APPENDIX:
Country analyses

Germany: the economy is lacking dynamism

The economic situation in Germany stabilised in the first half of 2013. In the second half of 2012, an economic recession had seemed probable. The stabilising of the economy has been based on two factors: The first is monetary policy, where the pledge to make unlimited emergency purchases of bonds has stabilised the monetary environment. This has not only secured a minimum level of confidence on the finance and capital markets, leading to a recent surge on the stock markets, but has also ensured more favourable lending conditions for the real economy.

The second stabilising factor has been the robustness of the labour market in Germany. Despite the low growth rates, the level of employment has continued to expand, with notably faster wage increases. Taken together, this has led to a perceptible rise in incomes, with consumption thus acting as a strong buffer against a slide into recession. Along with the monetary stability, improved consumption has broken the long-standing trend of decreasing investment and we now see an increase in private capital expenditure, a good sign for the economy.

Against this backdrop, the GDP in Germany should grow by 0.4% this year, though the number of people employed has only risen slightly and the number of unemployed has also slightly increased. But this stability does not indicate a dynamism which could spark a shift into a phase of self-sustaining economic growth. The potential for such a shift is there, but the strain of the euro-crisis and the associated fiscal restraint is too strong and is preventing the emergence of a growth cycle, despite the economy having reached its probable trough and the gradual ending of output losses. Should the euro crisis reignite, Germany may slide towards recession. This is the primary risk in the economic outlook.

As the increase in demand from developing markets has also waned, the economic environment is not as promising as it had been in 2012. In addition, the euro has appreciated in value against the currencies of most developing nations as well as against the U.S. dollar. Over the coming year, however, exports to these markets should increase and, in particular, deliveries within the euro area should gradually stabilise subsequent to the economic bottoming-out. Given that imports will increase more rapidly than exports over this year and the next, one can expect a negative contribution to GDP from external trade. In 2013, this will amount to a 0.4% reduction in GDP, while in 2014 it will represent a 0.7% reduction.

Domestic demand therefore remains the most important economic pillar. Capital expenditure as well as investment in construction are both trending upwards, having previously dropped for a number of quarters. Private consumption remains – as in previous years – the central engine for domestic demand.

Given the increasing economic momentum in the second half of this year, the German economy will grow at an improved rate of 1.2% in 2014. A comprehensive shift to a strong growth cycle is, however, not to be expected. The level of employment will increase slightly, with the number of unemployed dropping somewhat.

Prices will rise at a rate far below the target inflation rate of the ECB. The 2013 rise in consumer prices for Germany will mirror the rate for the euro area at 1.5%. The 2014 inflation rate of 1.5% for Germany will outstrip the euro area average of 1.2% – and that for the first time since the founding of the monetary union. The fiscal budget will be more or less balanced for the forecast period, and in net terms monetary policy will provide no growth impulse worth mentioning. The level of gross debt will continue to decline.

Table. ECLM-IMK-OFCE macroeconomic forecasts

Germany

In %	2012	2013	2014	2015
GDP	0.7	0.4	1.2	1.6
Private consumption	0.8	1.0	1.5	1.3
Investment	-2.1	-0.7	4.0	5.4
Public consumption	1.0	1.0	1.4	1.6
Exports	3.2	0.1	4.4	3.5
Imports	1.4	1.0	6.6	4.8
Contribution to growth				
Internal demand	-0.3	0.5	1.7	2.1
External trade	1.2	-0.3	-0.4	-0.4
Inventories	-0.6	0.2	-0.1	0.0
Unemployment rate	5.3	5.2	5.0	4.8
Inflation	2.1	1.5	1.5	1.5
Public deficit	0.1	-0.1	0.0	0.0
Fiscal impulse	-1.2	0.4	0.2	0.0
Public debt % GDP	81.2	79.2	76.8	75.8
Current account % GDP	7.0	6.8	6.7	6.5

Source: National accounts, OFCE-IMK-ECLM forecasts.

France: Less fiscal consolidation, more growth

The turnaround in French economic activity after the 2008/09 recession, of +1.6% and +2% percent in 2010 and 2011 respectively, reflected that growth was not out of reach after the deep financial and economic crisis of the late 2000s. However, instead of strengthening in 2012 and 2013, growth came to a standstill, leading to a stagnation phase and a new pick up in the unemployment rate to near its historical record level.

Several factors have interrupted the recovery in the euro area, such as the resumption of the increase of the oil price and the unusual monetary conditions driven by the sovereign debt crisis in the euro area. But the crucial factor for the downturn has been the fiscal consolidation, which was implemented from 2010 and drastically intensified in 2011, 2012 and 2013. In addition, negative external impulses resulting from the same strategy conducted by European countries have further dampened national growth.

After two years of weak conditions, the outlook for the French economy is clearing up, but stagnation is expected due to the persistence of adverse influences. Although the EC, in May 2013, has postponed to 2015 the achievement of the 3 percent public deficit target, fiscal consolidation will still be conducted in 2014. The change in the composition of austerity, an increase in direct and indirect taxes on households combined with a restriction in public spending, while unemployment continues to rise, will not lower fiscal multipliers so that activity will still suffer from weak consumption. External trade will be affected by wage deflation in south euro area and will not contribute to growth in 2014. Only a moderate recovery in firm investment can be expected, driven by the need to upgrade plants and equipment after a long period of continuous decline.

The stagnation that the French economy has been experiencing for two year follows a phase of recovery which started in mid-2009 after the recession and which was completed in the first half of 2011. These former developments, which pushed up the y-o-y GDP growth rate to 2.8 percent in the first quarter of 2011, suggest that the economy retains a capacity for growth which relies on the absorption of overcapacities inherited both from the recession and from the 2011 downturn. Many institutions, OECD, IMF, EC, French government, OFCE estimate a large negative output gap for France, lying between -5 and -3 percent. Business survey data support the same idea with still high production capacity margins. At the same time, industrial firms reporting demand difficulties as a factor for limiting production are in majority.

Business surveys have been more optimistic the last few months, while national accounts have displayed the highest GDP growth rate since the first quarter of 2011, +0.5 percent in the second quarter of 2013. However, it is too early to see in that performance a signal for a recovery. The rebound relied both on a strong consumption growth, stimulated by bad weather conditions in spring which led to higher energy consumption, and by a positive contribution of stocks. By contrast, private investment continued to decrease while foreign trade did not contribute to growth. The most recent national account release, a -0.1% percent GDP growth in the third quarter of 2013, confirms that the French economy is still weak and that a sustained narrowing of the output gap is not in view in the near term. Nevertheless, consumption developments will probably be pick up in the final quarter of 2013 as a result of the increase in VAT scheduled on 2014 January 1st which may temporarily stimulate purchases before the measure enters into force.

Household consumption will not support growth in 2014 despite a slight pick up in the nominal disposable income. Indeed, an acceleration of consumer prices is expected from the increase in VAT which will offset nominal income gains. Austerity will still be conducted in 2014, with a higher contribution of households through a strong rise in both indirect taxes and social contributions while social benefits should stagnate in real terms. In a context where unemployment will increase further, budget multipliers will remain high. In contrast, the government has set up a fiscal package – i.e. Crédit d'Impôts pour la Compétitivité et l'Emploi (CICE) –, to lower firm tax burden through a tax credit benefit based on the payroll of companies. In theory, this should enhance competitiveness by giving firms incentives to lower prices. The resulting government tax losses are offset for 60 percent by an increase in VAT which should be neutral for consumers given the lowering of the pre-tax prices. The potential benefit for the overall economy lies in the decrease in export prices which is expected to encourage competitiveness on foreign markets and thus promote exports.

The success of such a strategy depends on how firms will allocate the tax cut. In the context where operating surplus ratio seriously worsened since 2008, firms will probably try to ensure better financing conditions rather than lower selling prices. As a result, the external trade should not contribute to growth next year especially as it is suffering from wage deflation in the south in the euro area.

A positive impact can be expected from the CICE as an incentive to plan upgrading investment programs. However, the recovery in capital expenditures should be moderate since the accelerator effect will not play its normal role as it usually did during past upturns.

The expected growth in 2014 will fail to improve the situation of the labor market. Facing over-staffing, firms will try to restore productivity rather than hire new workers. Job creation will be carried out by non-profit sectors through assisted jobs subsidies, only compensating for losses in the private sectors. As a result, unemployment will continue to rise.

Table. ECLM-IMK-OFCE macroeconomic forecasts

France

In %	2012	2013	2014	2015
GDP	0.0	0.1	1.1	1.5
Private consumption	-0.3	0.3	0.9	1.1
Investment	-1.2	-2.6	1.2	0.0
Public consumption	1.4	1.5	0.9	1.0
Exports	2.5	0.7	3.4	4.2
Imports	-0.9	0.6	3.1	4.1
Contribution to growth				
Internal demand	-0.1	0.1	1.0	1.4
External trade	1.1	0.0	0.1	0.0
Inventories	-1.0	0.0	0.1	0.0
Unemployment rate	10.1	10.6	10.9	11.2
Inflation	2.2	1.3	1.8	0.9
Public deficit	-4.8	-4.1	-3.5	-3.0
Fiscal impulse	-1.2	-1.4	-0.7	-0.7
Public debt % GDP	90.2	93.3	94.9	94.5
Current account % GDP	-2.2	-1.6	-1.6	-1.6

Source: National accounts, OFCE-IMK-ECLM forecasts.

Italy: a light at the end of the tunnel

By the end of 2012, Italy had managed to reduce its budget deficit to 3% of GDP and to meet its European commitments. With negative carryover growth of -1.8% in 2013, Italy's economy will experience a sluggish second half-year, marked by flat consumer spending and investment. Several favourable factors should result in a slight improvement in 2014, and in particular the negative fiscal impulse will be weaker (0.6 percent of GDP), since the bulk of fiscal adjustment has already taken place. In addition, foreign trade should boost activity, offsetting the weakness in private consumption and bringing a halt to the decline in investment. Investment will also be spurred by the payment of the arrears accumulated by business, which are expected to come to 27 billion euros in 2013 and 20 billion in 2014. Freed from the shackles of austerity, Italy should return to more balanced growth in 2015, driven by both internal and external demand.

Considering the size of the fiscal stimulus, the reduction of the budget deficit has been slow: with a multiplier above 1, reducing the deficit by 0.8 percentage points in 2012 required a negative impulse of 3 GDP points. This enabled Italy to get back to a 3% public deficit. In 2013, the fiscal adjustment is continuing with plans for a new negative impulse of 24 billion euros, or 1.5 GDP points. Unlike in 2012, when three-quarters of the fiscal adjustment was based on a tax increase, the law of August 2012 and the 2013 budget both focus the bulk of the effort on cuts in public spending (health and regional expenditures). Some taxes (income tax, corporation tax) have been revised downwards. In addition, two key measures, the postponement of the VAT increase and the elimination of the property tax, reflect how the Letta government has loosened the reins on the budget, resulting in a loss of more than 4 billion euros for the public purse. We assume these concessions will be offset in 2013, otherwise the impulse would ultimately only come to a negative 1.2 GDP point, and the deficit would reach 3.2% of GDP. Indeed, the negative impulse for 2013 will be offset by exceptional measures authorizing the payment of commercial debts by the government. The budget deficit will thus rise to 2.9% of GDP by end 2013. Because of these payment arrears, the debt will peak in 2014 at more than 130% of GDP, before slowly falling from 2015. In 2014, the fiscal impulse will come to only a negative 0.6 GDP point, with a one-point increase in the standard VAT rate (from 21% to 22%) and spending cuts.

The budget purge was accomplished at the cost of a severe recession, with eight consecutive quarters of declining GDP. In the first half of 2013, private consumption fell sharply (-3.3%), as did investment; foreign trade alone helped cushion the fall in GDP, but only by means of reducing imports.

With regard to households, the increase in taxes and the reduction in income from employment and capital hurt disposable income in 2012, despite a positive contribution from social benefits. The unemployment rate continued to rise, to 12% of the labour force in July 2013, which negatively affected wages. Inflation slowed sharply in the second quarter of 2013, due to lower energy prices. We anticipate a decrease in gross disposable income in the second half of 2013 and in early 2014 as a result of high unemployment rates, which are continuing to hurt wages, higher taxes (VAT, local taxes) and the reconstitution of savings, which at end 2012 had fallen to a record low. As a result, consumption will continue to decline in late 2013, before picking up very slowly in mid-2014. Lending conditions in the second quarter of 2013 were still tough: interest rates on new bank loans have stagnated for consumers and business, and the volume of new lending to consumers and business was still at a historically low level.

On the business side, the increase in unit labour costs that began in 2007 is continuing, but profits are cushioning the impact on competitiveness. Business margins in Italy are down significantly, which has helped limit inflation. Due to the impact of a sharp decline in GFCF in construction, the productive investment rate plunged in the first quarter to a record low, before stabilizing in the second quarter. The utilization of production capacity has followed the same pattern, but rebounded strongly in the second quarter of 2013. Several factors argue for an end to the deterioration in GFCF and the stabilization of the investment rate in the second half of 2013 and for a recovery in 2014: these include an improvement in the investment climate and in order books in the third quarter of 2013, and the payment of 20 billion euros of arrears by the administration (1.3 GDP points) in 2013, and then in 2014. We expect a recovery in very compressed business margins, reflecting an improvement in productivity, followed by a pick-up in investment in early 2014.

Foreign trade remains the main positive factor driving growth in late 2013 and in 2014, with exports picking up pace, while imports continue to be limited by the sluggishness of consumption. The improvement in the trade balance, which began in 2011, should persist. Italy will nonetheless continue to lose market share to its competitors, due to labour costs that are still higher than for its partners.

Table. ECLM-IMK-OFCE macroeconomic forecasts

Italy

In %	2012	2013	2014	2015
GDP	-2.4	-1.8	0.3	1.0
Private consumption	-4.2	-2.6	-0.5	0.6
Investment	-8.0	-5.5	0.1	1.8
Public consumption	-2.9	-0.1	-0.3	0.1
Exports	2.2	-0.4	1.6	2.7
Imports	-7.8	-4.0	-0.3	2.0
Contribution to growth				
Internal demand	-4.7	-2.5	-0.4	0.7
External trade	3.0	1.0	0.6	0.3
Inventories	-0.8	-0.3	0.1	0.0
Unemployment rate	10.7	12.1	11.9	11.2
Inflation	3.3	1.5	1.2	1.2
Public deficit	-3.0	-2.9	-2.5	-1.5
Fiscal impulse	-3.0	-1.5	-0.6	-0.3
Public debt % GDP	127.0	131.7	132.6	131.6
Current account % GDP	0.0	0.2	0.1	0.1

Source: National accounts, OFCE-IMK-ECLM forecasts.

Spain: Adjustment *via* deflation

The latest available indicators for the Spanish economy are looking up. It seems that production has bottomed out, and confidence indicators are recovering. Fiscal discipline, together with support from the ECB, has made it possible to normalize the risk premiums on Spanish government debt. Wage deflation has restored the competitiveness of Spain's businesses, which are gaining market share in exports. The adjustment of employment has given a strong boost to productivity and lifted business margins to a historically high level.

But these glad tidings do not mean that Spain is now out of the woods. The road will be long before the country returns to the production levels prevailing before the crisis, and any improvement will be only partial, as further adjustments are still needed to complete the fiscal consolidation. The situation of households is particularly worrisome. Mass unemployment, fiscal pressure and constraints on lending are affecting their ability to consume. Household income is suffering from a combination of falling real wages, tax hikes, a decline in pensioners' purchasing power and the loss of benefits by unemployed people reaching the end of their rights. Defaults on household debt could thus accelerate, further weakening the banking system. The depth of the current crisis will affect the country's long-term growth potential. GDP will fall by -1.4% in 2013, followed by growth of 0.7% in 2014 and 1.4% in 2015. At end 2015, Spain's real GDP will still be 5% below its pre-crisis level, and GDP per capita 6.6% below.

Spain's economy will get out of the recession in the first quarter of 2014. Growing exports, driven by the recovery in Europe's economies and by the competitiveness of Spanish products, should lead to renewed productive investment. Since 2009, foreign trade has been the country's only engine of growth. Exports of goods and services, measured in volume, rose by an annual average of 7.2% over the last four years, with demand for Spanish exports up by 4.9% per year. Spain has thus gained 12 points of market share. We forecast an increase in demand for Spanish exports on the order of 1% per quarter, with exports growing by 1.5%. Spain will thus continue to gain market share (+9 points by 2015) and will reabsorb its trade deficit. It will even record a trade surplus of 0.3 GDP point in 2015, whereas it ran a trade deficit of 3% of GDP in 2012 and 8.4% in 2007.

Based on the accelerator effect, strong exports will boost productive investment, which, having stabilized at around 7.5% of GDP since 2010, will rise to 9% by late 2015. The construction sector, still suffering from unabsorbed overcapacity, will not benefit from this pick-up in growth. Real estate investment is expected to stabilize at around 12% of GDP.

Business margins have reached a record 41% of GDP, up from 34.5% in 2000. Margins should slide slightly by 2015 due to the downturn in the productivity cycle, but will remain at a comfortable level, allowing companies to finance their investment projects. Productivity in the market sector has accelerated significantly during the crisis, rising from average growth of 0.4% between 2000 and 2007 to a rate of 2.9% between 2008 and 2012. For the years 2013 to 2015, we expect a decline of 0.5% per year, which will lead to the creation of 550,000 jobs by 2015.

The unemployment rate should begin to fall slowly, from 26.4% in the second quarter of 2013 to 23% in late 2015. Consumer spending will remain depressed due to wage deflation. Employees have already lost 5.4% of their purchasing power in three years, and we expect this downwards trend to continue. Household disposable income will grow only moderately in real terms, under pressure from the loss in pensioners' purchasing power, the continuing wage freeze for civil servants and further rate hikes in income tax and indirect taxes (VAT on certain products, environmental taxes). The only relief Spanish households will experience is from job creation (+0.7% in 2014 and +1.6% in 2015). After a decline of 2.7% in 2013, household consumption will stagnate in 2014 (+0.1%) and increase slightly in 2015 (+0.7%), stabilizing the savings rate.

Whatever the growth potential retained for Spain's economy, the output gap has worsened considerably (-11.6% in 2013 by our estimates, -9.6% according to the OECD). The fiscal situation is still a long way from being healthy, with a debt approaching 100 percent of GDP and a deficit that we forecast at 6.8% in 2013, 6.2% in 2014 and 5.3% in 2015. The fiscal consolidation announced for 2014 is continuing to weigh heavily on growth, even if the European Commission's postponement of the deficit targets has given the government a little breathing room. But the persistence of the crisis is keeping the fiscal multipliers at a high level (well above 1), and Spain will see a renewal of a level of growth capable of significantly reducing unemployment only once the fiscal adjustment has been completed.

Finally, the current level of non-performing loans, which peaked at 11.6% of total loans in the second quarter of 2013 (17 GDP points), is very bad news for the health of the Spanish banking system, whose restructuring could be longer and more costly than anticipated.

Table. ECLM-IMK-OFCE macroeconomic forecasts

Spain

In %	2012	2013	2014	2015
GDP	-1.6	-1.4	0.7	1.4
Private consumption	-2.8	-2.7	0.1	0.7
Investment	-7.0	-5.8	1.6	3.5
Public consumption	-4.8	-1.9	-2.3	-1.5
Exports	2.1	5.3	6.8	6.1
Imports	-5.7	0.1	5.1	4.8
Contribution to growth				
Internal demand	-4.2	-3.1	-0.1	0.7
External trade	2.8	1.8	0.8	0.7
Inventories	-0.2	-0.1	0.0	0.0
Unemployment rate	25.1	26.2	25.1	23.6
Inflation	2.4	1.7	0.5	0.8
Public deficit	-10.6	-6.8	-6.2	-5.3
Fiscal impulse	-3.4	-1.6	-1.0	-1.0
Public debt % GDP	84.1	91.2	96.4	99.6
Current account % GDP	-1.1	-0.3	0.0	0.0

Source: National accounts OFCE-IMK-ECLM forecasts.

Ireland: in the kingdom of blindness, the one-eyed man is a king

Since 2011, Ireland has been presented as the best student among the crisis countries. It is often seen as an example of successful austerity. It is true that Ireland has suffered from a lower decline in GDP compared to Greece, Portugal or Spain. GDP in Ireland has grown by (+2.3%) from the end of 2010 until the second quarter of 2013, whereas it has plummeted by 11.9% in Greece and by 5.9% in Portugal. It cannot be denied that Ireland has generally reached the deficits targets receiving positive assessments from the Troika. It has been the first country among those helped by the EFSF to go back in the financial markets to raise funds. The sovereign spread has sharply declined from a record level at 13.9% in July 2011 to less than 4% two years later. But social and economic situations might not be so idyllic. Growth has indeed picked up in 2011 but it has followed a collapse of GDP between 2007 and 2010 of more than 9%. Compared to other crisis countries, it cannot be denied that Ireland has done better. But, the rebound of activity has remained lower than the one observed in France or in the UK. Per capita GDP is still significantly below the pre-crisis level. More recently, growth has rebounded (+0.4% in 2013Q2) but it has just taken over from 3 quarters of decline. In 2013, GDP will decrease by 0.5%. Unemployment rate has recently stabilised but remains at 13.8%. Employment has indeed recently rebounded but the decrease in the unemployment rate also hinges on a stabilisation of the work force participation (-3000 since 2011Q3 and – 130000 since 2008Q3). Immigration has strongly slowed down and the migration balance has become negative for the first time since 1995. Employment is stalling and will recover only progressively. Avoiding the worst might not be called a success.

The economic outlook for Ireland should however improve. Compared to the other crisis countries, Ireland appears indeed in a better position. Before the outbreak of the crisis, it already benefited from foreign direct investment boosting exports. Despite a harsh fiscal consolidation, Irish government has preserved the fiscal advantage of Irish firms[1] and households have borne the brunt of the weight of consolidation. The tax rate on benefits is still one of the lowest in Europe. The housing bubble has burst but Irish competitiveness has strongly improved, resulting from a decline in wages and from positive productivity developments. According to the European Commission competitiveness indicators, relative unit labour costs have decreased by nearly 20 % since 2008. The current account is now in surplus whereas the deficit reached a peak of 6.7% in 2008. This deficit mainly stems from the balance of revenues. The rise in exports will be sustained by the global improvement of external demand from Europe and from the United States. It will progressively stimulate firms' investment. Margin rates have indeed increased as a result of the internal devaluation. Besides, credit constraints should slowly loosen in line with the reduction of sovereign debt spread. Additionally, private consumption will remain at low levels. From 2008 to 2013Q2, it has fallen by more than 9.5%, which is in line with the decrease in the real disposable income. It must be stressed than in 2008, 2009 and 2010, the decline in the real disposable income was mainly due to the negative contribution of wages. Social benefits and reduction in taxes have notably cushioned the shock in 2008 and

1. The tax rate on profits has been kept at 12 % in Ireland.

2009. But once the Irish government started to implement austerity measures, the stabilisation role of the social and tax system has been reduced. In 2011 and 2012, social benefits have stagnated whereas the negative contribution of taxes has increased. New austerity measures have been announced for 2014. The government will however soften the path of consolidation since the fiscal impulse has been revised downward to 1.5% of GDP. From 2010, cumulative austerity will amount to 9 points of GDP, that is 1.8 percentage points per year, which is higher than during the episode of fiscal contraction implemented from 1982 to 1989 where annual consolidation amounted to 1.5% per year. Households will still suffer from austerity in 2014. Wage growth will also remain subdued. The deleveraging process will continue to limit the scope for a buoyant households' consumption. In terms of disposable income, the debt ratio of households has decreased by 17 points since 2010 but it is still at 210%. We expect savings' rate to increase so that quarterly private consumption growth rate will not exceed 0.1% in 2014 and 2015.

GDP growth is then expected to turn positive (1.4%) in 2014 after a decline of 0.5% in 2013. It will accelerate to 1.9% in 2015. The rebound will be mainly driven by external trade as exports will grow more than 4% each year. The contribution of external trade will rise to 2.4 and 1.5 points of GDP respectively. Domestic demand will recover very progressively through increases in productive investment.

There remain fragilities as banks should still cope with high risk of default related to the collapse of the housing market. The Irish economy is also sensitive to external demand from the euro area but also from the United Kingdom and the United States. The global economic outlook for the world economy will improve but a strengthening of fiscal austerity, notably in the US cannot be excluded. It might then dampen world growth and among the euro area countries, Ireland would be the first country to be exposed to this risk.

Table. ECLM-IMK-OFCE macroeconomic forecasts

Ireland

In %	2012	2013	2014	2015
GDP	0.1	-0.5	1.4	1.9
Private consumption	-0.3	-1.6	0.2	0.3
Investment	-0.7	-10.7	0.3	3.7
Public consumption	-3.2	-1.8	-1.2	-0.8
Exports	1.6	0.1	4.1	4.6
Imports	0.0	-0.3	2.9	4.7
Contribution to growth				
Internal demand	-0.7	-2.3	0.0	0.4
External trade	1.8	0.4	2.4	1.5
Inventories	-0.9	1.4	-0.9	0.0
Unemployment rate	14.7	13.8	13.5	13.5
Inflation	1.9	0.8	1.0	1.0
Public deficit	-7.5	-6.6	-5.2	-3.0
Fiscal impulse	-2.1	-1.7	-1.5	-1.7
Public debt % GDP	117.6	124.6	122.8	120.3
Current account % GDP	4.4	2.3	3.0	3.1

Source: National accounts OFCE-IMK-ECLM forecasts.

Portugal: the end of recession?

The economic stimulus in 2008-2009 had allowed the Portuguese economy to recover after the financial crisis. But the rebound has been short-lived. Since the end of 2009, Portugal had been concerned by an excessive deficit procedure and has to take austerity measures to reduce its deficit. These measures have been reinforced after Portugal asked for financial assistance to the European Union in April 2011. Consequently, Portugal has experienced a deep recession since the end of 2010. After 10 consecutive quarterly declines in GDP, growth finally came back in the second quarter of 2013. But it should slow down again in the following quarters and remain very moderate. Public deficit will reach 5.9% of GDP in 2013, including a one-off support to BANIF bank (0.4% of GDP). Fiscal restriction should decrease in 2014 and 2015 but should still hamper growth. We expect GDP to rise by 0.9% in 2014 and by 1.4% in 2015. GDP per capita should still be 5% lower than its pre-crisis level. Unemployment rate and public debt should remain very high.

As a result of a slackening growth, the European Commission accepted twice to push back the deadline for a deficit of 3% of GDP (from 2013 initially to 2014 then to 2015). But it has recently refused the government's request to increase the deficit target for 2014 to 4.5% of GDP instead of 4%.

The ability of Portuguese government to return to the financial markets in mid-2014 seems to be less and less likely as 10-year bond rates remain at a high level. Besides, financing needs have been underestimated in the first Economic Adjustment Program in 2011. It forecasted, indeed, that the public deficit would reached 3% of GDP in 2013 and the public debt 108,6%. Yet, the public debt has rocketed and reached 131.3% in the second quarter of 2013 according to the latest data from Eurostat. The increase in interest expenditures (+1.5 points of GDP between 2007 and 2013), the fall in GDP and the support for financial institutions (5% of GDP since 2008) explain these bad outcomes despite a very restrictive fiscal policy. This is also why financial markets' fears are still important. Whereas in May 2013, 10-year bond rates reached a low of 5.3%, which allowed Portugal's Debt Management Agency to issue 10-year bonds for the first time since February 2010 (at a rate of 5.65%), tensions started again after the generalized rise of interest rates in the US and in Europe. They were strengthened by July's political crisis in Portugal. Tensions have eased recently. 10-year bond rates have decreased but remain high: 6.3% at the beginning of November, forcing the Portugal's Debt Management Agency to issue only low maturity securities (Treasury Bills). The three-month bills issued in November 2013 had a yield of 1.2%, while the yield for 9-month issues was 1.7%[2].

In order to support their access to market financing when exiting the current bailout program, the maturity of loans granted both to Portugal and Ireland under the EFSM and EFSF have been extended by 7 years in June 2013. For the

2. Comparatively, France and Germany recently issued six-month securities at rates close to zero (0.03% and 0.08% respectively) and 12-month securities at very low rates (0.11% and 0.15%). Germany is issuing two-year securities at a rate of 0.06%.

moment, the government rejects any debt restructuring and a second bailout program. It will probably try to negotiate a precautionary program with the European authorities, i.e. a precautionary credit line for one year, to reassure financial markets. This credit line would only be used in case of necessity.

The evolution of GDP growth in the next quarters will be crucial for the improvement of confidence. GDP is expected to grow in the second semester of 2013 and in 2014-2015. Exports will be the main driver of GDP growth, while internal demand will not grow before 2015.

Given the recession and the unemployment rate (17% in the second quarter of 2013), deflationary pressures are emerging: wages have decreased both in nominal and real terms (respectively -2.7% and -4.1% in 2012). Core inflation is now close to zero. Improving competitiveness has allowed Portugal to gain export market shares in 2013 for the third consecutive year and this will continue in 2014 and 2015. In the second quarter of 2013, the trade deficit amounted to 3.1% of GDP, whereas it reached 12.5% in 2008. But, it should be stressed that only one third of this improvement stems from the increase in exports, while the rest is due to the fall in imports resulting from the slump of private consumption in line with the decrease in disposable income (-1.3% in 2011, -1% in 2012). The government wants to stimulate investment and improve competitiveness by cutting by 2 points off the corporate tax in 2014.

Recent statistics and surveys show some signs of improvement or at least stabilization in the labour market and in the manufacturing sector. Employment has risen in the second quarter of 2013 and the unemployment rate has decreased for the first time since 2008. The rate of productive investment has stabilized and industrial new orders are on an upward trend. Confidence indicators are increasing, although they remain at low levels. The return to growth depends both on external demand and on fiscal impulse. If external demand turns to be weaker, it will hamper GDP growth and the reduction of the deficit. Fiscal impulse should reach -1.7% of GDP in 2014 and again -0.5% in 2015. In 2014, the budget deficit should decrease to 3.8% of GDP. The bulk of the consolidation in 2014 will stem from cuts in expenditures: wage cuts of 2.5% to 12% for civil servants with wages higher than 600 euros a month, 40-hour work week instead of 35 in the public sector, reduction of civil servants, pension reform and healthcare reform. There will also be increases in indirect and direct taxes. However, there are uncertainties about future decisions of the constitutional court, which has already rejected austerity measures 4 times since 2011.

Table. ECLM-IMK-OFCE macroeconomic forecasts

Portugal

In %	2012	2013	2014	2015
GDP	-3.2	-1.8	0.9	1.4
Private consumption	-5.4	-2.4	-0.2	0.2
Investment	-14.3	-9.3	-2.6	2.3
Public consumption	-4.8	-2.4	-1.3	-1.4
Exports	3.2	6.3	5.0	4.8
Imports	-6.6	1.9	1.5	2.2
Contribution to growth				
Internal demand	-7.2	-3.6	-0.8	0.2
External trade	4.2	1.8	1.6	1.3
Inventories	-0.2	0.1	0.1	0.0
Unemployment rate	15.9	16.9	16.5	16.1
Inflation	2.8	0.7	0.9	1.1
Public deficit	-6.4	-5.9	-3.8	-2.4
Fiscal impulse	-3.8	-1.3	-1.7	-0.5
Public debt % GDP	123.6	128.9	129.9	128.9
Current account % GDP	-1.5	0.2	0.4	0.6

Source: National accounts OFCE-IMK-ECLM forecasts.

Greece: awaiting growth

Greece is still mired in a recessionary spiral in 2013, with a recession of 4.1% forecast, which follows five previous years of negative growth. As a result, the country's GDP will have fallen 24% in real terms between 2008 and 2013. The fiscal impulse will remain significantly higher than in other euro area countries, which will cut growth particularly sharply since the fiscal multipliers are still high due to the heavy liquidity constraints weighing on households. With prices and wages continuing to fall in 2013 and 2014, the engine of domestic demand is still seized up. The decline in prices will of course help improve the trade balance; however, so long as wage cuts do not lead to a significant fall in export prices, any improvement in cost competitiveness will remain limited, and the added foreign demand will not be enough to offset the decline in domestic demand.

The recession, which has now lasted five years in Greece, will continue, with GDP expected to contract by 4.1% in 2013, and to a lesser extent in 2014. Greece still does not have a solid basis for growth. Indeed, austerity measures are leading to a fall in domestic demand, and external demand, which is closely linked to the overall economic situation in the euro area, is also sluggish. Austerity is proving ineffective: the recession has caused tax revenues to fall off, making it difficult to absorb the deficit through spending alone.

The particularly sharp reduction in household consumption in 2012 (-9.1%) is due to the sharp drop in disposable income, with both wages and social transfers down. Business investment in 2012 has fallen in real terms to a third of its 2007 level. As a result, the contribution of domestic demand to growth was again very negative (10.4 percentage points in 2012, after -10.1 points in 2011). Foreign trade was morose, due to widespread austerity in the euro area; the improvement in the current account mainly came from the drastic drop in imports (-13.8% in 2012) and the more positive trade balance.

The deflationary process is worsening, with the CPI down -0.8% in the third quarter of 2013. The decline in the price level will continue in 2014. This deflation is due not only to rising unemployment, which hit 26.8% in the second quarter of 2012, but also to measures that are directly aimed at reducing labour costs, with hourly labour costs falling by 8% in 2012. Furthermore, the many measures adopted since 2010 include the 22% reduction in February 2012 of the minimum wage to 586 euros gross (510 euros gross for those under age 25) and the freezing of salary increase clauses until the unemployment rate falls below 10%.

The counterpart of this deflationary process is improved competitiveness, as in Spain. Greece has gained market share since 2007, and the cost indicator for the economy as a whole recovered in 2012 to its 2000 level. However, wage cuts were not fully reflected in export prices, and the improvement in cost competitiveness has thus been limited compared to the effort made on the level of wages.

The effort at fiscal consolidation will continue in Greece. Leaving aside exceptional measures, the primary fiscal deficit came to 1.3% of GDP in 2012, lower than the deficit target (1.5%), and this should balance in 2013 before showing a surplus in 2014. Another positive development is that the burden of interest charges on the debt is a bit lighter; the rate of interest on the debt fell from 7.1%

of GDP in 2012 to 5% in 2013. However, this progress is not reflected in the deficit figures, because of the exceptional measures in 2012 and 2013 related to the recapitalization of the banks (to bring them into compliance with prudential requirements), which led to a change of 4.4 points of GDP in exceptional measures in 2012), which are continuing in 2013. As a result, the public debt will continue to grow, from 157% of GDP in 2012 to 179% of GDP in 2013, before reaching a peak in 2014 at 180% of GDP.

In 2013, the new measures being implemented in Greece should represent 5.1% of GDP (9.4 billion), and will focus on reducing public spending (7.6 billion euros) rather than on increasing revenue (1.8 billion). Among the key measures, the main focus is on lowering spending on pensions and on civil servant wages and benefits, on restructuring the administration, and on reducing health care costs. However, the revenue forecast from privatization fell short of expectations. While Greece made a commitment to raise 2.5 billion euros by the end of 2013, IMF estimates predict this will come to 1.5 billion.

Greece's public debt, which had been reduced to 157% of GDP in 2012, will continue to grow in 2013, despite the reduction in the primary deficit, due to the recession, the interest burden and the recapitalization of the banks. In its report of 31 July 2013, the IMF identified a need for refinancing not covered in the Greek program in the amount of 4.4 billion euros in 2014 and 6.5 billion in 2015, if the country is to meet the debt reduction target set at 124% of GDP by 2020. Part of this new need stems from the refusal of the euro area central banks to extend the maturity of the Greek bonds they are holding, as originally provided for in the second aid plan. Europeans could again have to come up with new funding in the amount of 10.9 billion euros.

Table. ECLM-IMK-OFCE macroeconomic forecasts

Greece

In %	2012	2013	2014	2015
GDP	-6.4	-4.1	-0.4	2.4
Private consumption	-9.1	-6.9	-1.6	2.0
Investment	-19.2	-4.2	8.1	5.3
Public consumption	-4.2	-4.4	-6.2	-4.8
Exports	-2.4	3.0	4.6	5.4
Imports	-13.8	-6.5	1.0	1.2
Contribution to growth				
Internal demand	-10.4	-6.2	-1.2	1.3
External trade	3.7	2.6	1.0	1.2
Inventories	-0.3	-0.5	-0.1	0.0
Unemployment rate	24.3	26.9	27.0	27.0
Inflation	1.0	-0.6	-0.4	0.6
Public deficit	-10.0	-7.8	-3.3	-2.1
Fiscal impulse	-5.0	-3.3	-1.7	-0.3
Public debt % GDP	157	179.2	180.5	176.1
Current account % GDP	-3.4	-1.0	-0.5	-0.5

Source: National accounts OFCE-IMK-ECLM forecasts.