Reasons to be cheerful

Is Europe broken? Economic indicators and the balance of geopolitical risk suggest not

The wheels of history are turning. If political risks materialise this year, the European project as we know it could be brought to an end. If it all goes wrong with the elections in France, and possibly Italy, the EU could unravel. Such risks cannot be taken too lightly. But they are no more than tail risks. Underlying economic fundamentals are healthy. There are a few good reasons to be optimistic about Europe's medium-term growth prospects.

First, the recovery is entrenched. It would take a major shock to throw it off course. Lest we forget, the initial eurozone recovery after the financial crisis kept pace with the US and UK. It was disrupted when the European Central Bank (ECB) failed in its duty as lender of last resort to prevent contagion spreading from tiny Greece to the rest of the vulnerable eurozone periphery. It took ECB president Mario Draghi's 'do whatever it takes' speech in 2012 to finally calm the panic. While the pace of the post-euro crisis recovery has remained modest, the economy has expanded at its 1.6% trend rate for the past two years now. All components of demand are contributing to growth. Survey measures show that economic participants' confidence and expectations for future growth are rising.

Second, Europe is currently benefiting from the rebound in world demand that began in mid-2016. Generating around 30% of their GDP from exports, European economies are sensitive to fluctuations in global demand. The spending appetite of households in the US, the largest economy in the world, remains the keystone of global demand. As long as the solidly responsible Republican Congress reins in a somewhat unpredictable president Trump on his anti-trade rhetoric, Europe should see a further gain in external demand stemming from an acceleration in US growth in late-2017 as the US fiscal stimulus and tax reforms begin to take effect.

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Third, all elements of economic policy are supporting growth. Through its aggressive asset-purchase programme – likely to last until mid-2018 – monetary policymakers at the ECB are helping to keep long-term borrowing costs low and the euro exchange rate competitive. That supports a rise in demand from home and abroad. Since underlying inflation remains well below the ECB's target of 'close to, but below 2%', the central bank is not under pressure to withdraw stimulus any time soon. Meanwhile, austerity has been over across almost the entire eurozone since 2015. Fiscal policy is no longer a drag on growth. Instead, governments' decisions on spending and taxation can add 0.1-0.2 percentage points to annual growth over the coming years.

Fourth, political risks probably will not materialise. After the upsets of Brexit and Trump last year, markets will keep a close eye on elections this year in Germany and France, and possibly Italy. But even if Angela Merkel loses the German election in September, German politics does not pose a serious threat to the European project. All key parties in Germany are solidly pro-EU. If anything, the challenger to current chancellor Merkel, ex-president of the European Parliament Martin Schulz, is even more pro-Europe than she is.

France presents more opportunity than risk. Both the centre-left reformer Emmanuel Macron and the more Thatcherite François Fillon enjoy comfortable leads over ultra-right Marine Le Pen in a second round run-off vote, according to opinion polls. Like Thatcher's Britain and Schröder's Germany, France could be the next major economy to switch from 'sick-man of Europe' to one of its main growth engines if it puts a reformer at its steering wheel.

While Italy is unlikely to actually opt for the chaos of a euro exit, it tops the list of tail risks in Europe. After ex-Italian prime minister Matteo Renzi stepped down following the referendum defeat on constitutional reform late last year, the risk that an anti-euro party, or coalition, could come to power in Italy is greater than almost anywhere else. But even then, Italy would probably shy away from the costly turmoil of an Italexit.

Touch wood, the political risks will not materialise. If so, the stage is set for Europe to enjoy its best economic performance since the stalled post-Lehman rebound with stable growth and steady gains in employment. For once, risks are even skewed to the upside. With luck, the Brexit divorce will not affect the large European economy very much, Italian politics will remain too fragmented for any serious threat to emerge and the newly elected French president may reform Europe's biggest growth laggard, France. With just a little luck, 2017 could even see a new air of optimism return to Europe.

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