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The Strategy for Europe

The EU needs to be seen as working – to be attractive and influential again

EU reform: turning more into a club of clubs

- **Solid framework for all:** democracy, rule of law, human rights, common market
- **Enhanced co-operation** between sub-groups of EU members

The key challenges are at home

- **Germany:** still strong – but beyond its peak
- **France:** a golden decade ahead – if Macron delivers
- **Italy:** an accident waiting to happen
- **Brexit:** Paying the price for populism

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Economics

The French potential: catching up with the German reforms

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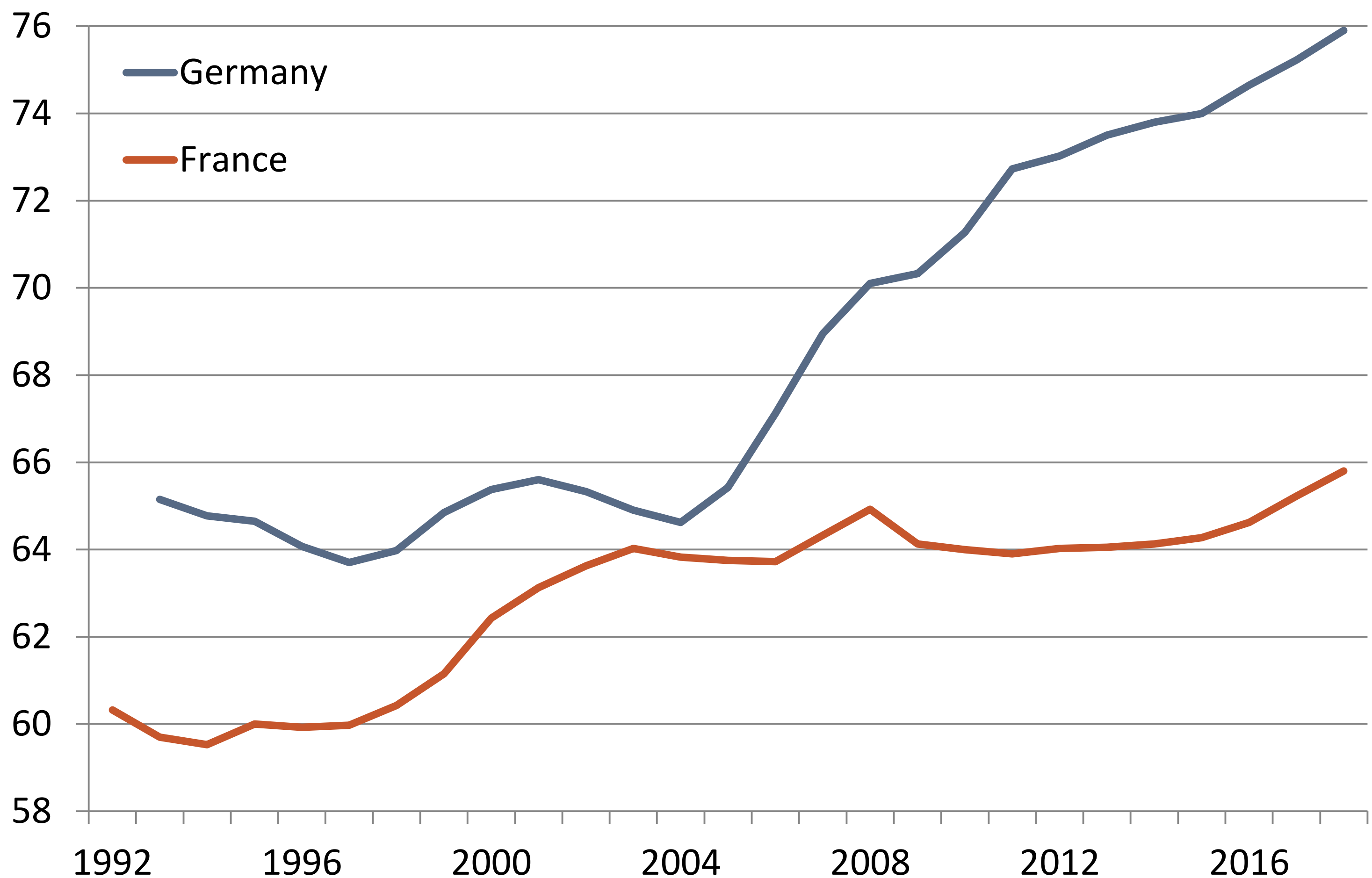
French and German employment: big gap means big potential



- Reforms matter. Think Thatcher, Schröder or Rajoy.
- German employment took off after its 2003-2005 reforms.
- President Macron promises to deliver the labour market, pension and public sector reforms that France needs.
- Two cheers for the French labour market reform of September 2017: Macron has started to tackle the key issue.
- Work in progress: unemployment insurance and pensions.
- France is heading for a golden decade if Macron continues to deliver, as he probably will.
- The gap between German and French employment rates indicates the potential which France could unlock with its reforms.

Employment in percent of working age population (16-64 years), 2018 estimate based on year-to-date data.
Source: Eurostat.

What ails Italy? It is not the euro

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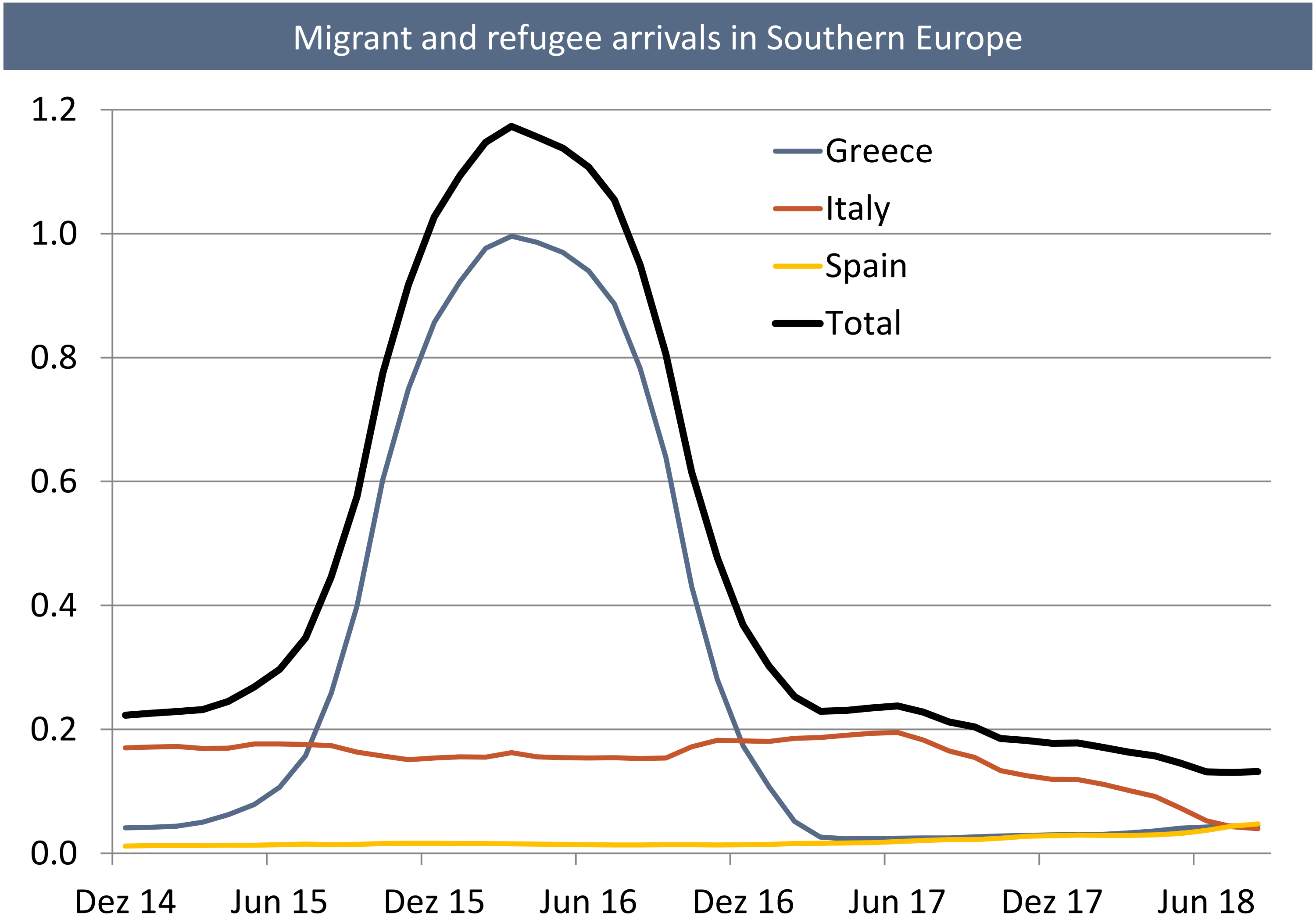
Real GDP, indexed at 1991Q1=100. Sources: Destatis, Istat.

- Germany and Italy were in lockstep from 1991 to 2006. Both had serious structural problems.
- The advent of the euro in 1999 made no difference.
- Germany outperformed shortly after its 2004 structural reforms. With a reformed supply-side, Germany recovered fast from the 2008/09 recession.
- Italy remains half-reformed. Reform reversals could make it even more vulnerable.
- In a debt crisis, Italy may face the stark choice Greece had to make in 2015:
  1. get real and pursue serious reforms
  2. or leave the euro and descend into chaos.
- Like Greece, Italy would probably choose painful reforms over chaos.

Migration: the big issue in Europe

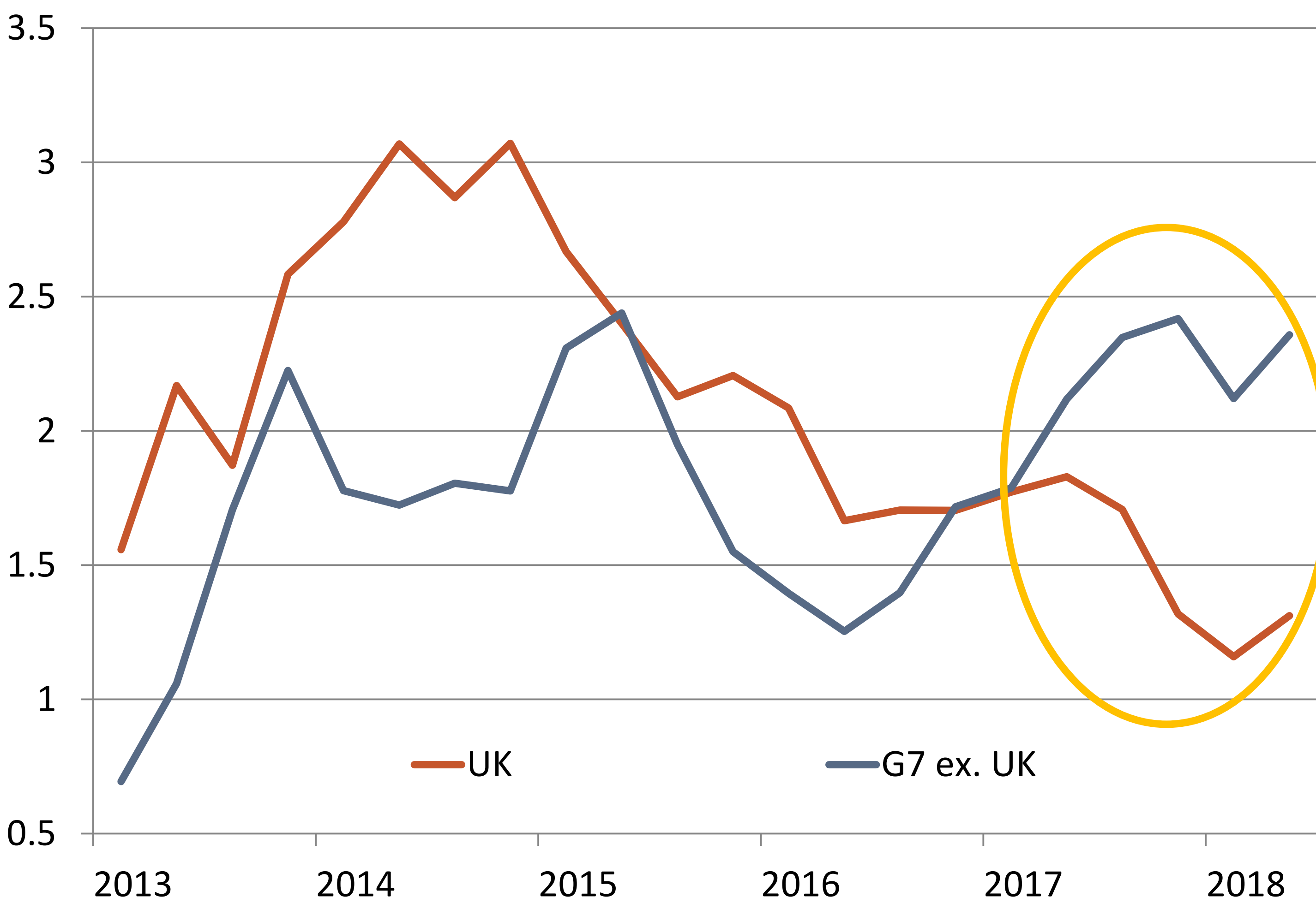


See arrivals into Greece, Italy and Spain, plus arrivals over the Turkish-Greek land border since December 2017, 12-month rolling sum, in millions, estimate for August 2018. Source: UNHCR, Berenberg

- Europe is attractive: Seeking peace, security and a better life, many people from war-torn and poorer countries are trying to enter Europe.
- The number of migrants and refugees reaching the top three countries of entry into the EU dropped sharply in 2016 and has continued to decline ever since.
- Nonetheless, migration still shapes much of the political debate in the EU.
- A migration dispute rocked the German Merkel's government in mid-2018.
- The stance of the EU and most member states continues to harden.
- Italy started to work with Libya to reduce migrant flows in 2017 and is now taking a particular hard line under its new government.

Brexit hurts

UK GDP growth lagging behind since shortly after the Brexit vote



Quarterly data. Annual growth of real GDP, in %. Sources: ONS/Haver Analytics

- For long, the UK had outperformed other major developed economies. Shortly after the Brexit vote, the UK started to lag behind badly
- Serious barriers to imports crimp economic growth, stoke inflation and disrupt supply chains. Trade wars could mean a dose of Brexit-lite for everybody.
- The damage has happened although the UK is still in the EU. Uncertainty counts. Mind the fear factor.
- Before the Brexit vote, the UK enjoyed strong trend growth of c2.1%.
- A semi-soft Brexit (UK stays in single market for goods but not services) would likely cut trend growth to c1.7%.
- A hard Brexit could cut the trend to just c1.4%.

Turkey: Weak Lira = further inflation spike in the pipeline

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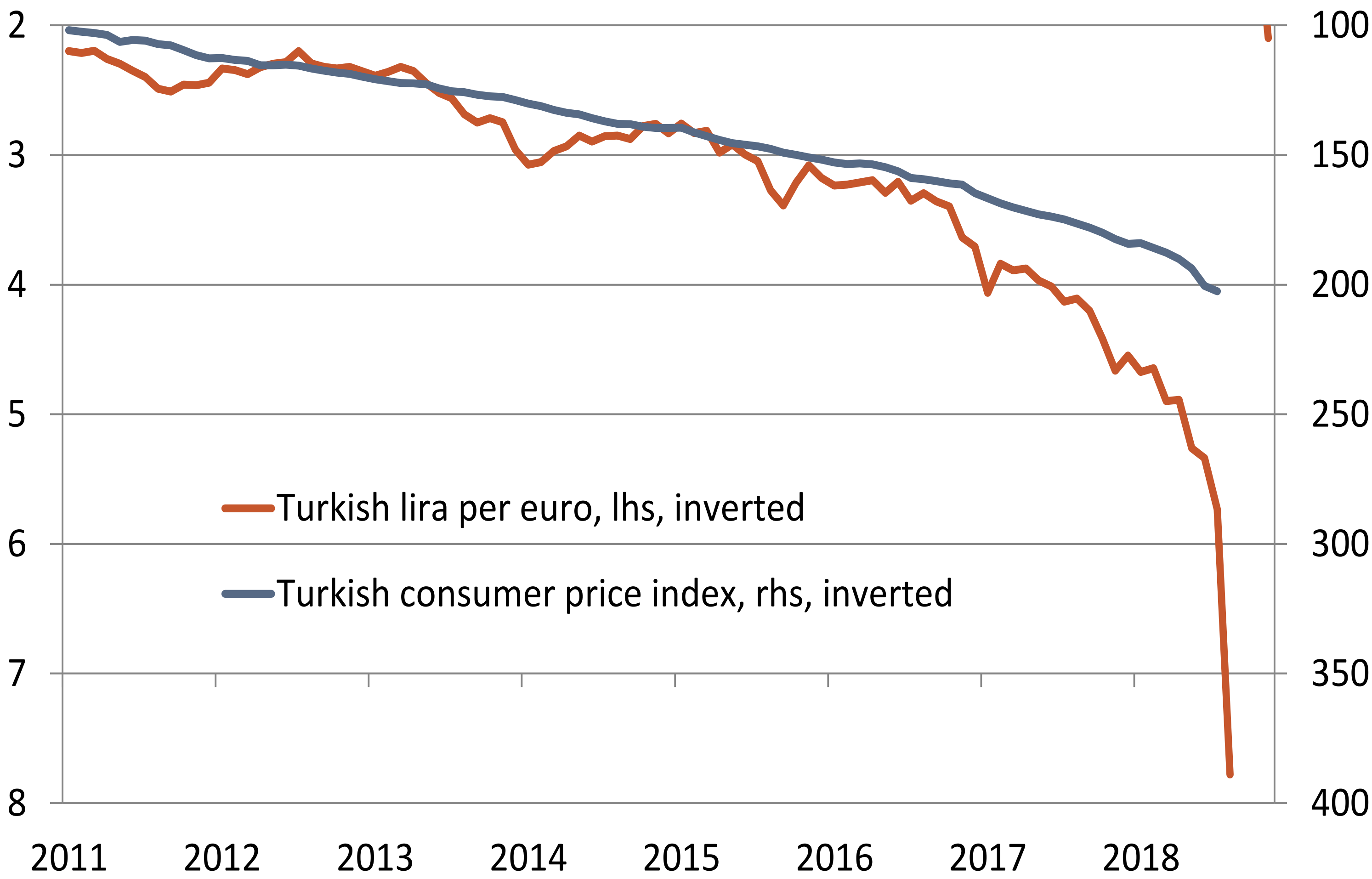
Unless corrected fast, plunge in Lira could raise consumer prices sharply



- Turkey is in trouble partly because its autocratic president Erdoğan controls the central bank.
- The Turkish central bank cannot credibly commit to its 5% inflation target as long as Erdoğan prevents the necessary rate hikes.
- Inflation reached 15.9% yoy in July and looks set to surge beyond 20%.
- External and internal devaluation: to fully catch up with the plunge in the exchange rate since the end of 2016, Turkish consumer prices would have to rise by 71% from their July 2018 levels .
- A 75% pass-through of the entire devaluation would still raise prices by a further 48%.

TL/EUR exchange rate and Turkish consumer price index, rebased to 2010=100, inverted. Turkish Statistical Institute, Wall Street Journal, Berenberg calculations.

More on EU reforms and the strategy for Europe

Key Berenberg publications

Understanding Germany – a last golden decade ahead
13 October 2010

After Trump: notes on the perils of populism
14 November 2016

The Macron effect: can France overtake Germany again?
5 May 2017

Reforming Europe: which ideas make sense?
19 June 2017

2017 Euro Plus Monitor: Into a higher gear
30 November 2017

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