Eurozone economy

2014 Outlook

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- The expected recovery of the Eurozone economy arrived in 2013, and we are taking an in-depth look at its fundamentals and its growth outlook with an emphasis on 2014.
- We are reaffirming our forecast for an uneven and modest recovery that moves the Eurozone toward its long-term trend growth rate amid a declining fiscal drag and an accommodative monetary stance.
- The Eurozone economy is expected to grow +1.1% in 2014 and +1.5% in 2015. It should return to the Gross Domestic Product (GDP) level that prevailed before the European financial crisis by the end of 2014 and to the GDP level that prevailed before the global financial crisis by the end of 2015.
- Germany, among the large countries, remains the best positioned to grow. Countries that undertook major reforms in the past years will also have a relative advantage.

The environment in the Eurozone has improved. Not long ago, doomsayers predicted short-term economic meltdown and at least a partial disintegration of the monetary union. In reality, the Eurozone is growing again. Two peripheral countries (Spain and Ireland) have exited their bailout programs and seen their ratings stabilize. Italy was one of the first countries to graduate from the Excessive Deficit Procedure. The Eurozone continues to grow in number, and Greece presides over the European Council in the first half of 2014. In what follows, we will elaborate on some selected 2014 Eurozone highlights in chronological order, and conclude with our economic outlook.

2014 Highlights

After two years of rapid progress, a certain degree of complacency is setting in at the policy level as the heat of the summer of 2012 has subsided. The European Union (EU) Council's agreement on banking union in December 2013 is a case in point. Although it is a large step forward by historical standards, it failed to live up to hopes for more integration: what resulted for now was a relatively segregated banking union with little pan-European money on the table. That came about despite the agreement on the Bank Recovery and Resolution Directive ensuring that the link between sovereigns and banks will weaken from 2016 on. This shift in integration speed and Germany's insistence on the Principle of Subsidiarity (see Treaty box) is partly a reaction of Germany to the loss of reform momentum in other countries.

Table of contents

Source: UBS

Highlighted economic research

- Italy's disregarded housing crisis is underway, 20 November 2013
- Eurozone economy: Quo Vadis?, 27 March 2013
- ECB's new SMP may resemble a ESM banking license, 2 August 2012
- ECB and economic outlook, 22 June 2012

Source: UBS

Treaty box: Principle of Subsidiarity

The principle is established in Article 5 of the Treaty of the EU. It specifies that the EU may only intervene if it can act more effectively than member states, based on three criteria:

- Does the action have transnational aspects that cannot be resolved by member states?
- Would national action or inaction contradict the Treaty's requirements?
- Does action at the European level have clear advantages?

Source: European Union

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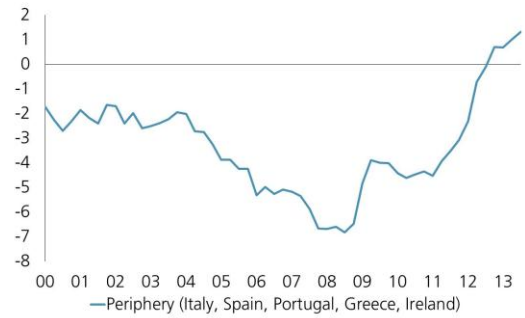
Against this background, the speed of integration will likely abate. Greater macroeconomic and financial stability should result from the sharp turnaround in peripheral current accounts (see Fig. 1). This stability, along with the continued recovery that we expect, could keep the speed of reform at half-throttle for several years. In this case, those countries that have undertaken major reforms in recent years (such as Ireland or Spain) should have a relative advantage, while others, such as France, could be dubbed the new sick men of Europe and be compared to the Germany of the beginning of the last decade. If the Eurozone were to face a significant crisis, such as a global recession, the speed of change and reforms would likely pick up again though.

The European elections in May 2014 will show how much the last crisis has cost in terms of support for the European idea and the single currency. Polls suggest that non-mainstream parties could increase their share of parliamentary seats to 20%-30%. Policymakers are aware of the difficulties such a fragmented parliament portends for future legislative dealings between the EU Parliament, EU Commission and EU Council; they were keen to come to some agreement on the banking union in the December 2013 EU Council so that such a scenario would not leave the banking union legislation unfinished before the elections. Nevertheless, we believe that the potential fragmentation and the likely grand coalition in the European Parliament will not be a risk to Europe. However, strong showings from the Greek Syriza party or the French National Front could strengthen their position in their own countries.

With a new European parliament, no major national election, and the economic recovery probably gaining traction, the summer of 2014 will see the centennial commemorations of the start of World War I. French President François Hollande has already invited 72 countries involved in the Great War to Paris on July 14. Given that World War I also began from an unsustainable equilibrium, the occasion will offer the opportunity to reflect on the way forward for Europe. Its most pressing problem remains historically high unemployment, in particular among the young, so we could see a greater focus on it. In fact, the European Central Bank (ECB) estimates that the unemployment rate will only decline to a still very high 11.8% in 2015 (see Fig. 2). Against this backdrop, the ECB could feel pressure to keep its easing bias for longer than it would like and maybe to do more (see section on monetary policy).

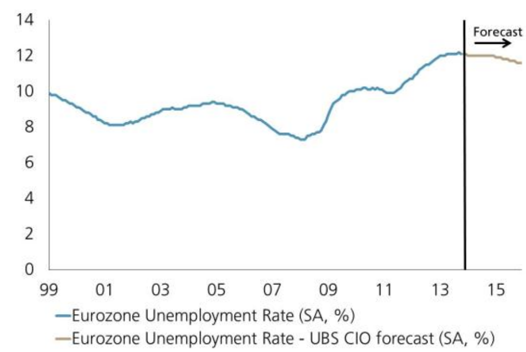
Due to the change in EU Commission and the US midterm elections, the autumn could then see the conclusion of the negotiations on the Transatlantic Trade and Investment Partnership with the US to avoid major delays. The agreement would constitute the biggest free trade agreement in history, would remove the remaining trade tariffs (less than 3% on average) and most importantly harmonize regulation. A comprehensive agreement would boost growth by an estimated 0.5% per annum and consolidate the US and EU as global standard setters.

Fig. 1: Current account position (% GDP)
Historical turnaround



Source: UBS, Eurostat, Barclays, Haver.
Note: Seasonally adjusted. As of 3Q 2013.

Fig. 2: Unemployment rate
At historically high levels



Source: UBS, Eurostat, Haver.
Note: SA = seasonally adjusted.

In November of 2014, the ECB will officially take over as the supervisor of banks under the Single Supervision Mechanism (SSM), while also communicating the results (including capital shortfalls) of its Asset Quality Review and bank stress tests. The Eurozone has been slow to come to grips with its post-Lehman banking problems compared to the US or the UK. It is thus of strategic importance that legacy problems at banks are cleaned up so that the banks can start to contribute to economic growth. Nevertheless, we believe that the ECB will try to strike a balance between a complete cleanup, which would involve a substantial hit to growth, and a sufficiently credible exercise that doesn't compromise short-term growth more than necessary. Hence, the exercise will probably hurt credit growth in 2014 but not jeopardize the sluggish and uneven recovery.

By the end of 2014, we expect the Eurozone economy to have returned to the level of economic output it enjoyed before the start of the European recession in 2011. We see it returning to its pre-global financial crisis level of economic output by the end of 2015. Accordingly, we will lay out our expectations for Eurozone fundamentals in terms of fiscal and monetary policy and the implications for economic growth, with an emphasis on 2014. We will conclude our study with an analysis of Germany, France, Italy and Spain.

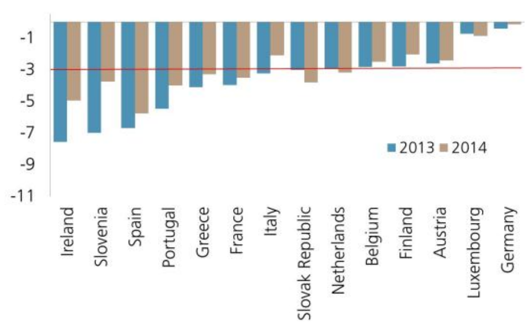
Fundamentals: Fiscal policy

The EU Commission has granted several countries additional time to achieve their fiscal targets under the Excessive Deficit Procedure. Countries have used up all the room granted to them for the 2014 budget (see Fig. 3) and are generally shifting the focus from tax increases to spending cuts. In the autumn of 2013, the EU Commission accepted the 2014 budgets of these countries but also signaled that the leeway in the area of fiscal tightening has been exhausted. We see this action as a sign of frustration with the slower pace of reforms at the country level. In any case, the amount of fiscal tightening in the Eurozone will decline from approximately 1% of GDP in 2013 to about 0.5% in 2014. While still restrictive, this reduced tightening is substantial for an economy with a long-term trend growth rate of close to 1% and tax revenues that have already reached their highest level since the inception of the euro (EUR) as a percentage of GDP. Furthermore, the drag from fiscal tightening on economic growth (the fiscal multiplier) is becoming smaller given past peripheral government bond yield decreases.

The flipside of the coin is that slower deficit reduction in many countries delays the stabilization of government debt-to-GDP ratios (see Fig. 4). Thanks to confidence in the slew of new fiscal frameworks (see Glossary), including the European Semester, Fiscal Compact, Two Pack, etc., as well as the Outright Monetary Transactions, the market is currently giving the countries the benefit of doubt, which at this stage is highly welcome and timely from a cyclical growth perspective. In terms of peripheral program countries, the focus will shift from Spain and Ireland's bailout exits in 2013 to Portugal and Greece. For Portugal, policymakers are waiting to see whether bond yields decline further in the spring

Fig. 3: Government deficits

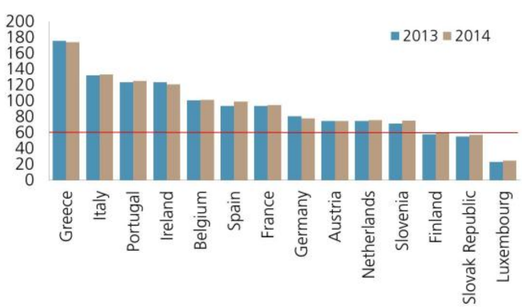
EU Commission turns a blind eye this time



Source: IMF.
Note: The 3% deficit line refers to the Maastricht limit.

Fig. 4: Government debt-to-GDP ratios

Not quite there yet



Source: IMF.
Note: The 60% debt-to GDP line refers to the Maastricht limit.

before making a decision about ending the bailout or granting more funding. Greece will claim its promised debt relief in the spring while holding the EU Council presidency. We see outright debt haircuts as unlikely and believe that debt relief on official loans to Greece will more likely come in the form of interest rate changes and/or maturity extensions. Nevertheless, Greece will enjoy a generous share of the EU's cohesion funds, so that the Greek economy should be able to grow in 2014. Last but not least, unless Matteo Renzi manages to materially change the reform situation in Italy, the most important peripheral country will likely see less wiggle room for negotiating its 2015 budget with the EU Commission.

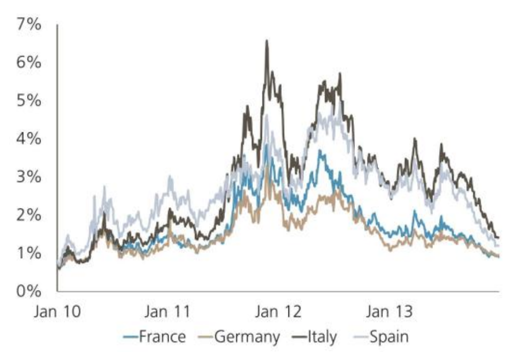
Fundamentals: Monetary policy
Recent ECB research suggests that Eurozone structural unemployment, given the duration of much of the joblessness and the skill mismatches, exceeds 10%. With the current unemployment rate at over 12%, the spare capacity in the labor market is still substantial, keeping consumer price inflation at very low levels amid still relatively rigid wages and product prices. This is also supported by protracted weakness in energy prices that is holding noncore inflation at bay, while growth remains too weak to bring down the unemployment rate quicker. Moreover, tax increases are slowing down and medium-term inflation expectations are firmly anchored. Against this background, inflation is set to remain quite low (see Fig. 5) at +1.2% in 2014 and +1.4% in 2015, below the ECB's inflation target of below, but close to +2%.

With inflation low and unemployment historically high, the ECB is likely to remain accommodative for years to come and even ease policy further, if necessary. What can the ECB do to support the desired recovery? We think that a collateral loosening is in store to support the EU Commission's lending initiative. If economic data disappoints, the ECB Governing Council could also reduce the main refinancing rate by 0.15% to 0.10%. We don't believe that the deposit rate would be cut to negative, however. ECB Vice President Vítor Constâncio recently stated that it should only be moved into negative territory in extreme circumstances, which we don't expect in 2014. The likelihood of this happening would rise, though, if EUR per US dollar moved above 1.40 on a sustainable basis or if inflation again undershot ECB projections (+1.1% for 2014), which could prompt the ECB to act to avoid the risk of deflation. We are even more skeptical of the longer-term refinancing operation (LTRO) for lending to small and medium enterprises (SMEs). The ECB today already offers full allotment for non marketable credit claims to at least July 2015 (which is likely to be prolonged again). In addition, the downtrend in bank funding costs (see Fig. 6) should help peripheral lending rates to decline going forward. According to the bank lending surveys, it is not the liquidity situation of the banks (in fact they are repaying the three-year LTROs) but company-specific risks that are weighing on lending to SMEs in the periphery. Last but not least, we expect the ECB to begin making its meeting minutes public, which should strengthen forward guidance and communication in general, thereby reducing financial market volatility at the margin.

Fig. 5: Inflation outlook
Turning just before getting deflationary

Source: UBS, Eurostat, Haver.

Fig. 6: Bank funding costs trending down
5-year credit default swaps of leading banks



Source: Bloomberg.

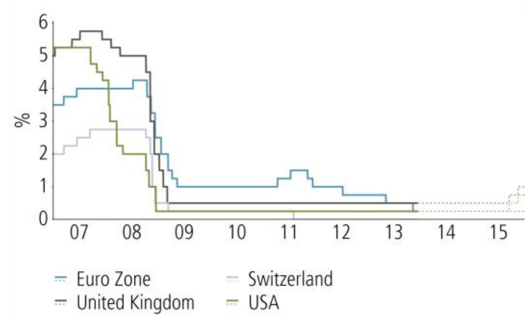
Since the US Federal Reserve (Fed) is expected to raise rates in 2015, the question becomes: How will the ECB react? Looking at the situation historically, one would conclude that the ECB would probably execute its first rate hike in the second half of 2015. Yet, we do not believe that this is either politically or socially feasible. The ECB itself forecasts the unemployment rate to remain very high at 11.8% in 2015. What's more, the Eurozone rates are unlikely to be able to fully shield the economy from the impact of rising US rates. Despite its forward guidance, the ECB itself is assuming a rise in the three-month Euribor rate to 0.5% in 2015 as a reflection of the Fed's action. Since many financial contracts in the Eurozone are linked to short-term interest rates, the Fed will thus effectively raise Eurozone interest rates for the ECB in 2015 (see Fig. 7). It will be much easier for the ECB to wait until 2016 at the earliest to hike rates, as the increase will have a smaller impact by then and be easier to sell amid persistently high unemployment.

In our and the ECB's outlook, the Eurozone GDP level should reach pre-global financial crisis levels in 2015. In such a scenario, the ECB could be asked amid the stubbornly high unemployment and the youth joblessness of over 20% why the US rate is almost half that of the Eurozone's and why the US exceeded its pre-global financial crisis level of GDP years before the Eurozone did, while also achieving price stability and reducing its fiscal deficit. We can imagine that calls for quantitative easing (QE) in the Eurozone will become louder as the broader public realizes that the unemployment rate has barely fallen. Although not base case in the next years, we believe that the ECB would thus undertake QE in a future global recession at the latest, as a recession would make the social and financial pressure from the fiscal compact unbearable. Unlike earlier when Germany, a core country, failed to abide by the Maastricht criteria, most countries, at the very onset of this future recession scenario, would be already bumping against the limits of their debt capacity. Such a program of QE would probably also include government bonds, as private asset markets alone are likely too small, fragmented and illiquid to have a big and targeted impact on their own.

Economic growth: Investments

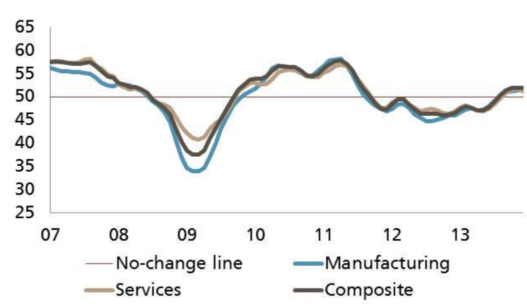
The changed environment has led to an increased optimism among firms already visible in business surveys such as the purchasing manager indices (see Fig. 8). Bank lending surveys have revealed increased demand for working capital financing for inventories. Indeed, after the long recession, inventory managers are changing from recessionary to growth mode. This dynamic is usually a good lead indicator of the corporate investment cycle. Furthermore, since capacity utilization is rising, there should be some substitution and repair effects. In addition, due to the structural shift to net exports, some demand should also arise in export industries and related sectors. Given the Eurozone fundamentals, we believe that PMIs will move mostly in the 50-55 range in 2014, which would be consistent with an increase of +1%-1.5% in corporate investment. On the construction side, any positive momentum will mainly come from Germany, as property

Fig. 7: Central bank rate path
Federal Reserve to raise rates before ECB



Source: UBS, Reuters EcoWin.

Fig. 8: Eurozone PMIs
Signalling more corporate spending



Source: UBS, Bloomberg, Markit.
Note: 3 month moving average.

markets in other, mainly peripheral countries will most likely still be adjusting in 2014.

Economic growth: Consumption
After contracting for seven quarters on the back of harsh austerity, consumption is set for a comeback. Real disposable income is expected to turn positive given better wage growth, the decline in fiscal tightening and low inflation. We believe that consumer confidence is in line with 0.2%-0.3% quarter-on-quarter gains on average in 2014. Even with the unemployment level at record highs, the fact that it is stabilizing should help consumer confidence to squeeze out some further gains (see Fig. 9). Additional success stories such as the Irish and Spanish bailout exits and the entry of a new country (Latvia) into the Eurozone should also support consumer confidence at the margin.

Economic growth: Net trade
The Eurozone trade balance has improved markedly in recent years (see Fig. 10), thanks in part to competitiveness reforms and to a retrenchment of imports due to fiscal tightening. Eurozone exports are well positioned to participate in rising world demand. At the same time though, the receding drag on disposable household incomes should allow some pent-up demand to materialize, unwinding some past cyclical retrenchment of imports. We thus do not expect the net trade balance to contribute significantly to the real GDP growth rate in 2014.

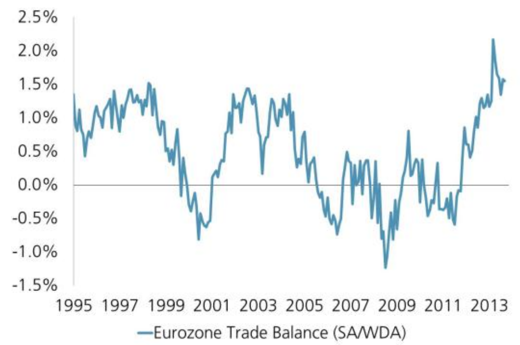
Bottom line: Back to modest growth
Against the backdrop of an accommodative monetary stance and receding fiscal pressure, domestic demand is set to outshine net trade again after several years of weakness. Following the expected recovery, this overall picture leaves us with a +1.1% and +1.5% real GDP growth forecast, respectively, for 2014 and 2015, by the end of which the Eurozone should return to the GDP level that prevailed before the global financial crisis (see Fig. 11). Yet, this would still constitute a sluggish recovery even by Eurozone standards. In fact, growth averaged +2%-2.5% in the 1980s-'90s and +2.3% from 2000 to 2007. Given that the Eurozone is coming out of two financial crises, a global and a European one, this sluggishness is quite normal. Beyond that, the debt overhang in the Eurozone remains an unsolved problem and will drag on growth for a long time. Following the Excessive Deficit Procedure on fiscal deficits, the next phase will focus on reducing government debt over the coming 20 years in an environment of weak demographics.

In terms of risks, the Outright Monetary Transactions (OMT) verdict of the German constitutional court in Karlsruhe is key given the paramount importance of the OMT for market confidence. We expect a "yes, but…" ruling, i.e. the court is expected to confirm the program's legality but insist it be implemented properly and will remind the Bundestag of the risks involved. The court could also refer the case to the European Court of Justice in Luxembourg, which, we believe would likely issue a more positive verdict than Karlsruhe. Furthermore, the European parliament could push back on the banking union,

Fig. 9: Consumer confidence
In line with normalization of consumption

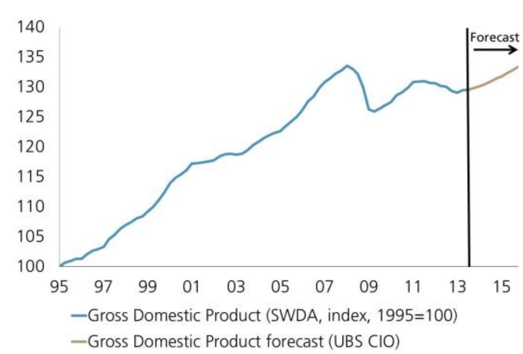
Source: UBS, Eurostat, European Commission, Haver.
SA = seasonally adjusted.

Fig. 10: Net trade as percentage of GDP
Record levels following the recession



Source: UBS, Eurostat, Haver. SA/WDA = seasonally and working day adjusted.

Fig. 11: Eurozone GDP level
Recovery from the global financial crisis by 2015



Source: UBS, Eurostat, Haver.
Note: SWDA = seasonally and workday adjusted.

leading to major delays. However, we assign only a low to medium probability to this risk case. Last but not least, the free trade deal with the US could be postponed. Yet, given the determination of both governments to reach an agreement, we believe that in such scenario a conclusion would only be postponed to 2015.

Table 1: Eurozone real GDP growth forecasts
Getting back on feet

	Quarterly forecasts								Annual growth			Consensus	
	1Q 14E	2Q 14E	3Q 14E	4Q 14E	1Q 15E	2Q 15E	3Q 15E	4Q 15E	2013E	2014E	2015E	2014E	2015E
Quarter on quarter growth	0.2%	0.3%	0.3%	0.4%	0.3%	0.4%	0.4%	0.4%	NM	NM	NM	NM	NM
Year over year growth	0.9%	0.9%	1.0%	1.2%	1.3%	1.4%	1.4%	1.5%	-0.4%	1.1%	1.5%	1.0%	1.4%

Source: UBS estimates, Bloomberg.

Germany: Back to normal

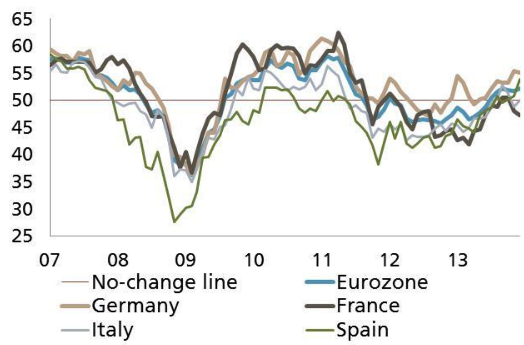
The German economy has turned itself around (see Fig. 12). We expect a slightly positive fiscal stance following the coalition agreement – in line with the constitutional debt brake – that will limit any substantial impulses on the government consumption side. Yet, domestic demand should be strong enough in itself to push German growth above its long-term trend rate. Very attractive financing conditions, more macroeconomic stability in Europe and beyond, elevated confidence and a recovering European economy have already started to push investments into positive territory. In addition, construction investment is expected to remain strong amid easy financing conditions and a turn in labor demographics (see Fig. 13) thanks to strong immigration and the resulting higher demand for living space. In sum, we expect total investments to pick up substantially.

With the increased optimism at the firm level and the better growth environment, we anticipate improving tariff wage agreements. They should combine with the record-low unemployment rate, solid consumer confidence, continued immigration and higher pensions on the heels of the coalition agreement to increase consumption. The newly envisaged minimum wage to be introduced by 2017 (covering approximately 17% of the German workforce) should help temporarily, although it could lead to problems, in particular in the border regions of Eastern Germany, over the medium term.

On the trade side, the faster global growth we foresee should boost German exports, even in the face of negative relative labor cost dynamics. Imports are expected to rise more forcefully due to improving domestic demand and keep the German net trade contribution weaker than usual. This should lower the German current account surplus and reduce tensions with the EU Commission, which has recently classified Germany's current account balance as excessive. The German government is currently analyzing the factors that led to the high balance, which we think stems from weak German investment in the wake of the debt crisis and a too low exchange rate for Germany.

Taking all of the above into consideration, we expect real GDP

Fig. 12: Purchasing manager indices
Turnaround



Source: UBS, Bloomberg, Markit.

Fig. 13: German labor force
Immigration trumping demographics

Source: UBS, Haver, Destatis.
SWDA = seasonally adjusted and working day adjusted.

growth to accelerate above its long-term trend, reaching +1.6% in 2014 (with some upside potential) and +1.9% in 2015. The German economy should remain the star performer among the largest Eurozone countries. Although the Bundesbank would also accept higher inflation, we believe that consumer price inflation should stay at a moderate +1.3% in 2014 and +1.5% in 2015. Key risks for the German economy include major growth disappointments abroad (given Germany's high export share), a re-escalation of the debt crisis, and the labor market and product market plans in the coalition agreement, which put pension sustainability (such as retirement from age 63 after 45 years of work) and recent reforms, such as the German "Agenda 2010", at risk. The new measures could drag down growth at the margins in the medium term. Last but not least, the forthcoming ECB bank asset quality review could reveal some latent issues in the German shipping industry and the bank loans related to it. It is worth recalling that shipping has been declared one of the focus areas of the ECB asset quality review, mainly due to Germany.

Table 2: German real GDP growth forecasts
At the doorstep of a virtuous cycle

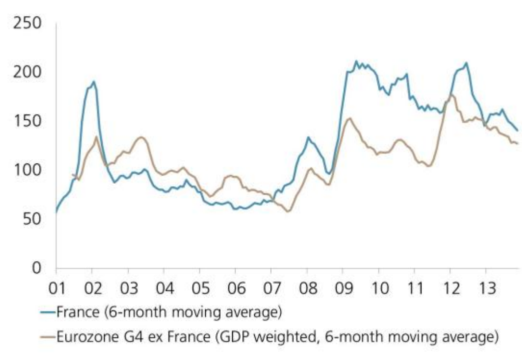
	Quarterly forecasts								Annual growth			Consensus	
	1Q 14E	2Q 14E	3Q 14E	4Q 14E	1Q 15E	2Q 15E	3Q 15E	4Q 15E	2013E	2014E	2015E	2014E	2015E
Quarter on quarter growth	0.3%	0.4%	0.5%	0.5%	0.4%	0.5%	0.5%	0.6%	NM	NM	NM	NM	NM
Year over year growth	1.7%	1.4%	1.5%	1.8%	1.8%	1.9%	1.9%	1.9%	0.5%	1.6%	1.9%	1.7%	1.9%

Source: UBS estimates, Bloomberg.

France: Taking it slowly

The recent downgrade of France's rating from AA+ to AA by Standard & Poor's summarized the situation in the country in 2013. Other Eurozone countries have endured years of adjustments, but French unit labor costs have barely moved, and the push for reform in France has faded somewhat. With Hollande suffering very low popularity, the upcoming European elections in May 2014 could further slow unpopular reforms to avoid giving the National Front Party additional arguments and appeal in its election campaign. Hence, we expect that the envisaged tax system overhaul will be fleshed out mainly in the second half of 2014 and applied from 2015 onward. On a more positive note, fiscal tightening is slowing in 2014, from 1.5% to a manageable 0.7% of GDP, although chances are that the deficit targets in 2014 and 2015 will be missed without additional fiscal measures. This overall combination is likely to keep policy uncertainty above average European levels (see Fig. 14).

Fig. 14: Policy uncertainty
Above average since the global financial crisis



Source: UBS, Economic Policy Uncertainty.

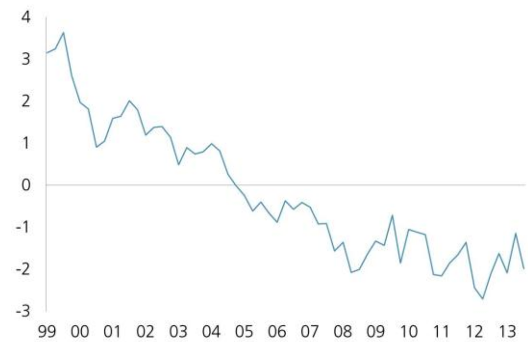
French firms will benefit from the tax break to take effect in 2014 that is designed to increase their competitiveness. Also, credit conditions are relatively easy as the ECB's monetary policy has been transmitted better in France than in other countries. Yet we believe that companies will remain cautious and focus more on profitability than on investing and creating jobs. Hence we expect only muted growth in investments in 2014 at best, followed by a more solid rise in 2015.

As far as consumption, the traditional fuel of French growth, goes, fiscal tightening will fall mainly on households in 2014. The value added tax (VAT) rate increased on January 1 from 19.6% to 20.0%. The environment is also not conducive to strong consumption gains in 2014: the unemployment rate is unlikely to fall much before 2015, because labor market reforms need time to yield results and the labor force is still growing for demographic reasons. At the same time, consumer confidence remains far from robust. On a more positive note, French wage rigidity means that wage increases in 2014 are likely to be in the usual range of +2.0-2.5% and will limit downside risks to consumption, even though disposable income will be negatively affected by tax increases and spending cuts.

On the trade side, the French are simply not competitive enough. The country's current account balance has been trending down for over 10 years (see Fig. 15) as wages have outpaced productivity gains, and it is now one of the worst in the Eurozone. Although the competitiveness tax break should slow down the loss of export market share, we think it will fail to push export performance above world demand growth.

This leaves us with a +0.9% real GDP forecast for 2014 and +1.5% for 2015, with downside risks. On the inflation side, France is unlikely to escape the Eurozone's low inflation environment despite the VAT increase. We foresee it at +1.0% in both 2014 and 2015. Key risks include additional policy uncertainty and weaker-than-expected domestic demand, a higher euro (France is more sensitive to the exchange rate than Germany) and a sharp increase of government bond yields due to its current account deficit.

Fig. 15: French current account
The mirror image of the malaise (% of GDP)



Source: UBS, Banque de France, Haver.

Table 3: French growth forecasts
Slowly leaving the austerity tunnel

	Quarterly forecasts								Annual growth			Consensus	
	1Q 14E	2Q 14E	3Q 14E	4Q 14E	1Q 15E	2Q 15E	3Q 15E	4Q 15E	2013E	2014E	2015E	2014E	2015E
Quarter on quarter growth	0.1%	0.3%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	NM	NM	NM	NM	NM
Year over year growth	0.9%	0.7%	1.0%	1.1%	1.4%	1.5%	1.5%	1.6%	0.2%	0.9%	1.5%	0.8%	1.3%

Source: UBS estimates, Bloomberg.

Italy: Looking for a way out of long-term stagnation

Italy was one of the first countries to emerge from the fiscal straight jacket known as the Excessive Deficit Procedure (EDP), which has been key to the improved confidence the country registered over the summer of 2013 (see Fig. 16). Yet the problems responsible for its low growth remain, i.e. static productivity, high government debt with an annual financing need of approximately EUR 400 billion and a difficult business environment. According to the 2012 World Bank "Doing Business" report, Italy ranks near the bottom in the Eurozone, just above Greece. Italy's reform path is of major relevance to Europe, since the country is still the world's fifth-biggest manufacturer and third-largest bond market. The unresolved political situation has been delaying reforms and limiting corporate and household spending. According to the Organization for Economic Co-operation and Development's (OECD) reform commitment index, Italy is far behind Spain, Portugal and Greece when adjusting for the difficulty of reforms. This paralysis will likely lead to more pressure from the EU Commission for the country to reduce its government debt-to-GDP ratio to 60% of GDP, which will likely limit the leeway for the 2015 budget at the least, unless Matteo Renzi manages to turn around the reform path. This will be difficult before the European elections in May 2014 and the Italian elections, which we expect to take place in the first half of 2015. The pressure could also mount as the budgeting exercise will occur contemporaneously with the country assuming the presidency of the EU Council in the second half of 2014 and its banks likely being the weakest link in the forthcoming ECB asset quality review.

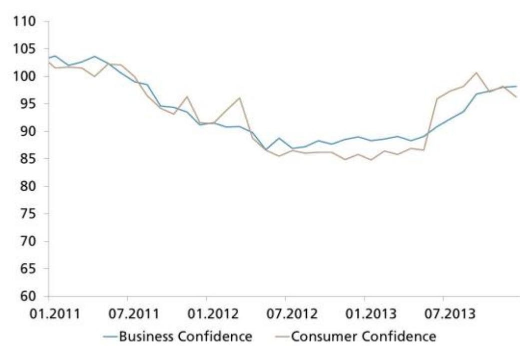
Following what looks to have been the bottoming out of the recession in the second half of 2013, Italy's exit from the EDP means that fiscal tightening measures will decline from 1% of GDP in 2013 to around zero in 2014. We also expect the country to continue to comply with the Maastricht 3% government deficit limit. What's more, the liquidation of government arrears amounting to an estimated EUR 47 billion by summer 2014 should on its own boost GDP growth by approximately half a percentage point in 2014. The strong headwinds that corporates face due to high lending rates (see Fig. 17) are thus partly mitigated, as most of the government's money is effectively bypassing banks and being injected directly into firms. We believe that the latter are unlikely to increase their investments substantially before the next elections, though. In terms of construction investments, we don't see a positive contribution in 2014 since we don't expect home prices to stabilize until 2015.

The Italian consumer is thus still suffering from negative wealth effects because of declining house prices and an unemployment rate unlikely to fall significantly before 2015. The stabilization of the jobless rate and the end of the fiscal adjustment under the EDP should help stabilize consumption in 2014, however. In fact, recent data suggests that the rise in the labor participation rate during the two-year recession could be unwinding, which would further stabilize unemployment.

On the trade side, the recession was instrumental in turning around Italy's current account deficit, which in turn has substantially reduced the dependence of the Italian economy on foreign investors. A significant part of this improvement, however, came about because imports declined due to the recession, a situation that should reverse. Unfortunately, Italy has failed to adjust its relative unit labor costs, which are too high given that past wage increases were not in line with productivity gains. In fact, the International Monetary Fund (IMF) estimates that a depreciation of 10% is necessary to fix the competitiveness issue. Although measures to address it are a key priority of Renzi, he will likely face an uphill battle. Overall, we expect the net trade contribution to become much smaller as the economy recovers.

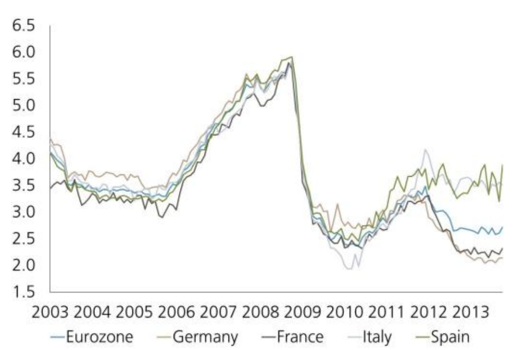
In sum, we forecast balanced growth of +0.4% in 2014 and +0.7% in 2015, with inflation of +1.6% in both 2014 and 2015.

Fig. 16: Italian confidence
Improvement from very low levels



Source: UBS, ISTAT.

Fig. 17: Lending rates currently too high
Non financial corporations



Source: UBS, European Central Bank, Haver.

Key risks include a bigger-than-expected house price correction, political instability, social unrest due to the very high youth unemployment, a tougher-than-anticipated EU Commission and unexpectedly high capital shortfalls stemming from the 2014 bank stress tests.

Table 4: Italian growth forecasts
Back to modest growth

	Quarterly forecasts								Annual growth			Consensus	
	1Q 14E	2Q 14E	3Q 14E	4Q 14E	1Q 15E	2Q 15E	3Q 15E	4Q 15E	2013E	2014E	2015E	2014E	2015E
Quarter on quarter growth	0.1%	0.2%	0.1%	0.2%	0.2%	0.2%	0.2%	0.3%	NM	NM	NM	NM	NM
Year over year growth	-0.1%	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%	0.8%	-1.8%	0.4%	0.7%	0.5%	0.9%

Source: UBS estimates, Bloomberg.

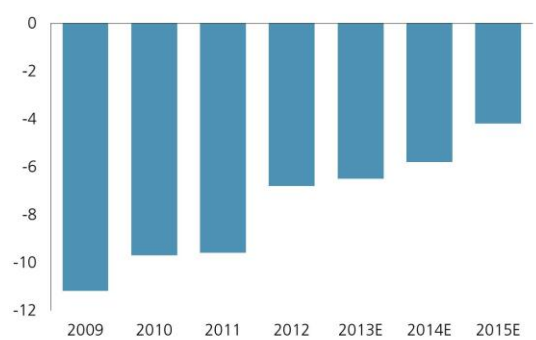
Spain: Riding the export train
Spain has emerged from recession but fiscal challenges remain as the EU Commission is requiring the government to bring its fiscal deficit down from a target of 6.5% in 2013 to 5.8% in 2014 and 4.2% in 2015 (see Fig. 18). According to our estimates, government debt-to-GDP will peak above the 100% threshold only in 2016. Moreover, the deleveraging in the private sector is set to continue as nonfinancial corporate debt still by far exceeds the Eurozone average. Although fiscal tightening will slow the speed of recovery, the fiscal measures are falling from over 3% of GDP in 2013 to a more manageable 1.6% in 2014, which should enable Spain to grow moderately in 2014. Furthermore, the 2014 bank asset quality review and stress tests are not expected to reveal any major capital shortfalls, as Spain has already gone through a bank bailout program.

Despite the bank bailout, financial conditions remain tight for firms. The continued recovery should give banks more access to wholesale funding and improve lending rates, but investment spending will likely be concentrated in the export sector and related industries, so the overall investment rate is unlikely to stabilize before 2015. The same holds true for construction investments, although residential prices could bottom out in 2014 or early 2015 (see Fig. 19) as the adjustment is far advanced (construction as a share of GDP is roughly one-third of its peak level).

On the consumption side, real gross disposable income should turn slightly positive in 2014, thanks in part to very low inflation, and help consumption stabilize. Yet the reversal of immigration and a structural unemployment rate not far from the 20% level are limiting any major gains in it as employment growth and consumption are highly correlated (close to 90%).

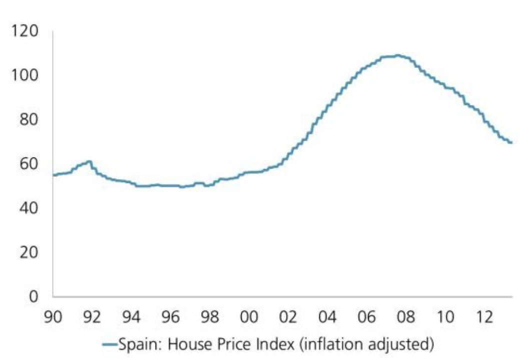
The export sector will continue as the main bright spot in the Spanish economy. Unit labor costs have fallen sharply in recent years (see Fig. 20) and will likely help Spain gain further export market share. As a matter of fact, the turn in the trade performance has helped Spain reverse its current account deficit from over -10% to low positive single digits. The current account is set to improve further (though more slowly) as faster global

Fig. 18: Fiscal deficit path (% of GDP)
Still a lot of wood to chop



Source: UBS, IMF, EU Commission.
Note: 2012 is net of bank recapitalisation (3.8% of GDP). 2013-2015 are EU Commission targets.

Fig. 19: Residential home prices
Moving toward the bottom

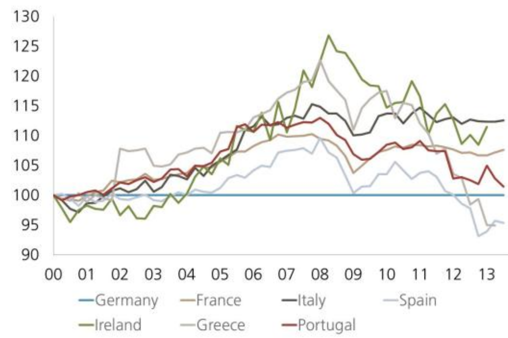


Source: UBS, Dallas Fed, Bloomberg.

growth should offset a rise in imports brought about by stabilizing consumption. Nevertheless, despite past sharp improvements, the IMF estimates that Spain's very high net external total indebtedness makes an additional 8%-12% improvement in competitiveness appropriate.

Our forecast for the Spanish economy calls for growth of +0.4% in 2014 and +1.0% in 2015 – despite continued fiscal austerity. Inflation is expected at a very low +0.8% in 2014 and +1.5% in 2015 as the debt crisis-related tax increases filter out of year-over-year comparisons and the marked slack in the labor market prevents substantial price increases. While the economy appears more likely to offer positive surprises (in particular regarding domestic demand), downside risks are still abundant. The success of the export motor also means that Spain would be hurt badly should global growth disappoint or the euro rise strongly in value. In fact, the country's share of exports to GDP has risen from one-quarter before the crisis to one-third. Moreover, social instability triggered by the high youth unemployment is a latent risk. Last but not least, potential political unrest due to the scheduled November 2014 Catalan secession referendum and the government elections in 2015 could, when coupled with the very high external net debt position, stress Spanish financial markets. Overall though, we believe that the Spanish recovery will be more dynamic than, say, the Italian one.

Fig. 20: Unit labor costs
A huge step in the right direction



Source: UBS, Haver, Eurostat.
Note: As of 3Q 2013 for France, Italy, Spain, Portugal. As of 2Q 2013 for Greece. As of 1Q 2013 for Ireland.

Table 5: Spanish growth forecasts
Reaping the rewards of reforms

	Quarterly forecasts								Annual growth			Consensus	
	1Q 14E	2Q 14E	3Q 14E	4Q 14E	1Q 15E	2Q 15E	3Q 15E	4Q 15E	2013E	2014E	2015E	2014E	2015E
Quarter on quarter growth	0.1%	0.1%	0.2%	0.2%	0.2%	0.3%	0.3%	0.3%	NM	NM	NM	NM	NM
Year over year growth	0.2%	0.4%	0.5%	0.6%	0.7%	0.9%	1.0%	1.1%	-1.3%	0.4%	1.0%	0.6%	1.2%

Source: UBS estimates, Bloomberg.

Glossary

Bank Recovery and Resolution Directive (BRRD)
The draft directive proposed by the Commission in June 2012 would introduce EU-wide rules for the recovery and resolution of credit institutions and investment firms. It is aimed at providing national authorities with common tools and powers to tackle bank crises pre-emptively and to resolve any financial institution in an orderly manner in the event of insolvency, thereby minimizing taxpayer exposure to losses.

Current account
The current account measures the cross border flow of goods, services, net investment income and cash transfers in a given period. Usually, the trade balance is the largest component of the current account. A current account surplus (normally associated with a trade surplus) means that the respective country has increased its net foreign assets or in case of net liabilities reduced it in a specific period.

Deposit Guarantee Schemes Directive (DGSD)
The European Commission in July 2010 presented a legislative proposal for a revision of the existing directive on the protection of bank deposit guarantee schemes (DGSs). Its main elements include: simplification and harmonization, in particular relating to coverage and payout arrangements; further reduction, to one week, of the time limit for paying out depositors, and better access for DGSs to information about their members (i.e. banks); harmonization of minimum *ex ante* financing requirements for DGSs; mutual borrowing between DGSs, i.e. a borrowing facility in certain circumstances.

ECB Deposit Facility
A standing facility of the Eurosystem which counterparties may use to make overnight deposits at a national central bank. Such deposits are remunerated at a pre-specified interest rate ("deposit rate").

ECB Executive Board
One of the decision-making bodies of the ECB. It comprises the President and the Vice-President of the ECB and four other members, all of whom are appointed by common accord by the Heads of State or Government of the EU Member States whose currency is the euro.

ECB Governing Council
The supreme decision-making body of the ECB. It comprises the President and the Vice-President of the ECB plus the other members of the Executive Board and the governors of the national central banks of those EU Member States whose currency is the euro.

ECB longer-term refinancing operation (LTRO)
A regular open market operation executed by the Eurosystem in the form of a reverse transaction. Longer-term refinancing operations are carried out through monthly standard tenders and normally have a maturity of three months.

European Semester
A six-month period each year when member states' budgetary, macro-economic and structural policies are coordinated so as to allow member states to take EU considerations into account at an early stage of their national budgetary processes and in other aspects of their economic policymaking.

European Stability Mechanism (ESM)
The European Stability Mechanism is an intergovernmental institution based in Luxembourg, set up to provide financial assistance to Eurozone member states experiencing, or being threatened by, severe financing problems, if this is indispensable for safeguarding financial stability in the Eurozone as a whole. The maximum lending capacity of the

ESM is set at €500 billion. This is achieved with subscribed capital of €700 billion (€ 80 billion paid-in capital, the rest callable). The ESM entered into force on 27 September 2012. It will take over the tasks currently fulfilled by the European Financial Stability Facility (EFSF).

European System of Financial Supervision (ESFS)
The group of institutions in charge of ensuring the supervision of the EU's financial system. It comprises the European Systemic Risk Board, the three European Supervisory Authorities (the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority), the Joint Committee of the European Supervisory Authorities, and the national supervisory authorities of the EU Member States.

European Systemic Risk Board (ESRB)
An independent EU body responsible for the macro-prudential oversight of the financial system within the EU. It contributes to the prevention or mitigation of systemic risks to financial stability that arise from developments within the financial system, taking into account macroeconomic developments, so as to avoid periods of widespread financial distress.

Eurosystem
The central banking system of the euro area. It comprises the ECB and the national central banks of those EU Member States whose currency is the euro.

Excessive Deficit Procedure (EDP)
The corrective arm of the Stability and Growth Pact (SGP) ensures that Member States adopt appropriate policy responses to correct excessive deficits by implementing the Excessive Deficit Procedure (EDP). The EDP operationalises the limits on the budget deficit and public debt given by the thresholds of 3% of deficit to GDP and 60% of debt to GDP not diminishing at a satisfactory pace.

Full allotment policy
This policy provides banks with access to unlimited ECB liquidity, as long as eligible collateral is delivered to the ECB. The MRO interest rate applies to the liquidity lent out under fixed allotment policy.

Main refinancing operation (MRO)
A regular open market operation executed by the Eurosystem (in the form of a reverse transaction) for the purpose of providing the banking system with the amount of liquidity that the former deems to be appropriate. The interest rate on MROs represents the key policy rate for the ECB to implement its monetary policy stance.

Marginal lending rate
The interest rate on the Eurosystem's marginal lending facility which banks may use for overnight credit from a national central bank that is part of the Eurosystem.

Monetary aggregate
Currency in circulation plus outstanding amounts of certain liabilities of monetary financial institutions (MFIs) that have a relatively high degree of liquidity and are held by non-MFI euro area residents outside the central government sector. The Governing Council has announced a reference value for the growth of M3.

Outright monetary transactions (OMT)
A program under which the ECB makes purchases ("outright transactions") in secondary, sovereign bond markets, under certain conditions, of bonds issued by Eurozone member-states. Conditions for eligibility are that the government has asked for financial assistance through the ESM or EFSF and that it agrees to implement certain domestic economic measures.

Purchasing Manager Index (PMI)
The Markit PMI™ series are monthly economic surveys of carefully selected companies compiled by Markit. They provide advance insight into the private sector economy by tracking variables such as output, new orders, employment and prices across key sectors.

Securities Markets Programme (SMP)
Interventions by the Eurosystem in public and private debt securities markets in the Eurozone to ensure depth and liquidity in those market segments that are dysfunctional. The objective is to restore an appropriate monetary policy transmission mechanism, and thus the effective conduct of monetary policy oriented towards price stability in the medium term.

Single Resolution Mechanism (SRM)
The Single Resolution Mechanism complements the Single Supervisory Mechanism. It is set to centralize key competences and resources for managing the failure of any bank in the Eurozone and in other Member States participating in the Banking Union.

Single Supervisory Mechanism (SSM)
In the SSM proposed by the European Commission, ultimate responsibility for the supervision of all Eurozone banks would lie with the European Central Bank (ECB), while national supervisors would continue to play an important role in day-to-day supervision and in preparing and implementing ECB decisions.

Six-pack
A set of six legal acts adopted in 2011, strengthening procedures for the surveillance of the member states' fiscal policies (the "Stability and Growth Pact") and introducing new ones for their macroeconomic policies. The aim is to better control public deficits and national debt and to better address macroeconomic imbalances.

Stability and Growth Pact
The Stability and Growth Pact (SGP) is a rule-based framework for the coordination of national fiscal policies in the European Union. It was established to safeguard sound public finances, based on the principle that economic policies are a matter of shared concern for all Member States.

TARGET2
The second-generation TARGET system. It settles payments in euro in central bank money and functions on the basis of a single IT platform, to which all payment orders are submitted for processing. This means that all payments are received in the same technical form.

Treaty on stability, coordination and governance (fiscal compact)
The fiscal compact is an intergovernmental treaty signed by 25 EU member states in the margins of the European Council meeting on 2 March 2012. It will enter into force following ratification by at least 12 Eurozone member states. The treaty requires national budgets to be in balance or in surplus.

Two-pack
The second package of proposals on economic governance was presented by the Commission in November 2011 and builds on the so-called "six-pack" of economic governance proposals. Once adopted, the two draft regulations will introduce provisions for enhanced monitoring of Eurozone countries' budgetary policies.

Unit labor costs
Unit labour costs (ULC) measure the average cost of labor per unit of output and are calculated as the ratio of total labor costs to real output. A rise in an economy’s unit labor costs represents an increased reward for labor’s contribution to output.

Source: ECB, European Union, Markit, OECD.

Appendix

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