Europe stretched to the limit

A report by The Economist Intelligence Unit
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Europe—or, more particularly, the EU—is now in the seventh year of a multi-stage political and economic crisis, which it entered in 2010. This crisis has been defined by a failure of the region’s institutions to provide effective governance and leadership in response to political and economic challenges. The early stages of the region’s institutional crisis were characterised by challenges to the survival of the single currency. The Economist Intelligence Unit believes that the threat to stability in the region is much wider; this has been demonstrated by the events of the past two years. The euro crisis has not gone away, and the intra-bloc tensions it has engendered have now been compounded by a migration crisis. Disagreement about the free movement of people has become the latest existential threat to the legitimacy of the EU and its major governments.

As in the euro crisis, the main impediment to an effective solution to the migrant crisis is disagreement about collective action at a European level. Regional policymakers have yet to reach consensus about what types of action should be implemented at supranational level, while divisions are ever starker as to what type of policies should be pursued. There is an increasing focus on transactional politics, with policymakers looking to defend national interests at the expense of their neighbours.

In managing its multiple crises since 2010, the region has had to resort to “muddling through”. We regard this policy approach as having been moderately successful, certainly when compared with some of the disastrous outcomes that appeared possible in the early stages of the crisis. However, muddling through, by definition, does not offer a medium- or long-term strategy for addressing the region’s problems and has eroded the political capital of the policymakers involved.

This has led many commentators to suggest that Europe will be forced ultimately to decide between significantly greater integration and break-up. We acknowledge that the region faces major unanswered questions, but Europe is capable of maintaining a muddle-through policy for a sustained period of time. In the long term, the critics are probably right: Europe would need to integrate much more substantively to find solutions to the crises it is facing. There is little to suggest, however, that the region’s strategy cannot be sustained over the medium term, albeit at significant political and economic cost. That is exactly what we expect to happen during our five-year medium-term forecast period.

This paper explores the multiple challenges that the region will face over the next five years. The maps on page 4 show the extent to which political and economic risks remain heightened in the region.
In the sections that follow we focus on a number of key challenges. In particular, we discuss:

i) Migration: The migration crisis touches on crucial issues of sovereignty, culture, borders and free movement. Europe’s confused response so far has risked worsening the problem, although there are tentative signs that the recent EU-Turkey deal has slowed migrant flows.

ii) Brexit: The risks of the UK leaving the EU have increased over recent weeks—chiefly because of a series of hits to the reputation for competence of the prime minister, David Cameron—but we continue to expect the UK to vote “remain” in June.

iii) Grexit: We expect Greece to leave the euro zone during our five-year forecast period. Grexit would represent a huge political failure for the bloc, with potentially destabilising consequences: the principle of irreversibility would have been shattered.

iv) Monetary policy: A deepening reliance on accommodative monetary policy has been one of the hallmarks of the post-crisis period in Europe. This is creating its own challenges which the region is hard placed to address.

v) Productivity: The region faces an ongoing crisis of productivity which it needs to address if it is to deliver improved growth.

vi) Regional security: Russia has become aggressively revisionist in the last several years, posing a challenge to the regional security architecture.

vii) Populism: Populist movements have come to prominence in rich and poor countries alike, and the region will struggle to manage the implications of an erosion of post-war political structures and voting patterns.

While in theory any of these challenges has the potential to be highly detrimental, we expect that in most cases national governments and supranational institutions will manage these challenges in turn, in each case steering the region through interim solutions. Greece is the exception to the rule of muddling through: we do not believe that policymakers will succeed in keeping Greece in the euro zone throughout our five-year forecast period. This will create particular risks for other fiscally stressed countries in the euro zone, but we expect the region’s firewalls to be sufficient to contain these risks.

However, Europe would find itself particularly stretched if several of these crises were to crystallise at once. For example, while the region could probably handle Brexit, Grexit or an escalation of the migrant crisis individually, it would be unlikely to navigate successfully a situation in which several of those crises came to a head simultaneously. It is not impossible that this could happen as early as mid-2016, when the UK votes on whether or not to remain in the EU, Greece has large debt payments falling due and this year’s migrant influx is likely to peak, but this is not our baseline forecast.

We expect the story of the next five years in Europe to be very similar to that of the past five years: a messy process of muddling through, characterised by suboptimal policy solutions and a suboptimal growth performance. That will leave the Europe of 2020 a troubled place, but with little fundamental having changed in the continent’s institutional underpinnings.
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Risk in Europe, 2016-20
(Green=least risk, red=most risk)

Macroeconomic risk

Political stability

Source: The Economist Intelligence Unit. The maps reflect countries’ scores in the political stability and macroeconomic risk sections of our Risk Briefing model.
Migration: an existential crisis

The migrant crisis continues to have dramatic political effects in Europe. The Economist Intelligence Unit has argued since migrant inflows surged last year that this issue represents a new and more dangerous stage in Europe’s rolling political and economic crises. The first stage was dominated by financial issues. The focus has now shifted to more politically challenging problems concerning borders, sovereignty, culture and security. It is too early to tell whether the EU’s recent deal with Turkey will change the dynamic of the migrant crisis in the way that Mario Draghi’s “whatever it takes” speech in 2012 changed the dynamic of the euro zone crisis. It’s a more ambitious deal than expected, with the potential to create significant deterrent effects. But it is subject to legal, political and practical difficulties that could cause it to unravel.

In domestic terms, the impact of the migrant crisis has been felt most sharply in Germany, where last year the chancellor, Angela Merkel, adopted a welcoming policy stance that contributed to a surge in migrant arrivals to 1.1m in 2015. This, in turn, led to fears in Germany that the crisis was spiralling out of control and that lasting damage would be done to the country’s social fabric and cultural identity. Reversing this sense of loss of control in Germany remains the key to managing the migrant crisis. A successful resolution to the crisis does not require anything like a complete cessation of inflows. It requires a sufficient reduction for Ms Merkel to be able to reassure her electorate that she has regained control of the issue. The two key metrics, therefore, are the numbers of migrants arriving in the EU and Ms Merkel’s approval ratings. It is early days, but there have been tentatively promising signs on both.

The key political developments have been the contentious agreement that the EU reached with Turkey in March 2016 and the steps taken a few weeks earlier by Austria and nine Balkan states (Albania, Bosnia and Hercegovina, Bulgaria, Croatia, Kosovo, Macedonia, Montenegro, Serbia and Slovenia) to close one of the key migrant routes from Greece across the EU. The closure of the Balkan route happened unilaterally, without consultation with other European partners, raising significant concerns about the erosion of the EU’s collective policymaking capacity on the migrant question. The deal with Turkey at least restores policymaking to formal multilateral channels, even if it is clear that equitable burden-sharing within the EU on migration is politically impossible, given the refusal of some states to participate in a scheme proposed last year to redistribute refugees across the bloc. The
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Even if the deal works in the short term, there is a risk that major legal, political and practical challenges will cause it to unravel.

The essence of the deal with Turkey is that migrants arriving illegally from Greece will be returned to Turkey, from where registered Syrian refugees would then be accepted into the EU on a one-for-one basis. The intention is twofold: first, to reduce the flow of refugees (by creating disincentives for anyone thinking of travelling directly to the EU), and second, to impose more control on the resettlement process (the refugees accepted from Turkey would be transferred straight to their destination rather than, as at present, having to seek a route via Greece).

Although there is anecdotal evidence of a fall in the number of arrivals in Greece since the deal was agreed—the latest official data are summarised in the chart above—it remains too early to determine whether the deal will work. Our initial assessment is that the deal, if implemented, could lead to a decisive reduction in the flow of refugees (notwithstanding the fact that alternative routes will almost certainly spring into existence), but that it has at least three major shortcomings that could lead to its failure.

First, the deal may be illegal. The EU has stipulated that it will comply with its international obligations and ensure that individual asylum applications are processed in Greece, but there is clearly an appetite to err on the side of transferring as many people as possible back to Turkey as swiftly as possible. This could lead to legal challenges, which, if successful, could undermine the effectiveness of the new scheme.

Second, the deal’s reliance on Turkey is a vulnerability. Turkey is asking a high price for its co-operation, and the promise of visa-free access for Turkish citizens to the EU (or the Schengen area) is likely to be politically unacceptable in many EU member states. By the first week of April Turkey was already threatening that it would cease co-operating with the EU on migrant transfers if the EU’s pledges are not honoured.
Third, the deal requires a level of administration in Greece that far exceeds what the authorities can provide, and the EU has so far failed to deliver on its promise of many hundreds of additional personnel to help implement the deal.

This last point highlights the mounting problems that Greece is facing as the key frontline state in the EU through which most migrants have been transiting. As the EU has become more effective at preventing migrants from moving across the bloc, so the pressures in Greece have been escalating. We expect the Greek government to encounter serious difficulties in accommodating the migrants, processing their asylum claims and returning them to Turkey. And this is not simply an administrative challenge; there are huge public-order challenges too. There have already been numerous violent incidents, and there is a clear risk of worsening violent clashes both among the migrants and between migrants and the Greek police. Moreover, all of this is happening at a time when the Greek government is once again at loggerheads with its international creditors over the terms of its latest bail-out deal ahead of a large bond repayment that is due in July. The risk of Greece suffering yet another lurch into crisis is significant.
The UK electorate will vote on June 23rd 2016 on whether or not to stay in the EU. Even at a time of profound institutional strain across the EU, the UK remains an outlier in terms of the uneasiness of its relationship with the EU and its sovereignty-pooling underpinnings. The UK’s “Brexit” referendum has been brewing for two decades or more and is rooted in domestic political considerations, but it is nevertheless a dramatic illustration of the increased fragility of the bonds that tie the EU’s 28 member states together. If there is a “leave” vote, the immediate consequences would be much more pressing for the UK than for its neighbours, but it would set a destabilising precedent for the EU, which has never before lost a member.

The risks of the UK leaving the EU have increased over recent weeks owing to a series of missteps by the “remain” campaign, but The Economist Intelligence Unit continues to expect the UK to vote in June to stay in the EU. Our view is that the result will ultimately be decided by a large enough number of voters being sufficiently worried about the uncertain economic consequences of “Brexit”. As is often the case when a constitutional referendum is held, defending the status quo is easier than arguing for a radical departure from it. The force of that status-quo bias will strengthen in the final stages of the unusually long campaign.

There are numerous potential outcomes for the UK if it leaves the EU, and there is no way at this point in time that advocates of Brexit can guarantee that a vote to leave will result in a favourable rather than an adverse outcome. Supporters of Brexit argue that outside the EU the UK would be free to pursue a wider range of political and economic opportunities. But the “remain” campaign will counter that leaving the EU would be a dangerously high-risk strategy given the real possibility that Brexit might, on the contrary, undermine some of the political and economic advantages that are currently taken for granted.

A key pillar of our Brexit call is the fact that David Cameron, the prime minister, is leading the “remain” campaign. He is far and away the most influential politician in the UK, and he has been unexpectedly forceful in his campaigning on this issue. For this reason the fact that he has spent much of March and April 2016 on the back foot—first due to a senior ministerial resignation and then due
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After the initial shock of a Brexit vote there would be a gradual return to market stability, but broader investor sentiment would be slow to recover.

to Mr Cameron’s embroilment in the “Panama Papers” leak—could be a potential game-changer if not remedied.

We acknowledge that there are downside risks to our Brexit forecast. Opinion polls currently point to a very narrow vote, and the momentum is with the “leave” campaign as successive news cycles focus on issues that damage the “remain” campaign. Individually, none of these news events will be sufficient to swing the result to “leave”, but if they continue to mount up, there is a risk that they will accrue a cumulative force that could swing the vote. However, we expect much of the current campaign noise to have faded by the time the vote approaches, and we also expect the “remain” campaign to learn from its recent errors and to begin to operate more effectively.

The most pressing downside risk to our referendum forecast is the issue of immigration, cultural and economic aspects of which underpin much of the leave vote. If there were an immigration-related shock or crisis in the run-up to the referendum, it could cause a substantial number of “remain” voters to swing to “leave”, pushing the overall electorate towards a leave vote. The fact that Europe is still mired in an unprecedented migration crisis clearly heightens the risk of such a shock or crisis.

If the UK were to vote to leave the EU, it would trigger economic and political turmoil, albeit largely in the short term. We already expect the currency to depreciate in the run-up to the referendum, but a vote for Brexit would prompt a sharp renewed sell-off, driven by an assessment of the potential costs involved in leaving the EU. Investors would be concerned that capital and labour flight would impair the economy, undermining the UK’s safe-haven status. After the initial shock there would be a gradual return to market stability, but broader investor sentiment would be slow to recover and credit spreads would be wider than before, reflecting higher risks associated with UK borrowers. Uncertainty about the economic outlook would also lead to an increase in precautionary savings and delayed investment decisions, ultimately hurting the pace of economic growth.

Economic turmoil would be accompanied by a domestic political crisis, probably involving the swift resignation of Mr Cameron. His replacement would have to lead a governing party that would be entirely riven on the issue of Europe, with around half of the Conservative Party’s 331 parliamentarians having positioned themselves on each side of the debate. These divisions within the governing party would undermine government effectiveness. So too would the need to devote significant political resources to countering the surge in uncertainty that a vote to leave would have created.

The medium-term economic costs associated with Brexit would depend entirely on the precise details of the exit agreement, which the UK would have two years to negotiate once it notified the EU of its intent to withdraw. Exit negotiations would involve striking a balance between (i) retaining access to EU markets and (ii) freeing the UK from EU rules, notably in relation to the free movement of people. Following a vote to leave, the EU would have little incentive to offer the UK a favourable deal. In exchange for continued access to the single market, the UK would therefore be likely to end up having to accept key elements of EU legislation, including some potentially contentious continuing obligations on free movement. A deal that focused only on trade in goods would be achievable at lower cost to the UK, particularly on free movement, but given the significance of the services sector to the UK, this would be problematic.
In the event of a vote for Brexit, we would expect a sizeable drop-off in foreign direct investment (FDI) from companies that view the UK as a gateway to Europe. This would make it more difficult for the UK to finance its current-account deficit, which remains substantial. In the longer term, however, the UK remains an attractive business environment, and we would expect economic growth to recover, albeit to a level below our current baseline forecast. London would retain its status as a strong international financial centre by virtue of its language, time zone and deep concentration of interconnected businesses. Structural features of the UK economy, such as a flexible labour market and a broadly pro-business policy orientation, would also help the UK to remain an attractive destination for inward investment. However, these features would be set against a wider and more persistent current-account deficit and a reduced supply of labour from the EU, which would undermine the prospects for a recovery in productivity.

In the short term, a vote in favour of Brexit would cause much less disruption in the EU than in the UK. However, the corrosive medium-term effects should not be understated. The EU is a project that has only ever had to consider its evolution on two integrationist dimensions: broadening and deepening. If the UK were to exit, then the risk of further fragmentation would immediately increase, particularly in the context of elevated nationalist and anti-establishment sentiment in many countries. Moreover, the internal balance of the EU would be altered significantly by the loss of the UK. In some respects this would probably be beneficial for the remainder of the EU—the UK has not been an easy passenger in recent decades. However, the loss of the UK would impose costs as well. Senior German officials, for example, have repeatedly made it clear that they value the UK’s reformist instincts and would feel less confident about the EU’s ability to modernise and adapt without the UK sitting at the table. One likely response to the UK leaving would be an intensification of efforts to increase supranational political integration, particularly in the euro zone. The risk of this leading to a crisis of EU political legitimacy and to a further surge in support for Eurosceptic parties across member states should not be discounted.
Greece: still on course for Grexit

After the high political drama of 2015, which ended when the radical left Syriza Unifying Social Front (Syriza) government signed up to a third bail-out programme to avoid tumbling out of the euro zone, the risk of Greece leaving the euro zone (“Grexit”) appeared to many to have receded. However, since last year The Economist Intelligence Unit has maintained the view that there is a 60% risk of Greece leaving before the end of our five-year forecast period. We do not think that the policies contained in the third bail-out programme will generate sufficient economic growth to mitigate Greece’s debt burden or reduce popular disaffection. Grexit would probably not result in serious contagion in the euro zone in the short term, but we have greater concerns about the long-term political fallout.

We expect domestic political tensions to intensify as the government tries to pass the reforms required to finalise the first review of Greece’s third bail-out programme. There have been mounting protests from diverse groups over the government’s proposed social security reforms and tax increases. The government is damned by its electorate if it tries to pass the reforms and damned by its creditors if it tries not to. Passage of the required budget cuts will make the government deeply unpopular, and there is a risk that the government could lose its parliamentary majority, precipitating a reorganisation of the government or another snap election. The challenges facing Greece are formidable:

*Implementation risk*. It is questionable whether any Greek government, of any political complexion, could implement the measures required under the third bail-out programme. It will be difficult for any government to implement controversial reform measures and more budget cuts in the face of opposition from vested interests and an austerity-weary population.

*The growth/debt challenge*. Even under a best-case reform scenario, it will be difficult for Greece to restore competitiveness and achieve significant growth while remaining inside the euro zone. Structural reforms recommended in the bail-out programme are “slow burners”, which are unlikely to deliver growth in the short term. Meanwhile, further spending cuts and tax increases will hinder...
growth by prolonging the squeeze on domestic demand. Greece may get debt relief in the form of an extension of maturities, longer grace periods and lower interest rates, but without a debt write-down the debt burden will depress economic activity for decades.

_Euroscepticism on the rise._ According to an Alco opinion poll conducted at the height of the political crisis in late June 2015, popular support for staying in the euro zone was 57%. However, opposition to bail-out policies is strong. In the coming years support for remaining in the euro zone “at all costs” is likely to diminish as the new programme fails to deliver rapid economic growth and reduce unemployment.

We are sceptical about Greece’s chances of restoring competitiveness and attaining stronger growth while remaining in the euro zone without recourse to currency devaluation. Even assuming a best-case reform scenario under the bail-out programme, the IMF has forecast very modest average annual growth rates over the medium term of 1.5%. Only if total factor productivity (TFP) growth rates were to match those of Ireland, the euro zone’s best performer, could Greece expect to maintain real GDP growth rates of 2% per year. Such growth rates would be stellar in a recent historical comparison. After Greece joined the EU in 1981, annual real GDP growth averaged 0.9%; after it joined the euro zone in January 2001, real GDP growth contracted by an average of 0.1% per year. Since the global economic and financial crisis of 2008, Greece’s real GDP has shrunk by more than one-quarter. The economy returned to growth in 2014, expanding by 0.7%, but preliminary estimates from the Hellenic Statistical Authority (ELSTAT, the national statistics office) show that real GDP growth contracted by 0.3% (seasonally adjusted) in 2015.

The prospects for the economy in 2016 are gloomy, mainly because of the political difficulties associated with implementing bail-out programme measures that are likely to cause delays and encourage investor uncertainty. The capital controls regime and uncertainty about when it will be lifted continues to hold back investment. At the same time, private consumption will suffer from a triple blow of higher taxes, higher social security payments and debt repayments, which together will put further pressure on disposable income. Successful bank recapitalisation in late 2015 was a welcome relief, but the outflow of deposits from the banking system is continuing, and a lack of credit is throttling the economy and having a damaging effect on fixed investment. We forecast a contraction in real GDP of 0.7% in 2016.

Our forecast is that Greece will leave the euro zone by the end of the forecast period, but it is impossible to pinpoint the timing. Grexit would produce a severe recession in Greece in the first year or two, but the economy could then begin to grow at a rapid pace, assuming a relatively responsible fiscal policy (guided by the need to achieve a primary surplus). Growth rates under this scenario would be faster than those in our current medium-term forecast.

The predominant view is that the euro zone is much better placed to deal with a Greek exit today than it was in 2012 and that a Greek exit would be only a minor shock for the monetary union. First, the euro zone has built a firewall to protect itself from direct financial contagion if Greece were to
leave. In particular, Greece presents less of a systemic risk to the banking sector. Second, the other main bail-out countries—Portugal, Ireland and Spain—are back on their feet and growing again. Third, economically and institutionally the bloc is stronger now than a few years ago, and growth is gradually accelerating. Greece, the argument runs, is more of an odd man out this time around, and so Grexit would no longer threaten the rest of the system.

It is true that the euro zone has improved its resilience by reducing banking sector exposure to Greek debt, and in this sense it is better placed to withstand the fallout from Grexit. But politically the euro zone is in a much weaker position to withstand the negative fallout from a country leaving the single currency. European solidarity was badly damaged during the post-crisis years. The migrant crisis of 2015-16 has led to further strains. For Greece to leave the euro zone would represent a huge political failure for the bloc, with potentially destabilising consequences given that the principle of irreversibility would have been shattered. As the president of the ECB, Mario Draghi, put it: “The success of monetary union anywhere depends on its success everywhere.”

If Greece were forced out, investors would immediately question whether the euro zone was still a permanent monetary union or a looser form of currency regime. They would look for the next most Greece-like country in the bloc and start to probe its vulnerabilities. We believe that the euro zone institutions—and the ECB in particular—would be able to withstand these challenges, but it is far from an open-and-shut case. And with political instability on the rise across Europe, if growth deficits and underlying economic divergences persist over numerous electoral cycles, the future of the euro will increasingly be called into question.
In most of Europe monetary policy is exceptionally accommodative and will remain so throughout the Economist Intelligence Unit’s five-year forecast period. This is particularly the case in the EU, where the bloc’s bias towards tight fiscal policy puts an unusual degree of pressure on the monetary authorities. At the start of this year we made significant revisions to our interest-rate forecasts for the euro zone and the UK; in both cases we now expect interest rates to remain on hold until 2020. A deepening reliance on accommodative monetary policy has been one of the hallmarks of the post-crisis period in Europe, and there is little evidence that policymakers have either the political will or the capital to begin using fiscal policy and supply-side reforms to bolster the region’s still-weak economic recovery.

Having initially been well behind the curve with its crisis response, the European Central Bank (ECB) has steadily become bolder and more creative in its policymaking since Mario Draghi took over from Jean-Claude Trichet as president. Almost five years on and Mr Draghi’s ECB remains firmly in a loosening phase, deepening its use of unconventional policy tools once again at the last meeting of the governing council in March 2016. We were at the dovish end of expectations ahead of the March meeting, but Mr Draghi went significantly further, announcing a broad package of measures including rate cuts, increased quantitative easing (QE) purchases and a scheme that in effect pays banks to lend to households and businesses. Mr Draghi did well to put himself so far ahead of expectations, but the idea that the ECB can boost the euro zone singlehandedly bumped up against the law of diminishing returns some time ago. In every speech he makes Mr Draghi exhorts the euro zone’s political leaders to do more to promote growth in their economies. There is little evidence that they take these exhortations seriously.

In the UK, the initial monetary response to the financial crisis was much more decisive than in the euro zone, and the economic recovery was much more robust. However, we have been cautioning for many years that the UK economy’s underlying vulnerabilities would hamper the process of normalisation, and this is precisely what has happened. A significant slowdown in economic activity is under way—exacerbated by nervousness ahead of the “Brexit” referendum on June 23rd—leading the Bank of England (BoE, the UK’s central bank) to adopt a more decisively dovish stance. Inflationary...
pressures are extremely subdued at present, and although they will build by 2018-19, our forecast of a short-lived US downturn in 2019 leads us to project that the BoE will delay policy tightening until mid-2020, as the chart above illustrates. Meanwhile, the government’s planned fiscal targets have so far been unbending in the face of downward revisions to official growth forecasts. Far from allowing the process of fiscal consolidation to decelerate, the government is pencilling in sharper than expected adjustments to meet its target of a budget surplus in 2020.

In part because of ECB policy, a key challenge facing several central banks in western and central Europe has been the strength of their countries’ currencies against the euro. This has been a concern because of the impact on export competitiveness (and, by extension, GDP growth), and also because of the downward pressure on import prices, which is a particular issue in the context of generally weak domestic demand-pull inflationary pressure and collapsing commodity prices. The policy response from other central banks to the ECB’s stance has been varied but proactive. A number, including Switzerland and Denmark, have opted for a combination of negative interest rates and direct intervention in the foreign-exchange markets to manage the impact of upward pressure on their domestic currencies. In the Czech Republic, the central bank has resisted negative interest rates, instead relying on intervention to defend an exchange-rate ceiling. By contrast, the Riksbank in Sweden has steered clear of currency intervention, relying instead on an unusually aggressive interest-rate policy.

For those central and eastern European countries with currencies that are pegged to or managed against the euro (mostly in the western Balkans), risks of volatility have moved in line with expectations of tightening by the Federal Reserve (Fed, the US central bank). However, we do not see significant risks to the currency boards in Bosnia and Hercegovina or Bulgaria, or to the peg in Macedonia. Croatia is more of a concern, especially in light of recent legislation to force banks to convert Swiss franc-denominated loans to euros. However, at present our forecast is for a gradually managed weakening of the kuna against the euro, rather than a dramatic sell-off.
A number of central banks in the region, including those in Poland, Hungary, Turkey and Russia, had to grapple with currency depreciation in 2015 and early 2016. In Poland and Hungary, concerns about the worsening investment climate were exacerbated in late 2015 by worries about the onset of monetary tightening by the Fed in December, weakening the zloty and forint against the euro. Both countries are vulnerable to the exchange-rate volatility that may result from diverging ECB and Fed monetary policy this year—Hungary because of its high debt levels and suboptimal institutional and policy environment, and Poland because of the less business-friendly economic policy promised by the new government, led by the national-conservative Law and Justice (PiS) party. Both countries are still struggling with deflation and have eased monetary policy in recent years (albeit with policy rates still quite high relative to countries further west). We expect interest rates to remain broadly steady for most of 2016, at 1.5% in Poland and 1.35% in Hungary, as the emphasis remains on support for currencies amid volatility on international financial markets.

In Turkey, monetary policy remains an area of contention owing to political pressure on the Central Bank from the president, Recep Tayyip Erdogan, and his supporters to lower interest rates to boost economic growth. Combined with the expiry of the term of Erdem Basci as governor on April 19th 2016, this pressure has weighed on investor sentiment towards Turkey. The government’s nomination on April 11th of one of the deputy governor, Murat Cetinkaya, as Mr Basci’s successor—which we expect the president to approve—has helped to ease uncertainty, even if the appointment is unlikely to put an end to the politicisation of Central Bank’s interest rate policy. The future direction of Turkish monetary policy is likely to depend on Mr Cetinkaya’s ability to resist political pressure for lower interest rates, which as yet is unclear, as well as on external developments. A recent shift in global liquidity and a stabilisation of the lira as a result of a less hawkish outlook for US monetary policy have increased the Turkish central bank’s scope to ease policy. Our baseline forecast is that the central bank will leave its main policy interest rate—the one-week repo lending rate—unchanged at 7.5% during 2016, constrained by still high inflation and concerns about the possibility of renewed exchange-rate volatility. However, it is likely that policy will be loosened over time, albeit only moderately and, at least initially, through downward adjustments to the central bank’s interest rate corridor, which allows the bank to vary on a daily basis the cost of funding to banks. If monetary policy comes more directly under the influence of Mr Erdogan, this could lead to a spell of rate-cutting that could put the lira under intense pressure, pushing up consumer price inflation and forcing the central bank eventually to raise interest rates sharply.

In Russia, inflation averaged 15.5% in 2015 as the sharp depreciation of the rouble fed through to import prices. Inflationary pressures weakened substantially in the first quarter of 2016, and surveys by the Russian Central Bank (RCB) suggest that inflation expectations have also fallen significantly. The RCB is under significant pressure from some policymakers and producers to loosen monetary policy, but the bank’s senior management appears to have the support of the presidential administration in its efforts to control inflation. Nevertheless, we expect the policy rate to reach around 9% by the end of the year and expect further reductions in 2017 as inflation falls. In the event of a significant rise in commodity prices, the RCB is likely to buy foreign currency to build up reserves, limiting the appreciation of the currency.
Productivity: the slump goes on

Productivity growth has slowed across Europe since the global financial crisis, reflecting both cyclical factors resulting from the recession and deeper structural changes. The differing responses of the EU’s five biggest economies to the challenges posed by the global downturn have resulted in diverging patterns of labour productivity growth. The shifts under way both domestically and in the global economy make it unlikely that these countries will return to their pre-crisis rates of productivity growth. Productivity in Spain and Italy has stagnated since 2014, and The Economist Intelligence Unit does not expect a pick-up in the short term. However, we do expect a slowly strengthening recovery in the UK and a continued mild improvement in Germany and France in 2016-20.

The collapse of productivity growth in the UK after the global financial crisis, and its failure to pick up even in subsequent years, has received a lot of attention. However, the UK is not alone in having had weak productivity growth post-2008: similar slowdowns were seen across the EU after the crash, albeit with country-specific variations that have played a crucial role. As the contribution to long-term growth from capital and labour slows—especially given the poor demographic outlook in Europe—progress in growth and living standards will increasingly come from productivity improvements, making this metric quite important. Here we focus on the outlook for productivity growth in the EU’s five largest economies: Germany, the UK, France, Italy and Spain.

The post-crisis productivity slowdown shouldn’t surprise us. The chart on page 18, which compares labour productivity with an EU average, shows the strong pre-crisis levels of productivity in these economies in a European context (with the exception of Spain). In part, this is likely to reflect the presence of multinationals and large financial flows in these countries (Luxembourg comes first in the EU on this measure). The split between manufacturing and services also has a bearing on these figures, as does the share of full-time versus part-time workers. Other factors that typically boost labour productivity include good public institutions, a high quality of human capital, strong infrastructure, openness to innovation, well-functioning product and labour markets, and easy access to capital.

The chart also shows a general decline between 2006 (before the crisis) and 2014 (latest comparable data). The fall in the UK is particularly steep, whereas output per person in France barely
Lower labour costs do not necessarily lead to better productivity, and too narrow a focus on cost competitiveness carries risks.

Productivity growth tends to be pro-cyclical, so the general slowdown in the wake of the global financial crisis is not a surprise. However, the steep slip in UK labour productivity owes much to the fact that many companies retained workers but reduced their hours, anticipating a temporary slump in demand. This resulted in a comparatively small rise in unemployment—to 7.6% in 2013—but a large fall in output per worker. In contrast, France’s unemployment rate rose to 10.3% in 2013, with a larger share of highly skilled and full-time workers perhaps flattering the productivity figures, while the gap between labour market “insiders” and “outsiders” widened. Spain is an even more extreme example: unemployment spiked to 26.1% in 2013, and far from indicating that the economy is in good health, the improvement in productivity simply reflects the drastic contraction in employment.

Much of the policy focus since the crisis has been on increasing the cost competitiveness of exports. However, lower labour costs do not necessarily lead to better productivity, and too narrow a focus on cost competitiveness carries risks: first, since it may neglect the supply-side measures necessary to boost productivity, and second, because keeping wages low risks depressing domestic demand, with a knock-on effect on GDP. In small and open economies raising export growth is an effective way to kick-start an economic recovery; elsewhere the relationship is not so straightforward.

The chart opposite shows unit labour costs (the compensation of employees as a share of GDP) since 2010. Spain is the most obvious outlier here, with reforms implemented in 2012 resulting in a sharp fall in wages as part of a policy of internal devaluation to improve the country’s competitiveness and so prompt an export-driven recovery. In contrast, labour costs in Germany have risen more steeply than elsewhere. Far from indicating a deleterious loss of competitiveness, however, this is a useful correction after a decade of productivity rises exceeding wage growth. Stronger wage rises in Germany should help to boost import demand, which will support export growth across the rest of
Europe stretched to the limit

Europe stretched to the limit

Nominal unit labour costs
(2010=100)

Sources: Bundesbank; Office for National Statistics; INSEE; National Statistics Institute; Istat.

Sharp divergences in productivity growth have emerged between countries. The evolution of real labour productivity since 2010—see chart on page 20—, shows that Italy is the underperforming outlier. Output per person has fallen in part because the labour market did not adjust efficiently by shedding jobs in the wake of the recession (in contrast to Spain). However, more fundamental issues are also at play. A lack of competition, particularly in the non-tradeable services sectors and among utilities, results in high input costs, and the predominance of small companies, which invest very little in innovation, means that firms seldom move up the value-added chain. Italy has begun a reform programme aiming to bring about an internal devaluation, but its impact has yet to be felt, suggesting a weak short-term outlook for Italian productivity growth.

The UK, on this metric, has seen a significant improvement in productivity since 2013. However, since there is no distinction here between full-time and part-time workers, this is probably heavily influenced by a rise in the share of full-time workers since 2013, reversing the trend towards more part-time work in the immediate post-crisis years. An alternative measure of labour productivity—output per hour worked—shows little improvement for the UK since 2010. However, there was a sharp return to growth on this measure in 2015, suggesting a possible nascent recovery.

Labour productivity in Spain surged in 2010–13, but while this in part reflected labour reforms to boost competitiveness, it also owed much to a spike in unemployment. Output per person has stagnated since 2014 as the unemployment rate has started to decline, and in the short term—as the cyclical improvement in the labour market runs its course—improvements remain unlikely. The
negative impact on human capital of a prolonged period of high unemployment will also weigh on Spanish productivity growth in the medium term. In contrast, labour productivity in France and Germany has been on a broadly upward trend since 2013, which suggests that productivity gains are likely to continue at a reasonable pace in these countries in 2016-20.

We expect productivity growth to be maintained, but at slower rates than before 2008. Much has been made of the UK’s failure to resume the trend rate of productivity growth seen before the global financial crisis. However, the fact that this failure is not exclusive to the UK suggests that broader issues are at work. Cyclical issues, such as lower credit growth than before the crisis, years of fiscal austerity constraining public investment in infrastructure and an emerging-markets slowdown, are holding back productivity growth at the moment for all of these countries. Structural issues, including the shift away from industry and towards services, and western Europe’s fading comparative advantage in areas such as educational attainment and institutional quality, mean that improvements in productivity growth will become progressively harder in the long term.

The outlook suggested here—of mild but sustained productivity growth in France and Germany; a slowly strengthening recovery in the UK; and a marginal improvement in Italy and Spain—is in this context far from a failure. A stronger outlook would result from more successful supply-side reforms than we currently expect. These could include a greater uptake of information and communications technology, faster improvements in infrastructure, greater spending on research and development, or a policy mix that increases support for innovation and entrepreneurship. Downside risks stem from slower progress than we currently expect in any of these areas, and from a fall in demand for European goods owing to the structural shift in China away from industry and towards consumption.
Russia: the key security challenge

Russia’s annexation of Crimea and the conflict in the Luhansk and Donbas regions of Ukraine have pushed Russia’s relations with the EU to their lowest ebb since the end of the cold war. The Minsk II peace plan, signed in February 2015 in the Belarusian capital, has led to a de-escalation of the conflict in eastern Ukraine but is unlikely to lead to a durable political settlement. The Economist Intelligence Unit believes that, provided relative peace is maintained, the EU is likely to relax its sanctions against Russia in the medium term. However, this will not resolve a fundamental conflict of interest between Russia and the West in their so-called common neighbourhood. Even if, as seems likely, the EU’s appetite for engagement with its eastern neighbours wanes, domestic developments in those countries may be sufficient to provoke further political and even military crises in the region.

The so-called Minsk II agreement signed in February 2015 (a previous ceasefire signed in September 2014 quickly collapsed) has reduced the intensity of the conflict in eastern Ukraine, but the likelihood that it will lead to a lasting political settlement is low. The Russian policymaking establishment is now dominated by the view that the expansion of Western influence in the post-Soviet space—the region roughly aligning with what the then president, Dmitry Medvedev, in 2008 called Russia’s “zone of privileged interests”—represents a first-order threat to Russia. This is seen not just as a matter of Russia’s standing as a great power, but as a potential existential threat. As Nikolai Patrushev, the head of the Russian security council, explained to Rossiiskaya Gazeta in an interview in February 2015, the West is seeking to use events in Ukraine as a means to break up Russia: “Ukraine in itself is not interesting for the USA. Their aim is to weaken our position. Through events in Ukraine the Americans are trying to draw the Russian Federation into an inter-state military conflict, overthrow our government and ultimately break up our country.”

Moreover, the annexation of Crimea and the war in Donbas have helped to make many of the worst fears of the Russian political establishment more credible. War has contributed to the consolidation of Ukrainian national identity, and NATO membership—one a divisive issue within both the Ukrainian political class and the broader population—would probably be embraced if it were again to be put on
The most likely scenario is that the conflict in eastern Ukraine remains unresolved in the coming five years. From Russia’s perspective, and as Georgia and Moldova show, an unresolved territorial dispute can provide a guarantee against such a scenario.

Although Russia would undoubtedly like to see sanctions against it eased, we continue to believe that it is highly unlikely that the Kremlin will allow Ukraine to restore full control over its international border with Russia. This is the final element of the Minsk II agreement and would allow the Ukrainian authorities to restore their sovereignty in Donbas. There may be scope for Russia to soften some of its demands under Minsk II, but not on any fundamental points, such as securing a high degree of autonomy for the separatist regions, which would allow Russia to embed its proxies within Ukraine’s political system, thereby exercising an effective veto over Ukrainian integration with NATO.

The Russian government may still believe that time is on its side, because Russia has greater staying power than the government in Ukraine and a deeper interest in Ukraine than the Western states backing the Ukrainian administration. Moreover, Russia can currently argue that implementation of Minsk II is being held up by the Ukrainian government, which has yet to adopt a decentralisation bill required by Minsk II, and which probably lacks the constitutional majority to do so. This provides an opening for Russia to blame Ukraine for the collapse of the peace process, undermining the case for the prolongation of EU sanctions.

The most likely scenario is that the conflict in eastern Ukraine remains unresolved in the coming five years. In the short term, this means that the EU is highly likely to renew in full its sanctions on Russia when they come up for renewal in July 2016. Over the past year the EU has incrementally strengthened the link between the implementation of Minsk II and the lifting of sanctions. Despite public and business opposition to sanctions in some countries, there is currently little willingness to depart from a political consensus that has been led strongly by the German chancellor, Angela Merkel.

Over the medium term, however, we believe it is likely that sanctions will be substantially eased as Minsk II increasingly becomes a dead letter, leading to a weakening of the linkage between sanctions policy and implementation of the agreement. If fighting remains at the current relatively low level, we believe that it will become increasingly difficult for the EU to sustain the unanimity required among member states to keep sanctions in place.

However, such a scenario will not bring the EU’s relations with Russia to a stable equilibrium. First, relative peace may hold only as long as Russia believes it can achieve its objectives in Ukraine through non-military means. At present, Ukraine is engulfed in a deep political and economic crisis. IMF support has averted the immediate risk of a sovereign debt crisis, but support for Ukraine among its Western backers is fraying, and frustration is growing over the lack of progress in tackling systemic corruption and reforming key institutions. However, should Ukraine succeed in stabilising its economy, a renewal of fighting in Donbas remains one of the levers to which Russia could resort in an effort to destabilise the country.

Second, the underlying conflict of interests between Russia and the West in the “common neighbourhood” is likely to lead to further political and even security crises. The countries of eastern Europe, the Caucasus and Central Asia are characterised by unstable or undemocratic politics, which entails the risk of unexpected and contested changes of regime. The conviction of the Russian
establishment is that when popular unrest erupts, it reflects orchestration by the West as a means to undermine Russian interests. There is consequently a significant risk that a change of government in the post-Soviet space could become internationalised, leading to another standoff between Russia and the West.

Even EU disengagement from the region is unlikely to avoid conflict. Longer-term forces will continue to push Russia’s neighbours in the post-Soviet space to diversify their economic and political relations, regardless of regime type or declared geopolitical orientation. It was after all Viktor Yanukovych, supposedly a pro-Russian Ukrainian president, who sought to sign an association agreement with the EU that was one of the triggers for the standoff with Russia. This is of particular salience to Belarus, which Russia considers no less a part of its East Slavic heartland than Ukraine.

These are challenges that the EU is ill-prepared to manage, particularly as there is significant disagreement within the EU as to the significance of these issues. It took the downing of a passenger aircraft over eastern Ukraine and the death of EU citizens to reach consensus among member states on the imposition of sectoral sanctions. Since then a number of EU leaders have begun to call publicly for the sanctions policy to be relaxed. Political dynamics within many EU member states mean that there is limited appetite for developing a proactive strategy of engagement with partner states in the post-Soviet space, or with Russia itself. However, EU inertia is unlikely to provide a guarantee against future conflict with Russia. Even if EU policy is at a standstill, the countries and societies of Russia’s neighbours are not.
Democracy: the party’s over

There is an underestimation of the scale of the political problems confronting European democracies. Insofar as the problems are acknowledged, their causes are misdiagnosed. Issues related to the quality and stability of governance are likely to become increasingly pressing. This is because the political party system that sustained representative government for a century is breaking down. The age of the mass party and of mass democracy that began in the early 20th century is passing. This is producing new problems for those who are trying to form governments in some of Europe’s advanced democracies, as recent elections across the region illustrate. The result is likely to be a prolonged period of increased political fragmentation, electoral volatility and governmental instability.

Recent election results have confirmed a trend towards political fragmentation and growing challenges to governance across the EU. In October 2015 Portugal’s incumbent centre-right coalition of the Social Democratic Party (PSD) and the conservative Popular Party (CDS-PP) edged out the centre-left Socialist Party (PS) to take the largest share of the vote, but fell short of a majority. After refusing to facilitate an administration led by the centre-right, the PS struck an unprecedented agreement with the country’s hard-left parties to form a minority government in late November.

Weeks later, at Spain’s election on December 20th, the ruling Popular Party (PP) also lost its lower house majority, despite taking the most votes. Both the PP and its main rival, the Spanish Socialist Workers’ Party (PSOE) fell to historic lows in terms of support, with two new political movements—the leftist, radical Podemos (“We Can”) and the centrist, liberal Ciudadanos (Citizens)—cementing their place among the country’s main political forces. Difficult post-election negotiations are under way, and if no government is formed by May 2nd, a new election will be called for June 26th.

At the time of writing, government formation talks are in progress in Ireland after the centre-right Fine Gael maintained its position as the largest party in the February 26th general election, but together with its former coalition partner, the Labour Party, failed to secure a governing majority. Fine Gael’s main rival, Fianna Fail, made significant gains, and the radical, nationalist Sinn Fein and a host of smaller parties and independents also performed strongly. A Fine Gael minority government
Europe stretched to the limit

or a Fine Gael-Fianna Fail grand coalition are possible, but a new election within the next 12 months is likely, regardless of the immediate outcome.

Most recently, Slovakia held an inconclusive election in March 2016, in which the centre-left incumbent Direction-Social Democracy (Smer-SD) lost a large share of its previous vote and the number of parties in parliament increased from six to eight. Under pressure to ensure stability during the country’s turn at the rotating EU presidency, Smer-SD has united a series of disparate centre-right formations into a four-party coalition, the broadest in the country’s history. The government is likely to hold together until end-December 2016, when Slovakia’s EU presidency ends, but political volatility is set to increase under the new administration.

These developments, and others in countries as diverse as Denmark, Finland, Greece and Sweden, where traditional party systems of government have been rocked by the rise of populist parties of both the left and right, highlight the extent of the challenges to governance in Europe.

The twin phenomena of the disarray of the political mainstream and the rise of populist political movements are not confined to any sub-region of Europe. They are evident everywhere, in the eurozone core as well as in the EU periphery, in the Eurosceptic UK as well as in that traditionally most pro-European of countries, France. The ubiquity of the problems casts doubt on the notion that the rise of populism is simply a reaction to the economic crisis. That populist movements have come to prominence in rich and poor European countries alike suggests that they are not the product solely (or even primarily) of the crisis. Also, economic issues are not at the forefront of the populists’ concerns; issues of culture, identity, tradition and values dominate the populists’ discourse and resonate with their supporters.

Many European populist movements predate the economic crash of 2008, even if they have achieved greater prominence in recent years. The Front national (FN) in France has been around for decades but is a different party today, both in terms of its political appeal and support levels. The new populists cannot easily be categorised according to the old political left-wing or right-wing labels. Typically, the designation “populist” is used disparagingly to denote parties of the right espousing anti-immigrant, xenophobic and socially conservative views. But populism has not been the sole preserve of the right—radical left parties have emerged in Spain and Greece. Many populist parties are not easily classified. Some populists combine views that are typically regarded as right-wing with others that are seen as left-wing.

In keeping with this more fluid political orientation, many parties have managed to attract support from voters from both sides of the political spectrum. In recent regional elections in Germany, for example, Alternative for Germany (AfD) has attracted support from voters who have in the past voted for the centre-left Social Democratic Party (SPD), the centre-right Christian Democratic Union (CDU) and the liberal Free Democratic Party (FDP).

The roots of the recent growth of populist politics lie deeper than a purely economic account suggests. Changing voting patterns are an expression of the exhaustion of traditional, mainstream political

Traditional political parties remain in place today, but they are too disconnected from wider society to sustain democracy in its post-1945 form
parties in Europe and of their dwindling popular appeal. Today the political parties that dominated the post-1945 political landscape in Europe can no longer assume that they will take turns to govern, or even that they will be able to govern in coalition.

This erosion of the post-war political order began in the 1970s, as the post-war economic boom came to an end. It accelerated in the 1980s and 1990s, so that by the turn of the century the political system and the parties that represented it bore little relation to their forebears of the 1950s and 1960s. The rupturing of the relationship between Europe’s post-war political parties and their traditional support base—especially, but not exclusively, the relationship between social democratic, labour and communist parties and their working-class supporters—is illustrated in spectacular fashion by the statistics on declining party membership.

Up to the 1980s Europe’s political parties retained much of their vote share. By the end of the 1980s the convergence of left and right in most advanced democracies made it difficult for parties to maintain distinct identities. The decline in party membership accelerated in the 1990s, and while the traditional political parties remain in place today, they are so disconnected from wider society that they are incapable of sustaining democracy in its post-1945 form.

The traditional parties are acutely aware of the growing fragility of their ties to their electorates, but they do not seem to have grasped the potentially seismic consequences. Academics have made the running in this area, notably the late Peter Mair in his book *Ruling The Void: The Hollowing Out Of Western Democracy*. Mair’s forebodings about the negative impact on democracy of the withering of the mass party were echoed by Paul Whiteley, an academic at the University of Essex, who in 2010 warned presciently that the increasingly technocratic nature of traditional party politics “is likely to lead to lower turnouts, more support for anti-system parties and problems of governance in general”.

Overemphasis of the role of economic factors in the populist upsurge ignores an important dynamic of populist politics—its appeal to voters who feel alienated from the traditional political elites. The growing distance between the political mainstream, whether in Brussels, Westminster or Paris, and the mass of the population is being filled by Europe’s populist parties. They have been able to connect with people’s hankering for a sense of belonging. The populists present themselves as the champions of the people in their revolt against remote, out-of-touch political leaders.

There is a tendency to dismiss the upsurge of populism in Europe as a “protest vote” or an “anti-austerity backlash”. This underestimates the scale of the problem confronting the traditional political order in Europe. The assumption that populism will fade away once conditions in Europe return to “normal” is misplaced. On the contrary, we have entered an era in which the traditional party system as we have known it for the past century is breaking down. The changing character of political parties has had a major negative impact on the standing, legitimacy and effectiveness of democracy. As a consequence, the modern system of representative democracy itself is under threat. Today, as Mair put it, we have a downgraded—or hollowed-out—version of democracy that excludes the popular component, which had depended on the existence of mass parties.

The trend towards political fragmentation and the problems that Europe’s political parties are encountering in forming governments are likely to intensify over the next decade. Without
a reinvigoration of political debate, public participation in the political process—the bulwark of democracy—will continue to decline. With the passing of popular involvement, the electoral process is likely to become increasingly enfeebled: commitment to political parties will waver, electoral turnout will decline, popular choices will become more arbitrary, electoral volatility will increase, and election outcomes will become less predictable.
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