Europe's economy needs help

By David Mchugh & Lorne Cook
Journalists

OPINION

Even before the French and German governments collapsed, Europe's economy had enough difficulties. Tepid growth and lagging competitiveness versus the US and China. An auto industry that's struggling. Where to find billions for defense against Russia? And now Donald Trump is threatening tariffs.

Solutions will be harder to find while the two countries that make up almost half of the eurozone economy remain stuck in political paralysis well into 2025.

Where once there was the so-called French-German axis to push Europe ahead, now there's a vacuum. French Prime Minister Michel Barnier resigned Thursday after losing a vote of confidence, and while President Emmanuel Macron will appoint a successor, the new head of government will lack a majority. Elections are not constitutionally permitted until at least June.

Germany's coalition led by Social Democratic Chancellor Olaf Scholz with the Greens and pro-business Free Democrats fractured in November, triggering an early election on February 23. Talks to form a new government could last into April.

The European Central Bank is pictured next to containers in Frankfurt, Germany, on April 9, 2024.
MICHAE PROBST/AP

At least Germany's likely new chancellor, conservative opposition leader Friedrich Merz, appears open to loosening constitutional restrictions on borrowing to enable pro-growth spending and investment, said Mujtaba Rahman, managing director for Europe at Eurasia Group.

France, however, could be facing "complete paralysis on the economic question," Rahman said. "It's highly unlikely they're going to get a political equilibrium that has a mandate to implement a credible fiscal course correction."

"And that's obviously a problem for Europe because it means the great potential of the European economy is not what it otherwise should be, because you don't have France and Germany firing on all cylinders," he said.

Then there's Europe's lagging business environment, dissected by former European Central Bank head Mario Draghi in a report that contains recommendations such as common borrowing to support public investment; EU-wide industrial policy; and integrating financial markets to help startups raise capital. Yet "nothing can move in Europe without Franco-German alignment," Rahman said.

Meanwhile, Europe's auto industry has sought a review of tough EU emissions standards in 2025 instead of 2026, saying slackening demand for electric cars means they won't be able to avoid heavy fines and that the money would be better used to develop new electric vehicles.

Anne-Laure Delatte, a French economist and head of research at the National Center for Scientific Research, said financial markets remain cautious but are not overly alarmed by France's political instability. But economic weakness in France and Germany could have broader implications for the European Union.

"This could either weaken Europe's position globally or shift power and influence to other European countries like the Netherlands or Spain, which are performing well at the moment," she said.

France is expected to see growth of 1.1% this year and 0.8% next year, while Germany's economy is expected to shrink 0.1% this year, the second consecutive year of contraction, and rebound modestly with 0.7% next year. Germany faces headwinds from a shortage of skilled labor, excessive bureaucracy, and higher energy prices, and efforts to address those issues have been stalled by squabbling in Scholz's coalition.

European Commission President Ursula von der Leyen, head of the EU's executive arm, is equipped with serious powers, especially on trade, a key EU authority delegated to Brussels by member countries. But there's only so much von der Leyen can do without political backing from the two biggest member countries, whose national budgets are bigger than the EU's.

The most urgent matter may be how to respond to US President-elect Donald Trump, who takes office on January 20. European officials are trying to defuse a potential trade conflict involving new US tariffs or import taxes on European goods that would seriously ding the continent's export-focused economy.

Europe could decide not to retaliate to any US tariffs, thus avoiding a mutually destructive tit-for-tat cycle. The bloc could also commit to buying US liquefied natural gas to mollify Trump, or spend billions more on defense for Ukraine to answer his complaint that European countries don't meet NATO commitments on defense spending.

Europe is seeing only modest growth as consumers pummeled by inflation remain cautious about spending. The economy is expected to expand 0.8% this year and 1.3% next year for the 20 EU member countries that use the euro currency, according to the European Commission.

While the direct impact on growth is small, the political logjam means Europe is missing an important opportunity to engage Trump, said Holger Schmieding, chief economist at Berenberg Bank.

"It would be ideal if Europe — at the moment when Trump is not yet in office — would prepare a big offer for Trump, such as: We spend significantly more on defense if on trade and on Ukraine you don't disappoint us. This is unfortunately not happening."

"The risk is that Trump on trade might be tougher on us than otherwise because Germany and France are missing in action," he said.

Von der Leyen can offer to get countries to purchase more US natural gas and remind Trump that the EU could retaliate, but "the offer that Europe can make to Trump is small, rather than a big offer where there would be German and French money behind it."

The EU Commission estimates that as much as 500 billion euros ($528 billion) will be needed over the next decade to help meet the bloc's security needs. Defense Commissioner Andrius Kubilius has indicated common defense bonds could raise that enormous sum. But moving ahead without Germany, the bloc's biggest member, is hard to imagine.

The big issues such as defense and competitiveness "require the fiscal and parliamentary resources of the biggest member states and the question is whether Germany and France are in a position to enable that at the European level," said Rahman.

"I think the answer is probably yes, but I feel a bit less certain than I would have had Germany and France not had this very difficult political time."

The article first appeared on The Associated Press.

> The most urgent matter may be how to respond to US President-elect Donald Trump, who takes office on January 20. European officials are trying to defuse a potential trade conflict involving new US tariffs or import taxes on European goods that would seriously ding the continent's export-focused economy.