The Economist Intelligence Unit

Where next for the euro zone?

A special report from The Economist Intelligence Unit

Contents

Introduction

The political and economic events taking place in Greece and across Europe are shaking confidence in the future of the euro zone, and the spotlight has been focused on where the economic future of Europe lies. This report provides a snapshot of The Economist Intelligence Unit's outlook for some of Europe's most important as well as some of its most fragile member states: Greece, Spain, France, Germany, Italy and Ireland. Each article analyses current political and economic events, forecasting short- and long-term trends that help you to influence decision-making and economic outcomes for your business.

Greece

"Grexit" risk is rising

Several factors have led us to raise the risk we attach to Greece leaving the euro zone from 30% before the January 25th 2015 election to 40% now. These are the composition of the new government, in particular Syriza's choice of junior coalition partner; the narrowing of the room for manoeuvre in negotiations between Greece and its euro zone creditors as a result of populist, anti-mainstream parties challenging the electoral status quo; and the possibility of a prolonged stand-off between the two sides leading to meltdown in the Greek banking sector. Our baseline forecast is that a compromise deal will be forged, but the political goodwill (on both sides) that is needed to allow that to happen has been eroded by several weeks of confrontational politics.

Before the election, we said that Syriza Unifying Social Front (Syriza) would win Greece's pre-term poll and form a coalition government. We said that such a government's room for manoeuvre in relation to Greece's bail-out programme reforms and debt restructuring would be limited. We warned that a radical break with the Economic Adjustment Programme (EAP) would lead to a breakdown in relations with Greece's external creditors and would risk precipitating a Greek exit from the euro zone, and assigned a 30% risk in the short term to such a "Grexit".

Three developments have led us to raise our assessment of the risk of a "Grexit" to 40%. The first was Syriza's choice of coalition partner. Instead of seeking a coalition with the more moderate, centre-left To Potami (The River), Syriza opted to go into government with the 13-seat Independent Greeks (IG), a nationalist, ultra-right splinter from the main conservative party, New Democracy (ND), with which it has nothing in common but an antipathy for Greece's two EAPs and their overseers, the troika of Greece's external creditors—the European Central Bank (ECB), the European Commission and the IMF. This was a statement of intent by Syriza, saying that it was not prepared to budge in its opposition to the bail-out programme.

Little political room for manoeuvre

The second reason for regarding a Grexit as more likely now than we had thought two weeks ago is that the room for manoeuvre for both sides may be even narrower than we had previously supposed. It has become clear that Syriza cannot go back on its anti-bail-out position without committing political suicide, so it will not request an extension by the February 16th deadline stated in the EAP, even though the programme is due to expire at the end of the month. The government will continue to insist on a "new deal" and a financing lifeline from Greece's creditors while it negotiates such a deal. It is evident too that that Greece's euro zone creditors do not have much political room for manoeuvre in the context of the growing populist electoral threat to the mainstream parties across Europe. Making concessions to Greece would fuel support for the mainly right-wing populist parties opposed to bailing out Greece, and for those mainly radical left parties opposed to more German-led austerity policies for the euro zone.

Finally, given the difficulties of reaching an agreement that is acceptable to both sides, and the likelihood that reaching a compromise will take time, the potential for market reactions to occur that are outside the control of the main political actors is considerable. The most worrying manifestation of this is the large withdrawal of deposits from Greek banks in recent months. As of February 11th, Greek banks will be wholly reliant on emergency liquidity assistance (ELA) funds from the Bank of Greece (the central bank) to meet their cash demands, following the ECB's decision on February 4th to stop accepting Greek bonds as collateral for the supply of cash to local banks. If relations between Greece and its creditors were to deteriorate further, the risk of a run on deposits would increase, resulting in the imposition of capital controls and other extraordinary measures that would call Greece's euro zone membership into question.

Contours of a compromise

Despite the difficulties in reaching agreement and the fraught circumstances in which negotiations between Greece and its creditors will be conducted, we continue to believe that a compromise is possible. Implicit in our 60% evaluation is a judgment that neither side wants to risk the uncertain—and potentially catastrophic—consequences of Greece leaving the euro zone. What sort of deal can the euro zone's political leaders offer and what can Syriza accept and sell to its coalition partner and the Greek people?

The three elements of a new deal for Syriza would include some concessions on the country's debt repayments, such as an extension of maturities, a further reduction in interest rates and/or repayments linked to real GDP growth; some adjustment of the (unrealistic) programme-linked primary budget surplus targets; and the replacement of the bail-out programme with a reform programme over which Greece has more "ownership", but which is nevertheless subject to a monitoring regime. The third element is the most problematic and may prove to be the sticking point in talks in coming days. Some euro zone officials and leaders insist that the existing bail-out programme, which is due to expire at the end of February 2015, having already been extended by two months from end-December 2014, must be completed before Greece can receive further financing from its creditors. Others, such as the European Commission president, Jean-Claude Juncker, have acknowledged that the political ground has shifted irrevocably and that Europe's political leaders need to come up with an alternative to the bail-out programme quickly. Some kind of fudge that allows a short-term period of conditionality-lite financing to continue while a longer-term deal is negotiated may yet emerge out of the current apparent impasse.

For political reasons arising from the advance of populist parties across the continent, Europe's leaders cannot be seen to be making concessions to Greece without getting something concrete in return within a short timeframe. This includes a commitment from the new government to budget discipline, which implies that many of the policies unveiled by the prime minister, Alexis Tsipras, in his speech to the Greek parliament on February 8th, could not be implemented; a commitment by the government not to renege on specific key reforms that have been implemented by previous governments; and a commitment to further structural reforms, including privatisation and an anti-corruption drive. Negotiating the details of these commitments, and the timeframe for implementing

them, will be problematic and will test the patience of both sides. The danger is that in the meantime the Greek banking system, weakened by continuing large deposit withdrawals and subject to extraordinary financing arrangements, buckles under the strain.

Syriza does not desire an exit from the euro zone and most euro zone political leaders fear the consequences of a Grexit. Yet both are dug into their positions, with little political room for manoeuvre. The scene is set for a confrontation between Greece and its creditors over the coming weeks, justifying an increase in our Grexit risk assessment to 40%.

Spain

Employment growth accelerates to a post-crisis high

Event

The Spanish economy generated a net 433,900 jobs in 2014, the first full year of employment growth since 2007. The unemployment rate averaged 24.4% for the year.

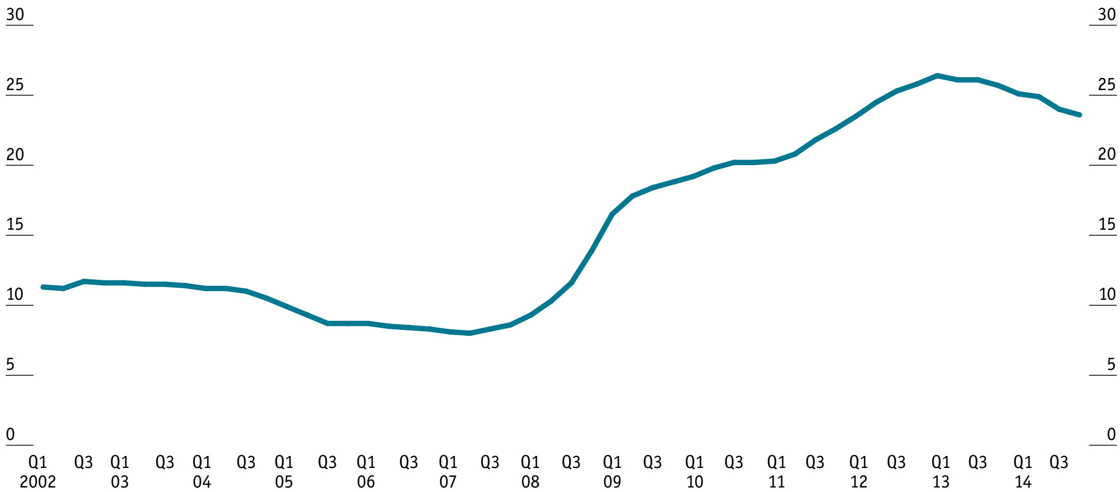
Analysis

The Spanish labour market is providing further evidence that Spain's economic recovery is gathering pace. Total employment grew by an unadjusted 65,100 between the third and fourth quarters, according to the National Statistics Institute (INE), in a period when employment usually falls because of seasonal factors. Indeed, this was the best fourth-quarter result since 2006.

On a seasonally adjusted basis, employment rose by 1% quarter on quarter, the best result for any quarter since the crisis began. Full-year growth thus reached 433,900 in 2014—equivalent to 1,700 new jobs a day—bringing total employment in the economy to 17.57m, an impressive 2.5% more than a year earlier. Moreover, 212,800 of these new jobs were indefinite (permanent) job contracts, compared with a net 176,900 fixed-term (temporary) contracts. The notorious duality of Spain's labour market is being slowly eroded, with temporary workers accounting for 24.2% of salaried employment in 2014, well below the rates of over 30% that were prevalent in the boom years.

The private sector generated more than 95% of all new jobs in 2014; public-sector employment did rise in 2014, for the first time in four years, but by just 18,100 people. This mild upturn has had little impact on the total employment level in the public sector, which stands at 2.93m, 307,200 fewer

Unemployment rate
(%; seasonally adjusted)



Source: National Statistics Institute.

than in the final quarter of 2011. That is, almost one in ten of all public-sector workers have lost their job since the crisis began. A breakdown by sector shows that net employment for the full year grew by 344,200 in services, 98,000 in industry and an encouraging 40,000 in the construction sector. By contrast, employment fell by 48,400 in agriculture.

Despite rising employment, unemployment actually increased by 30,100 in the final quarter, to 5.46m, because of growth in the number of people seeking work. Nonetheless, the unemployment rate was still 2 percentage points lower than in the year-earlier period, standing at 23.7%.

Impact on the forecast

The unemployment rate in 2014 was marginally higher than our 24.3% estimate, but we reaffirm our forecast that the rate will decline to 22.7% in 2015.

France

Subdued sentiment at start of year

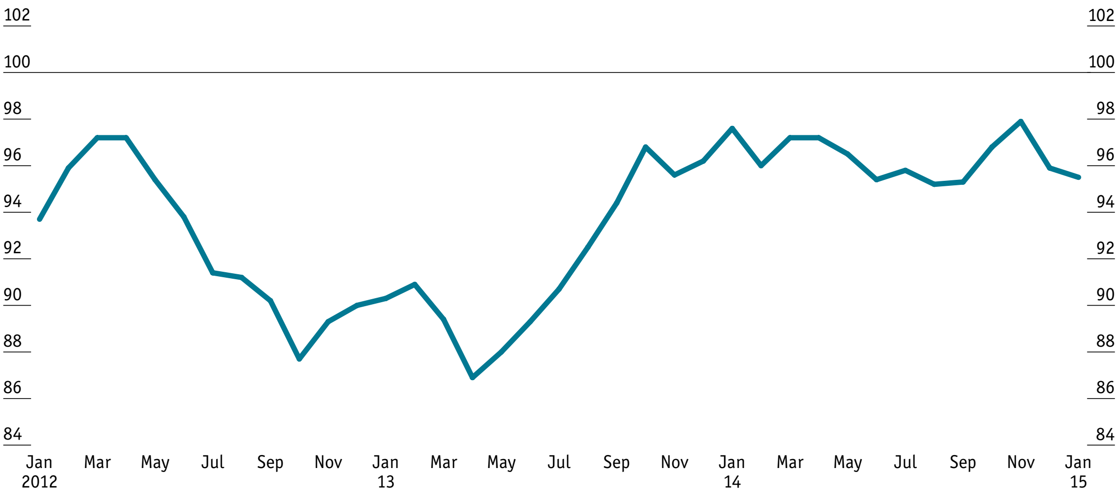
Event

The European Commission's economic sentiment index (ESI, a composite measure reflecting trends for consumers, industry, services, construction and retail) declined for a second successive month in January, to a four-month low of 95.5, below its average level in 2014. The composite purchasing managers' index (PMI) published by Markit slipped to 49.3, signalling a slight fall in private-sector output.

Analysis

The latest sentiment indices from the European Commission underline the current gloom pervading French households and businesses. The composite ESI (which assigns weights of 40% to industry, 30% to services, 20% to consumers and 5% each to retail and construction) declined by 0.4 points in January, to 95.5, having turned lower in the final month of 2014. The index has wavered around its present subdued level for more than a year, reflecting the weak trend across all sectors of the economy.

Economic sentiment indicator
(long-term average=100)



Source: European Commission.

The implied boost to real household incomes and consumer spending from recent price movements was highlighted in the January data by a fourth successive monthly improvement in retail trade confidence, mirroring the trend across the broader euro zone, although the indicator remained firmly in negative territory.

There was little encouragement elsewhere. Industry sentiment was unchanged at a weak level, while the slump in the construction sector continued apace (housebuilding has declined steadily in recent years). Perhaps most worrying was a third consecutive monthly fall in services confidence on the back of declining demand and employment expectations. This tallies with recent PMI surveys, which point to a marginal decline in private-sector output over the past couple of months.

France's GDP barely expanded in real terms in 2014, rising by an estimated 0.4%. Although we recently revised higher our projection for real GDP growth in 2015 by 0.1 percentage points, to 0.9%—to reflect some modest feed-through to private consumption from the collapse in oil prices—the lack of momentum across the economy at the beginning of the year implies a significant downside risk to the forecast.

Impact on the forecast

Our forecast for real GDP growth of 0.9% in 2015 is likely to stay unchanged, but will remain under close review.

Germany

Record-high trade surplus in 2014

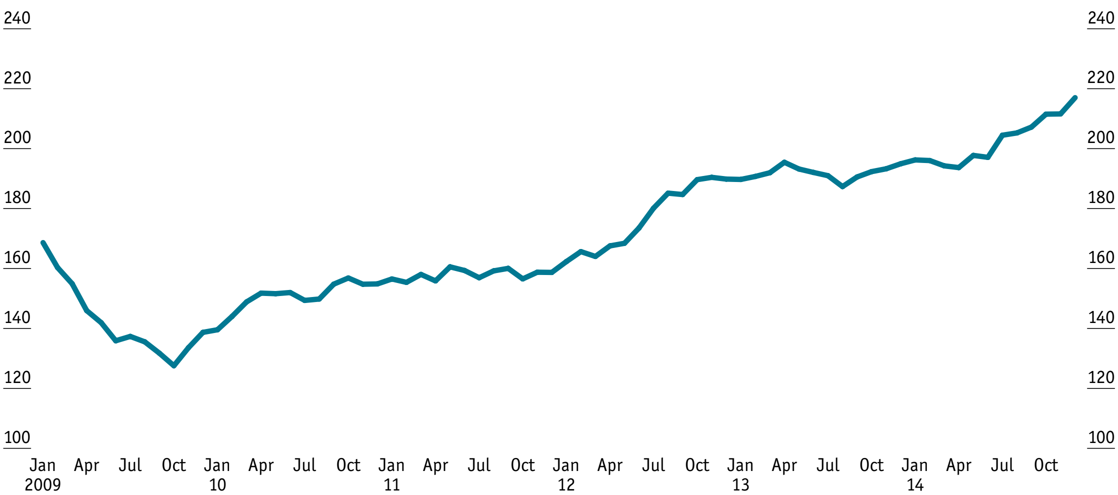
Event

The seasonally adjusted merchandise trade surplus widened in December 2014 to €21.8bn (US$25bn), from €16.9bn a year earlier, as exports increased and imports eased lower. Over 2014 as a whole Germany recorded its largest-ever annual trade surplus of €218.7bn (an estimated 7.6% of GDP), up from €197bn in 2013.

Analysis

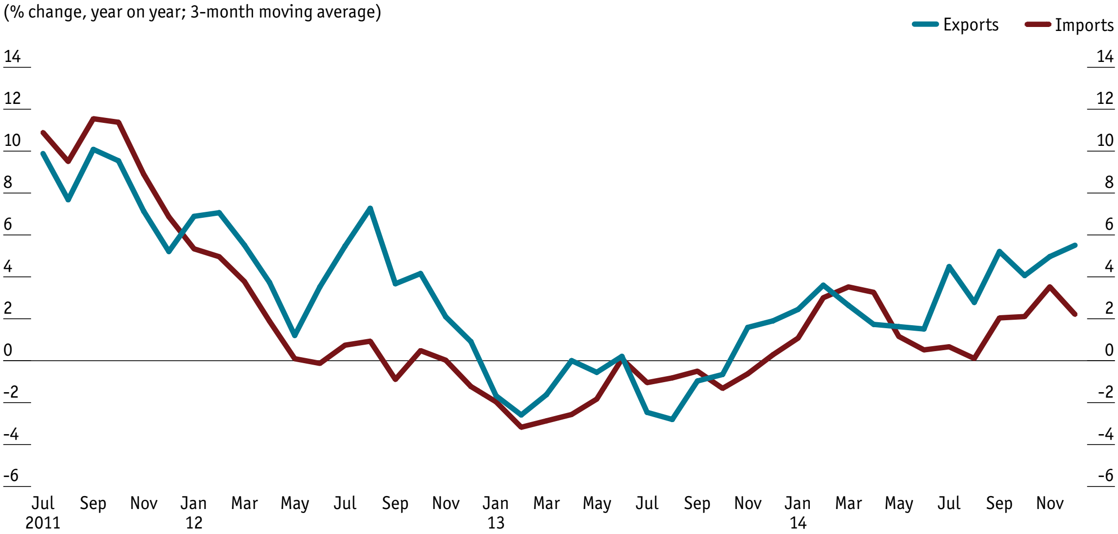
The German export sector ended 2014 on a strong note, with the value of goods exports in December 7.5% above their year-earlier level. With the impact of lower oil prices contributing to a modest fall in the monthly import bill, the merchandise trade surplus increased to €21.8bn in December, equalling the record-high level set just five months earlier. Over 2014 as a whole, the value of goods exports rose by 3.6% (having stagnated in 2013), which given the weak trend in export prices points to solid growth in export volumes. The import bill also increased over the year, but by a more modest 2%, resulting in the surplus on trade in goods widening to an all-time high in nominal terms in 2014.

12-month rolling trade surplus
(€ bn)



Monthly trade figures are subject to volatility, so a better picture of the recent underlying trend can be gleaned from three-month data. On this basis, there was a merchandise trade surplus of €60.6bn in the final quarter of 2014, €2.6bn higher than in July-September. The value of goods exports rose by a quarterly 1.4%, compared with a 0.5% increase in imports. This solid performance fits with evidence of a gradual strengthening of business sentiment in Germany and across the wider euro zone since October, in response to the boost from lower energy costs and a weakening euro.

Merchandise trade
(% change, year on year; 3-month moving average)



According to unadjusted data from the Federal Statistical Office (Destatis), the strongest external demand for German goods in 2014 came from EU countries outside the euro zone (such as the UK, Sweden, Poland, Czech Republic and Romania), with exports rising by 10.2%. Shipments to other euro zone countries, which comprise around 36% of all German exports, increased by a modest 2.7%. Demand from non-EU countries rose strongly in December (up 10% year on year), but the performance over 2014 as a whole was much weaker, with exports up just 1.5%.

Impact on the forecast

We are unlikely to revise our forecast of steady growth in goods export volumes and another large merchandise trade surplus in 2015, equivalent to 7.5-8% of GDP.

Italy

Forza Italia suspends Renzi-Berlusconi pact

Event

The main centre-right party in opposition, Forza Italia (FI) led by Silvio Berlusconi, declared on February 4th that it considers the political reform pact with Matteo Renzi, the prime minister and leader of the dominant centre-left Partito Democratico (PD), to be “no longer binding”.

Analysis

FI’s decision risks derailing plans to introduce the most significant political and institutional reforms of the last 25 years. These include a reform of the electoral system for the Chamber of Deputies (the lower house of parliament) to favour large parties and government stability; and the related plan to reduce the Senate (the upper house) to an unelected chamber with no legislative powers in order to end Italy’s bicameral system of government. The reforms were born of an agreement reached between Mr Berlusconi and Mr Renzi in January 2014, shortly before the latter became prime minister. The lower house electoral reform is close to final approval, but the reform of the Senate still has some way to go as it requires changes to the constitution.

The election of Sergio Mattarella as president on January 31st precipitated the rupture. Mr Renzi had put forward Mr Mattarella as the PD’s candidate without the agreement of his smaller centrist and centre-right coalition partners or Mr Berlusconi and his party. In reality, however, FI’s decision followed the eruption of tensions that had been simmering for some time in the ranks of FI and the PD’s junior coalition partner, the centre-right Nuovo Centro Destra (NCD), an FI splinter party. Before the presidential election, FI hardliners had become increasingly critical of Mr Berlusconi’s leadership of the party , blaming his backing of Mr Renzi’s political reform agenda for the slump in the party’s electoral support and the recent resurgence of the populist right-wing Lega Nord.

Mr Renzi used Mr Mattarella’s candidacy to appease a large leftist minority of PD dissidents opposed to the prime minister’s style of leadership and his reform agenda. It seems unlikely that they will moderate their position, while FI now looks set to return to a position of outright opposition. Mr Renzi, who is now actively seeking to attract several independent moderate groups into the coalition to shore up his slim majority in the Senate, faces an uphill struggle to enact the constitutional reforms needed to reform the upper house.

Impact on the forecast

We maintain our current forecast that there will be an early general election in the next 12-18 months.

Ireland

Fiscal deficit continues to narrow

Event

The general government recorded a cumulative deficit of €6.5bn in January-September, equivalent to 4.8% of GDP, according to the Central Statistics Office (CSO). This compares with a deficit of €8bn in the corresponding year-earlier period. The stock of general government debt totalled €208.2bn at end-September 2014, equivalent to 114.8% of GDP.

Analysis

A protracted period of austerity has contributed to a marked narrowing of Ireland's fiscal deficit, which peaked at an alarming 32.4% of GDP in 2010 (swelled by huge bank bail-out costs). There was considerable volatility in the public finances around the time of the contentious intervention in the banking system, but since 2012 the deficit has followed a gradual falling trend, against a backdrop of ongoing austerity and, more recently, a rebound in economic output. Strengthening activity and a recovery in the labour market have underpinned a marked upturn in government revenue and in nominal GDP, both of which have helped to bear down on the headline fiscal deficit (in absolute terms and as a share of GDP).

The CSO data suggest that the public finances remained on track last year to achieve the government's latest estimate (in its 2015 budget) of a deficit of 3.7% of GDP in 2014, down from 5.7% in 2013. Deficit reduction is expected to continue this year, albeit at a slower pace as the government reverts to a moderately looser fiscal stance in an effort to boost its ailing support ahead of the next general election, due by March 2016.

Government revenue totalled €46.3bn in January-September 2014, up 5.4% year on year. The overall tax take, which accounts for around 70% of all revenue, was up 7.9%, reflecting solid growth in receipts from a broad range of taxes. Total government expenditure in January-September was €52.8bn, up from €52bn a year earlier. Most categories actually reported modest year-on-year declines, with the public-sector wage bill down 1.2% and interest expenditure 5.1% lower than in January-September 2013. However, these were offset by a small increase (0.4%) in spending on social benefits, which account for by far the largest share—around 40%—of all public expenditure, and a near 10% rise in capital transfers, mainly reflecting the contribution to the controversial new water utility, Irish Water.

Impact on the forecast

We expect to maintain our forecast that the general government deficit will come in below 3% of GDP in 2015, down from an estimated 3.7% of GDP in 2014.

Conclusion

These articles provide an analytical insight into how current political and economic developments affect business environments in individual countries and across Europe. At such a crucial time for one of the world’s largest economic entities, it is more important than ever to be able to filter out the noise of daily news reports and remain up-to-date with the most significant issues. Every day presents a new issue or event, and The Economist Intelligence Unit’s country analysis services can help you to put these into context, enabling you to pinpoint the potential opportunities and challenges facing your organisation in an ever-changing business environment.

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