Vision

Edition 5 | 2018

Where Is The World Going? How Do We Get There First?

Editor | James Hoge

Europe's Risky Business Environment

Political Fragmentation, Populism Not Over (Yet)

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For all the fears of a populist takeover, 2017 ended on pretty traditional terms in European politics: having won the September Bundestag elections, German Chancellor Angela Merkel concluded day one of her fourth consecutive term in office with a dinner at the Elysee Palace in Paris – hosted by France's reformist, pro-European, and Germanophile President, Emmanuel Macron.

Why had corporate leaders and financial markets worried so much about "the end of Europe" in the first place? Had fears been unfounded that Norbert Hofer in Austria, Geert Wilders in the Netherlands, and Marine Le Pen in France would lead their countries out of the euro and the EU? Is the risk of populist market disintegration and protectionism over in Europe?

The answer is: No.

For companies that had anticipated a win for populist forces in Europe's busy 2017 election cycle, the end of the year must have come as a surprise. Yet, at Teneo Intelligence, we were warning already in 2016: the main task for CEOs was not to prepare for Marine Le Pen to lead France out of the euro.

The challenge had always been far more complicated – and it will continue to be so in 2018: populists might not win in the largely proportional electoral systems of Western Europe; but political fragmentation increases volatility and makes policy outcomes more uncertain, as centrist parties remain under pressure to incorporate views that pose risks to both corporations and financial markets.

This means that CEOs must keep a close eye on politics. 2018 will not boast the same number of high-stakes national elections across Europe. This reduces the number of singular events to follow – but also raises the risk of CEOs becoming complacent on political risk.

In this chapter, we lay out a short overview of items a CEO should be watching in the coming year: a scan of elections looming in 2018, followed by a look at some slower-moving, but highly business-relevant, issues such as Brexit and monetary policy. These developments will continue to shape the business landscape that corporate leaders and financial market investors must navigate in 2018.

The bottom line is straightforward: 2018 might not get that noisy, but anticipating and understanding politics will remain crucial for businesses this year – and well beyond.

Italy and Beyond

The main European election to keep an eye on in 2018 is doubtlessly Italy. In the aftermath of the 2008 financial crisis, the country is carrying the burden of an unresolved banking sector crisis – which, via a huge amount of non-performing loans, is testament to decades of economic malaise.

As is well-known, Italy has not seen proper economic growth ever since entering the euro in the early 2000s.

When Italians go to the polls by May 2018, there will be good and bad news for businesses and investors. Those concerned with a potential referendum on leaving the euro will be reassured by the fact that holding such a vote is currently impossible under the country's constitution. More importantly, outright political dominance by the anti-establishment Five Star Movement (M5S) is not in the cards: the proportional electoral system will make it impossible for former comedian, Beppe Grillo, to call the shots, unilaterally, in Italian politics.

Yet there is also a clear downside associated with this: former Prime Minister Matteo Renzi had wanted to abandon the proportional system to finally enable government to enact the bold reforms for which businesses and investors in Italy, and, in fact, in the rest of the Eurozone, are so desperately awaiting. With his proposals rejected, the proportional franchise will save Italy from the Five Stars, but the price to pay for this might be the return of an old acquaintance: forming centrist majorities might be impossible without the support of Silvio Berlusconi.

CEOs and investors alike should therefore prepare for an Italy that remains committed to Europe, but which likely stays incapable of addressing its huge structural political and economic issues – and which therefore continues to pose a lingering political risk for the Eurozone as a whole. Merkel and Macron will likely work together towards closer cooperation. Yet the absolute precondition for Berlin to agree to the greater levels of risk sharing that markets have been demanding for years will be success for the young French president's domestic reform agenda – in this regard, watch France's traditionally combative political and industrial relations systems in 2018.

Even if Macron delivers, structural reforms will take time until they show on France's macroeconomic scorecard – and neither CEOs nor investors should hold any illusions about what the Germans are willing to commit to in return: talk about a "European Finance Minister" will likely get very noisy in 2018, and there is likely to be some progress on the discussion. Yet the effective outcome will be a setup that remains very much dependent on political consent for bail-outs from national governments and parliaments; the latter will also retain a close grip on their respective economic and social policies.

National sovereignty is also a key point for governments in Central and Eastern Europe, especially Poland, which will likely continue in a very visible war of words with the European Commission over basic legal standards in the country. This will remain a slow-moving story, but no investor in Poland should have any doubt about the determination of the far-right government to tighten its grip over the judiciary. One victim has been, and will remain, the quality of the business environment in the only EU country that made it through the financial crisis without a recession.

Warsaw's main ally, Hungary's Victor Orban, will likely be re-elected in the spring. Compared to Poland, Orban looks like a somewhat more manageable partner to the EU and its Commission President, Jean-Claude Juncker. Meanwhile, the far-right Sweden Democrats are unlikely to acquire control of their country's government in autumn; and the scattered, highly decentralized political system of Belgium, where regional elections are due in October, is arguably used to dealing with permanent tensions: pit Flemish nationalists in the Dutch-speaking north, against hard-left Socialists in the French-speaking south. When it is time to bargain, they all meet in Brussels, the country's quirky, multi-lingual capital in the middle of the country and, indeed, of Europe.

Policies in Slow Motion

None of these one-off events, alone, are likely to rock the boat in which investors and CEOs navigate the business environment in 2018. Yet they all point to a political environment that remains difficult to predict and prone to producing outcomes that are risky for businesses. The same can be said for two longer-term and extremely business-relevant developments that will not come to a formal close in 2018, but whose shape will be defined decisively this year.

As the Brexit conversation continues to drag on in Brussels and within the UK, the preliminary result in 2018 could potentially be the snap polls everybody had been waiting for since Prime Minister Theresa May's ill-fated election gamble in 2017. But even in this scenario, and regardless of who might potentially replace May, the big issues surrounding Europe's UK-EU relations are likely to remain marred by ambiguity, amid record levels of social polarization in the UK.

The base case remains that during 2018, both sides will prepare the ground for a so-called transition phase as of March 2019, in which economic relations remain largely unchanged until the UK has negotiated a free-trade agreement with the EU. Yet the price for this comparably pragmatic outcome will likely be an eventual agreement that will confront businesses with many more obstacles to economic exchange than now – especially in the services sector.

The other slow-moving story is one that has in many ways underpinned the relative calm Europe has lately been enjoying: monetary policy. European Central Bank (ECB) President, Mario Draghi, is haunted by a double tragedy. The first was the extra-ordinary success of his 2012 promise to do "whatever it takes" to defend the euro in the financial markets – as traders shied away from betting against the ECB, the pressure on governments to reform abided. This left Draghi with little power to insist on the structural reforms he has been preaching ever since.

The situation the central bank chief faces in 2018 is somewhat comparable: Draghi's asset purchase program is the main reason behind the Eurozone's recent, relative economic recovery; but the ECB's Bundesbank-inspired, tight mandate, coupled with the risk of intensifying political pressure, forces him to start tapering now. Yet the political risks to the Eurozone's economic outlook are all but resolved.

The calm Italian banker, who prefers to enter European summit meetings through a side door later in the evening once heads of state and government are done with their media statements, again holds the key to Europe's future. If Draghi moves too fast (as fast as many Germans would want him to), 2018 might be the year that we will look back on as the moment in which economic worries returned to Europe.

Once monetary policy normalizes, it will start to become clear that politicians have been complacent on the reform front over the last years – both in Southern Europe and in Germany. In the south of the currency zone, governments have reformed their labor markets, banking and pension systems only when under pressure from international creditors. And in Germany, solidarity and greater burden sharing became politically possible only when the very existence of the Eurozone was at stake.

Whether, when, where exactly and to which degree markets start to pay attention again to the institutional imbalances in the Eurozone is the question once Draghi slowly begins to wind down his asset purchases.

If pressure on individual member states returns at some point, it will likely become clear that the phasing out of ECB asset purchases reflects a lowering of European political risk only at first sight. A closer look reveals that tapering might well bring those risks to the forefront again.

Up until markets began to calm down in 2012, Europe's economies looked bad, but the politics were stable enough to save the Eurozone. This time might be different: the anti-establishment forces might not have won elections, but they have been strengthened almost everywhere. Finding the majorities to do what needs to be done – from painful economic reform in the south to unpopular fiscal transfers in the north – could be much more difficult to engineer politically if the crisis were to go into a next round.

CEOs should learn the lesson to get there first: businesses and investors cannot afford to be careless towards the continued political risks of fragmentation and populism in Europe.

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