

The future of Europe

Grant Thornton International Business Report 2015

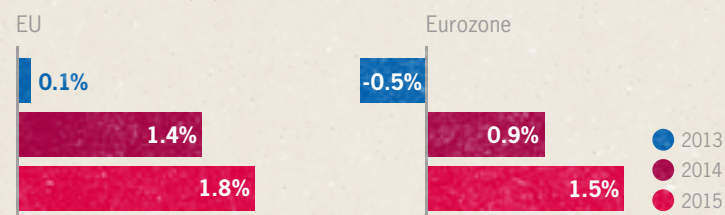


Executive summary

Recovery: gaining momentum

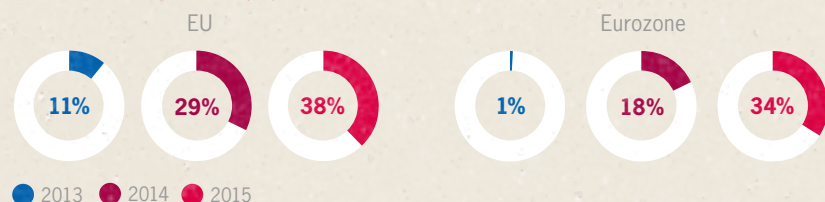
- growth prospects have improved significantly over recent months, but remain subdued by pre-crisis standards
- some of the economies worst affected by the sovereign debt crisis, such as Ireland and Spain, are now growing robustly

Real GDP growth (%)



- debt levels remain high, especially in Greece and Italy, but are forecast to fall
- unemployment rates are still very high in southern Europe, with more than half of young people out of work in Greece and Spain
- business growth prospects have steadily improved due to greater economic certainty and ECB action
- regional economic optimism has climbed above the global average for the first time in almost four years.

Net business optimism (%)



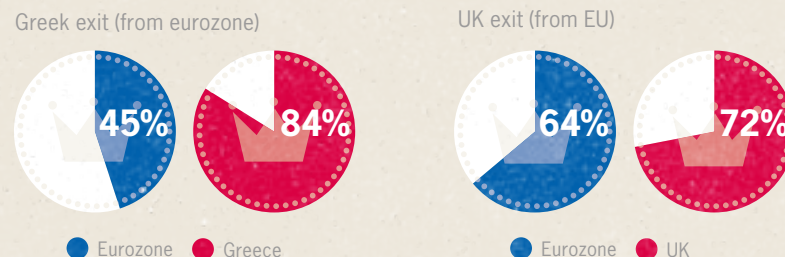
The future: still uncertain

- high unemployment and low growth are cited as the biggest threats to stability inside the eurozone, while other EU economies are more concerned with high debt and the rise of populist parties



- the proportion of business leaders wanting to leave the euro has halved to just 5% over the past 12 months
- nine in ten eurozone business leaders want to see further EU integration, compared with just one in two of those outside the single currency
- some northern European economies are less keen on further EU integration compared with this time last year
- business leaders are more worried about the impact of the UK leaving the EU, than of Greece leaving the eurozone.

Businesses more worried by Brexit than Grexit



Foreword

European leaders could be forgiven for feeling they are being besieged from all angles. From the East, tensions with Russia over Ukraine have echoes of the Cold War, dampening business growth hopes in neighbouring economies and highlighting reliance on Russian natural resources.

From the North, the UK may seek treaty changes ahead of an in-out referendum on EU membership in 2017 which now looks certain to go ahead following the election result earlier this month.

From the West, relations with the United States have become somewhat strained due to US spying allegations, declining EU military spending and disagreements around the Transatlantic Trade and Investment Partnership.

Europe is facing multiple challenges, at home and from abroad.

And from the South, Greece is taking a combative stance to debt negotiations and thousands of migrants from the war-torn Middle East and North Africa are seeking a new life within EU borders. Meanwhile, at the heart of Europe itself, populist parties, many of them virulently anti-EU, are gaining ground. In Denmark, France and the UK such parties came first in last year's EU parliament elections, and third in Austria, Finland and Greece.

However, as the Future of Europe 2015 explains, these (largely) political problems should not mask the serious economic progress made over the past 12 months. The EU economy posted growth of 1.4%, not spectacular by historical standards, but a significant improvement from 2013. Having contracted, on an annual basis, for two years in a row, the eurozone grew by 0.9% last year. And both regions are expected to accelerate in 2015. The euro has fallen sharply against the dollar, but this benefits exporting businesses, and should boost inflation which is still running close to zero.

Europe has made significant economic progress despite multiple challenges.

These improving growth prospects, alongside greater economic certainty and the decision by the European Central Bank (ECB) to launch a programme of quantitative easing have all helped create a much more fertile environment for

business growth. Regional business optimism is higher than the global average for the first time in close to four years according to our International Business Report and many of the economies which required bailouts at the height of the crisis, such as Ireland and Spain, are now firmly back on track.

Clearly Europe is still grappling with a number of challenges from the threat of deflation and still-high debt to high unemployment and the rise of populist parties. But there is a growing sense that the economy has turned a corner, strong enough to deal with Greece exiting the single currency should negotiations break down irrevocably (although I remain hopeful a solution will be found ahead of our global conference in Athens later this year) and ready again to take a lead in global development and innovation.



Ed Nusbaum
Global CEO, Grant Thornton



The recovery: gathering momentum

Economic growth

Despite a number of regional challenges, many of which remain unresolved, the European Union (EU) grew by 1.4% in 2014, up from 0.1% in 2013. The eurozone posted an even sharper turnaround, with real GDP increasing by 0.9% last year compared with a contraction of 0.5% over the previous 12 month period. In 2015, the region is expected to accelerate further with the EU (1.7%) forecast to expand slightly faster than the eurozone (1.3%).

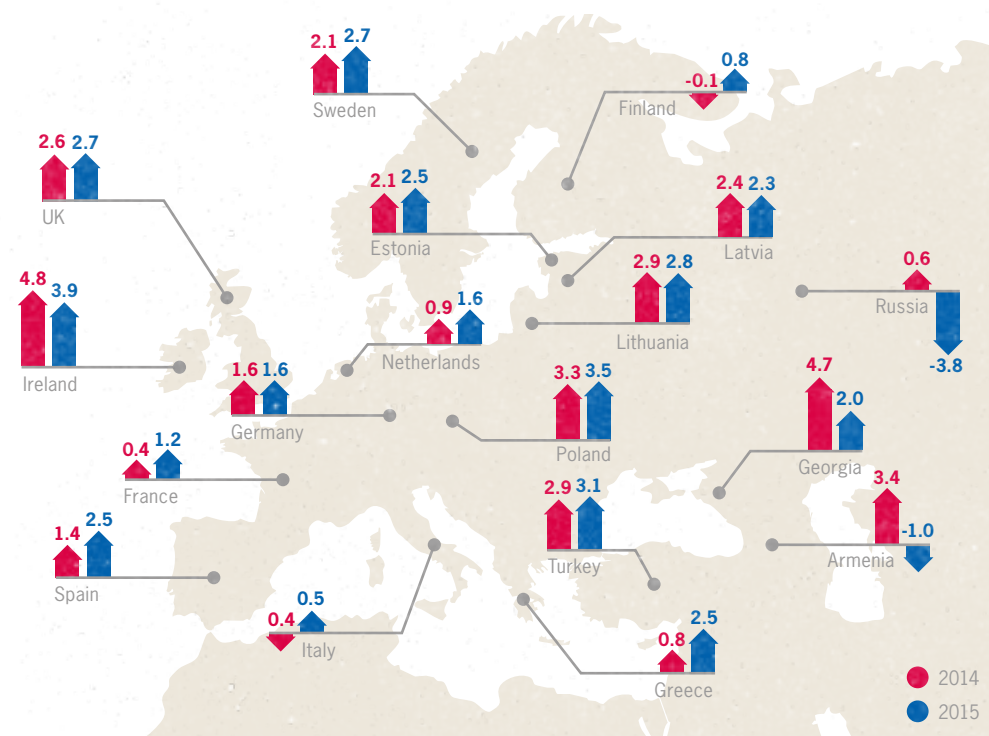
Some of the economies worst affected by the regional slowdown are gathering momentum. Ireland was the standout performer over the past 12 months, posting GDP growth of 4.8%, driven by a 12.6% increase in exports, although growth is expected to moderate to 3.9% this year as overseas sales slow. Spain also returned to growth after three consecutive years of annual contraction. Its economy expanded by 1.4% in 2014, accelerating to a forecast 2.5% in 2015 as export growth picks up to 6.3%. Even Greece's economy expanded in 2014 (0.8%) after six consecutive years of negative growth, although its outlook is clouded by ongoing debt negotiations.

By contrast, the last 12 months have been something of a struggle for the eurozone's three largest economies. Germany grew by 1.6% in 2014, up from 0.2% in 2013, but a sharp moderation from 2010-11 (3.8%),

and the forecast is for more of the same this year. France remains stuck in the doldrums with growth creeping along at 0.4% for the past three years, although it is expected to accelerate to 1.2% this year. The Italian economy contracted in 2014 (-0.4%), although less severely than in the previous two years, and is forecast to post mild growth this year (0.5%).

Some of the larger regional economies outside the single currency have much healthier growth prospects. Poland close to doubled its growth rate in 2014 (3.3%) from the previous year, despite the impact of the slowdown in Russia, and is forecast to expand even faster in 2015 (3.5%). The UK economy grew by a robust 2.6% in 2014, the third consecutive year growth has accelerated and the forecast for 2015 is similarly healthy (2.7%). Growth in Sweden in 2014 was 2.1% and the forecast is for 2.7% this year.

Real GDP growth (%)



Source: IMF 2015

Deflation

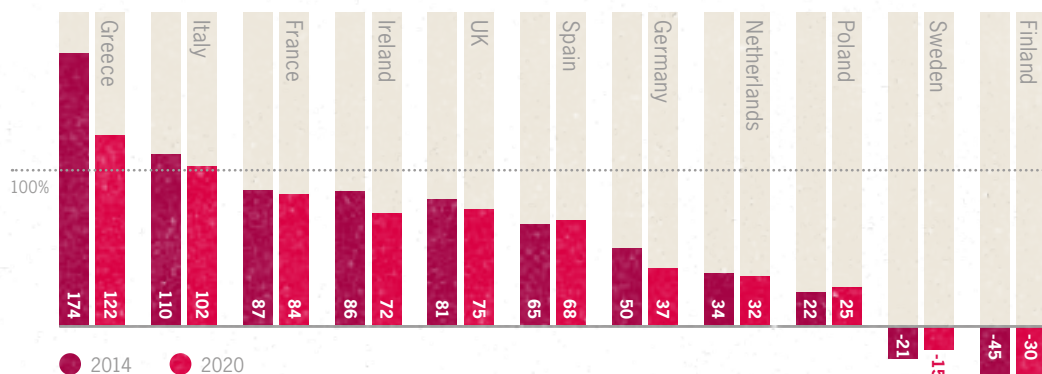
The deflation-fuelled slowdown in 1990s Japan offers a sobering lesson for European policymakers. When the regional inflation rate turned negative at the beginning of the year, many economists feared a negative spiral where consumer spending would be delayed in the expectation of cheaper prices and business spending constrained by the higher real burden of loans.

However, the falling inflation rate has largely been driven by the global oil price fall (core annual inflation - which excludes energy and food prices - remains at 0.6%). As the purchase of these staples cannot be easily substituted or delayed, the main effect has actually been to increase business and consumer spending power, bolstering the recovery.

The threat of deflation did however cause the ECB to finally start a quantitative easing (QE)

programme, similar to those employed by the Federal Reserve and the Bank of England. Aside from trying to raise inflation back towards its 'close to 2%' mandate, the cash injection is aiming to stimulate the region's economy by buying up to 60 billion euros of bonds each month until late 2016. Interestingly, the introduction of QE is supported by just 56% of eurozone business leaders, ranging from 90% in Greece to 35% in Germany.

General government net debt (% GDP, selected economies)



Source: IMF 2015

Debt

Anti-austerity parties, from Podemos in Spain to the SNP in Scotland, have become increasingly popular and vocal over recent months.

But nowhere is their influence as evident as Greece, where the ruling Syriza party came to power vowing to rewrite the terms of its bailout, although Syriza has not found European finance ministers as accommodating as it hoped despite Greek public debt totalling 175% of GDP. This is supposed to steadily decline (under the agreed bailout conditions) but will likely still be significantly above 100% by the

end of the decade. In Italy too public debt is forecast to remain above total annual GDP in 2020.

While other countries are making progress in lowering their debt piles, France, Ireland and Spain are forecast to owe an amount considered 'excessive' (ie greater than 60% of GDP) under the terms of the Stability and Growth Pact five years from now.

Labour market

Businesses are undoubtedly cautious about taking on new people permanently with the recovery so fragile and unemployment is still running well into double figures in the eurozone despite recent economic progress.

An estimated 11.3% of people in the eurozone are out of work, although this had edged down from over 12% in mid-2013. The EU figure dipped below 10% in early 2015 for the first time since the end of 2011.

Germany (4.8%) has the lowest proportion of its workforce unemployed

across the region, closely followed by the UK (5.5%). Greece (26.0%) and Spain (23.2 %) still have the highest rates - driven by the 50%+ of young people looking for work. Italy (42.6 %) also has a severe youth unemployment problem.

Business growth

Business leader confidence has picked up over recent months as growth prospects improved across the region. In the first quarter of 2015, business optimism in both the eurozone (34%) and the wider EU (38%) climbed above the global average (33%) for the first time in almost four years. And across Europe, greater certainty means businesses are planning to add jobs (31% plan to hire people in 2015, the highest since the fourth quarter of 2010) which should lower high unemployment rates.

However, business leaders remain cautious, acutely aware of a series of false dawns since the sovereign debt crisis. Indeed, business optimism across the region stood marginally higher than it does today in the second quarter of last year. The difference this time, as discussed above, is that this rise in

confidence is running in parallel not only to action undertaken by the ECB, but also to the Greek debt negotiations. Tellingly, the last time the danger of Greece leaving the single currency was perceived to be this high, business confidence in the eurozone slumped to -22%.

Austerity working?

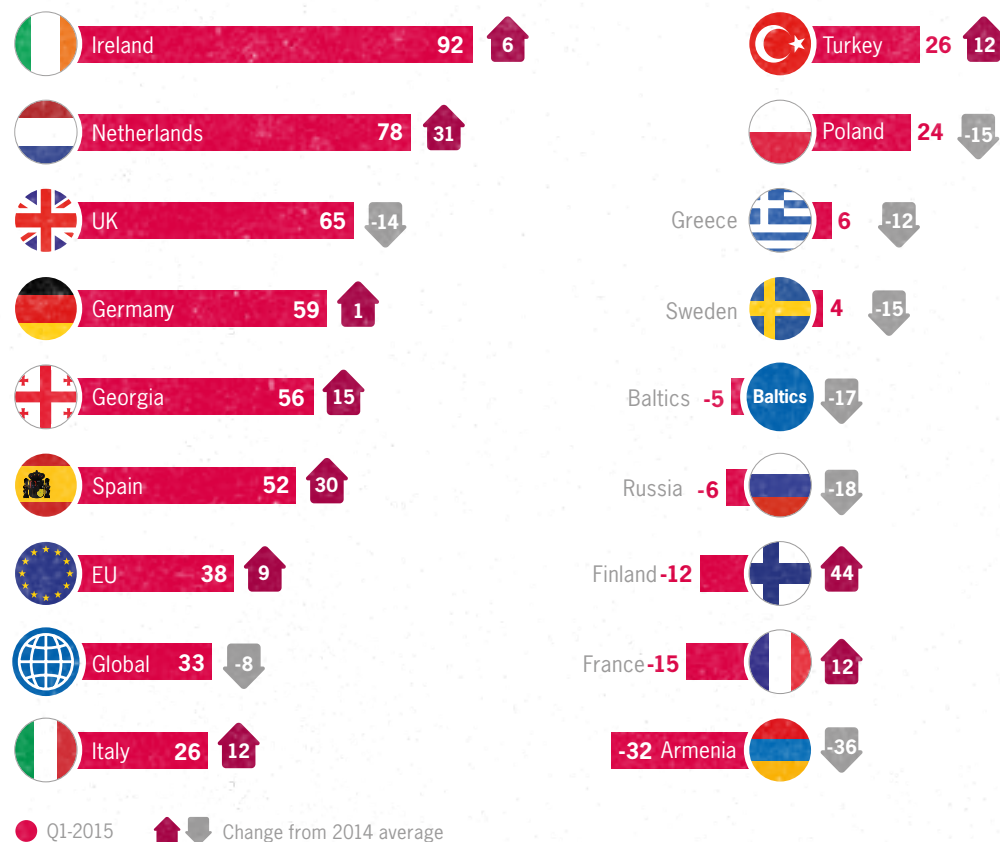
Business communities in some of the regional economies that suffered the steepest downturns, are leading the charge.

Ireland is the most obvious example: at 92% it has the highest level of business optimism in the world; 66% expect to see profits rise over the next 12 months, up from 61% on average in 2014 and 37% in 2013; and just 18% are struggling with low demand, well below the global average (27%).

Spain has also seen a dramatic improvement with 52% of businesses optimistic in the economic outlook,

compared with just 15% this time last year, while 32% of businesses expect to add jobs over the next 12 months, compared with 19% on average in 2014. The situation in Greece is somewhat more fluid: business optimism climbed to 34% in the second quarter of 2014 as the economy improved but business leaders were clearly spooked by the election and confidence now stands at just 6%

Net business optimism in the economic outlook



Source: Grant Thornton IBR 2015

France becalmed, Italy improving

French business leaders remain very downbeat about growth prospects. Business optimism stands at -15%, the fifteenth straight quarter of pessimism, although this is an improvement from the previous quarter (-36%).

With the outlook so unclear, very few businesses are expecting to raise revenues, increase profits or add jobs over the next 12 months. The European Commission has given France more time to bring its budget deficit below the 3% target (somewhat to the annoyance of smaller eurozone countries who have been forced to stick by the rules) in order to boost competitiveness which has fallen well behind Germany since 2003.

By contrast, Italian businesses are increasingly confident in the ability of their energetic Prime Minister Matteo Renzi to push through tough reforms. Almost a third of businesses are now optimistic in the economic outlook (32%) compared with -1% in 2014 on average. A further 36% of businesses now expect to increase profits (compared with just 2% this time last year) and 22% expect to add jobs up from just 11% on average last year.

Trouble in the East

The fallout from the Ukraine crisis is clearly dampening business growth prospects across Eastern Europe as supply chains become harder to manage and traditional export markets dry up.

Poland saw a sharp drop in business optimism in Q1, falling to 24% from an average of 39% in 2014. Meanwhile the outlook for exports (around 5% of which go to Russia) has fallen: just 10% of businesses expect to increase overseas sales, compared with 33% on average in 2014.

In the Baltics, optimism has fallen even further, dropping to -5% in Q1, down from 12% on average last year. The proportion of businesses citing a lack of orders has jumped to 36% across the three states, up from 25% on average in 2014, and well above the eurozone average (26%). Export (down to 17% from 21% in 2014) and profitability (16%, from 20%) expectations have both declined.

Armenian businesses are even more concerned in the economic outlook (-32%) with profitability and export expectations flat (0%) although their counterparts in Georgia remain remarkably upbeat (56% optimistic). Businesses in Russia itself are starting to feel economic sanctions bite: a majority are now pessimistic (-6%), a drop of 18 percentage points on the 2014 average.

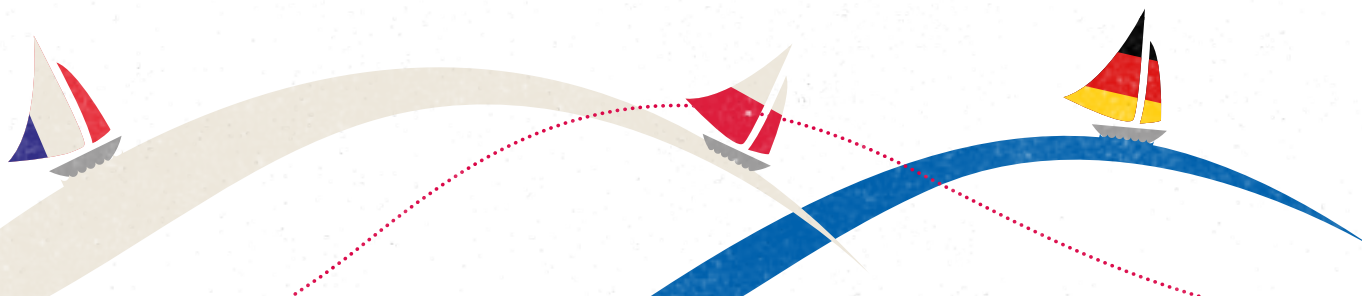
Northern Europe upbeat

German business confidence remains robust despite tepid economic growth prospects.

59% of businesses are optimistic in the outlook for 2015, broadly the same as the 2014 average (58%), while they remain in the top ten globally for revenue (67%) and profitability (52%) growth. Two major clouds on the horizon are the ageing population (29% of businesses cited a lack of skilled workers as a growth constraint over the past 12 months) and rising energy costs (34%) due to the green energy transition, which means some German businesses face energy costs twice as high as their US competitors, and the fact that Russia supplies over a third of its gas needs.

Business confidence in the UK moderated somewhat in the build-up to the general election on 7 May, but 65% of business leaders are optimistic in the economic outlook, the sixth highest globally. Indicators for raising exports, investment in plant and machinery and R&D have all climbed steadily over the past three years, while just 12% of businesses are worried about a lack of demand (compared with 27% globally) driven by improving consumer confidence and low inflation.

In the Netherlands, business optimism has surged to 78%, up from 47% on average across 2014 with export expectations (42%) now ten percentage points higher than last year and businesses increasingly likely to add jobs (36%). The fluid political situation in Sweden following last September's elections means confidence has dropped to just 4% (from 43% this time last year) but businesses remain more upbeat about their own growth prospects, although less so compared with 2014, with a lack of demand (36%) high on the agenda.



The future: still uncertain

Despite the gathering momentum of the recovery, the future of Europe is still very uncertain. Germany is pushing for ever closer union and broader governance over eurozone budgets to avoid a repeat of the sovereign debt crisis. Paradoxically, this push for greater unity could lead, if not to a break-up, then perhaps to a stoking of nationalistic flames and ultimately to countries leaving either the single currency (Greece) or the EU (UK) which could send dramatic if unknown reverberations across the region.

Drifting apart

Business leaders across Europe appear more sanguine about the possibility of Greece leaving the single currency, the so-called 'Grexit', than they might have been three years ago.

Europe's banks are certainly much better insulated against a Greek default and so the risks of financial contagion have fallen since the 2012 restructuring. Policymakers in Italy, Portugal and Spain are more certain now that their economies and financial systems are strong enough to survive a Grexit although the knock-on effects in terms of EU integration are hard to predict.

Across the eurozone, fewer than half of business leaders think a Grexit would have a negative effect on the single currency; a fifth actually think it would have a positive effect. Clearly Greek businesses are most worried (84%) but their counterparts in northern Europe, including the Netherlands (24%), Finland (26%) and most importantly Germany (37%) are less concerned.

Europe is better insulated from the repercussions of a Grexit but the ultimate impact is hard to predict.

Business leaders are more concerned with the possibility of a UK exit from the European Union or 'Brexit'. The

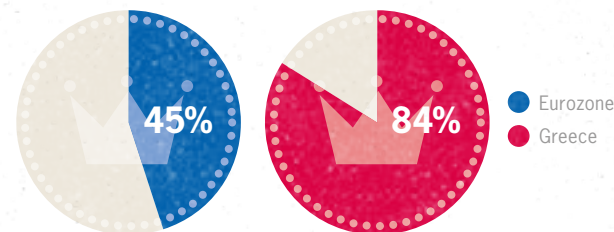
prospect of a British referendum on EU membership now looks a certainty following the result of the UK general election but it remains to be seen whether David Cameron can exact the concessions he wants from other European leaders.

Close to a third of eurozone businesses (64%) believe a Brexit would have a

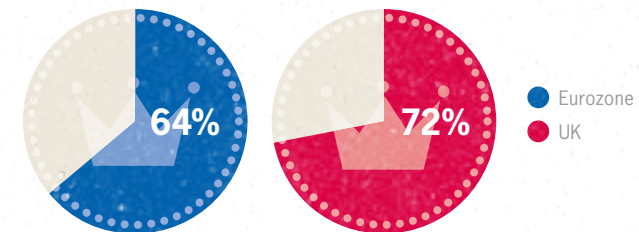
negative impact on Europe, and just 5% would expect a positive impact. Close trading partner Ireland (92%) is the most concerned by the prospect of the UK leaving the EU, as are Spain (84%), although Germany (61%) and France (51%) are relatively less worried.

Percentage of businesses who think exit would have a negative impact on the European economy

Greek exit (from eurozone)



UK exit (from EU)



More or less Europe?

Attitudes to further European integration within the eurozone remain comparable with 12 months ago, but they have hardened somewhat for EU member states outside the single currency, accentuating the split between the euro ‘ins’ and ‘outs’.

Just 5% of eurozone business leaders want to exit the single currency, down from 9% this time last year, and 89% want to see further integration of some sort, unchanged from 2014. Further economic integration is supported by two-thirds of eurozone business leaders (66%), led by Spain (82%), Germany (75%) and Estonia (70%). In Greece too more than two thirds of business leaders are looking for further economic integration (68%), perhaps in the hope of sharing the national debt burden. However, business leaders in some northern European economies - particularly Ireland (54%), the Netherlands (48%) and Finland (44%) - are markedly less keen than 12 months ago.

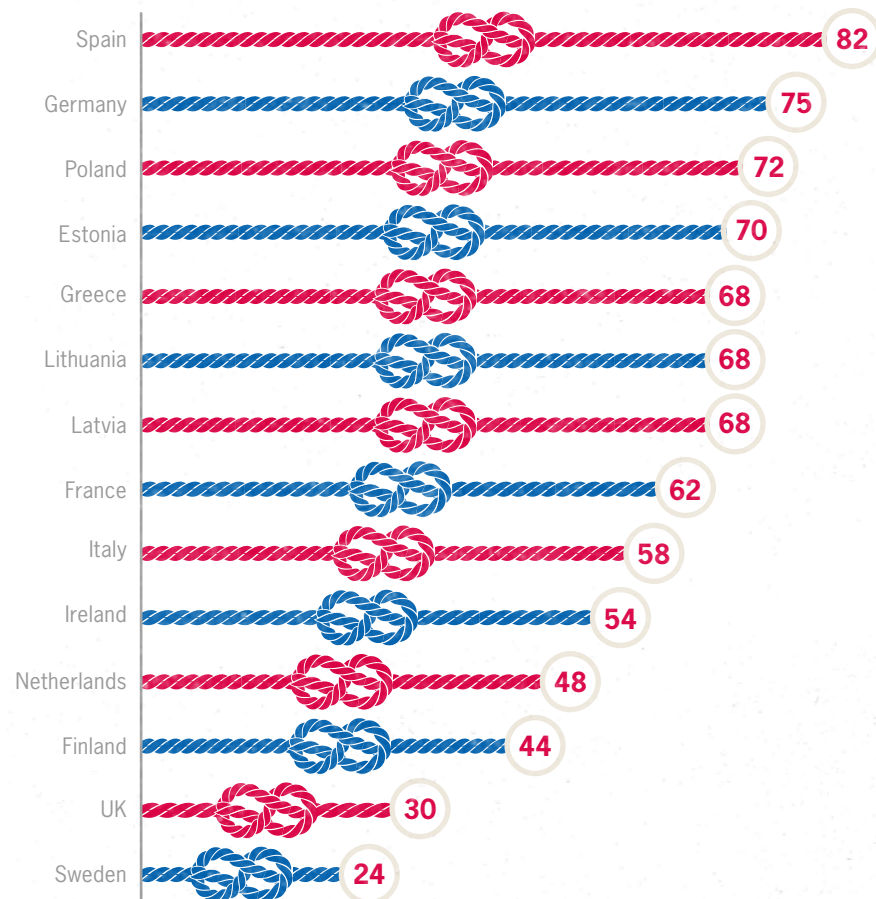
In Germany, Greece, Italy and Spain more than two in five businesses want to foster closer political ties, more than double the rate in Finland, Ireland and the Baltics.

Outside the euro, just 35% of EU businesses support further economic integration, although this masks a significant split between Poland on one side, with Sweden and the UK on the other. Almost three-quarters of Polish businesses (72%) want more EU economic unity, up 5 percentage points from 2014, and 42% want to join the single currency (although this is down from 64% in 2012).

Polish business leaders want to see more EU integration but support for joining the euro has fallen.

By contrast, just 30% and 24% of UK and Swedish businesses respectively want to see more economic collaboration (although 24% of Swedes are keen on closer political ties, compared to 4% in the UK). And the proportion of businesses in each economy that want to join the euro remains fairly low at 28% in Sweden and 13% in the UK.

Percentage of businesses who want to see further European economic integration (%)



Source: Grant Thornton IBR 2015

Multiple threats

Europe clearly faces a number of challenges, even as economic conditions improve. Businesses inside the eurozone see high unemployment (25%) as the greatest threat to EU stability. In the short-term unemployment can incite social unrest and in the long-term it lowers a country's growth potential as people suffer 'skills atrophy'.

Business leaders in Spain (45%) and Italy (44%), where unemployment is running very high, are particularly concerned. Outside the eurozone, Sweden (38%) is much more worried about high unemployment than the UK (11%), where a record number of people are now in work.

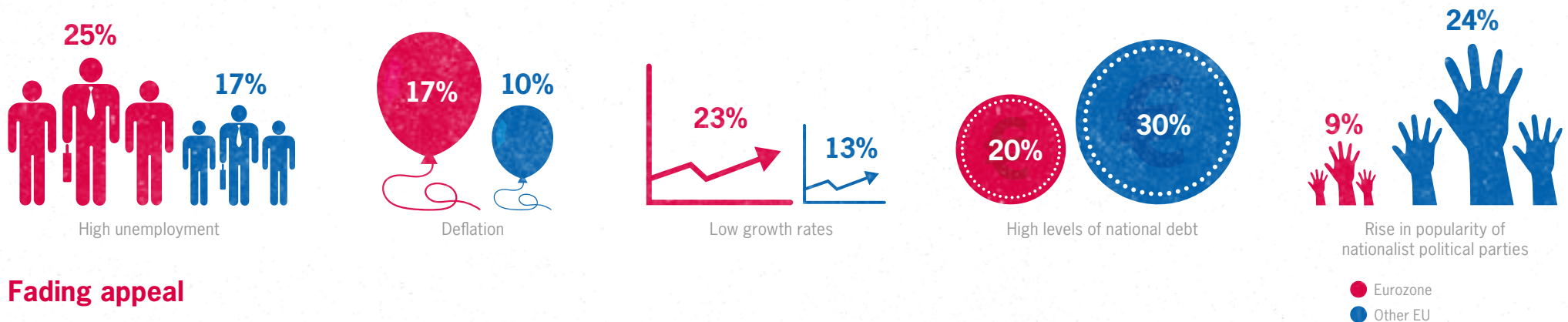
Low growth rates are cited by 23% of eurozone business leaders and are a particular concern in the Baltic states of Estonia (48%), Lithuania (32%) and Latvia (26%), as well as France (31%). High levels of national debt are a concern to a fifth of eurozone businesses, particularly Germany (25%) and

Lithuania (36%) and 30% of those outside the euro, led by Poland (30%) and the UK (32%).

German business leaders are most concerned by high debt and deflation.

Deflation is cited by 17% of eurozone businesses, including 24% in Germany and 38% in Greece, while 24% of non-euro businesses are worried about the rise in popularity of nationalist political parties, unsurprisingly led by 28% of UK businesses ahead of an election where such parties won an increasing share of the vote.

Which of the following do you think represents the biggest single threat to the economic stability of the EU?



Fading appeal

For those working in economies bordering Europe, the economic slowdown in the region has had a significant impact on the attractiveness of the EU as a place to do business. While the draw of the world's largest single market remains strong, this is

a reminder of the potential damage to long-term European growth prospects, particularly if businesses in these markets choose to invest in other economies with stronger growth prospects. Half of businesses in Russia (50%) say the

slowdown has had a negative impact on the region as a place to do business, although this may have something to do with economic sanctions, ahead of Georgia (40%), Armenia and Turkey (both 30%).

Four big issues for Europe



Energy security

Shortages of food, water and energy are likely to be the greatest drivers of global conflict over coming years.

While Europe is well blessed with agricultural land and water supplies, energy security is a far greater threat.

Resistance to fracking, unclear new carbon emission guidelines and tension with Russia all make powering growth across the region harder. The energy transition in Germany offers one possible model of increasing long-term energy security, but this has imposed high short-term costs on businesses and consumers which some more indebted nations are unwilling to levy. It remains to be seen whether plans for a single EU energy market get off the ground.



Grexit contagion

Debt negotiations between Greece and the troika (IMF, European Commission and ECB) continue with Greece's place in the single currency in the balance. Southern European countries claim to be better placed to deal with any contagion effects from a Grexit, but the longer term ramifications - for example, on trade and eurozone unity - are unknown. Greece accounts for just 2% of eurozone but a default would still put significant stress on creditor economies, notably France and Germany. If a larger heavily indebted economy, such as Italy, were to default, these problems be greatly magnified.



Blurred borders

The EU was created to lower trade and cooperation barriers between member states, but the borders between countries have now become so blurred that tensions are rising in a number of areas. The rise of the digital economy has overridden physical borders and has led to the accommodating transfer pricing policies of economies such as Ireland and Luxembourg being questioned. The wider implications of single visa travel in the Schengen area have been sharpened by the thousands of migrants fleeing conflict in North Africa. And the free movement of workers across the region has been seized upon by populist political parties who want to limit immigration.



Neighbourhood policy

EU neighbourhood policy hit a brick wall in Ukraine. Policymakers appear to have misread Russia's probable reaction and the question now is whether EU relationship building with its immediate neighbours and better relations with Russia are mutually exclusive. Even if they are not, some accommodation will be needed on both sides if developments in countries such as Armenia and Georgia are not to cause tensions to rise. Improved EU-Russia relations would benefit the global economy but there will be further hurdles to overcome even if a resolution can be found to the conflict in Ukraine.

IBR 2015 methodology

The Grant Thornton International Business Report (IBR) is the world's leading mid-market business survey, interviewing approximately 2,500 senior executives every quarter in listed and privately-held companies all over the world. Launched in 1992 in nine European countries, the report now surveys more than 10,000 businesses leaders in over 36 economies on an annual basis, providing insights on the economic and commercial issues affecting the growth prospects of companies globally.

The data in this report are drawn from 1,173 interviews with chief executive officers, managing directors, chairmen and other senior decision-makers from all industry sectors in mid-market businesses (50-499 employees) conducted in February 2015. Responses are weighted by economy GDP.

Participant economies (and total interviews):

- **eurozone (648):** Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Netherlands, Spain
- **Other EU (275):** Poland, Sweden, United Kingdom
- **European neighbours (250):** Armenia, Georgia, Russia, Turkey

More information:

Publications: www.grantthornton.global

Methodology: www.grantthornton.global

Data: dataviztool.internationalbusinessreport.com

Dominic King

Editor, global research
Grant Thornton International Ltd
T +44 (0)20 7391 9537
E dominic.king@gti.gt.com



© 2015 Grant Thornton International Ltd.

'Grant Thornton' refers to the brand under which the Grant Thornton member firms provide assurance, tax and advisory services to their clients and/or refers to one or more member firms, as the context requires.

Grant Thornton International Ltd (GTIL) and the member firms are not a worldwide partnership. GTIL and each member firm is a separate legal entity. Services are delivered by the member firms. GTIL does not provide services to clients. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions.

www.grantthornton.global

Grant Thornton in Europe

- 12,000 people
- 41 countries
- Total revenue of US\$1.86bn
- 6% growth in 2014

Please contact your local [Grant Thornton](#) member firm to understand how we can help unlock the potential for growth in your business.