TOMORROW'S CHALLENGES

TERMINATOR ECONOMICS

WILL EUROPE BE BACK IN 2015?

By IMD Professor Nuno Fernandes – January 2015

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Arnold Schwarzenegger returns as the Terminator in 2015. The big question is whether the fifth movie in the series, which comes out in July and once again stars the former governor of California, will be a huge success or a total flop.

While much of the world will discuss whether Arnie still has it, the more important question is whether Europe's economy will "be back" this year. Will Europe's leaders finally get their act together and help the continent to grow again? Or are we in for another 12 months of economic failure?

The outlook for Europe is probably the biggest of four key economic questions in what promises to be a highly uncertain year. The others concern the oil price, shadow banking, and the continued rise of emerging-market firms.

Wake up, Europe!

Global economic growth in 2015 will be slower than previously expected. It will be uneven too. Emerging markets will again grow faster (close to 5%) than developed markets (more like 2%). And big differences will remain between developed countries, with the US and UK growing strongly while the EU is once again the laggard, dragging down the rest of the world.

Given this gloomy outlook, the European Central Bank (ECB) must do in 2015 what it should have done three or four years ago: start buying government bonds to give some impetus to Europe's ailing economies. The US Federal Reserve bought trillions of dollars' worth of bonds with its "quantitative easing" to help the US avoid European-style stagflation, and the UK and Japanese central banks also provided monetary stimulus to their respective economies. The ECB, by contrast, is the only major central bank to have shrunk its balance sheet over the last three years.

Yes, purchases of government bonds are more complicated in the euro zone than in the US, and the EU's complex decision-making processes don't help either. But the ECB must act quickly and decisively this year to help avoid a lost decade.

Although Europe's economic health in 2015 should not depend solely on the ECB, it's not clear where other help could come from. European institutions have little accountability and no proper performance measures. They have failed Europeans in general in recent years, but their top officials have neither resigned nor been fired.

The new European Commission, led by Jean-Claude Juncker, recently announced a €315 billion investment plan for 2015-17, but this will most probably have little impact. The idea is that €21 billion of EU money (€16 billion from the EU budget and €5 billion from the European Investment Bank) will be leveraged 15 times using private-sector money and additional debt, to reach the €315 billion figure.

However, there is no new money being invested (the €15 billion is from unused EU budget transfers). The EU guarantee is unlikely to lure private investors into projects with a low profitability/risk profile. And if the plan does take off, then it will almost certainly crowd out other private-sector investments.

Europe could help itself more by doing two other things in 2015. First, it should reform product and labor markets so that bigger European corporations can compete with their US and Chinese counterparts. Second, it should give more thought to Asia, Africa, and other faster-growing parts of the world. Focusing only on intra-European trade is not a recipe for growth.

Oil and shale

Oil prices started 2015 at their lowest levels for about eight years. This is good news for big energy importers such as Japan, India and China, and for the EU as a whole. It is bad for Russia and major Middle East oil producers. High oil prices in recent years have resulted in a massive transfer of wealth from consumers to producers. This will slow down and possibly reverse in 2015.

Lower oil prices will also raise fresh questions as to whether shale oil has the potential to reshape the global economy, increase growth, and boost energy-intensive industries in developed markets. The re-industrialization trend in Europe and the US is here to stay.

A shadow banking crisis?
"Shadow banking" that bypasses traditional banks will continue to make news in 2015, not all of it good. Non-bank financing has tripled worldwide since 2008, and accounts for more than 50% of all financing in China since then. This gives companies alternative ways to borrow, and provides fresh investment opportunities.

But such products are often used to hide leverage via non-traditional investment vehicles, as we saw in the 2007-08 subprime crisis. Recent high-profile bankruptcies and big investor losses (Prokon in Germany, and China Credit Gold) should be a warning to investors. There are no free lunches, and when something seems too good to be true, it's not true.

Emerging forces
In 2015 we will see more emerging-market multinationals buying assets and companies in Europe. Chinese investors already have sizable stakes in carmaker Peugeot, the Weetabix breakfast cereal, and the Thames Water utility in the UK, for example. In Portugal, Chinese investment accounts for nearly 40% of the money raised via privatizations over the past three years. And non-European sponsors are increasingly prominent on team shirts in Europe's Champions League football competition.

Europe starts 2015 dangerously close to the tipping point. Failure to act will mean another year of stagnation and high unemployment, especially for younger generations. Let us hope that both Europe and the Terminator make successful returns this year.

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