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5 Minutes for Business

European Forecast: Cloudy with Brighter Days Ahead

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Recent headlines about Europe have been dominated by fears of crisis, with a dramatic election in Greece and new action by the European Central Bank to avert deflation. Many businesses are looking at opportunities in European markets, but they have questions about the risks, or more succinctly, what is going on in Europe?

Collectively, the European Union is the world's largest market with a $17 trillion economy, more than 20% of global GDP. It is among the richest consumer markets in the world and it leads in many innovative sectors.

But Europe is also struggling with 19 very different countries all using the same currency, which is why it's the Euro crisis. The advantages of a common currency are impressive: more trade and closely integrated financial markets. But the main disadvantage of a common currency, giving up control over monetary policy, is actually much worse than we thought.

Consider that between 2000 and 2006, countries like Germany and France stagnated with their economies growing just 0-1%. At the same time, Peripheral Europe (Portugal, Ireland Spain and Greece) were growing at 3-6%, with inflation averaging 5%. The European Central Bank could only set interest rates at a one-size-fits-all level for the overall Eurozone. This meant that rates were simultaneously too high to stimulate moribund Germany and too low to slow down the overheating economies of Ireland and Spain.

As a result, the countries of Peripheral Europe suffered high inflation, with wages and input costs rising by 5% every year against European competitors, which made their economies uncompetitive. Worse still, massive flows of capital left the slow-growing countries in Northern Europe to seek higher returns in Peripheral Europe, inflating the bubble even further.

When the crisis hit in 2008, countries like Spain and Ireland and Greece were left with far too much debt and severely uncompetitive economies. Unable to depreciate their currencies, the only way to regain competitiveness was to struggle with years of high unemployment so that costs and wages gradually declined. Greece's wages have fallen by 18% while the real economy has contracted by 27% from its pre-crisis peak. This is a more severe downturn than what the U.S. experienced during the Great Depression, so it's little wonder they've elected a government that rejects further austerity.

But the crisis also forced governments to undertake much-needed reforms, from more flexible labour markets to improved regulation. Greece needs debt relief, and there are months and years of tough wrangling ahead, but the Europeans will find a political solution. At the same time, the European Central Bank is providing a wall of cash, €60 billion per month, to support bank lending. And wages have fallen to the point that competitiveness is improving so that growth is starting to emerge. Remember Ireland, the country with the world's worst housing crash? It's set to grow 3.3% this year, according to the IMF. Spain's growth in the fourth quarter was the fastest in Europe and it is forecast to grow around 2% in 2015. Even struggling Greece will grow 2.5% this year.

What does it all mean for business? Overall EU growth will be moderate this year at 1.6% and the road ahead will be bumpy, but there are enormous opportunities for those who can see ahead to the long-term.

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