The Eurozone recovery is still tentative, with a combination of external factors weighing on industrial firms in particular. Activity in the service sector has shown more resilience, yielding total GDP growth of 0.2% in the third quarter, and we expect the same in the fourth. Overall, we expect the Eurozone economy to expand by 0.8% this year, following a decline of 0.4% in 2013.

Looking ahead, we think there are reasons to expect a steady pick-up in growth next year. Household budgets will be supported by lower oil prices, and combined with the modest improvement in labour markets, this will allow consumer spending to gather pace. Exporters will start to feel the full benefits of a weaker euro, as well as stronger demand in advanced economies. And though the effects of recent ECB measures on bank lending remain unclear, they should loosen credit standards, which may support business investment.

Overall, we forecast a pick-up in GDP growth to about 1.2% in 2015 (revised down a little since last month in light of slower growth in emerging markets), and 1.6% in 2016. But several constraints will keep growth around 0.5 percentage points below the average in the decade to 2007, including restrained government spending and modest private consumption growth by historical standards, as households also deleverage.

The outlook remains vulnerable to downside risks, especially given uncertainty about the severity of the Chinese slowdown and conflict in both Ukraine and the Middle East. In addition, deflation remains a threat. We believe inflation will start to pick up from recent lows, and a depreciating euro should help nudge CPI inflation to 0.7% in 2015 and 1.3% the year after. But given such limp rates, combined with high unemployment and still fragile business sentiment, it would not take an especially powerful shock to push the Eurozone back towards deflation.

| Forecast for Eurozone (Annual percentage changes unless specified) |
|-------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
|                         | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
| Domestic Demand         | -0.9  | 0.8  | 1.1  | 1.5  | 1.5  | 1.5  |
| Private Consumption     | -0.6  | 0.7  | 1.3  | 1.4  | 1.4  | 1.4  |
| Fixed Investment        | -2.4  | 0.0  | 0.9  | 2.7  | 2.6  | 2.5  |
| Government Consumption  | 0.2   | 0.8  | 0.3  | 0.5  | 0.7  | 0.8  |
| Net exports (% of GDP)  | 4.1   | 4.1  | 4.3  | 4.4  | 4.5  | 4.6  |
| GDP                     | -0.4  | 0.8  | 1.2  | 1.6  | 1.6  | 1.6  |
| Industrial Production   | -1.0  | 0.8  | 1.1  | 2.3  | 2.2  | 1.8  |
| Consumer Prices         | 1.3   | 0.5  | 0.7  | 1.3  | 1.5  | 1.6  |
| Current Account (% of GDP)| 2.0  | 2.2  | 2.3  | 2.3  | 2.2  | 2.2  |
| Government Budget (% of GDP)  | -2.9  | -2.5 | -2.1 | -1.7 | -1.4 | -1.1 |
| Short-Term Interest rate (%)  | 0.2  | 0.2  | 0.1  | 0.1  | 0.3  | 0.8  |
| Long-Term Interest Rates (%)  | 3.0  | 2.1  | 1.9  | 2.3  | 2.7  | 3.0  |
| Exchange rate (US$ per Euro)  | 1.33 | 1.33 | 1.24 | 1.21 | 1.20 | 1.19 |
| Exchange rate (YEN per Euro)  | 129.6| 140.4| 145.0| 145.7| 147.1| 148.1|
Forecast Overview

Industry slowing, services growing

The Eurozone economy in aggregate has maintained a modest but steady pace of growth this year. But this conceals a rebalancing of growth from industry to services, as a cooling Chinese economy and conflict in Ukraine weigh on demand for capital goods, while tentatively improving domestic demand boosts services output. GDP expanded by 0.2% in Q3, and we expect a similar rate in the final three months of the year. This is in line with the average rate over the first half of the year. We expect GDP growth of 0.8% for 2014 overall.

Fundamentals support pick up from 2015

Much of the recent Eurozone commentary has focused on the risks of a slip back into recession. While this is understandable given the weakness of some recent data and the scale of challenges faced, we are slightly more positive as a number of factors are set to become more supportive in the coming quarters.

- **Stronger exports** – barring an intensifying conflict in Ukraine or a more serious slowdown in China, exports should continue to recover over the coming couple of years, aided by strengthening demand in advanced economies in particular. A weakening euro (reaching $1.22 by end-2015) will also support exports, particularly in countries that have done least to improve competitiveness. Exports should grow by 3.7% in 2015, and around 4% thereafter.

- **ECB policy** – encouraged by rising foreign demand and narrowing spare capacity, firms will step up capital spending. But with bank lending criteria little eased since 2012-13, firms’ willingness to invest may hinge on the ECB’s ability to restore normality to the Eurozone banking system. For this reason, weak demand for TLTROs in September was seen by some as a disappointment, but October’s ECB Bank Lending Survey suggests firms’ demand for loans is picking up.

- This suggests December’s TLTRO round might be rather better subscribed. Combined with ECB efforts to reinvigorate the Asset-Backed Securities market (banks selling bundles of business and consumer loans) this should drive an expansion of bank lending from early 2015. In turn, this will support business investment growth of 1.1% in 2015 and 3.1% the year after. In both cases these forecasts are a little weaker.
than in October, reflecting our downward revisions to activity in capital intensive sectors.

**But constraints on medium-term recovery**

Nevertheless, the recovery will be constrained by a number of factors, including:

- **High unemployment** – recovering business confidence and investment will encourage firms to increase hiring in the next couple of years, allowing a rebound in consumer spending. But we do not expect the unemployment rate to dip below 10% (currently 11.5%) until 2019. So wage growth will remain modest, at around 2.5% a year, which will limit consumer spending to around 1.4% a year – 0.5% points or so weaker than in the decade to 2007.

- **Fiscal constraints** – although emergency austerity would seem to be over, governments will remain constrained for some years. Low bond yields have eased the burden of interest payments, and there are calls for increased flexibility in the treatment of public investment in fiscal targets. Nevertheless fiscal policy will remain focused on the stabilisation of public debt ratios. As such, we expect a very modest fiscal drag to remain from 2015 onwards, limiting government spending growth to 0.5-1% per year.

Overall we expect Eurozone growth to pick up to 1.2% in 2015 (a further modest revision downwards to our forecast in light of weaker external demand), and remain no higher than around 1.6% in the medium term.

**Sovereign QE remains unlikely**

By setting a balance sheet ‘target’ in November, the ECB appears to have undertaken a major change in tack, which pushes the ECB’s unconventional policy support closer to Fed-style QE. Our central view is that the ECB will boost the size of its balance sheet by about €1trn over the next couple of years via its TLTROs and private sector asset purchases.

There is a possibility that the ECB will increase the scale of its planned asset purchases if the region is buffeted by further negative shocks. However our view remains that government bonds are low down the list of potential assets that the Bank will purchase; ECB Executive Board Member Mersch recently noted that gold, exchanged traded funds or real estate could also be purchased. We think that it will take further significant negative shocks for the ECB to contemplate extending its asset purchases to include government bonds.
Risk Assessment

Overall risk in the Eurozone is expected to decline slightly in the medium term. While the current account is in surplus and austerity has significantly reduced the budget deficit, public and private sector indebtedness remain high. The latter could have severe ramifications for growth prospects if the regions suffered from a sustained period of price and wage deflation.

Emerging risks

External weakness spreads – the failure of the recovery to gain momentum this year partly reflects industrial weakness in response to events abroad. There remains a risk that external concerns prompt sentiment in the domestic sectors of the economy to slip.

Domestic recovery gathers pace – the publication of the stress test and the ECB’s pledge to return its balance sheet to its 2012 peak, combined with less austerity and the weaker euro, could result in the domestic recovery gaining more traction than commonly assumed, particularly if the Russian-related ‘uncertainty shock’ fades.

Key risk scenarios

Eurozone slumps into deflation – although the region is recovering gently, the large amount of spare capacity in the economy and falling oil prices suggest that a period of deflation should not be ruled out in the region as a whole. Falling prices, wages and asset prices could worsen the health of public and private sector balance sheets, exacerbating the need for deleveraging. Rising bad loans could prompt renewed concerns about the banking system further increasing worries about the solvency of some governments.

Russia-Ukraine tensions escalate – despite the ceasefire it remains to be seen whether the worst of the crisis is over. An escalation of sanctions and a restriction of gas flows from Russia to Europe would damage sentiment, prompting firms to delay investment spending. Higher energy prices would hit increasingly cautious households, potentially leading to falls in private consumption, too – although the recent drop in oil prices would suggest that this impact might now be less potent than a few months ago.
Long-Term Prospects

Very slow recovery from crises

The global and Eurozone crises will leave their mark on growth for years to come. We estimate that the Eurozone’s potential growth rate is only 1.1% in line with our estimate for the past decade, itself significantly affected by the crisis, and 1.8% in the 10 years to 2008.

The slow restructuring of the banking sector means that credit availability will be limited for a long time, hindering investment and affecting the efficiency of capital allocation in the economy. Moreover, high unemployment for a prolonged period, especially among the young, will have long-lasting negative effects on skill levels and ability to work. Combined with a shrinking population of working age, despite increases in the retirement age, these factors imply that availability and quality of labour will be constrained compared with the pre-crisis period. These factors will only be partly offset by further increases in the participation rate.

Some of the reforms implemented in the peripheral countries should help raise the economy’s productivity growth to at least what it was before 2008. But much more will be needed to offset other negative trends.
Background

The creation of a single European currency was achieved in 1999, with notes and coins being introduced in 2002. The eleven initial members were Germany, France, Italy, Finland, Ireland, Netherlands, Belgium, Luxembourg, Austria, Portugal and Spain, with Greece joining European Monetary Union (EMU) in 2001 and introducing notes and coins at the same time as the other countries. Slovenia was the 13th member in January 2007, Malta and Cyprus joined a year later, Slovakia became the 16th member in January 2009, Estonia the 17th in January 2011 and Latvia the 18th at the start of 2014.

To qualify for membership of the Eurozone, countries have to pass a number of nominal convergence criteria set out in the Maastricht Treaty: the inflation rate should not exceed by more than 1.5% points the average inflation rate of the three EU countries with the lowest inflation; the government deficit should not exceed 3% of GDP and gross government debt should be no higher than 60% of GDP; countries should have been members of ERM II and have not devalued their currency in the previous two years; and long-term interest rates should not be more than 2% points higher than the average in the three EU countries with the lowest inflation. In practice, these conditions were applied quite loosely to the original EMU members, with elements of the fiscal criteria being selectively overlooked for Italy and Belgium (and then Greece) and with little attention as to whether the budget deficit was below 3% of GDP on a sustainable basis. However, the narrow failure of Lithuania to win approval for adopting the euro in 2007 suggests that the convergence criteria will be applied much more strictly to new EU members.

Joining EMU sees the member country pass control of its monetary policy to the European Central Bank (ECB). The ECB is one of the most independent central banks in the world and was built on the lines of the German Bundesbank. Not only does the ECB have ‘operational’ independence – allowing it to set interest rates free from political control – but it also has ‘goal’ independence to set its own targets. The ECB objective is to achieve price stability and this is pursued through economic and monetary analysis; the ECB targets inflation of close to, but not exceeding, 2%, and maintains a reference target of 4.5% for M3 money supply growth. The two components of analysis were to act as a crosscheck, but economic analysis has taken precedence in recent years, with monetary targeting slipping into the background. Since 2008, the ECB has increasingly focused on providing liquidity to banks, with in particular two sets of three-year loans granted in December 2011 and February 2012.

National governments retain control of fiscal policy, although there are limits to their freedom in this area as specified in the Growth and Stability Pact, which essentially applies the fiscal requirements of the Maastricht Treaty on an ongoing basis. Even before the global crisis, a number of Eurozone countries had difficulty keeping their budget deficits below 3% of GDP and debt below 60% of GDP on a sustained basis and faced sanctions by the EC. However, the effectiveness of the Growth and Stability Pact against the major Eurozone economies of Germany, France and Italy proved limited, while smaller countries such as the Netherlands made painful adjustments when their deficit exceeded the 3% of GDP threshold and others observed the requirements stringently. This forced a reinterpretation of the Pact, which is now applied over the economic cycle.

The fallout from the financial crisis, and in particular the troubled fiscal situation faced by Cyprus, Greece, Italy, Ireland, Portugal, Slovenia and Spain, showed the limitations of the fiscal framework behind the single currency. The possibility of a debt default by Greece, coupled with the threat of contagion to Italy and Spain, has put Eurozone leaders under immense pressure to come up with a rescue plan that would prevent the collapse of the single currency. However, there are significant differences of opinion among the largest members regarding who should carry the burden and what mechanisms should be used to provide financial support to the European banking system. The measures proposed include a move towards a banking union that would sever the links between banks and their sovereigns. However, political hurdles to closer integration and debt burden sharing remain very high. Changes to the Eurozone’s structure and institutions are likely to be slow and erratic.
### Key Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

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<th>Month</th>
<th>Industrial production (% yr)</th>
<th>Unemployment (% point)</th>
<th>CPI (% yr)</th>
<th>Business confidence (% balance)</th>
<th>Consumer confidence (% balance)</th>
<th>Exports (% yr)</th>
<th>Imports (% yr)</th>
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### Financial Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

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<th>Month</th>
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<th>Money Supply (M3)</th>
<th>Exchange rate $/€ avg.</th>
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### TABLE 1: SUMMARY ITEMS

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<th>Years Beginning Q1</th>
<th>Consumers Expenditure</th>
<th>Gross Fixed Investment</th>
<th>Domestic Demand</th>
<th>Real GDP</th>
<th>Industrial Production</th>
<th>Unemployment Rate (%)</th>
<th>Average Earnings</th>
<th>Whole Economy Product-Value Added M3</th>
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#### TABLE 2: SUMMARY ITEMS

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<th>Trade Balance (Euro BN)</th>
<th>Current Account (Euro BN)</th>
<th>(% of GDP)</th>
<th>Financial Balance (Euro BN)</th>
<th>Financial Balance (% of GDP)</th>
<th>Short-Term Interest Rate</th>
<th>Real Short-Term Interest Rate</th>
<th>Real Long-Term Interest Rate</th>
<th>US Dollar Per Euro (1999-200)</th>
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**Note 1:** Real Interest Rates = Nominal interest rate (RSH or RLG) - % change in CPI.
### Long-Term Forecast for Eurozone

Annual percentage changes unless otherwise specified

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<td>Long-term Interest Rates (%)</td>
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<td>Participation Ratio (%)</td>
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<td>Output gap (% of potential GDP)</td>
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Key Facts

Politics
President of the ECB: Mario DRAGHI
Vice president of the ECB: Vítor CONSTANCIO
EC commissioner for Economic and Monetary Affairs: Olli Rehn
Chairman of Euro Group of Finance Ministers: Jeroen Dijsselbloem

Long-term economic & social development

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<th>1990</th>
<th>2000</th>
<th>2013*</th>
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<td>GDP per capita (US$)</td>
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<td>38309</td>
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<td>Inflation (%)</td>
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<td>1.3</td>
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<td>Population (mn)</td>
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<td>305</td>
<td>315</td>
<td>333</td>
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<td>Urban population (% of total)</td>
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<td>Life expectancy (years)</td>
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<td>76.0</td>
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Source: Oxford Economics & World Bank

Structure of GDP by output

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<td>2010</td>
<td>1.6%</td>
<td>26.3%</td>
<td>72.0%</td>
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Source: WDI

* 2013 or latest available year

Structural economic indicators

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<th>2000</th>
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<td>Current account (US$ billion)</td>
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<td>54</td>
<td>-95</td>
<td>306</td>
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<td>Trade balance (US$ billion)</td>
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<td>FDI (US$ billion)</td>
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<td>3.0</td>
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<td>Oil production (000 bpd)</td>
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<td>313</td>
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<td>238</td>
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<td>Oil consumption (000 bpd)</td>
<td>9715</td>
<td>10483</td>
<td>10927</td>
<td>9611</td>
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Source: Oxford Economics / World Bank / EIA / ECB

Corruption perceptions index 2013

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<td>Eurozone</td>
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Source: Transparency International

Scoring system 100 = highly clean, 0 = highly corrupt

Composition of extra-EMU goods & services exports, 2012

- Manufactured products 62.2%
- Food, Drink & tobacco 5.4%
- Mineral Fuels and Lubricants 5.0%
- Services 25.2%
- Goods n.e.s 2.3%

Source: Eurostat / Haver Analytics

Destination of goods’ exports (2012)

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<td>Eurozone 46.3%</td>
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<td>UK</td>
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<td>US</td>
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<tr>
<td>China</td>
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<tr>
<td>Switzerland</td>
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<td>Poland</td>
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Source: Eurostat / Haver Analytics