

Recovery strengthens while political challenges remain

- A somewhat stronger and still uneven recovery
- Domestic demand to increase further
- Grexit is unlikely
- Inflation to pick up moderately

2015 could be a positive turning point for the Euro area. A favourable combination of external and internal factors gives the economy a fair chance to finally embark on a steeper growth path. And this is badly needed. At 11.2% unemployment is still high, public debt keeps rising and GDP is 2% below the pre-crisis level. We raised our growth forecast to 1.3% for this year and to 1.6% for 2016. A somewhat stronger recovery than what we anticipated before, but still very unevenly spread between member countries. ^{3/4}

The most beneficial external factor is the sustained fall in oil prices. Measured in EUR, oil prices fell by around 40% from last summer. This alone could add around $\frac{3}{4}$ percentage point to GDP growth, mostly by supporting private consumption and investment spending. We expect private consumption to be the main growth driver both this year and the next.

On the other hand, we don't expect an investment boom. Companies are well aware that many fundamental factors restraining long-term growth remain in place despite the cyclical recovery. That said, the implementation of the Juncker Plan will likely have some positive effect. It aims at unlocking public and private investments of at least EUR 315 bn from 2015 to 2017.

Weaker EUR supports exports

The depreciation of the EUR is mainly due to monetary policy divergence between the ECB, which is becoming more and more expansionary, and the US Fed, which is approaching policy tightening. In trade-weighted terms, the EUR is now some 15% weaker than a year ago. This supports exports to such a degree that we expect external trade to contribute positively to GDP growth, too.

On the domestic front, growth gets support from both fiscal and monetary policy. After years of tax hikes and cuts in public spending, fiscal policy is no longer a drag on growth. This does not only mean that governments no longer restrain growth; it also supports consumer and business sentiment.

A significant QE programme

By far the most important policy initiative is the ECB's enlarged bond purchase programme that now also includes public sector bonds issued by governments and certain agencies and institutions. With intended purchases of EUR 60bn per month at least until September 2016, this programme is simply too large (around 11% of the Euro area's nominal GDP) to have no effect. On financial markets, the anticipation and the first QE purchases have contributed to even lower bond yields, lower bond spreads and a weaker EUR.

On top of the interest rate and the exchange rates channel, QE works through wealth effects, mostly on house prices and equity markets. Since the start of the year until mid-March equity prices as measured by the Euro Stoxx 50 rose by 17%. That reflects increasing optimism but also indicates that the ECB might be creating a bubble. We expect the ECB to buy bonds at least until September 2016. However, the programme might have to be scaled down or adjusted in other ways, eg if the ECB fails to find sufficient eligible bonds.

Diverging country perspectives

At country level, we expect the German economy to grow by 1½% to 2% in 2015 and 2016. A rising tide lifts all boats, as the saying goes, and so we also expect the French and Italian economies to pick up. However, growth is likely to remain subdued due to a lack of competitiveness and unresolved structural problems.

With an annual growth rate of 2% to 2½%, we expect Spain to remain the fastest growing among the larger economies. The recovery seems fairly broad-based and stable. Regional and national elections later this year will be a first test of whether Greek-style political changes

Euro area: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2011 (EURbn)	2012	2013	2014	2015E	2016E
Private consumption	5,492	-1.3	-0.6	1.0	1.6	1.6
Government consumption	2,046	-0.1	0.2	0.7	0.6	0.7
Fixed investment	2,024	-3.5	-2.4	1.0	1.9	3.7
Exports	4,075	2.6	2.1	3.7	4.4	4.3
Imports	3,935	-1.0	1.3	3.8	4.2	5.3
Net exports*	139	0.9	0.3	0.0	0.4	-0.2
GDP		-0.8	-0.4	0.9	1.3	1.6
Nominal GDP (EURbn)	9,768	9,483	9,579	10,075	10,307	10,602
Unemployment rate, %		11.3	12.0	11.6	11.0	10.4
Consumer prices, % y/y		2.5	1.4	0.4	0.2	1.2
Current account balance, % of GDP		1.8	2.6	2.9	2.9	2.7
General government budget balance, % of GDP		-3.6	-2.9	-2.6	-2.2	-1.9
General government gross debt, % of GDP		91.0	93.3	94.5	94.6	93.4

* Contribution to GDP growth (% points)

will spread to other countries. It's our base case that Spain will continue to play by the rules of the creditor countries.

Grexit unlikely but not off the table

Greece has recently grabbed many more headlines and much more market attention than warranted by the country's weight in terms of Euro-area GDP (1.9%). The bailout has been extended to end-June, but it remains unclear, whether the new government's reform and consolidation steps will be judged sufficient by the international creditors. Moreover, it is hard to see how Greece can do without a new bailout programme – which the country refuses – or some form of debt relief which the creditor countries refuse. Ultimately we expect that the political will to avoid the precedent of a country leaving the Euro area will prevail, but it will not be easy.

As we see it, Grexit would be a much bigger problem for Greece than for the Euro area. Greece would fall into a deep recession coupled with high inflation due to a depreciating New Drachma, and possibly into political turmoil. Contagion risk cannot be dismissed but seems for the moment manageable.

Grexit is a risk scenario with a probability of, say, 20%. However, the significance of the political development in Greece goes beyond Greece. It points to the fact that the Euro area remains very much an unfinished project, both politically and institutionally. But at least the economic outlook has improved.

Moderate rise in inflation over the medium term

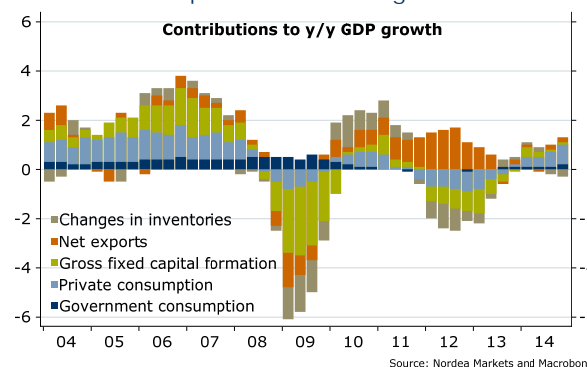
The strong decline in oil prices has led consumer price inflation into negative territory. Inflation excluding energy prices was at 0.6% y/y most recently and has fallen much less than overall inflation. So while the inflation rate is clearly below the ECB's target of "close to but below 2%", the Euro area is not in deflation. There is no evidence at all that consumers are postponing major purchases because they expect even lower prices, which would be a sign of deflation.

The risk of future deflation has declined for various reasons. Growth above trend in 2015 and 2016 leads to a narrowing of the output gap, decreasing the downward pressure on inflation due to underutilised resources. At the same time, we expect oil prices to recover to an average of USD 75 per barrel (Brent) in 2016 and the EUR to weaken a bit more, leading to higher import prices. Therefore inflation is likely to pick up over the medium term. However, until summer, we expect rates to hover around zero.

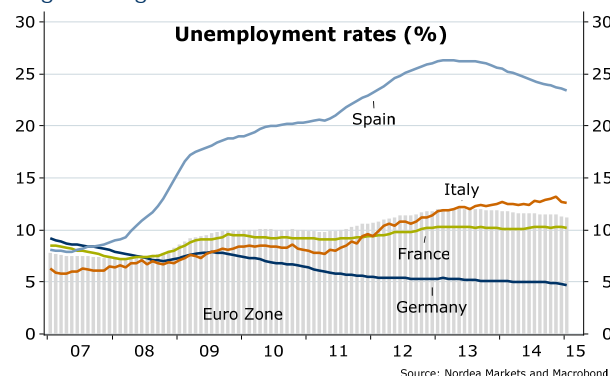
Somewhat stronger growth



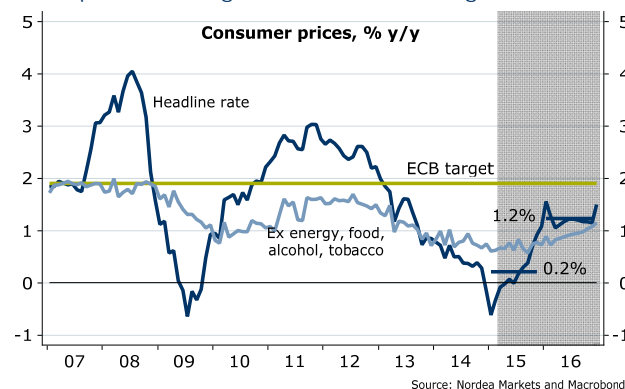
Private consumption is the main growth driver



Huge divergence in labour markets



We expect sub-target inflation for a long time



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