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EUROPE IS BACK: ASSESSING THE BIG PICTURE

Berenberg Macro Views

Europe is back. By and large, the conversations at Berenberg's European Conference 2025 in Manhattan this week have confirmed this impression. The case for Europe rests on two pillars:

1. The US looks less attractive due to the unsettling antics of President Donald Trump.
2. In Europe, Germany is finally assuming the leadership role which it should have played for the last 15 years already.

Although the US economy remains resilient on many counts, the transatlantic growth gap looks set to narrow decisively. While Trump policies impair US trend growth, Europe is regaining momentum, helped by policy changes in Germany. In Europe, pervasive checks and balances can slow down change. But they also prevent Trump-style policy mistakes. Against the backdrop of unsustainable US fiscal policies, putting more money to work in Europe for the long haul makes sense.

No need to shun Europe

To some extent, the current interest in Europe reflects a belated shift in perceptions. In my view, Europe was never as bad as many observers had believed after the euro crisis of 2010-2012. Focusing on significantly stronger US growth after the pandemic and on the spectactacular rise of new US tech companies, markets had not rewarded the Eurozone for bringing unemployment down from 12% in 2013 to a record low of 6.2% in late 2024 and for its more sustainable fiscal deficit of 3.1% of GDP last year versus 6.9% in the US.

Key positives

Checks and balances prevent big mistakes: As a voluntary club of 27 countries, the European Union is the embodiment of checks and balances. Except for the European Central Bank with its mandate to conduct monetary policy and safeguard financial stability in the Eurozone, the EU lacks a central body that can take big decisions fast. The pronouncements of European Commission president Ursula von der Leyen are not among the top things that investors have to check every morning. That is a disadvantage when big decisions have to be taken fast and/or when big changes ought to be driven from the top. But in the age of Donald Trump, Xi Jinping, Vladimir Putin and other leaders who are firmly in control of their domestic political arena, this has turned into a reassuring characteristic. Because of its cumbersome internal processes geared towards building a near-consensus over time, the European Union is not at risk of making huge mistakes of the kind that Trump, Xi, Putin, Erdogan and other less constrained leaders are imposing on their countries.

Shocked into action by Putin's full-scale invasion of Ukraine in 2022, Europe is now slowly rebuilding its capacity to deter would-be aggressors, which it had neglected since the collapse of the Soviet Union in 1990. But the clumsy EU or any of its member countries, which are mid-sized at best and constrained by EU and NATO commitments, could not seriously threaten a peaceful neighbour in the way in which China is trying to intimidate Taiwan with potentially highly disruptive consequences. More to the point, Europe is incapable of waging a Trump-style trade war. Member states would never agree to give the European Commission a mandate that would allow Brussels to suddenly impose an extra 145% tariff on China.

The Brexit lesson: The last major policy mistake, Brexit, has taught much of Europe a lesson: do not leave the EU and its common market. Having suffered the consequences of Brexit, the UK is now drawing a little closer again to the EU. Tellingly, most right wing-populists across the EU have ditched earlier calls for their

countries to get out of the EU. In this respect, the EU looks fairly safe. Even Hungary's Victor Orban is shying away from it.

Monetary policy: Unlike the US Fed which has to grapple with the inflationary consequences of Trump tariffs, the European Central Bank (ECB) can mitigate the trade war damage by cutting rates.

Fiscal policy: Unlike the just-downgraded US, Europe's biggest economy, Germany, has fiscal space which it can use without having to fear the proverbial bond vigilantes. The fiscal boost following the German debt brake reform will take time to materialise. Germany's new government of chancellor Friedrich Merz will likely finalise the draft budget for 2025 only on 25 June for parliament to pass it in mid-September. Near-term, trade war risks can still delay the German recovery. However, we expect Trump to defuse the costly trade tensions by striking deals within the next two months, including either an accord with the EU or an agreement to extend the current reprieve by another 90 days ahead of a deal or further extensions – see Macro update (12 May 2025). If so, the German conomy can start to expand again later this year.

The Merz effect: We project 1.2% growth in 2026 and 1.4% in 2027 for Germany after almost four years of stagnation. The likely return of Europe's biggest economy to significant growth will have positive spillover effects on other European countries for whom Germany is usually the single biggest trading partner.

Modest policy changes

Some modest supply-side reforms can underpin the new momentum on the EU and the German level. Do not expect any revolution. But the political shift towards the centre-right in Germany this year and in the elections to the European Parliament last June will have some consequences.

- **Deregulation:** Brussels and Berlin are no longer inclined to issue one regulation after the other. Instead, they now focus on easing the regulatory burden somewhat, for instance by reducing reporting requirements and raising thresholds below which regulations do not apply.
- **Migration:** Since 2015, an inflow of uninvited migrants has fueled the rise of right-wing protest parties and placed burdens on national welfare systems. Step-by-step, the highly controversial migration policy is becoming more rational. For example, Germany is combiningh a harsher clampdown on illegal immigrants with more steps to attract the qualified migrants which it needs for its labour market.
- **Trade:** Reacting to Trump's trade wars, the EU is now more eager to conclude trade deals with other countries or regions. For example, the chances that the EU will ratify the Mercosur agreement with much of Latin America have improved. This week's mini deal with the UK provides another example. However, the EU will not change its attitude towards China fundamentally. Precautions against a potentially disruptive surge in imports from China, a desire to not become overly dependent on Beijing and other strategic considerations will limit the scope for increased interaction with China.

Problems persist

After listing arguments in favour of Europe, we need to put them into context. Many of the key points that global investors have long cited as reasons to underweight Europe remain valid:

- Europe is not at the forefront of the artificial intelligence revolution, just as it was not a pioneer of the internet and the vast business opportunities that came with it. However, European companies can still excel at making use of technoligical breakthroughs, as they did with the "internet of things".
- Europe remains overregulated.

- The continent will continue to lack the deep and liquid capital market of the US. Despite the travails of the US dollar, the euro thus cannot take over as the new safe haven of the world.
- Europe in its great diversity has plenty of promising startups. But for the reasons cited above, scaling them up will always be more difficult and slower in Europe than in the US.
- Observers often find it difficult to understand the European Union, a unique club of 27 sovereign nations.

Narrowing the transatlantic growth gap

Like most other major economies, Europe also faces serious long-term challenges such as those stemming from a shrinking domestic labour force. We do not expect the Eurozone economy to outperform that of the US. However, the growth gap will likely narrow significantly.

Driven mostly by the German turnaround, we project Eurozone growth to accelerate modestly from 0.8% in 2024 to 1% this year, 1.4% in 2026 and 1.5% in 2027. In the US, tariffs will likely remain signifcantly higher than they were before Trump returned to the White House, probably with an average extra tariff of c10% on most goods imports from most countries and a somewhat higher base tariff on most deliveries from China, even if Trump strikes the deals we expect. Without falling into stagnation or worse, the US economy looks set to lose some momentum as a result.

Beyond the neat term, the domestic legacy of Trump in the US will likely be more debt, higher financing costs and lower trend growth. In addition to tariffs that reward the less efficient companies, the tight clampdown on illegal immigration and a lack of respect for facts, science and the institutions that keep a country humming will take their toll. As a result, we recently lowered our assessment of US trend growth from 2% to 1.5% per year. Whereas this is still above the Eurozone trend rate of c1.2%, it is not enough to make the exorbitant fiscal deficits of the US sustainable. Slowly but surely, a less dynamic US will be heading for a fiscal reckoning eventually, although probably not immediately unless Trump were to make major additional policy mistakes soon.

Against this backdrop, putting more money to work in Europe for the long haul makes sense, in my view.

See also: Europhoria? (21 March 2025)

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