Grant Thornton

An instinct for growth™

# The future of Europe

Grant Thornton International Business Report 2014

# Executive summary

Welcome to the third edition in our 'Future of Europe' series which uses economic and business survey data from our International Business Report (IBR) to provide insight into how Europe is recovering from the sovereign debt crisis. The report focuses on three main areas:

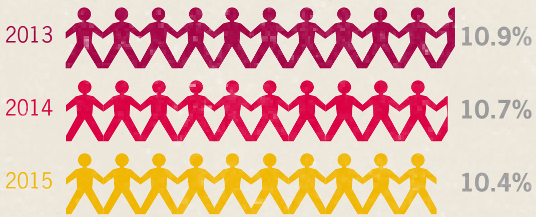
## Recovery

- the recovery took hold in Europe last year with all economies expected to grow this year

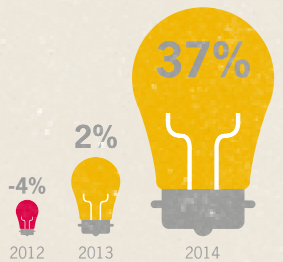
**GDP growth**


- unemployment rates remain elevated but are expected to fall over the next two years

**Unemployment (%)**




**Business optimism (%; Q1)**

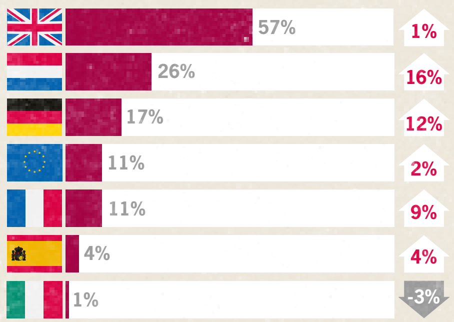



- levels of public debt remain high, but should peak this year as deficits decline
- business optimism has risen sharply since this time last year as uncertainty subsides.

## Integration

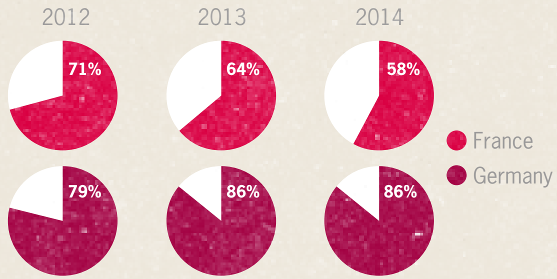
- majority of European businesses are open to more integration, but attitudes in Germany have hardened

**% of businesses that do not want to see further EU integration**




- French and German businesses have very different experience of euro membership

**% businesses positive about euro membership**

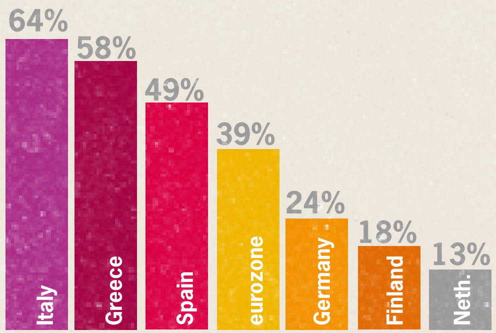



- support for euro remains high, with most businesses regarding membership as positive.

## Expansion

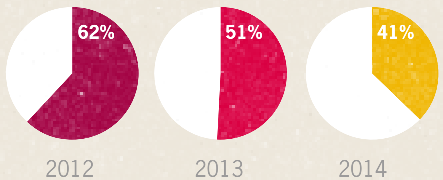
- majority of eurozone businesses do not want to see single currency expand further

**% of businesses that want to expand the eurozone**




- sovereign debt crisis has damaged attractiveness of EU as a place to do business

**% non-EU businesses that think further integration would help grow their business**




- Demark and Lithuania remain eager to join, but support in Poland fading.

# Foreword

## The economic outlook for Europe is much more positive compared with this time last year. In 2013 this report talked of regional stagnation with growth rates flat, unemployment rising and painful fiscal adjustments constraining the spending power of businesses, consumers and governments.

Twelve months on the picture is much brighter; the region is expected to post modest growth in 2014, unemployment and debt levels are creeping down while measures of consumer and business confidence are rising. The turnaround in fortunes is perhaps most evident in those economies hit hardest by the crisis: Ireland has exited its bailout programme and business optimism is soaring; Portugal and Spain are exporting themselves out of recession; Greece recently met the criteria for its latest tranche of bailout funds and the government is forecasting a primary budget surplus this year.

Despite this improved outlook, a number of challenges remain for regional policymakers. Deflation is a mounting concern, with the inflation rate falling to just 0.5% in March well below its 2% target. This is stoking fears of a Japan-style stagnation, as businesses and consumers delay purchases in the expectation of lower prices, and loans become more expensive in real terms, putting pressure on the ability of countries to service their sovereign debts.

The European Central Bank (ECB) has taken steps to ease monetary conditions, dropping interest rates to a historic low of 0.25%, and has discussed introducing quantitative easing.

The outlook for France and Italy is also a concern. Together their two economies account for 38% of total eurozone output but growth rates in both are expected to lag the regional average over the next two years with political uncertainty complicating attempts to reform labour and product markets.

Youth unemployment also poses a significant risk to long-term economic vitality with close to one in four young people looking for work across the European Union (EU). Time spent outside the workforce erodes productivity as key business skills, employability and sometimes motivation fade. Young people are likely to pick up new processes and techniques relatively faster than older peers but if they are inactive in these 'business formative' years, the opportunity is lost.

Youth inactivity and social unrest looks set to play into the hands of right wing parties, which tend to favour looser European ties, in the upcoming parliamentary elections. Indeed rising nationalist sentiment is evident across Europe with Scotland to vote on whether to remain part of the UK later this year; Cataluña pressing for a referendum; the secession of Kosovo still to be resolved; and the UK possibly to hold a referendum on EU membership as early as 2017.

Add to this the energy and geopolitical uncertainty caused by the annexation of Crimea by Russia and it is clear that the business outlook remains delicately poised. However, in our profession, recent EU accounting reforms should boost transparency and competition in the market, creating opportunity and improving information for investors. And with business confidence and growth indicators on the rise, I am excited about the prospects both for us and our clients across the region over the coming months and years.

Ed Nusbaum
Global CEO, Grant Thornton

# Recovery

**The recovery in Europe finally took hold in the second quarter of 2013. Since then it has spread out across the region, strengthening and steadily becoming more balanced. Output in the eurozone last year as a whole contracted by 0.4%, and the wider EU grew by just 0.1%, but the outlook for 2014 looks much brighter.**

The eurozone is expected to expand by 1.2%, accelerating to 1.8% in 2015 with the EU expected to grow even more quickly, by 1.5% in 2014 and 2.0% in 2015. Germany, which accounts for 28% of total eurozone output, had a comparatively poor 2013, growing by just 0.4%, down from 0.7% in 2012 as the regional slowdown threatened to derail its mighty export machine. However, with last year's elections returning a 'Grand Coalition' under the continued stewardship of Angela Merkel, growth is expected to match the EU average across the next two years.

France, which accounts for a further 22% of regional output, followed no growth in 2012 with expansion of just 0.3% in 2013. But despite the deep unpopularity of President Hollande, who has a particularly low standing amongst business leaders following a series of proposed tax rises, the economy is expected to grow by 1.0% in 2014 and 1.7% in 2015.

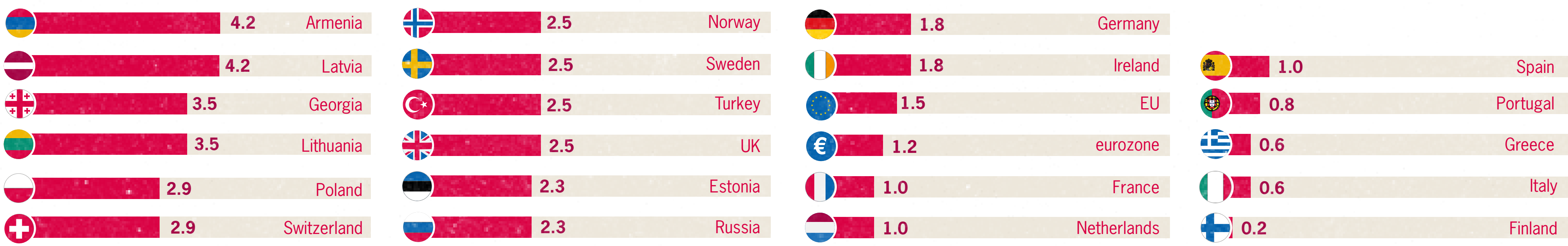
Spain returned to growth in Q3 last year on the back of a spectacular export performance following nine straight quarters of contraction and the economy is forecast to expand by 1.0% and 1.7% over the next two years. Ireland and Portugal are also expected to grow relatively robustly in 2014 bolstering the argument of advocates of austerity and the EU bailout programmes. Even Greece is finally expected to return to growth of 0.6% in 2014, accelerating to 2.9% in 2015.

> *The EU is expected to grow by 1.5% in 2014, rising to 2.0% in 2015.*

Outside the single currency, the UK was the standout performer in 2013. The economy expanded by 1.9%, driven by increased consumer spending and a housing boom, and is expected to top that over the next two years. Growth forecasts for Poland are even stronger, driven by improvements in Germany, its key trading partner, although further disruption in neighbouring Ukraine could pose a significant risk.

The situation in Italy is now perhaps the biggest concern for European leaders, where the the recent promotion of Matteo Renzi makes him the fifth of the last seven prime ministers appointed without a direct mandate from voters. The economy, which accounts for 16% of eurozone GDP, is not expected to reach its pre-crisis size until at least 2020. Growth of 0.6% is expected in 2014.

**Real GDP growth (%) 2014**




Source: European Commission, Economist Intelligence Unit 2014

## Debt

### The return to growth of Greece, Ireland and Portugal provides a major boost to supporters of fiscal austerity who have argued that economies should lower debt burdens rather than spend their way out of trouble. Governments are enjoying dramatically reduced borrowing costs as rising confidence in the creditworthiness of their economies, as well as capital flight from some emerging markets, bolsters demand.

The yield on Ireland 10-year bonds fell to 3.5% at the beginning of the year, down from more than 14% at the height of the crisis, while Greece and Portugal also successfully returned to international bond markets earlier this year.

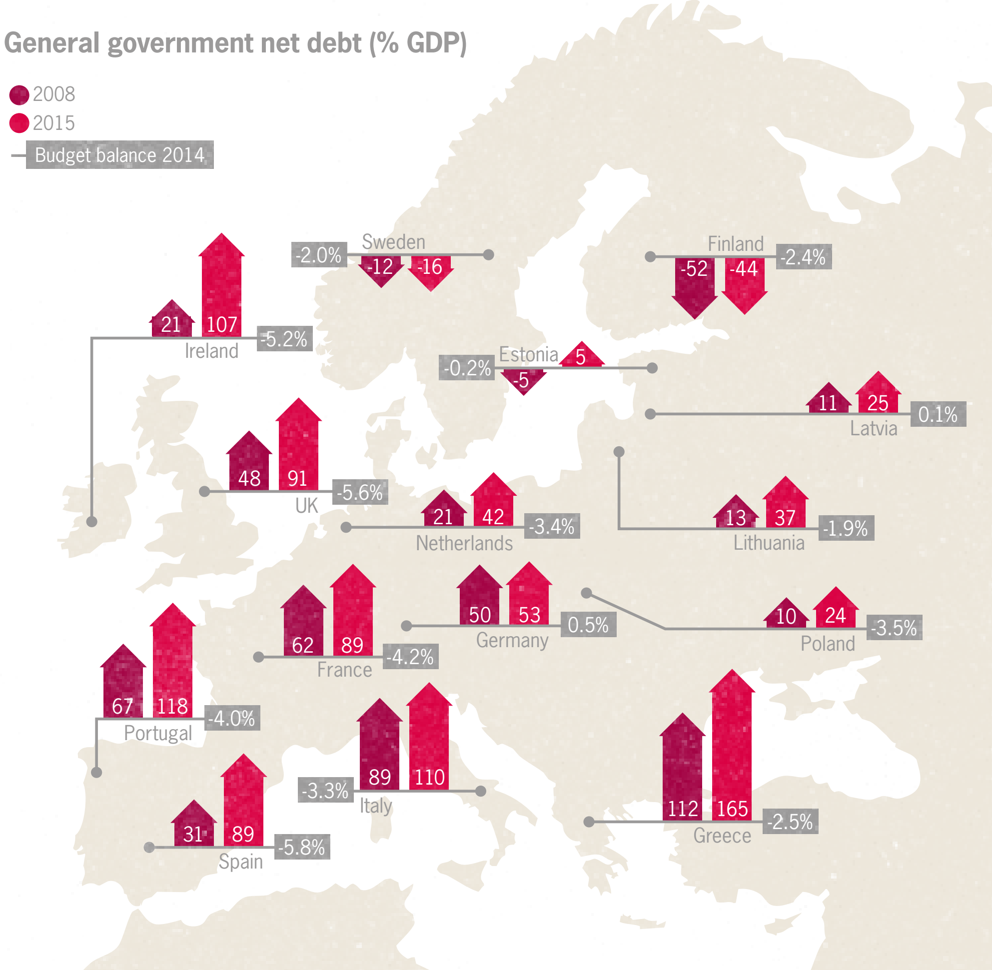
This is a remarkable turnaround, even from this time last year. Levels of public debt soared across Europe, first during the global financial crisis, and then during the regional sovereign debt crisis. Low levels of economic activity kept tax receipts low while high levels of unemployment (see Labour market) have kept benefit payments high, further squeezing government budgets. However, there are signs that debt levels are stabilising and even coming down.

Greece is the most indebted regional economy relative to the size of its economy, although the government expects to achieve a primary (ie before interest payments) budget surplus this year. Net government debt is expected to have peaked in 2013 at 173% of GDP. Portugal, Italy and Ireland all have debt piles greater than the annual output of their economies, but should see these begin to decrease from 2015. Greece is expected to meet the European Fiscal Compact criterion of a 3% budget deficit in 2014, but Italy, Ireland and Portugal are not expected to meet the target until 2016.

Governments in Spain and the UK are still suffering from having to bail out their large banking sectors and debt soared as the financial crisis erupted, almost doubling in the UK and almost tripling in Spain. Both are expected to run budget deficits of well over 5% in 2014. Spain is not expected to reach the 3% deficit target until 2017 with the UK (which did not sign the Fiscal Compact) arriving there a year later. In France, President Hollande pledged US$36 billion of budget cuts in 2015-17 but has asked for more time to meet its budget deficit target to allow it to develop its new growth plan

By contrast, German public debt has barely increased since the financial crisis and returned its budget to surplus in 2013. Poland, the Baltic and Nordic economies have very low levels of debt by comparison.

**General government net debt (% GDP)**




Source: IMF 2013

## Labour market

Improvements in labour markets tend to lag recoveries as businesses work off excess capacity and wait for uncertainty to subside before hiring new people. In many European economies stringent legislation, which makes it hard for businesses to shed workers, exacerbates this issue. Consequently unemployment rates remains stubbornly high across much of the region, in stark contrast to the dramatic improvements seen in the United States.

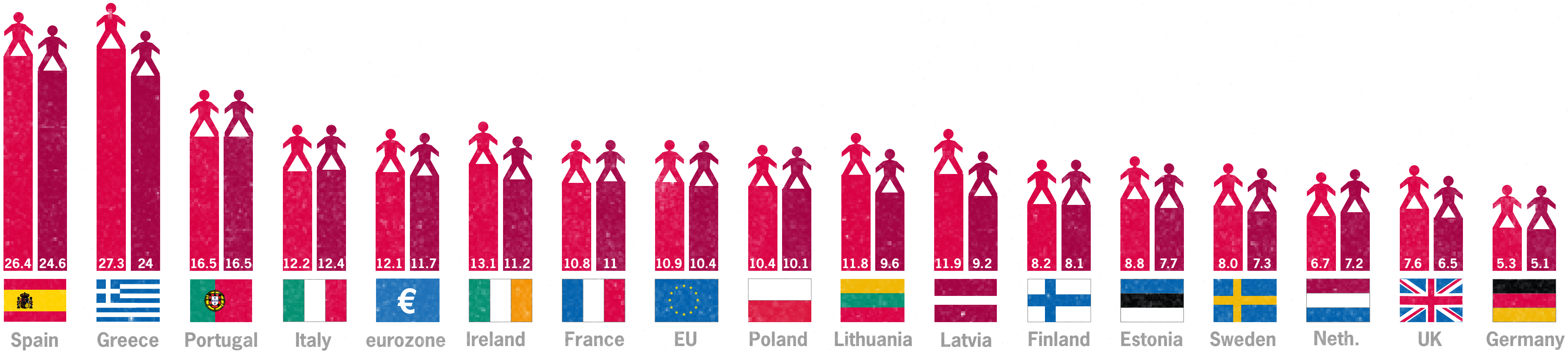
The labour market is expected to start slowly improving this year, with the unemployment rate across the EU falling from 10.9% in 2013 to 10.4% by 2015. Eurozone unemployment remains higher, but is forecast to fall from 12.1% in 2013 to 11.7% in 2015.

The situation in Greece and Spain, where more than one in four people of working age is unemployed, rising to more than one in two young people, remains pretty dire, although gradual improvements are expected over the next two years. In France, unemployment is actually expected to peak at 11% this year and decline thereafter. It remains to be seen whether the US$14 billion payroll-tax cuts for firms, as part of the 'responsibility pact' will actually encourage job creation. Italian unemployment is expected to rise to 12.6% this year, falling to 12.4% in 2015. Ireland and Portugal also have unemployment rates well into double figures, although in Ireland at least, labour market pressures have eased significantly.

*The unemployment rate in Greece and Spain is more than one in four, rising to one in two young people.*

The contrast with Germany, which boasts an unemployment rate of just 5.3%, is particularly telling while UK unemployment is forecast to drop to 6.5% in 2015, down from 7.9% in 2012. In Finland and the Netherlands, right wing political parties have made significant strides recently partly on the back of rising unemployment rates. In the Netherlands, the proportion of people out of work has jumped by more than two percentage points since 2012 to 7.4%.

**Unemployment rate (%)**




Source: European Commission 2014

2013
2015

## Business growth

The strength of the recovery is further evidenced by renewed business confidence in the economic outlook. Business optimism across the EU climbed to net 37% in Q1, up from 21% in Q4 and just 2% this time last year. In the eurozone, the figure has risen by 27 percentage points over the past four quarters to net 25%.

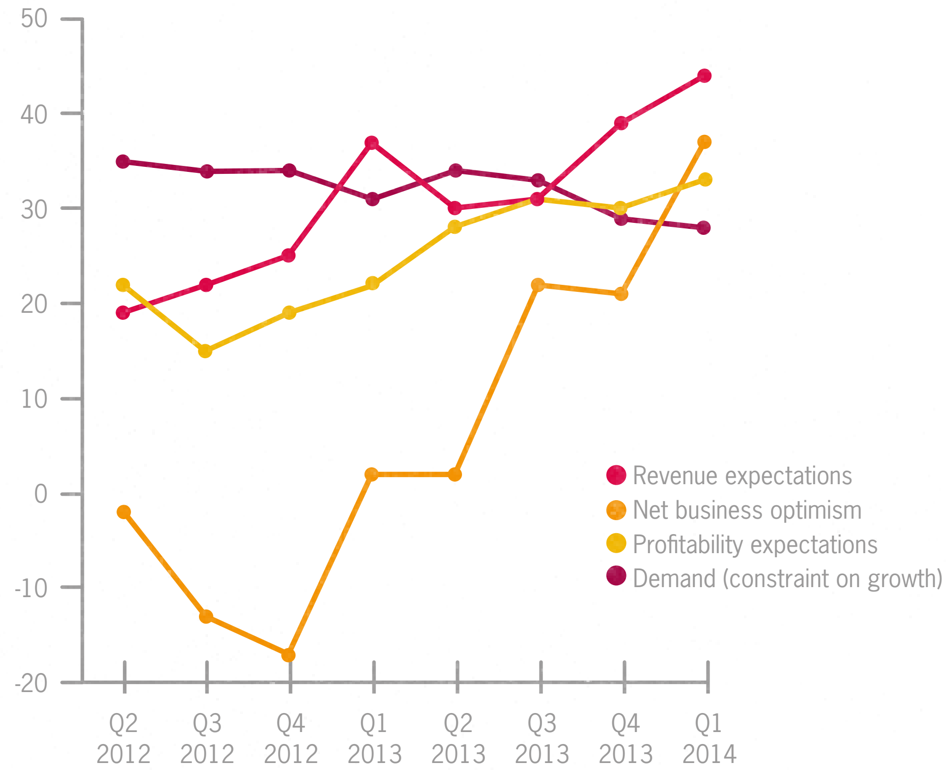
The situation for businesses in southern Europe has improved dramatically over the past 12 months, with business optimism climbing from net -27% to 11%; Spain alone has seen a positive reversal of 48 percentage points over this period. Optimism levels in the UK, net 83%, up from -1% this time last year, and Ireland, 94%, up from 50%, have reached record highs. Germany (65%) too remains solidly optimistic, recovering well from a significant dip in late 2012. The Netherlands (+44 percentage points) and Sweden (+45) have also seen massive positive upswings in confidence over the past 12 months. However, there are still signs of strife in France (-17%) and Italy (6%) where optimism levels are among the ten lowest globally.

Higher levels of confidence in the economic outlook are feeding through into business growth prospects, with around 10% fewer business leaders citing economic uncertainty as a constraint in Q1 compared with 12 months previously. The proportion of businesses expecting revenues to climb over the year ahead has risen to net 44%, up from 37% this time last year. Profitability expectations have risen even faster from net 22% in Q1-2013 to 33% in Q1-2014. However, while businesses in Ireland (64%), the UK (61%) Sweden (57%) and Germany (44%) are all expecting strong profit growth, their peers in Italy (2%) and France (8%) are much less optimistic.

*Optimism levels in the UK, net 83%, up from -1% this time last year, and Ireland, 94%, up from 50%, have reached record highs.*

Order books are also filling up across the region with 28% of businesses across the EU citing a lack of demand as a constraint on their expansion plans, down from 31% in Q1-2013, although still marginally above pre-crisis levels (25% in 2008). The situation in the eurozone has improved even faster with the proportion of businesses struggling for orders down eight percentage points to 28%.

**Business growth indicators (EU; %)**




Source: Grant Thornton IBR 2014

# Integration

Business support for the euro remains high; 93% of businesses in the eurozone want the currency bloc to survive, the same level as last year, and while only 75% regard their economy's membership of the euro as positive, only 9% want to leave.

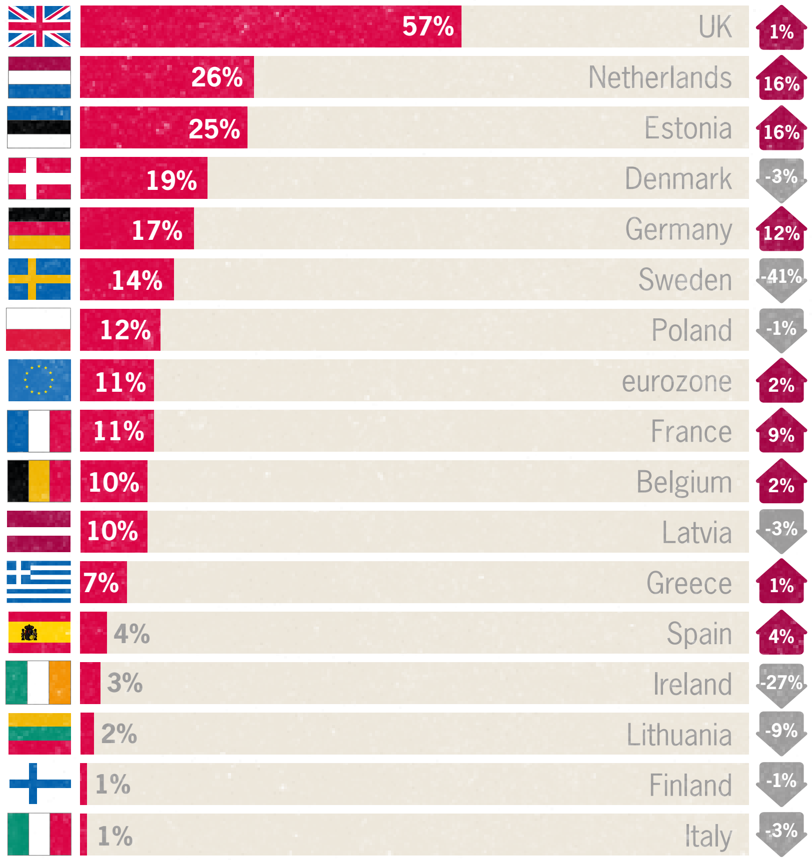
Despite this support, the integration of Europe's economies has moved ahead relatively slowly over the past 12 months. The European Fiscal Compact, signed in early 2012 by all members except the Czech Republic and the UK, extended the influence and oversight of the European Commission into member states' budgets and debt levels. But economies such as France and Spain are set to miss budget deficit targets, drawing rebukes from the Commission and more fiscally prudent peers.

More recently, the second and final stage in the creation of a banking union was finally agreed in March. Following the 'first pillar' under which the European Central Bank (ECB) was given a wide range of new supervisory and regulatory powers, the second sets up an agency with the power to shut failing eurozone banks. However, there will be no joint government fund to cover the costs of any closures after Germany resisted pressure from France and Spain to mutualise liabilities on bank losses. This is unsurprising given the aversion to pooling debts of German business leaders: just 22% support Eurobonds, compared with 85% in Spain, 78% in Italy and 63% in France.

*There will be no joint government fund to cover the costs of any closures after Germany resisted pressure from France and Spain to mutualise liabilities on bank losses.*

A majority of eurozone business leaders continue to support further economic integration of member states; 62% are in favour, although this ranges from 86% in Spain and 83% in Finland to just 55% in Germany, down from 76% this time last year, a potential major stumbling block to any further European agreements. Indeed, the proportion of German business leaders who do not want to see any further European integration has jumped from just 6% in 2012 to 17%. There have also been steep rises in anti-integration sentiment in Estonia and the Netherlands (both +16%). By contrast, just 3% of Irish business want to avoid

**Percentage of businesses who do not want to see further European integration**

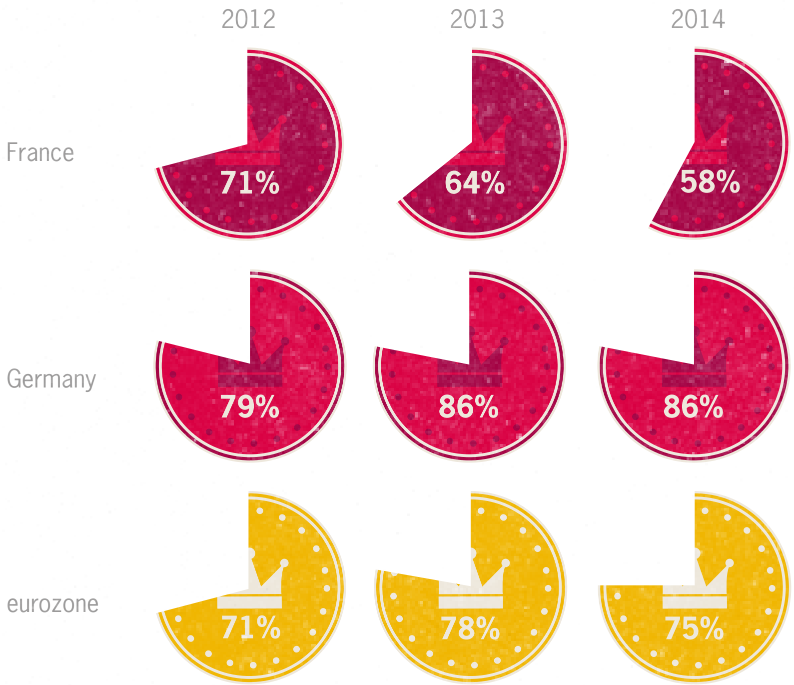



Source: Grant Thornton IBR 2014

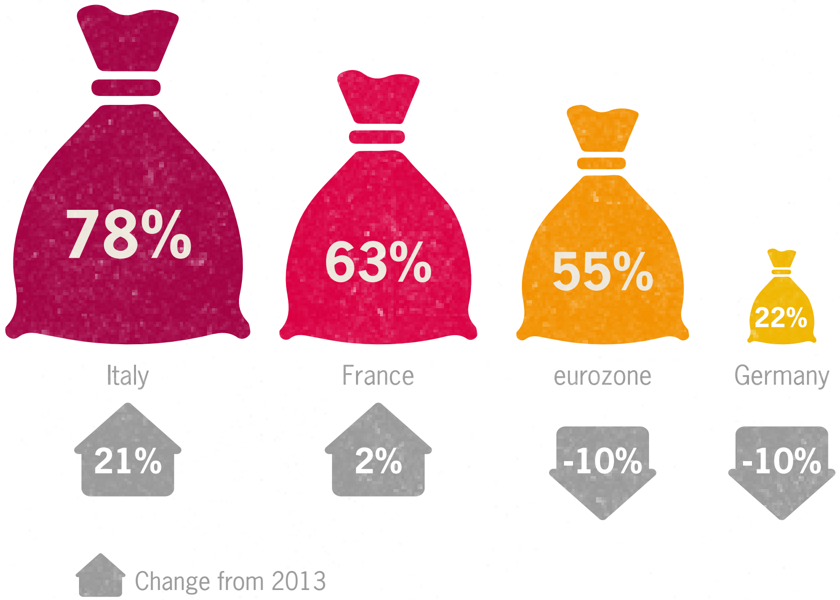
EU integration, down from 30% in 2012. Outside the single currency, UK business leaders (57%) are far less willing to integrate compared with Denmark (19%), Sweden (14%) - where business leaders have become markedly more open to integration over the past 12 months - and Poland (12%).

Another impediment to further European integration sits at the heart of the continent itself. In 1950, French foreign minister Robert Schumann first proposed the European Coal and Steel Community as a means to cementing peace between France and Germany, a body which would subsequently become the EU. These two economies drove through the adoption of the euro, but in recent years, divergent economic performances have led to a marked split in support for the single currency. In 2012, 71% of French businesses agreed that euro membership had been positive, slightly below German peers (79%) but level with the eurozone average. In 2013, this dropped to 64% in France while German sentiment improved (86%). This year, French business attitudes have worsened further (58%) while their German peers remain as buoyant as 12 months ago.

**All things considered, do you think that your country's membership in the Euro has been positive? (% yes)**




**Would you support the issuance of Eurobonds (ie bonds which are issued by a single state but backed by all eurozone members)?**




Source: Grant Thornton IBR 2014

# Expansion

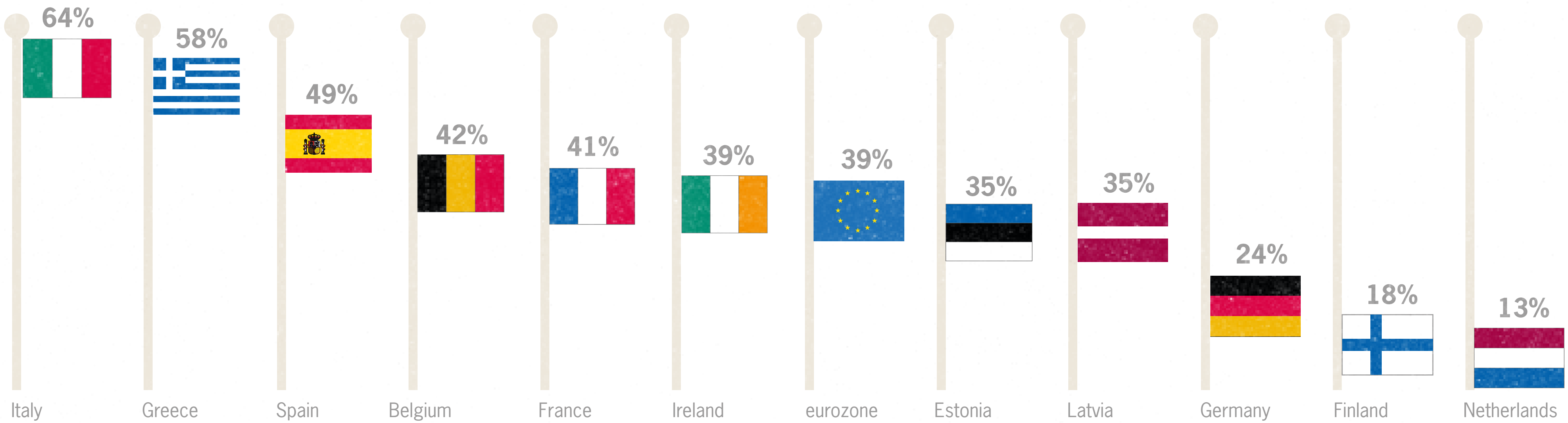
Croatia joined as the 28th member of the EU in July 2013 and a further eight countries remain official (or potential) candidates. However, the sovereign debt crisis has clearly had a major impact on the draw both of Europe and the euro itself, for governments and businesses.

Businesses inside the eurozone remain somewhat sceptical as regards admitting more members: 39% would like to see the single currency expand, led by the southern European states of Italy (64%), Greece (58%) and Spain (49%). This is broadly the same as 2013 (38%), although still well above 2012 levels (31%). A further 36% of eurozone businesses say no more countries should enter in the near future, rising to around 50% in Germany, Finland, Ireland and the Netherlands. Outside the euro, business leaders in Poland (53%) and Lithuania (46%), perhaps the two economies most likely to adopt the euro in the near future, are most keen that the eurozone admits more members.

Those businesses operating in economies which have joined the European Exchange Rate Mechanism (ERM II) are most enthusiastic about joining the euro: three in five businesses in Denmark (60%) want to join, slightly ahead of Lithuania (56%). In Poland, almost one in two want to join the euro (49%) but this is down from 56% in 2013 and 64% in 2012. Businesses in Sweden (32%) are much more positive as regards the euro compared with 12 months previously (20%) while those who wish to join in the UK remain firmly in the minority (16%).

Businesses in Lithuania are most confident about joining their Baltic neighbours Estonia and Latvia in the euro in the near future; 64% expect to

**Percentage of businesses that would like to see the euro expand**



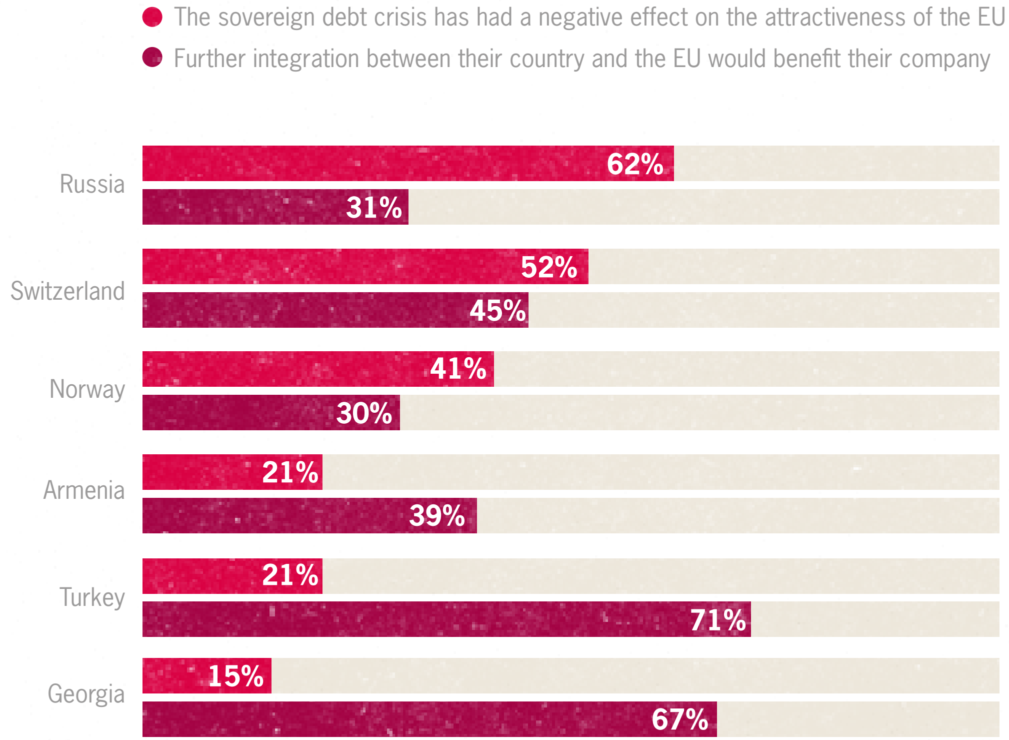

Source: Grant Thornton IBR 2014

join by next year. By comparison, 67% of peers in Poland (up from 45% this time last year) and 48% in Denmark think their country will join in 2018 at the earliest. Around three-quarters of UK businesses think their country will never join.

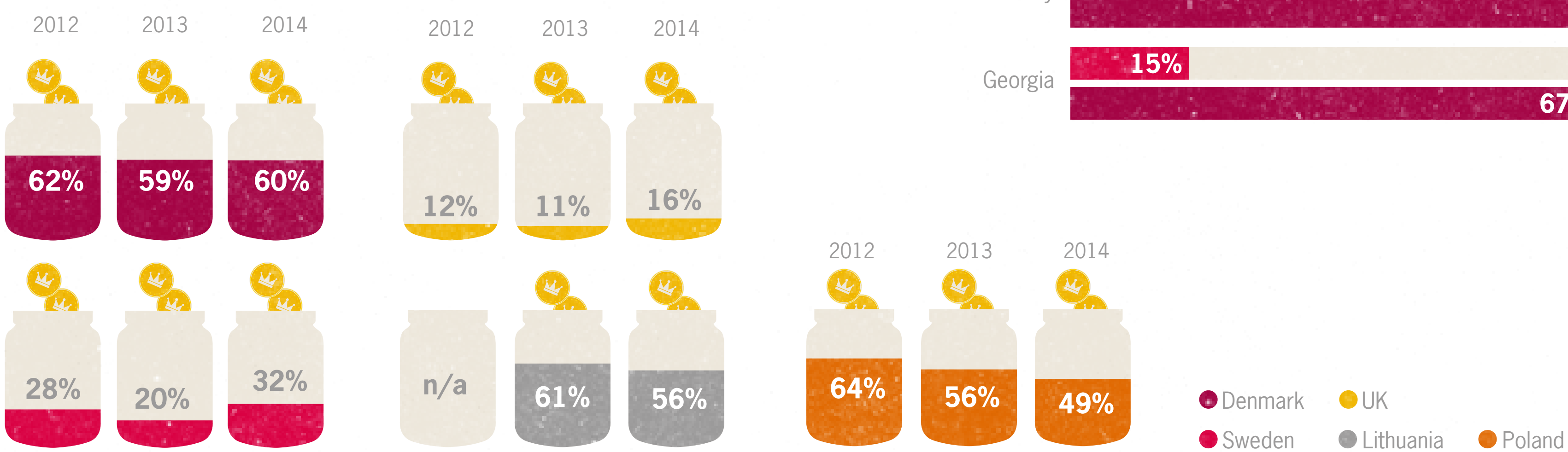
Outside the EU, a remarkable 96% of businesses in Norway are open to the idea of joining the euro (although only 18% say they would definitely like to join), as are 82% in Switzerland (but just 4% definitely). In Turkey, 33% say they would definitely like to join with a further 56% saying they would potentially like to join.

Despite the nascent regional recovery, the sovereign debt crisis has clearly damaged the standing of the EU in the world: 49% of European neighbour states in the survey say the crisis has had a negative impact on the attractiveness of the EU as a place to do business, rising to 52% in Switzerland and 62% in Russia. Moreover, business leaders see declining returns to further integration between their country and the EU; just 41% say this would benefit their business, down from 51% in 2013 and 62% in 2012. Armenia (down 22 percentage points to 39%) and Georgia (down 19 to 67%) have seen particular falls in enthusiasm. However, businesses in Turkey (71%) remain eager for more cooperation.

**Percentage of businesses that feel:**




**Would you like your country to adopt the Euro? (% yes)**




Source: Grant Thornton IBR 2014

## IBR 2014 methodology

The Grant Thornton International Business Report (IBR) is the world's leading mid-market business survey, interviewing approximately 3,300 senior executives every quarter in listed and privately-held businesses all over the world. Launched in 1992 in nine European countries, the report now surveys more than 12,500 businesses leaders in 45 economies on an annual basis, providing insights on the economic and commercial issues affecting companies globally.

The data in this report are drawn from more than 3,100 interviews with chief executive officers, managing directors, chairmen and other senior decision-makers from all industry sectors in mid-market businesses, conducted between November 2013 and February 2014.

Participant economies (and total interviews):

- **eurozone (1,350):** Belgium, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Netherlands, Spain
- **Other EU (1,050):** Denmark, Lithuania Poland, Sweden, United Kingdom
- **European neighbours (700):** Armenia, Georgia, Norway, Russia, Switzerland, Turkey

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**Dominic King**
Global research manager
Grant Thornton International Ltd
T +44 (0)20 7391 9537
E dominic.king@gti.gt.com

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