



Europe: Improved risk trajectory but threats remain

Country risks in Europe have been top of mind for some time. In fact, three of our top ten global risks in the Spring CRQ involved European scenarios, namely: Eurozone collapse, European sovereign debt crisis, and Italian banking sector crisis. Radical and anti-establishment sentiment in Europe has been fueled by protracted crisis legacies amid sluggish growth and a refugee crisis amid security and terrorism threats. Following last year's electoral surprises in the UK (Brexit) and the US, the big question earlier this year was: will the political centre hold? Halfway through 2017: so far, so good. So what has changed over the past few months to render us more optimistic on Europe?

On the political front, the Euro-skepticism that was so pronounced in 2016 did not fare well in elections thus far in 2017. Elections in the Netherlands and in France yielded resounding victories for pro-EU parties against far-right Euro-skeptic parties. Additionally, the far-right threat in Germany's upcoming election has virtually disappeared. The risk of a Eurozone collapse owing to, what had been, growing support for populist (and often radical) political parties has not disappeared entirely but has become ever more unlikely given how these key elections have unfolded.

From an economic perspective, while not stellar by historical norms, economic momentum has turned decisively stronger of late, with many leading indicators reaching cyclical highs and pointing to increasingly solid growth. What's more, growth has remained resilient enough to propel upbeat private sector sentiment and real activity even through key high-risk elections.

Whereas unmitigated economic malaise can transfer into the political scene, strong economic growth can cure political ailments. The EZ is testing this hypothesis with dramatic flair. Receding political risks combined with solid growth and the urgency to quell any resurgence of opposition to the EU/EZ could provide fertile ground to rekindle reform. The EU's reform agenda, which had been sidelined somewhat over events in 2016 and into 2017, is key to addressing the structural impediments to achieve faster, broadly-based, sustainable long-term growth, which is required to address societal grievances

across many member countries. Additionally, although the UK's vote to exit the EU exposed pockets of dissent within the bloc, Brexit has also provided a catalyst for broader debate about reforming and strengthening the bloc's architecture.

Despite the improving political and economic backdrop, there are some lingering risks on the European horizon that cannot be ignored. These include challenges to longstanding relations with both the US and the UK, protracted financial vulnerabilities in Greece and Italy, the continued security threat posed by terrorism, and pockets of nationalism among current and prospective EU members.

Why is this important? The future direction of the EU/EZ carries important implications for the region, for Canada and for the world. In Central and Eastern Europe, the EU/EZ has long served as a powerful magnet to propel political and economic reforms in a bid to gain membership. A weakened EU would not have the same drawing power or offer the same incentive to reform. Central and Eastern Europe, a region that includes countries dealing with entrenched corruption and nationalist undercurrents, is also being pulled by several forces with the EU, Russia and China looking to exert influence or strengthen partnerships in the region, for example through China's Silk Road strategy. Recent history demonstrates that this competition for influence can sometimes lead to heightened country risks and/or a more challenging landscape for Canadian exporters and investors.

In terms of impact on Canada, from a trade perspective, Europe as a bloc remains a major trading partner of Canada's and one whose importance will continue to grow with the implementation of the Canada-EU Comprehensive Economic and Trade Agreement (CETA). The centrist victory in the French election all but guarantees CETA's implementation in what may be seen as the first salvo in the battle against protectionism.

The bottom line? The lessening of country risks in Europe of late is noteworthy and promising, yet still nascent at best; Europe continues to face some key challenges. But after what was an eventful 2016, reasons for optimism are emerging.

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