



Eurozone

EY Eurozone Forecast

September 2014



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New opportunities are available, but businesses should remember that the Eurozone's recovery is still fragile.

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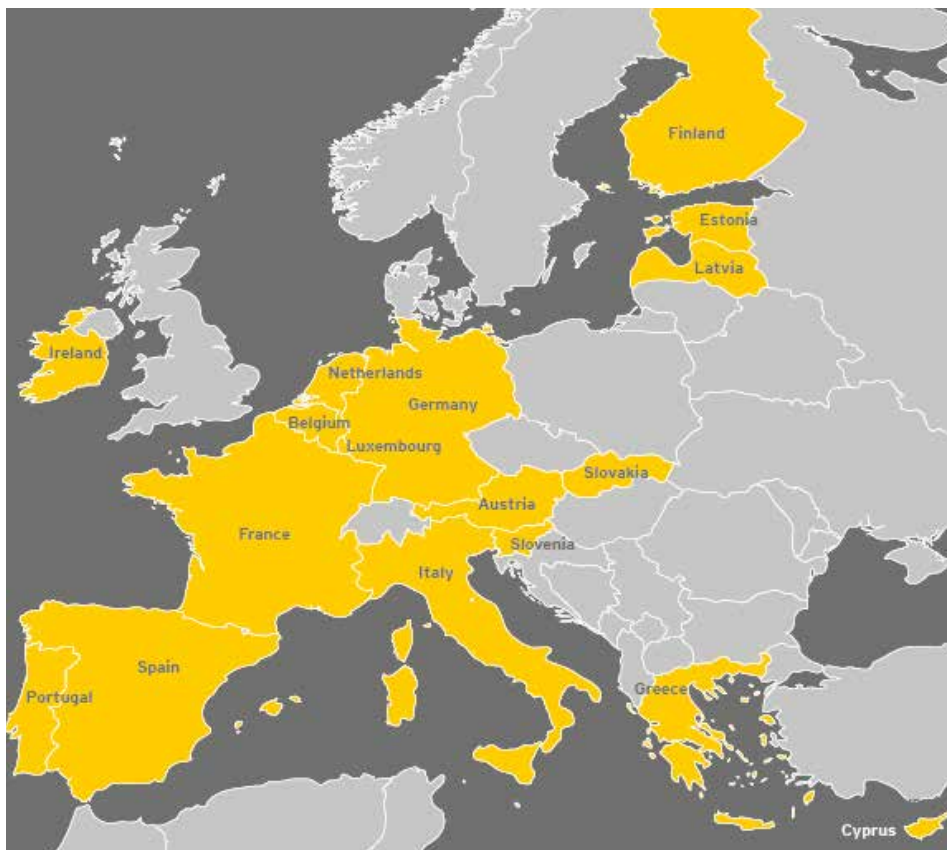
**OXFORD
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Investment to drive growth

The Eurozone economy is expected to gain momentum after a disappointing H1 2014. Supported by improved external demand and enhanced competitiveness, investment will emerge as a major driver of the upturn.



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Foreword



A handwritten signature in black ink, appearing to read 'Mark Otty', with a horizontal line underneath.

Mark Otty

Area Managing Partner, Europe,
Middle East, India and Africa

The European summer is drawing to a close. And unfortunately, there is something of an autumnal air to our latest *EY Eurozone Forecast*.



Customize data from the
EY Eurozone Forecast at
ey.com/eurozone.

The headline is that the Eurozone's recovery ground to a halt toward the end of the first half of the year. And this means we've had to revise our forecast for 2014 as a whole down from the 1.1% we expected in June, to just 0.9%.

We've been forecasting "slow but steady" Eurozone growth for some time now, and this latest development proves that the Eurozone's recovery is still very fragile – contrary to overly optimistic responses to news of growth from some quarters earlier in the year. Policy-makers and businesses need to make sure that they plan for growth, but hedge against the very real threat of contraction.

One cause of the stagnation has been the overvaluation of the euro, which has persisted for about 18 months now. This has led to a loss of competitiveness that has hurt exports and growth. The European Central Bank (ECB) agrees with this diagnosis. In the first week of September, ECB President Mario Draghi announced a further interest rate cut. As a result, the ECB's main refinancing rate is now just 0.05% and the interest rate for deposits was moved further into negative territory, to -0.2%. The bank hopes that this will be enough to boost lending and drive down the euro.

But despite the mid-year slowdown, there is plenty to be positive about too. At last, the Eurozone unemployment rate has stopped rising, even if it is still very high at over 11%. This should mean more money in the pockets of consumers and more spending as a result. Though this is probably cold comfort if you're unfortunate enough to live in one of the peripheral Eurozone countries where unemployment – especially among the young – is still extremely high.

Businesses looking outside the Eurozone also have reason to be hopeful. The euro is finally showing signs of weakening, which should boost exports. As business becomes more competitive, we also expect investment to grow, becoming a major driver of further recovery.

A weaker euro will also help to combat deflation, which has been a key risk for some time now. Happily, we still think it is unlikely that the Eurozone as a whole will fall into deflationary territory. However, inflation will remain very low for some time to come and some parts of the Eurozone will experience price drops.

Nevertheless, in the main a more balanced picture is emerging, and we expect to see increasingly even growth on most indicators throughout the Eurozone. The economic divergence between core and periphery continues to decline. But at the same time another divide is opening, as nations that have made painful reforms pull away from those that have not.

The main downside risk to our forecast – and indeed to Europe as a whole – is the effect of the tension in Ukraine. If the situation deteriorates, it will be a serious challenge to the fragile Eurozone recovery.

Despite the risks and the faltering growth, we still expect to see the Eurozone's economy gain momentum over the coming months and years. So our main message is still one of optimism – albeit cautious optimism.

I hope that the September 2014 *EY Eurozone Forecast* makes for interesting reading. Be sure to visit ey.com/eurozone for additional information on the forecast and to access the 18 individual country reports.

Highlights

Economic recovery will gain strength only slowly

- ▶ The Eurozone recovery is expected to gain momentum gradually after disappointing near-stagnation in H1 2014. Despite the easing of interest rates by the ECB in June and September, growth is expected to remain lackluster and fragile.
- ▶ We forecast GDP growth of 0.9% this year, down from the 1.1% projected in our June report, 1.5% in 2015 and 1.7% in 2016. This is substantially lower than the pre-crisis average of 2.3% in 1997-2007.
- ▶ However, the pace of the economic upturn will remain uneven across Eurozone countries. In particular, a faster upswing is expected in economies that have been prompt to implement structural reforms. The divergence between France and Italy on the one hand and Germany and Spain on the other is becoming more apparent. However, the recent depreciation of the euro is likely to bring more benefit to France and Italy, which are most sensitive to price competitiveness.
- ▶ Encouragingly, for the region as a whole, the economic revival is expected to be more balanced across the main GDP components, with investment and consumption overtaking net exports as the main drivers of growth from 2015.

Investment emerges as a growth driver

- ▶ A new driver of the upturn will be investment, sustained by gradually improving external demand and enhanced competitiveness from a weaker euro. Further easing in bank credit conditions, together with stronger final demand, may give a lift to business lending. We expect investment to grow by 2.4% in 2015 and 2.8% in 2016.

Consumer spending builds momentum

- ▶ Unemployment has stopped rising and this is having a material effect on consumer confidence and consumption more generally.
- ▶ This gradual improvement in the labor market, together with better lending conditions and the reduced drag from fiscal consolidation, is expected to support consumer spending. We see consumption growth accelerating to 1.4% in 2015 and 1.5% in 2016, up from 0.8% this year.

Deflation has been avoided so far

- ▶ Together with the continued healing of the financial sector and modestly strengthening activity, more supportive policy (with less emphasis on austerity and a more accommodative monetary policy) means that deflation is likely to be avoided.
- ▶ However, the Eurozone may still struggle with very low levels of inflation over an extended period of time, given continued significant spare capacity in the labor market and the need for further deleveraging.

Risks to our growth forecast are balanced

- ▶ Risks to our GDP forecasts are balanced. Downside risks include the impact of US and European Union (EU) sanctions on the Russian economy and Russia's retaliatory measures.
- ▶ Upside risks encompass stronger-than-expected earnings growth in Germany and a positive shock to exports boosted by the weaker euro and stronger world demand.

GDP (annual change)

2014	2015	2016-18
0.9%	1.5%	1.7%



Exchange rate (against US\$)

2014	1.34
2015	1.27

Exports of goods and services (annual change)

2014	2015	2016-18
2.9%	4.1%	4.1%

Eurozone forecast by sector (% change)

	2014	2015
Manufacturing	1.0	2.6
Agriculture	0.3	1.2
Construction	1.1	1.9
Utilities	0.8	1.8
Trade	0.5	1.6
Financial and business services	1.0	1.7
Communications	1.4	2.5
Non-market services	0.3	0.3



Inflation

2014	0.7%
2015	1.2%



Unemployment

2014	11.5%
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Implications for businesses:

Seeking growth amid uncertainty

Gathering pace

Much has changed in the three months since we published our last forecast. Business leaders can take heart in the progress that has been made, but they need to remember that the recovery is still fragile. After a disappointing Q2 and an apparently indifferent July and August, we believe the Eurozone is back on a growth path. Though full-year expansion of just 0.9% now looks more likely than the 1.1% we forecast in June, investment and consumer spending are set to pick up. However, we need to remain aware of the fact that growth in some key member countries remains very low by historic standards.

In the meantime, the weakening of the euro, which should help exports, accelerated at the beginning of September, when the ECB cut its benchmark refinancing rate to just 0.05%, doubled its charge for deposits to 0.2% and announced a stimulus package of asset-backed security (ABS) purchases. Fiscal tightening has slowed, austerity is easing, and deflation has so far been avoided. But there are still calls for further fiscal stimulus.

The ECB's move was confirmation that the recovery is distressingly weak and precarious. And beyond this, executives are also fretting about the geopolitical situation – especially events in Ukraine and the Middle East, which could hit demand and push up energy prices. Elsewhere, the independence questions in the UK and Spain demonstrate that regionalism is complicating some business strategies. And there are still some background tensions within the Eurozone, from calls for Germany to bolster consumption, to the distant possibility of a Eurozone breakup.

The US\$100b opportunity

So where should businesses look for opportunities? The Eurozone's projected growth of 0.9% is pitiful in comparison with rates in China, the US or even the UK. But last year the Eurozone generated over a fifth of global GDP. And 0.9% of the Eurozone's 2013 GDP of US\$12.7t is a hefty US\$114b of new business.

But geographically, opportunities are not evenly spread across the Eurozone. Italy is shrinking, France has stalled and Germany is plodding, while Ireland's economy is looking more lively. Companies need to look carefully at their markets, identify opportunities, and invest accordingly.

Who is buying more? Though the Eurozone retains a positive trade balance, the export-led recovery has fizzled out. Consumers willing to start spending again are more likely to be found in countries that have embedded reforms and where fears of job losses are receding, such as Germany and Ireland. But in others, such as Spain and Portugal, consumers may be held back by continued household deleveraging.

Serving consumers

Private consumption is the biggest single component of Eurozone GDP. Though consumption growth is unlikely to exceed 0.8% this year, there is good evidence that it is broad-based. Among several promising indicators, automotive component suppliers are stepping up production and, although European chemicals production dipped in May and June, output of consumer chemicals continued to climb.

In part, consumers are more confident because fear of job losses is easing, as Eurozone unemployment, though still high at above 11% of the workforce, had by the end of July fallen by 725,000 in 12 months. The critical question for companies is to anticipate how the consumers they serve will allocate their increased spending power.



Viewpoint

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Jean-Claude Juncker's new European Commission (EC) will start work in November. Juncker, a former prime minister of Luxembourg, has already set out his priorities for the EC's five-year term: building economic growth, integrating energy markets, concluding a transatlantic trade and investment partnership, pursuing Eurozone monetary integration, and deciding whether the UK will remain a member of the EU on modified terms.

As business leaders have been quick to see, the EU's overriding policy objectives for the rest of this decade are economic. The Commission's ability to deliver the growth opportunities business craves will therefore focus on the priorities laid down in the EU's multiannual financial framework. This seven-year investment plan, which kicked in this January and runs until December 2020, foresees spending of €960b. Although this is 3.4% lower than EU spending in the seven years to the end of 2013, the budget has been significantly rebalanced to bolster growth and aid job creation. And despite the fact that around a third will go on supporting farmers, and a hefty chunk on security, foreign policy and administration, the EC says that €450b, almost 47%, will be invested in its Smart and Inclusive Growth agenda.

Understanding how this money will be invested, and where, is vital for any business seeking to expand in the EU. It will help shape the geography of growth and the appeal of regions, provide a pointer to

fast-growth sectors and business opportunities – from concessions and public procurement to energy independence – and facilitate financing, including through innovation support.

The biggest chunk of funding, some €325b, will be channeled toward economic, social and territorial cohesion. The biggest beneficiaries will be Poland, Italy, Spain and Romania, which have significant planned-growth targets.

But there will also be large sums available for enhancing infrastructure integration, including €26b for transport, €5.9b for energy and €1b for digital projects. Transport projects, for example, will range from the nine transnational "corridors", where better road, rail and water connections are needed, to financing for research into developing better air-traffic management under the Single European Sky program.

Although the funding schedule is protracted, some of the money is already set aside for investments that will underpin market integration and could spur big cost reductions and efficiency improvements for industry and consumers alike. But such changes will increase the pressure on industrial laggards.

More than ever, a thorough understanding of EC policy and budgetary objectives has become an essential part of business planning.

An added complication is persistently low inflation, which gives little incentive to buy in a hurry. Though many durable goods may now need replacing, spurred by technology change, consumers have been showing some resistance to the incessant pressure to upgrade electronic gadgets.

To tackle these challenges, businesses should try to exploit big data resources to help align their products, services and pricing with increasingly segmented consumer profiles. However, the growth possibilities vary between countries and businesses need to have a realistic view of where to look for the best growth opportunities.

Increasing investment

With government consumption flat-lining, the growth in fixed investment, which represents about a third of private consumption, is a key area for consideration. In theory, there is plenty of spare capacity, but we expect a strong investment rebound next year as companies modernize and expand facilities. Having revised product and service plans and sales projections, businesses now need to launch product-development programs quickly, and then assess how they are going to meet objectives, and place orders for any additional equipment and facilities they will need.

Adjusting to a weaker euro

After a period in which it has been clearly overvalued, the euro has now fallen close to its equilibrium exchange rate against most currencies – although we expect it to slide further against the dollar to around US\$1.23 by the end of 2017. Companies should review their operations in light of this.

In addressing currency concerns, firms should ask themselves if their value chains are optimized to produce in, or source from, the most competitive locations, taking into account the costs of transport and benefits of short supply lines. Stronger growth in external markets, particularly in the US, UK and Asia, coupled with euro weakness, should help sustain demand for Eurozone exports.

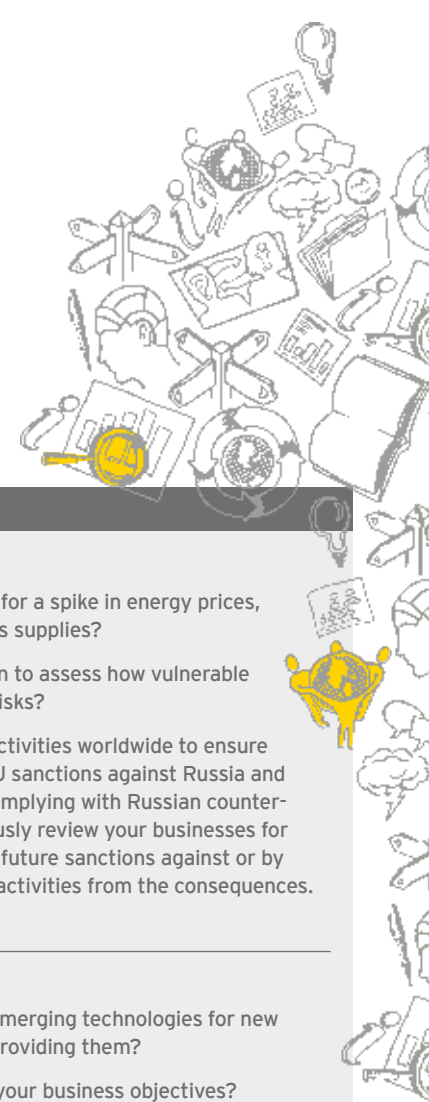
With some economies benefiting from early moves to enhance competitiveness through structural reforms, companies must look at what they do and where. They need to allocate capital carefully and consider whether to aim for consolidation or growth. Some firms may find themselves investing simultaneously to meet both stronger Eurozone and export demand, while retaining a very flexible approach.

Financing expansion

Against such a background, the role of the chief financial officer will be crucial to the success of many businesses. Global corporations will need to weigh Eurozone opportunities and returns against those available elsewhere.

Firms targeting Eurozone expansion or consolidation will need to consider their financing options. They know that banks are still husbanding their balance sheets. And although there are signs of a slight easing of lending conditions, those that need to borrow – especially smaller firms – may need to be looking to alternatives to conventional bank borrowing. Some companies will need to perform a thorough revision of their working capital situation to identify opportunities to free cash and reduce funding needs. Early moves are essential to ensure timely access to finance.

The current environment presents company leaders with an awkward strategic challenge: they must pursue cautious, conservative financial management while simultaneously investing heavily in innovation, in developing new technologies and business models, and in rearranging the value chain to protect their margins. When it comes to economic development, it is essential to have scenarios to deal with the different risks discussed in our report: deflation, geopolitical tensions, and the global economic situation as a whole.



▶ Key concerns for businesses

Today

Make sure that you assess and address risks to protect the near term. In particular:

- ▶ What impact would changing euro exchange rates have on your operations, revenues and debt obligations?
- ▶ Are your sales and procurement contracts protected against lowflation or even deflation?
- ▶ Are you positioned for growth where it is likely, and stagnation or contraction where it is not?
- ▶ Are you insulating your operations from the impact of prolonged tension between the EU and Russia?
- ▶ Have you made contingency plans for a spike in energy prices, or confrontation over European gas supplies?
- ▶ Are you checking your supply chain to assess how vulnerable your suppliers are to the existing risks?
- ▶ Are you assessing your business activities worldwide to ensure they are complying with US and EU sanctions against Russia and that any offshoots in Russia are complying with Russian counter-sanctions? You should simultaneously review your businesses for any present or likely impacts from future sanctions against or by Russia, and take steps to insulate activities from the consequences.

Tomorrow

Is your business aligned to benefit from recovery in consumer spending and investment? In particular, are you:

- ▶ Analyzing what your customers want from the data-gathering revolution?
- ▶ Reviewing market opportunities by country?
- ▶ Pursuing opportunities to relocate your value chain to countries and regions that have implemented labor market and economic reforms, or where price stability is more likely to protect margins?
- ▶ Seeking opportunities offered by emerging technologies for new products and services or ways of providing them?
- ▶ Assuring the financing to achieve your business objectives?
- ▶ Investing in new capacity where needed?
- ▶ Able to realign capacity to EU or export markets if the euro declines further?
- ▶ Attuned to declining relative costs in Europe as costs rise in emerging markets and aware of reshoring opportunities?



Investment to drive growth

Economic recovery to gain strength slowly

The Eurozone's disappointing growth performance in the year to date reflects two separate dynamics that have been largely working against each other. On the positive side, there are signs of reduced financial market fragmentation, supported by a continued decline in bond yields. Unemployment has stabilized, giving consumers renewed confidence to boost their consumption. There are also signs of renewed housing market activity and construction activity is rising. These positive developments are most clearly evident in Spain, where the economy has grown by 1% in the first six months of the year.

Working against this has been a sustained appreciation of the euro exchange rate, which rose by nearly 10% on an effective basis between August 2012 and March 2014. The resulting loss in competitiveness has hit business sentiment this year and put a sizeable dent in manufacturing activity, especially in those countries that have been slow to undertake necessary structural reforms. More recently, sentiment has been further adversely affected by rising geopolitical tensions, especially in Ukraine.

A number of factors appear to explain the euro's sustained appreciation. It is no accident that the rise started in summer 2012, after ECB President Mario Draghi's commitment to do whatever it took to defend the Eurozone. By confirming that it stood ready to

act as a lender of last resort to both sovereigns and banks alike, the ECB addressed market concerns about financial market fragmentation and about the sustainability of the euro. As confidence has grown in the ECB's commitment, bond yields have progressively declined, marking European sovereign bonds as one of the best performing asset classes over the intervening period.

This, together with the shrinkage in the ECB's balance sheet as the earlier three-year long-term refinancing operation (LTRO) was repaid, largely explains the euro's appreciation. However, with Spanish and Italian yields both having fallen to levels comparable with US 10-year yields, there are good reasons for believing the sustained attractiveness of Eurozone bonds has come to an end. Indeed, since March this year, when markets first began to discount the latest round of ECB easing, the euro has fallen by nearly 3% on an effective basis.

The Eurozone economic recovery is therefore expected to firm in the second half of 2014, after GDP stagnated in Q2. This will be supported by less austerity and slower private deleveraging. Nevertheless, the upturn will be modest and fragile, particularly if geopolitical tensions in Ukraine remain high. Indeed, the recent weakness of the composite Purchasing Managers' Index (PMI) and the EC Economic Sentiment Indicator suggest that the latest events in Ukraine are taking a toll on business confidence.

Table 1

Forecast for the Eurozone economy (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	-0.4	0.9	1.5	1.7	1.7	1.7
Private consumption	-0.6	0.8	1.4	1.5	1.5	1.5
Fixed investment	-2.8	1.3	2.4	2.8	2.6	2.6
Stockbuilding (% of GDP)	0.0	0.1	0.1	0.1	0.1	0.1
Government consumption	0.2	0.6	0.2	0.5	0.6	0.8
Exports of goods and services	1.5	2.9	4.1	4.3	4.1	3.9
Imports of goods and services	0.4	3.4	4.0	4.1	4.0	3.8
Consumer prices	1.3	0.7	1.2	1.5	1.6	1.6
Unemployment rate (level)	11.9	11.5	11.2	11.0	10.7	10.4
Current account balance (% of GDP)	2.4	2.4	2.4	2.3	2.3	2.3
Government budget (% of GDP)	-3.0	-2.6	-2.1	-1.7	-1.4	-1.2
Government debt (% of GDP)	95.0	98.0	99.0	99.1	98.8	98.1
ECB main refinancing rate (%)	0.5	0.1	0.1	0.1	0.2	0.8
Euro effective exchange rate (1995 = 100)*	120.8	123.6	119.9	118.8	118.8	118.4
Exchange rate (US\$ per €)	1.33	1.34	1.27	1.24	1.24	1.23

*A rise in the effective exchange rate index corresponds to an appreciation of the euro.

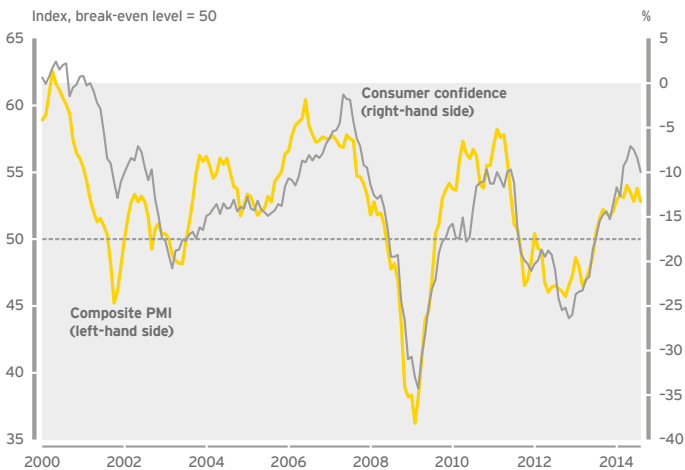
Source: Oxford Economics.

Investment to drive growth

We expect GDP to grow by 1.5% in 2015 and by 1.7% in 2016. This is a little bit better than the sluggish rise of 0.9% that we now forecast for 2014 (down from 1.1% projected in our June report). This lackluster recovery, coupled with the large amount of existing spare capacity, will mean that inflation remains well below the (ECB) target of "below, but close to, 2%" for an extended period of time.

Figure 1

Composite PMI and consumer confidence



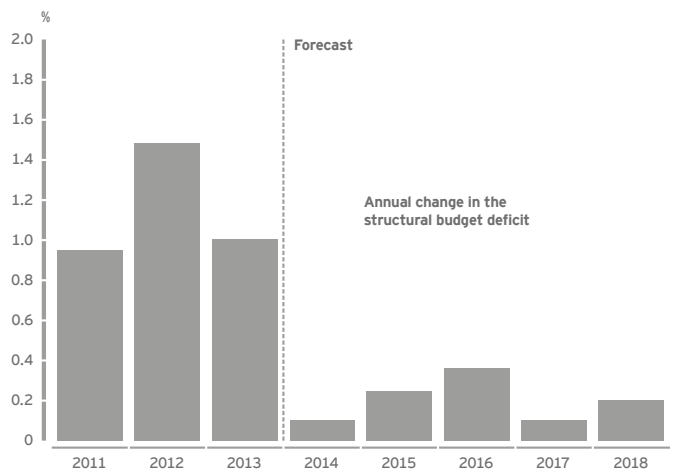
Source: Oxford Economics; Markit.

On a more positive note, the Eurozone economic upturn is now projected to be more broad-based across constituent countries, as activity has continued to strengthen in some of the peripheral states, such as Spain and Ireland. But while GDP growth differentials are expected to narrow between the core and the periphery over 2015 and 2016, the pace of the recovery will remain uneven. Economies that have been slow to implement much-needed structural reforms, such as Italy and France, will continue to lag behind.

The mild economic revival is expected to be more balanced across growth drivers too. After two years of contraction, domestic demand should overtake net exports as the main driver of overall GDP growth. Less fiscal austerity and highly accommodative monetary policy, together with better lending conditions and improving confidence, will support the expected upturn in both private investment and consumption. After several years of drag on GDP growth by about one percentage point, fiscal policy will be broadly neutral this year. Looking ahead, more flexibility in the conduct of Eurozone fiscal policy may be expected in order to achieve an appropriate balance between debt sustainability and support for demand in economies with high output gaps. The fiscal deficit in the region is set to decline to 2.6% of GDP this year, before dropping to 2.1% in 2015 and 1.7% in 2016.

Figure 2

Fiscal stance



Source: Haver Analytics.

As far as monetary policy is concerned, the ECB has taken a wide range of actions to lessen financial fragmentation and support credit. Financial conditions have significantly improved, especially in the periphery, and will continue to ease in response to the likely credit boost from the targeted longer-term refinancing operations (TLTROs). That said, long-term bond yields in the Eurozone are expected to bottom out near the end of 2014, particularly those in the periphery, where spreads over German bunds now look compressed. This could limit the potential for further capital inflows in the region. A side effect could be downward pressure on the euro.



► **Subdued growth expected for cyclical sectors**

The cyclical sectors that would normally bounce back strongly as economic momentum recovers – notably manufacturing and construction – remain subdued in the Eurozone. This indicates that our expectation of a sluggish recovery is well founded. The manufacturing sector is only expected to expand 1% this year (nearly the same rate as GDP, 0.9%) before seeing a small cyclical bounce in 2015. Construction activity – which remains nearly 25% below pre-crisis levels – is not looking much better, at 1.1%, with virtually no cyclical bounce in subsequent years.

The service sector can usually be counted on as a steady, if unspectacular, source of growth as the economy turns around, and this is reflected in our relatively subdued outlook for wholesale and retail trade and financial and business services. On the other hand, we do expect the continuing structural shift to information-intensive economic activity to bolster demand for communication services over the coming years.

Table 2

Forecast for the Eurozone by sector (annual percentage changes in gross added value)

	2013	2014	2015	2016	2017	2018
Manufacturing	-0.5	1.0	2.6	2.4	2.0	1.8
Agriculture	0.1	0.3	1.2	1.2	1.2	1.2
Construction	-3.7	1.1	1.9	1.8	1.5	1.4
Utilities	0.6	0.8	1.8	1.8	1.7	1.7
Trade	-0.4	0.5	1.6	1.9	1.9	1.9
Financial and business services	0.5	1.0	1.7	1.9	1.9	1.9
Communications	-0.6	1.4	2.5	2.8	2.9	3.0
Non-market services	0.2	0.3	0.3	0.6	0.7	0.9

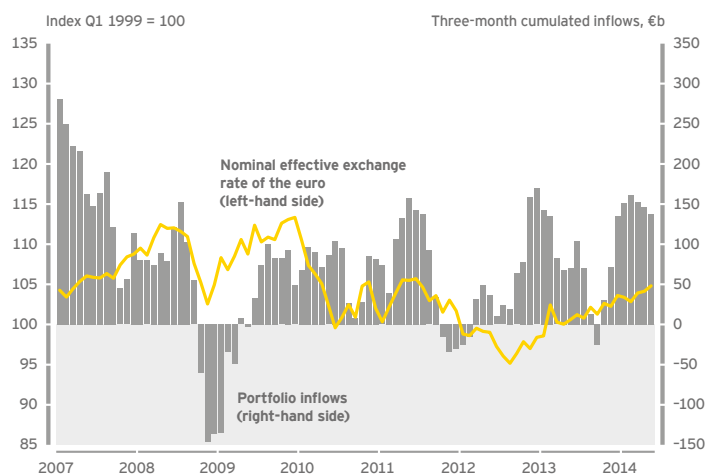
Source: Oxford Economics.

Furthermore, the ECB's cut in the refinancing rate in September, and the announcement that it will begin purchasing a substantial amount of ABS directly from banks, have significantly weakened the euro. The ECB has made it clear that it aims to bring the size of its balance sheet back to its early 2012 peak, which involves a possible expansion by as much as €1t. This announcement is close to outright quantitative easing (QE). During the ECB's press conference, President Draghi defined QE as the outright purchase of assets, noting that those assets could come from either the private or the public sectors.

Our forecast for the euro's exchange rate against the US dollar has therefore been significantly lowered, to 1.29 for Q4 2014 and 1.25 for Q4 2015. This profile is based on the assumption that the ECB will not broaden its program to sovereign asset purchases, that US interest rates will start to rise in Q1 2015, and that the ECB refinancing rate remains unchanged until early 2017. As Draghi mentioned in August, "the market fundamentals for a weaker euro are much better than a few months ago."

Figure 3

Euro and capital inflows



Source: Datastream.

► Real effective exchange rate misalignments in the Eurozone

External and internal imbalances between major economies, but also within the Eurozone, have again placed a focus on the need to rebalance trade between deficit and surplus countries, with special attention on price competitiveness via relative price adjustments.

In order to measure the scale of required internal adjustments in the Eurozone in relation to the rest of the world, we have to measure the equilibrium real effective exchange rate of the euro. Our equilibrium exchange rate estimate underlines a current euro overvaluation of about 7% against the dollar. Meanwhile, vis-à-vis all trading partners, the euro appears to be close to fair value equilibrium.

This overvaluation is expected to fade away and totally disappear by 2017, as illustrated in figures 4 and 5. We do therefore forecast the euro to weaken further to reach its equilibrium level of 1.23 by the end of 2017. Less-expected portfolio inflows in the region, given near historical lows of sovereign bond yields, together with divergent monetary stances and the different pace of growth between the US and the Eurozone, should contribute to weakening the euro.

Although the TLTRO and the ABS purchases by the ECB may put further downward pressure on the euro, we think that the purchase of assets from the private sector will not be the prelude for sovereign QE, leaving scope for potential disappointment among the market's participants. This, together with the current account surplus set to persist in the Eurozone, should limit the magnitude of the euro decline.

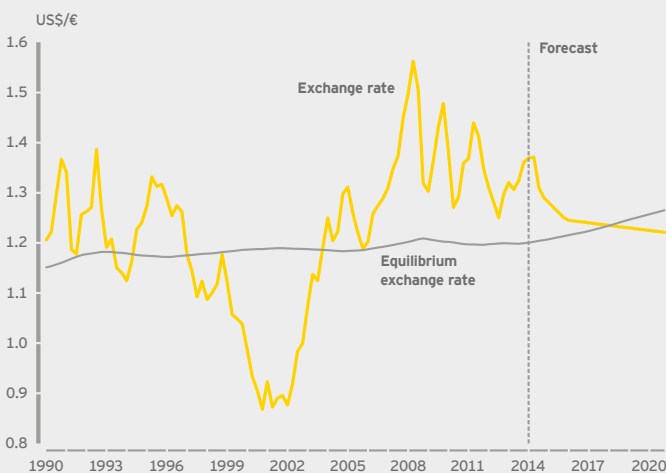
That said, the real equilibrium effective exchange rate against the dollar for France, Italy and Spain is probably much lower than 1.23, while for Germany it may be much higher. Within the Eurozone, any

lasting divergent dynamics of real effective exchange rates in individual economies has the potential to trigger economic and political tensions. A nominal devaluation to restore competitiveness is impossible in a monetary union and only a change in relative domestic prices can depreciate the real exchange rate of member states. The large overvaluation of Greece, Portugal and Spain observed at the beginning of 2000 has been significantly reduced from 2008 via sharp cuts in labor costs and low inflation or even deflation. In some of these countries, much of the cost reduction has come from declining employment, which put downward pressure on wages.

As a result of improved competitiveness and sluggish domestic demand, most of the southern Eurozone economies are now running a current account surplus. However, product and labor market inefficiencies remain and possible further reductions in prices and costs could be needed to ensure that they can run sustainable surpluses in the medium term, once domestic demand and hence imports begin to expand again. This is especially crucial for France and Italy, where cuts in labor costs have so far remained contained. These two countries have seen an ongoing deterioration of their trade balances since the launch of the monetary union, with the loss of competitiveness mainly stemming from a lack of structural reforms, rather than from prices and domestic demand.

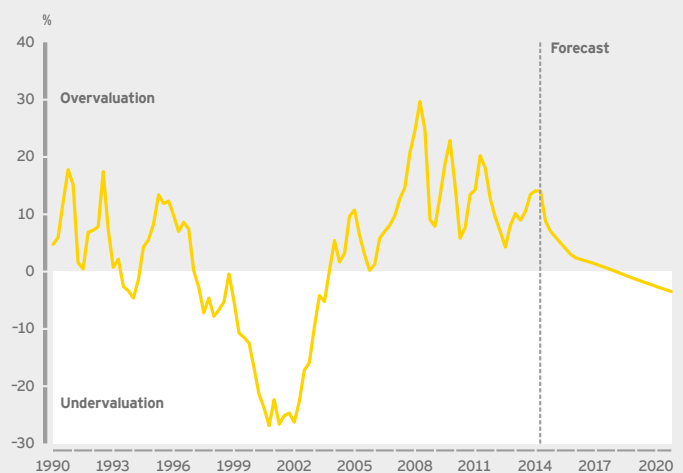
Further adjustments are needed to guarantee the success of the currency bloc in the long term, both in the peripheral and core economies. However, caution is needed because any further substantial cost and price reductions in the periphery would add to deflationary pressures in the Eurozone.

Figure 4
Euro exchange rate, current and equilibrium



Source: Oxford Economics; Haver Analytics.

Figure 5
Over/undervaluation of the euro against US\$

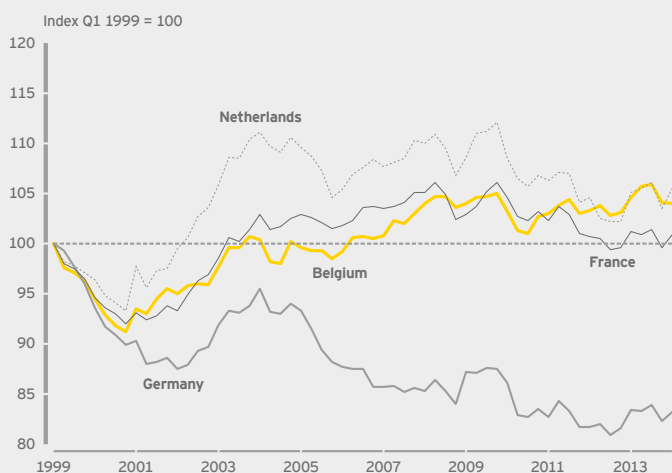


Source: Oxford Economics; Haver Analytics.



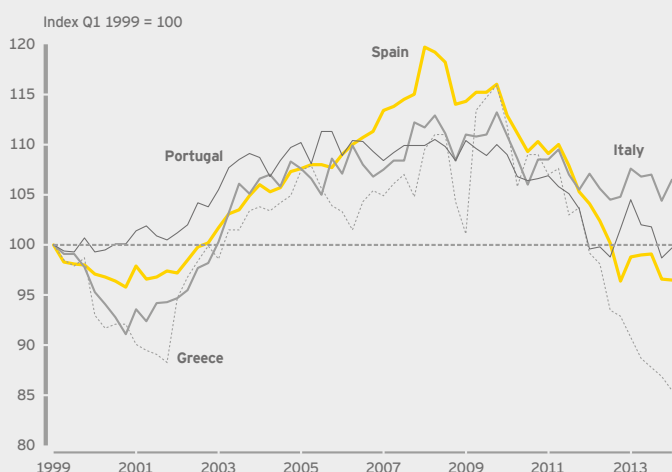
Hence, a rebalancing toward domestic demand in stronger core economies, such as Germany, may be more desirable. As the EC has stated, "From a euro-area perspective, the developments in two major surplus countries will be decisive. While wages are set to increase in Germany and the country is expected to reduce its surplus, subdued domestic demand combined with deleveraging pressures exert upward pressure on the Dutch surplus."

Figure 6
Harmonized competitiveness indicators



Source: Oxford Economics; Haver Analytics.

Figure 7
Harmonized competitiveness indicators



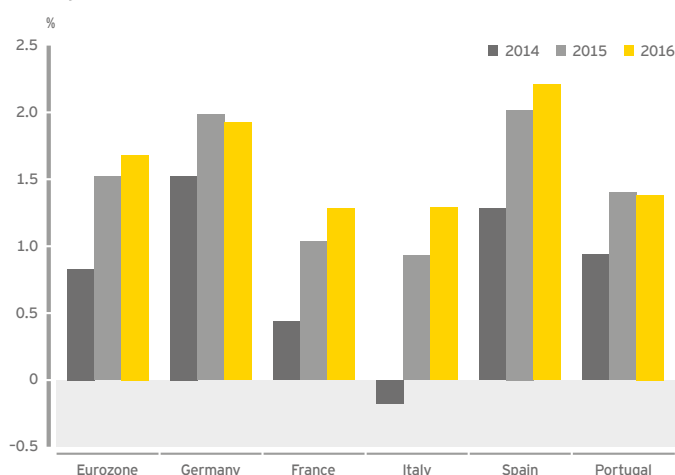
Source: Oxford Economics; Haver Analytics.

Uneven pace of recovery across core countries

While in terms of growth prospects, the distinction between core and peripheral economies is becoming less pronounced, the difference between economies that have and have not been prompt to implement structural reforms is increasingly significant to the diverging pace of the recovery between Eurozone countries.

Structural factors may hinder a faster upswing in France, Italy and, especially, Greece. In contrast to Germany and Spain, where sharp cuts in unit labor costs and drastic labor market reforms have boosted export market shares, competitiveness in France and Italy has deteriorated. Faced with rigidities in the labor market, corporations in France and Italy have steadily reduced their profit margins, which are now weighing on their capacity to invest. Unlike Germany and Spain, which are likely to record investment growth in 2014 of 2.5% and 1.1% respectively, France and Italy will probably post declines. In addition, both countries have lagged behind Germany in terms of fiscal consolidation. Further reforms leading to a slightly more restrictive fiscal stance may be expected in these two countries in 2015-16. Finally, spare capacity is also expected to diminish at a much higher pace in Spain.

Figure 8
GDP growth forecasts



Source: Oxford Economics; Haver Analytics.

In short, the lackluster GDP growth of 0.4% expected in France for 2014 and the 0.2% contraction expected in Italy, contrast with the more solid 1.3% and 1.5% growth projected in Spain and Germany respectively. Ireland is expected to stage a particularly robust rise in GDP of 2.8%. Over 2015-16, the difference in the pace of recovery across core Eurozone countries is forecast to narrow,

Investment to drive growth

but the gap will persist. Growth prospects in Greece and Cyprus, together with Finland and Italy, appear particularly vulnerable to shocks, either domestic or external.

Investment is the new driver of the upturn

Private investment is forecast to strengthen significantly as the main impediments to demand facing businesses recede. Indeed, we expect investment to emerge as one of the main growth drivers. We see investment growth rebounding to 2.4% in 2015 and 2.8% in 2016, up from 1.3% this year. Investment's contribution to growth, which was strongly negative in 2013, will be moderate in 2014 and then firm in 2015 and 2016.

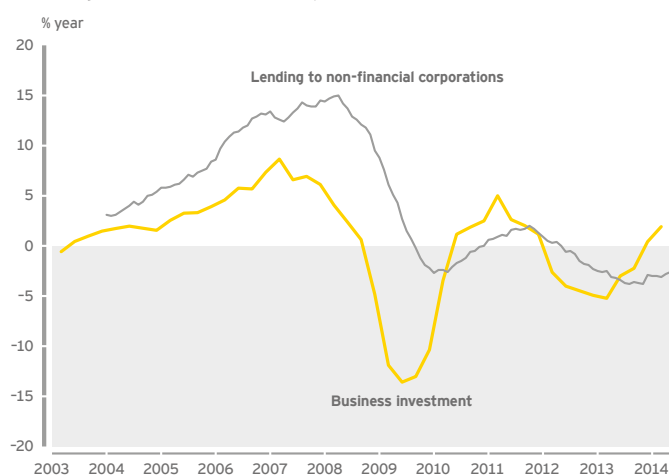
However, the investment recovery will probably be weaker than in previous recessions, given high levels of corporate debt, elevated real costs of borrowing for small and medium-sized enterprises (SMEs) and still-high financial fragmentation. At about 20% below their pre-crisis levels, investment volumes remain very low in this early stage of the rebound and it may take a decade or so for investment to return to its 2008 level in real terms.

Looking at previous cycles in the Eurozone, it may be worth noting that lending to non-financial corporations has tended to lag behind the pickup in investment. Accordingly, the continued weakness of bank lending to firms does not necessarily preclude a rise in

investment. The high level of cash on Eurozone firms' balance sheets could allow some self-financing. Issuance of corporate debt securities, which has recently stabilized the overall external funding of large corporations, could also support investment growth.

Figure 9

Lending to non-financial corporations and investment



Source: Datastream.

► The asset quality review and stress test

In preparation for the introduction of the Single Supervisory Mechanism (SSM), the ECB is conducting an asset quality review (AQR) and stress test of banks in the Eurozone. The exercise will be applied to 128 of the Eurozone's largest banks, which account for around 85% of the region's banking system.

The AQR aims to provide a single and transparent picture of the extent of asset quality issues in the Eurozone, including the adequacy of asset and collateral valuation and related provisions. Most importantly, it will apply consistent and common definitions to dispel doubts about the quality of banks' assets. The AQR will be based on a "snapshot" of balance sheets in Q4 2013.

The outcome of the AQR will also help to inform the starting point for the stress test, which will assess the resilience of the banks to a uniform set of risks over a three-year period (2014-16). The stress test will be conducted under the assumption of a static balance sheet, which implies no new growth and a constant business mix. Outcomes will be based on a common baseline scenario (using EC projections) and an adverse macroeconomic scenario incorporating a generalized repricing of global assets that acts as a trigger for domestic vulnerabilities in the EU.

The hurdle rates for participating banks to pass the AQR and stress tests is an 8% Common Equity Tier 1 (CET1) capital ratio for the baseline scenario and a 5.5% CET1 ratio for the adverse scenario. Independent estimates of the capital deficit facing the Eurozone banking system now range from €50b to over €700b, but we believe the AQR will reveal a manageable capital shortfall toward the lower end of this range.

The results of the AQR and stress test will not be published until October this year, but many banks have been taking advantage of the favorable conditions in financial markets to issue capital as a pre-emptive measure. It is also likely that the AQR has been a factor behind the ongoing shrinkage in bank balance sheets, although these trends have also been driven by broader regulatory and market pressures to restructure and cut costs.

Overall, we believe that the publication of the results of the AQR and stress tests will be positive for Eurozone banks, as it will help to boost confidence in the sector. Banks are also likely to be more willing to expand lending once the uncertainty about the outcome of the exercise has passed, which will be supportive for the broader economy.



However, 80% of external funding in the Eurozone comes from banks, and SMEs do not have access to debt-securities markets. In Spain, Italy and Portugal, SMEs represent 80% of all private sector employment and 70% of value added. Accordingly, access to bank finance for SMEs will be crucial if the region is to foster a significant and sustained upturn in investment.

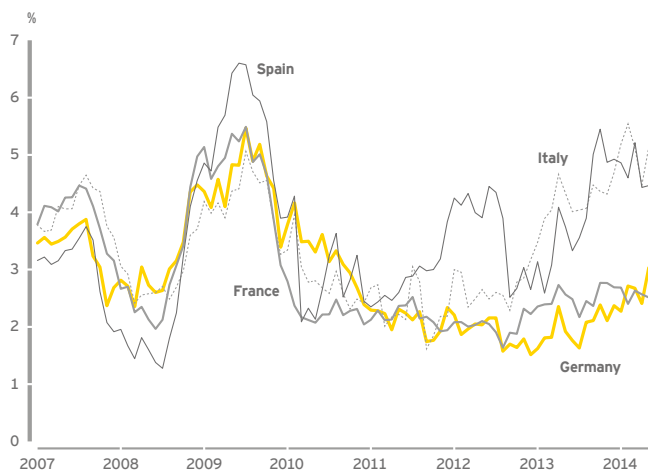
Against this background, reductions in real bank lending rates will be of crucial importance to the Eurozone periphery. Whereas the nominal costs of borrowing for SMEs have converged recently, this is much less the case in terms of the real cost of funding, given the low level of inflation in Spain, Italy and Portugal. In addition, cross-border flows have shrunk further, reflecting more risk-adverse liquidity provision across countries.

Encouragingly, however, the ECB's Q2 bank lending survey shows the first net easing in credit standards for the corporate sector since 2007. Most importantly, this was driven by peripheral countries such as Portugal and Italy. The AQR of Eurozone banks and the stress tests are also likely to restore confidence in the banking sector of the region, which should in turn help lending in the period ahead.

Although some banks may face challenges, we do not expect the AQR to pose significant challenges to the banking system as a whole. And combined with a good take up of the TLTRO, it is likely that banking will become supportive of growth over the next couple of years rather than remaining a drag. This is an important factor behind our forecast for a pickup in business investment. The substantial size of ABS that the ECB intends to purchase directly from banks' balance sheets is also likely to loosen credit markets in the Eurozone and to sustain investment in the period ahead. As ECB President Draghi mentioned in September, "We want to make sure that these ABS are being used to extend credit to the real economy." However, it remains to be seen whether the demand for new lending will be forthcoming.

Figure 10

Small and medium-sized enterprises, real lending rates



Source: Oxford Economics; Haver Analytics.

Consumer spending gradually building momentum

We expect consumption to gain momentum and to become an important engine of growth over 2015-16, reversing its negative contribution to growth in 2013. Consumer spending will be supported by the stabilization of the labor market and improved consumer confidence, together with better consumer lending conditions and the reduced drag from fiscal consolidation. Consumer confidence has recovered, as illustrated by the historically high level of the EC sentiment measure, although it has recently softened somewhat amid the Ukraine-Russia conflict.

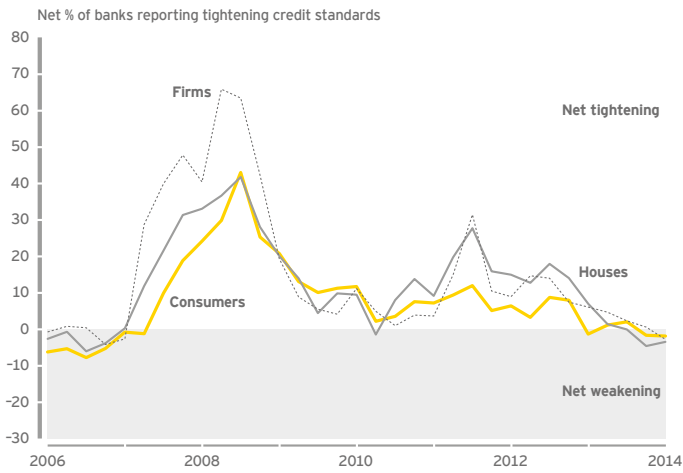
Meanwhile, the unemployment rate has stopped rising. Although the projected decline in the jobless rate will be gradual, from the current 11.5% to 10.9% at the end of 2016, this development is positive for consumption. Furthermore, the moderate recovery of real disposable incomes, expected to rise 1% in 2015 and 1.4% in 2016, will be supportive for spending. Rising incomes and falling unemployment may also encourage consumers to reduce their precautionary saving in favor of spending.

Investment to drive growth

A possible impetus to household spending may come from any rebound in consumer credit in response to the TLTRO program and the easing of credit conditions, as revealed by the ECB's June bank lending survey. And the survey also pointed to increased household demand for loans. Overall, these factors should contribute to an upturn in consumption of 1.4% in 2015 and 1.5% in 2016, up from just 0.8% this year.

Figure 11

Bank lending standards



Source: Oxford Economics; Haver Analytics.

But this upturn in consumption will be uneven across countries, given the need for further household deleveraging, especially in France and the Netherlands where deleveraging has hardly started. Meanwhile, although households in other economies, such as Spain, have started to reduce their debt burdens, this process is far from over. Accordingly, in the medium term, deleveraging will hinder Eurozone consumption growth.

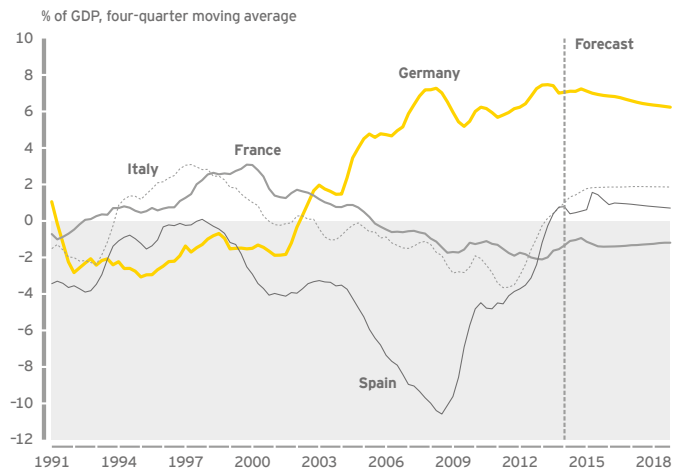
Gradually improving external demand

Since the crisis, the Eurozone current account has shifted into a sizeable surplus. While this is partly the result of Germany and the Netherlands maintaining large surpluses, it mainly reflects developments in countries under stress. Although some of the peripheral economies have enhanced their competitiveness by cutting unit labor costs and reducing their relative prices, the bulk of the improvement is down to steep falls in imports in response to weakening domestic demand. The widening current account surplus has put upward pressure on the euro.

The current account surplus of about 2.4% of GDP for 2014 is forecast to persist in 2015-16. The pickup in domestic demand will probably be offset by a sustained improvement in demand from the Eurozone's two main trading partners, China and the US, as well as by the expected weakness of the euro. That said, we still forecast relatively modest world trade growth by historical standards, rising to about 6% a year by the end of 2015.

Figure 12

Current account



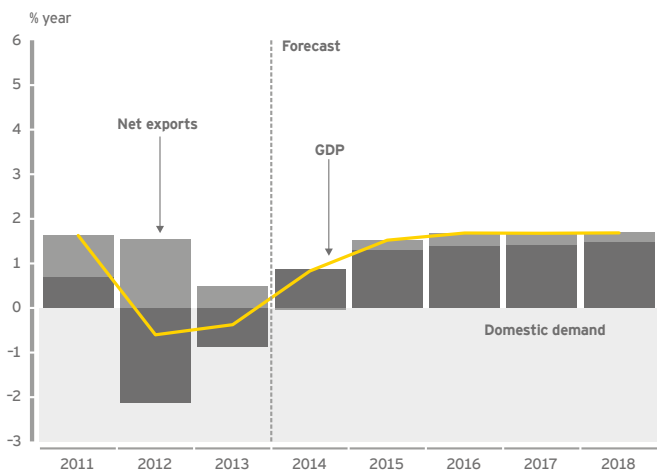
Source: Oxford Economics; Haver Analytics.

Net trade was the main engine of growth in 2013. Its contribution is expected to be insignificant in 2014, though will increase in 2015 and 2016.



Figure 13

Contributions to GDP growth



Source: Oxford Economics.

Deflation avoided so far, but a lengthy period of low inflation is likely

Inflation is expected to remain significantly lower than the ECB target for an extended period of time. Headline inflation has been slowing over the last couple of years as a result of declining energy prices and the appreciating euro. But more worryingly, core inflation – which excludes the most volatile components, such as food and energy – has also trended down. In August it was just 0.9%, close to its record low. Still-elevated spare capacity is expected to recede only at a very slow pace in France, Italy, Greece and Portugal.

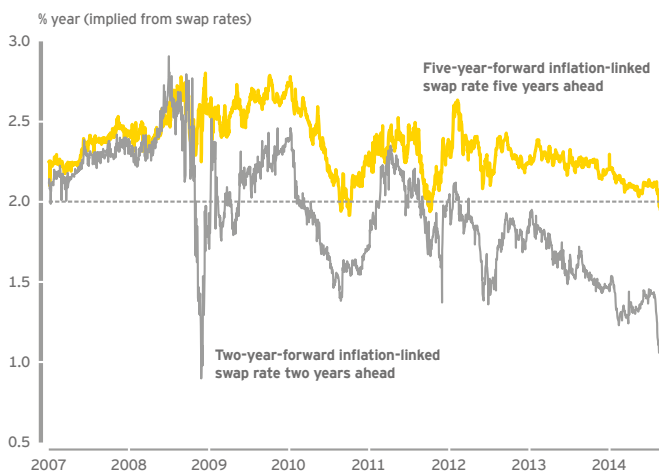
Despite the recent weak inflation figures posted by many Eurozone countries during the summer (with Portugal, Spain and Greece in particular recording negative figures) our forecast is that inflation in the Eurozone is now at a turning point and should gradually move upward, albeit very slowly in the period ahead. Although Greece and Portugal are set to face a negative inflation rate in 2014, at -1% and -0.2% respectively, we expect this to be only temporary. From 2015, all Eurozone countries are forecast to post positive inflation rates.

Headline annual inflation is projected to bottom out at 0.7% in 2014, before rising to 1.2% in 2015 and 1.5% in 2016. While market-based measures of long-term inflation expectations (five-year-forward inflation-linked swap rate, five years ahead) have remain broadly anchored, short- and medium-term measures derived from index-linked bonds and swap rates have

fallen significantly since 2013. Such a trend may reflect market doubts regarding the ability of the TLTRO to give an impetus to credit and growth, as well uncertainty about the capacity of the ECB to succeed in pushing inflation toward its 2% target. Looking ahead, the lower inflation expectations are, the higher the risk of de-anchoring expectations, which may significantly hamper the conduct of monetary policy.

Figure 14

Market-based inflation expectations



Source: Oxford Economics; Bloomberg.

More balanced risks to our GDP forecasts

Risks to our growth forecasts are balanced. Downside risks include the likely impact of US and EU sanctions on the Russian economy, and retaliatory measures from Russia. These tensions have the potential to significantly reduce growth in the Eurozone and possibly push it back into recession. Hence, despite fading constraints from the deep financial crisis, the recovery in the Eurozone remains fragile and vulnerable to any adverse shocks.

Furthermore, with policy-makers having limited room for maneuver from a policy-easing perspective, any shock has the potential to trigger a significant upward move in risk premiums. This could push up long-term bond yields in the periphery. Over the medium term, further deleveraging in the private and public sector could also be associated with a risk of stagnation.

Upside risks include the possible boost in credit growth and in economic activity from the TLTRO, and stronger-than-expected earnings growth in Germany.

Investment to drive growth



► Forecast assumptions: international environment and commodity prices

Our forecast for the Eurozone depends on a number of assumptions about the international environment, world GDP, and trade and commodity prices.

Having picked up steadily over the course of 2013 to a peak of 3% in Q4, world GDP growth has since slowed a touch, to about 2.7% in Q2 2014. Over the remainder of this year, we expect the pace of growth to slow a little further, partly in response to geopolitical factors and financial market wobbles. Over the year as a whole, GDP growth is expected to increase by 2.7%, slightly better than last year's 2.5% gain.

However, much of this improvement reflects the recovery in Europe. The UK's solid and sustained recovery continued in Q2 and, although its growth may ease in the second half of the year, we expect UK GDP to expand by 3.1% in 2014, the strongest annual rise since 2007.

Although the US economy rebounded strongly in Q2, after a weak start to the year, it is expected to grow by 2.1% for 2014 as a whole, a little below last year's outturn of 2.2%. Meanwhile, Japan is expected to see only a shallow recovery in the second half of this year – the country recorded a sharp fall in GDP in Q2 in response to April's hike in consumption tax. As a result, GDP will probably increase by just 0.9% this year, rather weaker than last year's solid 1.5% growth.

Although the recent performance of the advanced economies has been patchy, it is the emerging countries that have been the bigger disappointment. We now see GDP growth in the emerging markets as a whole weakening a bit from 4.7% in 2013, to about 4.1% this year. We have recently revised up our Chinese growth forecast for this year to 7.4%, reflecting the introduction of a series of stimulus measures.

However, this is still weaker than last year's rise of 7.7% and faster growth this year may prove detrimental to the medium-term outlook. We expect India's growth to be just below 5% for the third year running for the year as a whole. Asian economies such as Indonesia, Thailand and the Philippines are expected to see sharper slowdowns in 2014.

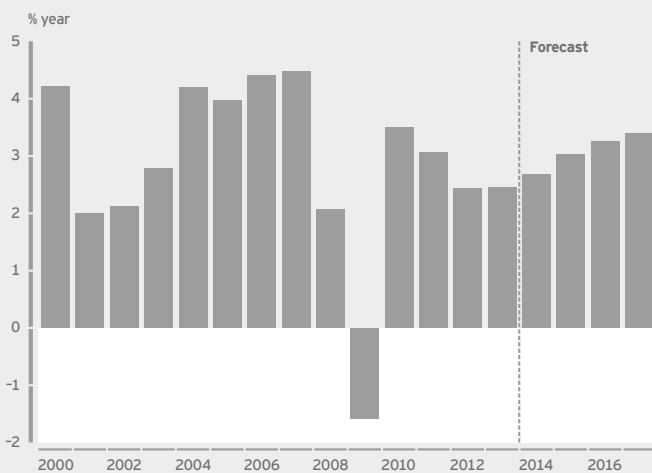
Meanwhile, apart from Mexico, the larger Latin American economies are also expected to slow pretty sharply. Continued inflationary pressures, widespread pessimism and pre-election uncertainties are taking their toll on activity in Brazil, where growth will slow from 2.5% in 2013 to 0.7% this year.

The Russian economy will suffer as a result of the ongoing Ukraine crisis. The weaker rouble, tighter monetary policy and the likely inflationary effects of Russia's retaliatory ban on food imports from the US and EU will damage economic activity, prompting GDP growth to slump from 1.2% last year to -0.1%. The main eastern European economies will buck this weaker trend and are expected to expand at a faster pace this year, thanks to the stronger Eurozone.

As a result, our forecast is for world GDP to grow by 2.7% in 2014, before steadily picking up to 3.4% a year in 2015-17. This growth profile will be echoed by a pickup in world trade growth, which is forecast to accelerate from 3.7% in 2013, to 5.3% in 2014 and then to average a little below 6% a year in 2015-17.

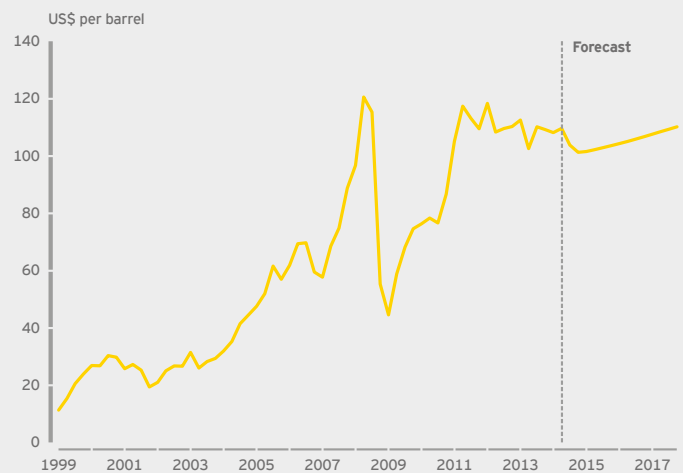
Brent crude oil prices have recently fallen back toward US\$100 a barrel. We expect Brent crude to average US\$106.5 a barrel this year, down from US\$109 in 2013, and then to fall to US\$103 a barrel in 2015, before starting to rise again slowly.

Figure 15
World: GDP growth



Source: Oxford Economics.

Figure 16
Oil price, nominal



Source: Oxford Economics.



Forecast for Eurozone countries

Austria
Belgium
Cyprus
Estonia
Finland
France
Germany
Greece
Ireland
Italy
Latvia
Luxembourg
Malta
Netherlands
Portugal
Slovakia
Slovenia
Spain



18 Eurozone countries

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Austria



► Conditions for an ongoing recovery in Austria remain largely intact. But weak performance in H1 2014 and rising geopolitical risks have led us to revise our GDP growth forecast down to 1% for this year, down from the 1.5% seen in June. From 2015, we expect average annual growth of 1.8%.

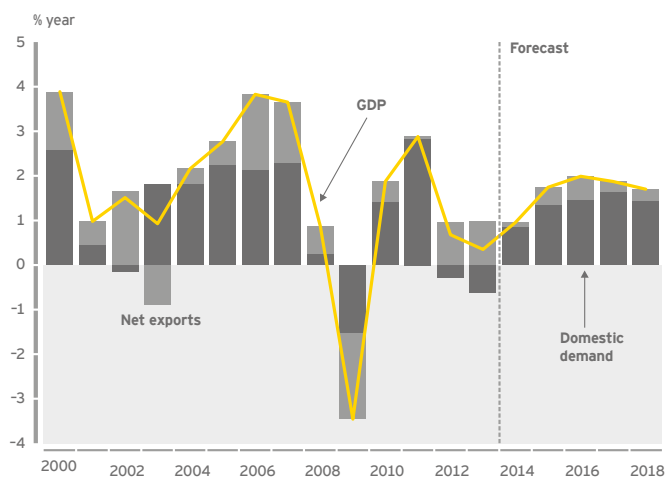
► The export sector remains structurally sound and cost-competitive, which, along with increasing diversification, should allow it to benefit from the expected revival of external demand.

► Despite a comparatively favorable environment, investment spending has been in broad decline since 2012. But it should return to growth in H2,

when previously shelved projects are reconsidered and replacement investment becomes more pressing.

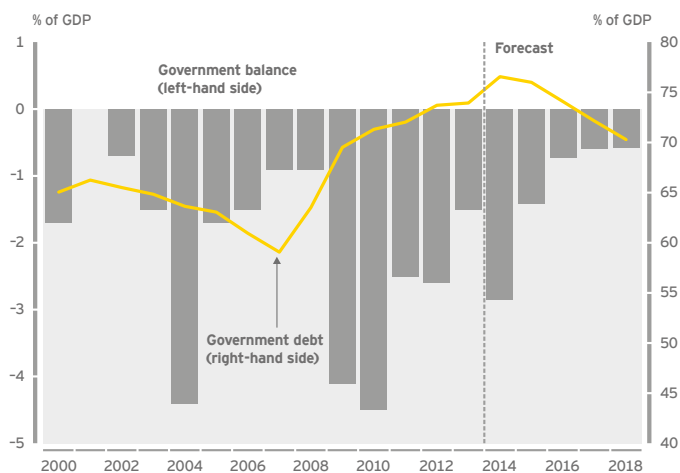
► Labor productivity has been in decline for more than three years, and a slowdown of employment growth is now overdue. As a result, the unemployment rate may not see any significant improvement from current levels, at around 5%, until late 2015.

Figure 17
Contributions to GDP



Source: Oxford Economics.

Figure 18
Government balance and debt



Source: Oxford Economics.

Austria (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	0.3	1.0	1.7	2.0	1.9	1.7
Private consumption	0.1	0.5	1.0	1.3	1.4	1.4
Fixed investment	-0.8	0.8	2.8	2.6	1.8	1.6
Stockbuilding (% of GDP)	-0.2	0.0	0.0	0.0	0.2	0.3
Government consumption	2.2	1.6	1.2	1.5	1.4	1.5
Exports of goods and services	2.5	2.8	5.7	6.0	4.7	4.3
Imports of goods and services	0.9	3.0	5.7	5.8	4.9	4.5
Consumer prices	2.1	1.6	1.7	1.8	1.7	1.8
Unemployment rate (level)	4.9	4.9	4.7	4.6	4.5	4.5
Current account balance (% of GDP)	2.7	2.5	2.9	3.0	2.9	2.9
Government budget (% of GDP)	-1.5	-2.8	-1.4	-0.7	-0.6	-0.6
Government debt (% of GDP)	74.5	77.7	76.4	74.4	72.3	70.5

Source: Oxford Economics.

Belgium



- ▶ Belgium's recovery lost a little steam in Q2 2014, but, buoyed by a depreciating euro and reasonably robust trade, we expect activity to pick up again in H2, yielding growth of 1% for the year, before accelerating to 1.3% in 2015, as consumers become more confident in the recovery.
- ▶ However, the pace of the recovery in the medium term will be weaker than

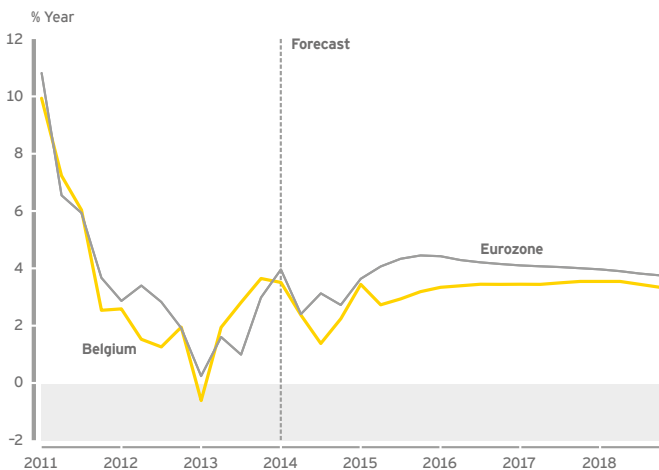
has been seen after previous recessions. Increased costs compared with Eurozone rivals will constrain export growth, and investment will also suffer from Belgium's loss of competitiveness.

- ▶ Meanwhile, the Government will need to exercise spending restraint to get the debt ratio on a declining path. We expect growth to peak at 1.8%

in 2018 – around 0.5 percentage points slower than the pre-crisis average.

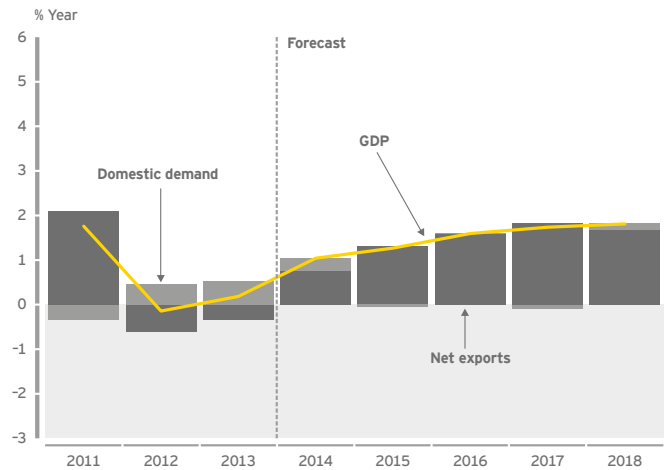
- ▶ More could be done to boost Belgium's competitiveness and longer-term outlook, in particular by cutting non-wage costs. The incoming government also needs to set out a credible long-run fiscal plan, in particular to deal with the costs of aging.

Figure 19
Export growth vs. Eurozone



Source: Oxford Economics; Haver Analytics.

Figure 20
Contributions to GDP growth



Source: Oxford Economics.

Belgium (annual percentage changes unless specified)

	2013	2014	2015	2016	2017	2018
GDP	0.2	1.0	1.3	1.6	1.7	1.8
Private consumption	0.8	1.2	1.3	1.4	1.6	1.6
Fixed investment	-1.4	2.2	1.8	2.5	2.8	3.1
Stockbuilding (% of GDP)	0.3	0.0	0.0	0.0	0.1	0.0
Government consumption	0.6	0.2	0.9	1.1	1.3	1.4
Exports of goods and services	1.9	2.4	3.1	3.4	3.5	3.5
Imports of goods and services	1.4	2.1	3.2	3.5	3.6	3.4
Consumer prices	1.2	0.7	1.3	1.8	2.0	2.0
Unemployment rate (level)	8.4	8.5	8.5	8.1	7.7	7.6
Current account balance (% of GDP)	-1.9	-0.7	-1.2	-1.2	-1.1	-0.8
Government budget (% of GDP)	-2.6	-2.3	-2.3	-2.1	-1.9	-1.7
Government debt (% of GDP)	101.5	104.7	107.2	108.8	109.8	110.3

Source: Oxford Economics.

Cyprus

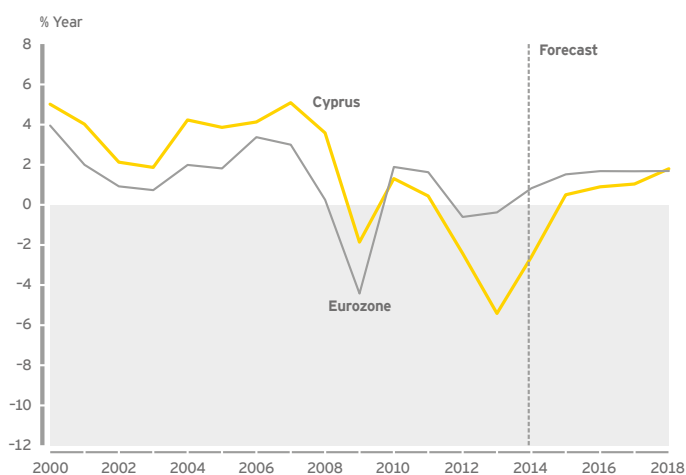
GDP growth

2014 **-2.6%**

- ▶ Following an expected 2.6% contraction this year, GDP is now forecast to return to growth in 2015, although it will be modest at just 0.5%. A better-functioning banking system, improved confidence overall and strong tourism should all boost the economy.
- ▶ Although the outlook is expected to brighten, the risks remain skewed to the downside. While the banking sector has stabilized and all domestic capital controls have been lifted, the financial sector remains weak and is expected to weigh on growth.
- ▶ The impact of tensions in Ukraine on Russia also represents a downside risk to our forecast. Cyprus is one of the main offshore investment destinations for Russian money and Russia accounted for 25% of tourists to the island in 2013.

Figure 21

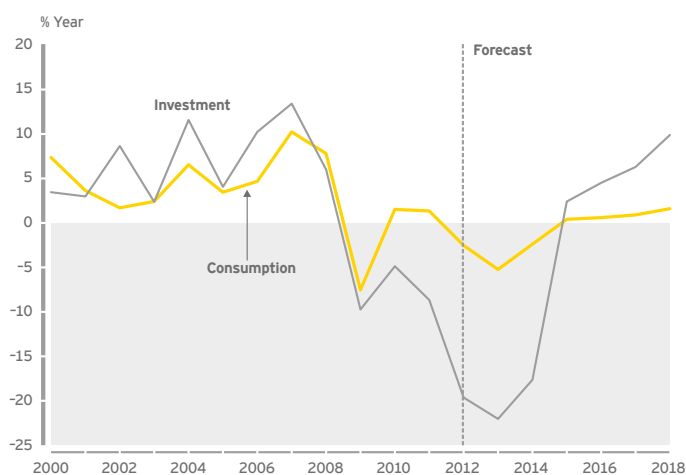
Real GDP growth



Source: Oxford Economics.

Figure 22

Real consumption and investment growth



Source: Oxford Economics.

Cyprus (annual percentage changes unless specified)

	2013	2014	2015	2016	2017	2018
GDP	-5.4	-2.6	0.5	0.9	1.0	1.8
Private consumption	-5.2	-2.4	0.4	0.6	0.9	1.6
Fixed investment	-22.0	-17.7	2.4	4.5	6.3	9.9
Stockbuilding (% of GDP)	-2.1	-1.2	0.2	1.9	2.5	2.7
Government consumption	-2.0	-1.5	-2.9	0.2	0.9	1.0
Exports of goods and services	-3.7	-0.1	2.9	3.5	4.7	5.2
Imports of goods and services	-14.0	-1.3	4.9	7.3	6.9	6.7
Consumer prices	0.4	0.8	1.0	1.2	1.5	1.8
Unemployment rate (level)	15.9	15.9	15.9	15.5	13.8	11.9
Current account balance (% of GDP)	-1.9	-0.3	-0.3	-0.3	-0.3	-0.4
Government budget (% of GDP)	-5.4	-5.7	-6.0	-4.7	-2.9	-1.8
Government debt (% of GDP)	111.7	119.6	123.7	125.9	125.6	123.0

Source: Oxford Economics.

Estonia

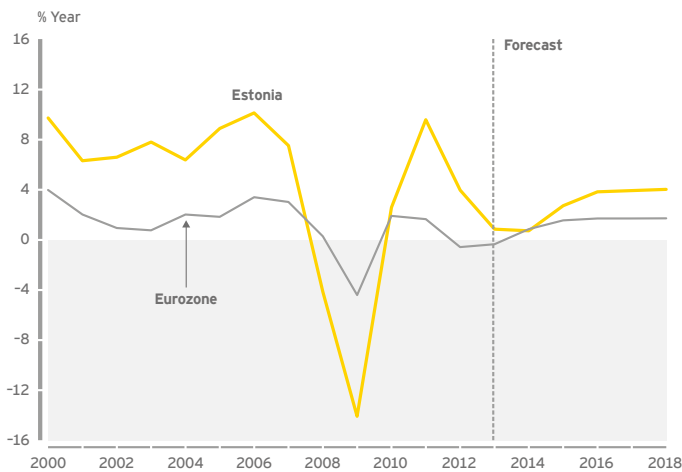
GDP growth

2014 **0.7%**

- ▶ Latest estimates suggest that Estonia's economy expanded by 0.5% in Q2 2014. Although this is encouraging, we have downgraded Estonia's growth forecast as the escalation of the Ukraine-Russia crisis will have an adverse impact in H2.
- ▶ We now expect GDP to expand by just 0.7% in 2014 and 2.7% in 2015, compared with our June projections of 1.6% and 3.2% respectively.
- ▶ Despite these developments, exports will be the main growth driver in the near term. Rising demand in Estonia's other important trading partners suggest that export growth will accelerate to 2.5% in 2014 and 6.3% in 2015, after increasing by just 1.8% in 2013. The outlook for domestic demand is also upbeat.
- ▶ Although Estonia's growth outlook is sound, downside risks, stemming from the possibility of more negative impacts of the Ukraine crisis, higher inflation and lower competitiveness, dominate the forecast. But with government debt at 10% of GDP, there is plenty of room for fiscal stimulus in the event that these risks materialize.

Figure 23

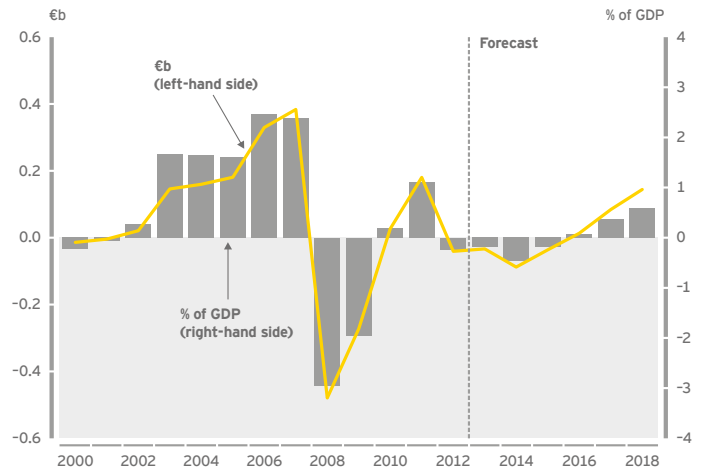
Real GDP growth



Source: Oxford Economics.

Figure 24

Government budget balance



Source: Oxford Economics.

Estonia (annual percentage changes unless specified)

	2013	2014	2015	2016	2017	2018
GDP	0.8	0.7	2.7	3.8	3.9	4.0
Private consumption	4.2	3.4	3.7	3.9	4.1	4.1
Fixed investment	1.1	3.0	3.8	4.2	5.3	4.9
Stockbuilding (% of GDP)	2.0	1.3	1.0	1.3	1.5	1.9
Government consumption	1.3	1.7	2.7	3.0	3.0	2.7
Exports of goods and services	1.8	2.5	6.3	8.5	8.2	7.5
Imports of goods and services	2.6	4.0	6.8	8.6	8.6	7.8
Consumer prices	3.2	0.8	2.7	3.1	3.2	3.0
Unemployment rate (level)	8.6	8.4	8.1	7.8	7.8	7.8
Current account balance (% of GDP)	-1.0	-1.7	-1.0	-0.5	-0.3	-0.1
Government budget (% of GDP)	-0.2	-0.5	-0.2	0.1	0.4	0.6
Government debt (% of GDP)	10.0	10.4	10.1	9.3	8.3	7.2

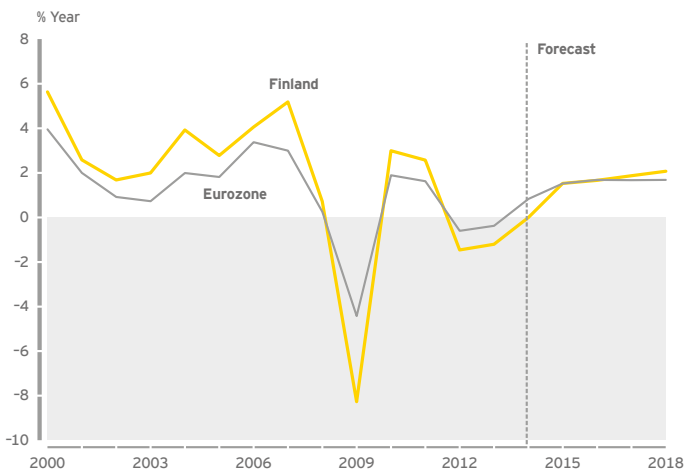
Source: Oxford Economics.

Finland



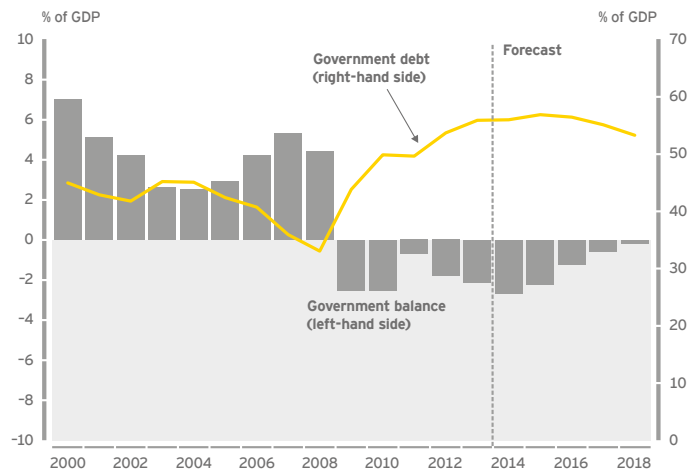
- ▶ There are signs that economic conditions in Finland are finally starting to improve, allowing it to exit its post-financial crisis triple-dip recession. After remaining broadly flat this year, we expect GDP growth of 1.5% in 2015.
- ▶ But the near-term outlook remains vulnerable to downside risks, including developments in Russia and the potential for the Eurozone's fragile recovery to stall.
- ▶ Structural challenges will also impede the pace of expansion, as Finland struggles to regain cost competitiveness and compensate for the decline of its paper and pulp and electronics industries. We therefore forecast only a gradual pickup in growth, to 2.1% by 2018.
- ▶ We believe there is a case for a modest fiscal stimulus to support the stuttering recovery, as the debt ratio is below most peers and borrowing costs remain historically low. With the EC recently confirming that it would not initiate an excessive debt procedure should Finland breach the threshold, the Government has some leeway to pursue a more growth-oriented stance.

Figure 25
GDP growth



Source: Oxford Economics.

Figure 26
Government budget balance



Source: Oxford Economics.

Finland (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	-1.2	0.0	1.5	1.7	1.9	2.1
Private consumption	-0.7	-0.2	1.0	1.6	1.8	1.9
Fixed investment	-4.9	-3.2	3.3	2.3	2.3	2.3
Stockbuilding (% of GDP)	-0.1	0.4	0.4	0.3	0.2	0.3
Government consumption	1.5	-0.1	1.1	1.2	1.4	1.4
Exports of goods and services	-1.7	0.1	3.7	3.4	3.3	3.2
Imports of goods and services	-2.5	-0.7	3.6	3.1	3.0	2.9
Consumer prices	2.2	1.2	1.7	2.0	2.0	2.0
Unemployment rate (level)	8.2	8.5	8.2	7.8	7.6	7.4
Current account balance (% of GDP)	-2.2	-1.3	-0.3	-0.1	0.0	0.1
Government budget (% of GDP)	-2.1	-2.7	-2.2	-1.2	-0.6	-0.2
Government debt (% of GDP)	54.8	57.1	57.7	56.8	55.3	53.3

Source: Oxford Economics.

France



GDP growth

2014 **0.4%**

► France's economy is increasingly losing pace with the rest of the Eurozone, with GDP flat in H1 2014. Growth in the remainder of the year seems dependent on modest export gains as the euro depreciates and demand picks up elsewhere. We expect GDP to increase by just 0.4% in 2014.

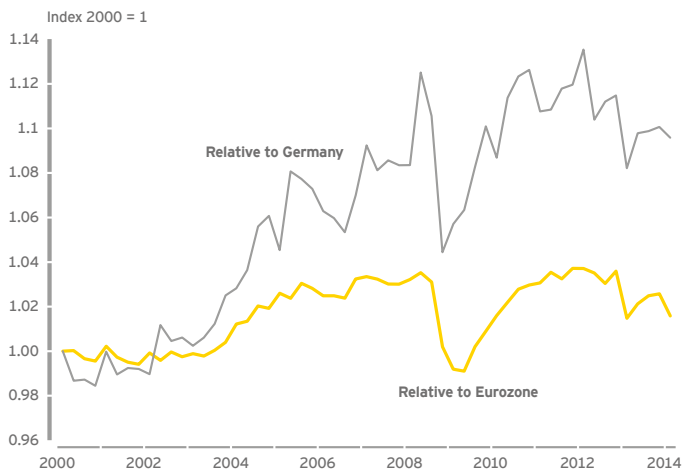
► Growth should pick up a little next year, as trade continues to recover and the

labor market stabilizes, supporting consumer spending. But these factors are unlikely to be able to push growth beyond 1% in 2015. And the Government's attempts to trim €50b from the annual budget over the next three years, along with the effects of weak competitiveness on trade and investment, will limit growth to just 1.6% by 2018.

► A reinvigorated reform effort would boost the sustainable pace of expansion over the medium term, and could have powerful impacts on confidence (and therefore potentially investment and employment) in the nearer term. Recent measures are a step in the right direction, but more can be done in the coming years.

Figure 27

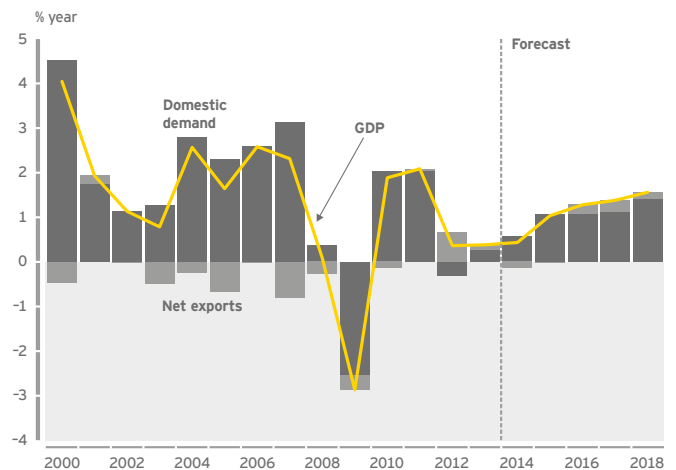
Labor costs



Source: Oxford Economics; Haver Analytics.

Figure 28

Contributions to GDP growth



Source: Oxford Economics.

France (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	0.4	0.4	1.0	1.3	1.4	1.6
Private consumption	0.3	0.3	1.3	1.5	1.5	1.4
Fixed investment	-0.8	-2.2	0.8	2.3	2.5	2.8
Stockbuilding (% of GDP)	0.1	0.6	0.7	0.4	0.0	0.0
Government consumption	2.0	1.7	0.5	0.4	0.4	0.5
Exports of goods and services	2.4	2.7	3.3	4.1	4.6	4.5
Imports of goods and services	1.9	3.1	3.2	3.3	3.6	3.9
Consumer prices	1.0	1.0	1.4	1.5	1.6	1.7
Unemployment rate (level)	10.3	10.1	10.0	9.8	9.7	9.5
Current account balance (% of GDP)	-1.3	-1.1	-1.4	-1.3	-1.3	-1.2
Government budget (% of GDP)	-4.3	-4.0	-3.5	-2.8	-2.3	-2.0
Government debt (% of GDP)	91.8	97.0	101.0	103.1	104.1	103.8

Source: Oxford Economics.

Germany



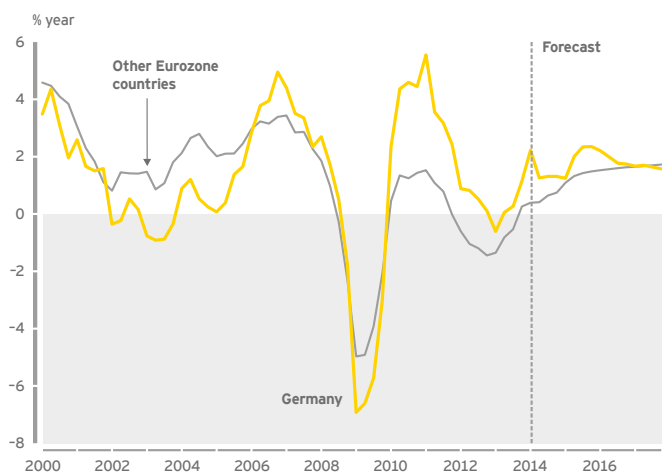
GDP growth

2014 **1.5%**

- ▶ Although recent data from Germany has been a little disappointing, Q2's 0.2% fall in GDP paints a misleadingly pessimistic picture of underlying conditions. Unless the situation in Ukraine takes a dramatic turn for the worse, we expect the recovery to build up steam in H2.
- ▶ The economy should gradually strengthen next year, reflecting a broad-based improvement by expenditure components. Healthy household balance sheets and rising income growth should ensure that consumer spending increases. And the investment recovery may build on the back of rising profits, improving demand prospects both at home and abroad, and easier access to credit.
- ▶ Overall, we expect GDP growth to rise from 1.5% this year, to 2% in 2015, before gradually slowing to 1.5% by 2018. In the short term, the biggest threat to our forecast is from a worsening of the Ukraine crisis. But Germany's strong underlying economic fundamentals suggest that in the medium term risks are limited.

Figure 29

GDP growth: Germany vs. rest of Eurozone



Source: Oxford Economics.

Figure 30

GDP and Ifo Institute business expectations index



Source: Oxford Economics; Haver Analytics.

Germany (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	0.2	1.5	2.0	1.9	1.6	1.5
Private consumption	1.0	0.9	1.7	1.5	1.4	1.3
Fixed investment	-0.6	2.5	2.1	3.7	2.8	2.4
Stockbuilding (% of GDP)	-0.9	-0.5	0.0	0.1	0.1	0.1
Government consumption	0.7	0.8	0.6	0.6	0.6	0.7
Exports of goods and services	1.1	3.5	4.5	4.7	4.3	4.1
Imports of goods and services	1.6	5.5	5.2	4.9	4.6	4.4
Consumer prices	1.6	1.1	1.8	2.2	2.0	1.5
Unemployment rate (level)	5.3	5.1	5.4	5.6	5.4	5.3
Current account balance (% of GDP)	7.1	7.1	6.8	6.6	6.4	6.2
Government budget (% of GDP)	0.0	0.0	0.2	-0.1	-0.2	-0.2
Government debt (% of GDP)	78.4	78.6	78.5	78.2	78.1	78.2

Source: Oxford Economics.

Greece



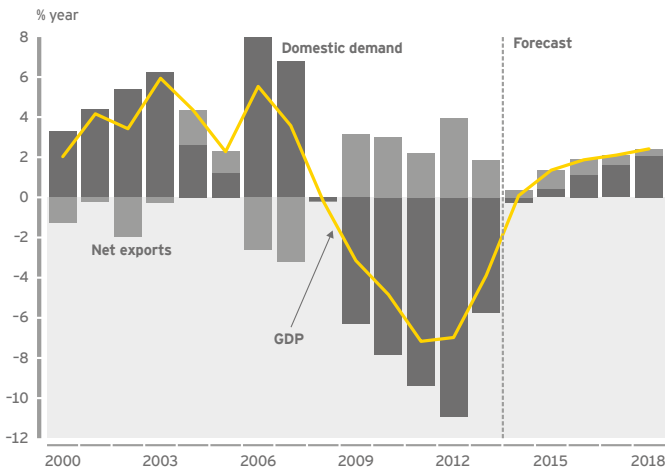
- ▶ After six years of recession, monthly indicators suggest that the Greek economy is no longer contracting. Our estimates suggest the economy may have returned to growth around mid-year.
- ▶ We now forecast GDP growth of 1.4% in 2015, after an outturn close to zero this year. Retail sales and industrial

production have both recently shown positive annual growth, while the unemployment rate has plateaued at 27%. However, Greece continues to face many challenges in translating this progress into a sustained recovery.

- ▶ Fiscal outturns this year are currently ahead of target, prompting some calls

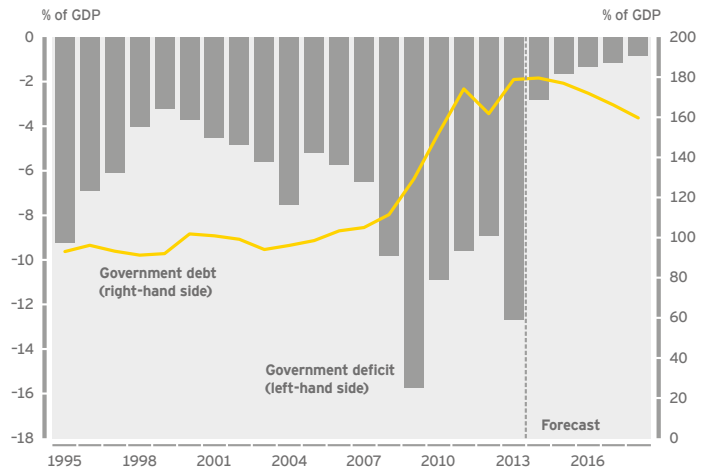
for tax cuts from the Government. Greece now has the highest cyclically adjusted primary surplus in the Eurozone. However, there is still a fiscal gap for 2015 of around 1% of GDP. How this will be addressed is the focus of current negotiations between the Government and its official creditors.

Figure 31
Contributions to GDP growth



Source: Oxford Economics.

Figure 32
Government deficit and debt



Source: Oxford Economics.

Greece (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	-3.9	0.1	1.4	1.9	2.1	2.4
Private consumption	-5.9	-1.2	0.8	1.2	1.4	1.6
Fixed investment	-12.7	-1.8	3.4	5.0	5.0	4.8
Stockbuilding (% of GDP)	1.6	2.4	2.7	2.1	1.8	1.8
Government consumption	-4.2	-3.3	-1.8	1.6	1.8	1.6
Exports of goods and services	1.3	5.0	5.0	4.9	4.8	4.9
Imports of goods and services	-5.4	3.5	1.6	2.3	3.3	3.9
Consumer prices	-0.9	-1.0	0.3	1.0	1.6	1.8
Unemployment rate (level)	27.5	27.1	25.7	24.0	22.1	20.3
Current account balance (% of GDP)	0.8	1.5	1.4	1.4	1.4	1.4
Government budget (% of GDP)	-12.7	-2.8	-1.6	-1.3	-1.1	-0.8
Government debt (% of GDP)	175.1	179.9	177.2	172.1	166.2	159.7

Source: Oxford Economics.

Ireland

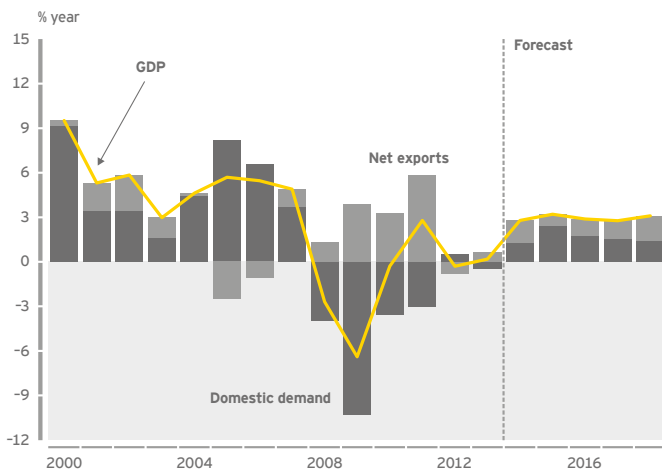


GDP growth

2014 **2.8%**

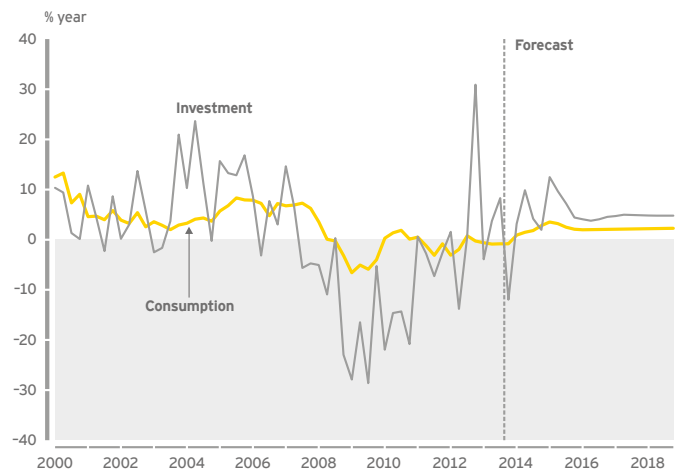
- ▶ Ireland's economic recovery is looking more secure, with GDP seeing a strong 2.7% quarterly rise in Q1 2014 to stand over 5% up on a year earlier. And more recent evidence points to the recovery becoming increasingly entrenched.
- ▶ While exports have done the heavy lifting so far, the recovery should be increasingly broad-based, with domestic demand adding to growth. GDP is now forecast to grow 2.8% this year and 3.2% in 2015.
- ▶ However, evidence that the Eurozone recovery faded out in Q2 will dampen exports, as will rising international geopolitical tensions. Moreover, very low inflation and associated weakness in nominal GDP will continue to pose problems for an economy as heavily indebted as Ireland's.

Figure 33
Contributions to GDP



Source: Oxford Economics.

Figure 34
Consumption and investment



Source: Oxford Economics.

Ireland (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	0.2	2.8	3.2	2.9	2.8	3.1
Private consumption	-0.8	1.8	2.8	2.0	2.1	2.2
Fixed investment	-1.8	4.7	8.3	4.1	4.9	4.8
Stockbuilding (% of GDP)	0.5	1.1	0.9	1.0	0.6	0.2
Government consumption	1.3	-0.2	-0.2	0.1	0.7	0.8
Exports of goods and services	1.1	5.7	4.1	4.0	4.0	4.3
Imports of goods and services	0.6	5.3	4.2	3.7	3.6	3.6
Consumer prices	0.5	0.6	1.3	1.6	1.8	1.9
Unemployment rate (level)	13.1	11.7	10.6	9.6	9.1	8.5
Current account balance (% of GDP)	4.3	3.8	3.9	3.7	3.6	3.5
Government budget (% of GDP)	-6.6	-3.7	-2.0	-0.8	0.0	0.2
Government debt (% of GDP)	123.7	122.6	118.1	113.7	108.7	103.3

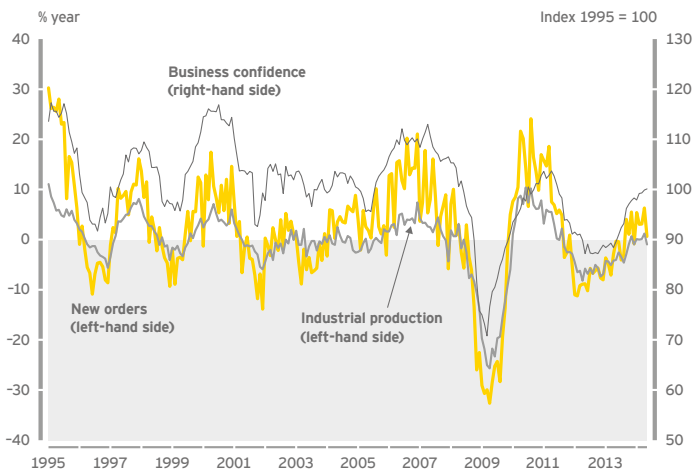
Source: Oxford Economics.

Italy



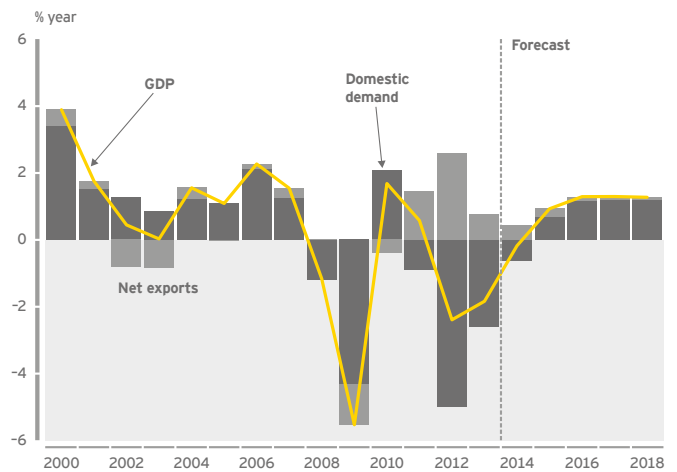
- ▶ Having shrunk 0.1% in Q1 2014, GDP contracted by 0.2% in Q2, so Italy is now back in recession, having posted just one quarterly rise in GDP in the last three years. GDP is now forecast to contract 0.2% in 2014 as a whole, the third consecutive year of decline.
- ▶ Looking ahead, we expect a very subdued recovery, with the economy seen growing by only 0.9% next year and 1.3% in 2016.
- ▶ Domestic demand will remain constrained in the coming years by the high level of unemployment, low wage pressures and tight credit conditions.
- ▶ Stronger external demand will support the recovery, but Italian exports are not expected to gain fully from the improvement in external conditions, as the country has done less than others to improve its competitiveness.

Figure 35
Industrial performance



Source: Haver Analytics.

Figure 36
Contributions to GDP growth



Source: Oxford Economics.

Italy (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	-1.8	-0.2	0.9	1.3	1.3	1.3
Private consumption	-2.6	0.0	0.6	1.1	1.1	1.0
Fixed investment	-4.6	-0.8	1.5	2.1	2.3	2.4
Stockbuilding (% of GDP)	-0.3	-0.7	-0.6	-0.5	-0.4	-0.3
Government consumption	-0.8	0.0	-0.2	0.1	0.2	0.3
Exports of goods and services	0.0	3.4	3.9	3.9	3.9	3.7
Imports of goods and services	-2.9	2.2	3.5	4.1	4.1	4.0
Consumer prices	1.3	0.3	0.7	1.2	1.3	1.5
Unemployment rate (level)	12.2	12.7	12.6	12.3	11.9	11.5
Current account balance (% of GDP)	1.0	1.8	1.9	1.9	1.9	1.8
Government budget (% of GDP)	-3.0	-3.1	-2.6	-2.2	-1.9	-1.6
Government debt (% of GDP)	132.6	135.5	135.4	134.1	132.4	130.5

Source: Oxford Economics.

Latvia



- ▶ A positive Baltic trade dynamic, which will be reinforced by Lithuania's Eurozone entry in January 2015, is helping to offset the short-term risks of Russian and EU export slowdown, lining up investment-led growth of 3.2% this year and about 5% a year in 2015-18.
- ▶ Improved labor market flexibility and financial capacity ensure a supply-side response to the rise in domestic and

export demand, supporting medium-term growth significantly above the Eurozone average.

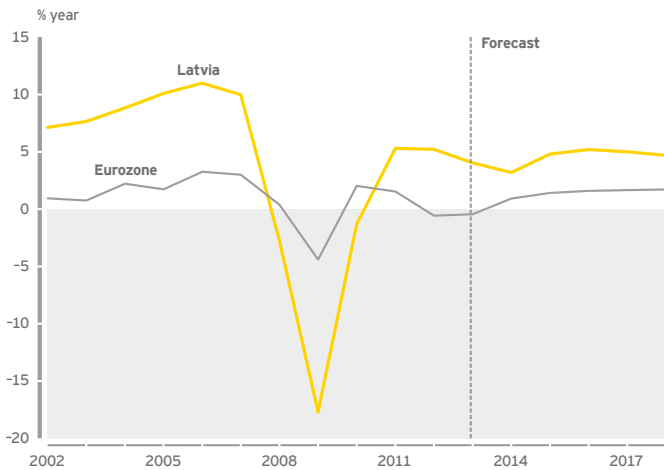
- ▶ Energy supply vulnerability and rapid wage growth since 2013 mean a possibility of overheating, which would lead to lower growth and faster inflation than forecast. But productivity is set to catch up with pay, as GDP growth accelerates and strains with Russia are

promoting more EU action to promote Baltic energy diversification.

- ▶ Financial sanctions on Russia could revive concern about banks' non-resident deposits, but the sector's defenses against systemic risk have been strengthened by restructuring at larger banks and Eurozone accession.

Figure 37

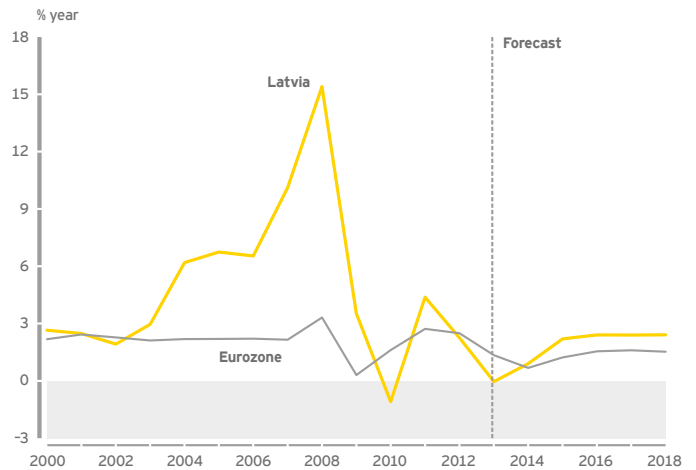
Real GDP growth



Source: Oxford Economics; World Bank.

Figure 38

Inflation



Source: Oxford Economics.

Latvia (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	4.1	3.2	4.8	5.2	5.0	4.7
Private consumption	5.3	4.1	4.8	4.8	4.8	4.8
Fixed investment	1.6	4.5	5.0	5.0	5.0	5.0
Stockbuilding (% of GDP)	0.2	-0.2	-0.9	-0.9	-0.5	-0.4
Government consumption	2.0	2.2	2.6	2.7	2.4	2.3
Exports of goods and services	2.1	3.8	6.5	6.5	6.5	6.5
Imports of goods and services	0.6	4.2	4.7	5.4	6.2	6.2
Consumer prices	0.0	0.9	2.2	2.4	2.4	2.4
Unemployment rate (level)	12.1	11.0	9.7	8.2	8.0	7.8
Current account balance (% of GDP)	-0.8	-1.1	-0.7	-0.2	0.3	0.4
Government budget (% of GDP)	-0.9	-1.0	-1.0	-1.0	-1.0	-1.0
Government debt (% of GDP)	40.3	39.7	38.0	36.3	34.7	33.4

Source: Oxford Economics.

Luxembourg



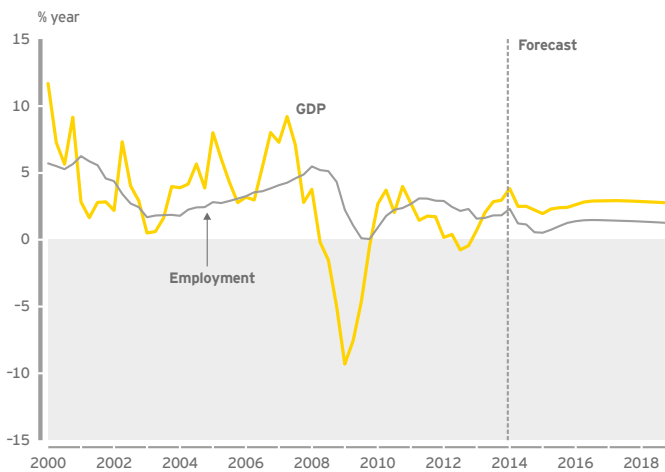
GDP growth

2014 **2.8%**

- ▶ Luxembourg's economy is on track to outperform much of the Eurozone this year, with GDP growth of 2.8% underpinned by an improved contribution from non-financial sectors. For 2015, we expect growth to slow to 2.3% due to fiscal tightening in response to a loss of value-added tax (VAT) revenues from e-commerce, estimated at 1% of GDP, before a pickup to 2.8% in 2016-18.
- ▶ This year and next, the financial sector will still be held back by the slow recovery in banking, which continues to face restructuring and regulatory challenges. Meanwhile asset management is set to continue to grow strongly, benefitting from established infrastructure advantages and expertise.
- ▶ Consumers will benefit from rising real incomes this year, thanks to low inflation, which should support ongoing spending growth. In anticipation of higher VAT rates in 2015, consumers are also likely to bring some spending forward to this year.

Figure 39

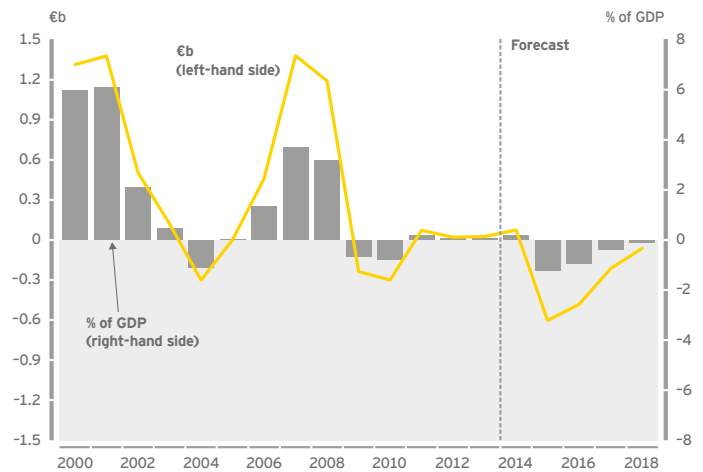
Real GDP and employment



Source: Oxford Economics.

Figure 40

Government budget balance



Source: Oxford Economics.

Luxembourg (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	2.1	2.8	2.3	2.8	2.9	2.8
Private consumption	1.7	1.9	1.8	2.3	2.5	2.4
Fixed investment	-4.3	8.6	5.2	3.8	3.1	3.0
Stockbuilding (% of GDP)	2.1	2.4	1.8	0.9	0.9	1.1
Government consumption	4.3	0.8	1.7	1.9	1.9	1.9
Exports of goods and services	2.6	5.0	5.9	4.3	3.5	3.1
Imports of goods and services	1.3	5.9	6.2	3.9	3.4	3.1
Consumer prices	1.7	1.1	2.3	2.0	2.0	1.9
Unemployment rate (level)	5.9	6.2	6.2	5.8	5.3	4.9
Current account balance (% of GDP)	5.2	4.2	5.1	5.7	5.7	5.7
Government budget (% of GDP)	0.1	0.2	-1.2	-0.9	-0.4	-0.1
Government debt (% of GDP)	23.1	22.2	22.4	22.2	21.5	20.6

Source: Oxford Economics.

Malta



► We have raised our forecast for growth in Malta this year to 2.2%, from 1.8% projected in June. Domestic activity, particularly investment, is gathering momentum and low unemployment will support consumer spending. Other favorable factors supporting demand include strong tourist spending and lower utility prices.

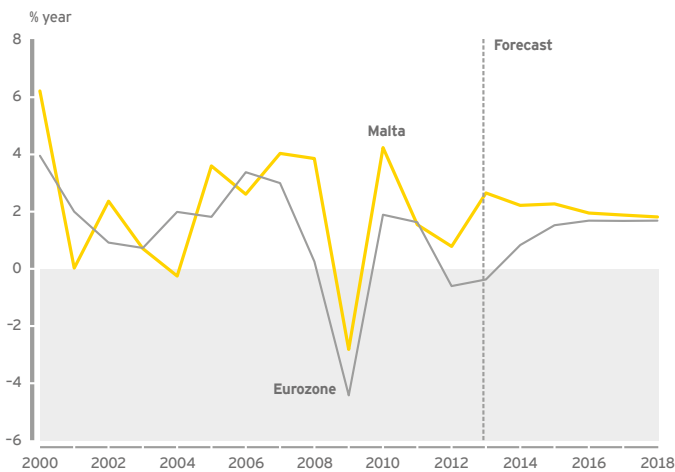
► As part of the EU Energy 2020 program, Malta is committed to reducing both dependence on fossil fuels and energy costs, and a number of big energy projects will boost investment. Construction has begun on a new power plant, due to open next year, which will provide Malta with 200 megawatts of energy capacity.

► Led by tourism and financial services, the service sector will continue to outgrow

industry. Exports of services have strong momentum and this is expected to drive a modest current account surplus over the forecast period.

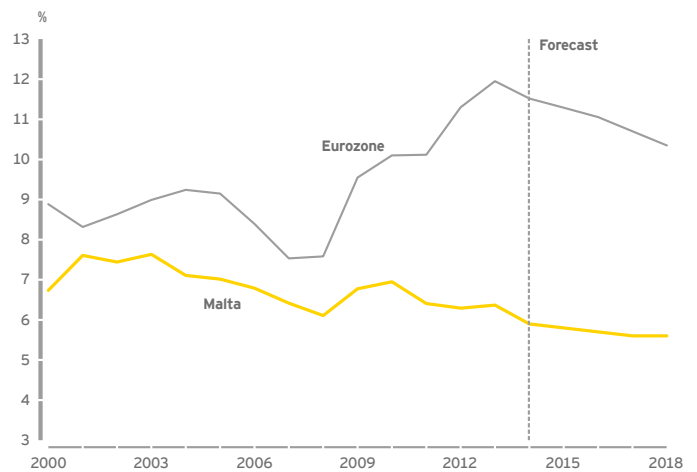
► The fiscal deficit narrowed to 2.8% of GDP last year, helped by a 10% rise in tax revenues. We expect the deficit to shrink to 2% by 2018, driven by higher revenue growth and slower expansion in government employment.

Figure 41
Real GDP growth



Source: Oxford Economics.

Figure 42
Unemployment rate



Source: Oxford Economics.

Malta (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	2.4	2.2	2.3	1.9	1.9	1.8
Private consumption	1.8	1.9	2.3	2.2	2.0	1.9
Fixed investment	-3.9	2.8	2.9	2.7	2.5	2.3
Stockbuilding (% of GDP)	0.8	1.4	1.3	1.2	1.1	1.0
Government consumption	-0.2	0.6	1.3	1.4	1.5	1.7
Exports of goods and services	-5.5	1.0	4.2	3.3	3.0	3.0
Imports of goods and services	-5.1	1.1	4.1	3.3	3.0	3.0
Consumer prices	1.0	1.0	1.5	1.9	2.3	2.3
Unemployment rate (level)	6.4	5.9	5.8	5.7	5.6	5.6
Current account balance (% of GDP)	0.9	2.8	2.4	2.2	1.7	1.3
Government budget (% of GDP)	-2.8	-2.8	-2.7	-2.6	-2.4	-2.0
Government debt (% of GDP)	72.6	74.0	73.9	73.7	73.1	72.2

Source: Oxford Economics.

Netherlands



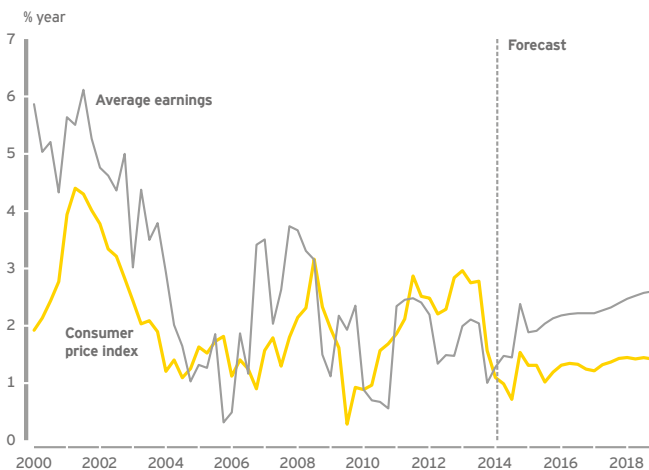
GDP growth

2014 **0.7%**

- ▶ The outlook for the Dutch economy is improving slowly, and we expect it to continue along a path of slow but steady growth. Exports will be the main driver of the recovery, with rising foreign demand expected to percolate through the domestic economy.
- ▶ The improving situation for households should help consumption to begin to recover after an extended period of contraction.
- ▶ Yet there are still considerable headwinds. Both households and the government are limiting their spending in an attempt to improve their financial situations, and this will limit growth in the near term.
- ▶ The corporate sector is also unlikely to contribute much to growth over the next few years, as a large amount of spare capacity depresses the need for new investment. But with large piles of cash available, there is an upside risk to our investment forecast.
- ▶ Overall, we forecast GDP growth of 0.7% this year, accelerating to 1.2% in 2015 and 1.3% in 2016.

Figure 43

Prices and earnings



Source: Oxford Economics.

Figure 44

Misery index*



Source: Haver Analytics.

*CBS unemployment rate plus CPI inflation rate.

Netherlands (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	-0.7	0.7	1.2	1.3	1.6	1.7
Private consumption	-1.6	-0.3	0.5	0.8	1.2	1.5
Fixed investment	-3.9	0.7	2.1	2.1	2.0	2.1
Stockbuilding (% of GDP)	0.1	0.1	0.2	0.0	0.1	0.2
Government consumption	-0.2	0.0	-0.4	0.0	0.3	0.8
Exports of goods and services	2.2	2.9	3.7	3.7	3.2	2.6
Imports of goods and services	1.0	2.4	3.3	3.3	3.0	2.6
Consumer prices	2.6	0.7	1.1	1.2	1.3	1.4
Unemployment rate (level)	6.7	6.9	6.7	6.6	6.5	6.4
Current account balance (% of GDP)	10.2	10.6	10.0	10.1	10.1	10.0
Government budget (% of GDP)	-2.5	-2.7	-2.5	-2.4	-2.2	-1.8
Government debt (% of GDP)	73.5	75.3	76.2	76.6	76.7	76.4

Source: Oxford Economics.

Portugal



GDP growth

2014 **0.9%**

▶ Portugal faced market scrutiny because of recent developments at Banco Espírito Santo, after its reported net loss of €3.6b (around 2% of GDP) in H1 2014. As this appears to have been mainly due to transactions conducted with some of the bank's holding companies, and the Bank of Portugal has swiftly applied the new European framework for bank recovery and resolution, further impact has been prevented and the markets have

responded favorably, with Portuguese sovereign debt yields at historic lows.

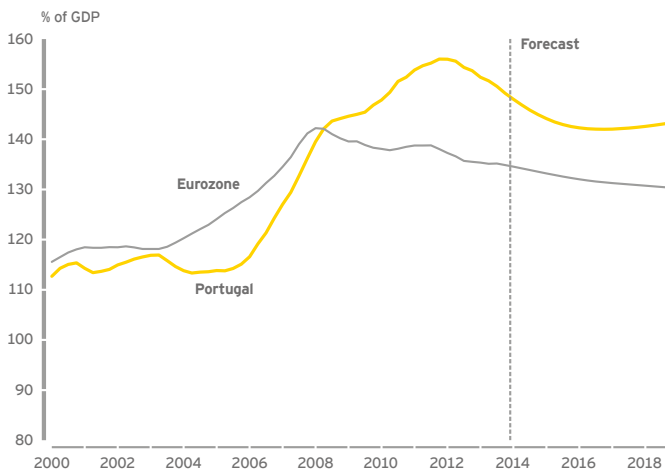
- ▶ GDP increased by 0.6% on the quarter in Q2, reversing a similar fall in Q1. We expect this momentum to continue in the coming months and forecast GDP growth of 0.9% in 2014, with net exports continuing to support activity.
- ▶ The rise in consumer confidence, currently at a seven-year high, will

continue to support private consumption, although domestic demand will remain constrained by fiscal austerity, high corporate indebtedness and a still-fragile labor market.

- ▶ We expect the economy to grow fairly slowly over the medium term, with growth seen at 1.4% in 2015, and a similar pace in 2016-18.

Figure 45

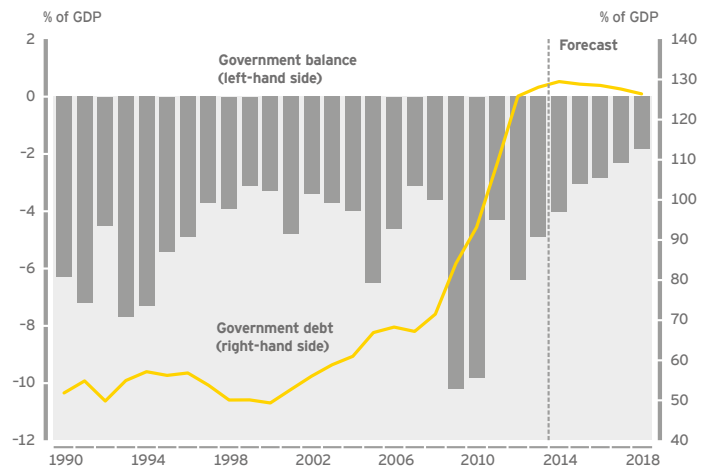
Corporate sector deleveraging



Source: Oxford Economics; Haver Analytics.

Figure 46

Government balance and debt



Source: Oxford Economics.

Portugal (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	-1.4	0.9	1.4	1.4	1.4	1.3
Private consumption	-1.7	0.9	1.0	1.0	0.9	0.9
Fixed investment	-6.3	0.1	2.5	2.9	2.5	2.4
Stockbuilding (% of GDP)	0.4	1.2	0.4	0.2	0.1	0.2
Government consumption	-1.8	-1.0	-1.0	0.9	1.3	1.2
Exports of goods and services	6.1	3.9	5.6	4.0	3.9	3.4
Imports of goods and services	3.1	4.5	2.4	3.3	3.3	3.2
Consumer prices	0.4	-0.2	0.5	0.8	1.1	1.4
Unemployment rate (level)	16.4	14.4	14.0	13.9	13.8	13.7
Current account balance (% of GDP)	0.5	-0.1	1.0	1.2	1.4	1.6
Government budget (% of GDP)	-4.9	-4.0	-3.0	-2.8	-2.3	-1.8
Government debt (% of GDP)	129.0	130.6	130.1	129.5	128.5	127.0

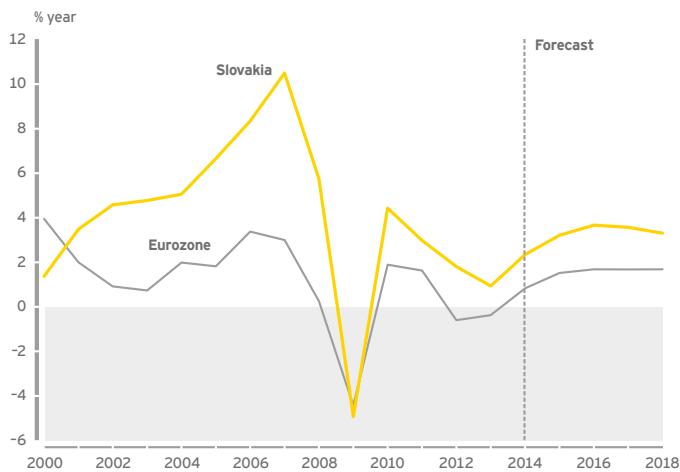
Source: Oxford Economics.

Slovakia



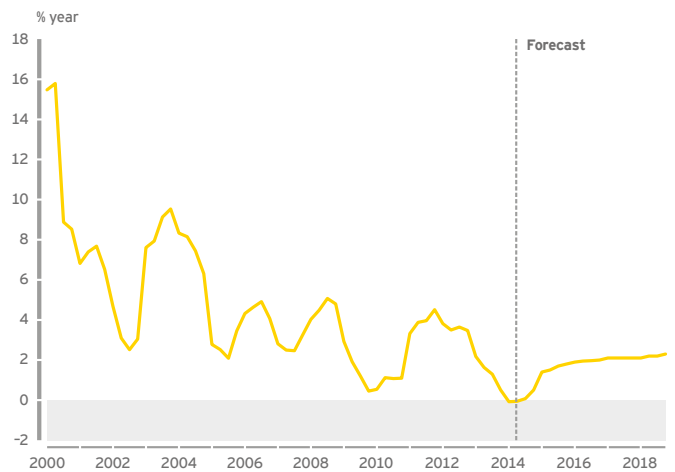
- ▶ We expect GDP growth in Slovakia to rise to 2.3% this year from just 0.9% in 2013, as fiscal policy is relaxed and foreign demand picks up. Economic activity will accelerate to 3.2% in 2015, as unemployment declines and credit conditions improve. A fresh fiscal squeeze will be a drag on the economy next year, but its effect will be mitigated by lower real interest rates and stronger demand for Slovak exports.
- ▶ Inflation should start to pick up from Q3, due to base effects in H2 2013, as well as rising inflation in the Czech Republic and the Eurozone, both key trading partners for Slovakia. Inflation will accelerate to 1.6% in 2015, when the effect of electricity price cuts disappears and import prices rise.
- ▶ Risks to our forecast have become more balanced. The ECB's TLTRO program might lift bank lending and hence growth in the Eurozone, boosting demand for Slovak exports. However, an escalation of the Ukraine-Russia tension could restrict the supply of gas to Slovakia and reduce demand in its key trading partners.

Figure 47
Real GDP growth



Source: Oxford Economics.

Figure 48
Inflation



Source: Oxford Economics; World Bank.

Slovakia (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	0.9	2.3	3.2	3.7	3.6	3.3
Private consumption	-0.1	2.5	2.2	2.8	2.7	2.6
Fixed investment	-4.3	2.1	3.4	4.6	4.5	4.0
Stockbuilding (% of GDP)	-2.1	-1.7	-1.5	-0.9	-0.4	-0.2
Government consumption	1.4	2.3	2.4	2.8	2.7	2.5
Exports of goods and services	4.5	5.0	5.0	5.8	5.2	4.8
Imports of goods and services	2.9	5.9	4.9	6.4	5.6	4.9
Consumer prices	1.4	0.1	1.6	2.0	2.1	2.2
Unemployment rate (level)	14.2	13.8	12.9	11.9	10.8	9.8
Current account balance (% of GDP)	2.2	2.5	2.4	2.4	2.4	2.4
Government budget (% of GDP)	-2.8	-2.6	-1.7	-1.3	-1.1	-0.9
Government debt (% of GDP)	55.4	54.9	54.0	52.4	50.6	48.9

Source: Oxford Economics.

Slovenia



- ▶ Although the recovery that began in Q4 2013 is forecast to continue, it will remain slow and heavily reliant on exports, as the need for fiscal tightening and further bank restructuring keep investment spending subdued in 2014-15.
- ▶ Bank recapitalization will continue and its costs will force the new Government to prioritize privatization in pursuit of debt reduction. The Government's

resistance to "strategic" asset sales has already softened. However, the need to restrain state spending and downsize the public sector will curb investment and growth throughout the forecast period.

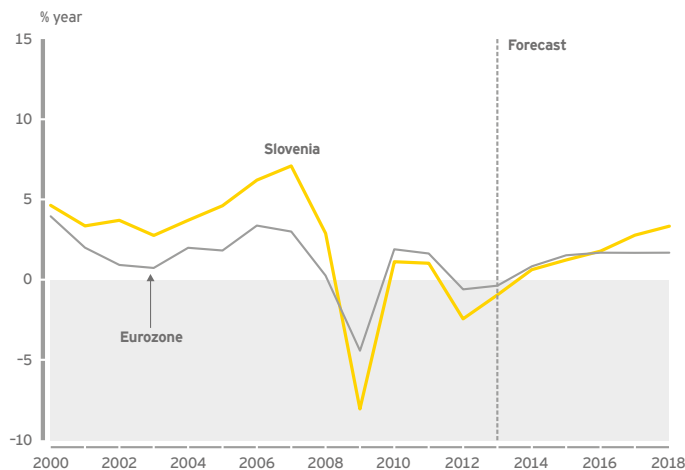
- ▶ The rapid rise of a new ruling party in July's election highlights a public readiness for change. However, the new coalition may still contain elements opposed to promised welfare and labor

market changes, and could lose support if it sticks to the cost-saving reforms expected by the EU.

- ▶ This year's renewed wage growth points to continued difficulty in turning productivity gains into cost reduction that sustains export-led recovery. In addition, the wide external surplus indicates continued difficulty in matching domestic saving with investment and attracting FDI.

Figure 49

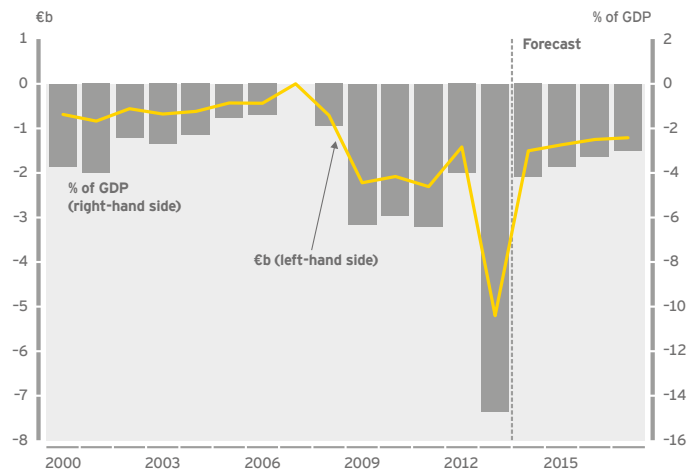
Real GDP growth



Source: Oxford Economics.

Figure 50

Government budget balance



Source: Oxford Economics.

Slovenia (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	-0.9	0.6	1.2	1.8	2.8	3.3
Private consumption	-2.9	-0.7	0.6	1.3	2.3	2.7
Fixed investment	-0.2	0.2	2.4	4.4	4.9	4.6
Stockbuilding (% of GDP)	-0.9	-1.2	-0.8	0.0	1.2	2.3
Government consumption	-2.0	-3.1	0.1	1.4	2.5	2.9
Exports of goods and services	2.7	3.8	3.3	2.7	2.6	2.2
Imports of goods and services	1.0	1.5	3.8	4.1	4.3	3.4
Consumer prices	1.8	0.9	1.6	2.0	2.4	2.5
Unemployment rate (level)	10.1	10.6	10.4	9.9	8.9	8.0
Current account balance (% of GDP)	5.9	7.1	6.5	5.6	4.3	3.4
Government budget (% of GDP)	-14.7	-4.2	-3.7	-3.3	-3.0	-3.0
Government debt (% of GDP)	71.5	71.1	64.8	60.5	58.6	58.3

Source: Oxford Economics.

Spain



GDP growth

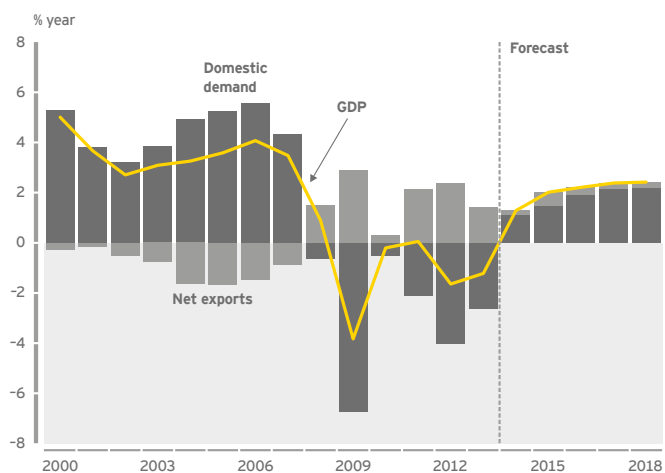
2014 **1.3%**

- ▶ Spain has continued to lead the Eurozone out of recovery in the past quarter, adding an impressive 0.6% expansion in Q2 to the 0.4% registered in Q1. We expect growth of 1.3% for 2014 overall, as momentum is sustained in H2.
- ▶ The recovery was initially trade-driven, and the gains from improved competitiveness will continue, with

exports set to grow 3.7% in 2014, and 4%-4.5% in the next couple of years. But domestic demand has caught up recently, in large part due to the gradual improvement in the labor market. We expect consumer spending to grow by 1.9% in 2014, and slightly faster in the years to come.

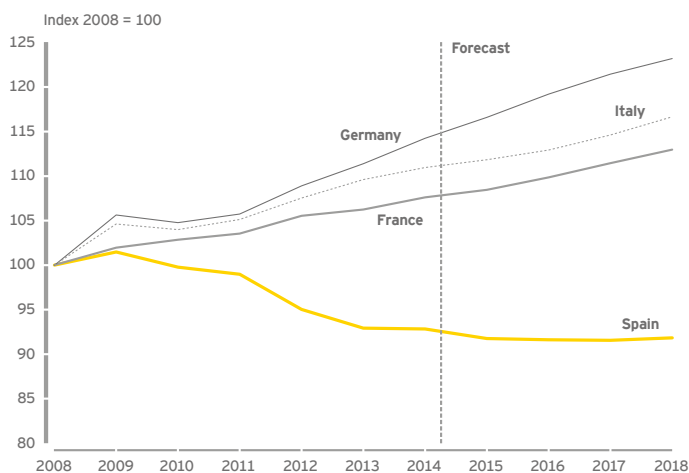
- ▶ On the downside, Spain has years of fiscal restraint to come. More cuts are due next year and subsequent years will only see the most modest government spending growth. Overall, the pace of growth will be limited to around 2.4% by 2017-18, leaving unemployment above 20% and meaning Spain will remain vulnerable to deflation for some time to come.

Figure 51
Contributions to GDP growth



Source: Oxford Economics.

Figure 52
Wage costs



Source: Oxford Economics.

Spain (annual percentage changes unless specified)						
	2013	2014	2015	2016	2017	2018
GDP	-1.2	1.3	2.0	2.2	2.4	2.4
Private consumption	-2.1	1.9	2.1	2.2	2.3	2.5
Fixed investment	-5.1	1.1	2.6	2.8	3.1	3.2
Stockbuilding (% of GDP)	0.9	0.9	0.7	0.7	0.8	0.8
Government consumption	-2.3	-0.7	-0.5	0.6	0.7	1.0
Exports of goods and services	4.9	3.7	4.4	4.0	3.7	3.6
Imports of goods and services	0.4	3.6	3.1	3.6	3.4	3.4
Consumer prices	1.5	0.1	0.4	0.9	1.0	1.1
Unemployment rate (level)	26.1	24.5	23.5	22.8	21.9	21.0
Current account balance (% of GDP)	0.8	0.6	0.9	0.9	0.8	0.7
Government budget (% of GDP)	-7.1	-5.6	-4.4	-3.3	-2.4	-2.0
Government debt (% of GDP)	93.9	100.3	104.2	106.6	107.8	108.4

Source: Oxford Economics.





Detailed tables and charts

Forecast assumptions

	2013	2014	2015	2016	2017	2018
Short-term interest rates (%)	0.2	0.2	0.1	0.1	0.2	0.8
Long-term interest rates (%)	3.0	2.1	1.9	2.1	2.4	3.0
Euro effective exchange rate (1995 = 100)	120.8	123.6	119.9	118.8	118.8	118.4
Oil prices (€/barrel)	81.8	79.2	81.1	84.9	88.0	91.5
Share prices (% year)	15.8	14.9	7.0	7.1	6.0	5.7

	2013				2014			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Short-term interest rates (%)	0.2	0.2	0.2	0.2	0.3	0.3	0.1	0.1
Long-term interest rates (%)	3.1	2.8	3.1	3.0	2.7	2.2	1.6	1.7
Euro effective exchange rate (1995 = 100)	118.8	119.2	121.7	123.7	125.6	125.1	122.2	121.3
Oil prices (€/barrel)	85.2	78.6	83.2	80.3	79.0	80.0	79.3	78.6
Share prices (% year)	8.2	21.1	15.9	18.6	15.5	19.2	16.5	9.0



Eurozone GDP and components

Quarterly forecast (quarterly percentage changes)

	2013				2014			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	-0.2	0.3	0.1	0.3	0.2	0.0	0.3	0.4
Private consumption	-0.2	0.2	0.2	0.1	0.2	0.3	0.3	0.3
Fixed investment	-1.6	0.1	0.5	0.9	0.2	-0.3	0.3	0.6
Government consumption	0.2	0.0	0.3	-0.3	0.7	0.2	-0.3	0.1
Exports of goods and services	-0.8	2.3	0.1	1.4	0.1	0.5	1.2	0.8
Imports of goods and services	-0.8	1.6	1.1	0.7	0.8	0.3	1.5	0.8

Contributions to GDP growth (percentage point contribution to quarter-on-quarter GDP growth)

	2013				2014			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	-0.2	0.3	0.1	0.3	0.2	0.0	0.3	0.4
Private consumption	-0.1	0.1	0.1	0.0	0.1	0.2	0.2	0.2
Fixed investment	-0.3	0.0	0.1	0.2	0.0	-0.1	0.1	0.1
Government consumption	0.0	0.0	0.1	-0.1	0.1	0.0	-0.1	0.0
Stockbuilding	0.2	-0.2	0.3	-0.2	0.2	-0.2	0.2	0.0
Exports of goods and services	-0.4	1.0	0.1	0.6	0.0	0.2	0.6	0.4
Imports of goods and services	0.3	-0.6	-0.5	-0.3	-0.3	-0.1	-0.7	-0.3

Annual levels – real terms (€b, 2000 prices)

	2013	2014	2015	2016	2017	2018
GDP	8,529	8,602	8,734	8,881	9,030	9,182
Private consumption	4,780	4,818	4,887	4,958	5,032	5,107
Fixed investment	1,520	1,539	1,576	1,620	1,663	1,706
Government consumption	1,829	1,839	1,844	1,853	1,865	1,879
Stockbuilding	-4	6	9	7	5	5
Exports of goods and services	3,961	4,076	4,244	4,425	4,605	4,783
Imports of goods and services	3,556	3,676	3,825	3,981	4,139	4,298

Annual levels – nominal terms (€b)

	2013	2014	2015	2016	2017	2018
GDP	9,608	9,776	10,059	10,394	10,739	11,084
Private consumption	5,497	5,583	5,733	5,908	6,095	6,283
Fixed investment	1,702	1,725	1,790	1,871	1,953	2,035
Government consumption	2,070	2,093	2,121	2,166	2,215	2,267
Stockbuilding	6	34	72	90	101	111
Exports of goods and services	4,417	4,542	4,813	5,107	5,406	5,711
Imports of goods and services	4,084	4,202	4,469	4,749	5,031	5,324

Prices and cost indicators

(annual percentage changes unless specified)

	2013	2014	2015	2016	2017	2018
HICP headline inflation	1.3	0.7	1.2	1.5	1.6	1.6
Inflation ex. energy	1.2	0.9	1.2	1.5	1.5	1.5
GDP deflator	1.5	0.9	1.3	1.6	1.6	1.5
Import deflator	-0.5	0.0	1.6	1.7	1.7	1.7
Export deflator	-2.6	-1.0	2.3	2.1	1.9	1.9
Terms of trade	-2.1	-1.0	0.6	0.4	0.2	0.2
Earnings	1.7	1.3	2.1	2.6	2.6	2.6
Unit labor costs	1.2	0.8	0.9	1.3	1.4	1.3
Output gap (% of GDP)	-3.2	-3.5	-3.0	-2.5	-2.0	-1.6
Oil prices (€ per barrel)	81.8	79.2	81.1	84.9	88.0	91.5
Euro effective exchange rate (1995 = 100)	120.8	123.6	119.9	118.8	118.8	118.4

	2013				2014			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
HICP headline inflation	1.9	1.4	1.3	0.8	0.6	0.6	0.6	1.0
Inflation ex. energy	1.5	1.2	1.3	1.0	1.0	0.9	0.8	1.0
GDP deflator	1.6	1.6	1.4	1.1	0.9	0.7	0.8	1.1
Import deflator	0.4	0.0	-1.6	-0.9	-0.3	-1.0	0.6	0.8
Export deflator	-1.0	-2.0	-3.6	-3.7	-2.1	-2.4	-0.8	1.2
Terms of trade	-1.5	-2.0	-2.0	-2.8	-1.8	-1.4	-1.4	0.4
Earnings	1.7	1.6	1.7	1.7	1.4	1.3	1.1	1.4
Unit labor costs	1.7	1.2	1.2	0.7	0.5	1.1	0.7	1.0
Output gap (% of GDP)	-3.2	-3.1	-3.3	-3.3	-3.4	-3.6	-3.5	-3.4
Oil prices (€ per barrel)	85.2	78.6	83.2	80.3	79.0	80.0	79.3	78.6
Euro effective exchange rate (1995 = 100)	118.8	119.2	121.7	123.7	125.6	125.1	122.2	121.3

Note: HICP is the European Harmonized Index of Consumer Prices.

Labor market indicators

(annual percentage changes unless specified)

	2013	2014	2015	2016	2017	2018
Employment	-0.8	0.4	0.4	0.4	0.5	0.5
Unemployment rate (%)	11.9	11.5	11.2	11.0	10.7	10.4
NAIRU (%)	9.2	9.1	9.0	8.9	8.8	8.7
Participation rate (%)	75.9	75.9	76.0	76.1	76.2	76.4
Earnings	1.7	1.3	2.1	2.6	2.6	2.6
Unit labor costs	1.2	0.8	0.9	1.3	1.4	1.3

	2013				2014			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Employment	-1.1	-1.0	-0.8	-0.4	0.1	0.5	0.6	0.6
Unemployment rate (%)	11.9	12.0	12.0	11.9	11.7	11.6	11.5	11.3
NAIRU (%)	9.1	9.2	9.2	9.3	9.1	9.1	9.1	9.0
Participation rate (%)	75.9	75.9	75.9	75.9	75.9	76.0	75.8	75.9
Earnings	1.7	1.6	1.7	1.7	1.4	1.3	1.1	1.4
Unit labor costs	1.7	1.2	1.2	0.7	0.5	1.1	0.7	1.0

Note: NAIRU is the non-accelerating inflation rate of unemployment; i.e., the rate of unemployment below which inflationary pressures would start to appear due to labor market tightness.

Current account and fiscal balance

	2013	2014	2015	2016	2017	2018
Trade balance (€b)	158.1	173.7	166.6	176.2	187.4	193.7
Trade balance (% of GDP)	1.6	1.8	1.7	1.7	1.7	1.7
Current account balance (€b)	230.7	235.7	237.7	243.0	246.8	251.5
Current account balance (% of GDP)	2.4	2.4	2.4	2.3	2.3	2.3
Government budget balance (€b)	-290	-251	-207	-179	-155	-134
Government budget balance (% of GDP)	-3.0	-2.6	-2.1	-1.7	-1.4	-1.2
Government debt (€b)	9,128	9,577	9,961	10,304	10,612	10,875
Government debt (% of GDP)	95.0	98.0	99.0	99.1	98.8	98.1

Measures of convergence and divergence within the Eurozone

	2004-08	2009-13	2014-18
Growth and incomes			
Standard deviation of GDP growth rates	2.0	2.3	1.1
Growth rate gap (max – min)	7.5	9.2	5.1
Highest GDP per capita (Eurozone = 100)	242.0	232.9	232.2
Lowest GDP per capita (Eurozone = 100)	59.2	68.0	68.4
Inflation and prices			
Standard deviation of inflation rates	1.0	0.9	0.6
Inflation rate gap (max – min)	4.0	3.9	2.1
Highest price level (Eurozone = 100)	117.3	116.0	118.9
Lowest price level (Eurozone = 100)	56.0	65.1	66.1

Cross-country tables

Real GDP (% year)								
Rank		2013	2014	2015	2016	2017	2018	Average 2014-18
1	Latvia	4.1	3.2	4.8	5.2	5.0	4.7	4.6
2	Slovakia	0.9	2.3	3.2	3.7	3.6	3.3	3.2
3	Estonia	0.8	0.7	2.7	3.8	3.9	4.0	3.0
4	Ireland	0.2	2.8	3.2	2.9	2.8	3.1	3.0
5	Luxembourg	2.1	2.8	2.3	2.8	2.9	2.8	2.7
6	Spain	-1.2	1.3	2.0	2.2	2.4	2.4	2.1
7	Malta	2.4	2.2	2.3	1.9	1.9	1.8	2.0
8	Slovenia	-0.9	0.6	1.2	1.8	2.8	3.3	1.9
9	Germany	0.2	1.5	2.0	1.9	1.6	1.5	1.7
10	Austria	0.3	1.0	1.7	2.0	1.9	1.7	1.7
11	Greece	-3.9	0.1	1.4	1.9	2.1	2.4	1.6
12	Belgium	0.2	1.0	1.3	1.6	1.7	1.8	1.5
13	Eurozone	-0.4	0.9	1.5	1.7	1.7	1.7	1.5
14	Finland	-1.2	0.0	1.5	1.7	1.9	2.1	1.4
15	Netherlands	-0.7	0.7	1.2	1.3	1.6	1.7	1.3
16	Portugal	-1.4	0.9	1.4	1.4	1.4	1.3	1.3
17	France	0.4	0.4	1.0	1.3	1.4	1.6	1.1
18	Italy	-1.8	-0.2	0.9	1.3	1.3	1.3	0.9
19	Cyprus	-5.4	-2.6	0.5	0.9	1.0	1.8	0.3

Inflation rates (% year)								
Rank		2013	2014	2015	2016	2017	2018	Average 2014-18
1	Portugal	0.4	-0.2	0.5	0.8	1.1	1.4	0.7
2	Spain	1.5	0.1	0.4	0.9	1.0	1.1	0.7
3	Greece	-0.9	-1.0	0.3	1.0	1.6	1.8	0.7
4	Italy	1.3	0.3	0.7	1.2	1.3	1.5	1.0
5	Netherlands	2.6	0.7	1.1	1.2	1.3	1.4	1.1
6	Cyprus	0.4	0.8	1.0	1.2	1.5	1.8	1.3
7	Eurozone	1.3	0.7	1.2	1.5	1.6	1.6	1.3
8	France	1.0	1.0	1.4	1.5	1.6	1.7	1.4
9	Ireland	0.5	0.6	1.3	1.6	1.8	1.9	1.4
10	Belgium	1.2	0.7	1.3	1.8	2.0	2.0	1.6
11	Slovakia	1.4	0.1	1.6	2.0	2.1	2.2	1.6
12	Austria	2.1	1.6	1.7	1.8	1.7	1.8	1.7
13	Germany	1.6	1.1	1.8	2.2	2.0	1.5	1.7
14	Finland	2.2	1.2	1.7	2.0	2.0	2.0	1.8
15	Malta	1.0	1.0	1.5	1.9	2.3	2.3	1.8
16	Luxembourg	1.7	1.1	2.3	2.0	2.0	1.9	1.8
17	Slovenia	1.8	0.9	1.6	2.0	2.4	2.5	1.9
18	Latvia	0.0	0.9	2.2	2.4	2.4	2.4	2.1
19	Estonia	3.2	0.8	2.7	3.1	3.2	3.0	2.6

Cross-country tables

Unemployment rate (% of labor force)								
Rank		2013	2014	2015	2016	2017	2018	Average 2014-18
1	Austria	4.9	4.9	4.7	4.6	4.5	4.5	4.7
2	Germany	5.3	5.1	5.4	5.6	5.4	5.3	5.4
3	Luxembourg	5.9	6.2	6.2	5.8	5.3	4.9	5.7
4	Malta	6.4	5.9	5.8	5.7	5.6	5.6	5.7
5	Netherlands	6.7	6.9	6.7	6.6	6.5	6.4	6.6
6	Finland	8.2	8.5	8.2	7.8	7.6	7.4	7.9
7	Estonia	8.6	8.4	8.1	7.8	7.8	7.8	8.0
8	Belgium	8.4	8.5	8.5	8.1	7.7	7.6	8.1
9	Latvia	12.1	11.0	9.7	8.2	8.0	7.8	8.9
10	Slovenia	10.1	10.6	10.4	9.9	8.9	8.0	9.5
11	France	10.3	10.1	10.0	9.8	9.7	9.5	9.8
12	Ireland	13.1	11.7	10.6	9.6	9.1	8.5	9.9
13	Eurozone	11.9	11.5	11.2	11.0	10.7	10.4	11.0
14	Slovakia	14.2	13.8	12.9	11.9	10.8	9.8	11.8
15	Italy	12.2	12.7	12.6	12.3	11.9	11.5	12.2
16	Portugal	16.4	14.4	14.0	13.9	13.8	13.7	14.0
17	Cyprus	15.9	15.9	15.9	15.5	13.8	11.9	14.6
18	Spain	26.1	24.5	23.5	22.8	21.9	21.0	22.8
19	Greece	27.5	27.1	25.7	24.0	22.1	20.3	23.9

Government budget (% of GDP)								
Rank		2013	2014	2015	2016	2017	2018	Difference 2014-18
1	Luxembourg	0.1	0.2	-1.2	-0.9	-0.4	-0.1	-0.3
2	Germany	0.0	0.0	0.2	-0.1	-0.2	-0.2	-0.2
3	Latvia	-0.9	-1.0	-1.0	-1.0	-1.0	-1.0	0.0
4	Belgium	-2.6	-2.3	-2.3	-2.1	-1.9	-1.7	0.6
5	Malta	-2.8	-2.8	-2.7	-2.6	-2.4	-2.0	0.8
6	Netherlands	-2.5	-2.7	-2.5	-2.4	-2.2	-1.8	0.9
7	Estonia	-0.2	-0.5	-0.2	0.1	0.4	0.6	1.1
8	Slovenia	-14.7	-4.2	-3.7	-3.3	-3.0	-3.0	1.2
9	Eurozone	-3.0	-2.6	-2.1	-1.7	-1.4	-1.2	1.4
10	Italy	-3.0	-3.1	-2.6	-2.2	-1.9	-1.6	1.5
11	Slovakia	-2.8	-2.6	-1.7	-1.3	-1.1	-0.9	1.7
12	France	-4.3	-4.0	-3.5	-2.8	-2.3	-2.0	2.0
13	Greece	-12.7	-2.8	-1.6	-1.3	-1.1	-0.8	2.0
14	Austria	-1.5	-2.8	-1.4	-0.7	-0.6	-0.6	2.2
15	Portugal	-4.9	-4.0	-3.0	-2.8	-2.3	-1.8	2.2
16	Finland	-2.1	-2.7	-2.2	-1.2	-0.6	-0.2	2.5
17	Spain	-7.1	-5.6	-4.4	-3.3	-2.4	-2.0	3.6
18	Cyprus	-5.4	-5.7	-6.0	-4.7	-2.9	-1.8	3.9
19	Ireland	-6.6	-3.7	-2.0	-0.8	0.0	0.2	3.9



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