

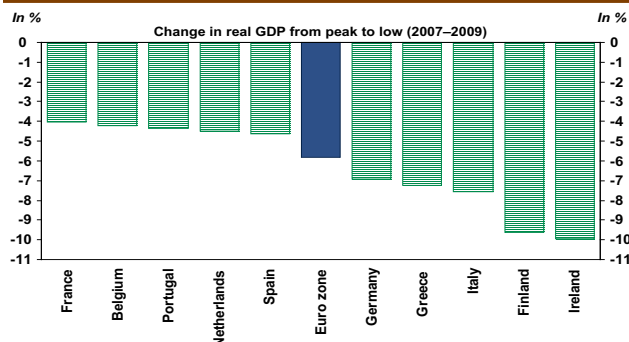
## Where is Europe heading? Medium-term issues

The European economy was looking forward to a promising future when it introduced its common currency at the end of the 1990s, but it has experienced years of disappointment since the economic and financial crisis of 2008–2009. Growth has been sluggish in both the western countries and in the emerging economies of the east. Even the advanced economies that stayed outside the euro zone have seen their share of problems. This *Economic Viewpoint* seeks to paint a picture of the current economic conditions in Europe, and to see what avenues are opening up for the years to come, in particular for investors.

### A PAINFUL RECOVERY

The recession dealt Europe a severe blow. From the cyclical high of the first quarter of 2008 to the low recorded in the spring of 2009, the euro zone's real GDP dropped by 5.8% (graph 1). That is more than the 4.2% contraction that occurred in the United States, even though that economy was the main source of the crisis. In the United Kingdom, the slump was 6.0%. In the Scandinavian countries that do not belong to the euro zone, the average contraction was 6.3%, not including the Icelandic economy, which saw its real GDP plunge by 11.7%. In Eastern Europe too, many economies suffered serious hardship, in particular the Baltic countries. Russia experienced negative growth of 9.6%, while that of the Czech Republic was more modest (5.8%).

Graph 1 – Real GDP contracted significantly in the euro zone during the crisis



Sources: Eurostat, Datastream and Desjardins, Economic Studies

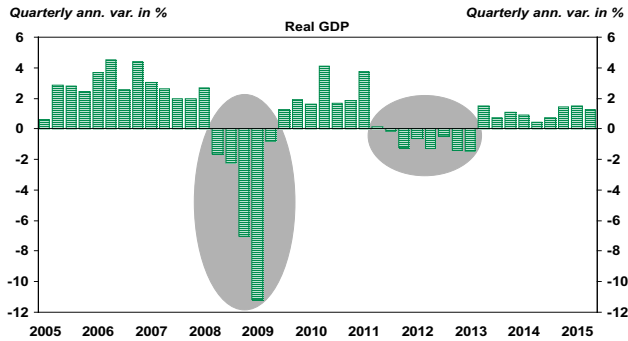
Just as we saw in North America, credit problems, especially for countries needing funds from beyond their borders, exacerbated the effects of the crisis considerably. Despite the efforts made by the central banks, it took a long time before credit resumed an upward trend. Furthermore, most of the economies in this zone got no help from government policies. Some aid programs were used at the beginning of the recession, but apprehensions about excessive government debt soon prompted more austere policies that further undermined the recovery.

The sovereign debt crisis, which mainly involved the fringe nations of the euro zone such as Portugal, Italy, Ireland, Greece and Spain, did damage to the euro zone economy while further weakening the countries of Eastern Europe. This crisis even sent the zone back into recession after the economy had temporarily improved between 2009 and 2010. The euro zone's GDP started to contract again in the summer of 2011 and kept on doing so until the beginning of 2013 (graph 2 on page 2). Consumer and business confidence indexes dropped again.

Due to this double-dip recession, the European economy has still not managed to catch up, in terms of economic activity, to where it stood before the 2008–2009 crisis (graph 3 on page 2).

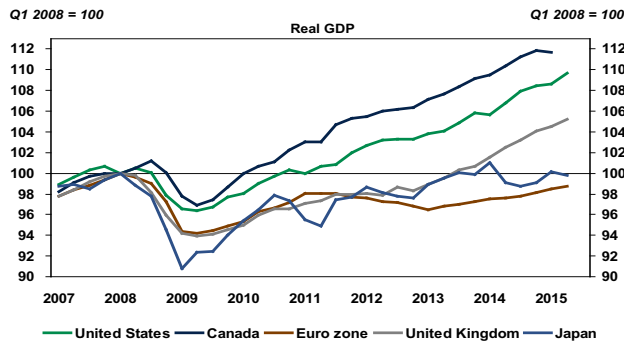
Like most advanced economies, the euro zone's real GDP is still below potential, despite the fact that growth potential there is low. The European Commission (EC) estimated

**Graph 2 – The euro zone suffered a double-dip recession**



Sources: Eurostat and Desjardins, Economic Studies

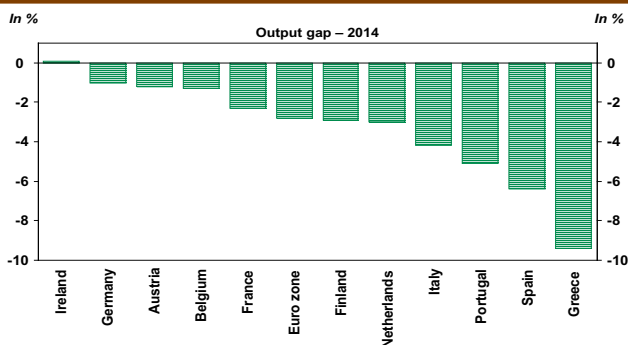
**Graph 3 – The euro zone economy is still below where it stood before the crisis**



Sources: Eurostat, Datastream and Desjardins, Economic Studies

growth at just 0.6% in 2014. This compares unfavourably with the potential gain of 2.0% estimated for the first half of the 2000s, or with the 2.2% that is currently estimated for the U.S. economy. Despite such meagre growth, the output gap is still wide: the EC estimated it at -2.8% for 2014 and at -2.1% in 2015. Obviously, great differences exist between the various countries of the zone (graph 4).

**Graph 4 – In most euro zone countries, the output gap is still wide**

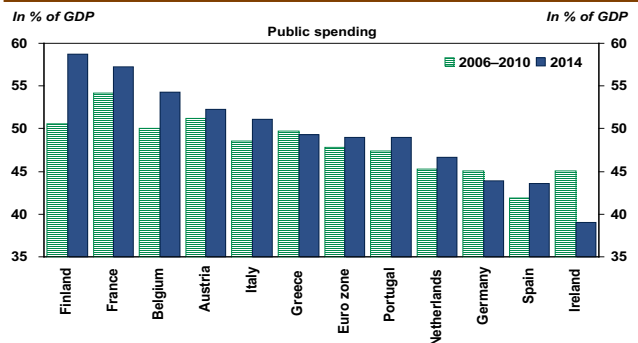


Sources: European Commission and Desjardins, Economic Studies

**FISCAL CONSTRAINTS**

The reform of European public finances is no longer doing as much damage to growth as was seen from 2011 onwards, but it is still restrictive. As a proportion of GDP, the total budget deficit for the euro zone reached 0.6% in 2007. It swelled to 6.1% in 2010 and then fell to 2.7% in 2011. Overall, while this improvement seems to have had negative effects on the economy, it did not take the form of major spending cuts. As a proportion of nominal GDP, spending stood at 45.1% in 2007 and reached a peak of 50.4% in 2009. It moderated to 48.7% in 2011, probably the year in which austerity made the toughest impact. Since then, the proportion of spending has been heading up, reaching 49.4% in 2014. That is 1% of real GDP less than in 2010, but still more than before the crisis. It would therefore be wrong to talk about a substantial disengagement by governments throughout the euro zone. Here again, the situation differs considerably from one country to another (graph 5). Obviously, spending declined the most in those European countries that experienced major constraints on their ability to take on debt and which were compelled to appeal to the International Monetary Fund (IMF) or to European institutions for aid. As for revenues, they obviously declined in parallel with the overall economy during the crisis. As a percentage of GDP, they remained relatively stable for the euro zone as a whole between 2008 and 2010. From 44.1% in 2010, they rose to 46.7% in 2014.

**Graph 5 – Public spending in the euro zone is still substantial**

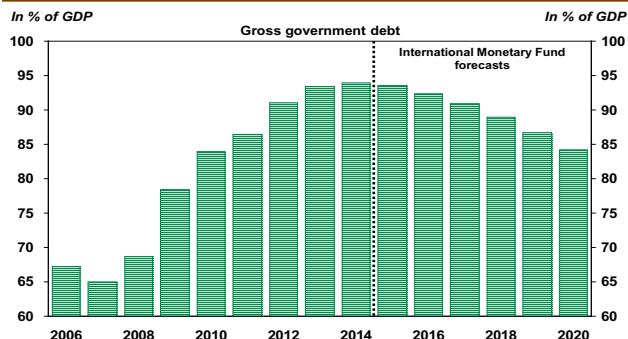


Sources: European Commission and Desjardins, Economic Studies

Since public debts are still high, with the euro zone as a whole recording a gross debt of 94% in 2014 after it had fallen to 65% in 2007 (graph 6 on page 3), spending growth will probably remain relatively weak, along with the public sector's contribution to economic growth.

The same trend may be seen in the United Kingdom, where the Cameron government has been trying to improve the public finance situation since it took power in 2010. After climbing from 3.0% in 2007 to 10.8% of GDP in 2009, the British deficit as a proportion of GDP fell to 5.7% in 2014.

**Graph 6 – Public debt has increased considerably in the euro zone**



Sources: International Monetary Fund and Desjardins, Economic Studies

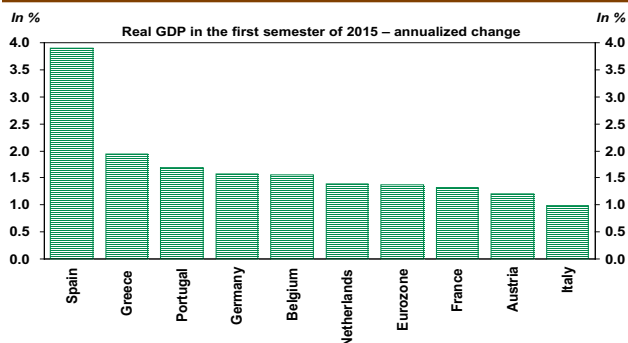
The gross debt is still relatively high, though, at 89.5% of GDP. The debts of the Scandinavian countries outside the euro zone are merely half that: 38.1% of GDP on average.

In Eastern Europe, the austerity imperative has been less obvious. In these countries, exchange rate fluctuations have enabled the economy to adjust. On average, the emerging countries of Europe have seen their proportion of government spending decline from a maximum of 41.1% in 2009 to 37.1% in 2011, and then rise again to 38.4% in 2014. At 30.9%, the gross debt of the European emerging countries is lower than that of the western countries, in part thanks to Russia, whose debt reached a mere 17.9% of GDP in 2014 (but it has doubled since 2007).

**RECENT IMPROVEMENT IN THE ECONOMY**

The recovery is still slow, and fears of another pullback were strong during 2014. However, we can now perceive some improvement in the euro zone economy, even if upturns in real GDP are still modest. The annualized real GDP growth that was recorded by the euro zone in the first semester of 2015 was only 1.4%. Amazingly, some of the most affected countries during the crisis experienced the best growth so far in 2015 (graph 7).

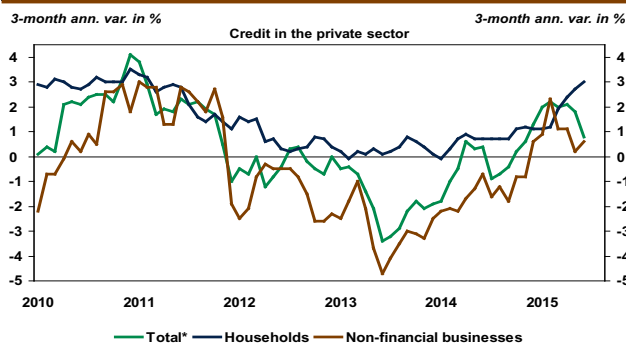
**Graph 7 – Some of the most troubled countries during the crisis have had a good start in 2015**



Sources: Eurostat and Desjardins, Economic Studies

Various factors account for the improving performance by the euro zone economy, in particular better economic conditions in the United States and the United Kingdom. As far as internal factors are concerned, after years of struggle, we are finally seeing acceleration in private-sector credit. Low interest rates and the measures set up by the European Central Bank (ECB) have now sparked a turnaround in the demand and supply of loans, and it is starting to bear fruit (graph 8). Credit levels are still weak, however.

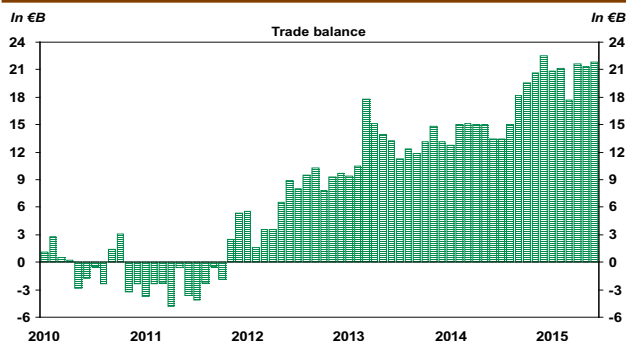
**Graph 8 – Credit recovery is continuing in the euro zone, especially among households**



\* Includes financial institutions other than banks. Sources: European Central Bank and Desjardins, Economic Studies

Even though the euro zone was struggling for many years, the currency remained relatively strong once the sovereign debt crisis abated. From the low of around €1.20/US\$ that was reached during the debt crisis in 2012, the euro climbed back up until the beginning of 2014, when the ECB was far less active than the other central banks (in particular the Federal Reserve) in providing monetary support for growth. The euro verged on €1.40/US\$ in the spring of 2014, but then plummeted to close to parity with the greenback (a low of €1.05/US\$ in March 2015). This weakness of the euro promotes internal growth by giving a significant boost to net exports (graph 9).

**Graph 9 – The euro zone’s trade balance is greatly improving**



Sources: Eurostat and Desjardins, Economic Studies

In the United Kingdom, growth was also sluggish at the beginning of the recovery, but the British economy posted a series of quarters of relatively strong growth starting in early 2013. These gains were supported by healthy growth in consumption and investment.

After facing challenges in 2012 and 2013 due to the weakness of the euro zone economy and a monetary policy that was probably not sufficiently expansionist, Sweden and Denmark enjoyed acceleration in real GDP in 2014. Norway's growth is more dependent on the fluctuations of the oil sector; 2014 was a good year, but the outlook is not so rosy.

In Eastern Europe, current economic conditions are mixed. The countries nearest to the euro zone are managing quite well; this is true of Poland, Hungary and Romania. However, the slump in commodity prices and the conflict with Russia are complicating things in the countries that lie further east. Russia appears to be sinking into recession as a result of collapsing oil prices and the sanctions that were imposed after the conflict in Ukraine. With a war on its soil, Ukraine is naturally experiencing severe economic problems; its real GDP tumbled by 6.5% in 2014.

**EFFORTS BY THE CENTRAL BANKS**

With the exception of the Bank of England (BoE), the European central banks are quite active these days. Many countries' key interest rates have been lowered and, in some cases, have even been set below zero (in the euro zone, Sweden, Denmark and Switzerland). The ECB and the Bank of Sweden are also easing their monetary policies through asset purchases (in particular, but not exclusively, government bonds). These measures are of course being adopted to support economic growth and, especially in Denmark and Sweden, to limit the fluctuations of their respective currencies against the euro. Inflation is also particularly weak in Europe due to the wide gap between the level of economic activity and its full potential (unused capacity) and to the collapse in energy prices. In July 2015, inflation stood at 0.2% in the euro zone, 0.8% in Sweden and 0.5% in Denmark. Norway stands out as an exception with an inflation rate of 1.5%, and the key interest rate set by the Bank of Norway (Norges Bank) is pegged at 1.0% (but is on a downward slope).

As for the BoE, it is pretty much in wait-and-see mode. The key interest rates have been static at 0.50% since March 2009, and the BoE ended its asset purchase program in the summer of 2012. The next monetary policy moves will probably consist in tightening the monetary conditions.

**BUSINESSES ARE STILL FRAGILE**

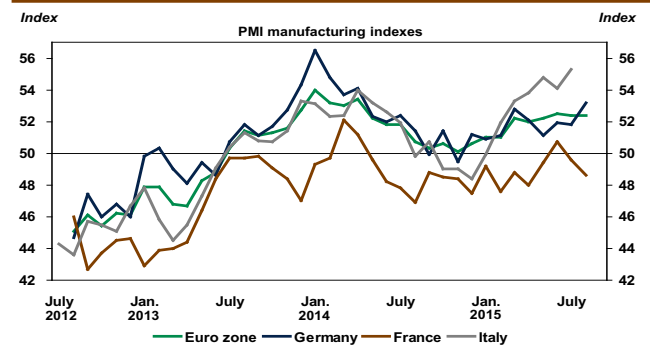
European businesses still find themselves in a fragile position. Of course, financial businesses are the ones that were hardest hit by the recent crisis episodes, but even non-financial businesses are having trouble getting back to normal. Among industry leaders, confidence is no longer at the bottom of the barrel as it was in 2009 or in 2012, but their morale is still rather in the doldrums and is not managing to get back to levels that would be more conducive to strong investment and economic growth (graph 10). The latest trends in industry leaders' confidence indexes, and in the PMI indexes, are treading water to some extent, or even deteriorating (graph 11).

**Graph 10 – Industry leaders' confidence does not yet point towards sharp acceleration in investments**



Sources: European Commission, Eurostat and Desjardins, Economic Studies

**Graph 11 – The PMI indexes are still relatively disappointing**

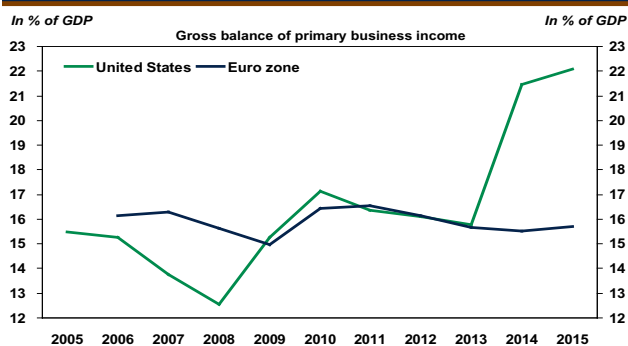


Sources: Markit, Datastream and Desjardins, Economic Studies

The inability to raise prices in a very low inflation environment, combined with anaemic economic growth, limp consumer confidence and practically zero productivity growth (graph 12 on page 5), are keeping a tight lid on business profit growth. As a proportion of GDP, business profits are far from the historic peaks that were recently hit in the United States (graph 13 on page 5). This situation reflects some degree of short-term weakness, but offers glimpses of attractive opportunities if we take into account the temporal shift in economic cycles; while even greater profit growth

**Graph 12 – Productivity growth is quite slow in the euro zone**

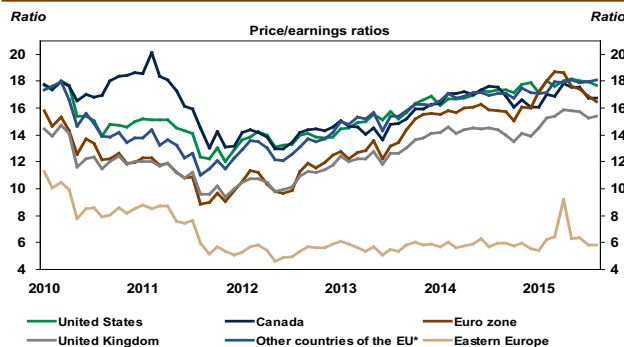
Sources: Eurostat and Desjardins, Economic Studies

**Graph 13 – Euro zone business profits are still modest**

Sources: European Commission and Desjardins, Economic Studies

in relation to the economy seems hard to imagine in the United States, improvements are still widely possible in the euro zone. Low interest rates should generally support the performances of European businesses, but they are so low in the euro zone that they also have the reverse effect of constraining profits in the financial sector, in particular for insurance companies.

Stock prices are in a more balanced position. At around 17, the price/earnings ratios in the euro zone are close to their average and are looking quite similar to what exists in North America (graph 14). However, with a greater possibility of profit growth in relation to the economy, stock price trends are likely to prove more appealing. This also applies to the countries that are members of the European Union (EU) but not of the euro zone. However, the British stock market (where the ratio is currently slightly lower) could be affected by more imminent monetary firming, reflecting how far along that country is in the current economic cycle. In Eastern Europe and the emerging European countries, the situation is very different and the price/earnings ratios are far lower. Clearly, stock prices are also affected by the uncertainty generated by the looming nearness of Russia.

**Graph 14 – U.S. and European price/earnings ratios are similar**

\* European Union.

Sources: Institutional Brokers' Estimate System, Datastream and Desjardins, Economic Studies

## OUTLOOKS

After these difficult years, the euro zone economy should improve further. With the support of interest rates that will remain very low, weak inflation that boosts real income, and a currency whose depreciation stimulates foreign trade, growth should firm up.

Beyond the recovery, economic growth will likely remain relatively slow. Most measurements of potential real GDP growth show that growth is slowing markedly compared with what was seen in the 1990s or 2000s. In the case of the euro zone, the annual change in potential real GDP has shrunk from 2.0% during the first half of the 2000s to 0.6% in 2014. An upturn of 0.9% is anticipated for 2016. Most of the main economies of the zone are in the same boat. France's potential growth is expected to be 1.1% in 2016, and that of Germany, 1.6% (in the latter case, this is higher than what had been estimated for 2001–2005). In Italy, potential should remain stuck in negative territory in 2016, with a forecast of -0.1%. Keep in mind that real GDP growth figures can turn out to be higher than these potential numbers; in fact, we foresee a partial closing of the gap. However, such weak potential reduces the possibility of lasting, strong real growth. It makes the economic cycles more fragile (higher possibility of negative growth), limits interest rate hikes and impedes business investment intentions and profit growth.

## Demographic issues

One of the main reasons for weak potential real GDP growth in Europe in the years to come is the slow demographic growth. Population growth there is modest, as it is in most of the advanced countries and in certain emerging economies, including China. This situation will probably continue for most of the European economies in the years, or even decades, to come, according to average forecasts compiled by the United Nations (UN). While the population of the countries that currently belong to the euro zone expanded

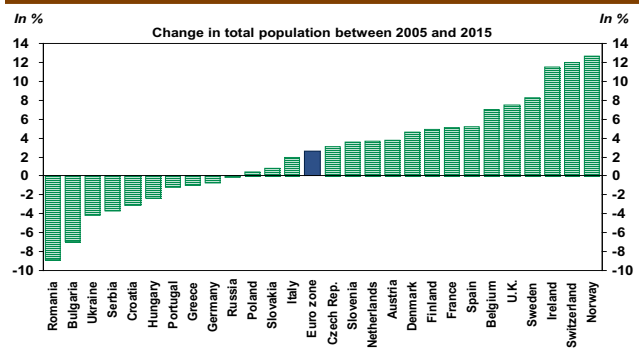
by 3.8% between 1985 and 1995, as it also did between 1995 and 2005, the 10-year gain between 2005 and 2015 was just 2.7% (graph 15). Over the next 10 years, population growth is expected to be anaemic: just 0.8%. In fact, net population declines are expected in the euro zone starting in 2030. The main engine of the European economy, Germany, is facing a major demographic problem: its population has been stagnating at around 81 million for over 15 years now. It even contracted by 0.8% between 2005 and 2015. Of the major European economies, France is recording one of the strongest population growths with a gain of 5.1% over the past 10 years. In the long term, this situation is likely to change the balance of forces in the euro zone. According to the UN's projections, France (currently 64 million inhabitants) will be more populous than Germany by 2060 (graph 16)! Being unable, according to these theories, to count on robust domestic demand in the medium and long terms, Germany will increasingly have to rely on its productivity and on foreign trade, something that, fortunately, it already does very well. In the Global Competitiveness Index compiled by the World Economic Forum (WEF), Germany ranks 5<sup>th</sup>, thanks to factors linked to innovation and sophistication. By comparison, France stands in 23<sup>rd</sup> place. The free-trade agreements with other major economic zones that are under

discussion or on the way to being ratified also constitute very interesting ways of making up for the weakness of domestic demand and should provide opportunities that the European domestic economy would be unable to develop on its own.

**Trade imbalances**

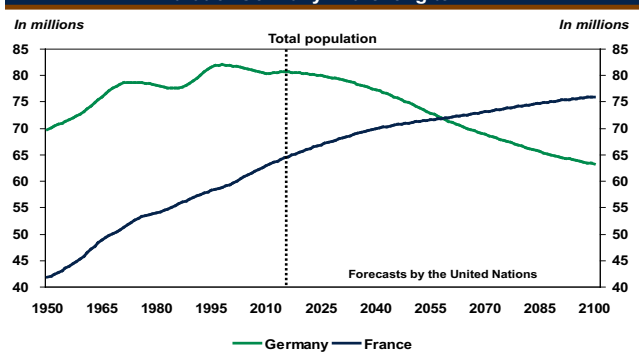
The importance of international trade for Germany also reflects another European problem: the economic position of the euro zone is still weakened by macroeconomic imbalances that have haunted it since the adoption of the common currency. These latent problems had been forgotten, or overlooked, in the mid-2000s. They returned to plague the economy during the financial crisis of 2008–2009 and the sovereign debt crisis. The great divergences in the economic structures of the zone's various member countries are reflected in many ways, in particular in the current account balances. On this point, we note that the large disparities that had formerly been observed have dissipated to some degree (graph 17). However, Germany still rakes in large surpluses in its current account, while France remains in a deficit. Since no currency adjustment is possible, current account rebalancing takes place through internal variations in production costs. In the short term, at least, this weakens domestic demand and confidence in the economies that are most affected (and least competitive) and which no longer have easy access to external funds, as they did during the 2000s, to compensate for, or to cover up, their problems.

**Graph 15 – Population growth is uneven across Europe**



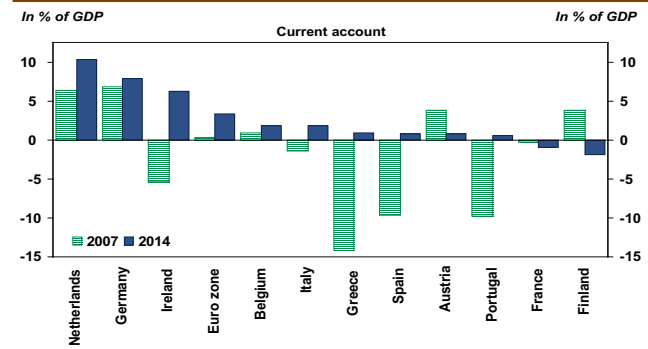
Sources: United Nations and Desjardins, Economic Studies

**Graph 16 – The population of France is expected to surpass that of Germany in the long term**



Sources: United Nations and Desjardins, Economic Studies

**Graph 17 – The current account imbalances have diminished, but still exist**



Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

**Productivity and potential**

In order to keep growing despite a constraining demographic situation, Europe will really need better productivity and investments. The EU has already announced the injection of €315B over three years for public and private investment projects. One may question the effectiveness of this program, which seems to cast a wide net rather than target the economies that are facing the most problems.



But at least this is a step in the right direction, helping to renew confidence in the European authorities, whose past message of austerity at any cost did more damage. In these circumstances, especially if we assume that the summer of 2015 is really drawing the curtain on the Greek crisis, the climate of confidence can only get better.

Furthermore, the structural reforms that have been set up since 2010 in many countries, often painfully, should eventually bear fruit and result in better productivity and a greater ability to adapt in the current growth cycle. For example, the Organisation for Economic Co-operation and Development (OECD) estimates that the reforms that have been introduced will increase France's potential GDP by 3% after 10 years. The same calculation calls for a gain of 6.3% for Italy! The economy will become more favourable for new private investments, and such opportunities should multiply and become more attractive.

### United Kingdom

In the United Kingdom, the 1.7% potential GDP growth forecast for 2016 should turn out to be twice as strong as estimated for the euro zone. This also reflects a more interesting demographic situation: the British population has expanded by 7.5% over the past 10 years, and a gain of 5.9% is expected for the next decade. According to the IMF, the British economy is somewhat deficient in the area of public infrastructures, which could limit its potential growth. But this is offset by a propensity for quick adoption of new technologies. However, the threat of the United Kingdom exiting the EU is a sword of Damocles that could undermine the economy between now and the referendum, scheduled for 2017. This concern offsets the potential benefits of the recent majority re-election of the Cameron government, which is widely perceived as being very pro-business.

### Scandinavian countries

In Scandinavia, the main long-term constraint is still the small size of the local market. However, healthy population growth in the past decade (+8.3% for Sweden, Denmark and Norway combined) has been a positive factor, which should continue to some extent between now and 2025 (+6.9%) according to the UN. Nevertheless, these countries need to be wide open to international markets and must take care to stay competitive. In fact Sweden (10<sup>th</sup>), Norway (11<sup>th</sup>) and Denmark (13<sup>th</sup>) rank well in the Global Competitiveness Index. In the short term, the Scandinavian countries have been rendered vulnerable by the economic weakness of the euro zone, and the depreciation of the euro has made things complicated for their central banks. The good news is that these economies should benefit from the improvement in the euro zone economy. However, a relatively high cost of

living seems to be limiting the ability of some businesses to hire highly-qualified personnel and is thus keeping development from progressing as fast as it might.

### Eastern Europe

The future growth of the Eastern European countries will depend to a large extent on what happens to the relations between Russia and the Western World. The war in Ukraine and the slump in the oil sector have given outlooks in this region a rough ride. To limit the unstable influence from Russia, these countries would be well advised to turn increasingly to their neighbours out West, and to continue their structural reforms designed to increase their productivity and, more importantly, the efficiency of a market economy that is still struggling. The best-performing countries of Eastern Europe (i.e. the Czech Republic and Poland, which are members of the EU) stand around 40<sup>th</sup> place in the competitiveness index. The demographics in this region are problematic: the population (including that of Russia) has declined by 1.5% since 2005 and a drop of 2.7% is expected by 2025. Lastly, to achieve better growth and better investment opportunities, it will be necessary to put the financial books in order, especially in the private sector.

### CONCLUSION

The European economy has suffered its share of problems, and some of them will leave almost permanent scars. However, despite some false starts and latent uncertainties, the recovery of that economy now seems to be sitting on more solid foundations. The euro zone is still at the beginning of an economic cycle, with a high unemployment rate, anaemic inflation and credit growth that is still in its infancy; but as the situation improves, attractive opportunities should emerge. The low interest rates (especially compared with other regions where key interest rate hikes are on the horizon), the value of the euro, and openings in terms of international trade (in particular with the United States) all represent appealing factors for businesses and investors in the short term. In the medium term, some constraining factors (such as low population growth) will also be very pervasive; but a new boom in investment and productivity, supported by ongoing structural reforms, should offer hope that the European economy will continue to be a major player on the global chessboard.

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