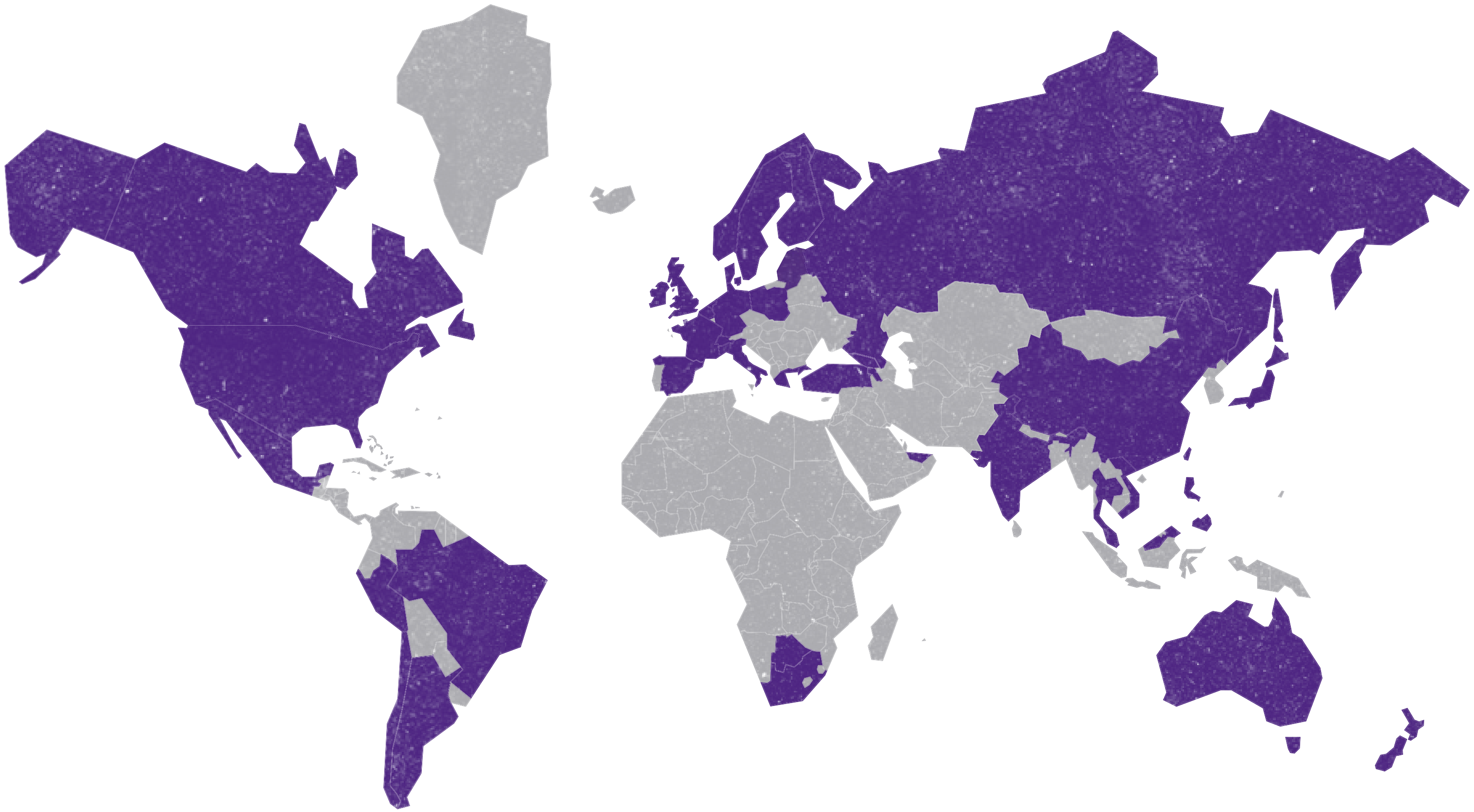

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