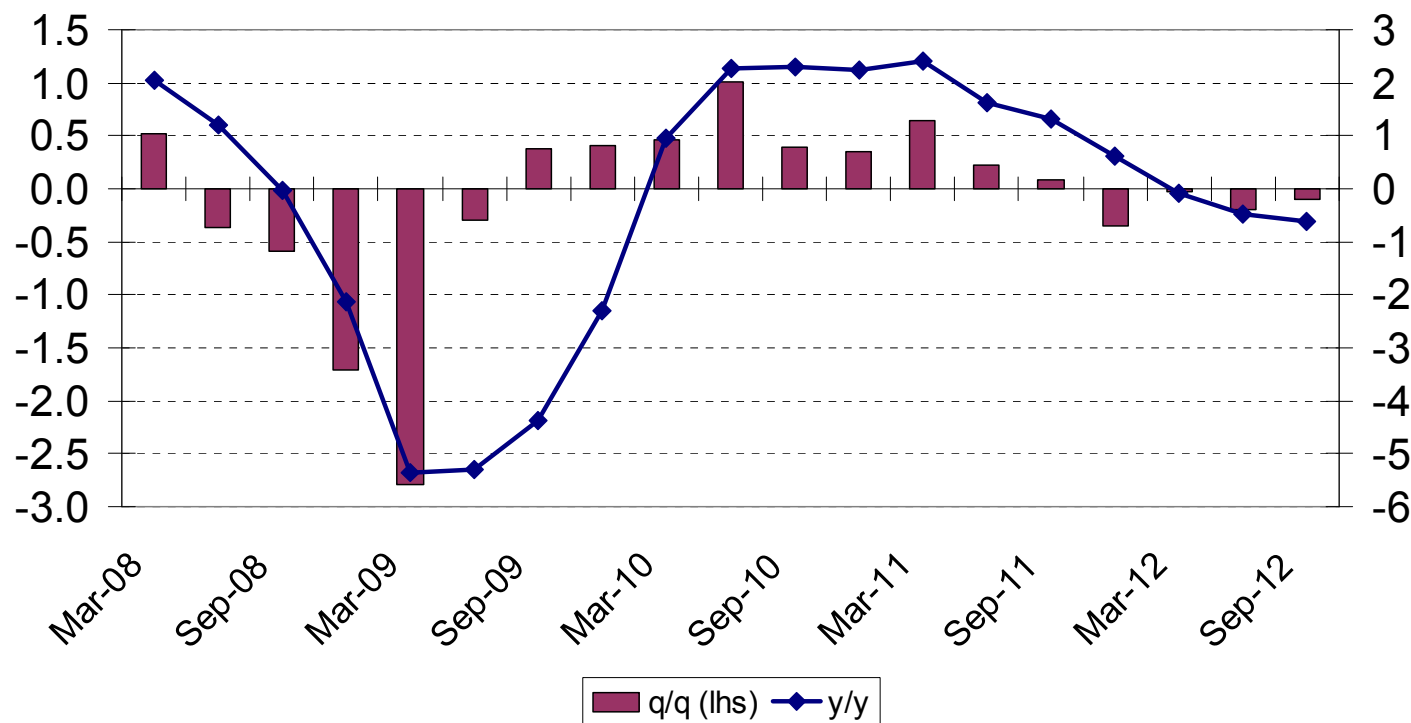

The European Economy

Simon Barry
Chief Economist Republic of Ireland

December 2012

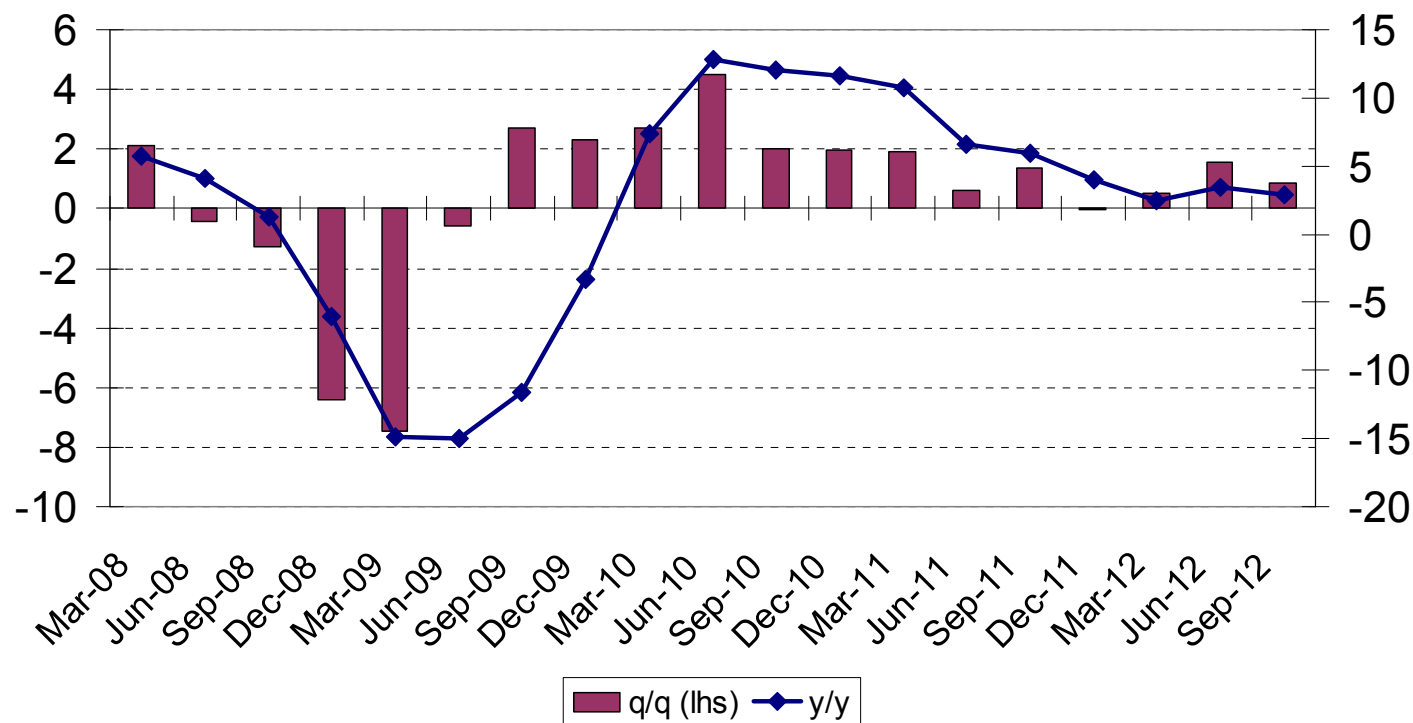
Euro area economy now back in recession as GDP contracts in 3 of the past 4 quarters...

Euro Area Real GDP Growth, %



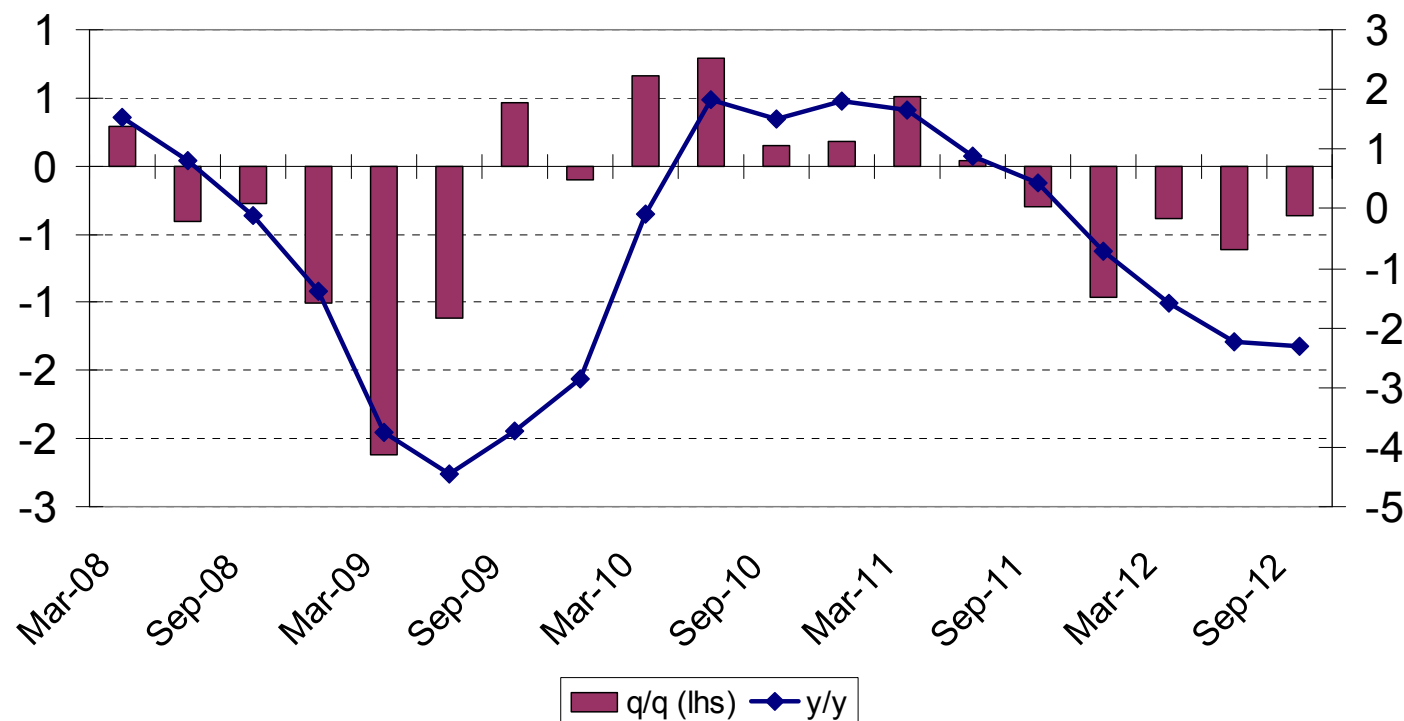
...exports have continued to provide a badly-needed source of growth, though trends have softened this year...

Euro Area Export Growth, %



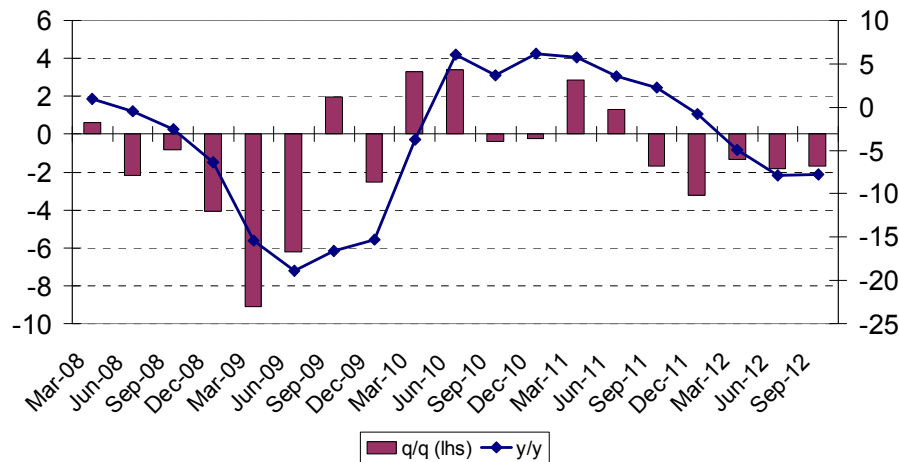
...the weakness has been concentrated in domestic demand which has been contracting for over 15 months now...

Euro Area Domestic Demand Growth, %

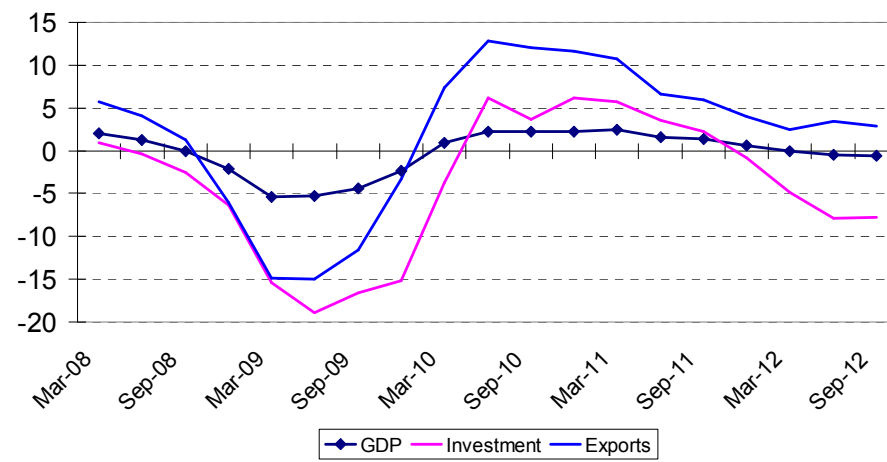


...investment trends have been particularly weak, reflecting concerns about future demand...

Euro Area Investment Growth, %

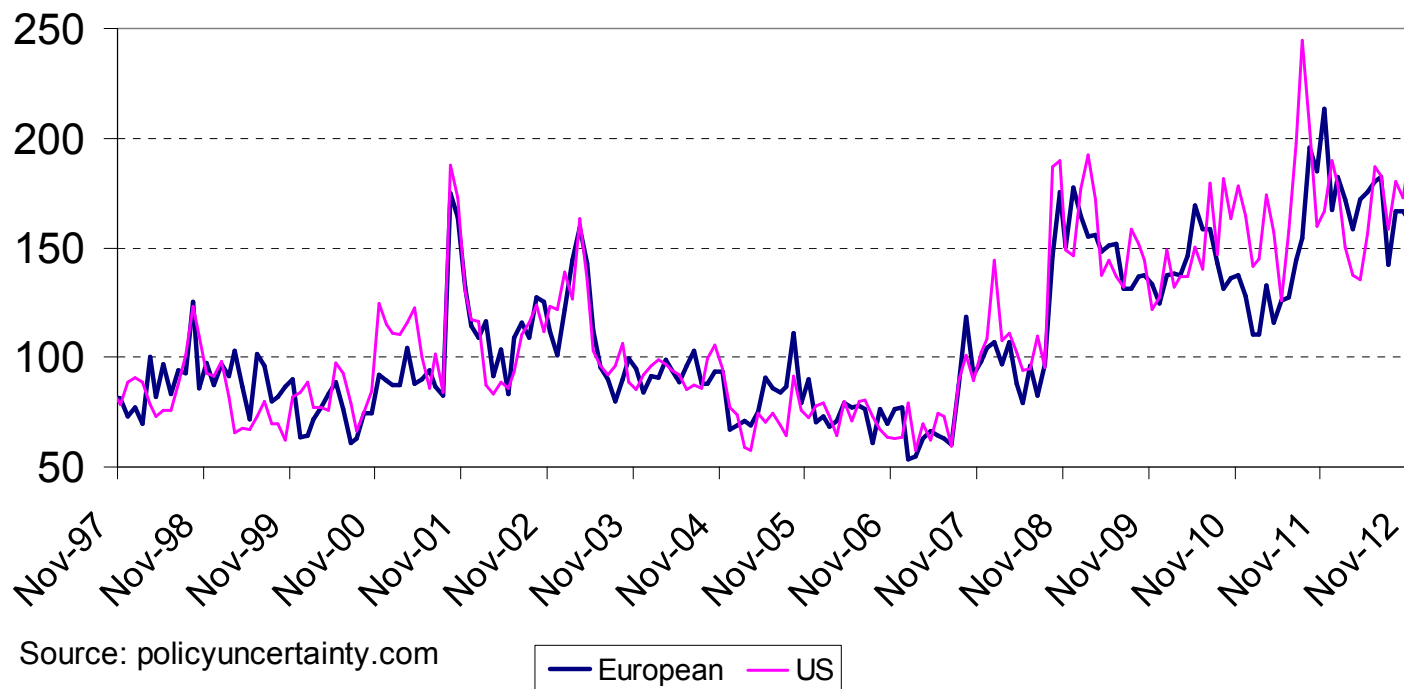


Euro Area GDP Growth, y/y %



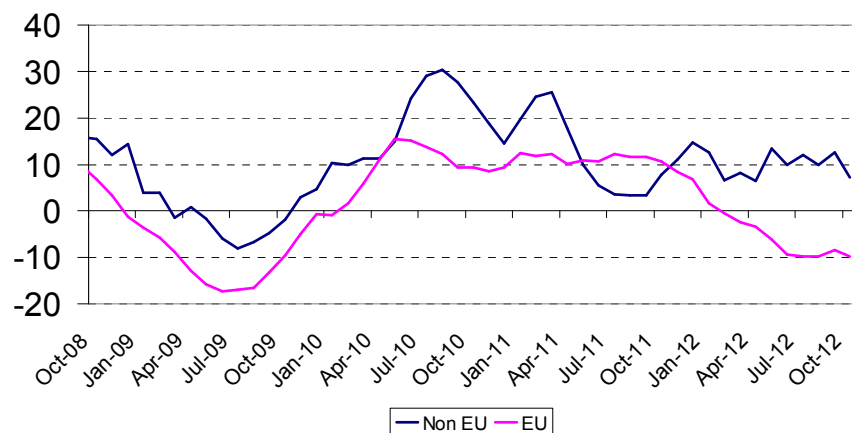
...and very high levels of uncertainty, both in Europe, and in the US

European & US Policy-related Economic Uncertainty Index

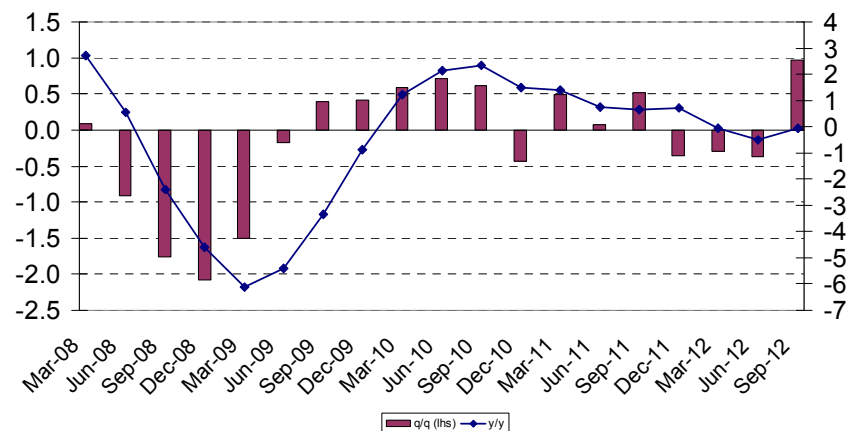


Euro area woes have contaminated the UK, which itself has 'double-dipped' this year...

UK Goods Exports £, y/y% (3mth avg)
(Ex oil and erratics)

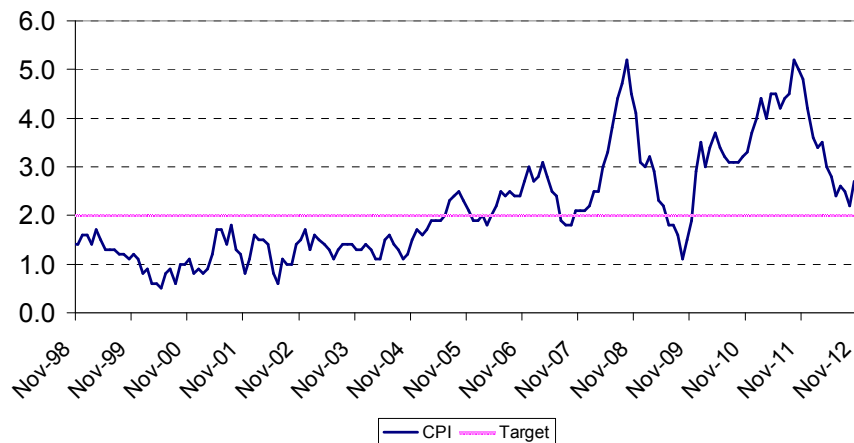


UK Real GDP Growth, %

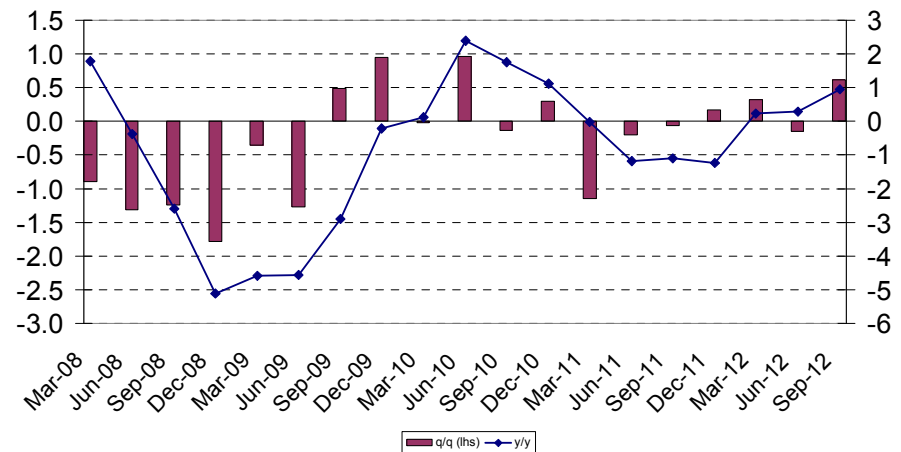


...and where the consumer has also faced a nasty real income squeeze, though this is beginning to ease

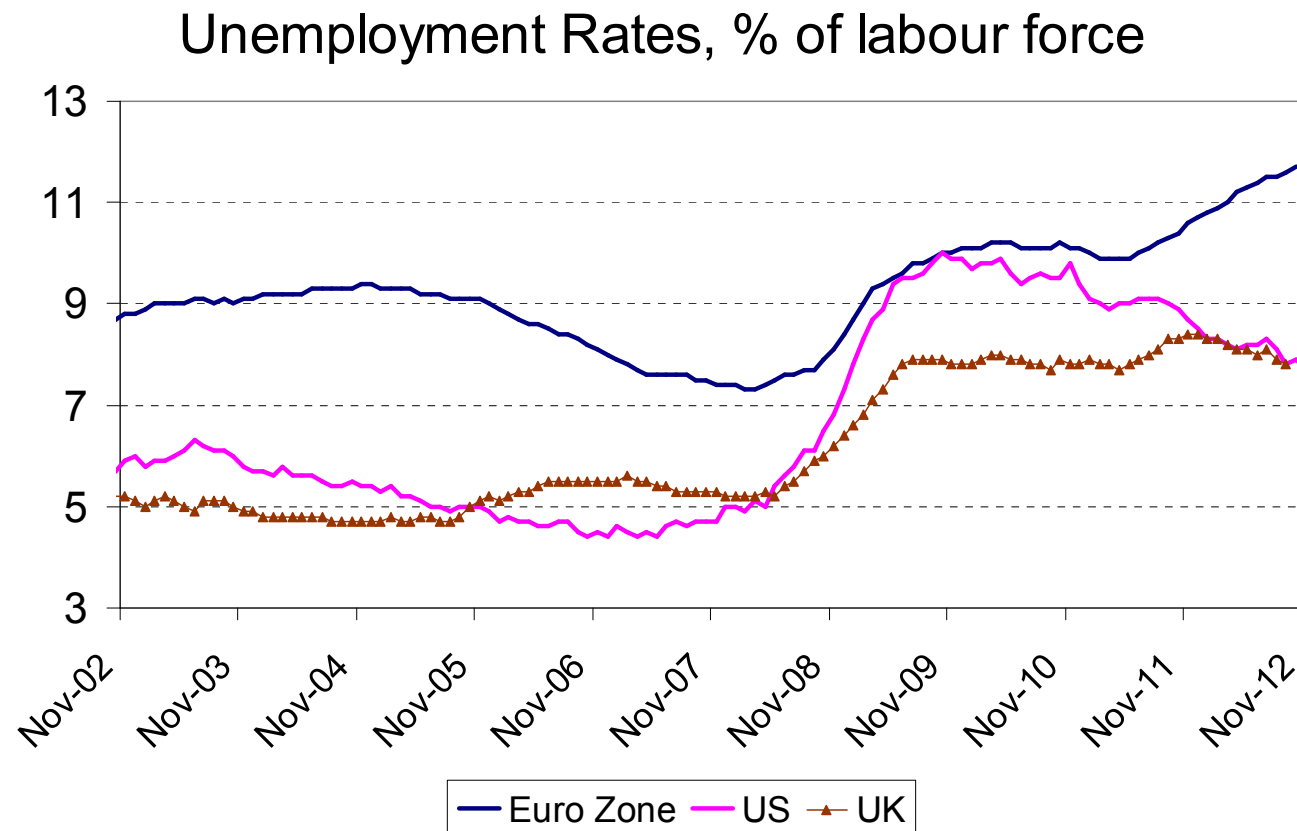
UK CPI Inflation, y/y%



UK Consumer Spending Growth, %

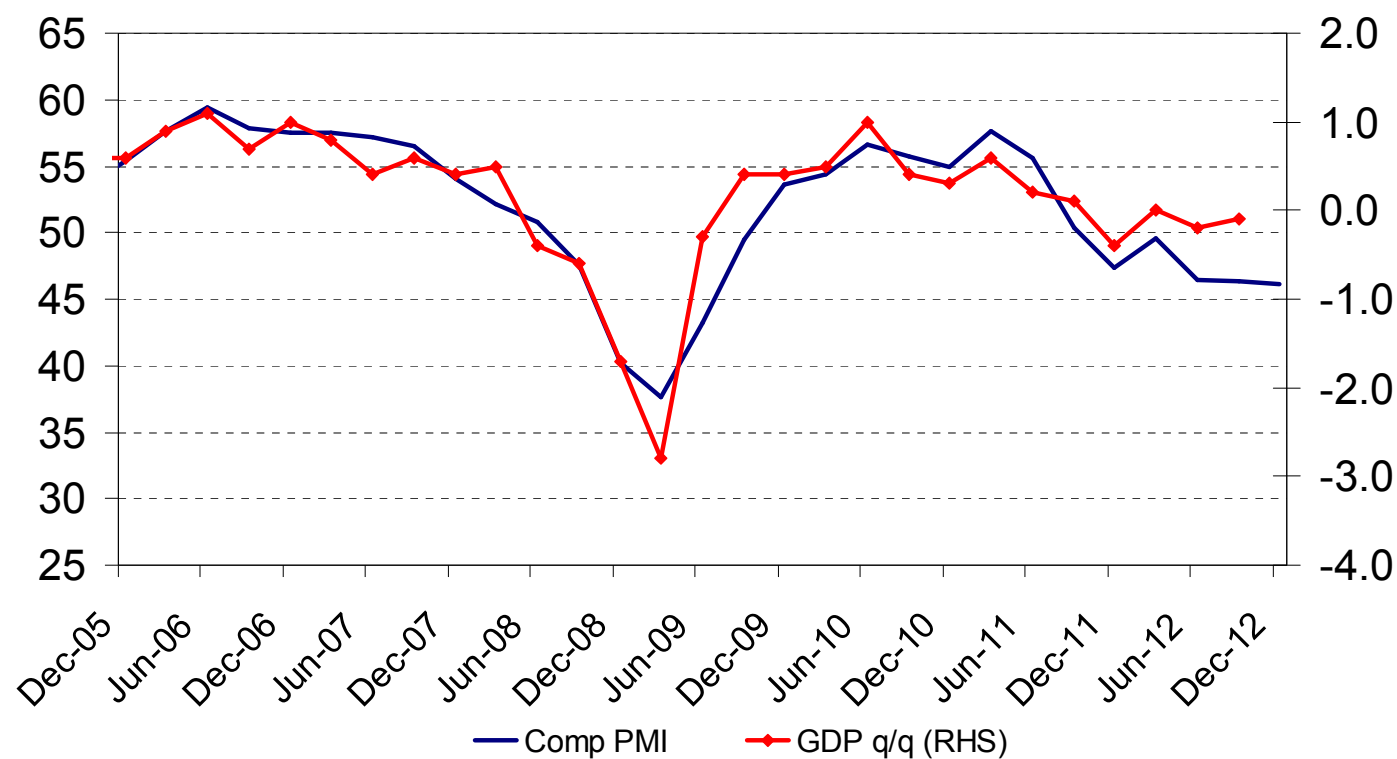


Overall, euro area labour market conditions continue to deteriorate, in marked contrast to the trends elsewhere

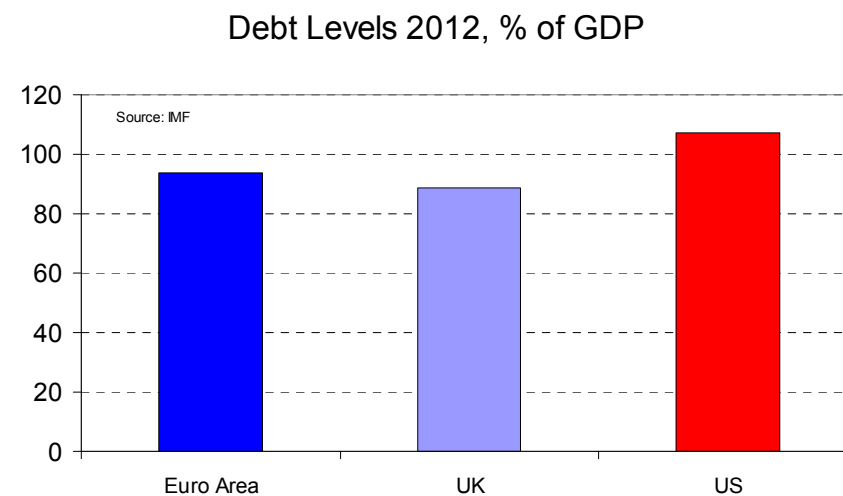
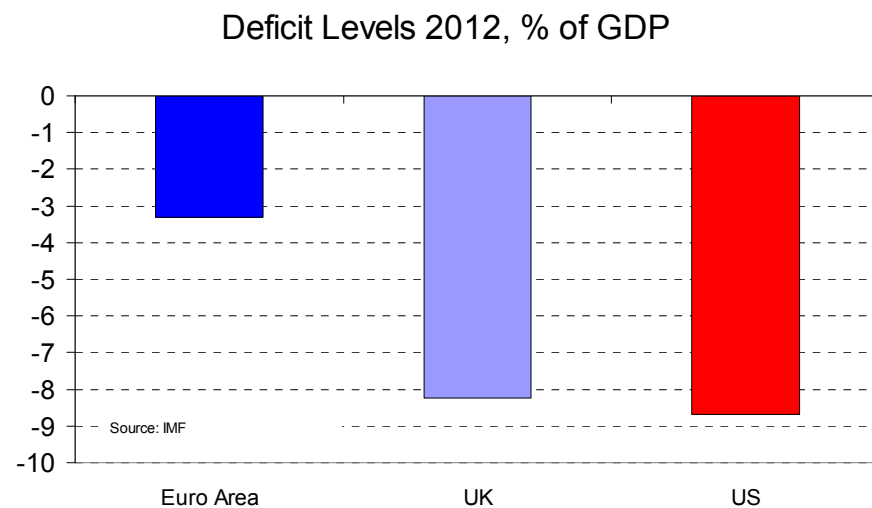


The latest business survey indicators indicate growth momentum remains very poor in Q4

Euro Zone Composite PMI vs GDP q/q %

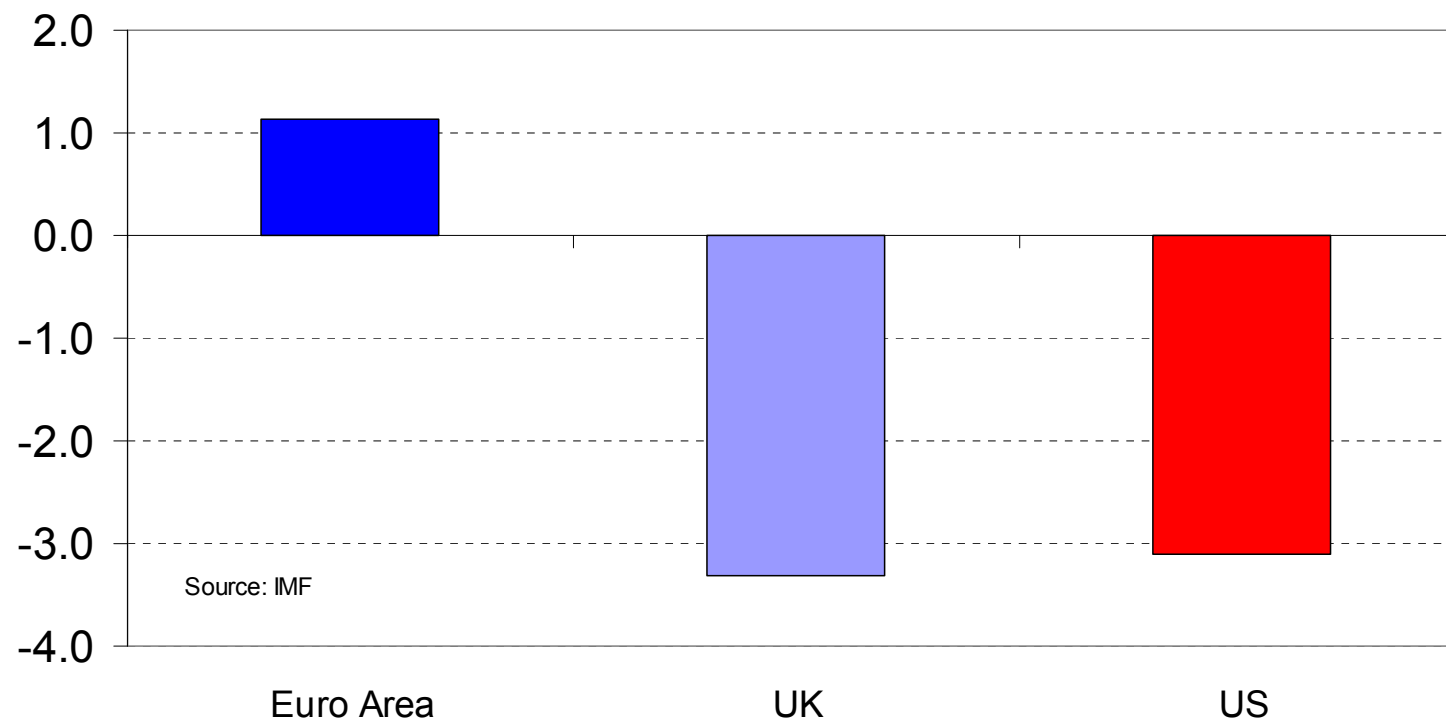


Euro area fiscal crisis? What crisis?!



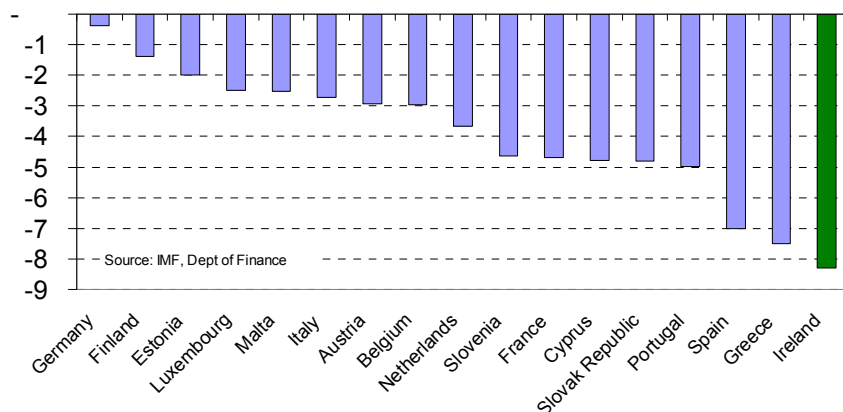
Chronic competitiveness problems? Really?

Current Account Balances 2012, % of GDP

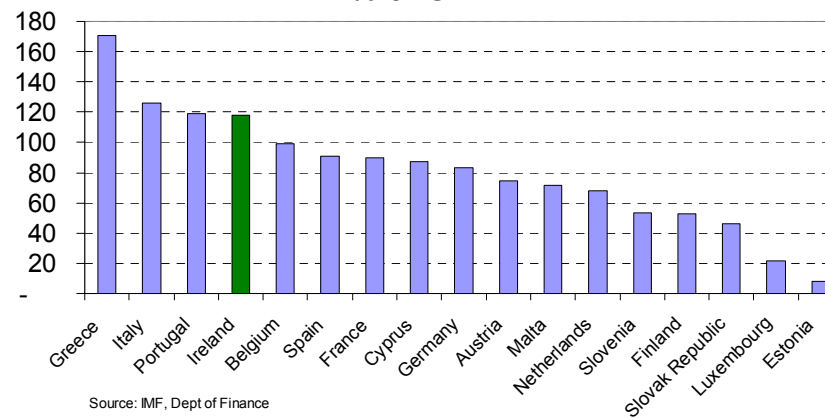


The pan-euro area averages mask the real story, which is one of enormous & highly problematic divergence in fiscal performance...

Euro Area Budget Balances 2012,
% of GDP

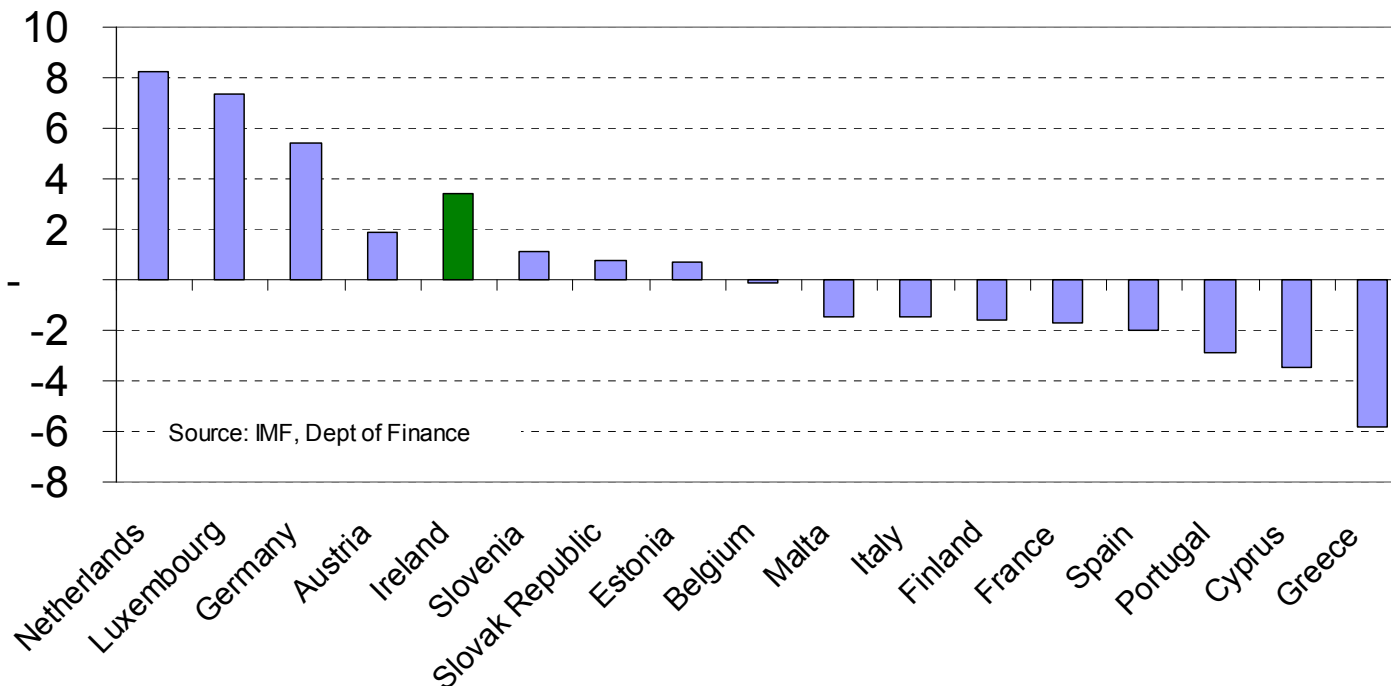


Euro Area Debt Levels 2012,
% of GDP



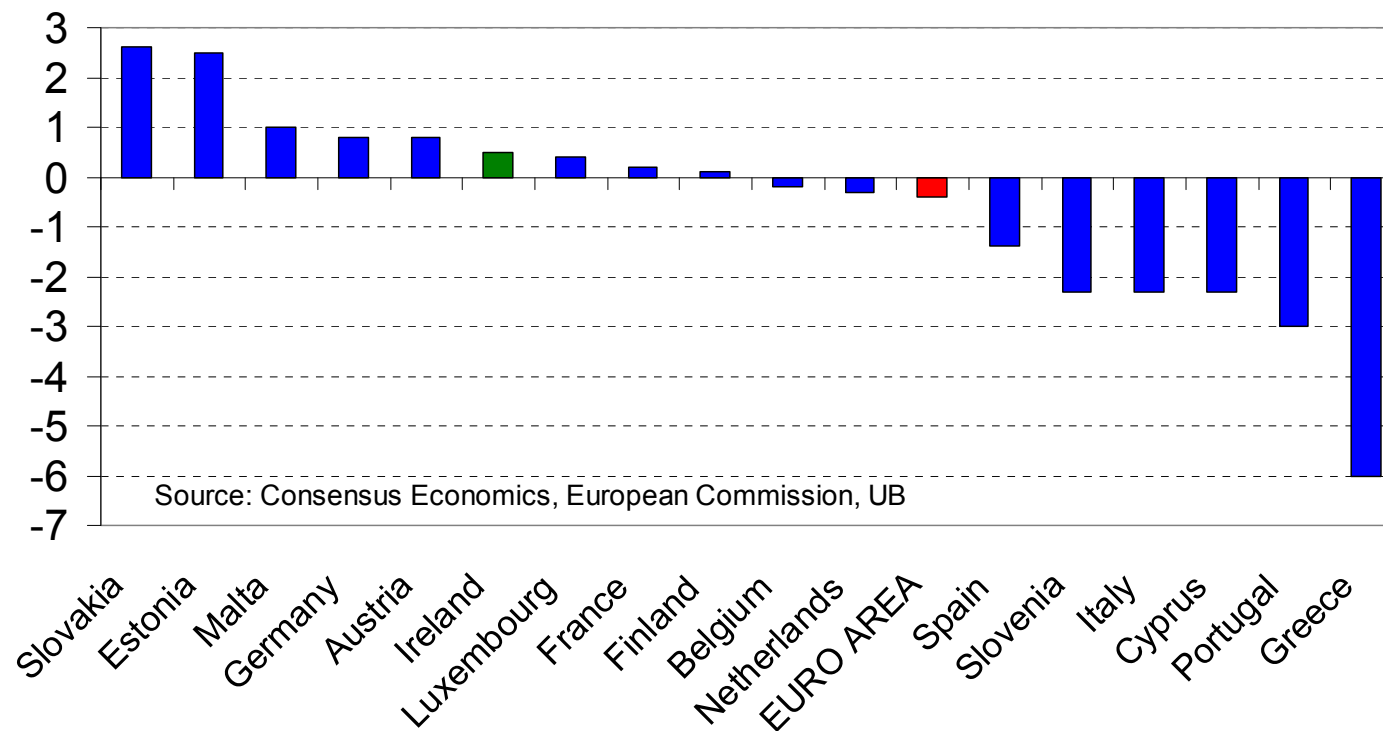
...in external balance positions (where high deficits are symptomatic of large, cumulative declines in competitiveness)...

Euro Area Current Account Balances 2012,
% of GDP

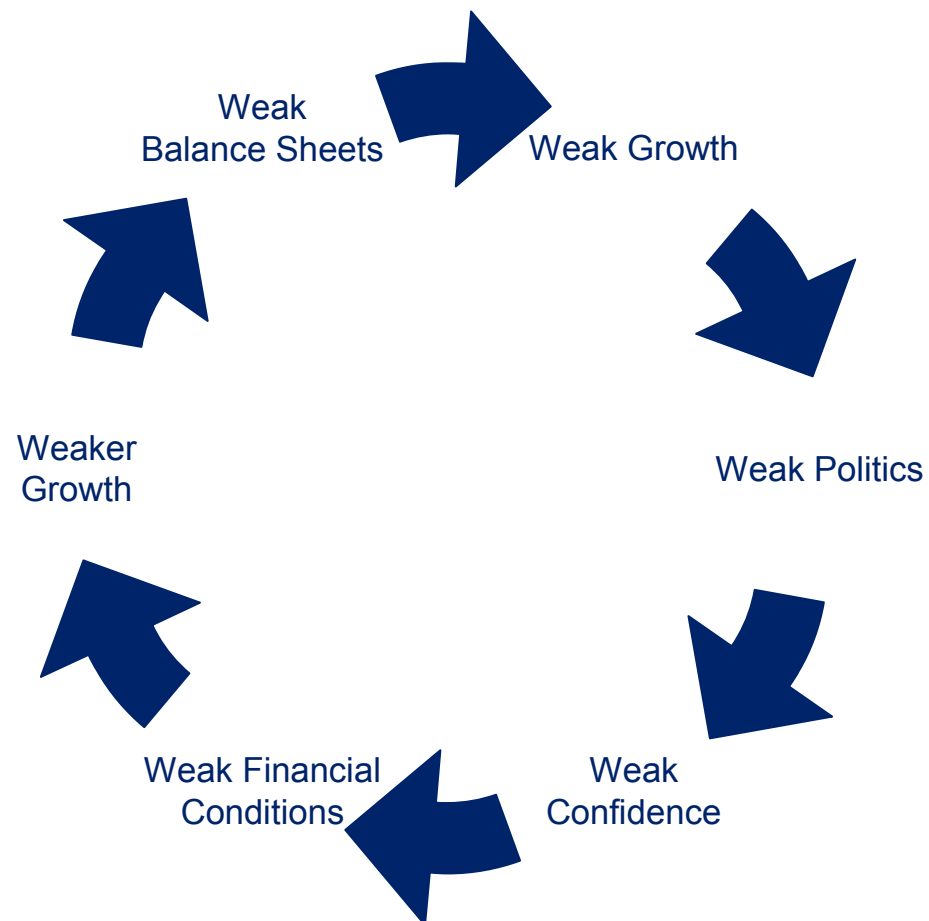


...and in growth performance

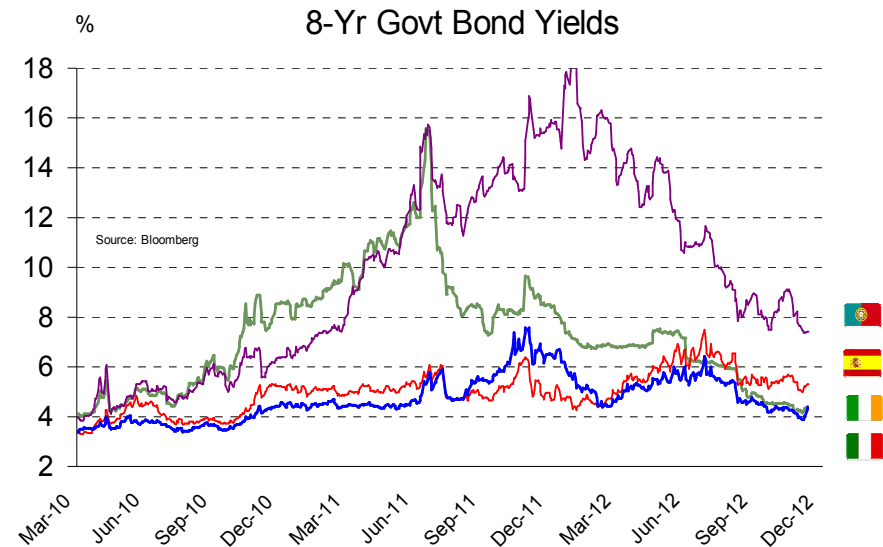
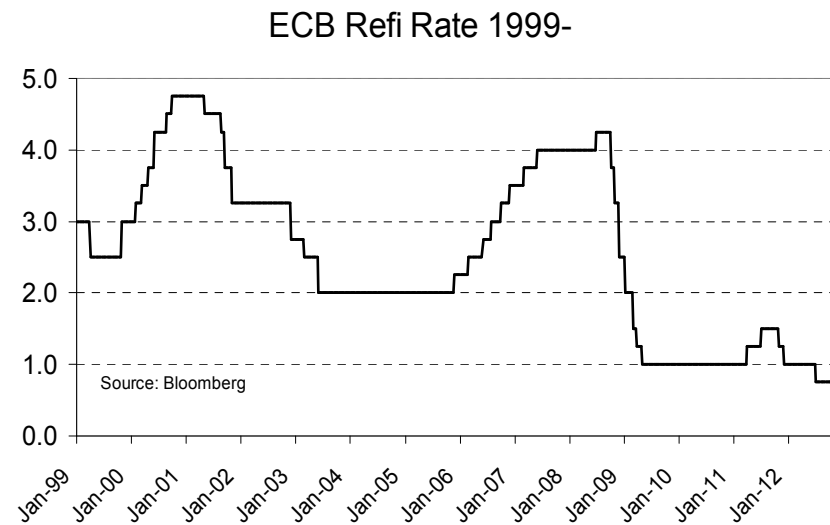
Euro Area 2012 Real GDP, y/y%



Decisive policy response is key to breaking the resulting negative feedback loops (including between sovereigns and banks)

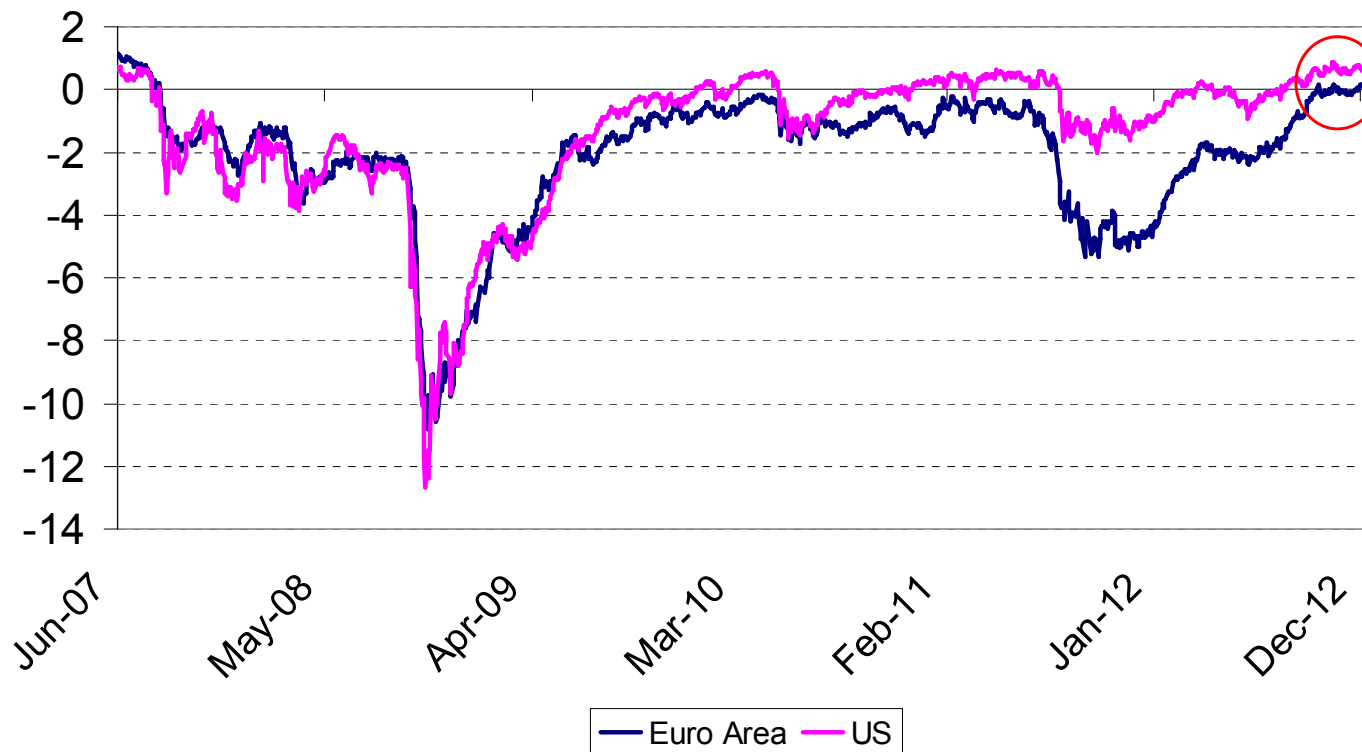


Mr Draghi (3 rate cuts, 2 LTROs, the OMT programme, and more..) deserves much credit...



The central banks have pulled out all the stops, and have succeeded in stabilising financial conditions, even in Europe...

Bloomberg Financial Conditions Index



...where break-up fears have receded considerably

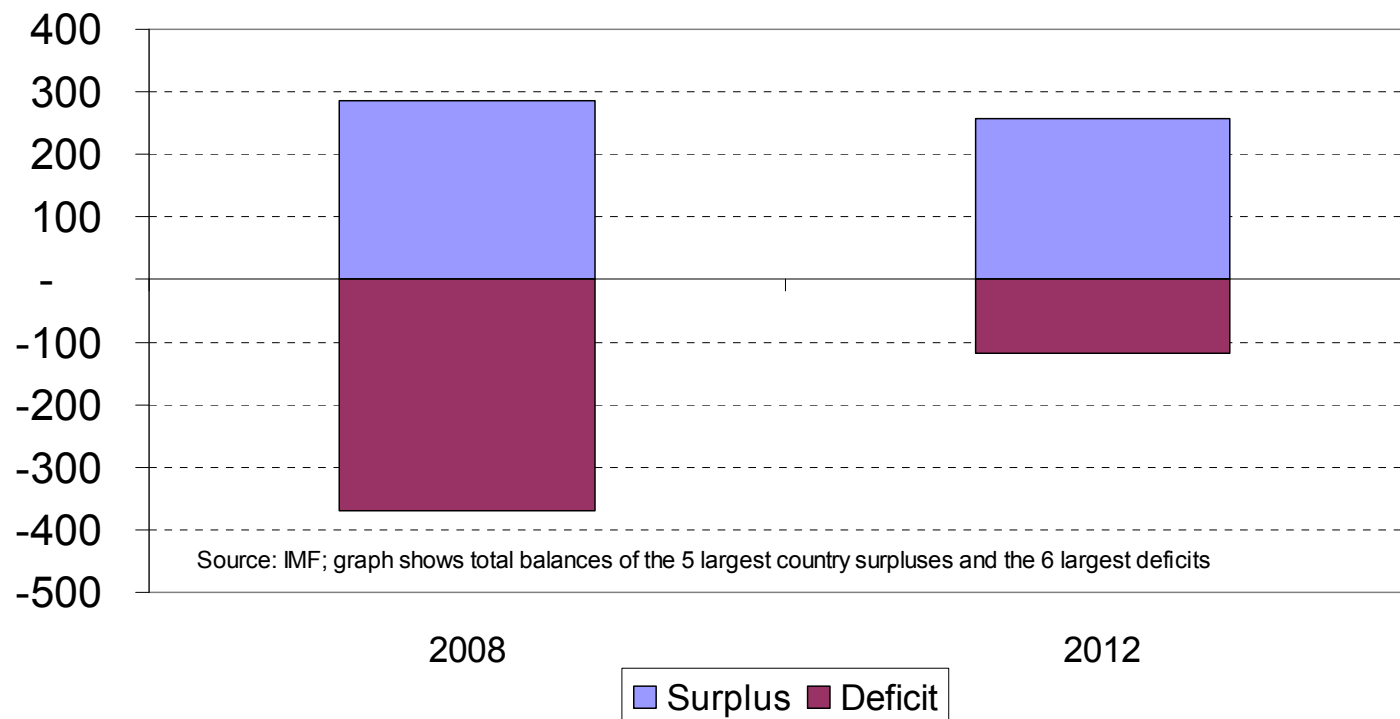


But much more needs to be done to 'complete the Union'; it's time for the politicians to step up

- Key elements of euro area reform agenda
 - Banking union
 - Fiscal integration
 - Rebalancing
 - Public finances
 - Private (financial and non financial) sector deleveraging
 - competitiveness
 - Stronger focus on growth-promoting policies
 - Political legitimacy
 - Institutional reform
- Track record to date:
 - Policy response has generally been reactive, slow in coming & behind the curve
 - Action & decisions have tended to come only under major market pressure (e.g. June summit)
 - But: important progress has been made (e.g. fiscal treaty, steps to Single Bank Supervisor)
 - And solidarity (albeit conditional, sometimes begrudging) has been an important feature of the policy approach (e.g. improved terms for programme countries, recent concessions for Greece); there is a strong mutual self-interest in avoiding destructive break-up scenarios
- So base case is for further gradual progress towards deeper integration
 - Should result in improved performance and, over time, reduced uncertainty
 - But the process remains subject to important economic and political risks which mean the journey is likely to bumpy, with associated bouts of volatility

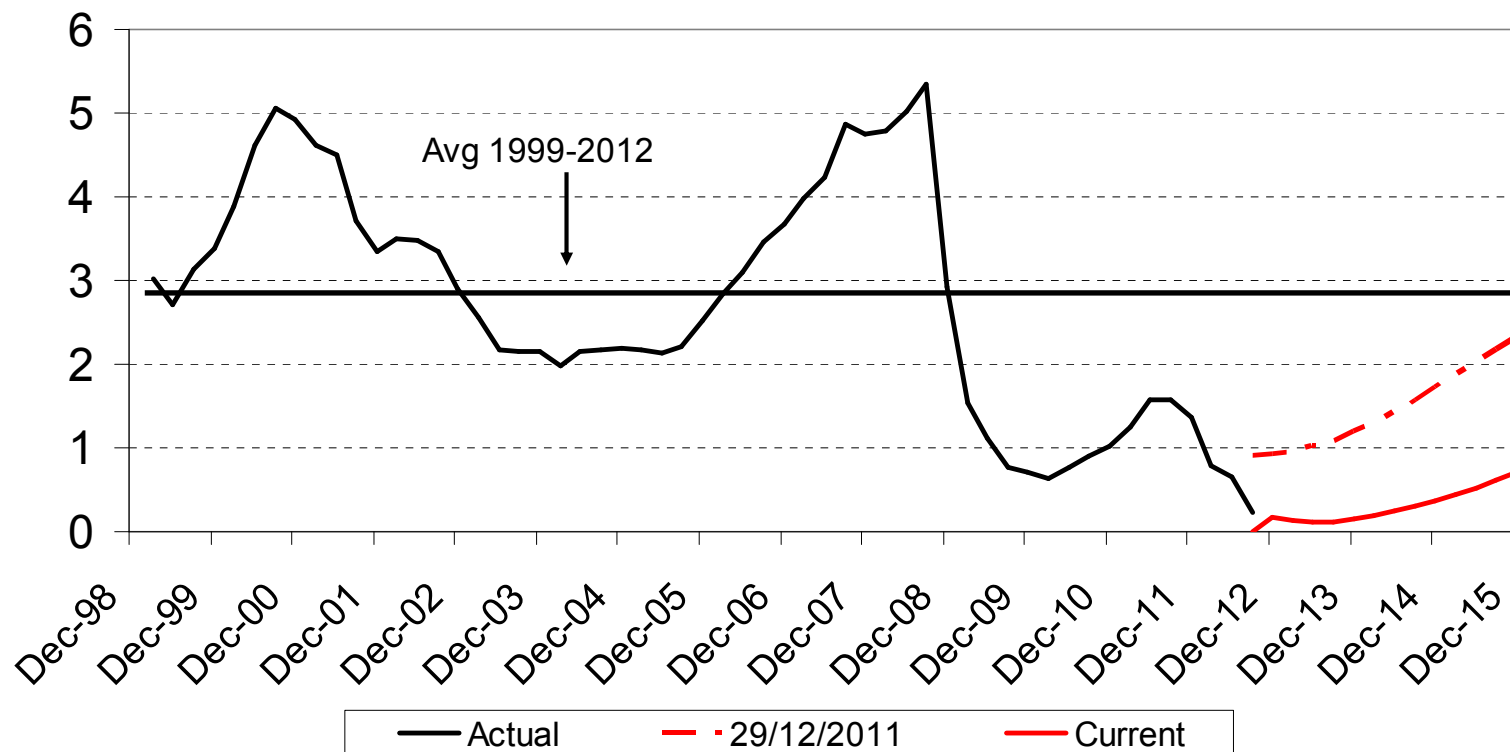
...some elements of the strategy look flawed; the surplus (i.e. excess savings) countries must also contribute meaningfully to the adjustment effort

Euro Zone Current Account Balances, USD



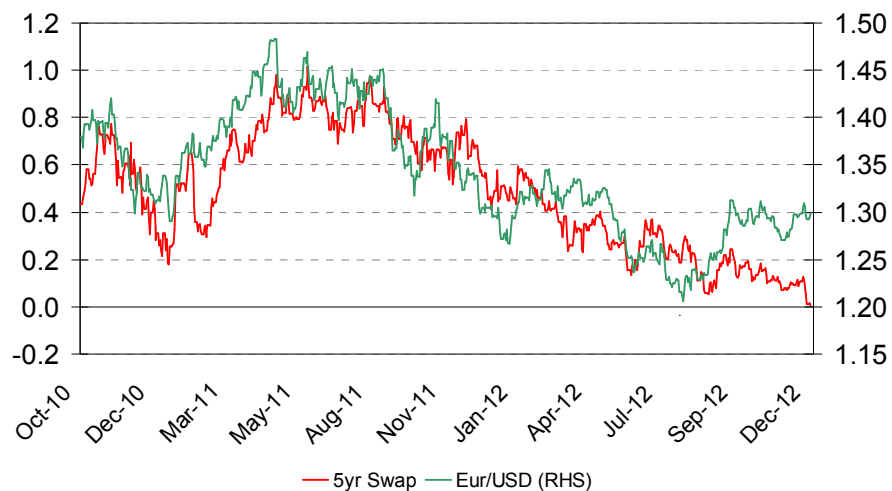
In the meantime, the ECB remains a key institutional actor;
watch out for more from Draghi in 2013...

Mkt Interest Rate Expectations: 3-Month Euribor

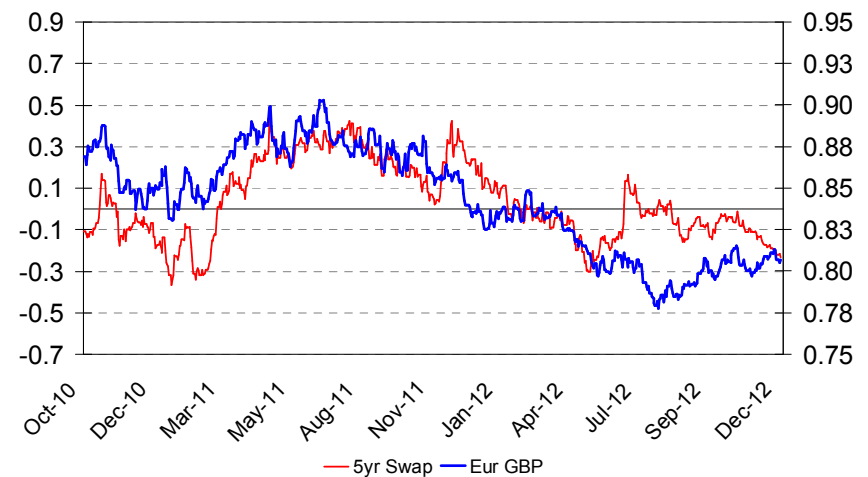


...so there may be some (modest) downside for the euro in the months ahead

Eur/USD vs Interest Rate Differentials



Eur/Stg versus Interest Rate Differentials



FX markets can be very volatile & a source of major headaches,
so active risk management of currency exposures is vital

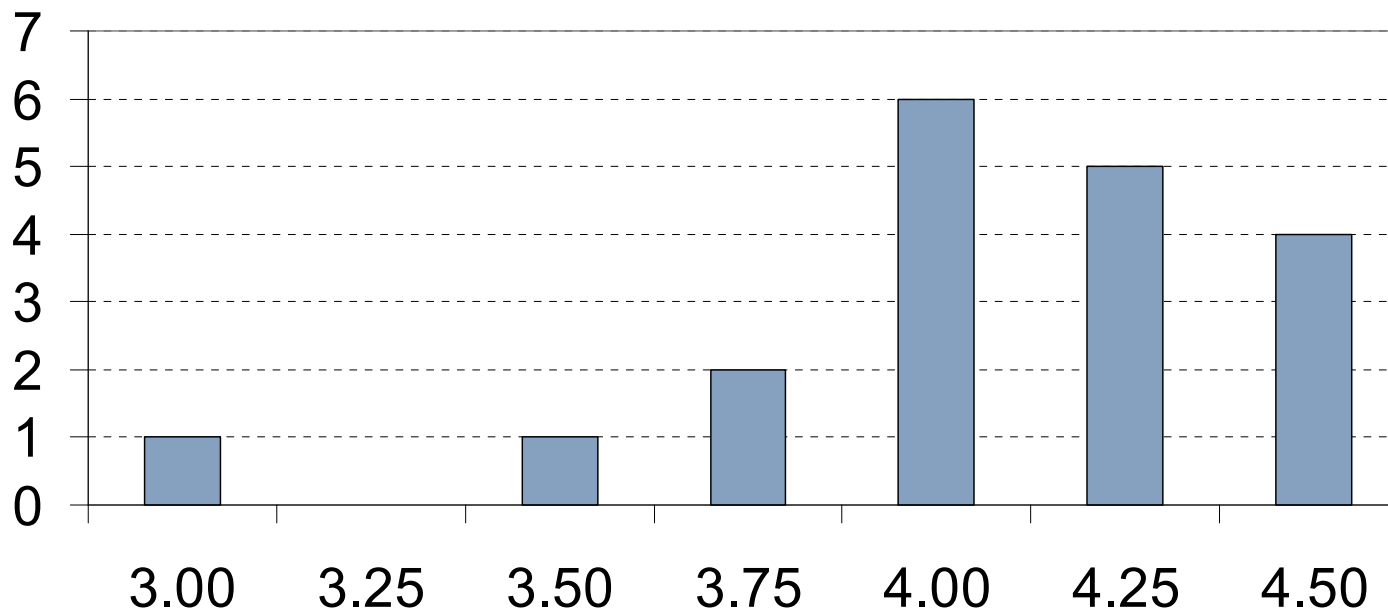
Past 2 years

| | High | Low |
|--------------------|------|------|
| Eur/USD, \$ | 1.49 | 1.20 |
| Eur/Stg, £ | 0.91 | 0.77 |

A note of caution on interest rates: 'lower for longer' \neq record lows forever

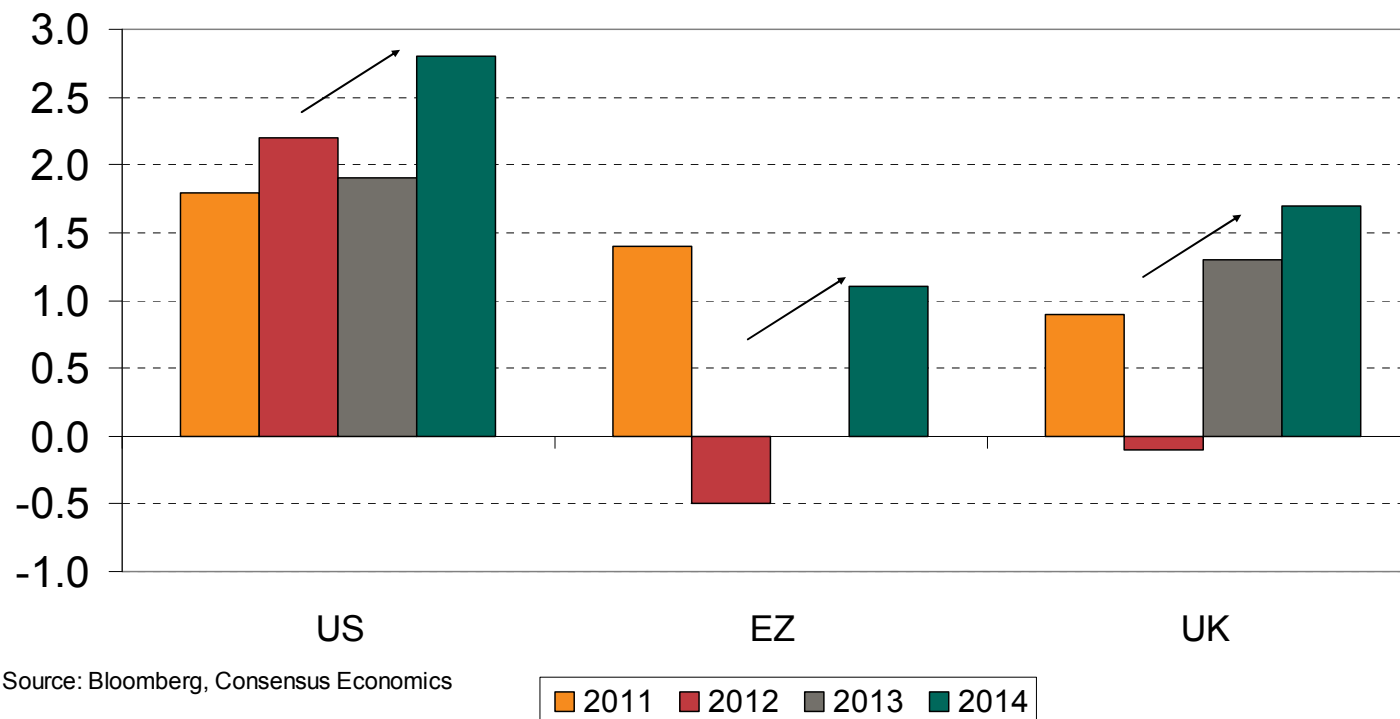
FOMC September '12 Projections for Fed Funds over the Longer Term

Number of members (vertical) vs. FF projection (horiz)

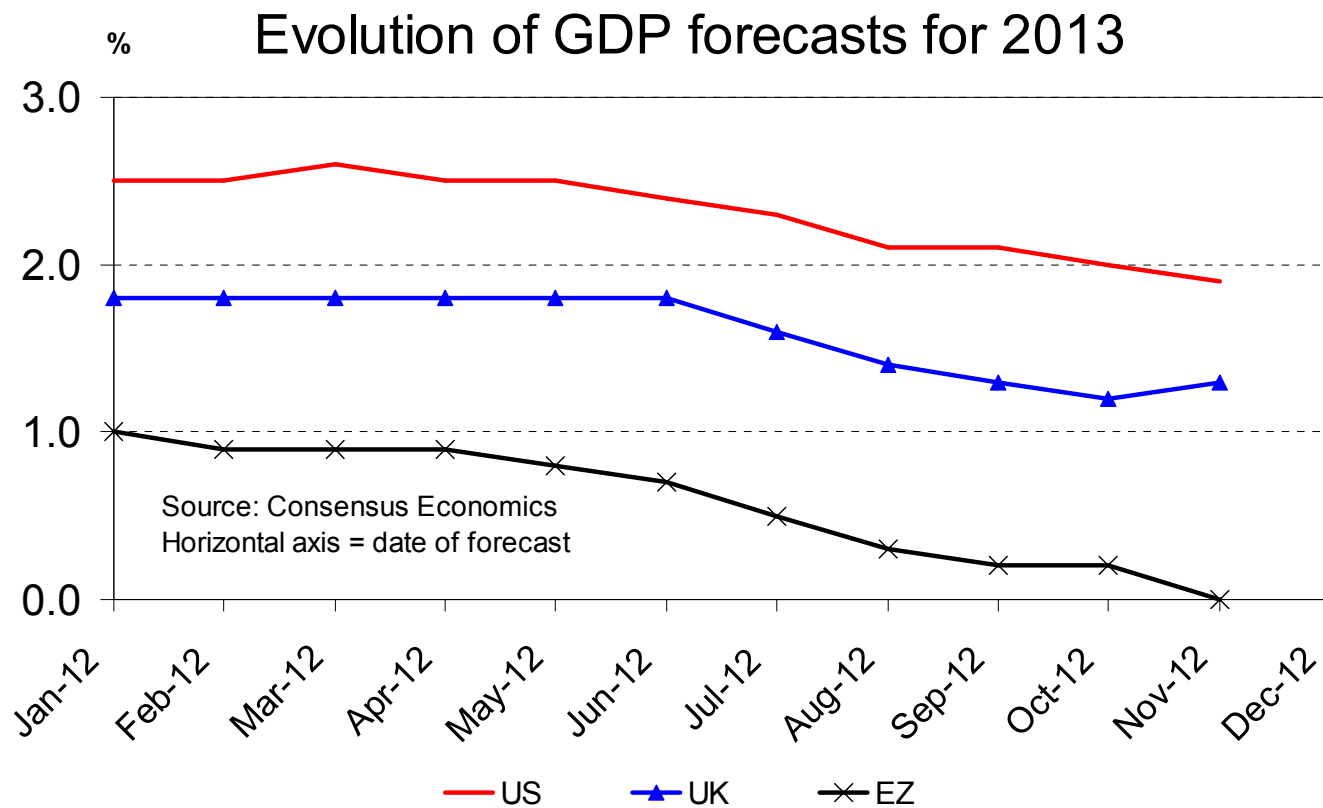


Base case is for weak, but at least improving European growth performance in 2013/14 as headwinds and uncertainties fade...

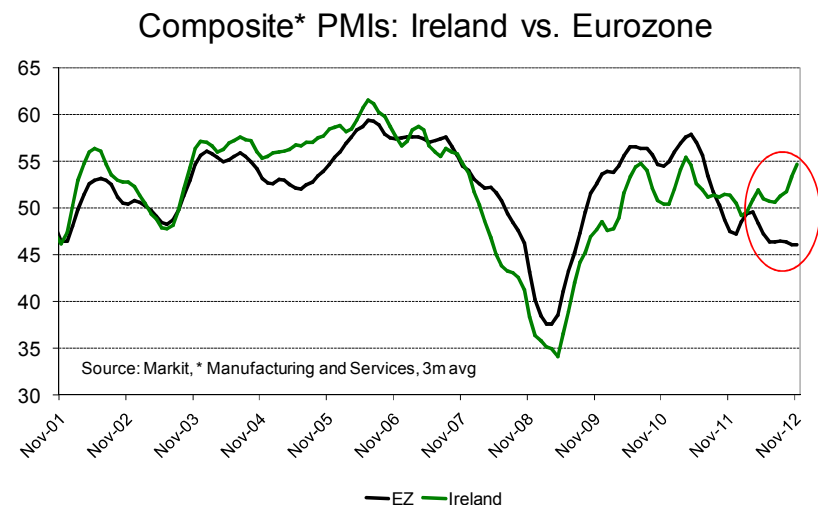
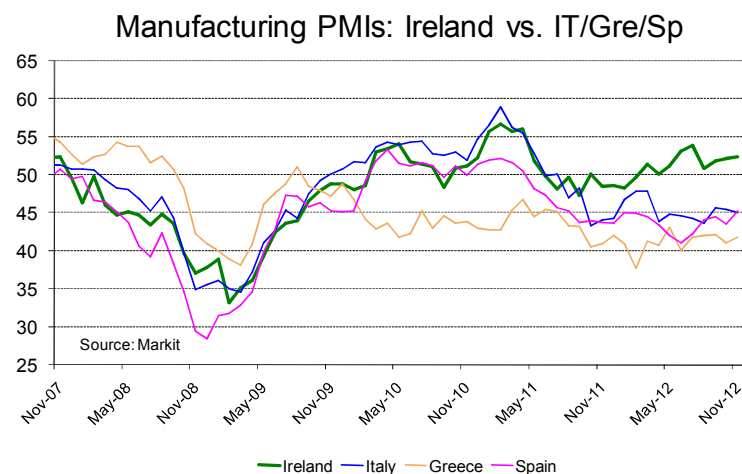
Annual GDP Growth, 2011-14



...but downside risks continue to prevail

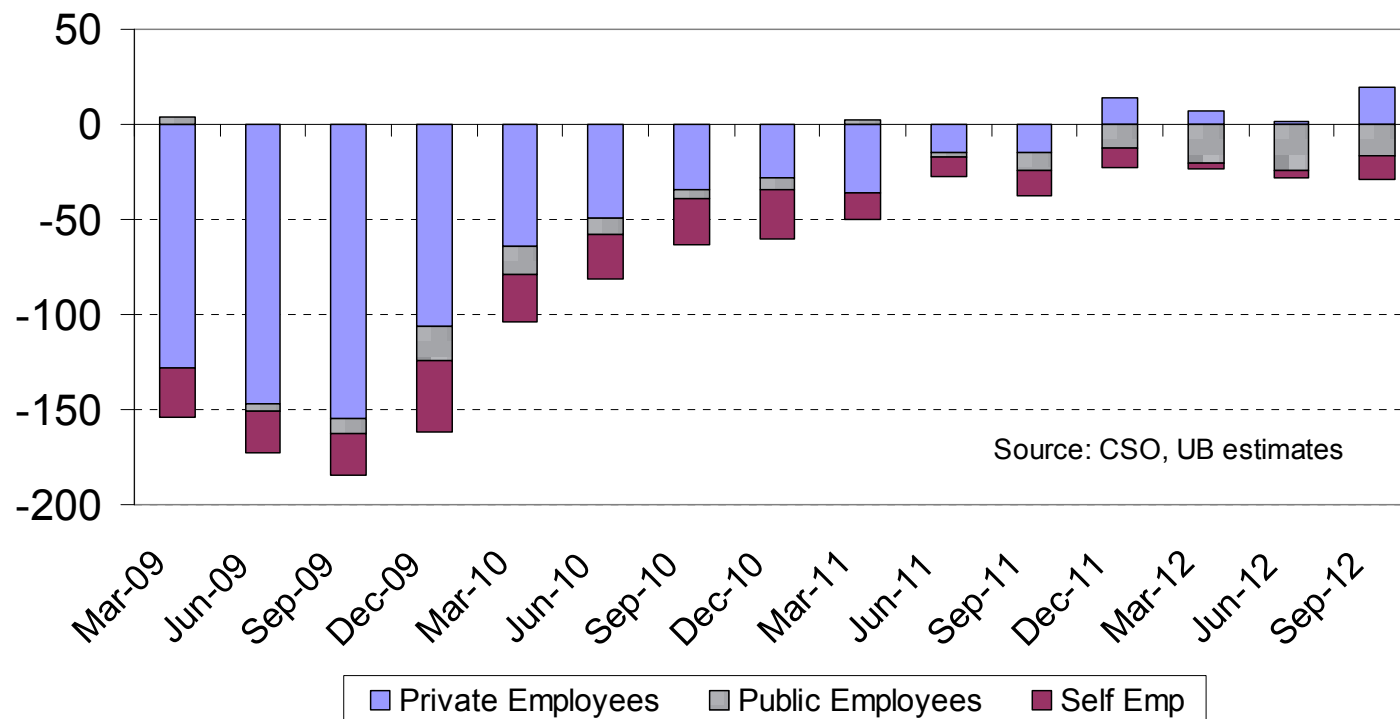


PMIs indicate Ireland's traded sectors are outperforming the wider euro zone, not just other 'vulnerable countries'



The private sector, not fiscal policy, holds the key to Irish recovery; the latest jobs trends offer much encouragement

Breakdown of Employment, annual change
(000s)



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