

2013 MID-YEAR ECONOMIC OUTLOOK ON THE EURO AREA ECONOMIES IN 2013-2014

ANOTHER TOUGH YEAR

May 2013



This bi-annual report is prepared by the members of the European Banking Federation's Economic and Monetary Affairs Committee comprising the Chief Economists of leading European banks and banking associations.

The report reflects a consensus (based on arithmetic averages) on the outlook for the euro area economies. This report is available on the EBF website: <http://www.ebf-fbe.eu/index.php?page=economic-outlook>

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TERMS & CONDITIONS

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The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

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1. THE EMAC CONSENSUS

Europe is going through another tough year. In 2012 the euro area nose-dived into recession; 2013 started off to the same tune. Political turbulence adds to the uncertainty for the prospects of the euro area's recovery. The underlying forces remain the same as in the previous forecast of the Chief Economists of the EBF's Economic and Monetary Affairs Committee. The ongoing deleveraging in the financial and corporate and household sectors, weak confidence and financial market tensions keep economic activity muted in the euro area. Lack of enthusiasm from domestic consumers and producers is reflected in various economic parameters. The unemployment remains persistently high, plateauing above 12% throughout the forecast horizon. Lack of new work placements results in citizens spending and investing less. Consumer spending is to contract by 0.8% this year, and may start growing in 2014 (+0.3%). Relatively brisk growth in the emerging markets gives some help to euro area exports, but it does not change the overall gloomy picture. Euro area GDP will contract by 0.4% in 2013, but growth is forecast to go into positive territory in 2014 (0.9% of GDP).

Subdued economic activity coupled with low core inflation and modest rise in unit labour cost will contribute to a rate of inflation in the euro area of +1.6 - +1.8% throughout the forecast horizon, which is close to the ECB's medium-term target of slightly below 2%.

TABLE: MAIN INDICATORS OF EMAC CONSENSUS
y-o-y growth rates unless specified otherwise, in %

	2010	2011	2012	2013p	2014p
Gross Domestic Product	1.8	1.4	-0.6	-0.4	0.9
Private consumption	0.8	0.1	-1.3	-0.8	0.3
Public consumption	0.7	-0.1	-0.4	-0.4	0.0
Gross investment (GFCF)	-0.8	1.5	-4.1	-2.3	1.3
Exports	11.2	6.3	2.7	2.6	4.7
Imports	9.6	4.2	-0.9	1.0	3.8
Unemployment rate	10.1	10.1	11.4	12.2	12.4
Prices (HCPI)	1.6	2.7	1.3	1.8	1.6
Government budget balance (% of GDP)	-6.0	-4.1	-3.5	-2.9	-2.5
Public debt (% of GDP)	85.4	88.1	93.1	93.8	95.7

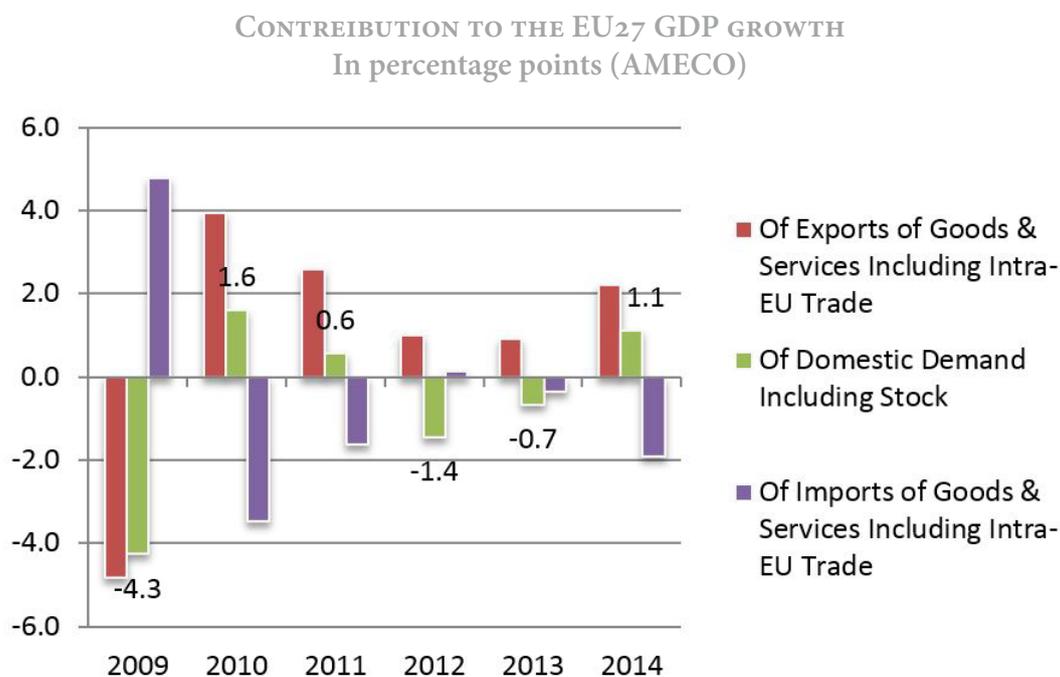
2010, 2011 and 2012 figures are fact (DG ECFIN); 2013 and 2014 are current EMAC projections

Although negative risks have recently receded somewhat, the European economy risks taking a long while to recover as there is no effective growth strategy in place to give a strong impetus for re-starting a sustainable business activity. A prospect of prolonged below-potential growth, compounded with ageing population and heavy debt burdens in all sectors of the economy, present a formidable challenge to the EU policy-makers.

2. DOMESTIC ECONOMY

Political and economic uncertainty is prevalent on a number of fronts in the euro area. The much-anticipated Italian elections resulted in a less-than favourable outcome, with no party winning clear majority. The outburst of the crisis in Cyprus has added one more element to the keychain of the euro area programme countries. The turbulence in Cyprus is echoing in other countries such as Malta and Latvia. Troubled messages are also coming out of Slovenia, where the economic data is looking somewhat shaky.

Overall, the entire region is being overwhelmed with the **reform and (fiscal) consolidation fatigue**. Euro area recovery will be export-led, coupled with a gradual improvement in domestic demand (see graph below).

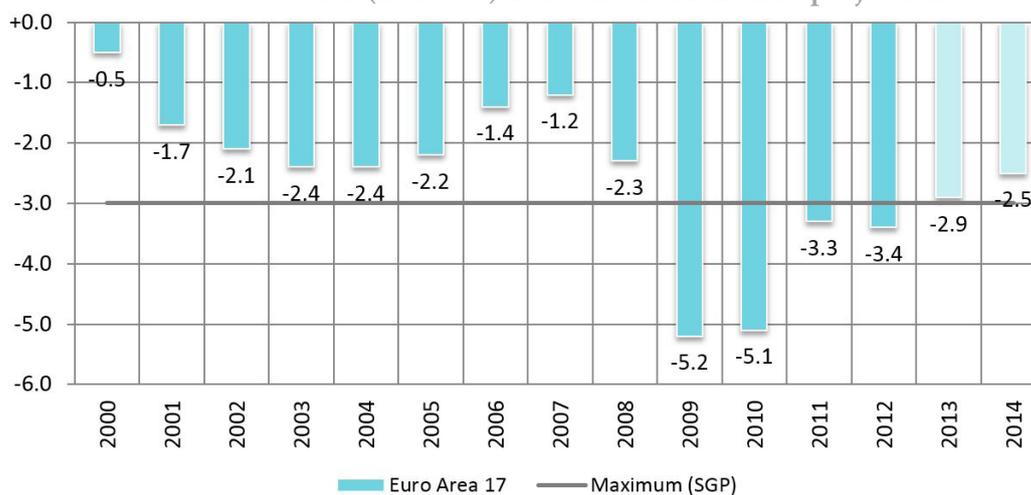


a. Fiscal policy and the economy

2013 is yet another year of contractionary **fiscal policy** right across the euro area perimeter. Fiscal consolidation is expected to ease in its intensity towards the end of 2014 (public consumption is expected to contract in 2013 by 0.4%, and is to remain unchanged next year). Of the large euro area countries, France remains an exception: it is still to introduce a number of fiscal reforms over the next two years.

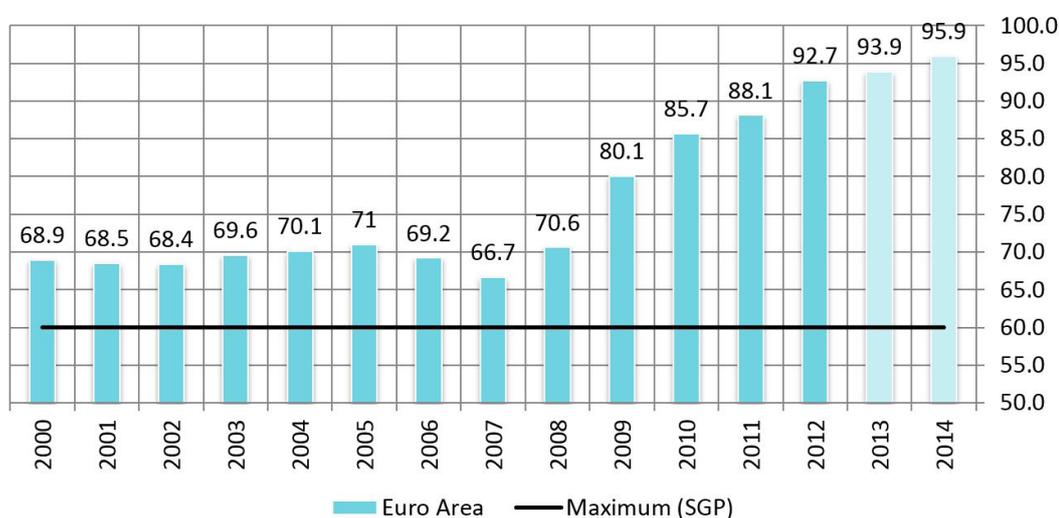
A number of euro area governments made a substantial effort to reduce government spending and achieve a primary budget surplus. This effort yielded some fruit: at the level of the euro area as a whole, both this year and next are expected to result in a less than 3% **government budget** (cyclically unadjusted) deficit. That said, more effort is required to bring budgets to an actual balance or even surplus, in order to escape from the downward spiral of debt accumulation. This may lead to a prolonged period of stringent fiscal discipline, leaving private sector on its own in an attempt to re-start economic growth in the euro area, while trying to support economic growth with a sounder fiscal environment in the medium term. Policy-makers are called upon to undertake the needed labour market and tax reforms so as to enable the revival of the private sector's economic activity.

GENERAL GOVERNMENT BUDGET BALANCE :
% of GDP (Eurostat) 2013 and 2014: EMAC projections



In the meantime, euro area's **government debt** rose to 93%, and will continue growing to just about 96% by the end of 2014. This phenomenon is inevitable in the context of a continued crisis, as well as governments being in the middle of the process of budget consolidation. To get the euro area economy into a healthy state, the level of debt will have to come down significantly, and this will take a while. Prolonged fiscal austerity is considered to be politically unacceptable. Economic growth, coupled with the objective of a primary fiscal surplus, would help bring down the debt ratio, a welcome development for all parties involved. Essentially, this is the goal that the EU Treaty on Stability, Coordination and Governance¹ in the Economic and Monetary Union (also known as "fiscal compact") tries to achieve among others.

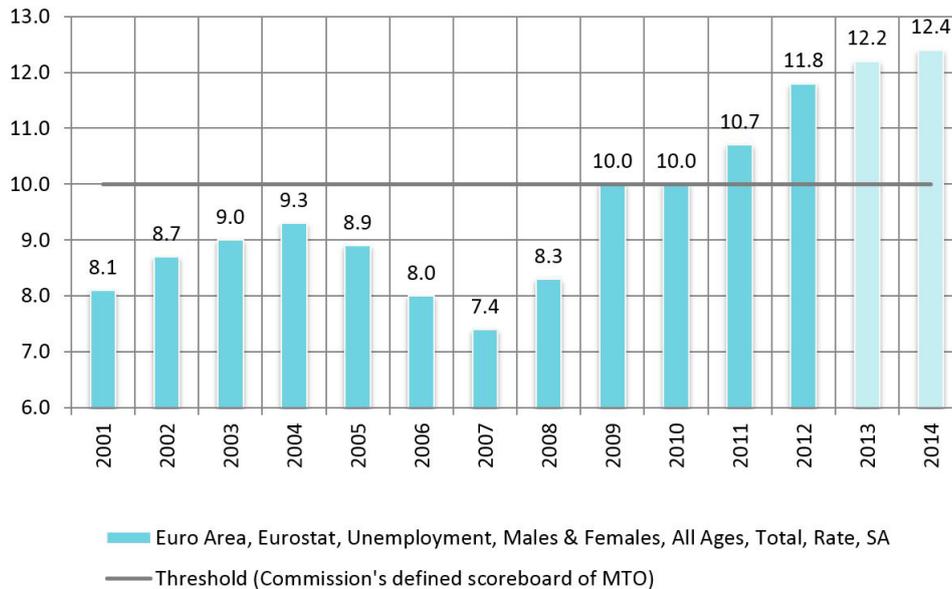
GENERAL GOVERNMENT CONSOLIDATED GROSS DEBT:
% of GDP (Eurostat) 2013 and 2014: EMAC projections



Weak economic sentiment and meagre performance of industrial production in 2012 is expected to continue into 2013, with a very gradual recovery towards 2014. This is one of the key underlying reasons for a continued growth in the **unemployment** rate in the euro area. It is expected to remain at an elevated 12.2-12.4%.

¹ See <http://www.european-council.europa.eu/home-page/highlights/fiscal-compact-enters-into-force-on-1-january-2013?lang=en>

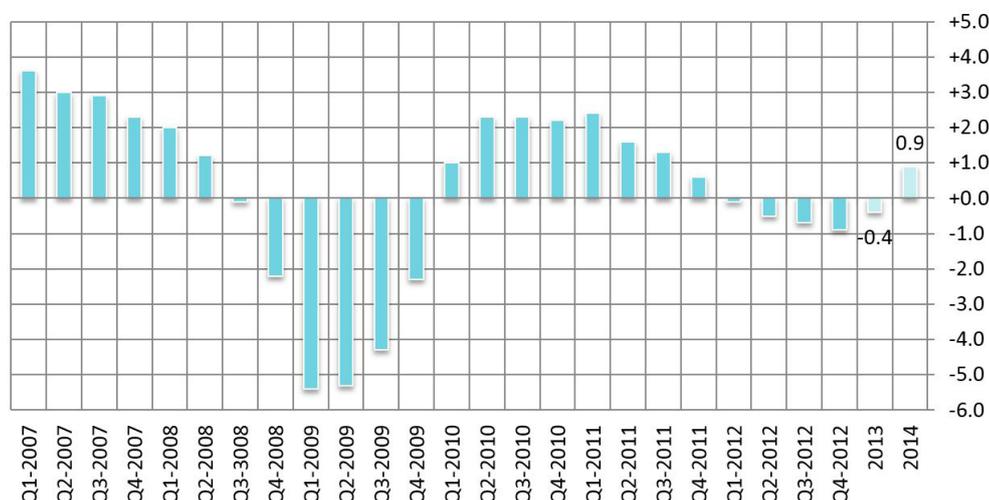
EURO AREA UNEMPLOYMENT RATE: % (Eurostat)
2013 and 2014: EMAC projections



The unemployment level remains high because euro area companies are not engaging staff. They are facing high degree of uncertainty about the development of their national economy, the soundness of the financial system and even about the future of EMU. Since the domestic near-term prospects do not appear bright, most euro area companies are not developing new business (nor taking on new bank loans for investments). Today's level of industrial production is mainly supported by export markets which develop at a healthier rate than those of the home economy. As a result, exports are growing at a faster pace than imports. This helps improve the euro area's trade balance. Euro area **exports** are expected to grow by 2.6% this year and 4.7% next, while imports are forecast to grow by 1% in 2013, and will pick up to 3.8% in 2014.

Investment (GFCF) is viewed to fall by 2.3% in 2013, tenderly picking up the pace in 2014 to +1%. Effects of continued deleveraging will continue to be felt. Economic adjustment is taking place at all levels: financial, fiscal, corporate and individual levels. The forbearance measures currently discussed by the European Banking Authority² aim at banks shedding low-quality assets, which may create a further impact on bank lending figures, and on the economy as a whole. All effects combined will dampen the overall economic performance in the euro area: GDP growth is expected to remain below zero in 2013. The following year promises a meagre yet positive economic growth of +0.9% of GDP.

EURO AREA GDP, QUARTERLY ANNUAL GROWTH RATE: % (Eurostat)
2013 and 2014: EMAC projections



² See <http://www.eba.europa.eu/News--Communications/Year/2013/EBA-consults-on-supervisory-reporting-for-forbeara.aspx>

The urgency of the need for sustainable long-term investment has become apparent in the EU, as well as for the G20, OECD, G30 and other important international bodies. Notably, the European Commission has recently launched a consultation on the *Green Paper on the Long-term Financing of the European Economy*³. The EMAC's Chief Economists welcome Commission's initiative, and believe that focused and targeted steps aimed at economic revival are crucial to the livelihood of industrialised economies, notably that of the EU.

Box: Reflections on the Single Supervisory Mechanism as part of the European Banking Union

Market fragmentation and the **vicious circle, linking sovereign and banking risks**, have given rise to an unsustainable divergence in funding costs among the euro area countries. Both problems are also a key obstacle for the proper functioning of the transmission of monetary policy.

Therefore, the European Banking Union is a natural step for the euro area to take, and one which will **underpin the Monetary Union** by removing national borders within the euro area, where greater convergence is needed, and thus advancing towards a higher state of political, financial and fiscal integration in the long run. Today, it remains a formidable challenge, as the current solution for the Banking Union foresees membership only of the euro area countries and any other EU member states that are willing to join. This fragmentation is not just financial, but is also highly political.

Banking Union includes **four elements**: a Single Rulebook; a Single Supervisory Mechanism (SSM); a Single Resolution Mechanism (SRM) with a resolution authority managing banking crises; and effective financial backstops. The development of these four elements is fundamental to avoiding asymmetries.

The SSM will undoubtedly impact European banks at various levels. Firstly, it will affect the **relationship between banks and supervisors**, since it entails a deep change of mentality and working procedures for all European banks, as well as for national supervisors. Secondly, it will favour the **level playing field** by creating uniform standards for bank supervision, thereby reducing unjustified national divergences in regulation. But this means that the Supervisory Board of the ECB (as well as the preparatory staff) should be as independent as possible from political and national pressure. However, this does not imply that the SSM should have the same guarded behaviour as is customary in monetary policy decision-making. Openness and transparency should be essential parts of supervision.

Centralising supervision in the ECB does not imply disregarding the expertise and knowledge that today's national supervisors possess. Especially in the initial phase of the SSM, it is of utmost importance to have close exchanges and discussion with the current supervisors.

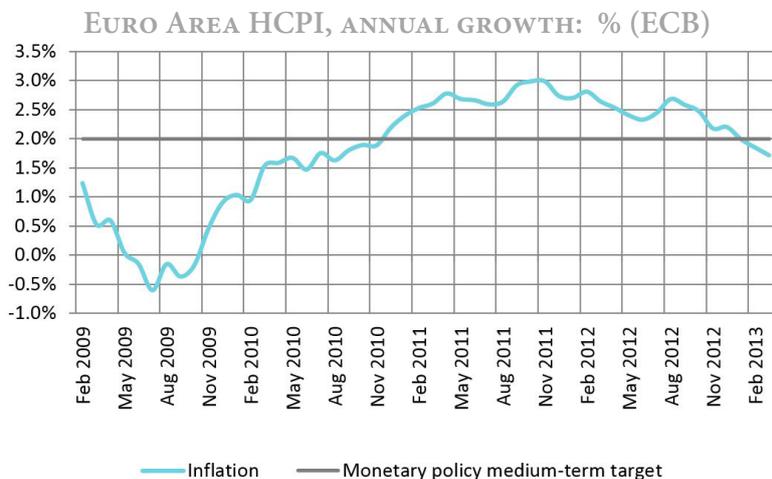
As for macro-prudential supervision, given the dynamic nature of the macro-prudential approach, the ability of credit institutions to foresee and to internalise the new potential requirements in their decision-making process will become a competitive factor. This will be apparent both in terms of a competitive advantage for some banks, and in terms of disadvantages coming from home authorities, some being more predictable than others. Any level of unpredictability in macro-prudential decisions may make it harder for the whole banking sector to manage their resources and to plan their operational strategies. As a result, **coordination between national authorities and the ECB** will be essential, so the requirement to cooperate on this issue must be made explicit and be governed by protocols.

Finally, in a system with **centralised supervision and decentralised resolution**, conflicts of interest could arise. Therefore, a Single Resolution Authority (SRA) will be essential within the European Banking Union in order to centralise and harmonise criteria, thus reducing the uncertainty of the process; to reduce the delay in the implementation of measures; and to avoid the lack of incentives to minimise the cost for the European taxpayer which national authorities often exhibit.

³http://europa.eu/rapid/press-release_IP-13-274_en.htm

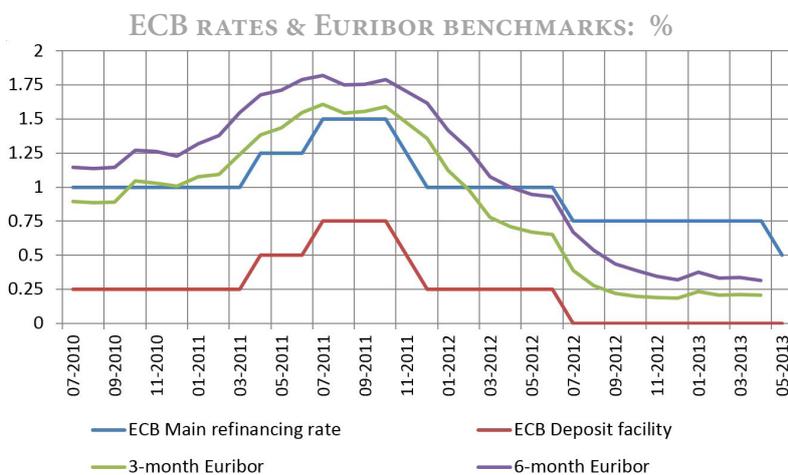
b. Inflation and monetary policy outlook

EMAC's Chief Economists expect monetary policy in the euro area to remain broadly accommodative (this approach to monetary policy is echoed in the US and Japan). The ECB's **monetary policy stance** has eased financial conditions and helped contain sovereign bond spreads. However, adverse economic conditions and continuing restructuring of the banking sector prevent financial conditions from improving and from spilling over to the real economy. This has also had an effect on **inflation**: from last year's highs, it is expected to fall to 1.8% in 2013, and decelerate further to 1.6% next year.



The ECB's main refinancing rate has recently been cut to 0.5%. This is yet another step towards stimulating economic growth in the euro area, although the transmission mechanism in some peripheral countries of the euro area has been largely broken for some time now (the 0.0% rate of the deposit facility is the actual driver of market interest rates today). And yet, it is in those countries that bank lending is lagging behind, and where it is desperately needed to help restart the economy. The ECB may want to consider measures restoring the transmission mechanism in the euro area periphery, as well as additional measures aimed at improving access to bank lending for firms. On the other hand, it should be borne in mind that low bank lending is also due to low credit demand in many euro area countries.

At the same time, the witnessed expansive monetary policy in the euro area is unprecedented, and causes concern as to the possible consequences it may imply. As part of the review of its role in the monetary union the ECB should also consider redefining its role as a lender of last resort.



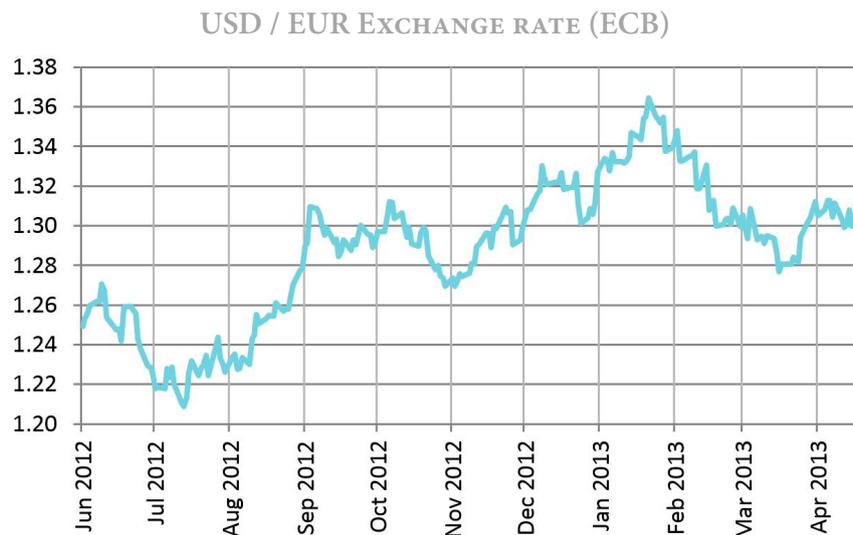
In light of the delayed economic recovery in the euro area, the ECB is not expected to raise its interest rate over the forecast horizon.

c. The euro

The **euro** is expected to depreciate against the US dollar: from 1.33 US\$/€ at the end of 2013 to 1.26 US\$/€ by

the end of 2014. Chief Economists see a number of reasons for that:

- the risk of a possible fiscal cliff has receded recently, and the US economy is now expected to grow at a healthy rate of above 2% both this year and next; this is in a stark contrast to the euro area economy, which struggles to dive out from the depths of prolonged recession;
- the euro in terms of purchasing-power parity is overvalued against the dollar; this gives rise to the expectation that in the medium term the parity will be restored;
- the likely exit from the quantitative easing and monetary policy tightening towards the end of the year in the US is already strengthening the dollar; the trend is to become more pronounced over time;
- finally, markets' weak growth outlook for the euro area will contribute to the depreciation of the euro.

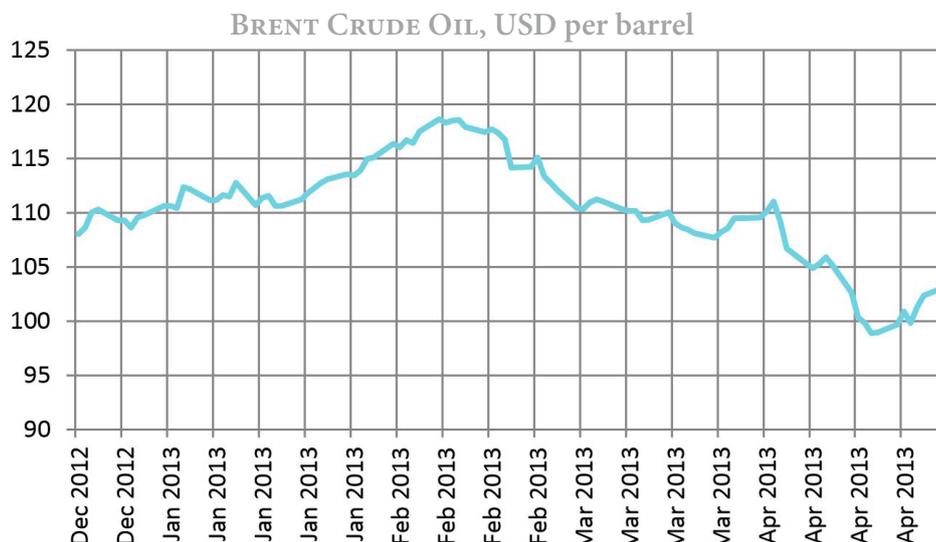


3. GLOBAL ECONOMIC ENVIRONMENT

Since the start of the crisis, the dynamics between the euro area and the external environment has flipped. The over-indebtedness of many euro area countries is having a negative impact on global growth. In turn, slowing global growth puts a cap on euro area exports, thus dampening economic expansion at home.

On the positive side, global economy - excluding Europe - is gradually moving back towards its potential growth. Since a large share of euro area business is export-oriented, this development will bring a badly needed boost to the euro area's economy.

At the same time, easing in the energy markets will help manufacturing grow. EMAC's Chief Economists expect the **Brent crude oil** price to descend from around 110 USD / barrel at the end of 2012 to around 107 USD / barrel throughout the forecast horizon.



4. RISKS TO THE SCENARIO

Since the outlook on the euro area remains relatively grim, the risks to the scenario remain significant. Many of the risks listed below have a low probability, but their large number call for policy-makers to choose a sustainable and consistent approach to tackling the crisis, in order to be able to pull the euro area out of recession.

Risks in Europe

- + German economy may experience a stronger pickup in growth than expected.
- + Faster return of confidence and diminished tensions in the financial markets owing to fiscal consolidation, structural reforms, and restructuring of the banking sector.
- + Loosening of fiscal targets may lead to higher growth in the short term, given the fiscal multipliers that are part of the forecasts.

- Cyprus’ depositor-bail-in; ability of Cyprus to lift capital controls, and subsequent possible contagion risk.
- Post-election political outlook in Italy.
- Worsening economic outlook in France: may affect European economic integration, not least it could affect relations with Germany.
- Banking sector vulnerabilities in Spain (and reluctance of the Spanish authorities to apply for official aid).
- The outcome of the German elections in September may play a big role in furthering European economic integration.
- Ongoing political risks related to populist, anti-EU political forces.
- Rising social discontent related to protracted fiscal / economic austerity.
- Rising unemployment and the consequences it brings.
- Tightened bank lending and its effect on domestic demand.
- Lack of willingness in Europe to advance with economic integration, causing negative repercussions of investor confidence and undermining financial conditions.
- Delays in the European institutional reforms (Banking Union; Single Resolution Mechanism).
- A double-edged sword of the economic policy risk: lacking progress in consolidation and structural reform on the one hand, and adjustment/reform fatigue on the other.
- Lack of domestic demand out of fear of future financial crises and its possible negative impact on the economy.

Risks emerging from the global environment

- + Stronger than anticipated external demand.
- + Positive spillovers from expansionary monetary policies in the USA and Japan.

- Stronger than expected moderation of growth in China and other BRIC countries may take place as a result of real estate sector bubbles.
- In the USA, fiscal consolidation may weaken the economic recovery more than expected in the short term.
- New monetary policy regime in Japan may result in currency war, bringing about negative consequences to the euro area.

ANNEX

END-YEAR POLL ON THE EURO AREA ECONOMIC OUTLOOK FOR 2013

TABLE 1	2010	2011	2012	EMAC Consensus 2013			2013		
				2013 mean	2013 range	Earlier EMAC Outlooks		Commission's Forecasts	
						end-year 2012	mid-year 2012		Spring 2013
1. Output and aggregate demand:									
	(Ann.% change)								
Gross domestic product (GDP)	1.8	1.4	-0.6	-0.4	-0.8	0.0	0.1	1.0	-0.4
Private consumption	0.8	0.1	-1.3	-0.8	-1.5	-0.3	-0.3	0.5	-0.9
Public consumption	0.7	-0.1	-0.4	-0.4	-0.5	-0.2	-0.6	0.0	0.0
Gross investment (GFCF)	-0.8	1.5	-4.1	-2.3	-4.6	-1.5	-0.5	1.2	-2.6
Exports	11.2	6.3	2.7	2.6	1.2	3.9	3.4	3.7	2.2
Imports	9.6	4.2	-0.9	1.0	-1.7	3.0	2.1	3.2	0.5
2. Labour market and prices:									
	(Ann.% change)								
Unemployment rate (%)	10.1	10.2	11.4	12.2	11.0	12.7	11.7	11.0	12.2
Wages (Unit Labour Cost)	-0.7	0.9	1.3	1.2	0.9	1.6	1.4	1.4	1.4
Prices (HCPI)	1.6	2.7	2.5	1.8	1.5	3.0	1.8	1.8	1.6
Core HCPI	1.6	2.0	1.5	1.4	1.3	1.7	1.4	1.5	
3. Public finances:									
	(% GDP)								
Government Balance	-6.0	-4.1	-3.5	-2.9	-3.2	-2.6	-2.9	-2.9	-2.9
Government Debt	85.4	88.1	93.1	93.8	79.0	97.1	95.0	92.3	95.5
4. External sector:									
	(% GDP)								
Trade Balance	0.6	0.5	1.6	1.8	1.3	2.1	2.0	0.5	2.2
Current Account Balance	0.3	0.2	1.8	1.5	0.4	2.3	0.8	0.3	2.5
(p.m.) US growth (Ann.% change)	2.4	1.8	2.2	1.8	1.5	2.1	2.0	2.3	1.9
(p.m.) Oil price (Brent) (US\$/bl)	80.2	110.9	111.8	107.3	100.0	120.0	110.5	111.7	104.9
5. Monetary and financial indicators:									
Interest rate on ECB's main refinancing operations	Jun-13	1.00	1.00	0.65	0.50	0.75	0.67	1.00	
	Dec-13	1.00	1.00	0.63	0.25	0.75	0.69	1.10	
3 month interest rate (EURIBOR)	(year-end)	1.02	1.39	0.27	0.10	0.60	0.45	1.12	
10 year government bond yield (Bund)	(year-end)	3.36	2.65	1.76	1.20	2.00	2.09	2.82	
M3 growth	(annual growth)	1.1	1.5	3.10	2.50	3.50	2.94	3.16	
Credit to private sector (M3 definition)	(annual growth)	1.9	1.6	-0.20	-0.40	0.00	0.83	2.00	
Exchange rate USD/EUR	(year-end)	1.34	1.29	1.28	1.33	1.20	1.90	1.25	1.35

END-YEAR POLL ON THE EURO AREA ECONOMIC OUTLOOK FOR 2014

TABLE 2		2010	2011	2012	EMAC Consensus 2014			2014	
					2014 mean	2014 range	Earlier EMAC Outlooks	Commission's Forecasts	
							end-year 2012	<u>Spring 2013</u>	
1. Output and aggregate demand:									
(Ann.% change)									
	Gross domestic product (GDP)	1.8	1.4	-0.6	0.9	0.0	1.6		1.2
	Private consumption	0.8	0.1	-1.3	0.3	-1.4	1.0		0.7
	Public consumption	0.7	-0.1	-0.4	0.0	-0.5	0.5		0.5
	Gross investment (GFCF)	-0.8	1.5	-4.1	1.3	-3.2	3.0		2.3
	Exports	11.2	6.3	2.7	4.7	2.1	7.6		4.9
	Imports	9.6	4.2	-0.9	3.8	0.2	7.6		4.7
2. Labour market and prices:									
(Ann.% change)									
	Unemployment rate (%)	10.1	10.1	11.4	12.4	12.0	13.0		12.1
	Wages (Unit Labour Cost)	-0.7	0.9	1.3	1.0	0.1	1.8		0.8
	Prices (HCPI)	1.6	2.7	2.5	1.6	1.2	2.0		1.5
	Core HCPI	1.6	2.0	1.5	1.4	1.1	1.7		
3. Public finances:									
(% GDP)									
	Government Balance	-6.0	-4.1	-3.5	-2.5	-3.2	-2.1		-2.8
	Government Debt	85.4	88.1	93.1	95.7	93.5	98.9		96.0
4. External sector:									
(% GDP)									
	Trade Balance	0.6	0.5	1.6	1.8	1.3	2.2		2.4
	Current Account Balance	0.3	0.3	1.8	1.6	0.6	2.3		2.7
(p.m.) US growth	(Ann.% change)	2.4	1.8	2.2	2.7	2.4	3.1		2.4
(p.m.) Oil price (Brent)	(US\$/bl)	80.2	110.9	111.8	106.7	95.0	130.0		99.2
5. Monetary and financial indicators:									
	Interest rate on ECB's main refinancing operations	Jun-14	1.00	1.00		0.64	0.25	1.00	
		Dec-14	1.00	1.00		0.73	0.50	1.25	
	3 month interest rate (EURIBOR)	(year-end)	1.02	1.39		0.57	0.10	1.30	
	10 year government bond yield (Bund)	(year-end)	3.36	2.65		2.24	1.30	3.00	
	M3 growth	(annual growth)	1.1	1.5		4.00	4.00	4.00	
	Credit to private sector (M3 definition)	(annual growth)	1.9	1.6		1.23	0.70	2.00	
	Exchange rate USD/EUR	(year-end)	1.34	1.29	1.28	1.26	1.10	1.40	1.35

