APPENDIX:
Country analyses

Germany: Low economic momentum

The economic situation in Germany continues to be lackluster in 2014. Strong growth in the first quarter was followed by a decline in GDP in the second quarter, and the third quarter brought little more than stagnation (0.1%). Despite the expansionary monetary environment and favourable lending conditions investment activity remains weak. This is partly the result of low global growth, especially in the other euro area countries, but also mirrors the lingering high uncertainty about economic developments in the euro area.

The robustness of the labour market in Germany continues to be a stabilizing factor. Despite the low growth rates, the level of employment has continued to expand, and wage increases remain relatively strong by historical comparison, picking up again after weakening in 2013. As a result, incomes continue to rise noticeably and private consumption contributes most to growth.

Against this backdrop, the GDP in Germany is expected to increase by 1.5% in 2014, with the number of people employed slightly higher and the number of unemployed slightly lower than in the previous year. There is no indication that the economy will shift into a phase of self-sustaining economic growth. The potential for such a shift is there, but the strain of the euro crisis in terms of depressed exports, high uncertainty and fiscal restraint is still too strong and prevents more dynamic investment.

The primary risk in the economic outlook is a deterioration of the outlook for the euro area as a whole. Should the deflationary tendencies become stronger or the euro crisis reignite, Germany could easily slide toward recession.

The depreciation of the euro, low lending rates and robust consumption demand contribute to a strengthening of economic activity in the forecast period. Exports will pick up both to the other euro area countries and to the rest of the world. Imports will increase more rapidly than exports during 2015, after slower growth in 2014, but the contribution to GDP from external trade will be slightly positive in both years. Domestic demand will remain the most important economic pillar.

Capital expenditure and investment in construction are trending upwards, albeit at relatively low rates. Private consumption remains—as in recent years—the central engine for domestic demand. Given slightly higher economic momentum as of the fourth quarter of 2014, German GDP will increase by 1.4% in 2015. The level of employment will increase slightly, with the number of unemployed dropping somewhat.

With a rate of 1.0% in 2014 and 1.2% in 2015, German inflation will be half a percentage point above the euro area average in both years but still far below the ECB's inflation target. The fiscal budget will be in surplus for the forecast period, and the gross-debt-to-GDP ratio will continue to decline.

Table 14. iAGS macroeconomic forecasts

Germany

%	2013	2014	2015	2016
GDP	0.2	1.5	1.4	1.7
Private consumption	0.9	1.1	1.7	1.9
Investment	-0.4	3.0	1.6	3.2
Public consumption	0.7	1.2	1.4	1.4
Exports	1.7	4.0	6.3	6.7
Imports	3.2	3.8	7.6	7.8
Contribution to growth				
Internal demand	0.5	1.4	1.5	1.6
External trade	-0.5	0.1	0.1	0.1
Inventories	0.1	-0.1	-0.2	0
Unemployment rate	5.3	5.0	4.9	4.7
Inflation	1.6	1.0	1.2	1.3
Public balance	0.1	0.5	0.4	0.4
Fiscal impulse	-0.4	0.2	0.1	0.1
Public debt % GDP	76.9	73.5	70.5	67.3
Current account % GDP	7.0	6.8	7.0	7.0

Source: National accounts, iAGS forecasts.

France: Duty-free growth

In early 2011, France was one of the few developed countries having fallen back to its pre-2008 level in terms of GDP. Growth recovered to 2 percent, and even 3 percent y-o-y in 2011Q1. However, these favorable developments did not persist. The recovery has stalled and growth, although slightly positive, is close to zero from 2011Q2 on average. This break in the recovery was due to four dampening factors.

First of all, fiscal consolidation conducted since 2010 severely dragged down activity, when fiscal impulses where stopped to make way for restrictive fiscal policy. Not only France but many European partners adopted the same strategy, so that the internal domestic restrictive effect of the fiscal stance has been worsened by recessionary effects resulting from the slowdown in external demand. The fiscal strategy has been the main factor explaining the downturn of the French economy. Other factors, such as the resumption in oil price, the unusual credit conditions driven by the sovereign debt crisis and the deterioration in price competitiveness from 2012 have been less crucial, although further dampening French growth.

Some see in this long period of lack of growth the result of the impact of the 2008/09 recession on potential GDP. Firm bankruptcies and low investment may have flattened the productivity trend and the rise in long term unemployment may have increased the NAIRU. As a result, both a downward shift of the potential output and a slowdown in the potential GPD growth may have occurred since 2008. However, even if such developments are likely although difficult to quantify, the capability of the French economy to rebound is not void. Many institutions, OECD, IMF, EC, French government, OFCE estimate a large negative output gap for France, lying between -4 and -2.5 percent. Business survey data support the same idea with still high production capacity margins and a majority of firms reporting demand difficulties rather than supply difficulties. At the same time, labour productivity is still lower than its trend level, suggesting that firms are constantly overstaffed.

Dampening factors will remain active in 2014. Again, the fiscal stance will be the main brake to growth, although in a lesser extent than previous years. At the same time, competitiveness of the French economy will deteriorate due to the appreciation of the euro up to mid-2013 and to higher competition from European countries where wage deflation has started. As a result, positive points of growth stemming from the weakening of the negative fiscal impulse will be offset by a weaker external demand.

By reorienting the economic strategy in favor of firms, the French government expects better supply conditions to restore the competitive position of France. While the fiscal package—"Crédit d'Impôts pour la Compétitivité et l'Emploi (CICE)"—became effective in 2014 and will be supplemented in 2015 with the "Pacte de Responsabilité et de Solidarité", full positive impacts from the lowering of firm tax burden should not be expected in 2014 and in 2015. On the contrary, activity will suffer in the near term from increased taxation on households implemented with the view to curb the public deficit when tax revenue on firms will be lightened. Positive multipliers involved by tax incentives set up to stimulate the supply side of the economy are far lower than negative multipliers generated by higher taxes on households. The overall impact of this strategy is a lower negative fiscal impulse in 2014 and in 2015 than during the former years but with a much strong negative impact on GDP.

Furthermore, the behaviour of the firms, which will benefit from the fiscal packages, can hardly be anticipated. In the context where operating surplus ratio seriously worsened since 2008 as a result of labour hoarding and of a marked deceleration of inflation, firms will probably try to ensure better financing conditions rather than lower selling prices. A positive impact on overall employment can be expected from tax cuts, but it will probably rely on maintaining jobs rather than job creation or wage increase. Another consequence of this conservative attitude is that investment should not recover: substitution of capital for labour would result from maintaining employment which will not help investment in a context where the accelerator effect will not play its normal role as it usually did past upturns.

Private consumption will still be dampened both by a heavier tax burden in 2014—the increase in VAT and some additional taxes—and by a continued rise in unemployment up to 2015. Employment in private sectors will not fully benefit from the weak growth pattern given the need for firms to restore productivity. In 2014 and 2015, employment growth would be twice as low as it was in 2010 and 2011. Active labour market policies, including subsidized jobs in the non-profit sector, will help to job creations but it will not prevent a further rise in unemployment to 9.9 percent of the workforce.

Table 15. iAGS macroeconomic forecasts

France

In %	2013	2014	2015	2016
GDP	0.4	0.4	1.1	1.7
Private consumption	0.3	0.2	1.3	1.7
Investment	-0.8	-2.2	-1.6	0.9
Public consumption	2.0	1.8	1.1	0.8
Exports	2.4	2.5	2.6	3.3
Imports	1.9	2.4	1.2	2.0
Contribution to growth				
Internal demand	0.4	0	0.6	1.3
External trade	0.1	0	0.4	0.4
Inventories	-0.2	0.4	0.1	0.0
Unemployment rate	9.9	9.7	9.8	9.7
Inflation	0.6	0.6	0.7	0.9
Public balance	-4.1	-4.5	-4.3	-3.6
Fiscal impulse	-0.9	-0.3	-0.3	-0.5
Public debt % GDP	92.2	95.4	97.4	99.8
Current account % GDP	-1.5	-1.2	-0.8	-0.2

Source: National accounts, iAGS forecasts.

Italy:
Endless quagmire

In the first half of 2014, Italy saw its GDP fall for two quarters in a row. Combined with a negative carry-over effect inherited from 2013, Italy seems unable to find its way out of the recession. Growth should remain subdued in the second half of 2014, thanks to a stabilization of private consumption. In 2015, internal demand should support a fragile recovery. After a dip into deflation territory at the end of 2014, inflation should remain at low levels in 2015 (0.3% in average), preventing real interest rates from declining. Public deficit would reach 3.0% in 2014, and 2,9% in 2015, and primary structural balance should slightly improve by 0,1 point.

Hopes for a recovery were rapidly dampened by the bad economic performance in the first half of 2014. Indeed, the downward trend in investment has been going on, and external demand has contributed to growth negatively. The only good news is that household consumption seems to stabilize at last. Compared to 2013, the year 2014 war marked by the end of austerity measures as regards tax rises and the implementation of some fiscal measures in favor of low income households: thus, in May 2014, the employees earning up to 1 500 euros saw a 80 euro increase in wages. This contributed to raising the savings rate and improving the situation of households. On the contrary, investment contracted further, and capacity utilization rate has been stagnating since 2013.

The Italian GDP will be negatively impacted by several effects in 2014. First and foremost, credit conditions would worsen, lowering growth by 0.7 point. Indeed, lower public interest rates did not lead to lower nominal interest rates for households and firms. Public rates decreased by 125 basis points between January and July 2014, versus 27 bp for household housing and 32 bp for non-financial corporations. Besides, Italy has been experiencing a fall in HIPC since the beginning of 2014, and it entered into a period of deflation in August 2014 (notably due to the strong decrease in energy prices), which triggered a rise in real interest rates. Deteriorating price competitiveness would also have a negative impact of 0.2 point on GDP growth rate. Fiscal measures would also contribute negatively to GDP growth: even though the national fiscal stimulus remains neutral (0.2 point of GDP) thanks to the payment of overdue debts by public administration, fiscal austerity in the euro area would shave 0.5 point off GDP growth in 2014.

In 2014, private consumption should remain subdued for two reasons: an increase in unemployment on the one hand, an improvement in credit conditions on the other hand. As regards investment, external demand would stagnate and internal demand would be insufficient to drive up investment. In 2015, the neutral budgetary policy should have a more positive impact on income growth. Firms could benefit from lower tax rates. Notably, the IRAP (regional tax on production) rate would decrease by 10%, financed by a tax on financial activities. The repayment of overdue debts to private companies would keep on in 2015. Even though firms mostly focus on their deleveraging process, our scenario forecasts a recovery in productive investment. Besides, the pace at which investment will recover will be highly correlated with the transmission of monetary policy to private rates (*pass-through*). As regards the households, tax cuts of 10 billion euros have been promised by 2015, and therefore we anticipate a growth in demand for durable goods. Yet, recovery will be fragile because households fall prey to a high level of unemployment, a persistency of wage freeze in the public sector, a weak inflation forecast, and a rising savings rate.

Unemployment should remain at its record level, around 12.6% because of a stagnating labor force, and partial unemployment disposals which remain at a high level. Employment per head should increase slightly in 2015.

Non-performing loans (NPL) are on the rise: in Italy, they account for 10.9% of outstanding loans in June 2014, among which 70% are due to non-financial corporations. NPL rate increased most for non-financial firms (with a 55 bp increase between January and June 2014), compared to a 3 bp rise for individual firms and 2 bp for households. This highlights the fact that firms are still in poor financial health. Moreover, while waiting for the results of the Asset Quality Review, Italian banks had been cautious and selective, and had curbed the access to credit, notably to SMEs. Given the failure of nine Italian banks to pass the stress tests designed by the ECB in October 2014, banks are likely to give the priority to the restoration of profit margins rather than credit distribution. Hence, the pass-through of monetary policy towards private rates could be very incomplete.

The warning of the European Commission, which urged Italy to reconsider its draft budget for 2015 and to speed up the pace of structural deficit reduction, we make the hypothesis that Italy will reduce its structural deficit only by 0.1 point in 2015. Indeed, Italy can claim exceptional circumstances due to the long-lasting recession and pending structural reforms.

Table 16. iAGS macroeconomic forecasts

Italy

In %	2013	2014	2015	2016
GDP	-1.8	-0.2	0.5	0.7
Private consumption	-2.6	0.1	0.6	0.6
Investment	-4.6	-1.8	0.4	1.3
Public consumption	-0.8	0.5	0.3	0.0
Exports	0.0	1.6	0.6	1.3
Imports	-2.9	1.3	0.9	1.2
Contribution to growth				
Internal demand	-2.5	-0.1	0.5	0.6
External trade	0.8	0.1	-0.1	0.1
Inventories	-0.1	-0.2	0.0	0.0
Unemployment rate	12.2	12.6	12.6	12.4
Inflation	1.3	0.2	0.3	0.5
Public balance	-3.0	-3.0	-2.9	-2.7
Fiscal impulse	-0.5	0.2	0.0	0.0
Public debt % GDP	127.9	131.6	134.1	133.6
Current account % GDP	1.0	-0.1	1.0	1.2

Source: National accounts, iAGS forecasts.

Spain: The end of the slump

In Spain, the worst seems definitely over. After 6-year recession, growth is positive again. In the third quarter of 2014, GDP has increased by 1.6% in annual change. On the whole year, we foresee a 1.3% growth, after a drop of 1.2% in 2013. In 2015 and 2016, growth is expected to accelerate at 2.1% and 2.3% respectively. The recovery is largely supported by the strengthening of the domestic demand, in a context of loosening financial conditions.

This recovery is allowed by the reversal on the labor market. After a fall of 19% of the full time equivalent employment on a 5.5-year period, employment picked up in the beginning of 2014 and the move is projected to keep on. In this context, unemployment has continued to decline. After a peak at 26.3% in the first quarter of 2013, the unemployment rate declined to 24.2% this summer and is projected to around 20% in 2016. Despite the fall, it still remains very high, and put strong downward pressures on wages. As employment begins to recover, wage moderation is very anchored. Wages are progressing at a very low path and are even decreasing in the third quarter 2014. Nevertheless, despite this slowdown, the gross income of households has progressed again. Moreover, helped by the very low or negative inflation in the last months (-0.5% in November), the real income has been allowed to progress faster. That should consolidate household consumption in the next years to increase at a path expected at around 2%.

The other support to Spanish recovery is the easing financing conditions. Since the middle of 2012, public long term interest rate has decreased by more than 4 points. They finish the year under 2%, which has never been seen in Spain. This decrease will be transmitted to households which are Indebted in variable rates and facilitate their financial adjustment. In this positive context, prospects are improving and companies have restored their margins and can finance their expenditures. Productive investment can stay dynamic.

But some problems remain present. Debt of households is high and some imbalances on the real estate sector still goes on, although the adjustment in construction is close to its end. The house prices stopped to decline and are barely stabilizing. Investment in residential sector was still decreasing in the second quarter 2014. But the drop could stop in the second half of 2014. We foresee an modest increase of 0.8% in 2015.

In spite of certain progress, banking sector is fragile because of the importance of the doubtful loans. Bankruptcy have decreased rapidly in 2014 but are still at around 2000 proceedings on an annual base. That exert a strong constraint on the credit activity.

External sector will stop supporting the activity. Net exports contribution could be slightly negative in 2014 and almost neutral in 2015 and 2016 because of the acceleration of imports. Unit labor cost could cease to decrease from 2015 but some further gains in competitiveness are still expected. After a poor performance in the first half of 2014, exports could gain momentum from the second half of the year. Fiscal consolidation will continue. In 2014, the fiscal impulse is expected to be of 1 point negative. In 2015 and 2016, the adjustment effort should be weaker (-0.4 point and -0.6 point). Public deficit could be just above 3% of GDP in 2016. But this sizable budget deficit combined with a still low nominal GDP growth could push the public debt ratio to around 101% in 2015.

In this context of slackened growth, high output gap and high unemployment, the growth is not exempted of risks. The wage moderation could get into a deflationary process and made more difficult the economic recovery, particularly because the real adjustment become more difficult.

Table 17. iAGS macroeconomic forecasts

Spain

In %	2013	2014	2015	2016
GDP	-1.2	1.3	2.1	2.3
Private consumption	-2.1	2.0	1.5	2.1
Investment	-5.1	0.6	2.8	2.9
Public consumption	-2.3	1.5	0.4	0.9
Exports	4.9	3.3	4.1	3.5
Imports	0.4	4.5	2.4	2.9
Contribution to growth				
Internal demand	-2.7	1.5	1.5	1.9
External trade	1.4	-0.3	0.6	0.3
Inventories	0.0	0.0	0.0	0.0
Unemployment rate	26.1	24.5	22.8	20.2
Inflation	1.5	0.1	0.2	0.6
Public balance	-7.1	-5.5	-4.2	-3.3
Fiscal impulse	-1.6	-1.0	-0.4	-0.6
Public debt % GDP	93.9	98.4	100.4	101.1
Current account % GDP	0.8	0.0	0.8	0.7

Source: National accounts iAGS forecasts.