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**Europe's existential need
for more growth**

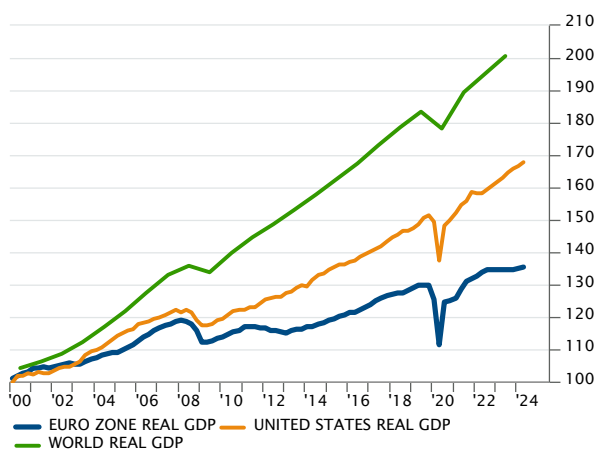
Making tough decisions in tough times: can Europe rise to the challenge?

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The first estimate of GDP growth for the third quarter will be released at the end of the month in the Eurozone, but don't hold your breath. It will most certainly be weak and disappointing, as it has been over the past two years. Since the end of the fiscally driven post-pandemic boost, growth has been anemic in Europe, and the GDP is barely up since Q3 2022. A number of specific headwinds have affected the Eurozone, such as energy supply disruptions, weak Chinese demand for industrial and manufactured European goods, tight monetary policy and reduced fiscal support. But Europe mostly suffers from structural flaws that have hampered its ability to grow over more than two decades now. In this context, Mario Draghi's report on "The future of European competitiveness", released in September, is a milestone for economic policies on the Continent. It unambiguously summarizes the reasons behind the growth slowdown since the start of the century, and it brings forward what needs to be done to save Europe from "a slow agony". Europe needs to grow faster, not only in the short run after the recent deterioration in economic indicators, but over the longer run as well in order to preserve its place in the new world economic order that is taking shape.

Europe has suffered a widening growth gap since 2000

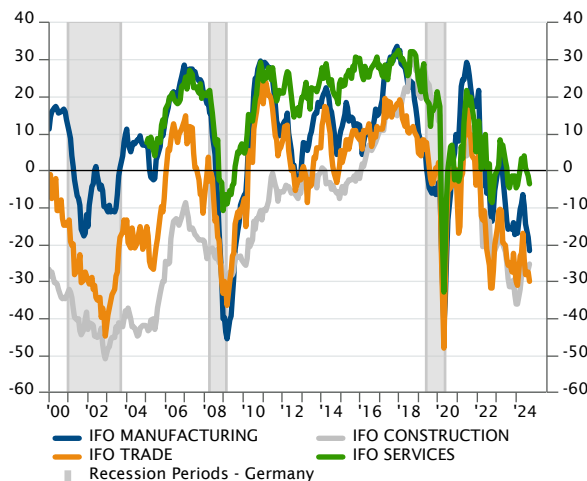


Short-term risks of recession after the summer slowdown

Mario Draghi's report was released at a time when the Eurozone is experiencing another episode of economic weakness. After a near recession in 2023, economic growth had resumed in early 2024 with a pickup in household consumption and exports. Unfortunately, this encouraging dynamic has rapidly lost momentum and the +0.2% growth in GDP recorded during the second quarter was only due to exports and government spendings, while private consumption stalled, and business investment declined.

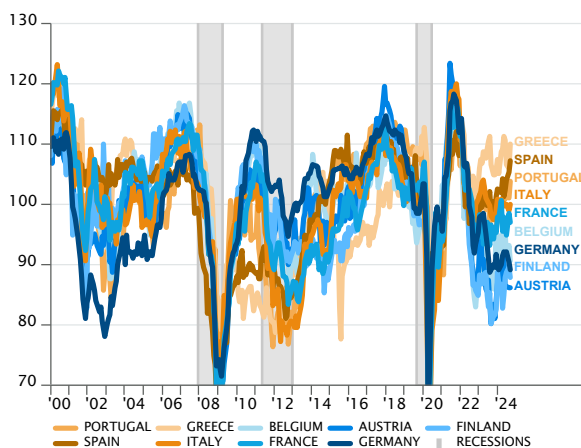
The slowing dynamic appears to have extended throughout the summer and doesn't bode well for GDP growth in the second part of the year: most economic indicators have disappointed expectations and deteriorated recently, pointing to subdued growth at best for the Eurozone as a whole. The PMI Composite index has fallen back below the limit between expansion and contraction of the activity in September and has remained in "contraction territory" in October. Germany is experiencing a particularly tough situation. The German industry is suffering from contracting activity since 2023, dragging the entire economy downward. The labour market has been deteriorating over the past two years as well, with the unemployment rate up from a record low of 5% in 2022 to its current 6%. Consumer confidence is depressed, and consumption stagnant, with no sign of imminent improvement in sight.

Confidence is depressed in all sectors of the German economy, at recession levels



Europe has been hit by a succession of adverse developments since 2022: sanctions against Russia following Ukraine's invasion, the ensuing cut from Russian gas supply, weaker Chinese demand for manufactured goods, a surge in inflation and the subsequent sharp rise in interest rates have been headwinds for all European economies. But they have affected Germany most, due to the structure of its economy, even if other Eurozone economies have suffered from the same circumstantial pressures.

Opposite to the early 2010's, economic sentiment is depressed in "core" European economies while quite positive in southern countries

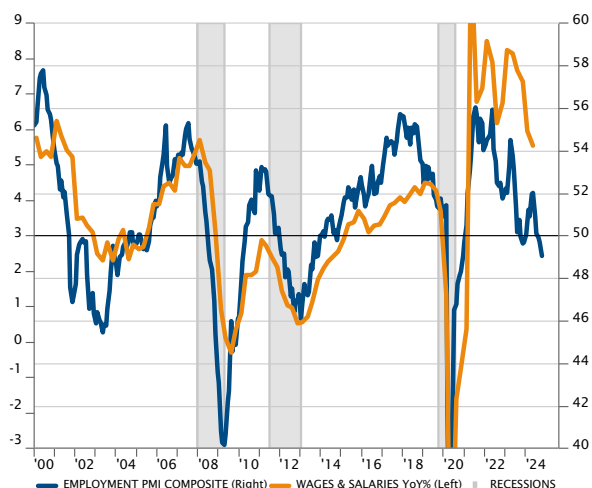


In contrast, Southern European economies have been less impacted by those factors and have benefited from resilient demand for services, and tourism in particular. Economic sentiment and growth in those economies have been on a positive trend in 2024, while Northern economies were losing steam. A stark reversal from the situation prevailing a decade ago when "peripheral" economies were plunged into severe recessions while "core" economies were driving growth in Europe...

Those diverging dynamics are also visible in the countries' employment dynamics. At the Eurozone level, the unemployment rate has stabilized since 2023 at its lowest level since the creation of the monetary union, at around 6.5%. But unemployment has been rising in Germany and France recently, while it has continued trending down in Italy and in Spain, to levels not seen since 2008. However, recent dynamics

point to a more broad-based deterioration of the labor market in Europe: the Employment component of the monthly PMI surveys has declined in October and has been in “contraction territory” for a third consecutive month. This slowdown of the European job market is likely to undermine an already feeble domestic consumption in the months ahead, with the risk that contraction in domestic demand would be the stroke breaking the camel’s back, i.e. creating the conditions of a recession for the Eurozone.

Gauges of the European labor market have been deteriorating recently and point to a decline in employment since August. Wage growth is therefore expected to slow down in the coming quarters



At least this deterioration of the employment market is providing some relief to the European Central Bank, that has been worried for some time by the impact of labor cost pressures and strong wage growth on the inflationary outlook for the Eurozone. As the ECB mentioned after its October 17th meeting, “labour cost pressures are set to continue easing gradually”, which allowed the central bank to accelerate the pace of its monetary policy easing with a new rate cut this month, after those of June and September.

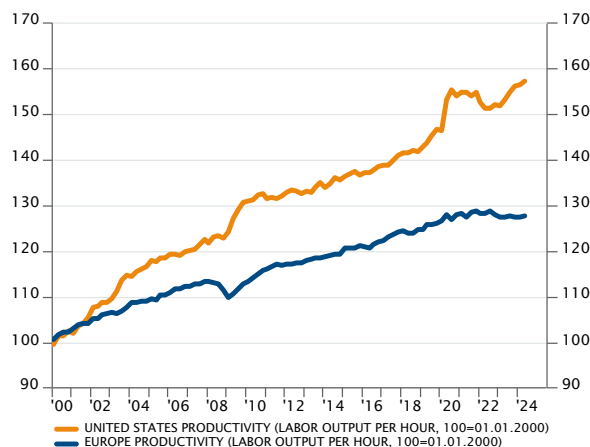
Indeed, the downward trend of the economic environment in Europe, and in particular of the employment market, will likely rapidly dissipate all forms of inflationary pressures in the Eurozone if they drive the economy in recession. In this context, the monetary policy stance of the ECB is likely too restrictive for the current economic conditions. Credit standards remain tight across the board. The weakness of credit growth in the private sector, due to a combination of ongoing weak demand and tight supply, is another factor currently undermining Europe’s growth prospects.

Current economic trends are therefore clearly negative in the Eurozone as a whole, despite the dynamism exhibited by the southern part of the monetary union. The northern part of the Eurozone is already in or close to recession, and the risk to see a weakening domestic demand in the coming months is very real. Some additional headwinds may appear in 2025 that could impact further growth dynamics in Europe: budget restrictions in France and in Italy, tariffs on exports to the United States, escalation of trade tensions with China... As the ECB is expected to ease credit conditions, it will provide some relief and support for interest-rate sensitive sectors and possibly households’ consumption. But it is unlikely to dramatically reverse the current lack of economic growth in Europe.

Long-term risks of a “slow agony” if economic policies are not changed

In September, former ECB President and Italian Prime Minister Mario Draghi presented a comprehensive report, “The future of European competitiveness”, that sets a milestone for Europe’s economic policies. Starting with an uncompromising analysis of the European Union’s economic situation, Mario Draghi then proposes a set of recommendations and policies that need to be implemented in order to foster sustainable growth in Europe and prevent “a slow agony” for the world’s second largest economy.

Europe needs to reignite stalling productivity growth



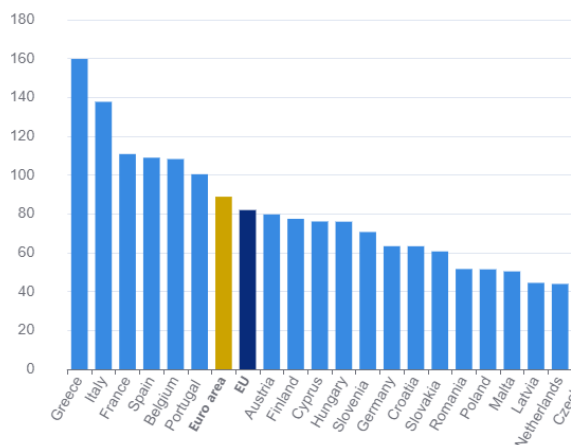
Mr Draghi’s statement is so clear it can simply be quoted: “Europe’s need for growth is rising. The EU is entering the first period in its recent history in which growth will not be supported by rising populations. By 2040, the workforce is projected to shrink by close to 2 million workers each year. We will have to lean more on productivity to drive growth. If the EU were to maintain its average productivity growth rate since 2015, it would only be enough to keep GDP constant until 2050 – at a time when the EU is facing a series of new investment needs that will have to be financed through higher growth. To digitalise and decarbonise the economy and increase our defense capacity, the investment share in Europe will have to rise by around 5 percentage points of GDP to levels last seen in the 1960s and 70s. This is unprecedented”.

5% of the European Union’s GDP represents more than EUR 800bn of new investment per year, indeed a considerable amount that will require combined contributions from both the private and public sectors. At a time when public debt has exceeded 100% of GDP in most large European economies (Germany being the noticeable exception), the idea of a sharp increase in public debt to finance those investments may sound paradoxical. However, the report points to the fact that, if those investments effectively increase productivity and growth going forward, they will ultimately contribute to improve the situation of public finances by creating more fiscal space for governments.

Europe needs to invest more even if public debt is high

Government debt to GDP ratio, 2024Q1

In percentage



Mario Draghi's report identifies three areas for action to reignite sustainable growth in Europe:

- ▶ Close the innovation gap with the US and China, especially in advanced technologies.
- ▶ Launch a joint and coherent plan for decarbonization and competitiveness in order to make it an opportunity rather than a headwind for growth.
- ▶ Increase security and reducing dependencies in a context of rising geopolitical risks.

A 328-pages document thereafter offers a detailed set of policy recommendations required to achieve those objectives.

The beauty of this report lies in the fact that it exposes plainly and comprehensively Europe's economic situation, where it is heading if nothing is done, and what needs to be done to change course. Now that it is said, it cannot be ignored! European leaders are now faced with the choice to either start implementing those recommendations or ignore them. But they will not be able to claim that they didn't know. The process will likely take some time as always in Europe, but most of Draghi's proposals can be implemented quickly to improve growth prospects. The meeting of EU heads of state scheduled on November 8th in Budapest could be the occasion to formally announce their collective willingness to turn those recommendations into actions. But the political environment in Europe makes this objective a task possibly more difficult now than ever.

Making tough decisions in tough times: can Europe rise to the challenge?

The timing of the release of the report on the future of European competitiveness can be seen from two angles. In a sense, it comes at a timely moment when the aftermaths of the Covid pandemic are now mostly dissipated, when deteriorating growth clearly calls for some reaction, and before the rise of higher challenges for the European economy as the global trade order is being redefined. Draghi's clear call for urgent and bold action sets a path forward for improving the currently bleak outlook of the European economy.

Unfortunately, this report can also be seen as coming at the worse possible moment given the current economic and political context in Europe. In essence, the strategy and recommendations of Mario Draghi require European countries to cooperate and take collective decisions that will improve common growth prospects over the medium-term. Just the opposite of short-sighted decisions designed to

address immediate public opinion's concerns, as is currently the Zeitgeist in Europe. In that respect, two reactions from Germany's finance minister have highlighted the difficulty of the task ahead: less than three hours after the release of the Draghi report, Christian Lindner clearly rejected the idea of shared borrowing at the European level: "Germany will not agree to this". A few weeks later, Christian Lindner was said to have warned his Italian counterpart against a takeover of Commerzbank by Unicredit. Those can hardly be seen as signs of enthusiasm from Europe's largest economy at the idea of more economic integration and cooperation.

More generally, the recent European elections have shown a rise of anti-establishment and populist parties across virtually all European countries, reflecting declining popular support for a common European project. Elections in France have led to a political paralysis, along with a shrinking base for pro-European parties that looks unlikely to be reversed if new elections are held next year. In Germany, the ruling coalition appears ever more weakened after each regional elections, and all parties already have next year's federal elections in sight. Anecdotal (or not), the decision by Europe's largest economy to unilaterally reinstate border control was a telling example of the current low appetite for European cooperation. And the latest European Council held this month was all about migration issues and geopolitical discussions on Ukraine and the Middle East, not much about the deteriorating economic situation at home.

In this context, the report prepared by Mario Draghi raises a fundamental point: there are solutions to improve the economic outlook of Europe, but they require political will and leadership. The current economic and political context is difficult, even if the ongoing monetary policy easing by the ECB, and an expected rebound in China's demand will likely provide some relief to the struggling European economy in the short run. It is up to European leaders to rise to the challenge and be able to take bold decisions in a difficult context. Ultimately, the political reaction of Europe will determine whether the Draghi report remains as a salutary wake-up call, or simply a pipe dream of what could have been done to save the European economy.

What are the chances of a major fiscal stimulus plan in Europe?

The United States have had their Bidenomics, that has spurred investment in infrastructures and new factories while supporting consumption with extended social benefits and tax cuts for households. China just announced a massive stimulus package that is so far focused on supply-side policies, to facilitate access to credit and halt the fall of the real estate market, but could soon be complemented by measures targeted at households and designed to revive consumption. Europe is the one large economic area lagging behind in terms of fiscal support, and this may be part of the explanation for the disappointing economic performances of the past two years.

Individually, the main European economies have no wiggle room to provide fiscal stimulus in the short term. After a concerning deterioration of public deficits in the past few years, France has no choice but to draw up an "austerity" budget for next year, that will have to be adopted via a special procedure given the lack of majority in Parliament for the government. Far from being a stimulus, fiscal policy will be a headwind for growth in France in 2025. Italy is in a similar situation, after the European Council opened an excessive deficit procedure for the third largest economy of the European Union, along with France, Belgium and a handful of East European economies.

As for Germany, it would have ample room for maneuver on the fiscal front given the low level of its debt-to-GDP ratio (just above 60%). But Europe's largest economy is constrained by its self-imposed constitutional rule prohibiting budget deficits. This debt brake rule was well intended when introduced in 2009 and played its role of preventing fiscal inconsequence in the ensuing decade. However, in the current context, this rule no longer makes sense as it deprives Germany of the possibility to counterbalance the impact of the external shocks that are dampening economic activity. Sadly, the debt brake will probably not be relaxed until the federal elections due next year, shutting down prospects for a fiscal stimulus in the months ahead.

The only way to achieve some form of fiscal stimulus in Europe in the coming months would therefore be to reach an agreement on the implementation of the Draghi report's strategy financed by some special debt issued at the European level. European debt issued to finance structural investments,

and jointly backed by all European countries, would bring a much-needed fiscal support to Europe, putting the Continent closer to par with the US or China in terms of economic policy. In that respect, the stakes are high ahead of the November 8th Budapest meeting for EU heads of state.

A failure to reach an agreement in principle would further raise the risk of Europe being left behind in the new world order. A convincing message by European leaders that they are ready to leverage Europe's joint borrowing capacity to boost growth prospects, on the opposite, could be a game changer. It would pave the way to sustainably higher nominal growth and revived investment opportunities on the old Continent. The other side of the coin being the risk of destabilization of the European fixed income market, as higher growth and potentially inflation would warrant persistently higher interest rates for the ECB and for the sovereign bond market. European leaders face a decisive moment for the future of one of the three largest economic regions of the world. Can they rise to the challenge?

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