

Will Macron and Merkel Save the European Union?

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"Don't build a glass house if you're worried about saving money on heating" Philip Johnson

Europhiles will tell you that the two most important continuing members of the European Union not only need the help of each other, but are on the cusp of forging a new entente cordiale, which will drive the European Union back to the high points of hope and political cohesion not seen for almost a generation. In this thinking the mercantilist Germans – with Angela Merkel looking a clear favourite to extend her decade plus reign as German Chancellor after September's elections – appear to be starting to understand that they cannot rely on the export markets of the United States and Asia forever, and want to re-engage more deeply with their fellow European nations. Meanwhile, the regionally highly influential French, with the election of Emmanuel Macron as their President, appear ready to acknowledge some element of economic change has to occur – a realisation which would cascade through the region and inspire other European Union nations to consider economic reforms of their own.

Such thinking is long overdue as the European Union has underperformed the United States on most conventional economic and financial market criteria for the last decade. And even though the worst fears coming into 2017 – the election of populist governments and further members following the lead of the UK and indicating their preference to exit – have not occurred, a feeling towards change of 'now or never' is beginning to build. Otherwise, the next cycle of political elections may not have such mainstream reactions.

Aside from political expediency, what are the main rationales for believing change is just about to occur? For Germany – the de facto paymasters of Europe – the rationale is partially practical economics, partially political legacy building and, finally, partially because of their inherently pan-European feelings.

The practical economic feelings that Germany has towards the rest of Europe has been largely laid out above: lower regional growth rates suppress demand for German exports, forcing the latter to seek alternative markets further afield – a risky strategy if the euro ever

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rises sharply in value or if defections from the European Union get a competitiveness boost from sharply depreciating currencies against a German dominated continuing euro.

Mindful of either of these two options, Angela Merkel is looking to build her political legacy in the knowledge that her Chancellorship is unlikely to run for too many more years – and what better way to go than having put Europe back onto the straight and narrow. That Germany and Mrs Merkel are committed to Europe is shown by the pragmatic way they have adopted negative interest rates, quantitative easing, immigration and agreed support and payments for reform to troubled southern European nations. The trouble is, the prolonged debates and extensive compliance guidelines have not engaged the wider pan-European electorate.

And this is where Emmanuel Macron – the new President of France – can offer a helping hand. France's role in Europe has always been as a counterweight to progressive German economic strength, and a France that accepts that the European Union needs to become more competitive and dynamic could inspire the rest of the region to undertake their own domestic, political led reforms. However, given that initiatives such as new labour legislation, tax reform and changes to training/education take time to produce any benefits, the enhanced

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winning the September General Election in Germany, but then bringing a nervous domestic populace with her on a broader pan-European journey involving still difficult decisions with countries like Italy and Greece. And for both, it requires striking the optimal tone over Brexit to ensure no material economic impact on the still economically recovering European Union.

The last couple of months have shown – via rising local equity markets and a higher euro – faith in the potential of this relationship. The next six months are going to have to show further progress to retain investor faith through into 2018. It is not hyperbole to suggest the future of the European Union depends largely on how these two leaders progress. ■

use of tax and spending ‘fiscal stabilisers’ makes good sense. And the main opposition to such stabilisers? The German desire for prudent European Union financing.

Put together, the Merkel-Macron combination could start to put into place the shifting of the European Union squarely into the economic 21st Century, with all the resulting benefits to regional equity market valuations that would occur. However, such a combination requires movement from both sides. For Macron, it means using his newly acquired Parliamentary majority to start the process of pushing through new labour market and related legislation, despite the inevitable opposition domestically. For Merkel, it means not only

KEY TAKEAWAYS:

- The European Union has endured a very difficult last 10 years economically and politically
- Both Germany and France individually and collectively have incentives to make the European Union work
- The market expects further progress with the next 6 months critical for holding investor faith into 2018

SUPPLY SIDE ACTIONS IN RESPONSE TO OECD RECOMMENDATIONS (2015-16)

	Reform recommendations	Reforms undertaken
Labour market policies	40	10
Labour tax policies	35	12
Tax structure	34	3
Competition	61	22
Human capital	67	20
R&D	21	5

Source: OECD

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