

Insights

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Europe: Three Things to Watch in 2018

- The risk of a disorderly Brexit is now at 40% (up from 30%).
- Leaders will start working towards EU reform, but the time window is very narrow.
- Short-termism dominates economic policy making amid continued populist pressures in CEE.

1. Brexit: Now For The Difficult Part

Negotiations between the EU and the UK are entering their crucial phase: they must be concluded by autumn 2018 to allow for sign-off on both sides in time for the UK's departure from the bloc in March 2019. 2017 talks about the three divorce items (Ireland, finances and citizens' rights) were slow and at times noisy, but they will appear to have been the easy part in light of the problems ahead in 2018.

The risk of a disorderly Brexit (no deal by March 2019) is now at 40% (up from 30%). This increased risk might not become immediately apparent in 2018. On the contrary, talks about a 21-month "status-quo transition" until December 2020 might progress relatively smoothly between January and the 22-23 March European Council. But once negotiators turn to the post-2020 relationship, it will become clear that UK ideas of a "Canada+++" agreement are wildly unrealistic. The EU will not grant access to its services market without UK acceptance of the internal market's so-called four freedoms. Neither will UK dreams of "enhanced equivalence" materialize.

But the main issue will likely be the return of the entirely unresolved Irish border question in the context of talks about the future relationship. This time, however, kicking the can down the road will not be an option. Some in Ireland and the EU might end 2017 on a self-congratulatory note: they believe to have forced the UK on a path towards a soft Brexit, via UK acceptance of all-island "alignment" in the divorce agreement.

Yet for the Leavers within the UK Conservative Party, the 2017 divorce agreement was merely a fudge to

buy time. In line with language in the agreement, the Brexiteers still believe in their ability to strike a deal next year which will somehow allow the UK to leave the customs union and the single market while at the same time preventing a hard border in Ireland. However, their proposals for practical border management remain extremely vague.

As of Q2/2018, Brexit will effectively force the Leavers to decide between the territorial integrity of the UK and the "Take Back Control" Brexit they promised in the referendum. Renewed compromise should remain the base case for now, but there is the serious risk of a Tory rebellion that could ultimately lead to the UK walking away or stumbling out of the EU with no deal at all.

2. EU: Time To Get Real

The 2017 victories of Emmanuel Macron, Mark Rutte, and Sebastian Kurz helped the political center in key West European states to fight off the onslaught of populism. In contrast, government formation in stability-prone Germany will continue to dominate the headlines in 2018 – until around Easter. The Social Democrats' (SPD) need to run the eventual coalition agreement through a membership ballot, and therefore the risk of new elections will remain elevated in Q1. However, another grand coalition led by Angela Merkel should be the base case going into 2018.

Once a new government is in place in Berlin, it will be time for Europe's centrist political leaders to start working towards EU reform. Macron will need to see first signs of progress on EU and Eurozone build-out to sustain his reform momentum



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at home in France. The time window is extremely narrow, however. The May 2019 European Parliament elections and the end of Jean-Claude Juncker's term at the helm of the EU Commission will already loom large in 2018.

An additional challenge could be the culmination of several developments around Q2/2018: Greece's program exit might make for difficult talks between the IMF and the newly appointed German government, Italy will likely struggle to form a government after its general elections, and Brexit could lead to renewed pressures on the UK government (see above).

Progress might therefore be greater on issues that are high up on European voters' agenda, such as security, border protection, and defense. In the Eurozone, intergovernmental solutions will continue to feature prominently. Germany's SPD is ending 2017 with strong calls for closer EU integration, but this rhetoric will likely make for a valuable bargaining chip in the end: the party must extract visible concessions from Merkel on health and pensions if it wants the coalition agreement to pass in its Q1 membership ballot.

3. CEE: Populism, Continued

Populism will remain a central feature of Central and Eastern European (CEE) politics in 2018. The conservative Law and Justice party in Poland will continue its drive for radical reforms, the centrist Action of Dissatisfied Citizens is set to take power in Czech Republic, and the nationalist Fidesz will likely win the Hungarian general elections in April.

The rise of populist parties is driven by the same factors as elsewhere, including popular disappointment with the globalized market economy and with liberal democracy. Nationalist and Eurosceptic rhetoric are therefore surging, in turn consolidating and emboldening pre-existing far-right movements.

As a consequence, economic nationalism will likely continue its rise in 2018, complicating the operating environment for international companies. Nationalist rhetoric will hamper efforts to alleviate labor shortages in key sectors (automotive, information technologies, healthcare). Short-termism will dominate economic policy making, which will likely translate into more social and less investment spending, with negative medium-term consequences.

Meanwhile, the top-down structure of populist parties will likely translate into a further development of political patronage networks, which may exacerbate problems with political corruption across the region. Relations with the EU will likely deteriorate further, as the European Parliament is set to debate the triggering of procedures that may lead to sanctions against Hungary and Poland, though such an outcome remains unlikely. With EU relations souring, CEE countries will likely step up their efforts for economic cooperation with China and, in some cases, Russia.



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