# Europe Is On The March

## June 23, 2017


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SUMMARY

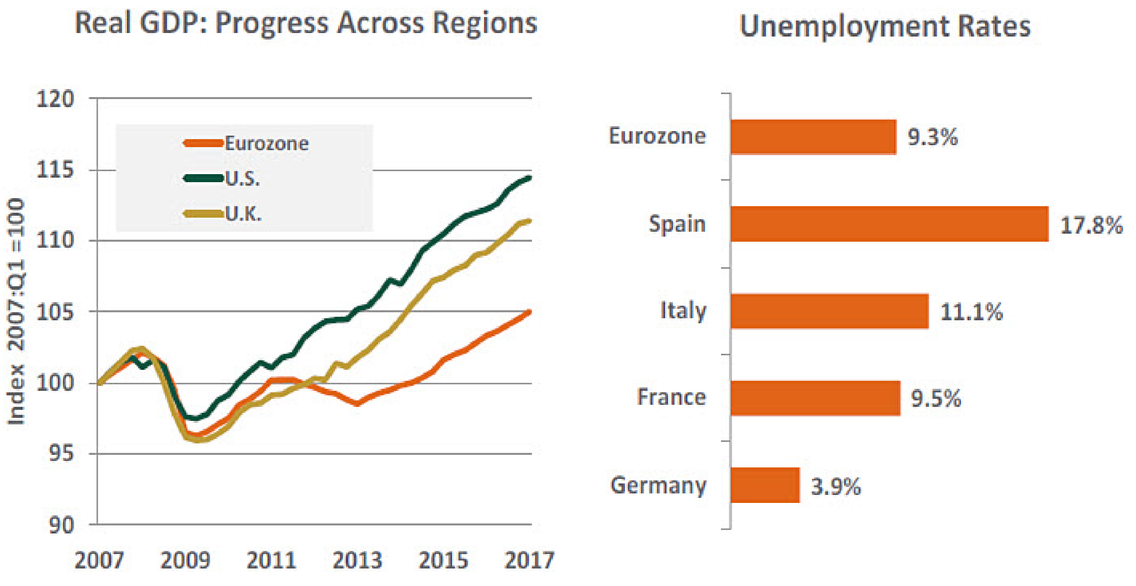
- Europe Is On The March
- Getting Women To Work More
- Feathers Fly At The Bank of England

I've just begun a long stretch of work in Europe. The schedule is challenging, but there are moments between meetings that allow a look at the beautiful scenery. The early summer finds the air clear, gardens flush and cafés full during long evenings. The conditions are ideal—at least for those with leisure time.

Economic conditions in Europe may not be ideal, but they are looking better than they have in quite some time. After suffering through a crippling recession, acute concern over government debt, and an existential threat from populism, the eurozone (the community of countries who share the euro as their common currency) now seems poised to perform at a higher level. Investors are newly optimistic on the region and are backing their positive expectations with capital.

While the worst may be in the past for Europe, its path forward is complicated. There remain significant structural limitations that constrain economic growth. Progress has been uneven within and across countries; unless fortunes converge, populist forces may re-emerge. New leadership brings hope for change, but Europe's window of opportunity may prove to be brief.

The eurozone is more than twenty years old. For the first decade of its existence, the association brought prosperity to its members, who were happy for the association. The past eight years, however, have been a different story.




*Source: Haver Analytics*

Europe was drawn deeply into the global financial crisis, and endured a sovereign debt crisis just three years later. As a consequence, economic growth in the eurozone has lagged well behind other developed markets and unemployment has remained at high levels across most of the area.

There are a series of reasons for this underperformance:

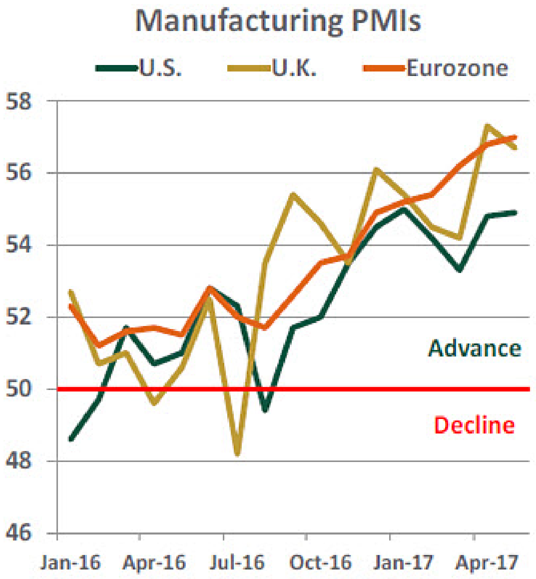
- The Maastricht Treaty, which limits government debt and deficits for eurozone members, proved countercyclical. Recession damaged the fiscal position of many countries, forcing them to pursue austerity to abide by the treaty. Budgetary conservatism added to contractionary forces at a time when fiscal expansion was desperately needed.

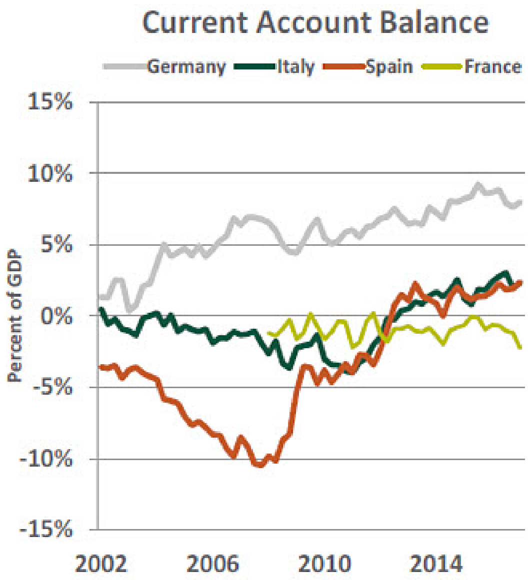
- The European Central Bank was slow to recognize the extent of the economic damage, and slow to react to it. Interest rates were higher for longer than they should have been, and quantitative easing started seven years after the U.S. Federal Reserve began its own bond-buying program.
- Europe has been slow to address its banking challenges. Rather than initiate an immediate reckoning of bad debt, authorities chose the “delay and pray” strategy. This hampered the provision of fresh capital that was needed to support growth.
- Businesses and the labor markets were hindered in their ability to adjust to changing conditions by government restrictions.

The lingering malaise, along with variations in fortune between and among populations, generated a great deal of discontent. This created political risk for the eurozone as we entered 2017: elections in Italy, Holland, France and Germany were all on the calendar, and populists were in the ascendance. Some candidates were more direct, others more subtle. But all played on a willingness of their citizens to reevaluate the benefits of the European association.

Fortunately, the polling pulled back from the precipice. The French balloting was pivotal, given the influence France has in Europe both culturally and economically. Centrist candidate Emmanuel Macron, a political outsider, not only won the presidency but also a working margin in the French legislature. Macron is very much pro-Europe, and his warm interactions with German Chancellor Angela Merkel provide a strong axis for the eurozone going forward.

With the worst seemingly in the past, the economic signals for the eurozone have changed from yellow to green. Consumers are buoyant, monetary policy is accommodative, and the continent may inherit some incremental business as a result of Brexit. Forecasts for the area have been upgraded, and risk assessments have eased.




*Sources: Haver Analytics, Eurostat, ECB*

Europe certainly has the capacity to expand more rapidly than other developed markets, with scores still out of work. Better growth would bring stability to the area after several years of frayed relations. But the current level of euro-optimism may run into some lingering barriers. France and Italy, the second and third largest economies in the eurozone, have been struggling and need structural reform desperately. French President Macron has been holding constructive talks with his country’s labor unions, but proposals to lengthen the work week and ease rules on hiring and firing have historically triggered national strikes. And Italy has been without a government since last December, which delays consideration of pro-growth measures.

Banks in the eurozone are still not fully healthy, and lending growth has been slow. Government borrowing remains a concern, as 14 of the 19 members of the euro have sovereign debt ratios that exceed the 60% limit. Germany’s effort to regain compliance with this limit has led the country to run substantial budget surpluses, even though Europe needs more spending. This situation has raised criticism from world leaders and editorialists alike.

The solution to the eurozone's remaining frictions is deeper association, not further separation. The more that the area considers itself a federation, the more effective policy will be. Unfortunately, a new nationalism has spread across the continent, and remains present even after this year's benign election results.

Selfishly, I am rooting for the eurozone to enjoy renewed success. I do not miss the days of having to change currencies and clear customs every time I cross a border in the region. The improvement in my productivity alone should be enough to justify deeper integration…

**The Power of Participation**

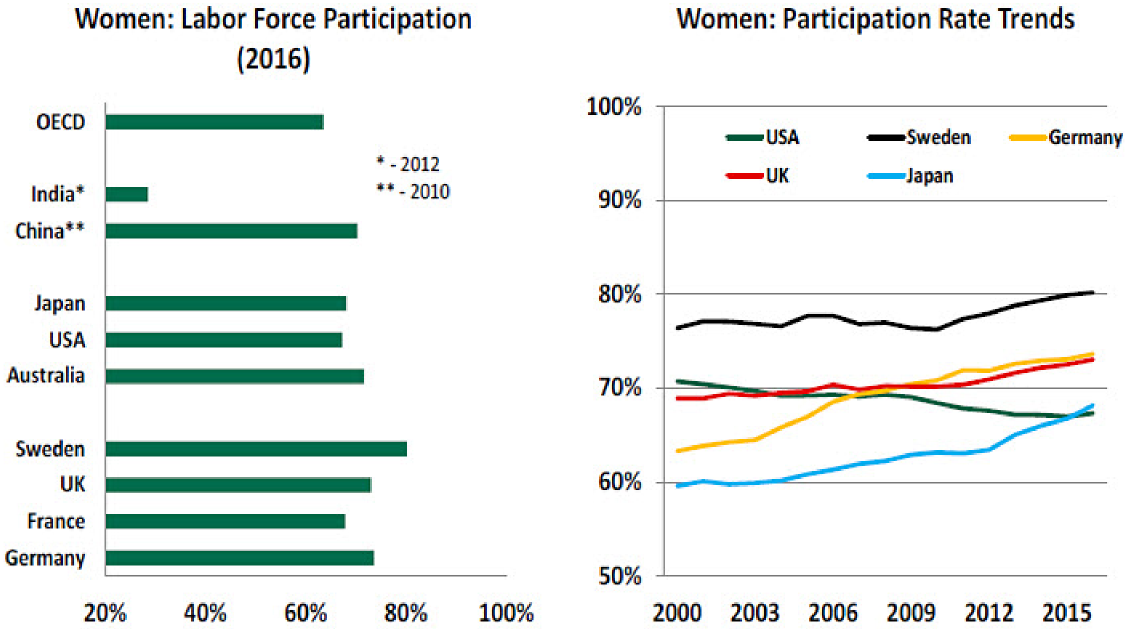
The entry of women to the workforce was a significant contributor to postwar economic growth. Programs that support career women are present in some countries, while there are significant shortcomings in other countries that have led women to opt out of work. With the labor force now growing very slowly in many developed nations, finding ways to sustain the participation of women is an international imperative.

Potential economic growth, which determines a country's standard of living, depends on productivity growth and labor force participation. If women leave the labor force, potential capacity is adversely affected and collective living standards are reduced. Educational attainment of women exceeds that of men across the OECD countries: in the United States, nearly 6% more women are college educated. Losing access to this talent is a significant limitation.

In the post-war period, the United States recorded two distinct experiences. Between 1950 and 2000, women entered the U.S. labor force in large numbers. The trend has since changed, with the share of women working in the United States showing a decline in recent years. Research indicates that less favorable family leave and part-time work policies in the U.S. account for a part of the decline in participation.

By contrast, women's representation in the workforce has increased in other developed economies. It is noteworthy that Japan has lifted its participation rate for women significantly over the past decade, overcoming cultural barriers.

There are economic and non-economic reasons for the variation in the labor force participation of women across countries. Wages, spousal income, and the opportunity cost of not working are the economic elements; the availability of day care services and social norms also has an important influence.




*Source: OECD*

The biggest challenge is that many women have to choose between a career and motherhood. To respond, countries have tried to ease the challenge of balancing work and family. Data compiled by the OECD shows the United States is the only advanced economy that does not provide federally mandated paid leave for new parents.

Some businesses in the U.S. provide paid family leave. Five states – California, New Jersey, New York, Rhode Island and Washington – and the District of Columbia have passed paid family and medical leave legislation. The features of the programs differ, and the maximum length of paid leave is significantly smaller than that of other developed countries.

It is widely recognized that programs supporting working women yield worthy benefits. At present, women are a smaller share of the labor force than men, despite representing more than half of college graduates. All other things being equal, increasing the participation of women in labor markets should enhance economic performance.

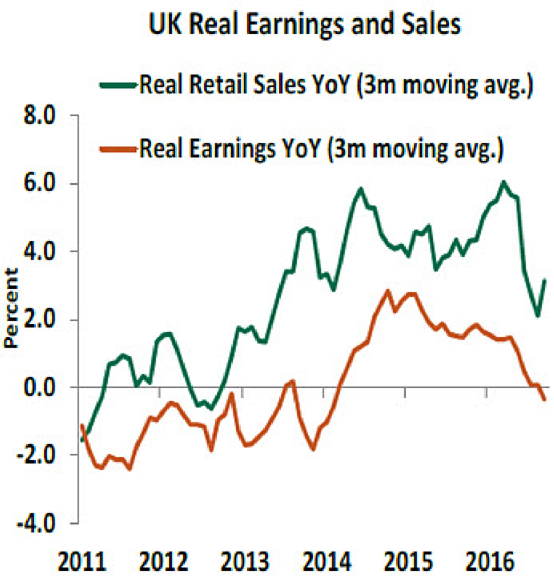
Family-friendly policies such as paid family leave for different purposes, suitable childcare policies and flextime encourage women to enter and remain in the working world. In the long-run, favorable policies focused on nearly fifty-percent of the world's population will bear strongly on productivity and well-being.

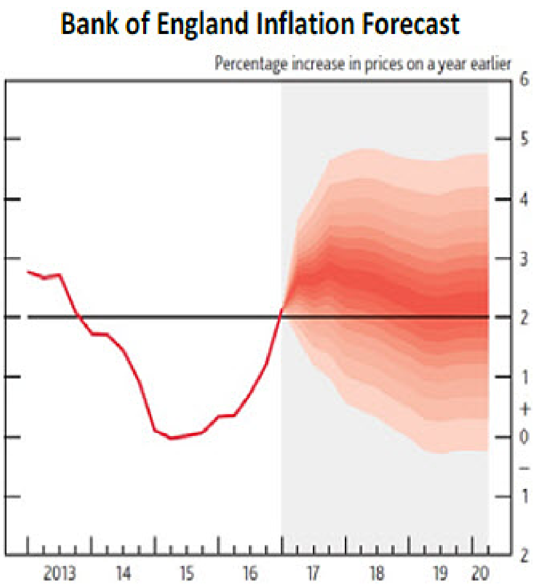
**Don't Take a Hike**

The hawks and doves at the Bank of England (BoE) appear to be thrashing at one another. The BoE's Monetary Policy Committee (MPC) surprised the markets with three dissenting votes to raise interest rates earlier this month, and BoE chief economist Andrew Haldane recently expressed his concern over the inflation outlook. But the best move for the BoE is no move at all.

Inflation in the United Kingdom has been above the BoE's 2% inflation target since February of this year and is forecasted by BoE to overshoot the target for at least the next three years. This is eating into the already abysmal wage growth, and therefore retail sales. Going strictly by the BoE's mandate, above-target inflation forecasts for such a long period should prompt a tightening of monetary conditions. But the source of that inflation makes the case for that response less obvious.

Imports represent a large portion of the U.K.'s consumption basket, and inflation has risen due to the pound's depreciation following the Brexit referendum. But this effect should fade over the next year or so. In addition, the BoE forecast is based on the assumption of a smooth Brexit, which may be driven by an understandable reluctance to take a negative public view on a politically charged topic. The consensus among private forecasters calls for a much more economically damaging Brexit, and we do not expect either the BoE's long term inflation forecast to be realized.




*Source: Bloomberg, Bank of England*

The question therefore is: should the MPC react to a temporary inflation overshoot caused by a one-time exchange rate adjustment? We believe that since the lower exchange rate is a reflection of the market's expectations for lower growth, tightening monetary conditions would only worsen the situation. Any temporary relief for the pound, and therefore inflation, could easily be derailed by downside economic or political surprises.

One of the hawks on the MPC, Kristin Forbes, has now been replaced by Silvana Tenreyro. While the latter is yet to cast her first vote, her public comments suggest that she takes a pessimistic view of the economic consequences of Brexit. We therefore expect the MPC to err on the side of caution and the balance of the committee to favor the doves.