European Banking Federation

END-2013 ECONOMIC OUTLOOK

ON THE EURO AREA ECONOMY
IN 2013-2014

Keep The Momentum!

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 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

Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

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

Thanks to the joint actions of all parties involved[1], the euro area has started to turn the corner and gradually climb out of recession. While this has been having a calming effect on the financial markets, it does not mean that the euro area is out of the woods yet. The European Banking Federation's Economic and Monetary Affairs Committee's Chief Economists[2] stress that EU leaders should focus more than ever on pressing on with Banking Union and economic structural reforms, in order to ensure a stable and sustainable recovery. This year is expected to yield a negative growth of 0.4% for the euro area GDP, and only next year GDP is seen to increase by 1%. Unemployment remains a cornerstone of concern, levelling off at 12.1% till end-2014, a level that is far too high.

Table: Main indicators of EMAC consensus

y-o-y growth rates unless specified otherwise, in %

	2011	2012	*2013p*	*2014p*
Gross Domestic Product	1.6	-0.7	*-0.4*	*1.0*
Private consumption	0.3	-1.4	*-0.6*	*0.5*
Public consumption	-0.1	-0.5	*0.0*	*0.1*
Gross fixed investment (GFCF)	1.6	-4.0	*-3.4*	*1.5*
Exports	6.5	2.5	*1.5*	*4.2*
Imports	4.5	-1.0	*0.4*	*3.7*
Unemployment rate	10.2	11.4	*12.1*	*12.1*
Prices (HCPI)	2.7	2.5	*1.4*	*1.4*
General Government balance (% of GDP)	-4.1	-3.7	*-3.1*	*-2.8*
General Government debt (% of GDP)	88.0	92.7	*95.5*	*96.6*

2011 and 2012 are data (Eurostat); 2013 and 2014 are current EMAC projections

Owing to quite a weak economic activity, inflation is expected to remain low, at 1.4% on average, through till the end of 2014. Moreover, moderate growth of the global economy helps keep energy prices from rising. The compound effect of all of the above implies that the ECB will continue its expansionary monetary policy, and keep the main refinancing rate at a low level until the end of 2014, at least. On the other hand, there are no general deflation risks. Inflation expectations are well anchored in a range around 2%. Furthermore, the recent appreciation of the euro, which lowered import prices, will most likely not continue in the coming months. However, in some Member States the risk of deflation is real.

National governments have been tightening their belts, and the euro area general government deficit is expected to result in-3.1% in 2013, and improving to-2.8% next year.

External economic environment is a mix of upside and downside risks, including concerns about the US fiscal situation, and the uncertainty of the Japanese economic strategy. On balance, growth in the Emerging Markets is expected to slow only slightly, thus providing a continuous demand for the euro area exports.

1 Those, inter alia, are: the European Central Bank and its expansionary monetary policy, the European Commission and its coordination of economic policies and recommendations to the Member States, the euro area national governments who implemented the tough measures in their home markets, banks and other financial market players who started putting in place new regulation, cleaning up their balance sheets and re-structuring.

2 Further in the text: EMAC's Chief Economists

2. Domestic Economy

After six quarters of contraction, the second quarter of 2013 showed a moderate growth in the euro area, an indication to the markets that a gentle economic recovery has begun. Early signs suggest that it will keep this pace in going forward: the annual euro area GDP growth in 2013 will still remain in the negative: -0.4%, but from 2014, a gentle pickup in growth is expected: +1% for 2014 is pencilled in by the Chief Economists. A further slowing of inflation would be a worrying indicator of a (still) fundamentally weak economic environment with low demand and negligible growth, presenting a formidable challenge for the policy-makers.

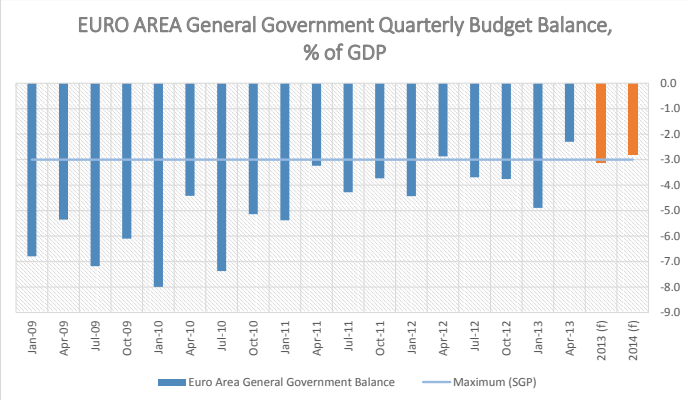
Fiscal policy and the economy

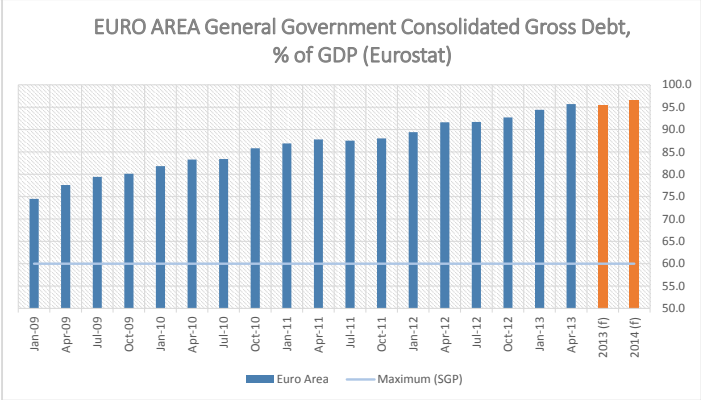
After years of belt tightening, 2013 became a year of a gradual easing of the **fiscal policy** stance. This comes as a relief to some observers, as reality has shown that austere fiscal policy does indeed lead to a GDP contraction. On the other hand, the tremendous loss of investors' confidence severely limited the alternatives to this policy. This year, the euro area's general government budget balance will arrive at-3.1% of GDP, improving to-2.8% in 2014. General government debt is expected to reach 95.5% and 96.6% of GDP respectively.

National governments are indeed in a conundrum: they are to stimulate national economies on the one hand, and to reduce the size of the government - especially on the expenditure side - on the other. This means that the simplest way to boost economic growth is out of their hands, and smarter solutions are necessary. Having lagged behind with structural reforms, so strongly called for by the Commission, OECD and IMF in the early 2000s, the EU Member States are now doing better. The EU level policy coordination mechanism, i.e. **the European semester of policy coordination** and all the processes and reports associated with it, are now in place. They facilitate the enforcement of structural reforms, though there is still room for improvement. That said, structural reforms in times of crisis are not the easiest of tasks, and progress in big EU Member States, such as France and Italy, has been only partial and, therefore, disappointing. Nonetheless, for the European Union to survive and thrive in the long term, a reform agenda with a coordinated fiscal consolidation at the Union level must be implemented.

> **" For the european union to survive and thrive in the long run, a reform agenda and a coordinated fiscal consolidation at the union level is required."**

One of the main goals currently pursued at EU level, including with the help of the Intergovernmental Treaty on Stability, Coordination and Governance, is to reduce the current debt ratios of Member States. It is a long-term vision for the EU, which aims to create a more stable and foreseeable environment for domestic and foreign investment, and for innovation, thus increasing the long-term growth potential of Europe. Even though in the short term it may cause pain through governments' belt-tightening, the Fiscal Compact will have a positive long-term effect on the euro area economy as a whole, because it will strengthen the sustainability of public finances, which will reduce uncertainty, lower risk premia in interest rates, thus promoting investment. Thus, it is important for every national government to explain the necessity of sound public finances to its citizens and to make every effort to reach a broad-based social consensus on this.





Source: Eurostat; EMAC forecasts for 2013 and 2014

National governments have a lot of work to do. Not only do they need to come up with a creative way to re-start their engines of growth, some Member States also need to put their financial systems on a solid footing. In order to ensure a sustainable functioning of national governments and healthy competitive economy in the medium to long term, structural reforms are paramount. These reforms must focus on such issues as pension systems, labour markets, liberalisation of professions, to name but a few. Moreover, fixing the EU construction by means of establishing all elements of a solid and operational Banking Union will create nurturing conditions for productivity growth and improvement of euro area's competitiveness.

The euro area is now strongly divided, and that – in the absence of a fiscal union - translates into the need for a differentiation of fiscal policy strategies, depending on whether it is a country that was shaken by the crisis, or one that weathered the crisis better. The **ability of euro area programme countries to re-gain and maintain full access to financial markets** in the near future is tightly linked to the respective governments' commitment to re-establish debt sustainability, repair their financial sectors' balance sheets and introduce a productivity-oriented growth model. To achieve this, policy-makers and the interested parties need to show commitment. As a result, political stability and credible reform measures in these countries will be decisive. In this context, the EMAC's Chief Economists have a constructive view on Ireland (as of 2014), while the outlook for Portugal remains more uncertain.

Box 1 - Quick view on progress in some euro area countries

Greece: The economy is still in recession, but the pace of contraction is abating. Progress has been made with regaining competitiveness, reform and fiscal consolidation, but a further aid package will prove necessary and further debt restructuring/forgiveness looks likely.

Ireland: The economy has returned to growth, with the competitiveness adjustment, improving private sector demand, and structural strengths pointing to better growth prospects than in the other peripheral economies. The government is on track to meet its budget targets and has managed a successful return to the bond market. The government is on track to meet its budget targets and has managed a successful return to the bond market. The deficit is on course to fall below 3%, and the debt is no higher than others, e.g. Italy, Belgium.

Italy: The recession in the economy is abating, helped by the stronger external environment and a reduction of fiscal consolidation. Government debt will still fall over the medium-to-longer term, but a slower pace than previously projected. Italy's key weakness is its long-term growth potential.

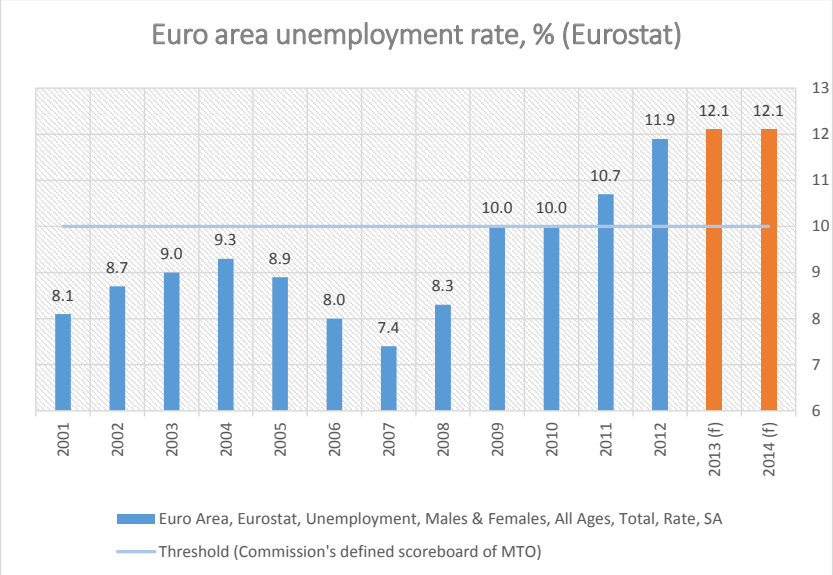
Portugal: GDP growth was strong in the second quarter of 2013, although is expected to decelerate again in the coming quarters before diving out of the negative in 2014. The EU-

IMF support package will end mid-2014. The country will probably need some extra financial support. After an energetic start, the country now seems to suffer from austerity fatigue, implying it could miss its deficit target this year, if additional measures are not implemented.

Spain: The economy is emerging from recession, benefitting from a stronger global economy and a shift in the European Commission's stance on austerity, which allowed Spain to ease the pace of budget consolidation. The country is quickly regaining competiveness. The process of restructuring the banking industry is almost complete and economic reforms are proceeding, but economy still needs to adjust.

By contrast, those euro area countries, in which the situation is sustainable, such as Germany, could make room for some well-targeted expansionary measures to support the recovery, with a clear focus on growth-supporting measures like investment in infrastructure, and in better education and research conditions. As far as government budget balance is concerned, they should focus on their capacity building with the help of lowering taxes, rather than increasing spending.

EMAC's Chief Economists hope for a fresh wave of **investment** to stimulate the euro area economy in 2014 (growth in fixed capital formation is expected to reach 1.8% in 2014), leading to a broad-based recovery of intra-European trade. This should help slow down, and eventually reverse, the pace of growth in **unemployment**, which is forecast to stay just above 12%, a level that is unacceptably high.



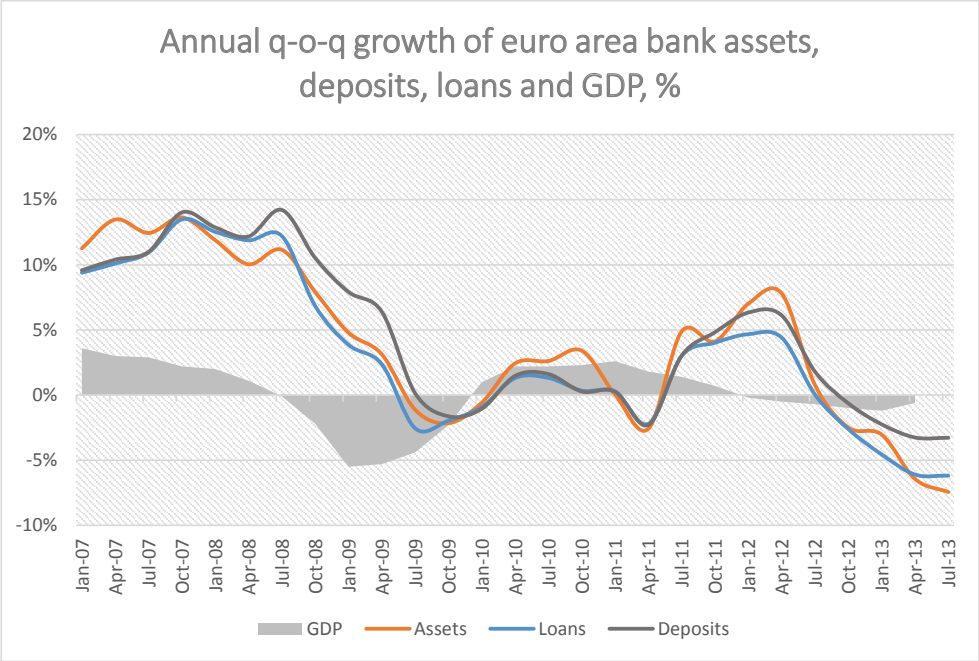
Pickup in investment and economic activity in general should help banks recover **lending to the economy**, which has been in the doldrums recently. Lending figures will not be stellar, being weighed down by continued deleveraging. As a result of important impact from the crisis and the consequent wave of regulation and restructuring, both banks' cross-border presence and cross-border service provision have fallen significantly (see Chapter 4 for a more detailed analysis). While tighter regulation was necessary, over-reaction should be avoided. Banks must be given more room to act as banks, if they are to continue playing their fundamental role as financiers of the economy. This factor will be critical, if banks are to finance growing demands for credit as the euro economy recovers.

In any event, alternative ways to support the economy, and especially Europe's Small and Medium-sized Enterprises (SMEs), are under active consideration. Those include crowd-funding, venture capitalists, export-risk guarantees by governments, pooling of loans, etc. This said, a bigger support to the SMEs (much more so than cash) would be the creation of a stable and transparent environment for them to operate in, sound infrastructure, as well as lower direct and indirect tax levels. At the same time, indiscriminate

subsidies would be counterproductive as they lead to misallocation of funds, which is unsustainable in the long run and go against the urgent need for fiscal consolidation.

> **" More than anything, SMEs now need a stable and transparent environment in which to work, rather than outright cash handouts."**

A potential brake on bank lending to the economy could come from the ECB's comprehensive assessment of banks. It may add an element of uncertainty to the markets in the near term, especially if there is no clear



agreement on what should happen if the comprehensive assessment exposes the need for additional capital.

Source: ECB, Eurostat

All things considered, the euro area **economic growth** outlook is lacklustre: significantly lower potential (trend) growth rates are expected during 2013-2018 (below 2%), compared to 2003-2008. The recovery will be mainly export-led: in 2013 exports will grow by 1.5%, followed by a stronger 4.2% in 2014 (compared to imports, which are expected to grow by 0.4% and 3.7% respectively). To facilitate economic recovery, most euro area economies must focus on regaining competitiveness. A number of ways exist to achieve that, including moderate wages (which are forecast to continue growing by 1.2% both in 2013 and 2014) and continuing comprehensive reforms both at the national level and the EU level, i.e. the Banking Union. **Weaker Member States should keep momentum** of reorienting the economy towards more productive tradable sectors. Moreover, further liberalisation of product markets, labour market reform, simplification of the tax system and amendments in the judicial system could enhance competition and competitiveness, resulting in higher potential growth. Indeed, the focus of the governments should be more on the structural reforms than on the outright numerical fiscal targets.

From a **demographic** point of view, by the time the euro area economy can get back to higher trend growth rates, the ageing population may start having a negative effect on labour supply; unless, that is, a reduction in structural unemployment takes place in counterbalance.

> **"Productivity in the euro area will increase only if structural reforms are in place."**

Monetary policy outlook and inflation

The European Central Banks' commitment "to do whatever it takes", together with the Outright Monetary Transactions (OMT) and longer-term refinancing operations (LTRO), help ensure a low interest rate environment and reduce financial market tensions. It is a way for the ECB to 'buy time' to allow the governments to implement such measures as the Fiscal Compact and the Banking Union. These reforms will take time to be put in place and take effect. For this reason, monetary policy is expected to be largely expansionary for a long time to come (while governments are to consolidate over the same period).

The EMAC's Chief Economists are of a view that the **Fed could soon start the tapering**, and let the US dollar appreciate. The ECB could follow with a lag, once the recovery in the euro area is on a more solid footing. At the same time, the Bank of Japan should put pressure on the Japanese government to deliver those structural reforms it has promised to present. Without these reforms the Bank of Japan would need to start tapering soon, otherwise there is a risk that Japan's problems are inflated away in a disorderly way with negative spill-over effects on the world economy.

The EMAC's Chief Economists welcome the ECB's effort to protect the fragile European economic recovery from the threat that could arise from the Fed's tapering. They encourage the ECB to continue coordinated actions by major central banks during the tapering phase; as well as to continue calming financial markets with forward guidance and commitments to OMT. Moreover, the ECB is urged to continue to ensure that money market conditions continue to deliver the necessary accommodative monetary policy stance.

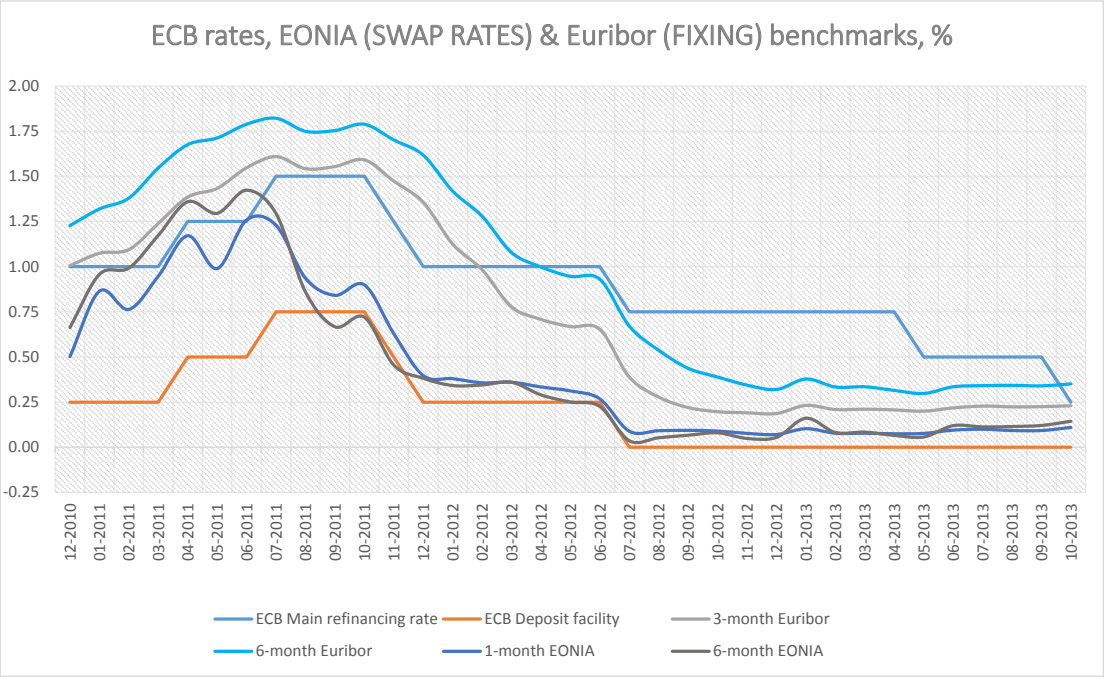
The tightening of US monetary policy is expected to lead to an increase in **longer-term (real) interest rates**, and this may also spill over to the euro area. The debt sustainability of the crisis countries may weaken somewhat, but this can be overcome by a continued fiscal consolidation and structural reforms. The impact on debt sustainability for peripheral economies should, in any event, be limited, owing to the still very accommodative stance of the ECB, given the less dynamic economic environment in Europe compared to that of the US.

> **"Rising interest rates in the us should have a limited effect on europe, if the structural reforms proceed at full speed, and the economy starts growing again."**

Regarding the need for future **liquidity** in the system, the Chief Economists' views diverge. On the one hand, early repayments of the 3-year LTROs by banks have slowed down, meaning that the liquidity surplus in the financial system is stabilising at relatively high levels, implying that liquidity is ample. This surplus has been keeping EONIA rates close to zero. The stabilisation of the liquidity surplus, therefore, reduces the risk of upward pressure on inter-bank rates.

On the other hand, unwarranted levels of short-term rates, triggered by declining excess liquidity and/or Fed tapering, are expected by some Chief Economists to necessitate a new round of long-maturity liquidity injection. These could take the form of an unconditional very long-term refinancing operation, as a substitute for traditional QE, or a targeted LTRO based e.g. on new lending. A stronger form of forward guidance tying the future path of policy rates to specific economic indicators could be more effective in anchoring short-term rate expectations. Finally, to address the persistent financial market fragmentation more effectively, liquidity provision should be designed to encourage lending to SMEs.

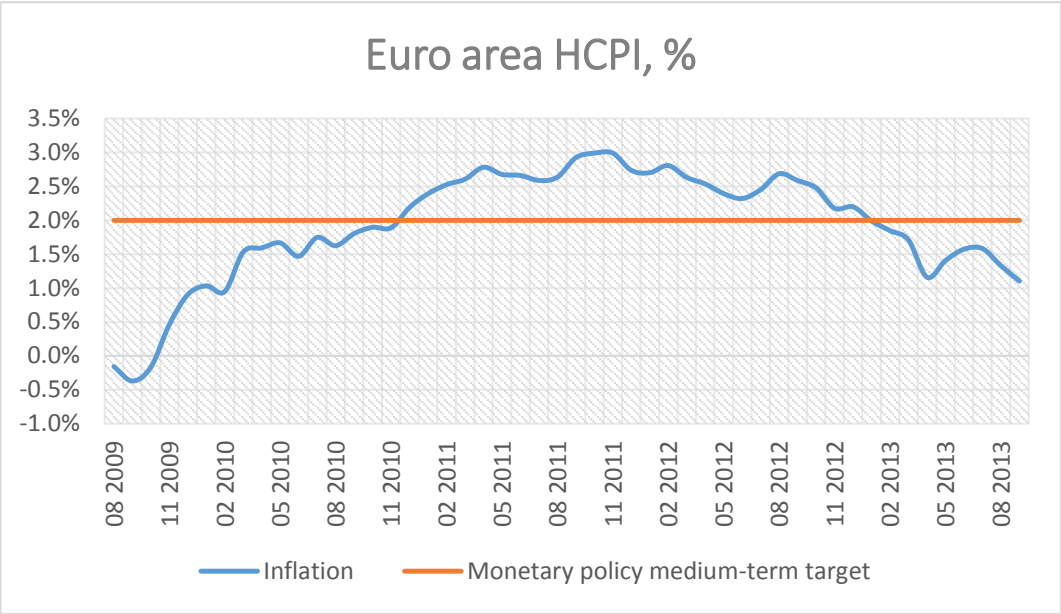
Inflationary pressure has eased substantially (annual inflation rate in September 2013 stood at 0.7%). In this light, the recent ECB's move to reduce the main refinancing rate to 0.25% aims to stimulate economic activity and avoid deflation. All things considered, the majority of the EMAC's Chief Economists agree that the key ECB rates will probably remain unchanged, at 0.25%, until the end of 2014, if not longer. That said, non-standard measures could prove more effective than policy rates in supporting recovery, because of the currently malfunctioning monetary policy transmission mechanism in the euro area.



Source: ECB

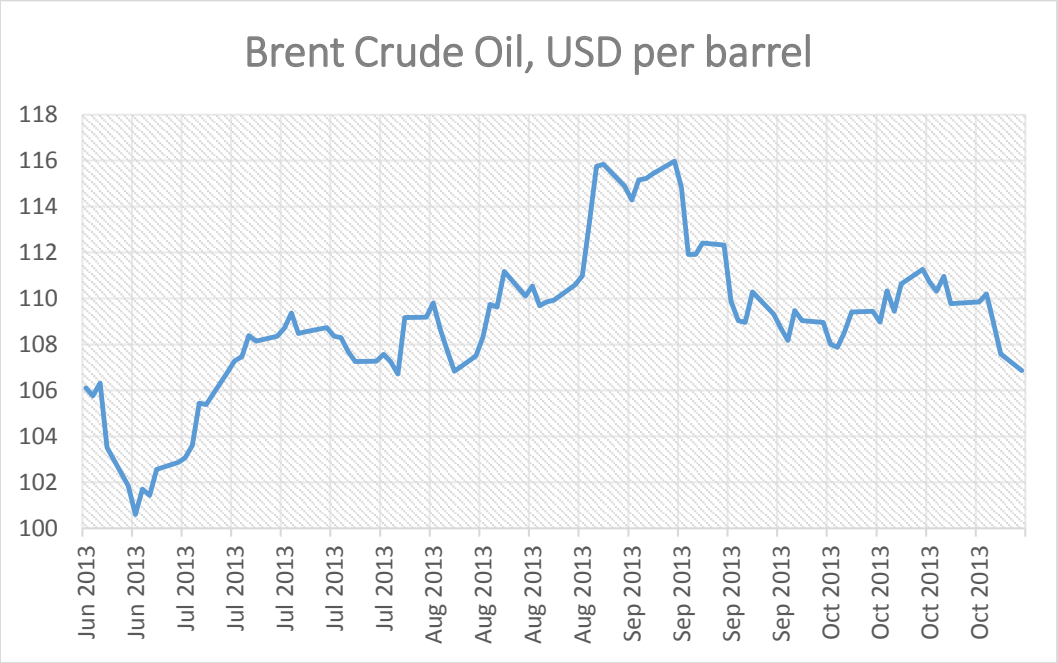
As mentioned above, the economy will be functioning below full capacity in the coming years, meaning that there will be little demand-driven consumer price inflation effects over the forecast horizon. Indeed, all segments of the economy are deleveraging: public, private, and financial. Furthermore, core inflation is set out to remain around 1% over the forecast horizon. This leaves the headline inflation outlook at a projected 1.4% for both this year and next, which is well below the ECB's target of "close but below 2%". This unusually low level of inflation is a concern to the Chief Economists.

"Subdued domestic demand will keep inflation low."



Source: ECB

Commodity price inflation will remain subdued, as well, owing to moderate global outlook for commodity-intensive emerging market economies. That said, as the world demand recovers in the medium term, crude oil prices might start rising again. So far, Brent crude oil price is expected to remain around 107.0 USD/barrel in 2013, and reduce marginally to 105.6 USD/barrel by the end of 2014, according to the Chief Economists.



Source: Macrobond

Box 2 – Impact of unconventional monetary policies on financial markets

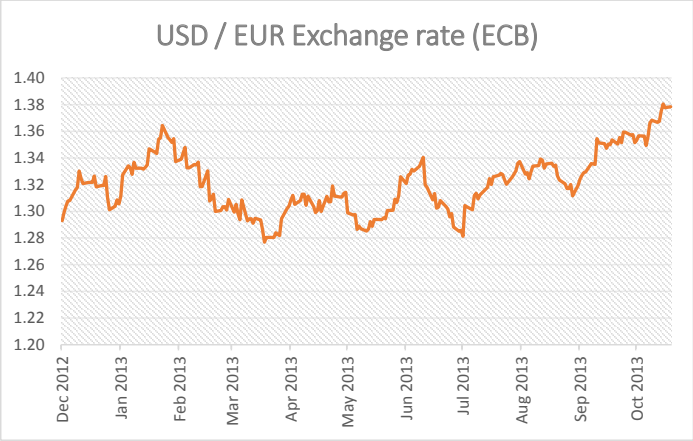
During the crisis, the stance of monetary policy in the main economic areas – Japan, the USA, UK, euro area – has been tailored to the needs of domestic economy, and this situation is still ongoing. Such an accommodating monetary stance is justified by fragile economic conditions. However, maintaining loose monetary policy for a period longer than warranted may lead to dislocations. Therefore, policy-makers have to walk a tight rope: exiting not too early so as not to stifle recovery, and not too late so as to risk the emergence of asset price bubbles. In the euro area in particular, signs of over-indebtedness fuelled by easy monetary policy are muted due to prolonged economic weakness. In addition, the ECB's unconventional measures are, by design, easier to unwind compared to those of the Fed, implying that there may be less room for mistakes in the monetary policy's exit in the euro area. Meanwhile, euro area banks should be discouraged from 'ever-greening' bad loans, financed by the ECB's liquidity largesse. In that matter, the comprehensive assessment, which has just started, is an important step in forcing banks to recognise impaired assets.

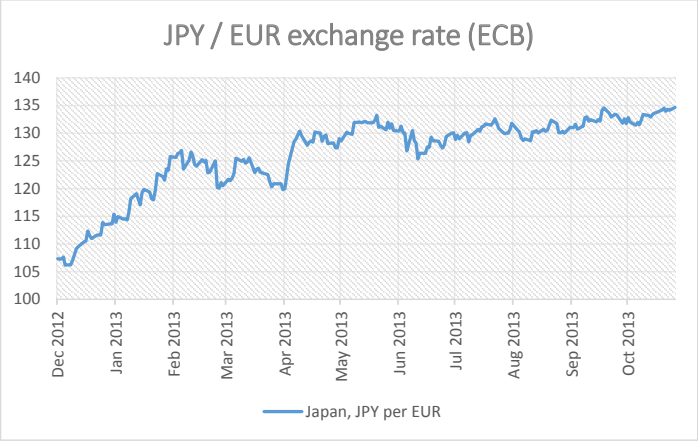
From 2008 to 2013, unconventional monetary policy measures have increased the relative value of some **emerging markets'** assets through substantial money inflows to many emerging economies, leading to sharp increases in asset prices (especially real estate prices) and indebtedness. In some countries, the situation has been made worse by inappropriate exchange rate policy, namely, fixed foreign exchange regimes. The recent reversal of these flows, caused by the announcement by the Fed that it might taper its unconventional policy measures, revealed these problems in a very tangible way. The risk is that the imbalances and bubbles in emerging countries will form a new strong headwind for the world economy and cause substantial losses for financial institutions in the euro area, which have been investing in these markets recently. This could happen through a Balance of Payments crisis in emerging markets with high dependence on external financing (current account deficit, high external debt relative to reserves).

It is therefore paramount to prepare for a post-monetary-stimulus-withdrawal world, and ensure transition to a more 'normal' environment compared to the current one. The example of Japan in the 1990's and early 2000's displays the risk of a near-impossible exit.

The euro

EMAC's Chief Economists see stabilisation of the US$/EUR exchange rate, with slight depreciation of the euro against the US dollar: 1.32 US$/EUR by the end of 2013, and 1.26 by the end of 2014. This is driven by the weaker economic fundamentals in the euro area, as well as a prospect of tapering of the Fed's unconventional monetary policy taking place sooner than that of the euro area.





Source: ECB

3. ECONOMIC AND FINANCIAL FRAGMENTATION IN THE EURO AREA AND THE EU

The past few years have seen the European financial markets and the economy fragment. This important consequence of the series of crises is now acting as an obstacle to the euro area economy's revival. Even though the process of disintegration has slowed in 2013, it is still painfully present. This is manifest in a large number of areas.

- Different developments in **bank lending** to the economy:
  - **To businesses** (especially SMEs): in distressed countries, loans to non-financial corporations have shrunk by almost 5% year-on-year in December 2012, while in non-distressed euro area countries they grew by 1.6%. The interest rates on new loans to non-financial corporations in non-distressed euro area countries stood at just above 2% at the end of December 2012, while in the distressed countries it was more than double, at 4.6%. The difference between the respective interest rates pre-crisis was close to zero[1].
  - **To households**: cross-country standard deviation of bank interest rates on loans to households for consumer lending over 1 year and up to 5 years' initial rate of fixation has increased from 107 basis points in June 2007 to 155 in December 2012. Rates on loans for house purchase of maturity between 5 and 10 years increased from 33 basis points in June 2007 to 69 basis points in December 2012.
  - **To financial institutions**: owing to a sudden drop of confidence in the wake of the crisis, the volume of inter-bank market activity has shrunk. The ECB stepped in with non-standard measures to avoid the credit crunch. Nonetheless, the indicators are indicating poor performance. Daily volumes for the EONIA panel have dropped by over 50% since the peak in 2007. Borrowing activity on unsecured money market in distressed countries fell by over 75% by end-2012 since the peak in 2007, while it fell only by a quarter in the non-distressed euro area countries.
- **Bank loan growth rates** to businesses are vastly different between the euro area countries and are increasing in Germany and France, while decreasing in Spain, Italy, the Netherlands, Portugal, Greece, and Ireland.
- Increased **risk spreads on government bonds**: the dispersion of euro area ten-year sovereign bond yields has grown substantially. The min-max range of euro area 10-year sovereign bond yields exploded from 0.3 percentage points in 2007 to 5.1 percentage points in 2012. The trend continues well into 2013, with 10-year government bond yield spreads over the bund well into the hundreds of basis points for such countries as Portugal, Greece, Italy and Spain.
- High volatility and low transaction volumes on **money markets** (especially for longer maturities);
- Declining **cross-border inter-bank claims**: euro area bank loans to banks in other euro area countries fell from 24% of all claims in September 2007 to 18% in September 2012. Those to banks in the rest of EU fell from 20% to 14% respectively.
- Share of banks' **cross-border holdings of government bonds**, which has fallen from the peak of 28% in March 2006 to just below 11% in December 2012. At the same time, domestic bank holdings of sovereign debt has grown from 67% in 2006 to 85% in 2013 (this is particularly the case for Spain and Italy).
- Increasing **TARGET2** imbalances: number of payments through the TARGET 2 system increased from 22% to 37% as a share of total payments between 2007 and 2012, although the share of total payments by value has fallen from 36% to 30% in the same period.
- **Increased spreads in Credit Default Swaps**: standard deviation of banks' CDS premia in the non-distressed euro area countries stood at 40 basis points at the end of 2012; for the distressed countries the spread was over 430 basis points. The last figure has come down substantially since the peak

1 The information on fragmentation of the euro area financial markets is extracted from the ECB, a page dedicated to the financial integration indicators: http://www.ecb.europa.eu/stats/finint/html/index.en.html

stress point due to a reduced 'convertibility risk' because of the OMT programme and the on-going consolidation efforts in many countries.

Substantial differences between Member States in bank lending reflect both supply and demand side factors. On the **supply** side, it is evident that the average financial health of banks (and the need for deleveraging) varies considerably from one country to another, affecting their ability to lend and the terms used, such as interest rates, lending conditions, etc. Likewise, the average financial health of banks' customers varies significantly from one country to another: in countries where economy is in recession or depression it is clear that the lending-related risks, such as risk of bankruptcy, risk of unemployment, risk of sudden changes in debt-servicing ability due to new taxes or wage cuts, risk of substantial declines in collateral values, are much larger than in countries where the economic situation is better. These differences are reflected in the pricing and supply of loans. As a result, the dispersion in SME lending rates between countries, for example, reflects both the financial health of banks and that of customers.

In addition, there are also **demand**-side factors affecting the differences between countries: as investment activity is low in recession/depression, so the demand for bank loans is correspondingly low. In many cases, loans are needed only for refinancing purposes, or for working capital.

Current fragmentation in financing conditions is only partly a market failure; sometimes, it is also the outcome of rational re-pricing of risks by financial markets. As a result, it is not a purely exogenous factor, but also an endogenous one. This makes it difficult to assess/isolate its impact on the economy. However, there are well known examples of corporates with similar credit risk experiencing different borrowing costs simply due to their geographic location.

The **consequences of fragmentation** are not to be underestimated. Financial fragmentation constrains economic growth prospects, reinforcing the negative feedback loop between the economy, banks, and sovereign debt. It undermines the monetary policy transmission mechanism, making it difficult for the European Central Bank to implement the monetary policy in the euro area. Fragmented markets, resulting from lower cross-country capital flows, result in higher cost of capital (money is scarce, risk *premia* go up) and ultimately affect the real economy. Moreover, fragmentation leads to a lower intensity of competition and, hence, to a less efficient provision of financial services.

The effect is exacerbated by the high dependence of European firms on banks for funding their activities. In the peripheral euro area countries, even healthy companies face tight credit conditions, hampering the re-orientation of production factors to export oriented activities.

Politically, fragmentation of financial markets is in contradiction with the European efforts to create a Single Market.

There are a number of ways to **address disintegration** of the European financial markets. In essence, fragmentation is an indicator of weakness of banks and the economy. Therefore, the solution is in making both banks and economies stronger. The primary way to tackle the reasons behind fragmentation should be to continue the consolidation of public finances, structural reforms (in product and labour markets) and cleaning up of banks' balance sheets via recapitalisations, sales of assets, mergers, asset separations, to name but a few. This will lead to a transparent, credible and enforceable set of rules for both governments and lenders and re-establish confidence in financial market stability and sovereign solvency.

The comprehensive assessment, undertaken in the framework of the Single Supervisory Mechanism, and the subsequent stress tests scheduled by the ECB and the EBA for next year should help achieve transparency and credibility. Backstops to fill capital shortfalls not covered by private markets should be in place beforehand in order to increase markets' confidence in the rigour of the assessment. Furthermore, the ECB should provide ample liquidity to banks through instruments carefully designed to target sectors such as SMEs, which depend heavily on bank credit. In coordination with the EIB, the ECB could give support to instruments which could

transfer risks out of bank balance sheets, such as SMEs' Asset Backed Securities. Asset purchases would remove credit risk from banks' balance sheets, thus encouraging financial institutions to extend credit to firms.

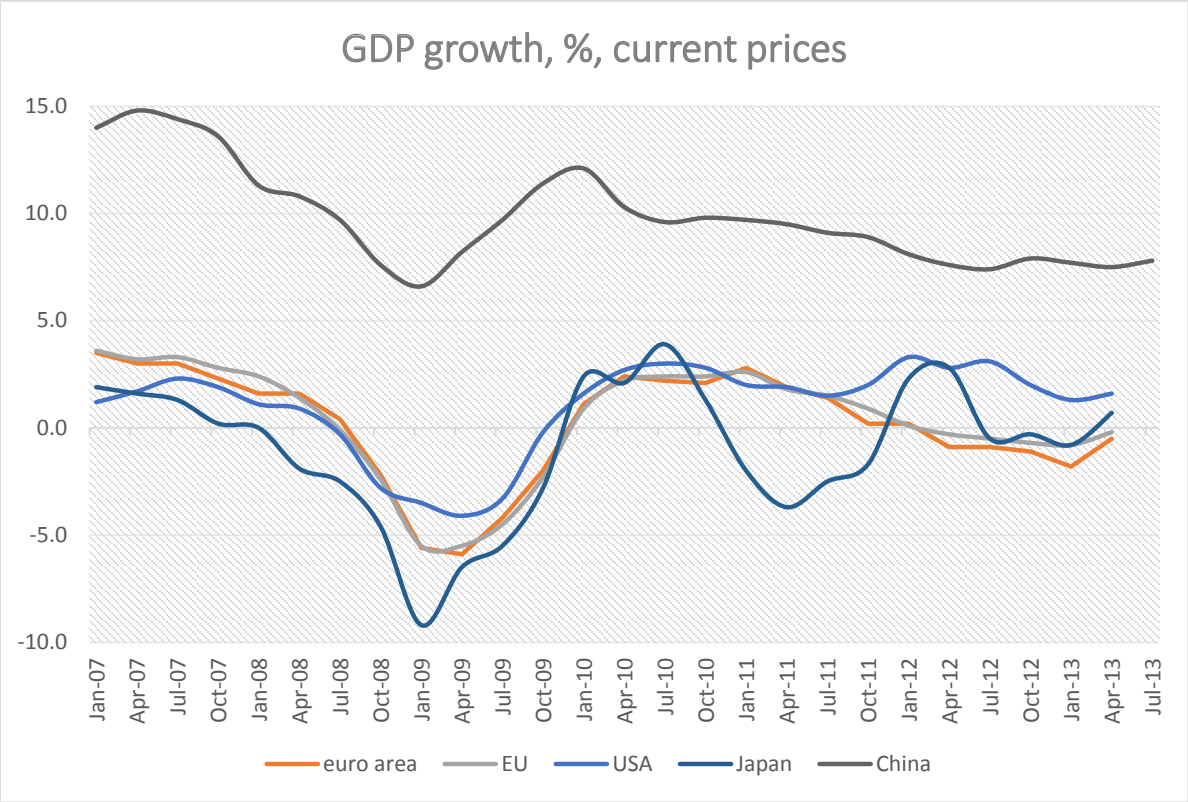
This process can be helped by EU-level actions such as targeted measures to increase banks' SME lending, but these measures can only be supportive and they should be designed so that the level playing-field is maintained (i.e. no support to zombie banks or zombie companies).

"Banking union will help achieve integration of financial markets. But that alone will not suffice. A general shift in attitude towards sound common budgetary policies is required."

4. GLOBAL ECONOMIC ENVIRONMENT

Economic growth in the **emerging markets** keeps up a relatively solid pace, although remains below the stellar pre-crisis levels. Either way, it remains a solid export market for the euro area, which will help it come out of the recession.

The **US economy** is picking up, thus giving a helping hand to the euro area. The EMAC's Chief Economists expect the US GDP to grow by 1.7% this year, and by a healthy 2.7% in 2014. The autumn worries about the US government's partial shut-down and its impact on the economy have receded, and although the uncertainty is not fully off the table, the situation now looks more stable than a couple of months ago.



5. RISKS TO THE SCENARIO

Even though the euro area is seeing shoots of growth, it is not out of the woods yet: risks to the outlook are on the downside both, economically and politically. On the one hand, numerous economic measures have already been taken, there is a better assessment of risk, and the wind is blowing in favour of more accommodative / expansionary measures. Nonetheless, many EU countries remain in a dire state vis-à-vis their debt, unemployment remains high, and the early signs of growth have not yet translated into growth in jobs. Presented below are the risks that EMAC's Chief Economists consider relevant to the current outlook for end-2013 to end-2014.

Risks in Europe

+ Quicker and lasting improvement in **economic sentiment** in Europe.
+ Faster than expected **stabilisation of financial markets** as a result of successful and rapid fiscal consolidation, structural reforms and banking sector restructuring, leading to growth in **domestic demand**.

- Increased **financial tensions** in the euro area.
- Risk of fading effort by governments to reform domestically and at EU level, given the diminished market pressure.
- Political risk that national governments and the EU Council will fail to find persuasive solutions as to how to react in the event that the ECB's comprehensive assessment discovers **grave balance sheet problems** in some banks.
- Political risk that **outstanding decisions on Banking Unio**n are delayed, or even weak, with respect to a full Banking Union, and to breaking the link between banks and sovereigns.
- ECB's comprehensive **balance sheet assessment** / stress test may speed up the deleveraging process in some cases before the year-end 2013.
- Timing and consequences of the **exit from unconventional monetary policies**.
- Risk of **deflation** in the euro area.

Risks emerging from the global environment

+ Stronger than expected rebound of global economy, contributing to increasing **confidence.**

- Possible mistakes that could be made by the U.S. Fed on its exit path, namely **tapering of asset purchases**, which may cause a Balance of Payments crisis in externally vulnerable emerging markets, affecting global financial markets and demand.
- Stronger than expected **moderation of growth in China** and other BRICs, due to real estate asset price bubbles.
- New **monetary policy regime in Japan** could lead to a currency war with negative consequences for the euro area exports.

ANNEX – SUMMARY OF THE EMAC CHIEF ECONOMISTS' POLL, 2013-2014

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

TABLE 1	2011	2012	EMAC Consensus 2013		2013		
					Earlier EMAC Outlooks		Commission's Forecasts
			2013 mean	2013 range	Mid-year 2013	end-year 2012	Autumn 2013
1. Output and aggregate demand: (Ann.% change)							
Gross domestic product (GDP)	1.6	-0.7	**-0.4**	-0.5	-0.3	-0.4	0.1	-0.4
Private consumption	0.3	-1.4	**-0.6**	-1.0	-0.5	-0.8	-0.3	-0.7
Public consumption	-0.1	-0.5	**0.0**	-0.5	0.3	-0.4	-0.6	0.0
Gross fixed investment (GFCF)	1.6	-4.0	**-3.4**	-4.2	-2.5	-2.3	-0.5	-3.3
Exports	6.5	2.5	**1.5**	1.0	2.6	2.6	3.4	1.3
Imports	4.5	-1.0	**0.4**	-0.3	1.9	1.0	2.1	-0.1
2. Labour market and prices: (Ann.% change)							
Unemployment rate (%)	10.2	11.4	**12.1**	11.8	12.3	12.2	11.7	12.2
Wages (Unit Labour Cost)	0.8	1.9	**1.2**	0.8	1.5	1.2	1.4	1.1
Prices (HCPI)	2.7	2.5	**1.4**	1.2	1.5	1.8	1.8	1.5
Core HCPI	1.4	1.5	**1.1**	0.9	1.3	1.4	1.4	
3. Public finances: (% GDP)							
Government Balance	-4.1	-3.7	**-3.1**	-3.5	-2.8	-2.9	-2.9	-3.1
Government Debt	88.0	92.7	**95.5**	93.6	97.5	93.8	95.0	95.5
4. External sector: (% GDP)							
Trade Balance	0.3	1.4	**1.9**	0.6	3.0	1.8	2.0	2.3
Current Account Balance	0.3	1.8	**2.1**	0.8	2.7	1.5	0.8	2.7
(p.m.) US growth (Ann.% change)	1.8	2.8	**1.7**	1.5	2.0	1.8	2.0	1.6
(p.m.) Oil price (Brent, annual average) USD / b	111.0	111.8	**107.0**	95.0	110.0	107.3	110.5	108.8
5. Monetary and financial indicators:							
Interest rate on ECB's main refinancing operations — June	1.00	0.10	**0.50**	0.50	0.50	0.65	0.67	
Interest rate on ECB's main refinancing operations — December	1.00	0.75	**0.25**	0.25	0.25	0.63	0.69	
3 month interest rate (EURIBOR) (year-end)	1.36	0.19	**0.22**	0.08	0.40	0.27	0.45	
10 year government bond yield (Bund) (year-end)	1.83	1.32	**1.88**	1.60	2.20	1.76	2.09	
M3 growth (annual growth)	1.5	3.0	**2.44**	2.00	2.70	3.10	2.94	
Credit to private sector (M3 definition) (annual growth)	2.1	-0.3	**-1.34**	-1.50	-1.10	-0.20	0.83	
Exchange rate USD/EUR (year-end)	1.29	1.32	**1.32**	1.28	1.35	1.33	1.25	1.33

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

TABLE 2		2011	2012	EMAC Consensus 2014			2014	
				2014 mean	2014 range		Earlier EMAC Outlooks	Commission's Forecasts
							mid-year 2013	Autumn 2013
1. Output and aggregate demand:	(Ann.% change)							
Gross domestic product (GDP)		1.6	-0.7	**1.0**	0.3	1.5	0.9	1.1
Private consumption		0.3	-1.4	**0.5**	-0.5	1.1	0.3	0.6
Public consumption		-0.1	-0.5	**0.1**	-0.3	0.6	0.0	0.3
Gross fixed investment (GFCF)		1.6	-4.0	**1.5**	-2.0	3.5	1.3	1.9
Exports		6.5	2.5	**4.2**	2.9	6.0	4.7	4.2
Imports		4.5	-1.0	**3.7**	1.8	4.8	3.8	3.9
2. Labour market and prices:	(Ann.% change)							
Unemployment rate (%)		10.2	11.4	**12.1**	11.5	12.5	12.4	12.2
Wages (Unit Labour Cost)		0.8	1.9	**1.2**	0.4	1.9	1.0	0.7
Prices (HCPI)		2.7	2.5	**1.4**	1.1	1.6	1.6	1.5
Core HCPI		1.4	1.5	**1.2**	1.0	1.5	1.4	
3. Public finances:	(% GDP)							
Government Balance		-4.1	-3.7	**-2.8**	-3.0	-2.5	-2.5	-2.5
Government Debt		88.0	92.7	**96.6**	94.0	100.2	95.7	95.9
4. External sector:	(% GDP)							
	Trade Balance	0.3	1.4	**1.7**	0.5	3.2	1.8	2.4
	Current Account Balance	0.3	1.8	**2.2**	1.0	3.0	1.6	2.9
(p.m.) US growth	(Ann.% change)	1.8	2.8	**2.7**	2.5	3.2	2.7	2.6
(p.m.) Oil price (Brent, annual average) USD / b		111.0	111.8	**105.6**	90.0	120.0	106.7	105.8
5. Monetary and financial indicators:								
Interest rate on ECB's main refinancing operations	June	1.00	0.10	**0.38**	0.25	0.50	0.64	
	December	1.00	0.75	**0.41**	0.25	1.00	0.73	
3 month interest rate (EURIBOR)	(year-end)	1.36	0.19	**0.36**	0.10	0.85	0.57	
10 year government bond yield (Bund)	(year-end)	1.83	1.32	**2.39**	1.90	2.80	2.24	
M3 growth	(annual growth)	1.5	3.0	**2.90**	2.00	3.50	4.00	
Credit to private sector (M3 definition)	(annual growth)	2.1	-0.3	**0.80**	0.30	1.20	1.23	
Exchange rate USD/EUR	(year-end)	1.29	1.32	**1.26**	1.20	1.35	1.26	1.36

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