Jefferies European Economic Outlook

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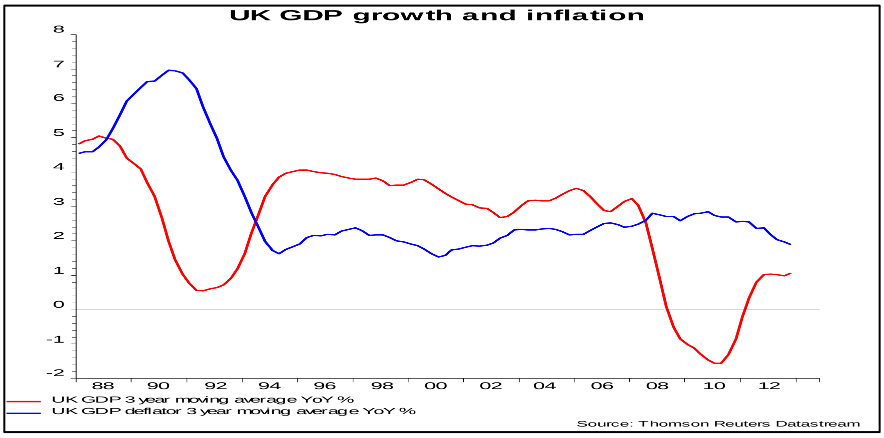
A low inflation world: Euro area skirting deflation and sub-1% UK inflation?

One of our major themes has been that the euro area would find itself with an inflation rate stuck below 1% for an extended period of time. Base effects may add additional volatility to the inflation profile in coming months, but the risk now has to be that inflation prints below 0.5% before year end. Moreover, the region can be seen as being one significant shock away from outright deflation, a view of the world that is gaining traction, leading to calls that the ECB needs to do more, including outright QE (something that we always thought could prove to be the end game for the ECB in this cycle).

However, it also has to be recognized that as far as the ECB is concerned it really is living in a world of small numbers, where what may appear minor differences to inflation and the growth rate of GDP could make a big difference to policy. At present surveys point to Q1 being the fourth consecutive quarter of recovery, giving the ECB more confidence that it can live with the current bout of low inflation. If though recovery stalled or inflation printed below 0.5%, the ECB would be under much more pressure to act. Moreover, the ECB is probably hoping to see a decisive turn in the currency later this year, as US Fed tapering comes to an end and the market starts pricing in a greater risk of US rate rises. As ever with the ECB there can be a tendency for the Governing Council to not really act until it is really forced to. And, let's not forget that since the beginning of this year we have seen further significant foreign buying of euro area equities and further spread compression with some periphery bonds rallying hard. Indeed, the clear impression we had from the ECB's last press conference was that policy was on hold until June at the earliest, when the staff forecasts are next published.

Arguably, UK inflation (down to only 1.7% in February) is now set to surprise. Given the history of UK inflation being above target for so long and recovery continuing apace, it is almost as if everyone is conditioned to expect inflation to head higher again, particularly with all the debate about the timing of when the BoE will first raise rates. However, from where we stand now in our view the balance of risks is that UK inflation prints lower, fitting the pattern of inflation to fall in the first two years of recovery - see chart below showing how, taking three year moving averages, inflation (according to the GDP deflator) continued falling long after recovery commenced in the early 1990s. In that sense inflation can be seen as something of an echo of the earlier cycle in GDP, often taking its lead from what happens to unit labour costs which slow as productivity accelerates.



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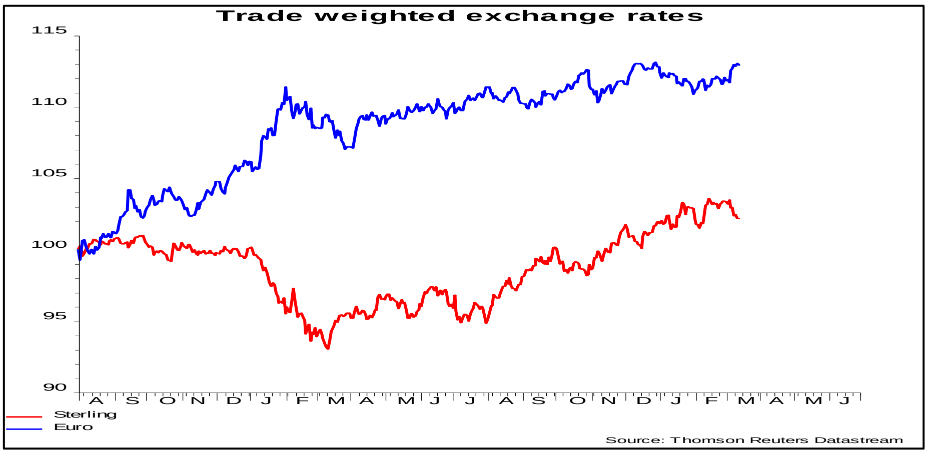


Disinflationary trends will be further reinforced this time by movements in exchange rates. This is more obviously the case with the euro, which has appreciated on a trade weighted basket by over 10% in recent months (and where extra-EMU exports and imports of goods and services comprise around 27.5% of GDP, making the euro area much more open than the US), but also sterling.

Our focus on disinflation in the euro area has long been a theme of ours. The UK has only relatively recently come onto the radar. A breakdown of the HICP basket for the UK though makes very interesting reading, with a collapse in the number of components seeing price rises of more than 2% on year, or 3% (see later). This fits the thesis of the UK being even more in the grip of disinflationary forces than might be appreciated. Faced with an economy that was still recovering quickly, but an inflation rate that say falls below 1.5% and heads towards 1%, what would the MPC do?

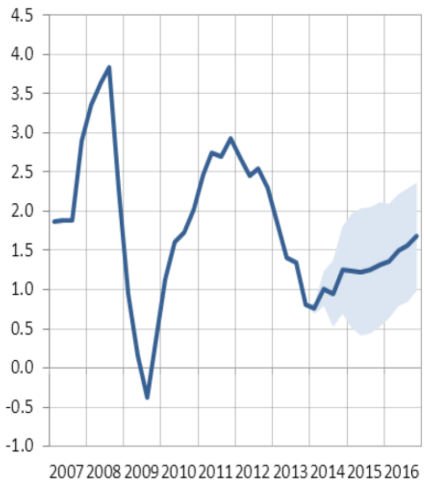
Mario Draghi had put so much emphasis on the need to wait until March to make a decision on what to do with policy, that it now seems the ECB may be perfectly content to sit on its hands for the foreseeable future and quite possibly won't have to seriously consider changes to policy until the next forecasting round in June. The euro remains a wildcard, but verbal intervention is likely to be the ECB preferred policy tool for now. Looking specifically at the quarterly macroeconomic projections, the 2016 inflation forecast of just 1.5% is very much on the edge in terms of how low the ECB could go and still maintain credibility. But in the opening statement, Draghi pointed out that HICP is expected to end 2016 at 1.7% - so the "below but close to 2%" inflation target remains in play (see chart below). Furthermore, HICP inflation ex energy, food and indirect taxes is expected to average 1.7% in 2016, and may be expected to end the year right around 2%. These longer-term forecasts clearly give the ECB confidence to look through the current period of low inflation, although it should be noted that, as a central case, the ECB expects inflation to start rising from the current levels. So if inflation were to dip back down toward 0.5%/0.6% in March, it would be an unwelcome surprise the ECB would at least have to acknowledge.

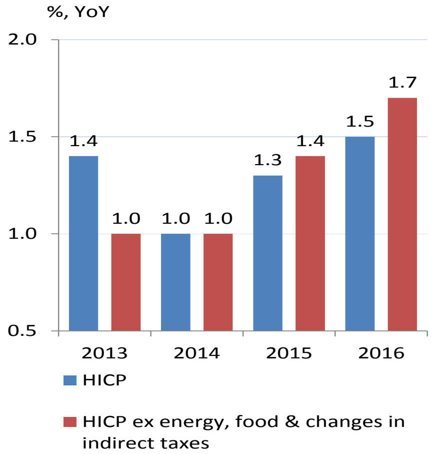
In terms of the GDP forecasts, the ECB has become a touch more optimistic on the growth outlook for the euro area and the new forecasts of 1.2% in 2014, 1.5% in 2015 and 1.8% in 2016 seem just plausible enough to us. As mentioned, the generally benign nature of the forecasts gives the ECB room to step back and watch developments in the coming months. And with GDP heading for growth of around 0.4% QoQ in Q1 and inflation set to spike higher in April because of unfavourable base effects, the current wait-and-see stance may well extend even past June. Of course if growth were to disappoint in Q2, or the euro were to spike higher, then, as

Draghi made clear, the ECB will respond - with all options, including QE, on the table. But for now, there is simply nothing to respond to. For now, the ECB's official stance can be summed-up as: the euro area is not Japan. Time will tell whether this is the right assessment

ECB's new macroeconomic projections

Euro area HICP
(year-on-year percentage changes)





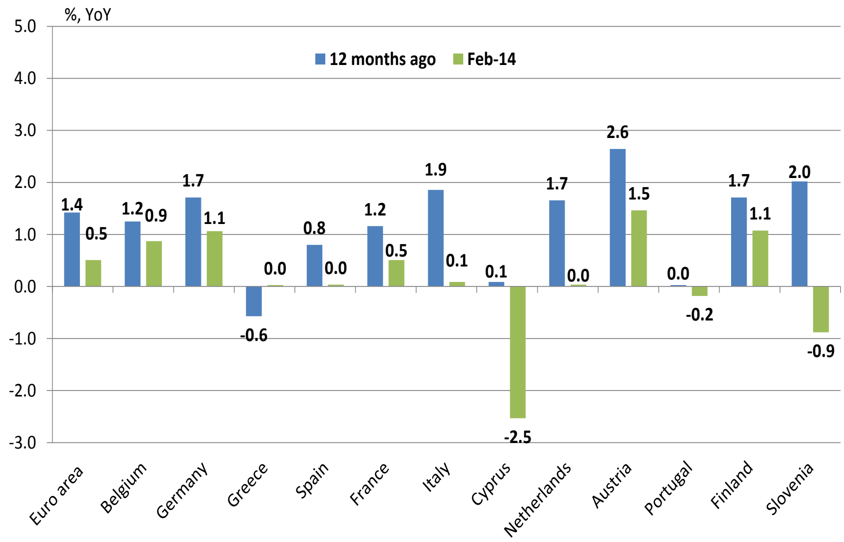
Source: ECB and Jefferies International

Deflation Monitor: digging into the euro area inflation data

Euro area HICP inflation was revised lower, to 0.7% in February from the 0.8% initial estimate. On the month, inflation fell in Germany, Italy, Spain and the Netherlands, and the rise in the French HICP reading to 1.1% YoY from 0.8% YoY previously (21% of the Euro area basket), was not sufficient to offset the drag from the rest of the euro area. As far as we can tell, the story behind the French inflation reading goes something like this: the VAT hike introduced on 1 January is expected to boost inflation by around 0.4pp in total (INSEE's estimate), but the impact did not come through in a single month - rather it is taking several months to work through the system. So both the January and the February French HICP figures are distorted as a result; thus making it difficult to disaggregate between the underlying 'true' inflation and the tax element on top. Unfortunately, on this issue, Eurostat's measure of inflation at constant tax rate is not of much use – because the assumption is that the entire tax hike comes through in a single month. Which is precisely why, on a constant tax rate measure, French HCIP inflation fell sharply in January (to 0.2% from 0.7% in December), only to record a big jump (to 0.5%) in February.

So the aggregate Euro area inflation numbers are distorted, but the country data (excluding France) are still valid – with the chart below highlighting the latest figures on HICP at constant tax rates. At the last several ECB meetings Draghi had stressed that low inflation is a problem for just a hand-full of countries. However, this simply is not the case, and as data below show, of the larger countries, only Germany, Austria and Finland are currently recording an inflation rate of over 1%.

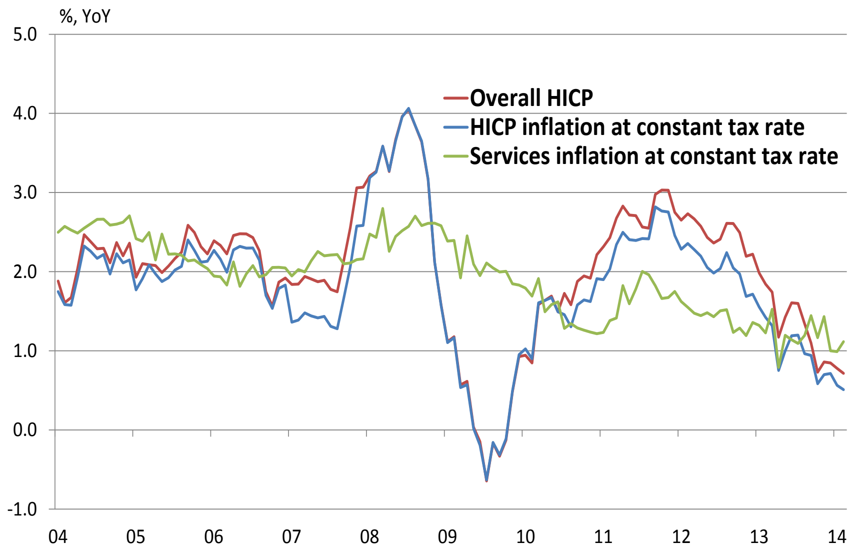
Country inflation at constant tax rates



Source: Eurostat and Jefferies International

The ECB is entirely correct, however, to emphasize the role of lower commodity prices in keeping inflation low at the moment. But if one looks at a measure of services inflation at constant tax rates – the idea here is to strip out the impact of energy and food prices, as well as tax distortions – it shows that euro area inflation has basically been running at around 1% for almost a year. So below target inflation is by no means a new phenomenon, and nor is it confined to the ‘programme’ countries as Draghi continues to rather optimistically assert.

Euro area inflation: headline and at constant tax rates



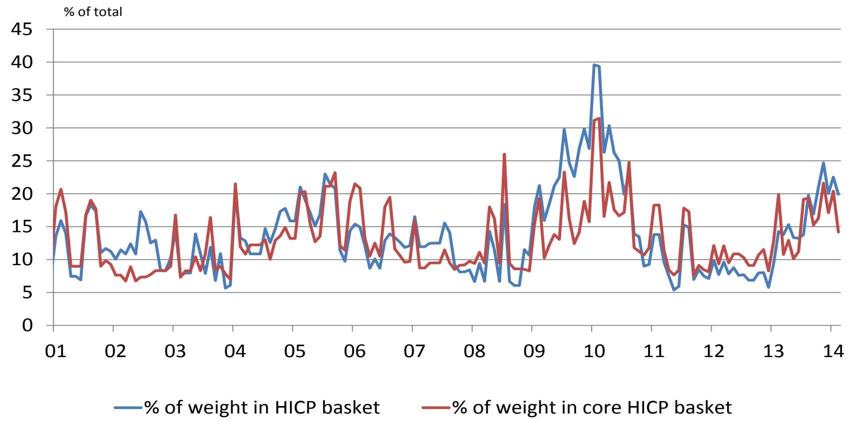
Source: Eurostat and Jefferies International

In terms of this month's Deflation Monitor, as previously, we calculate the inflation rates of the 94 components of the euro area HICP basket and the 73 components within the core HICP measure, and then track whether more or less of the basket is in deflation. So for example, the chart below shows the proportion of the euro area HICP basket where prices are falling year on year. We calculate two measures - the first, is the weight of items in deflation in the *total* HICP basket; and the second, the weight of items in deflation in the *core* part of the HICP basket (to strip away the movement of volatile food and energy components).

The key result this month, is that the proportion of the euro area HICP basket in deflation fell to 19.9% in February from a revised 22.5% in January. In terms of specifically the core inflation basket, the share in deflation fell dramatically to 14.2% from 20.4% in the previous month (see chart on the next page).

However, these aggregate falls are heavily distorted by the French figures, with Italy, Spain and the Netherlands all recording further signs of disinflation on the month.

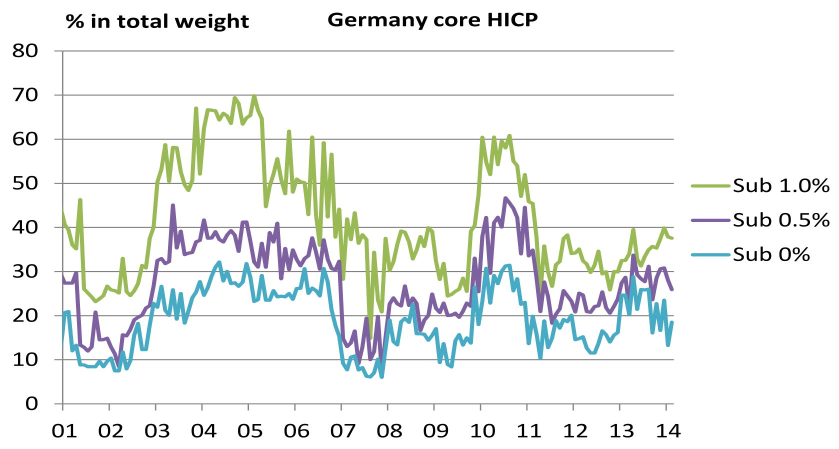
Share of euro area HICP basket with sub-0% inflation rate



Source: Eurostat and Jefferies International

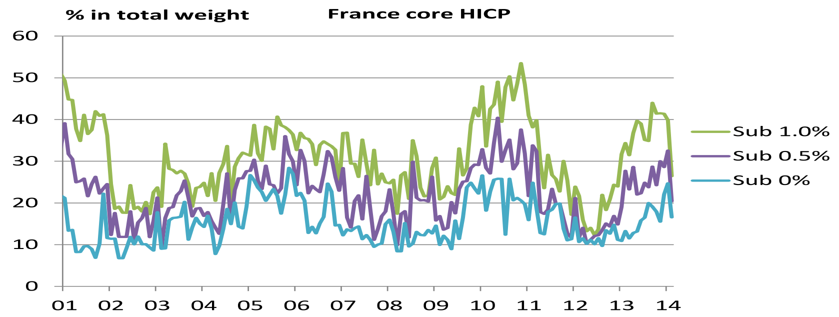
So for instance, of the larger countries, the data for Germany remain unremarkable (see first chart below). While, as discussed, the French figures are showing the impact of VAT-related price hikes (see second chart below).

Share of Germany's *core* HICP basket with sub 1%, sub 0.5% and sub 0% inflation rate



Source: Eurostat and Jefferies International

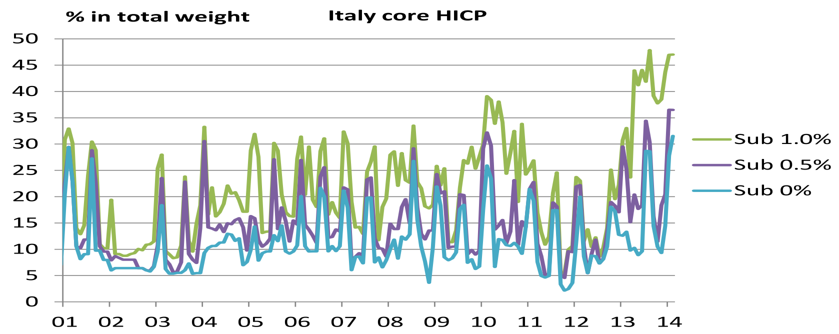
Share of France's *core* HICP basket with sub 1%, sub 0.5% and sub 0% inflation rate



Source: Eurostat and Jefferies International

However, the next three largest Euro area countries have all seen fairly big monthly jumps in the share of HICP basket in deflation. In particular, Italian figures show that over 30% of the core inflation basket is currently in deflation (the light blue line in the chart) – an all-time high.

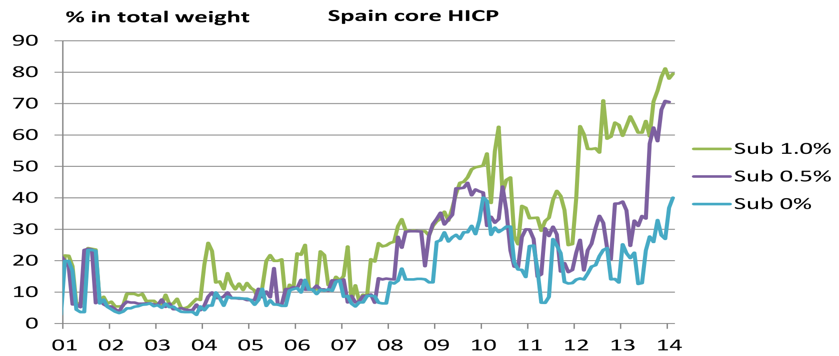
Share of Italy's *core* HICP basket with sub 1%, sub 0.5% and sub 0% inflation rate



Source: Eurostat and Jefferies International

The Spanish data show even more extreme signs of very weak pricing pressures. So for instance, the share of the index in deflation jumped to over 40% in February – matching an all-time high of 2009. While the share of core HICP items recording inflation rates of below 1% stands at 80% and the share of the index recording inflation rates of below 0.5% currently stands at 70% - both essentially at all-time high levels.

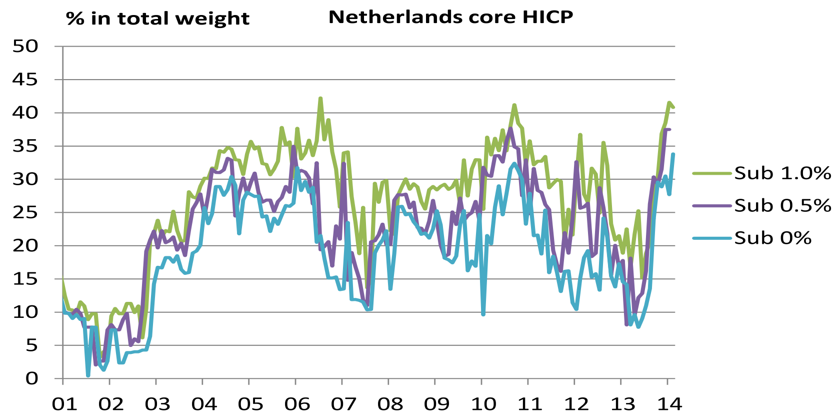
Share of Spain's *core* HICP basket with sub 1%, sub 0.5% and sub 0% inflation rate



Source: Eurostat and Jefferies International

The Dutch figures have traditionally shown more dispersion in inflation rates than other euro area countries (i.e. there has always been a substantial part of the HICP basket recording very low inflation rates, and a large portion recording high inflation rates). And recently the data have been distorted by the October 2012 VAT hike. But after the impact of the VAT hike had washed out, and specifically in the past several months, there has been a substantial deterioration in underlying inflation trends (see below).

Share of the Dutch *core* HICP basket with sub 1%, sub 0.5% and sub 0% inflation rate



Source: Eurostat and Jefferies International

Finally, the table below is a summary of the results for the weight of items in deflation in the *total* HICP basket.

Weight of HICP basket in deflation (%, by country)

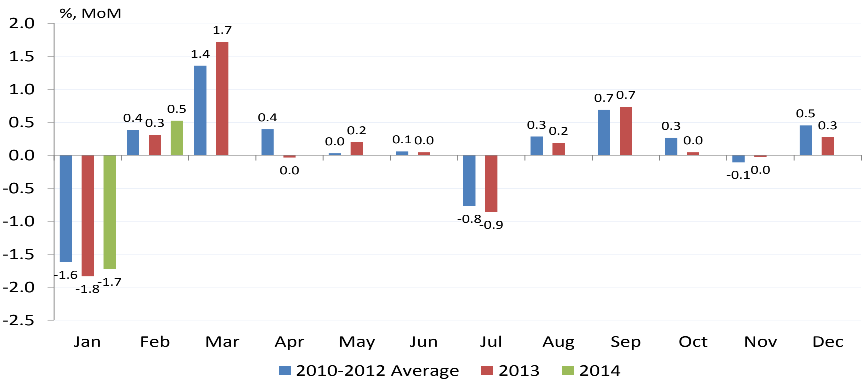
	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14
Euro area	9.9	7.7	9.6	7.8	8.8	7.6	7.7	6.9	6.9	8.0	7.9	5.8	9.4	14.3	13.8	15.3	13.3	13.2	13.8	19.7	16.9	20.9	24.7	20.0	22.5	19.9
Germany	12.4	11.8	10.9	11.4	11.3	11.2	12.8	13.9	13.3	12.5	13.0	12.3	20.6	21.0	20.8	26.9	21.7	24.9	24.8	25.9	17.9	22.6	19.6	24.9	17.0	20.7
France	12.9	8.5	9.1	7.1	8.9	7.1	8.1	7.1	9.8	9.2	13.1	11.1	15.6	14.6	18.4	19.5	19.7	22.4	21.9	25.2	24.7	27.6	27.0	30.1	31.7	27.5
Italy	10.9	15.3	7.3	5.1	9.1	6.1	5.1	5.7	7.3	12.7	12.1	8.9	8.8	9.4	7.1	12.3	11.3	11.8	23.0	28.1	18.2	19.0	19.4	21.6	30.6	35.0
Spain	12.6	12.9	12.8	14.6	16.1	14.7	16.7	16.4	16.1	9.4	9.4	8.7	16.7	14.9	14.4	28.8	21.8	14.5	21.7	29.6	28.5	33.7	25.2	22.2	32.1	38.8
Netherlands	8.8	13.9	15.3	16.1	13.0	12.6	11.1	18.8	15.5	11.2	10.4	12.6	10.2	10.7	11.5	12.6	11.8	6.8	8.2	15.4	23.1	32.8	33.9	36.4	34.3	43.7
Greece	32.9	38.4	42.2	34.3	38.0	38.5	40.8	44.9	52.7	48.8	48.7	65.8	61.7	61.1	64.5	66.4	66.5	62.3	65.2	68.0	69.6	85.8	83.6	85.5	76.7	76.7
Portugal	19.7	20.4	20.4	21.8	22.7	22.5	24.8	24.6	23.0	25.2	32.8	29.0	39.4	35.9	39.7	41.0	35.4	35.7	38.5	37.4	41.1	47.8	49.8	49.4	46.8	50.9
Ireland	49.0	46.4	35.5	31.6	30.3	29.9	32.0	29.6	26.4	27.4	31.2	25.9	27.8	28.4	37.7	38.9	40.8	42.0	38.9	41.9	42.7	42.4	44.4	41.0	46.9	46.0
Slovenia	27.4	26.9	29.9	27.8	25.6	23.1	26.7	28.0	24.8	30.3	27.5	23.1	30.7	27.0	34.1	43.8	35.6	34.6	28.4	32.0	37.2	32.2	36.8	39.0	43.0	45.1
Cyprus	38.7	38.8	36.4	33.0	26.8	31.7	33.6	36.0	32.6	36.6	35.1	34.8	29.1	29.7	39.7	43.6	42.2	38.3	40.1	46.1	42.9	72.4	67.2	69.2	64.7	62.5

Source: Eurostat and Jefferies International

Euro area Inflation Surprise Indicator

One simple way to illustrate why euro area inflation figures are likely heading for a volatile quarter ahead is to track the monthly changes in the core inflation index going back to the start of 2013. So in particular, the monthly change in the core index in the month of March had averaged 1.4% between 2010 and 2012 (see the blue bar in the chart below). But in 2013, the index jumped by 1.7% on the month. So all things being equal, a return to a more normal pattern of 2010-2012 suggests that in March, core inflation could slip back to 0.5%/0.6% YoY, from 0.8% currently. But the opposite base effect could drag the annual rate back up to 1% in April, before it dips back down to 0.8% in May. Then, with base effects fairly muted, we may well see a quiet June to September, before volatility comes back in October.

Monthly change in euro area core HICP index

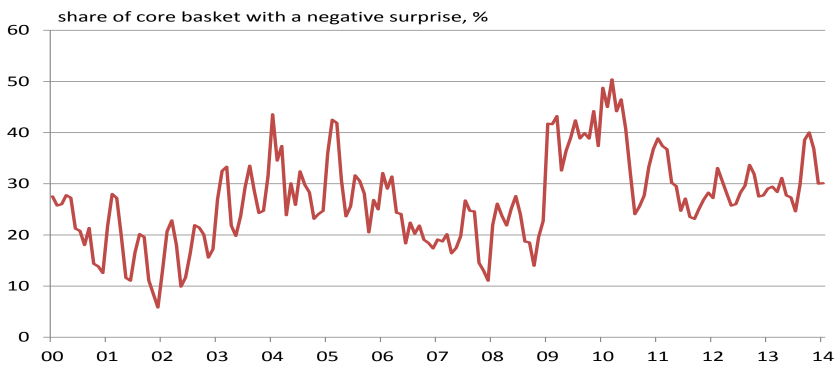


Source: Eurostat and Jefferies International

Another potentially useful way to think about the monthly changes in inflation is to disaggregate the inflation basket and to analyse why precisely inflation surprised. Essentially, the question is whether the annual inflation rate falls, or rises, in any single month because there is a rogue item in the inflation basket (for instance packaged holidays), or there is a broad-based inflation undershoot, or overshoot. This is the idea behind out Inflation Surprise Indicator presented on the next page.

For the calculation, we measure the average monthly change in each component of the HICP basket in the preceding three years, and then record whether monthly inflation in any single month comes in significantly above or significantly below this average reading (we use a deviation of more than 0.1% from the mean, as the cut-off point). We then add up the weight of items where inflation came in below the average reading – and this becomes our surprise indicator.

Inflation surprise indicator



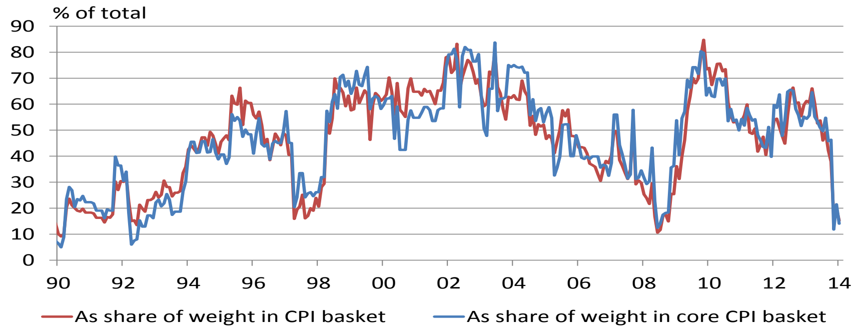
Source: Eurostat and Jefferies International

So what the data show, is that over the second half course of 2013 there was a steady rise in the share of the euro area HICP basket that was recording lower than normal monthly inflation prints. And back in September and October for instance close to 40% of core items by weight recoded an unusually low monthly inflation reading – in other words prices pressures were weak across the board, not just in a few items. Over the recent months, the ECB had stressed that inflation had been weak primarily due to lower commodity prices – and the improvement in the index since October is consistent with this thesis. Certainly our index seems to indicate that pricing pressures are less extreme than in 2009.

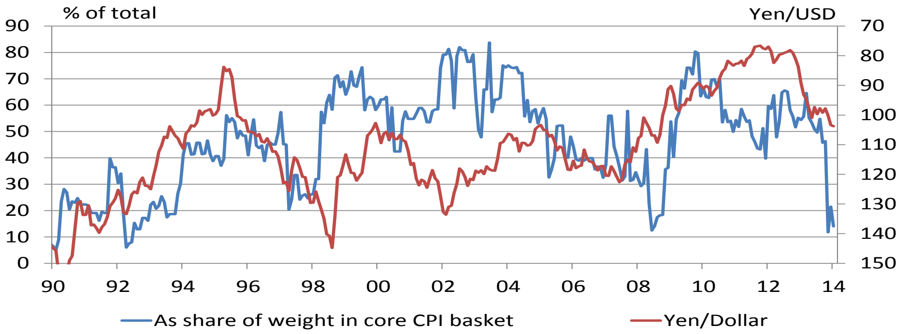
Euro area in a context of global disinflation

Monthly volatility aside, the euro area looks likely to be stuck in a world of 1% inflation for the foreseeable future. In this context, the Japanese experience is obviously relevant – and Draghi has made a point of distancing the euro area's current situation from what has been happening over there in the past twenty years. So what about the data? We applied our Deflation Monitor methodology to the Japanese inflation data – with the results presented below. We look at the 48 components of the overall CPI index (stripping out the rent component of the measure) and the 32 components of the core CPI index in Japan (also ex-rent) and measure what share (out of 100%) was recording a below zero inflation rate. The chart highlights that, at the peak, around 80% of the index by weight was in deflation. However, it also shows just how remarkable the recent turnaround has been. So that at the moment, the weight of items in deflation stands at around 15%. The chart on the next page of the weight of the core index in deflation and the Yen/USD exchange rate does not show a fantastic fit by any means, but it does seem to suggest at least some scope for Yen weakness – perhaps when the markets become more convinced that the deflation battle is being won (which it certainly seems to be on this measure at least).

Share of Japan CPI index in deflation



Share of Japan core CPI index in deflation and exchange rate



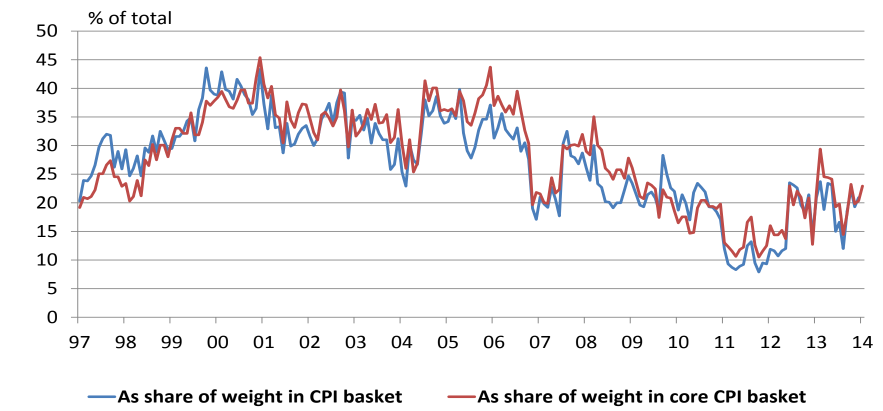
Source: Japan Statistics Bureau and Jefferies International

UK: Signs of disinflation mount. Risk of sub-1% inflation too?

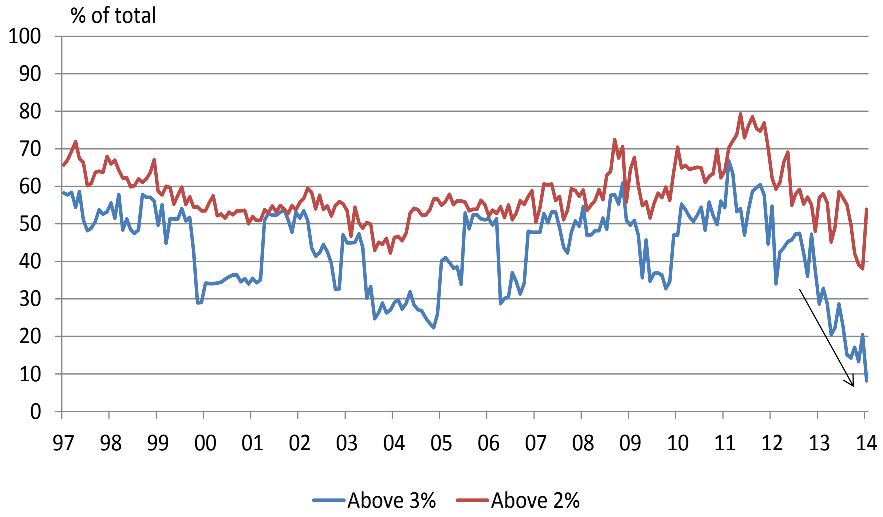
And what about the UK experience? In terms of the weight of the CPI index in deflation (here we measure the inflation rate of 90+ items in the basket), the current reading stands at around 23%, up from a low of around 11% in early 2012 (see first chart below). However, what's interesting is that the 'norm' for the UK is a reading of around 33% (the average between 1998 and 2007) - essentially a third of the core CPI basket was normally in deflation in any single month. The flip side is that over the same period, the UK inflation basket has around 42% of the items by weight recording an inflation rate of over 3%. These results seem consistent with the perceptions of the UK being a relatively flexible economy: with some items falling in prices, others showing high inflation rates, but there being little rigidity overall in prices adjusting to demand.

And what of the current juncture? What's most striking to us is just how weak the pricing pressures seem to be in the UK at the moment. So for example, in January 2014, the share of the core CPI index with an inflation rate of over 3% stood at just 8.1% - an all-time low figure (see first chart on the opposite page). Clearly the UK economy is continuing to expand, but at the same time, at least for now, inflationary pressures in the economy on this measure seem to be easing, not rising.

Share of UK CPI index in deflation



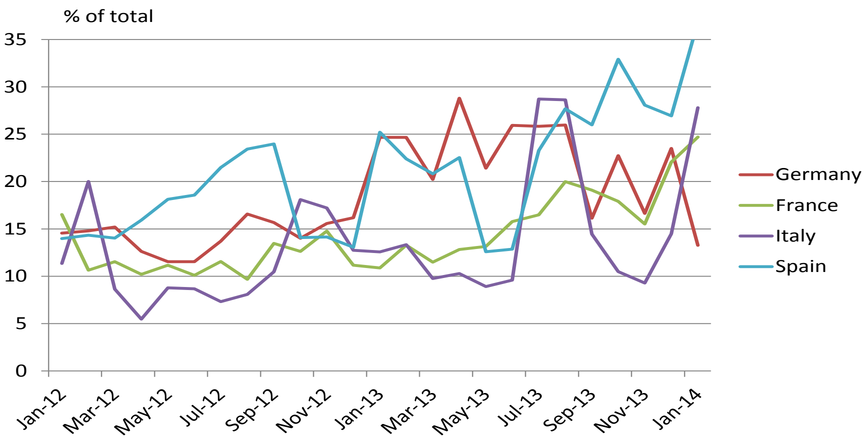
Share of UK core CPI index with inflation above 2% & above 3%



Source: ONS and Jefferies International

Returning back to the euro area, as we've been highlighting with the Deflation Monitor work for some time, the euro area is clearly experiencing more deflationary pressures than it did a year ago. And certainly, if you look at the largest economies, outside of Germany, the share of the index in deflation continues to climb (see first chart below). But the ECB can also look at the 2009/2010 period (see second chart below) and make a judgement that the euro area has been in a worse place before, and given that the economy is on a firmer footing, the threat of deflation remains just that – a threat.

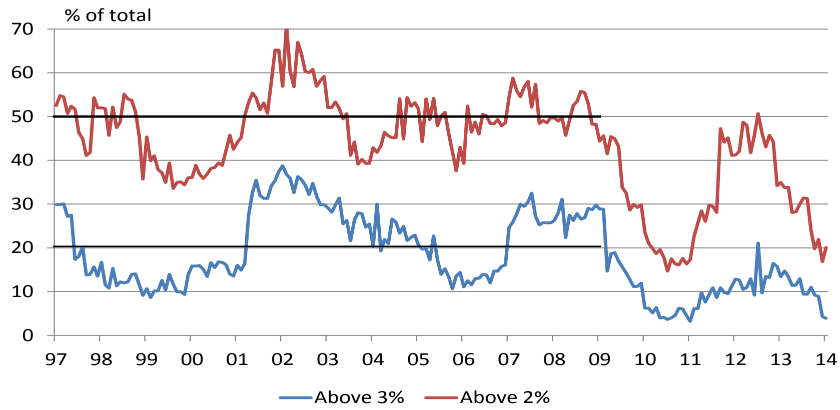
Share of core HICP index in deflation by country



Source: Eurostat and Jefferies International

However, as with the UK, it is worth highlighting just how unusual the current pricing environment is relative to history. So for example, as a 'norm', within the euro area HICP basket, roughly 50% of the items run an inflation rate of above 2%, and roughly 20% of the items run an inflation rate of above 3% (see below). Yet both of these measures are currently well below these long-term averages and right around the all-time low levels. In which case, surely what the ECB should be thinking is that, yes, given the euro area's pricing rigidities, it may be extremely difficult to see outright deflation, but how likely is it really that inflation will bounce back to target on a 2 to 3 year view given the amount of spare capacity and how far away from normal the inflation figures are?

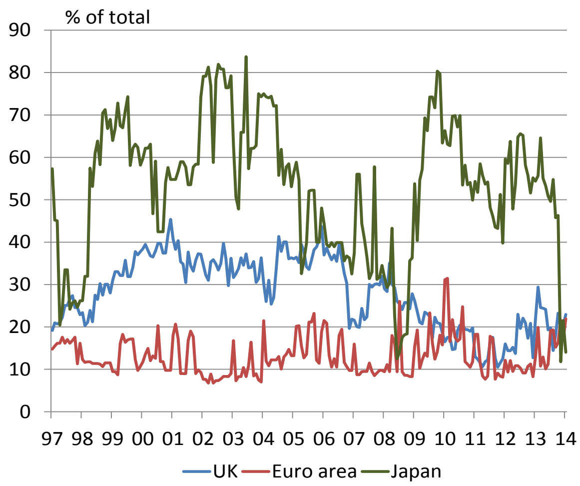
Share of euro area core HICP index with inflation above 2% & above 3%

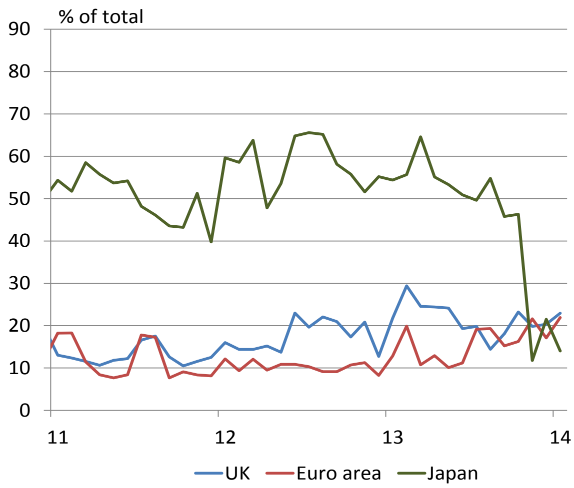


Source: Eurostat and Jefferies International

Finally, returning to the original Draghi assertion that the euro area is not Japan, the chart below puts together the data from the three regions discussed. The chart on the right simply zooms-in on the last three years of the data and shows that on the latest reading, the UK and the euro area both have around the same share of the inflation basket in deflation, with the share in Japan comfortably below both.

Share of core inflation index in deflation



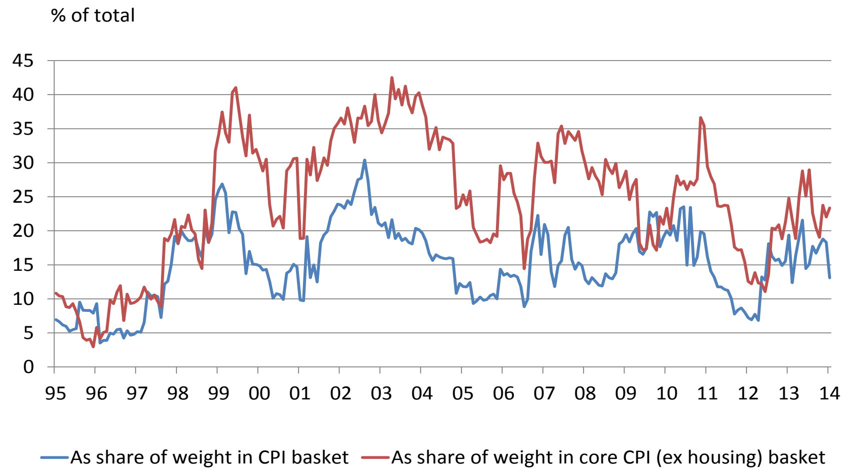


Source: Jefferies International

... and what about the US?

We have recently also extended the Deflation Monitor analysis to US CPI data, and similar to the work done on the euro area, Japan and the UK, analysed what share of the inflation basket is currently experiencing outright deflation. Stripping out housing related items (41.5% of the index) as well as food, energy, alcohol and tobacco (which leaves around 40% of the basket to analyse) we calculate that around 23% of the index is currently recording negative inflation rates. This is more or less in line with the average reading of 25% since 1995 – see chart below.

Share of US CPI index in deflation



Source: Eurostat and Jefferies International

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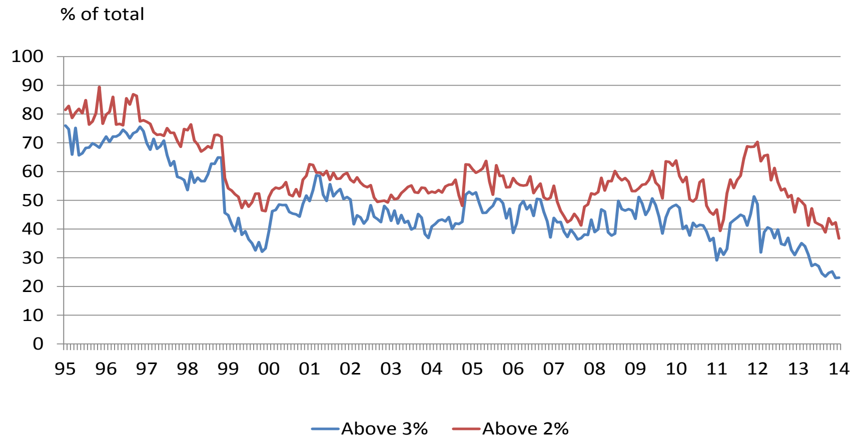
So on this measure, at least, the US data is flagging up fewer signs of outright deflation creeping into the economy than is the case of the euro area. But there are also some important parallels between the two regions to highlight. So for example, if we analyse the proportion of the core (again, ex-housing) basket where inflation is running at over 3%, that measure currently stands at just 23% - compared to a 20-average figure of 48%. Similarly, the share of the index with inflation of over 2% is running at just 37% - again a 20-year low.

Share of US core CPI index (ex-housing) with inflation above 2% & above 3%

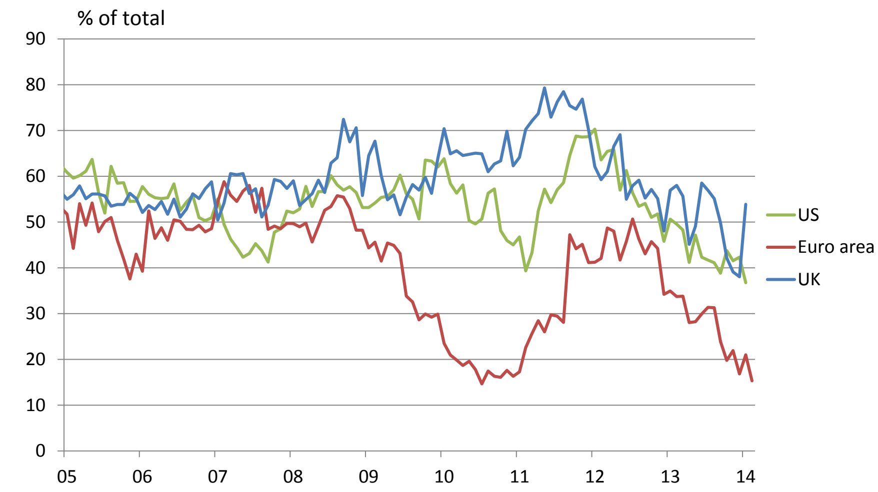


Source: BLS and Jefferies International

In terms of placing this disinflation trend into an international perspective, the chart below looks at the US, euro area and the UK, and highlights the share of the core inflation basket with an inflation rate of over 2%. It shows that in all three regions the indices are below historic averages.

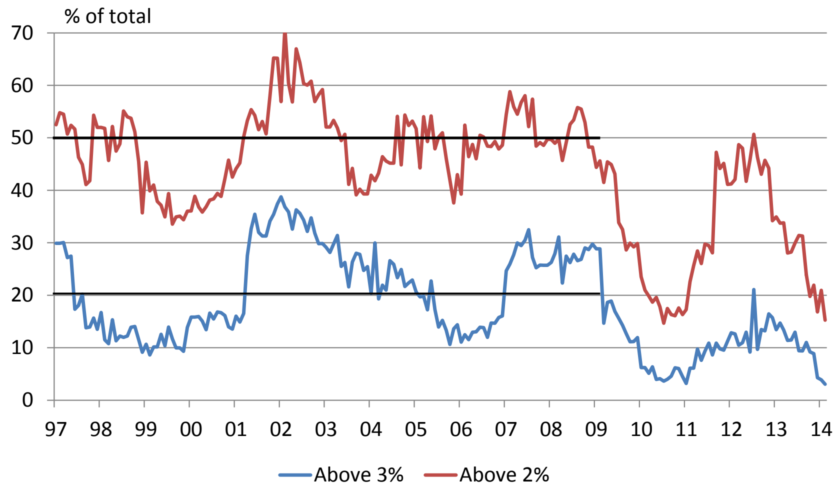
Again, relating these findings specifically back to the euro area, in 2010 when the rest of the world was running more or less 'normal' inflation, the ECB could perhaps be more confident that inflation would ultimately rebound. Whereas at the moment, when the whole world (ex-Japan) is going through a period of disinflation and the euro currency continues to appreciate, the return to a 2% inflation world may be more difficult to envisage.

Share of US, euro area, UK core indices with inflation above 2%



Source: Jefferies International

Share of euro area core HICP basket with inflation above 2% and above 3%

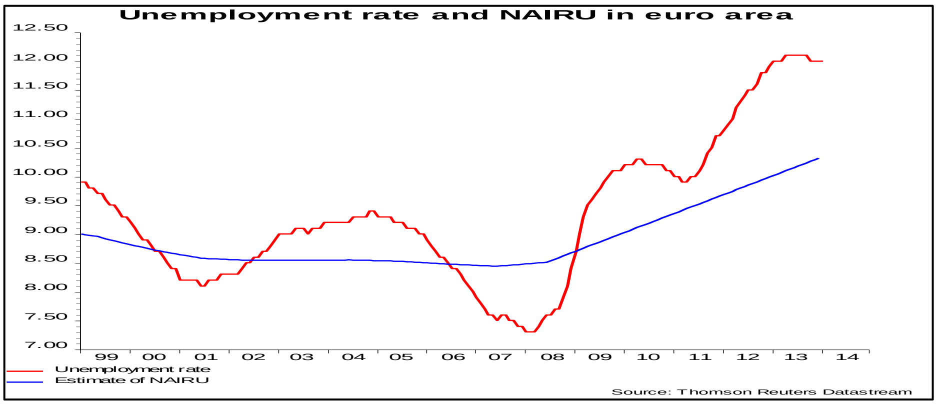


Source: Jefferies International

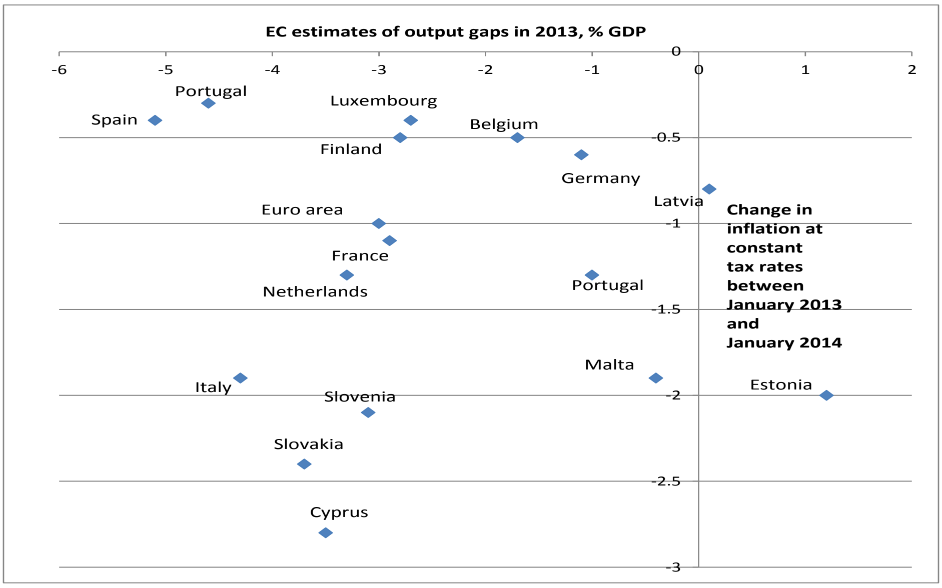
In large part, the rationale for us expecting inflation rates to fall in the euro area was the perception of how much spare capacity there was in the region. Coupled with indirect tax rises dropping out of the year-on-year comparisons and a higher exchange rate), it did not seem a particularly aggressive call to make the case for lower inflation rates. But, we have also been at pains to stress the uncertainties of predicting what may happen to inflation, particularly at very low rates of inflation.

For one thing, there is good reason to believe that the relationship between the inflation rate and the output gap may change at very low rates of inflation. Perhaps the easiest way to visualize this is to consider the example of the housing market. Anecdotally it is quite clear that house prices often fail to adjust fully in periods of excess supply in the housing market. Unless there is forced selling, rather than house prices falling, housing transactions may simply collapse. What may be true of the housing market is likely to be true of many other markets in the economy at low rates of inflation. With downward rigidity in prices and wages, in periods of excess supply the adjustment may more be seen in activity being constrained, rather than in lower inflation rates with the economy ultimately seeing a misallocation of resources.

So, even if one knew the output gap with certainty (which of course we don't) there is perhaps good reason to believe that the relationship between the output gap and inflation could change at sub-1% inflation rates.



All very logical perhaps, but then the EC in their latest forecast publication showed evidence that the output gap may now play a more important role in accounting for inflation developments than prior to the crisis in the euro area.
In particular, using time varying coefficients in their regression analysis, the EC argued that "*the inflation elasticity of the output gap appears to have surged particularly in vulnerable Member States, arguably due to structural reforms.*" The EC also discussed whether "*inflation might only react significantly to the output gap if it* (the output gap) *is large and persistent*" and also provide evidence of *"a gradually increasing role of inflation expectations in explaining price developments"*.

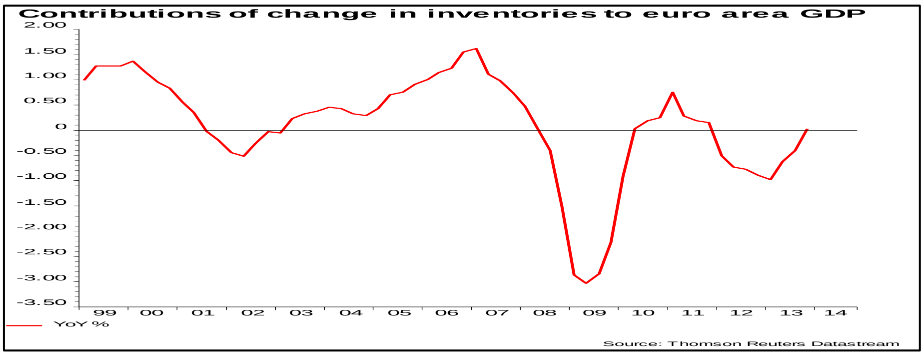


To the extent to which structural reforms have increased the sensitivity of inflation to the output gap, one might also expect employment to respond faster to activity than in the past. In particular, numbers of employees on temporary contracts or part-time working may gain traction earlier in this economic cycle.

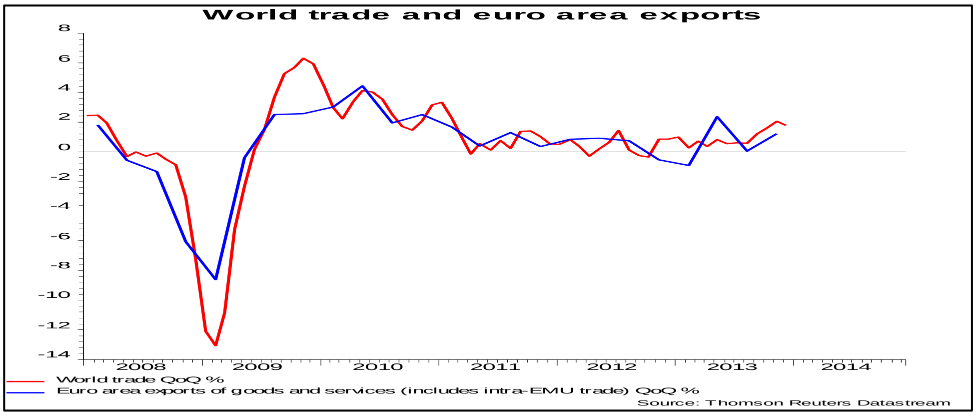
Nevertheless, the euro area's unemployment rate was an unchanged 12% in January (varying from 5% in Austria, 5.1% in Germany to 25.9% in Spain and perhaps 28% in Greece), a figure way above anyone's estimate of the NAIRU (the non-accelerating inflation rate of unemployment). If the euro area was to see a strong recovery then perhaps some regions or sectors would run into capacity constraints, pushing up measured inflation rates. This may be true of say Germany (unemployment, 5.1%), but not the overall euro area. Moreover, as we may now be seeing in the UK it is not unusual for inflation to fall in the first one or two years of a recovery phase, as productivity recovers and wages stay subdued (so unit labour costs decelerate). And, as we know inflation has fallen significantly everywhere, including the core.

If the euro area economy had not been recovering for four consecutive quarters (we assume survey evidence is correct and there is a further rise in GDP in Q1), then the ECB's tolerance for low inflation would be so much lower. They then would be in a much more difficult position to argue that inflation will eventually return towards target.

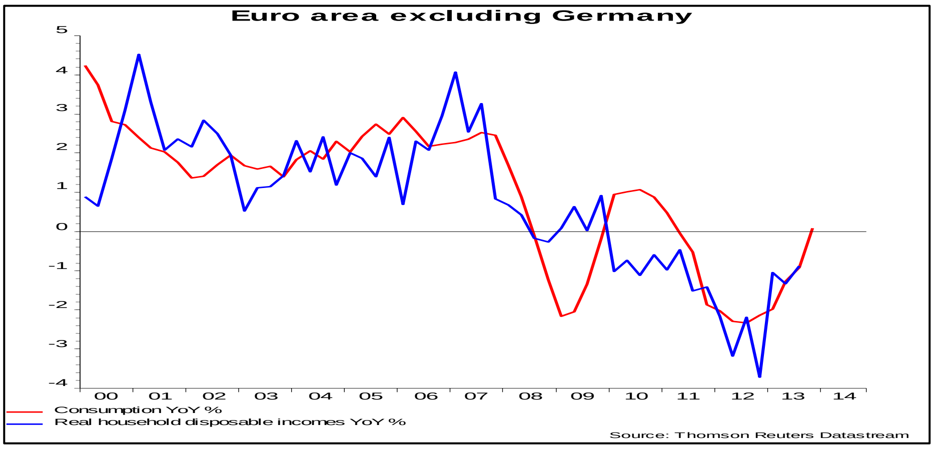
That then begs the question, how can the euro area be seeing any recovery at all, given the headwinds of a stronger exchange rate, and no significant balance sheet repair at a macro level, particularly when compared to the US and UK economies? Partly, the euro area is seeing the benefit of a turn in the inventory cycle.



Not that inventories are at present providing a significant boost to GDP (they actually fell £7.4bn in Q4), just that inventories are no longer such a major drag on the economy (see chart). In the initial phase of the downturn (2009) inventories were at their worst taking around 3 percentage points off GDP year-on-year, as the corporate scrambled to reduce the size of its sizeable financial deficit (almost 4% of GDP). Then in the second phase of the downturn (after 2011) inventories took as much as 1 percentage point off GDP year-on-year (Q1 2013). Now we may be entering the phase when inventories actually boost GDP again. As a conservative estimate it is probably not asking much of inventories to boost GDP by around 0.5% in the year ahead.



Despite the headwind of a stronger exchange rate, exports of goods and services (including intra-EMU trade) still grew by 1.2% in Q4 2013, with German exports up 2.6% and the rest seeing a 0.5% increase. Because of the exchange rate, the euro area continues to lose market share. World trade in the period was up 1.7%, its strongest quarterly rise since Q4 2010, but still in a historical sense relatively weak. Meanwhile intra-EMU trade in goods fell by 0.5% in Q4 2013, confirming it is not intra-EMU trade that is helping drive the overall recovery in the euro area.



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However, when looking at a variety of different indicators (survey and hard data, as well as the various monetary measures) a general convergence is apparent across the piste, with Germany (at least according to survey evidence and hard data) outperforming. It is no longer the case that, outside the core, indicators all still point down. A more general theme of convergence (with Germany the outperformer) is very much apparent. This may be an important factor driving a recovery more generally. In part, recovery should be seen in the light of some of the headwinds no longer being nearly so negative.

On the policy front, the latest EC figures imply a fiscal tightening equivalent of only 0.3% of GDP this year, less than the 0.9% of GDP in 2013, 1% in 2012 and 1.8% in 2011. The days of substantial fiscal tightening now seem to be largely behind us, as the table below highlights. To put this in context, given the change in its cyclically adjusted general government's primary balance the European Commission's estimates suggest that Portugal saw a 7.1% hit to GDP in 2011, Italy a tightening of 2.3% of GDP in 2012 and Spain 3.8% of GDP in 2013. Moreover, the Netherlands and Austria experienced fiscal tightenings of 1.5% and 1.2% of GDP, respectively last year. Now countries in the core can be seen to benefit from some modest easing in fiscal policy this year, followed next year by a more general easing in fiscal policy (0.3% of GDP), including easings in Italy and particularly, Spain.

It is difficult to know precisely what weight to put on these developments (care must also be taken when interpreting the data for some countries). But along with a more general easing in credit constraints and the resumption of capital flows, this change in the overall fiscal stance should be helping. Of course, the more that fears of austerity and a potential break-up fade from view and sentiment improves, the more likely companies and households who are seeing income gains, put this cash-flow to work.

Annual change in cyclically adjusted general government primary balances

% GDP

A positive number represents a tightening in fiscal policy/a negative number an easing

	2011	2012	2013	2014	2015
Belgium	-0.3	0.4	1.2	-0.3	-0.5
Germany	2.2	1.2	0.3	-0.2	-0.3
Estonia	-1.4	-1.9	0.4	0.3	-0.1
Ireland	16	5	2.1	2.1	0.1
Greece	4.5	-0.2	-4.5	10	-1
Spain	0.5	-0.2	3.8	0.6	-1.9
France	1.5	0.9	0.9	0.2	-0.1
Italy	0.8	2.3	0.5	0	-0.3
Cyprus	-0.9	1.1	2.6	0.9	-1.9
Latvia	3.1	0.8	-0.5	-0.2	-0.4
Luxembourg	0.6	0.2	0.1	-0.8	-2.2
Malta	0.8	-0.1	0	0	-0.3
Netherlands	0.5	0.9	1.5	-0.3	0.5
Austria	1.1	0	1.2	-0.5	0.1
Portgual	7.3	-1.1	1	1.2	0.8
Slovenia	-0.8	3.5	-10.4	11.1	0.4
Slovakia	3.1	1.1	2.2	-0.8	-0.4
Finland	0.5	-0.5	0.2	-0.2	-0.3
Euro area	**1.8**	**1**	**0.9**	**0.3**	**-0.4**

Source: European Commission

Indeed, perhaps the reason why consumption outside Germany managed to post a 0.2% rise in Q4 2013 was because the saving ratio fell slightly (see charts below). Through the maximum period of fiscal austerity and fears of more countries being

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faced to the Troika it would not be so surprising if many households had raised precautionary savings and postponed unnecessary spending, especially on big ticket items. True, this is not 2008 and 2009 when the saving ratio excluding Germany rose significantly, falling back later in 2009 and 2010. And, as a general rule the household sector's net acquisition of financial assets is not standing at a high level. This is not just true of the euro area, but has been very much a feature of the UK as well.

But as some of the concerns concerning EMU have faded from view so it would not be so surprising if some of the precautionary savings built up during the crisis had been rundown, boosting spending.

Pre-tax trading profits of non-financial corporations Year on Year %

	q1-2012	q2-2012	q3-2012	q4-2012	q1-2013	q2-2013	q3-2013	q4-2013
Euro area	-0.8	-0.6	-1.2	-2.1	-0.6	0.8	1.3	
Germany	1.1	-1.9	-1.5	-2.8	-4.6	7.2	5.1	8.3
France	-1.6	-3.4	1.3	-3.1	-1.9	-0.1	-1.2	
Italy	-0.9	-5.0	-8.2	-5.2	-3.2	-5.2	-0.1	
Spain	0.6	2.1	4.5	4.4	7.0	2.3	5.3	
Austria	0.2	-5.1	0.8	2.6	-5.8	-1.4	3.2	
Finland	-2.4	-6.1	0.1	-4.3	-5.6	-2.0	-1.0	
Greece	-1.1	-2.8	-1.2	-3.0	-4.2	-0.5		
Ireland	0.0	3.2	-0.3	0.2	-3.7	0.7	1.9	
Portugal	8.2	-0.8	-0.1	1.4	-9.0	4.6	4.8	
Slovenia	-1.0	-2.4	-1.3	2.0	-4.4	2.0	3.5	
Netherlands	-0.5	0.5	-4.2	-0.7	-2.9	-4.2	0.6	

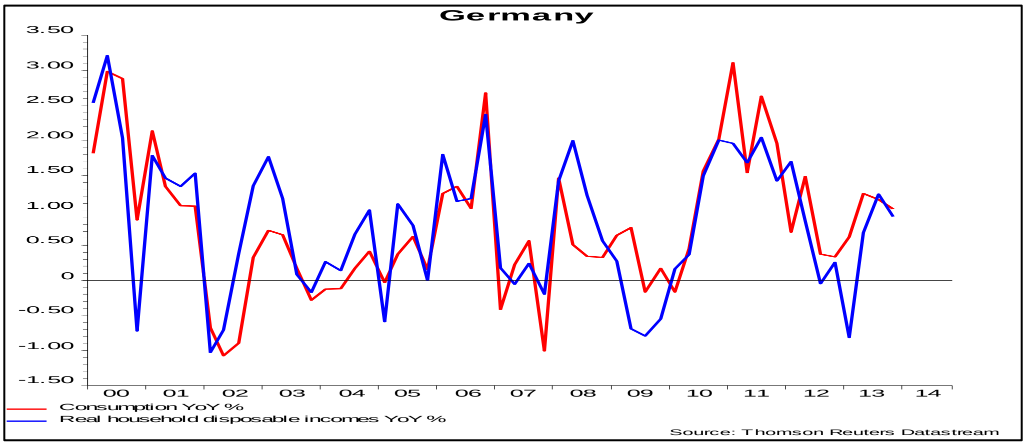
Household disposable incomes Year on Year %

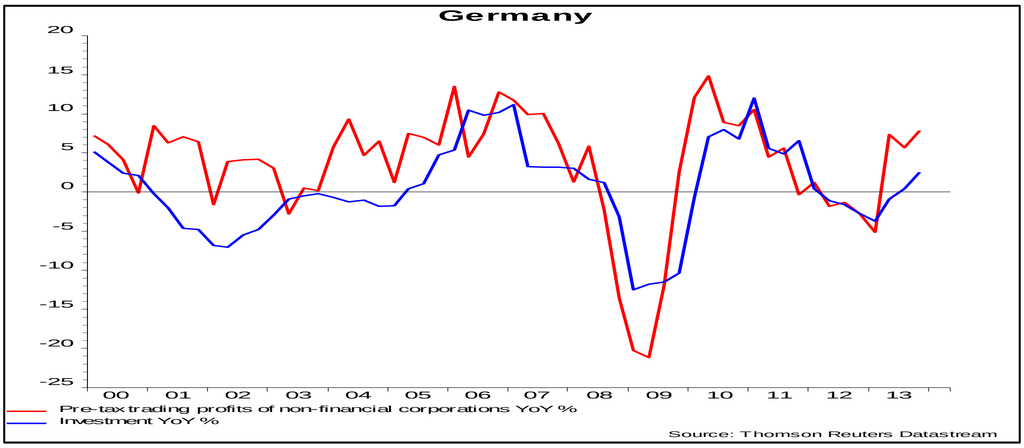
	q1-2012	q2-2012	q3-2012	q4-2012	q1-2013	q2-2013	q3-2013	q4-2013
Euro area	1.3	0.2	0.1	-0.3	0.1	0.3	0.8	
Germany	3.5	2.2	1.6	1.9	0.7	2.5	3.0	2.4
France	1.6	1.1	1.1	-0.2	0.7	0.7	0.9	
Italy	0.2	-2.2	-1.8	-3.6	-0.1	-1.9	0.9	
Spain	-1.9	-3.2	-1.9	-4.5	-1.9	-1.3	-1.5	
Austria	10.1	4.0	-0.1	1.3	-1.5	-3.5	6.2	
Finland	3.4	3.1	3.9	2.7	2.3	1.6	1.7	
Greece	-7.5	-11.9	-12.0	-7.2	-6.6	-9.2		
Ireland	1.3	0.7	-3.4	-3.0	-3.3	-2.4	0.4	
Portugal	-0.7	-5.0	0.7	-0.9	1.7	-0.7	-1.3	
Slovenia	-1.2	-5.3	-1.2	-3.3	-2.2	-2.0	-1.2	
Netherlands	0.1	-1.8	0.9	0.3	-1.0	-1.4	1.5	

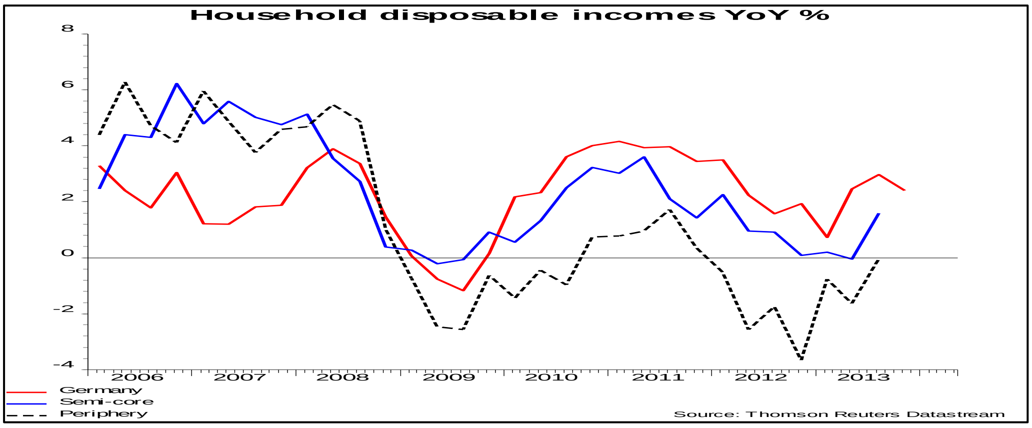
Source: Eurostat, the ECB and Jefferies

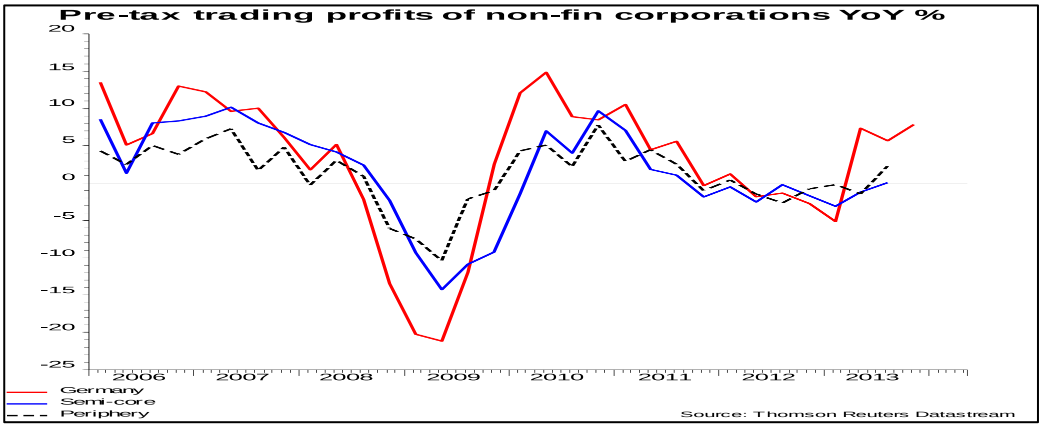
It was not just consumption that posted a rise outside Germany in Q4 2013, so did investment (up 0.5% excluding Germany, 1.1% if one includes Germany). Part of the story here could be that pre-tax trading profits are no longer falling significantly. This in itself is an important change from where we were in much of 2011 and 2012 (see chart). Pre-tax trading profits of non-financial corporations may still be falling in France, but they are still growing relatively strongly in Spain and in the last two quarters have picked up significantly in Portugal (see table). Moreover, they are no longer really falling in Italy.

Germany is in a different place (at a macro level pre-tax trading profits up 8.3% in the year to Q4 2013). But, if for the purpose of this analysis we define the semi-core as comprising France, the Netherlands and Austria and the periphery as Italy, Spain, Portugal and Ireland one can see that cash-flow of households and companies in the periphery, in particular, no longer looks so negative for trends in their wider real economies.

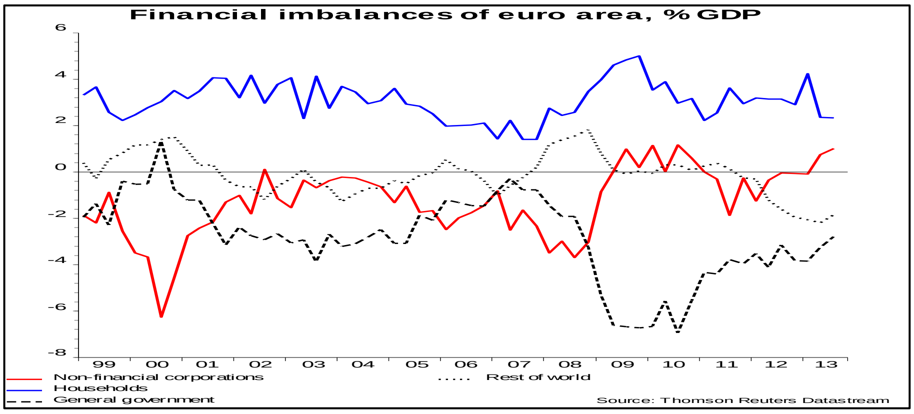

Germany
Consumption YoY %
Real household disposable incomes YoY %
Source: Thomson Reuters Datastream


Germany
Pre-tax trading profits of non-financial corporations YoY %
Investment YoY %
Source: Thomson Reuters Datastream

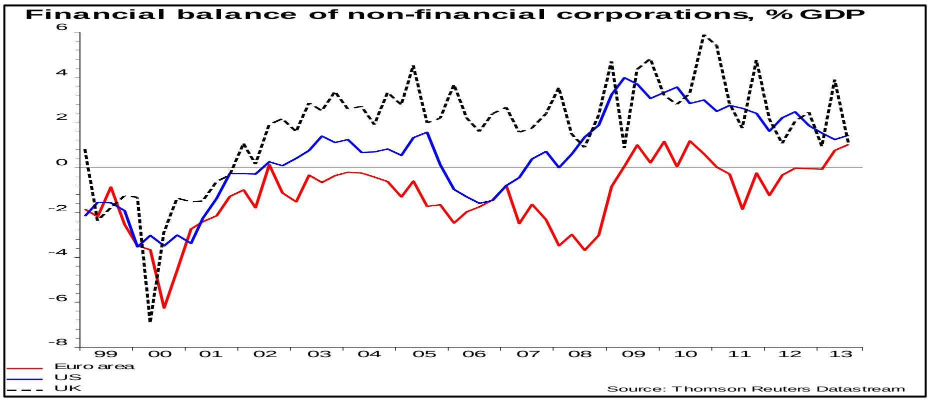

Household disposable incomes YoY %
Germany
Semi-core
Periphery
Source: Thomson Reuters Datastream


Pre-tax trading profits of non-fin corporations YoY %
Germany
Semi-core
Periphery
Source: Thomson Reuters Datastream

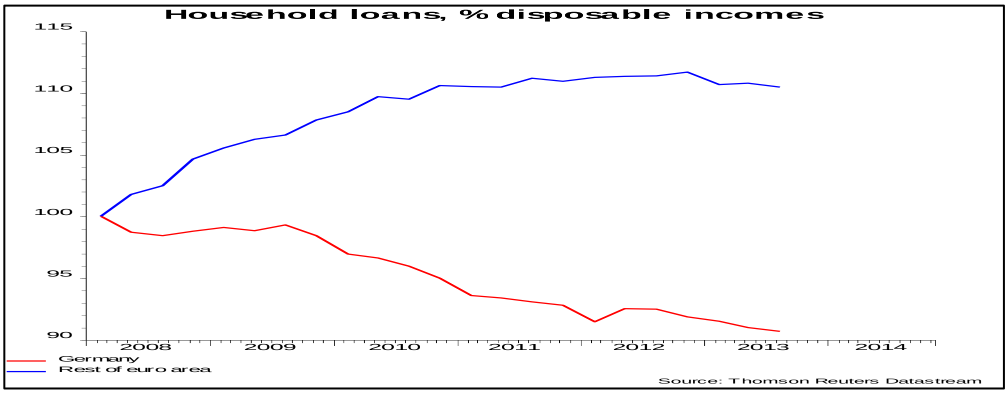
None of this suggests that the euro area will experience a strong robust recovery with economic indicators surprising on the upside month in month out. There has not been the balance sheet repair of the UK and US, the exchange rate remains a headwind, as does the Asset Quality Review in terms of probably reining back lending to the wider real economy, given the focus on banks' balance sheets. Moreover, recoveries never occur in straight line. The risk of some economic disappointment as say we go through the second quarter remains high. But, in a world of small numbers the fact that the euro area has recovered in the face of the more obvious headwinds the region faces will have given the ECB more confidence to delay any further policy decisions until perhaps June, especially in an environment when the inflation data may be relatively volatile.



Detailed Financial and National Accounts data for Q3 2013 paint a slightly better picture of the euro area economy than had previously been suggested. We stress the word slightly because we have yet to see the balance sheet repair at a macro level that arguably would really help drive recovery going forwards. However, in particular corporate cash-flow has improved such that non-financial corporations have moved back into small surplus.

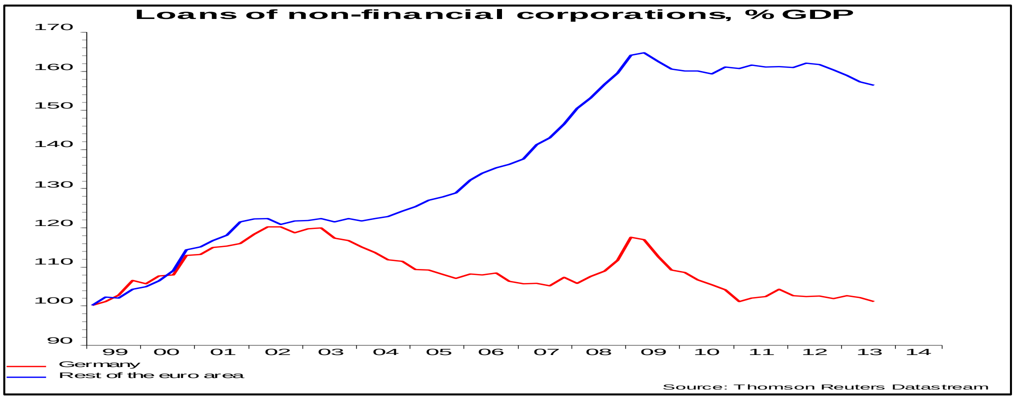


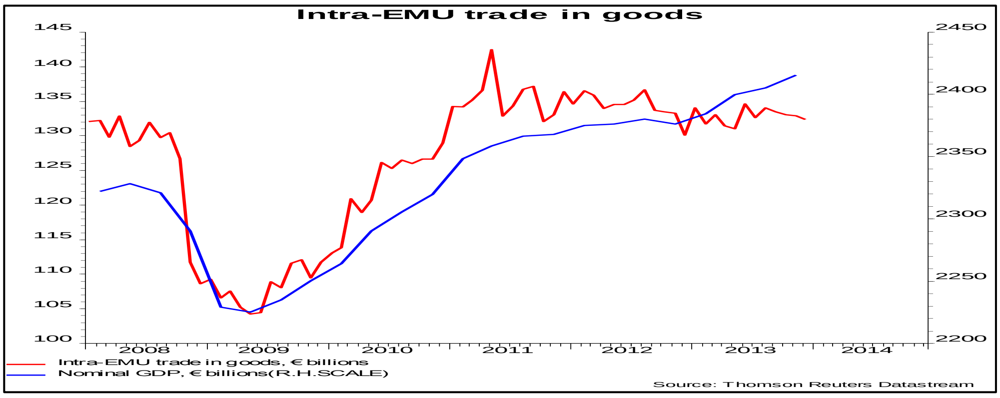
Indeed, expressed as shares of GDP, the financial surplus of non-financial corporations in the euro area looks very similar to that of the US and UK (see second chart below). This is a situation where the corporate sector is throwing off more cash-flow than it is spending on its investments in fixed assets and inventories. The only problem here is that at this stage of the economic cycle several years after the onset of recession the corporate sector should have been in surplus for a long time. This is precisely what we find in the US, but not the euro area. In the case of the US, one can build more of a convincing case that the corporate sector will now move back into deficit, as business investment kicks in and the recovery grows legs.

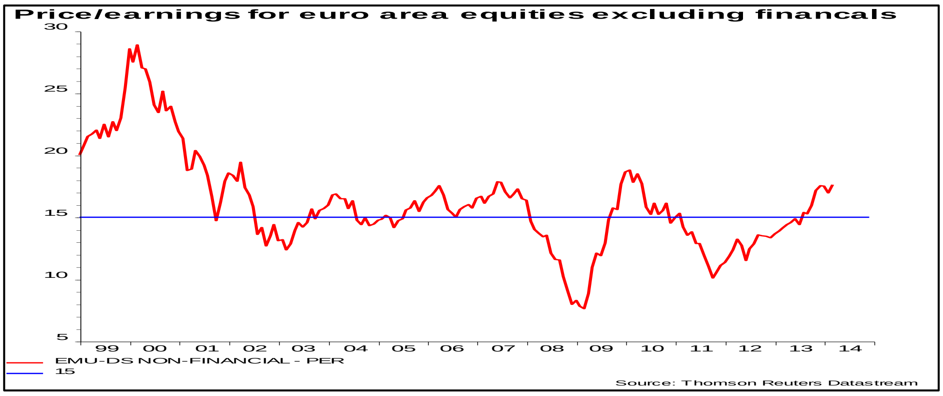


Loans outstanding of German households are almost 10% lower than at the start of the downturn in 2008 when compared to household disposable incomes, compared to 10% higher in the case of the rest of the euro area (see first chart).

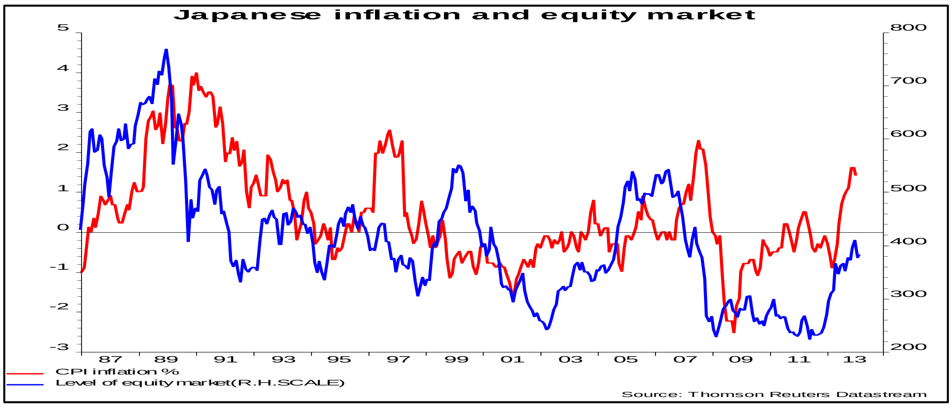
Moreover, expressed as a share of GDP loans outstanding of German non-financial corporations are no higher now than at the start of EMU in 1999, whilst that of the rest of the euro area (although recently falling) are still over 50% higher (see second chart). To put this further into context, as of Q3 2013 debt outstanding of non-financial corporations in Germany stood at 66.1% of GDP, compared to 104.6% for the euro area overall, 104.3% in France, 88.5% in Italy and 130.8% in Spain. Profit margins of German non-financial corporations, as measured by pre-tax trading profits to turnover, were 40.1%, compared to 37.5% for the euro area overall, 38.8% in Italy, 42.3% in Spain, but only 28% in France. Based on all this what odds German investment continues picking up?





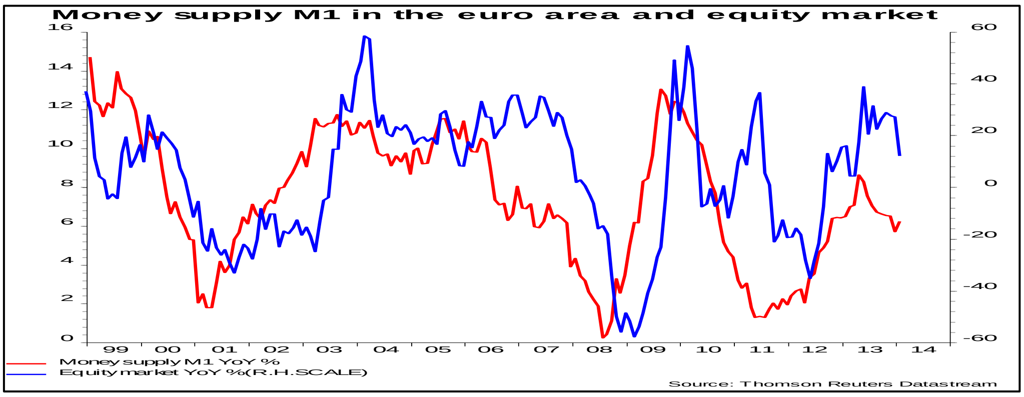


Of things to watch, it would clearly be encouraging if intra-EMU trade flows were to kick-in, such that the German recovery in particularly begins to more directly benefit other countries in the euro area and trade flows between the periphery and semi-core increase. So called trade-multipliers could help provide another leg to the recovery. Moreover, for the region to continue to attract capital flows in a world of more compressed yields, it would obviously be helpful if earnings at a quoted level meet or beat expectations. Price-earnings ratios can always go higher, but increases in earnings would help validate the move up that we have seen to date in equity markets. At the margin, those moves have been underpinned by significant capital inflows from outside the euro area, on the expectations that earnings would recover, and not just in Germany.

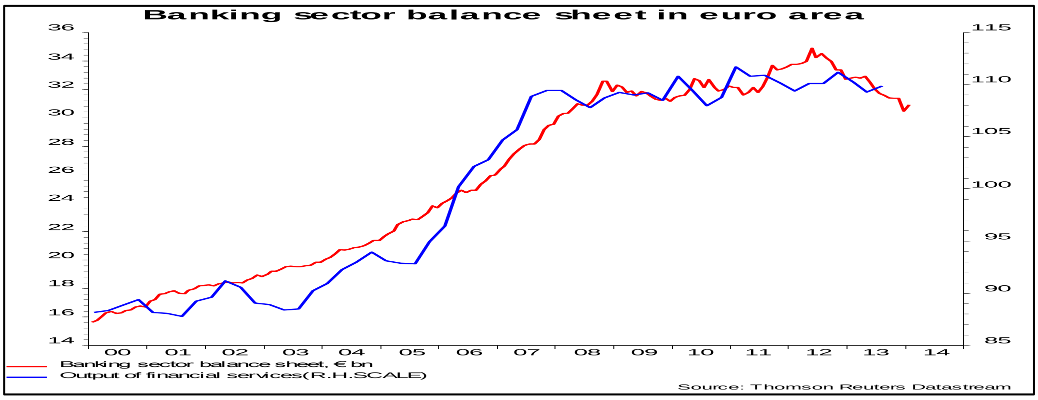


Our long-held view that the ECB will eventually end up doing QE has recently gained traction. But to be clear, this first, would involve a transparent policy of buying government bonds in the secondary market according to paid in capital shares into the ECB itself and second, would only occur after the ECB had tried everything else first. We are not there yet. Moreover, as already discussed in a world of very small numbers, small differences to inflation and GDP growth can make a significant difference. As ever, the ECB's default decision will always be delay and wait on more information.

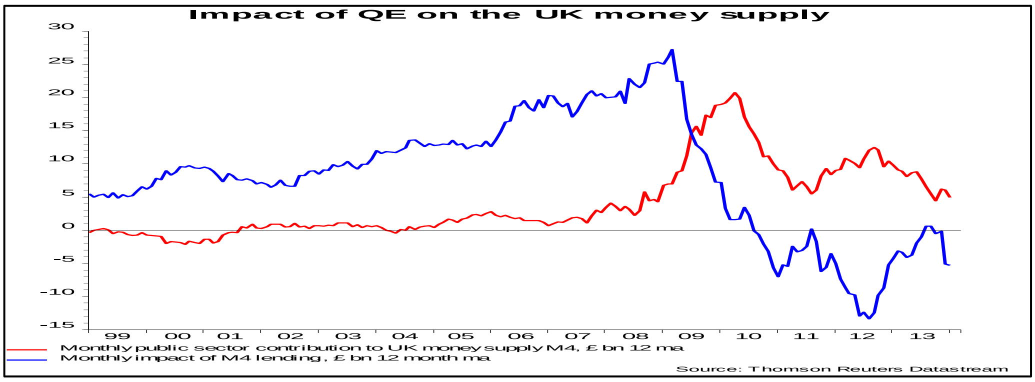
When discussing the risk of deflation it should also be highlighted that in the literature deflation is often seen as going hand in hand with significant equity market weakness. This is not just true of Japan (see chart), but in other countries in the 1920s and 1930s. This is not the situation that the euro area finds itself at present, although money supply M1 growth is weaker than at the peak (see chart).



We would also stress the potential importance of the Asset Quality Review for what happens next in the euro area. Everything being equal, it would not be surprising to see the banking sector shrink in the next 2 years. The question is what this implies for the wider real economy. The chart on page 5 shows the relationship between the banking sector's balance sheet, still around 3 times GDP, and output of financial services, 5.1% of gross value added in 2012. But, banking's importance to the wider real economy goes way behind its simple share of gross value added. Latest data confirms a further decline in lending to the wider real economy.

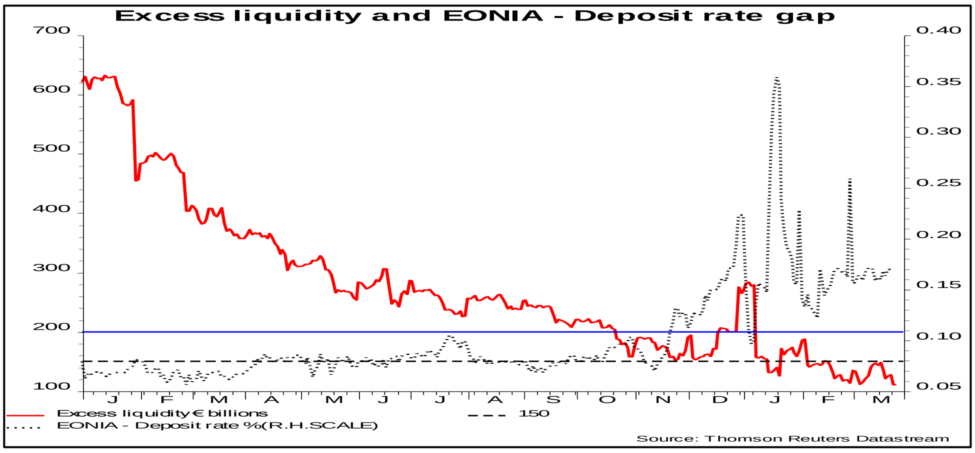


When thinking about QE it is important to recognize its potential effect on the banking sector's balance sheet. As the example of the UK shows, everything being equal QE creates liabilities (deposits) on the banks' balance sheet. As institutions sold Gilts to the BoE, so a deposit was likely created at a UK bank, at a time when there was enormous pressure on the UK banking sector (some 5 times UK GDP) to shrink. This can clearly be seen from the chart below.



So, QE might ultimately not just be potentially important to head-off the risk of deflation or help engineer a much weaker euro (a key theme of our foreign exchange colleagues), but keep any contraction in the banking sector's balance sheet to a minimum. When hearing QE discussed, this is not often mentioned, but should not be lost on policymakers. With no safety net of system wide deposit insurance one cannot entirely rule out the risk of further deposit leakage if certain banks are seen as being much weaker than the rest.

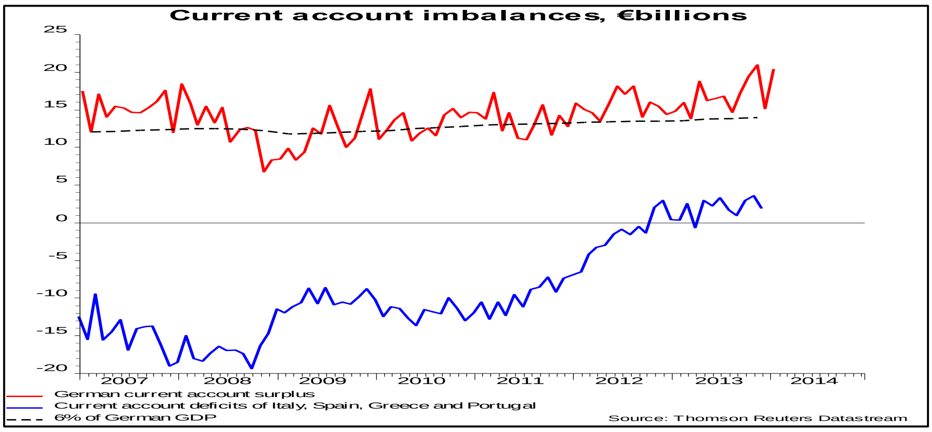
Finally, not fully sterilizing the SMP purchases seems almost a statement of the obvious, particularly in an environment of liquidity still draining out of the system. For every euro sitting on 7-day term, there may be less monies sitting overnight on deposit such that the ECB's measure of excess liquidity continues to fall, putting upward pressure on EONIA. February's month end fixing was higher than January's, but significantly below December's. Looking at the chart below one can see how those month end fixings were getting progressively higher each month going into year end, but may now be increasing again. However, we are probably not at the point where the ECB unduly worries about the very front end of the curve, although it may well take the view that the associated contraction in the Eurosystem's balance sheet has been a key factor underpinning a stronger euro.

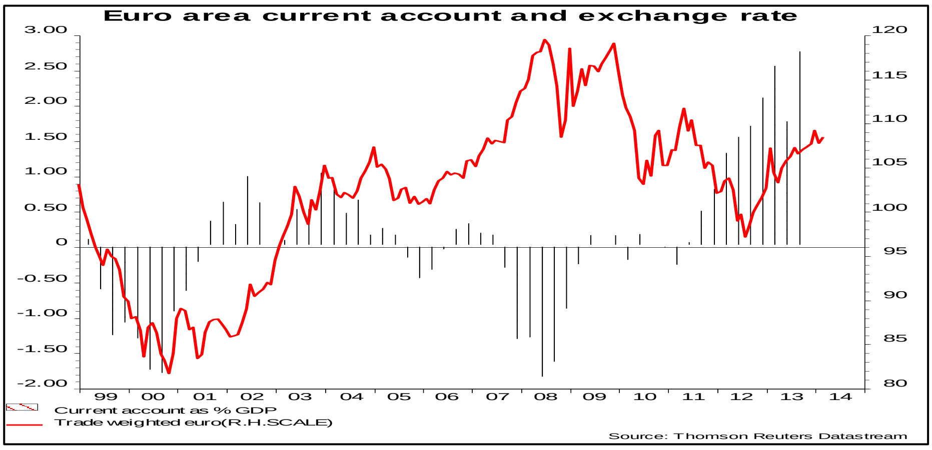


In their latest forecasts both the ECB and European Commission (EC) assume no reduction in the euro area's large current account surplus. In fact, the ECB expect it to become slightly larger rising to 2.6% in 2015 and 2.7% in 2016, after 2.4% of GDP this year. The EC assume an unchanged 2.7% of GDP both this year and 2015, but also provide a country breakdown.

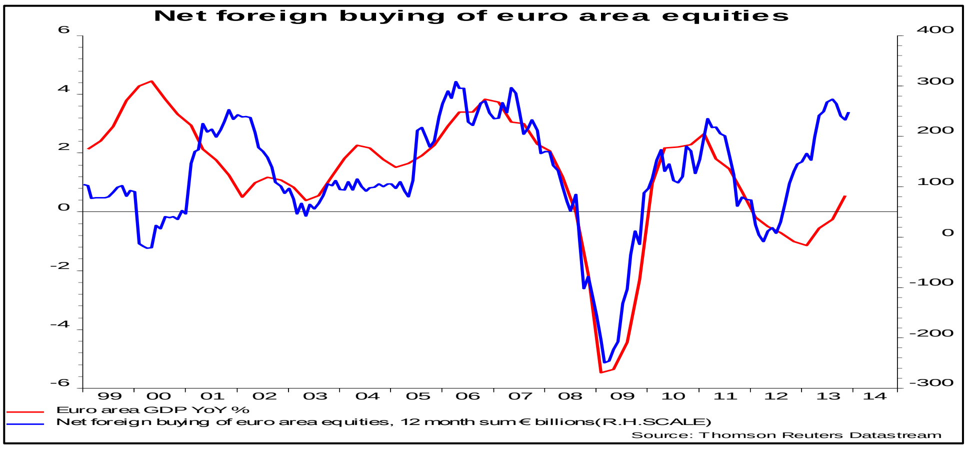
The EC expect Germany to continue running a current account surplus of more than 6% of GDP (6.7% in 2014 and 6.4% next year), whilst the larger countries that were in large deficit but are now in surplus see no significant change in their external positions either. So, Italy is seen by the EC to be running a surplus of 1.3% of GDP in 2014 and 1.2% in 2015, Spain 1.6% of GDP in 2014 and 1.8% in 2015. Portugal's surplus is put at 0.8% of GDP in 2014 and 1.1% in 2015, whilst France remains in deficit, -2% of GDP in 2014 and -2.2% in 2015.

Of course, if there is no significant reduction in the euro area's large current account surplus, then we are very unlikely to see any decline in the private sector's large financial surplus either, further locking the euro area into a weak recovery. For the recovery to grow legs we would probably need to see much more of fundamental shift in the euro area's financial balances, and a rundown in private savings. Moreover, if the euro area is set to still run a current account surplus of between 2.5% and 3% of GDP, there is the important question of what this might imply for capital flows.

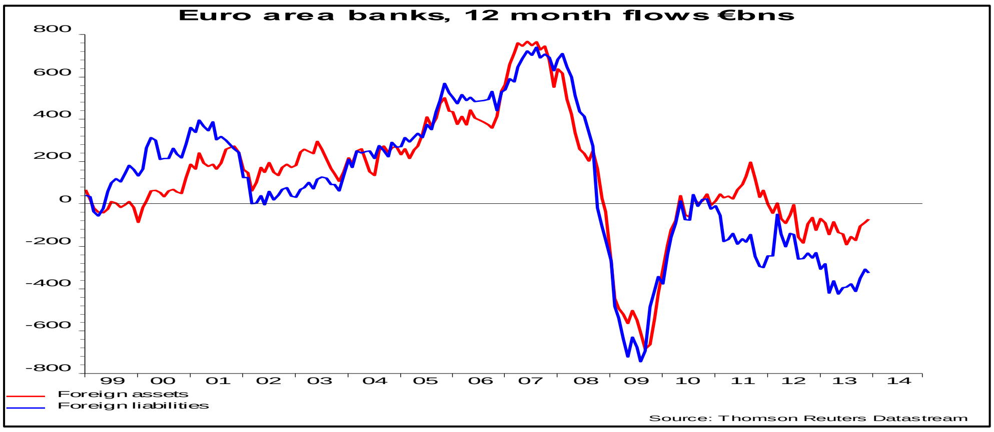




Of course, the flipside of a large current account surplus has to be net capital outflows. Often the assumption will be that this will take the form of outflows of net portfolio investment, but the trend of the last 18 months or so has been for the euro area to see significant foreign buying of euro area equities in particular (see chart below).



But, as we have highlighted before, one of the biggest swing factors in terms of the euro area's capital account has been the net external financing position of banks (see chart). Wind the clock back to pre-crisis and we saw a substantial increase in cross-border flows by banks. This did not have much of an overall impact on the capital account because the rise seen in the foreign assets of banks broadly corresponded with the increase in their foreign liabilities (external borrowings).



However, as the crisis abated so banks have again been reducing their overseas exposure, but importantly their foreign liabilities (borrowings) have been declining a lot faster than their foreign assets (note, the scale on the chart at the bottom of page 2 looking at euro area banks is very different to the other two charts on the same page). However, unlike 2008 and 2009 when the overseas exposure of the banks collapsed at the height of the crisis, this should be seen more as a sign of confidence returning and funding issues abating. In fact, the improvement seen in the current account between 2012 and 2013 (€90.5bn, the difference between €216.7bn and €126.2bn) in the table below is less than the net swing seen in the banking sector's external position (€150.9bn, the difference between €263.1bn and €112.2bn in the column on the right).

Balance of Payments of euro area, euro billions

		2012	2013			2012	2013
Goods				**Direct investment**			
	Credit	1919.5	1935.5		Investment abroad	329.9	198.3
	Debit	1824.6	1762.1		Investment in euro area	326.3	81.6
	Balance	**94.9**	**173.4**		**Balance**	**-3.6**	**-116.7**
Services				**Portfolio investment**			
	Credit	626.6	651.6		Investment abroad	186.4	222.7
	Debit	537.9	546.2		Investment in euro area	258.7	365
	Balance	**88.7**	**105.4**		**Balance**	**72.3**	**142.2**
				of which:			
Income				***Equity flows***			
	Credit	535.5	512.3		Investment abroad	57.6	136.5
	Debit	486.1	449.8		Investment in euro area	144.1	247.1
	Balance	**49.3**	**62.5**		**Balance**	**86.5**	**110.6**
				Bonds			
Current transfers					Investment abroad	126.5	68.6
	Credit	97.3	95.6		Investment in euro area	119.3	95.4
	Debit	204.1	220.3		**Balance**	**-7.2**	**26.8**
	Balance	**-106.8**	**-124.7**				
				Eurosystem			
Current account					Investment abroad	5.2	-20.4
	Credit	3179	3195		Investment in euro area	19	-81.6
	Debit	3052.7	2978.3		**Balance**	**13.8**	**-61.2**
	Balance	**126.2**	**216.7**				
				Banks (MFIs)			
				excluding Eurosystem	Investment abroad	-122.4	-65.7
					Investment in euro area	-234.6	-328.8
					Balance	**-112.2**	**-263.1**
				Other sectors			
					Investment abroad	112.4	-31.1
					Investment in euro area	11.5	12
					Balance	**-100.9**	**43.1**
				Reserves			
					Balance	**-13.9**	**-4.3**
				Financial Account			
					Balance	**-140.9**	**-246.5**

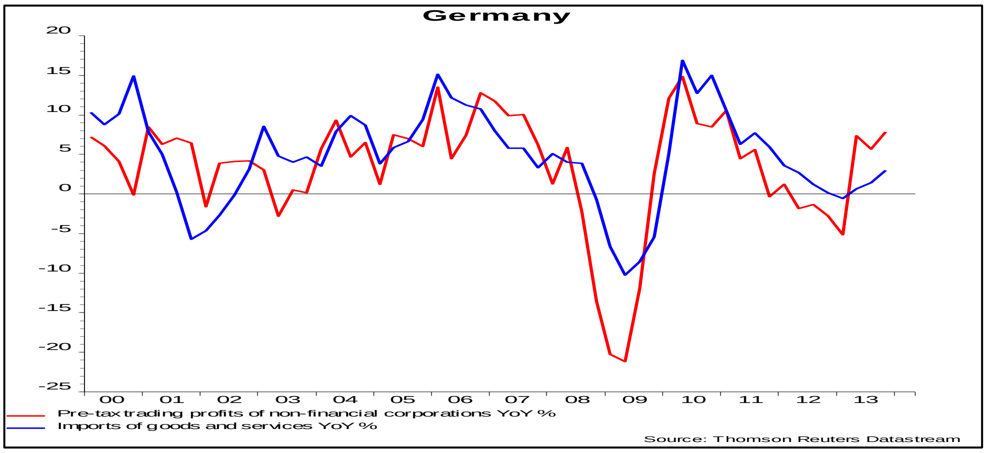
Source: ECB
Note: With the Financial Account inflows are a positive number, as are outflows.
Assets refer to investments abroad, liabilities to investments in the euro area.
With reserves a negative number is actually an increase.

However, what the table also shows is first, how what we are really looking at what are relatively small differences (if 2.5% of GDP can be described as small) between much larger numbers and second, how the balance of payments is made up of several moving parts, all very difficult to predict. And, the international exposure of the euro area in the form of its banks, other financial institutions and non-financial corporations goes way beyond simply portfolio flows, as the table also highlights showing outstanding investment positions.

Investment position, Q3 2013 euro billions			
Direct investments			
		Of euro area abroad	6069.2
		Foreign investment in euro area	4596.8
Portfolio investments			
		Of euro area abroad	5463.5
		Foreign investment in euro area	8676.2
	of which:		
Equity investments			
		Of euro area abroad	2171.6
		Foreign investment in euro area	3756.4
Debt instruments			
		Of euro area abroad	3291.9
		Foreign investment in euro area	4919.8
Other investments			
		Of euro area abroad	4739
		Foreign investment in euro area	4819.8
	of which:		
Eurosystem			
		Of euro area abroad	24.6
		Foreign investment in euro area	361.7
Banks (MFIs)			
excluding Eurosystem		Of euro area abroad	2847.2
		Foreign investment in euro area	2730.8
General government			
		Of euro area abroad	148.7
		Foreign investment in euro area	226
Other sectors			
		Of euro area abroad	1718.5
		Foreign investment in euro area	1501.4
Source: ECB			

This though still begs though a number of further questions. So, assuming the euro area is still running a large current account surplus, but that following publication of the Asset Quality Review say, banks increasingly start funding themselves internationally. How then do we square this with the need for there to be net capital outflows overall to offset the current account surplus? 2.5% of GDP) could be achieved in a variety of different ways. For example, to the extent to which recent portfolio investment inflows have been a reaction to international investors being underweight euro area assets at the height of the crisis, then perhaps these inflows will slow once this rebalancing has occurred. This would particularly be the case if by then spread compression has run its course in a world where the Fed is coming to the end of tapering. Moreover, if later this year speculation grows of a much weaker euro (say because of our long held theme that the ECB will eventually be doing QE) and/or because the market is more pricing in rate rises in the US and UK, then portfolio outflows could increase. If the currency then falls this trend could accelerate.

But, should we simply run with the assumption of no change in the current account? As the euro area recovers, so imports are likely to pick-up and perhaps at a faster rate than exports, especially given the move that we have seen in the currency to date. Not only should the lagged effect of a stronger exchange rate continue to cause the euro area to lose market share internationally (so extra-euro area exports grow slower than world trade), but promote import penetration. Germany's current account surplus in particular might fall, if domestic demand there starts to outperform. With German profits picking up further into Q4 for example, it would not be so surprising to see German imports growing faster (see chart). On a one year perhaps the German current account surplus will be less than 6% of GDP?



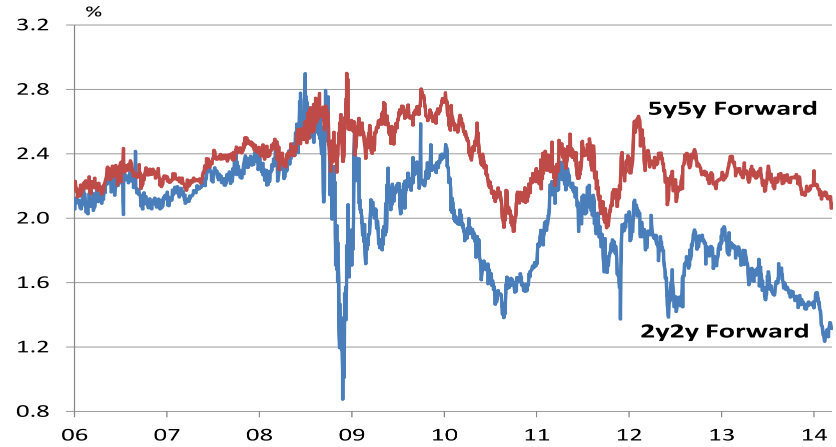
We are increasing being asked whether there is a level of the euro that the ECB would really be concerned about. Our stock answer is that more the change in the exchange rate that matters, with every 10% move in the exchange rate reducing GDP by around 1 percentage point and taking up to 0.5 percentage points off the inflation rate, rather than any absolute level. So if the exchange rate were to gap higher from here clearly the risk of outright deflation could rise significantly. But, clearly the ECB might prove very sensitive if the euro say was likely to breach 1.50 against the dollar.

This might be seen as psychologically an important figure in its own right. The ECB has intervened in the foreign exchange markets before, in 2000 when they faced the reverse of the problem than the one today; inflation above target and rising, a weakening exchange rate and a region in very large current account deficit. So, this would always be an option again. However, intervention then was not really successful. Far better arguably for the ECB to make more effective use of its balance sheet, and move to outright QE.

ECB Policy options remain limited

As Draghi stated at the February Q&A session, even "these levels of inflation for a protracted period of time, are a risk on their own: are a risk for the recovery, are a risk for the weight of debt in real terms, and are a risk for a variety of reasons." In other words, even if the threat of outright deflation may be considered slim by the ECB, the mere fact that the topic is being discussed is a problem in and of itself. So what about inflation expectations? In terms of consumer attitudes, inflation expectations for the euro area have essentially trended sideways over the past six months – something which will encourage the ECB. But it is a very different story if one looks at market expectations of where euro area inflation may end-up in the medium term. So for instance the 5y5y forward rate remains relatively well anchored around 2.15% (this is effectively what inflation is expected to average for the following five years in five years' time). But a 2y2y forward rate is telling the ECB something more troubling. So from the ECB's own forecasts we know that inflation is expected to average around 1.2% in 2014 and 2015. But on top of this, the markets are also effectively pricing in that inflation will average just 1.25% over the course of 2016 and 2017. Which, in aggregate, means more or less four years during which inflation is some 50bp below what the ECB considers to be its target.

Euro area inflation expectations: what's currently priced in?

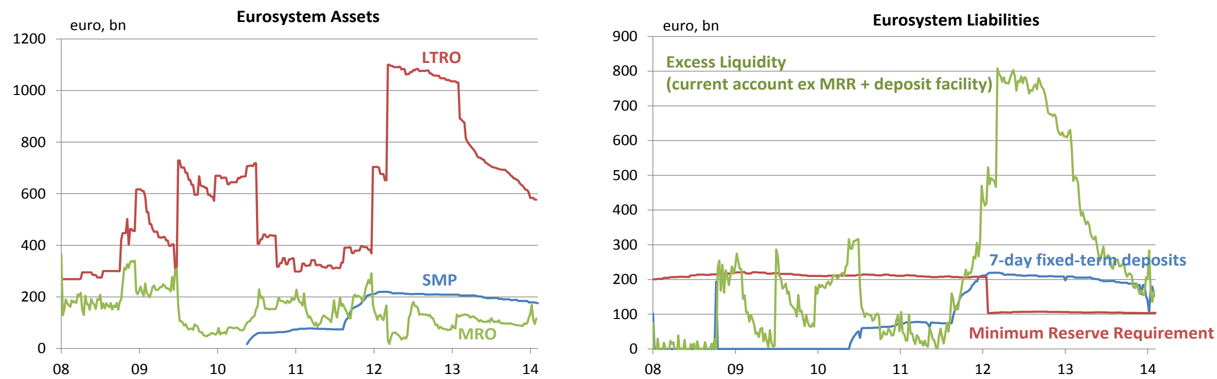


Source: Bloomberg and Jefferies International

One point that Draghi made during the last press conference is that the ECB will use appropriate tools for appropriate problems – so the problem of inflation expectations is something which is entirely different from a problem with liquidity. Notably, we still encounter a lot of confusion about how the various parts of the Eurosystem's balance sheet move around, what are the ECB's options and what the data are actually saying. After some volatility at the start of the year, the latest weekly data show that SMP purchases (an asset in the chart below) were successfully sterilised through the 7-day deposits. This also means that excess liquidity continues to fall.

Eurosystem assets (LTRO+MRO+SMP purchases) are the driver of what happens on the liability side of the balance sheet. So all things being equal, a repayment in LTRO loans should be matched one-for-one with a fall in excess liquidity. And arithmetically, if 7-day fixed-term deposits fall short of the amount the ECB is trying to sterilise, then it also most likely means a temporary spike in excess liquidity in the system as cash simply ends-up on a different account with the National Central Banks. So, in some ways, the whole thing is far easier to understand than it looks – whatever stress there is in the markets will be more visible in the EONIA rate than what happens to measures of excess liquidity which can swing around week to week for a variety of reasons.

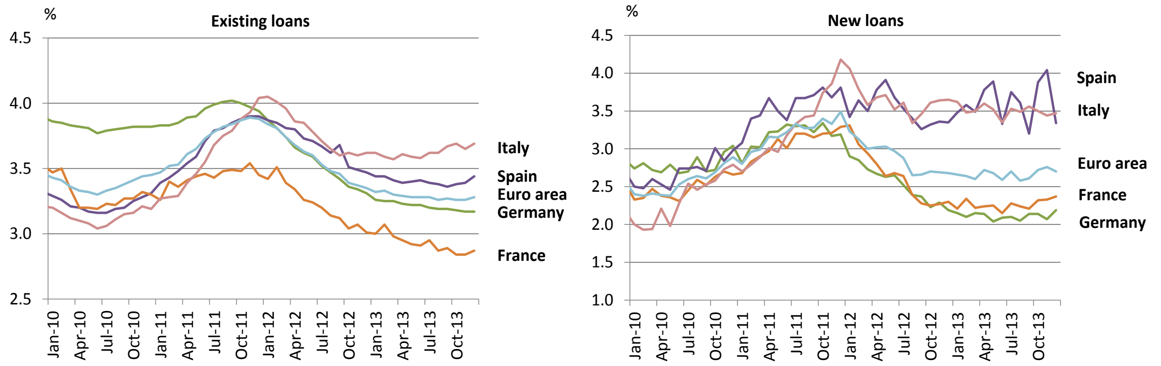
Eurosystem's balance sheet - assets and liabilities



Source: ECB and Jefferies International

Additionally, the latest data on bank interest rates paint a modestly more optimistic picture of financial conditions in Italy and in Spain – but not for the more obvious reasons. So for instance, the chart on the next page highlights that interest rates on lending to non-financial corporations have more or less continued to trend sideways over the final months of 2013. And Italian and Spanish corporates continue to pay a higher rate on both existing and new borrowing than German and French firms.

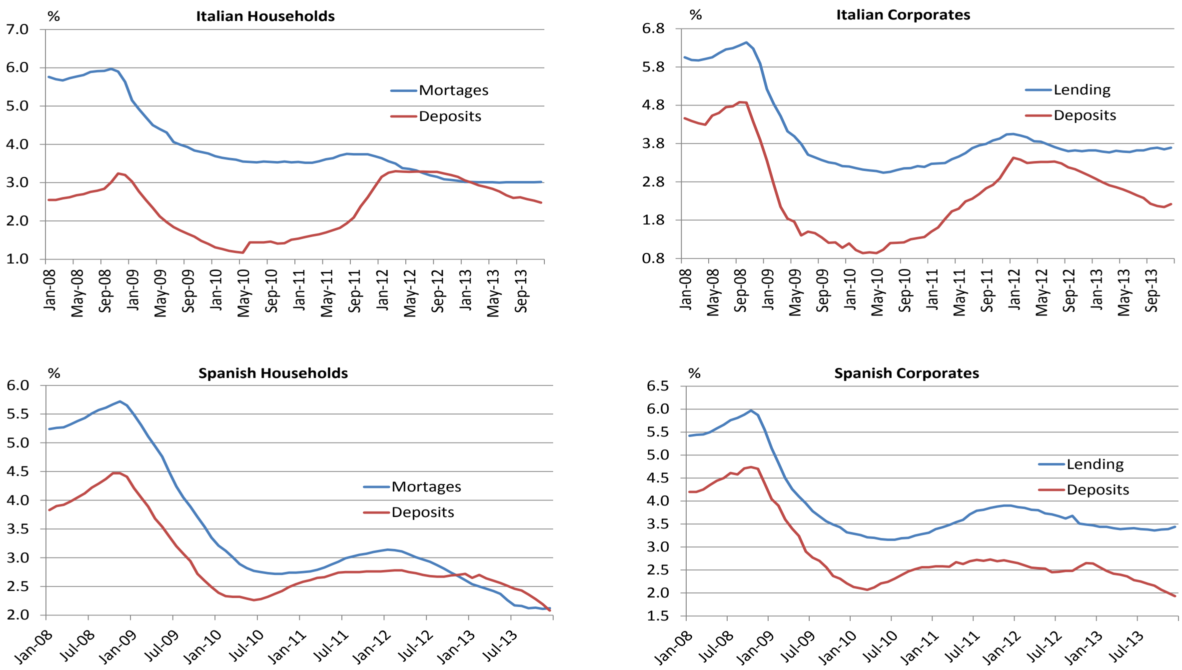
Lending rates to non-financial corporations



Source: ECB and Jefferies International

But the data also show that Italian and Spanish banks are paying less and less for their deposits. Ideally, the ECB would probably wish to see some combination of wider bank margins and lower borrowing rates, so this is not an ideal scenario. But some good news is better than none at all.

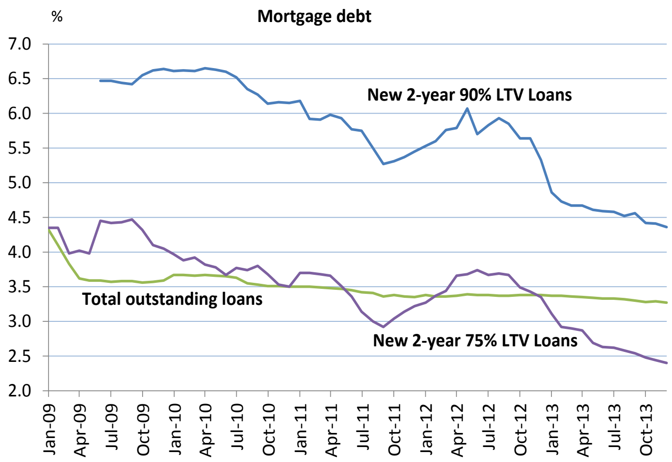
Italian and Spanish bank: interest rates paid and received

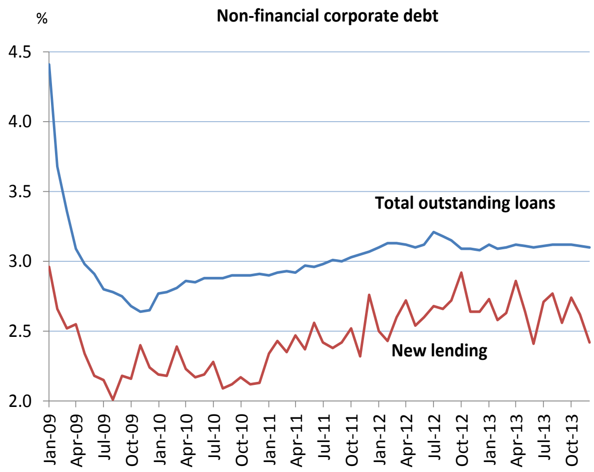


Source: ECB and Jefferies International

And also, as we've been highlighting in terms of the UK experience, even in the relatively healthier banking systems, banks have struggled to cut borrowing costs for non-financial corporations over the past two years. So certainly mortgage interest rates in the UK have fallen quite dramatically since the Funding for Lending Scheme was introduced in July 2012, but interest rates on new lending to non-financials had struggled to really shift over the same period. It may be the policy makers' obvious objective to try to stimulate bank lending to firms to drive investment and generate jobs growth, but the realities are proving difficult – not just in the euro area, but also clearly in the UK as well.

UK interest rates on new and outstanding lending to households and non-financial corporations

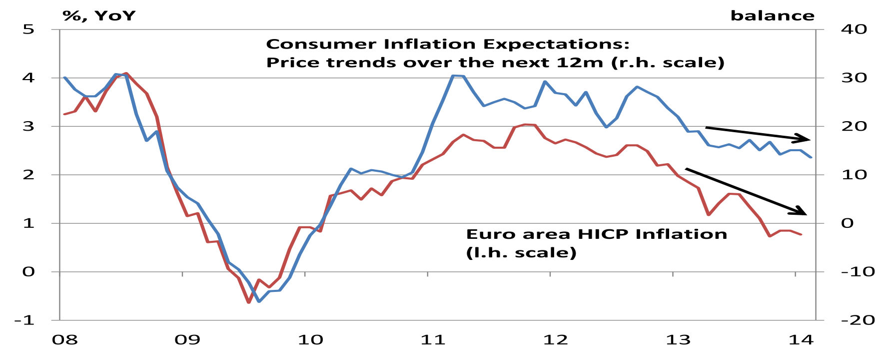




Source: BoE and Jefferies International

So what additional data likely goes into the ECB's reaction function? Here, we highlight two parts of the European Commission Economic Sentiment survey. The first is another decline in consumer inflation expectations; there was nothing radical in the February reading, just another fall in the series which has been moving gently lower for much of the past year. Should the fact that expectations seem to have diverged significantly from the actual inflation readings be reassuring for the ECB? To a point, yes, but it would be difficult to be comforted by the fact the index didn't fall by more.

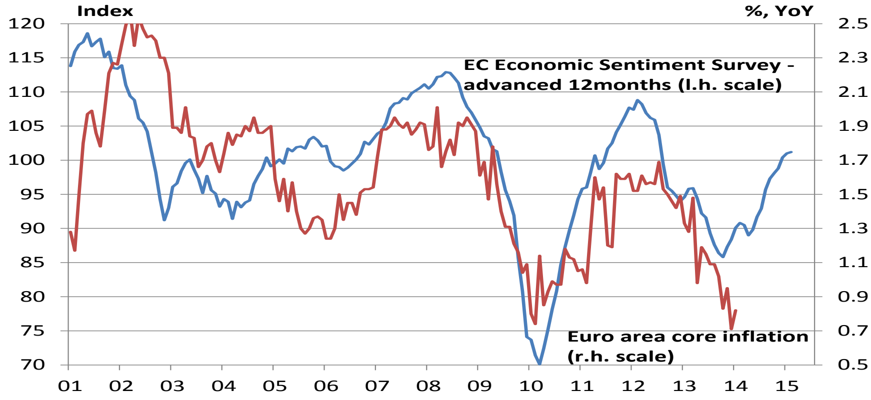
Euro area inflation and consumer inflation expectations



Source: Eurostat and Jefferies International

The ECB will likely be more encouraged by another monthly improvement in the overall Economic Sentiment reading; although there too, the data may raise some eyebrows (the Italian reading was up sharply, the Spanish reading flat, while France recorded a sizeable decline). Still, with the aggregate survey improving in every single month since last April, the more optimistic camp at the ECB may argue that no policy changes are required as inflation will sooner or later begin to catch up with the economic recovery.

Euro area core inflation and EC economic sentiment survey



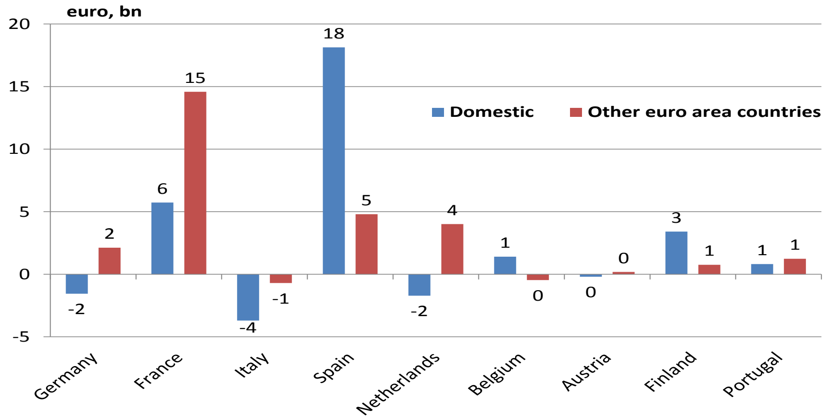
Source: Eurostat and Jefferies International

One related piece of the puzzle is how much contribution the region's banks are likely to make to any recovery. To that extent, the ECB fully acknowledged that the AQR process created distortions to the monetary data at year end – but now that fog will start to lift. In terms of lending data, January's M3 figures were disappointing – with net lending to non-financial corporations dipping back into negative territory.

Spanish/French banks buyers, Italian banks sellers of sovereign debt in January

Finally, in terms of sovereign bond holdings, January data highlighted a split in the behaviour of Spanish and Italian banks.

Change in holdings of euro area sovereign debt: in January 2014

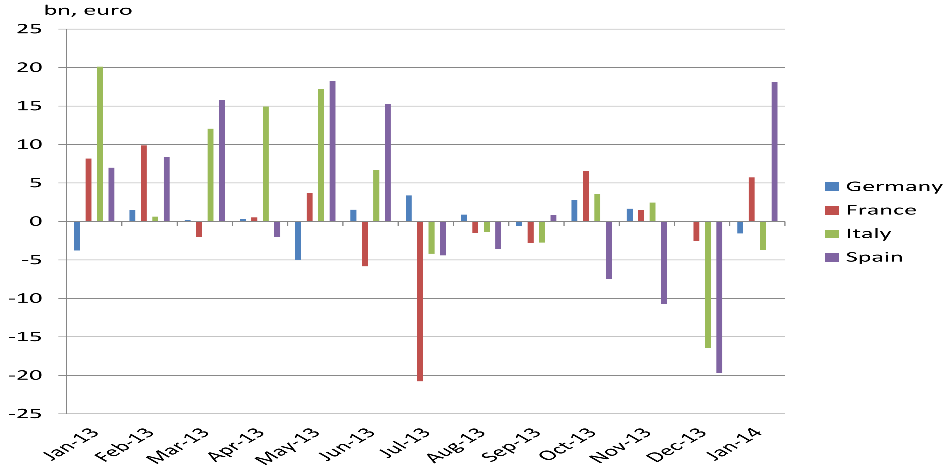


Source: ECB and Jefferies International

So, as expected, after reducing their domestic sovereign bond holdings by €38bn in the last three months of last year, Spanish banks came back and bought €18bn of paper in January. But in comparison, Italian banks, which sold €16.5bn in December, were net sellers again in January – reducing their holdings by another €3.7bn. The strong performance of the Italian paper since the start of the year seemingly without much domestic support should not be overlooked.

GLOBAL FIXED INCOME

Monthly change in holding of domestic sovereign debt



Source: ECB and Jefferies International

In terms of exposure to non-domestic euro area sovereign debt, the big move was from the French banks. They first bought heavily back in October and then sold heavily in December; before adding almost €15bn to their holding in January (see chart below).

Monthly change in holding of non-domestic euro area sovereign debt

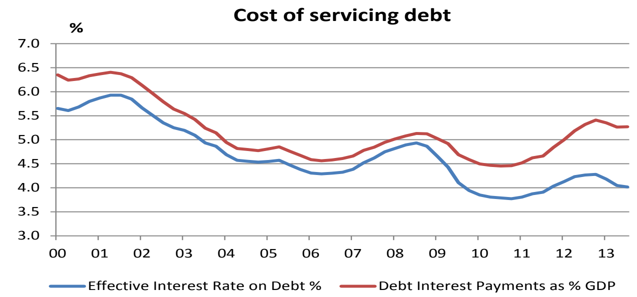
Source: ECB and Jefferies International

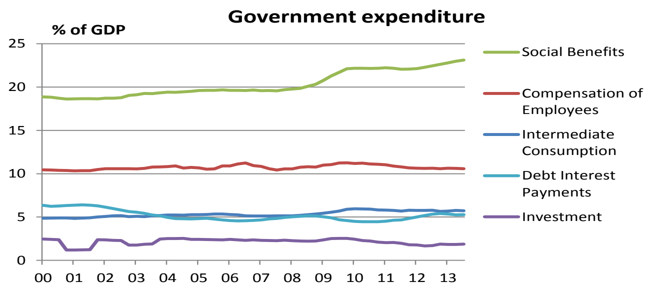
The inevitable grind to lower rates

Eurostat's publications on euro area public sector finances may not get much market attention, but the quarterly breakdown of the data (which now cover Q3 2013) is essentially the only way to understand the balancing act between austerity, borrowing costs and the importance of inflation in stabilising Debt/GDP ratios. So for instance, comparing Italy and Spain, it's interesting to see that Italian debt service costs peaked at around 5.4% of GDP at the end of 2012, and have been drifting marginally lower since (see first chart below). In Spain in comparison, the fiscal position remains more challenging, and so debt service costs as a share of GDP continue to climb and now stand at 3.3% of GDP – up from 2.9% at the end of 2012. This, despite the fact that Spain has implemented more in terms of austerity measures than Italy. The easiest way to see this point is on the bottom chart on the front page, which shows expenditure excluding debt service costs falling by €10bn in Spain over the past four quarters, compared to a rise of €5bn in Italy.

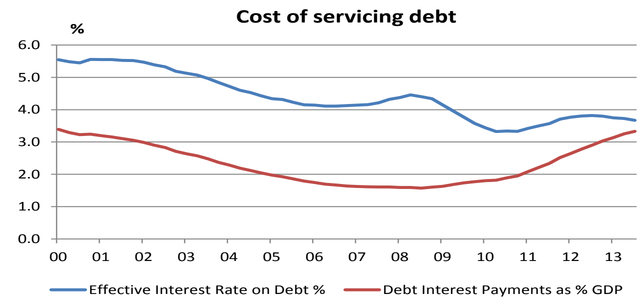
So how can Italy have done less austerity but achieve a greater improvement in debt service costs? There are several factors. The obvious point is that Spain, with its larger deficit, is adding to its stock of debt at a faster rate. But Italy, which rolls over more of its debt each year, has also seen a more rapid reduction in its effective borrowing rate. So for instance over the past year, the average interest rate Italy pays on its debt had fallen by 25bp, compared to 15bp for Spain. Finally, Italy, because of higher inflation over the past year, has seen its nominal GDP fall by less than 1%, Spain in comparison had seen a fall of almost 1.2%. This may be a fairly small difference, but in a world of small numbers, it also contributes.

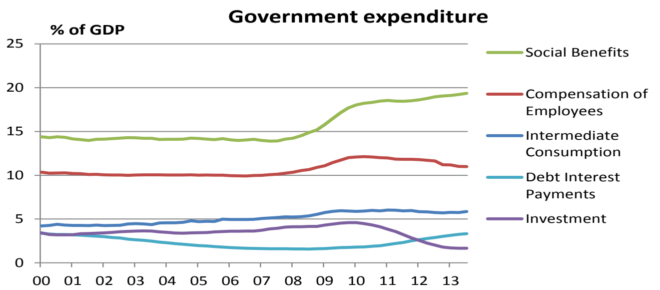
Italy: debt servicing and other categories of gov't expenditure





Spain: debt servicing and other categories of gov't expenditure

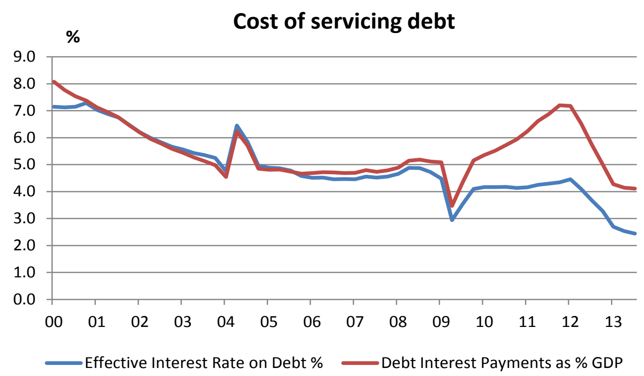


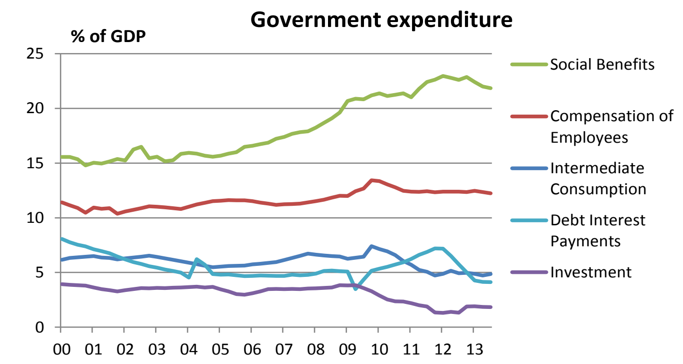


Source: Eurostat and Jefferies International

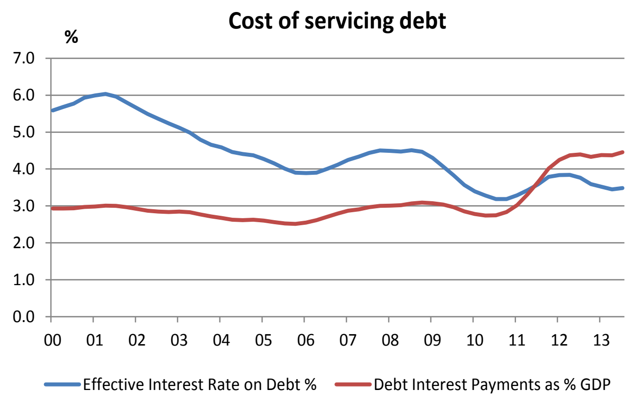
The same exercise was not possible to replicate for France and Germany, because these are the only two counties that do not allow Eurostat to publish quarterly debt servicing statistics. But for Greece, Portugal and Ireland, the data are presented below. Greece stands as a separate case, but the data for Portugal and Ireland show that, like in Spain, despite lower borrowing costs, debt service costs as a share of GDP continue to rise in the two countries.

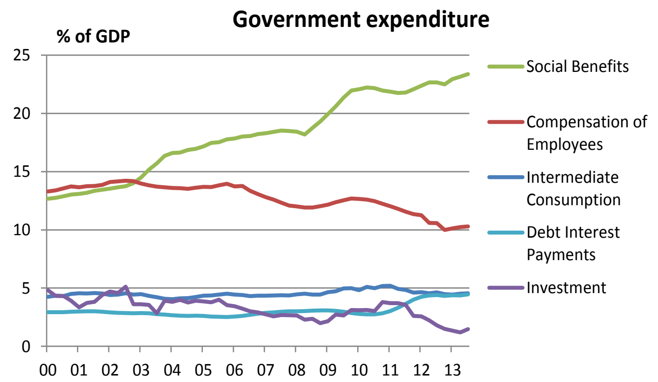
Greece: debt servicing and other categories of gov't expenditure



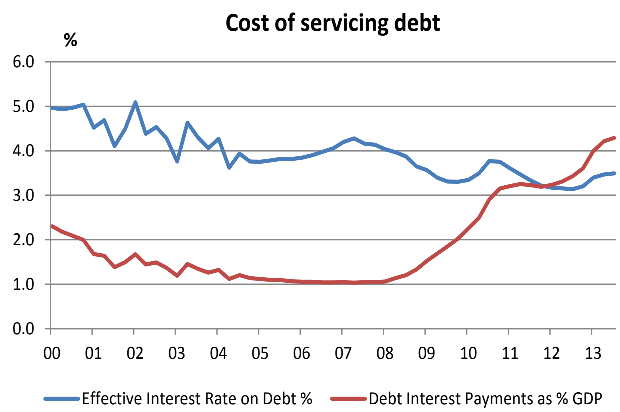


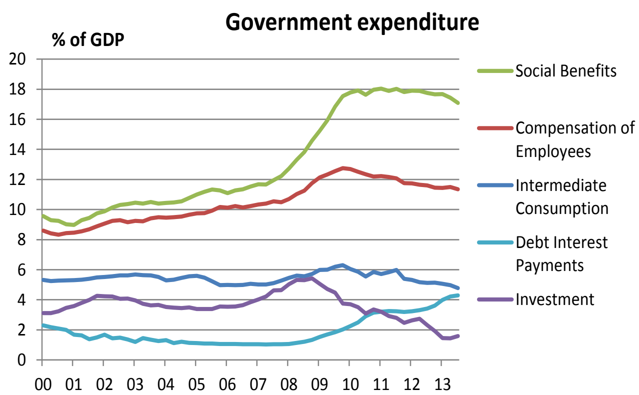
Portugal: debt servicing and other categories of gov't expenditure





Ireland: debt servicing and other categories of gov't expenditure

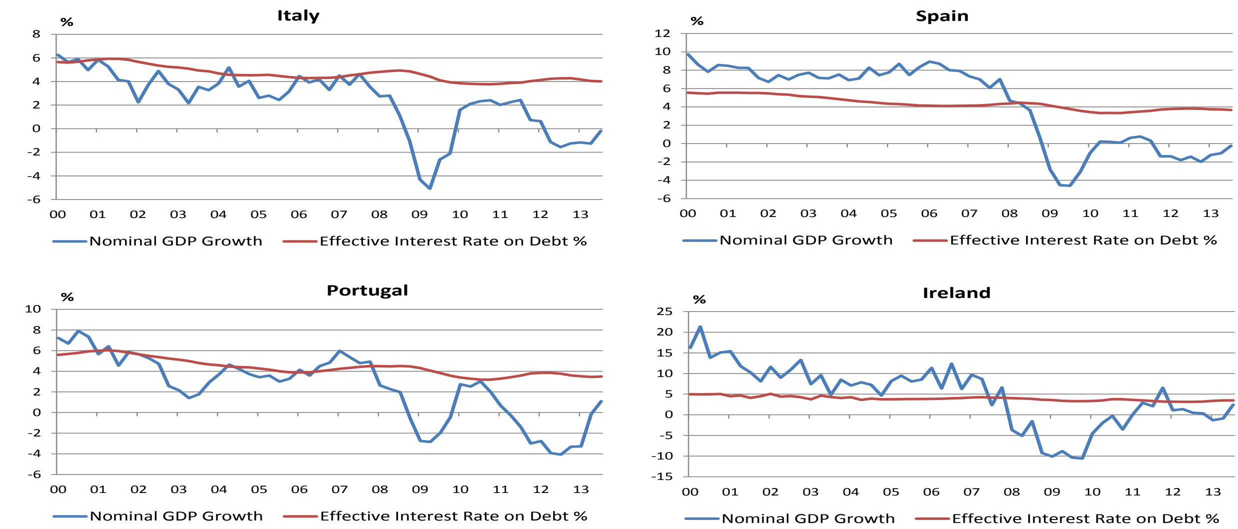




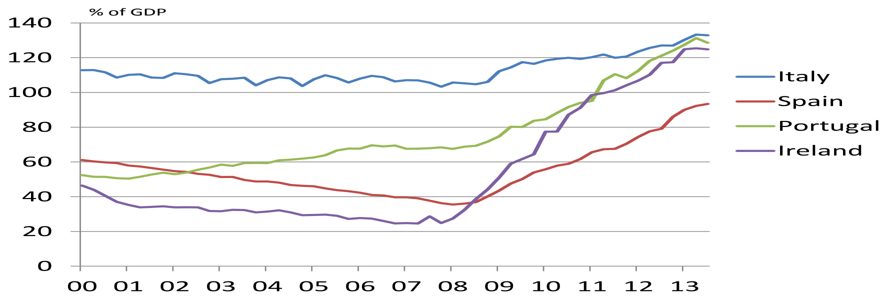
Source: Eurostat and Jefferies International

Finally, a the charts below highlight, prior to the crisis, even in Italy and in Portugal, nominal GDP growth more or less kept up with borrowing costs. And in Spain and in Ireland, nominal GDP growth was significantly higher than the interest rate paid on debt. Which then meant that Debt/GDP ratios stayed anchored (see second chart). But as we also stressed before, high inflation played a very large part in boosting nominal GDP growth (see table below) – something which is completely absent at present. So from the ECB's perspective, a world of 1% real GDP growth and 1% inflation may seem like a perfectly acceptable outcome for the next couple of years. But for most euro area countries 2% nominal GDP growth is simply too low to stabilise debt to GDP ratios. Which means that either: Debt/GDP ratios simply carry on rising, there is further austerity, or government borrowing costs have to fall further from here. This last option remains most likely, particularly in a world where ECB is slowly drifting toward outright QE.

Nominal GDP growth and borrowing costs



Debt as % of GDP



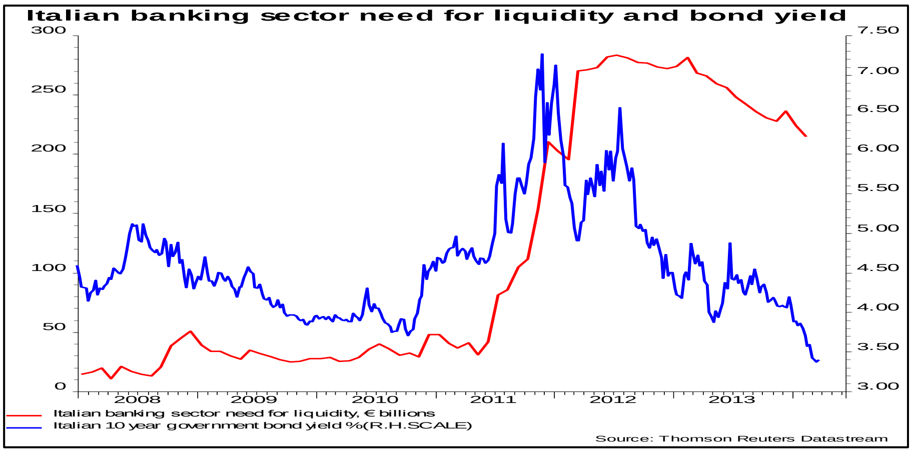
Role of inflation in nominal GDP growth (1990-2008)

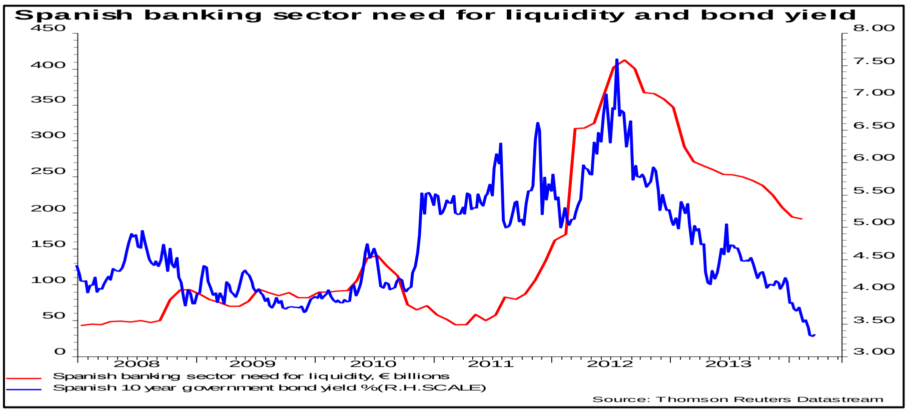
	Nominal GDP Growth	Real GDP Growth	**GDP Deflator**
Germany*	2.5	1.7	**0.8**
France	3.7	2.0	**1.7**
Italy	5.1	1.5	**3.6**
Spain	7.3	2.7	**4.6**
Netherlands	5.2	2.8	**2.4**
Belgium	4.3	2.3	**2.0**
Austria	4.4	2.6	**1.8**
Greece	7.3	4.2	**3.1**
Finland	4.4	2.4	**2.0**
Portugal	5.6	2.4	**3.2**
Ireland	10.5	6.4	**4.1**
* Germany 1995-2008			

Source: Eurostat and Jefferies International

Banks need for liquidity declines as bond yields fall

One encouraging development is that along with the decline seen in bond yields in EMU, the need of the banking sectors in the periphery for liquidity has fallen. This includes funding through normal financing operations and the ELA (emergency liquidity required if the banks run out of eligible collateral). Of the countries shown here this is most notable in the cases of Spain, Ireland and Slovenia, less so of Italy and Portugal. In absolute terms and expressed as a share of the banks' balance sheet the figures may still be high, but the trend has been in the right direction.





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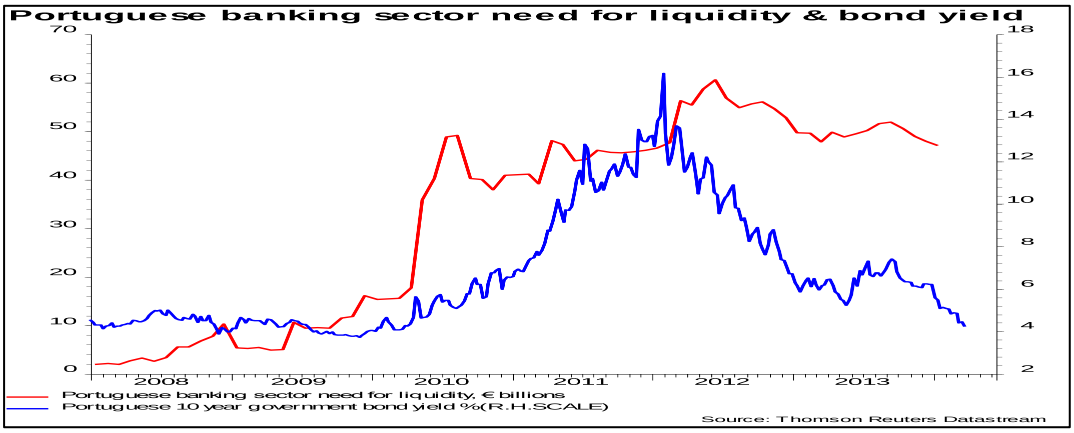
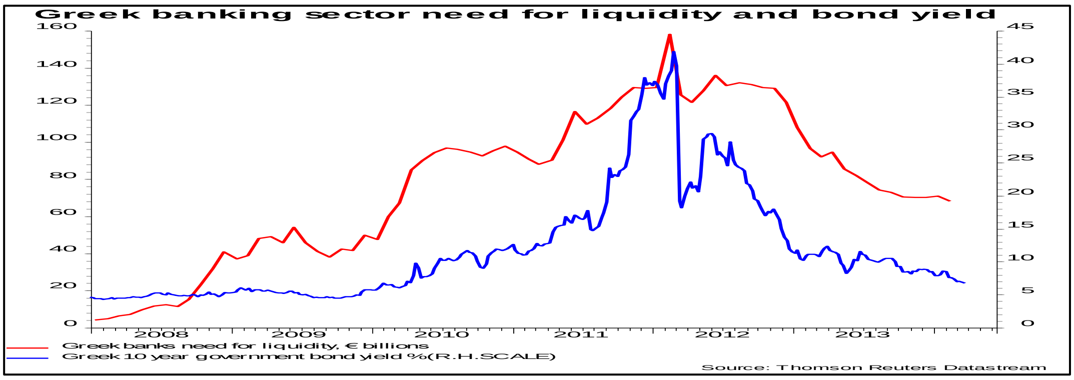
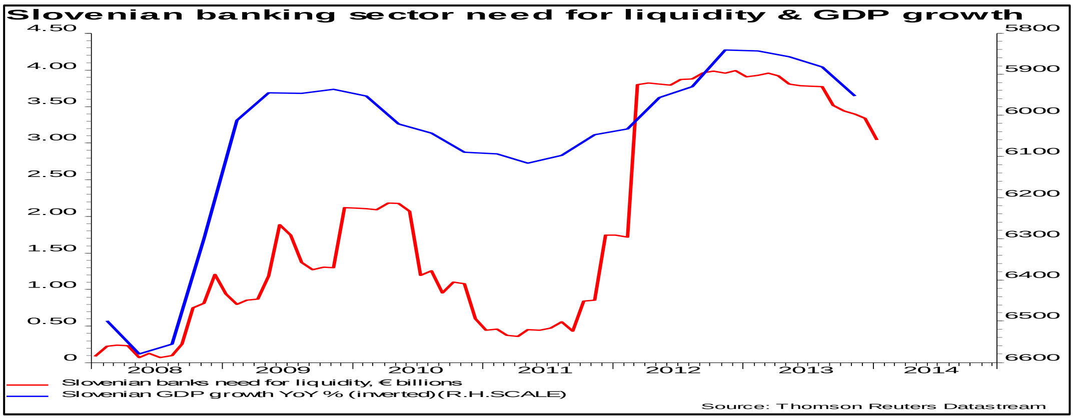




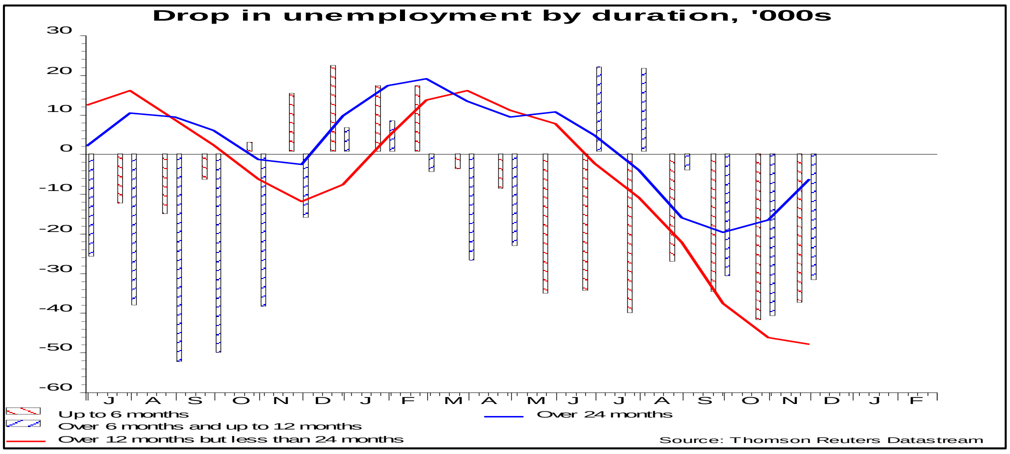


BoE and forward guidance in the UK

Phase 1 of the forward guidance introduced by the BoE last August by the BoE was in a period of much more uncertainty about the outlook. The purpose of forward guidance was to reassure businesses in particular that the BoE would not raise rates until the economy was a lot stronger, so increasing the odds that companies saw more reason to put cash to work.

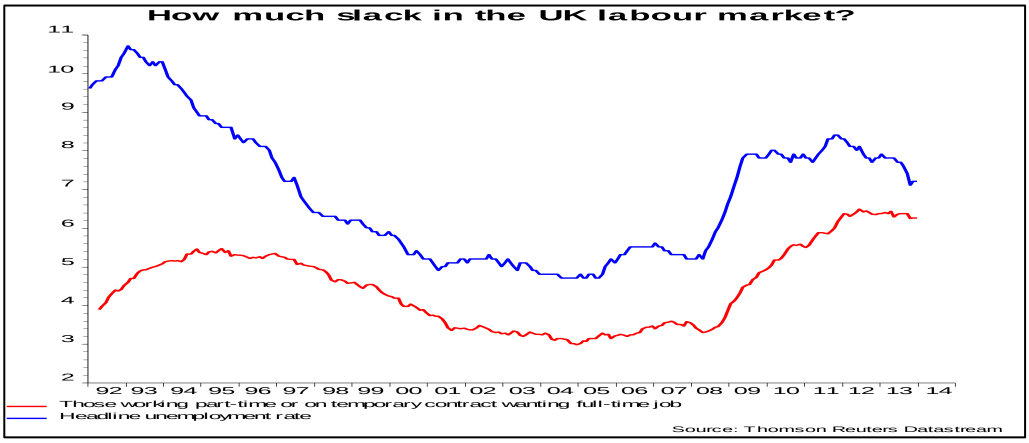
According to evidence presented in the last Inflation Report, after the introduction of forward guidance 45% of businesses surveyed by Markit and 47% surveyed by the Bank's Agents believed that rates would now remain low for longer than previously expected. According to Markit, 58% were more confident about the 1-2 year economic outlook, 74% according to the Banks' Agents. Moreover, according to the Banks' Agents 25% of companies were more likely to take on additional staff, 19% were planning on bringing forward investment and 19% to increase investment. As far as the BoE was concerned, this is what really mattered. Whatever the market prices in for rates was very much of secondary importance.

Moreover, as was very clear from the outset a 7% unemployment threshold was never really a trigger for a policy response, but more likely a way station to hopefully even lower unemployment. As the BoE argued in November, the medium term equilibrium unemployment rate was then 6.5% (not 7%), with every hope that it would overtime fall back towards the 5% that was seen pre-crisis. Then following the release of the Minutes of the February MPC Meeting it was quite clear that the BoE was thinking the NAIRU was lower than 6.5%. In particular, the focus was on the decline in long-term unemployment that seemed to be underway, a view given support by recent Labour Market releases.



So should anyone now be surprised if the BoE believes that the median term equilibrium unemployment is now between 6-6.5% rather than 6.5%?

Moreover, focus on the significant rise in the numbers only working part-time, or on temporary contracts, because they cannot find a full time job is nothing new. Estimates of so-called under-employment by former MPC Member Danny Blanchfower and David Bell have steadily been gaining traction and have been highlighted in MPC speeches and previous Inflation Reports. The fact that under-employment in the UK may be significantly higher than measured unemployment has not simply just come onto the radar.

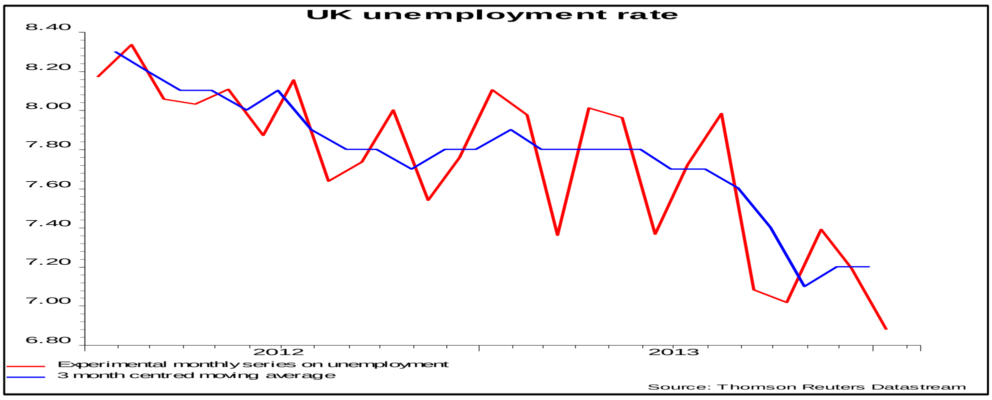


At its simplest, those wanting a full-time job but only able to work part-time or on temporary contracts represent about 6% of the labour force (of those working, or wishing to work), a figure double that pre-crisis and higher than that recorded in the early 1990s when unemployment was much higher (over 10%), as the chart below shows. Eurostat data also highlight that this figure of 6% is unusual (high) in a European context. And, unlike unemployment, this additional element of slack in the UK labour market has not fallen in recent months.

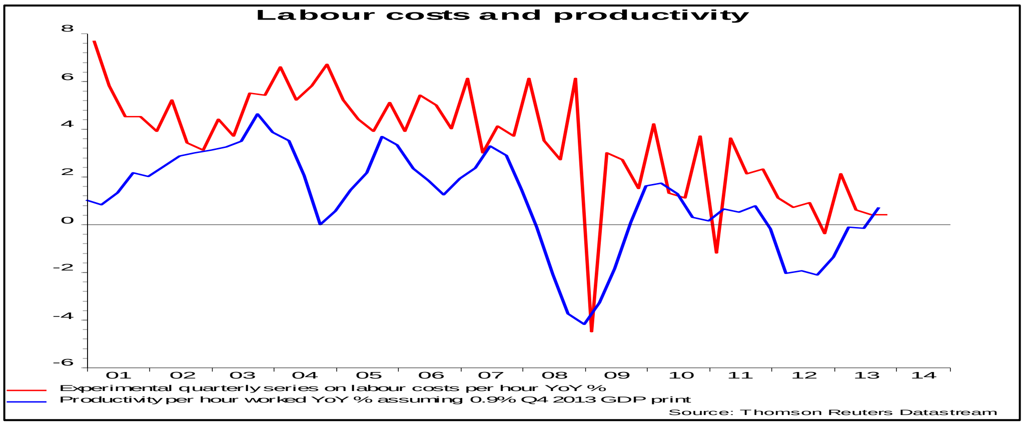
Blanchflower and Bell estimate that after taking account of all desired working (one also needs to adjust for those wishing to work fewer hours, not just those wanting to work more hours), underemployment before the last Labour Market release had been running at almost 200 basis points above the actual unemployment rate. So, actual underemployment was say closer to 9.5%. The important thing here is that prior to the Great Recession there was never much of a difference between unemployment and underemployment. But, that all changed in the downturn. Self-employment has also risen significantly in recent months.

So, we are now in the second phase of the BoE's forward guidance where the focus has more switched to measures of spare capacity in the economy. Moreover, as luck would have it, the BoE nuanced its forward guidance and moved away from the unemployment rate as a potential trigger at just the time when unemployment has risen slightly, from 7.1% to 7.2%. This though is not any reflection of weakness in the economy; it just further underlines the problem in forecasting unemployment, although the ONS' experimental monthly series points to a further fall in the month ahead.

What we know is that the BoE currently believe in general spare capacity in the UK to be around 1-1.5% of GDP (with some differences on the Committee). To be clear, this is not the same as the output gap, which may well be higher. Rather, it a measure of spare capacity more consistent with determining what will happen to inflation in the next 2-3 years (the policy relevant horizon for the BoE), rather than say estimates of the structural budget deficit. At its simplest around half of the spare capacity may be due to unemployment still being above its medium term equilibrium rate, half due to hours worked in general being less than desired, as well as participation.



Moreover, focus on the fact that the MPC now believe that as a central case the economy will grow on average by 3.4% in 2014 (a figure well above consensus) may miss the fact that they appear to be assuming some upward revision to the history. 3.4% GDP growth is then consistent with some slowdown in GDP through the quarters of 2014. This could be key to how quickly spare capacity is eliminated. Even assuming trend growth of only 0.5% a quarter, back of the envelope calculations might suggest 80% of the spare capacity will not be eliminated until Q2 2015. But one must also work on the assumption that spare capacity is not a static variable. In the last 3 months, the BoE has revised down its estimate of the median term equilibrium unemployment rate by up to 50 basis points. Conceivably this will be a trend. But, what we also know is that the MPC will probably be keen to start raising rates before spare capacity is completely eliminated.

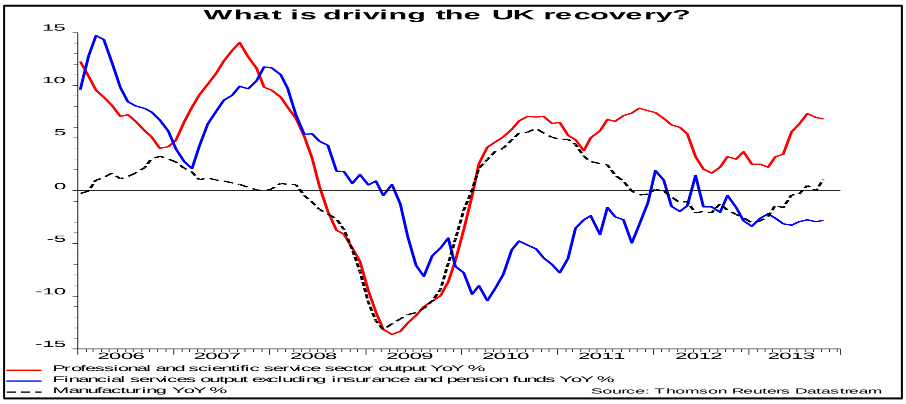


Importantly, assuming the BoE is correct and Q4 2013 GDP is revised up to 0.9%, the ONS' experimental labour costs per hour series suggests that productivity may now be growing faster than unit labour costs. This is an encouraging development, as is the recent acceleration and upward revision to business investment.

Also, unlike the stylized forecasts provided by econometric models recoveries never occur in straight lines. Certainly, growth could disappoint, if only for a period.

At no point now in the next three years do the MPC see as a central case the inflation rate back at target (2%). By the end of the forecast period unemployment is 6.3% (a plausible estimate), but inflation is 1.91%. Clearly, one important swing factor remains productivity as measured by GDP per hour worked (hence the scenario based analysis shown in the Inflation Report). As a central case the MPC now believe that productivity only gets back to its long-term historical average of 2% by 2016.

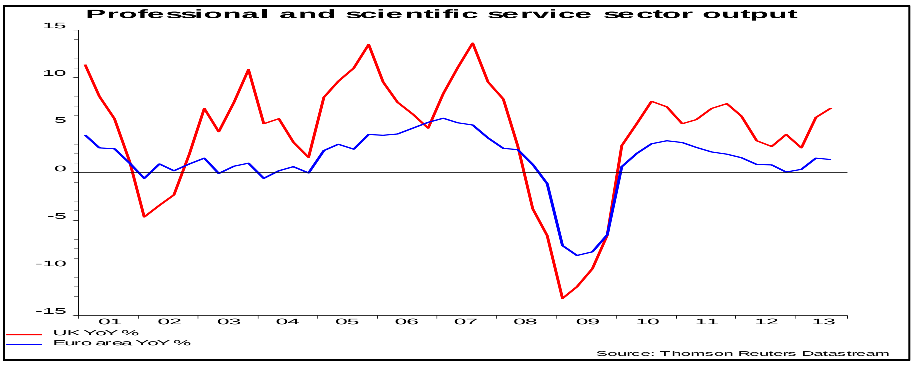
Having flat-lined for so long, UK GDP went on to accelerate and grow by 0.4% in Q1 2013, 0.7% in Q2 , 0.8% in Q3 and 0.7% in Q4. Break this down on the output measure of GDP (there are three different ways of measuring GDP, expenditure, income and output) and the UK recovery has continued to be led by so-called professional, scientific, administration and support (in 2010, 11.5% of all UK services, 8.9% of GDP), up 7.3% in the year to Q4 2013. This catch-all includes law, accountancy, management consultancy, architectural and engineering activities, technical testing and analysis, research and development including the social sciences and humanities, advertising, market and opinion poll research, design, photography and veterinary activities. In other words, relatively high value added business services.



Prior to the crisis, output of professional, scientific, administration and support was highly correlated with financial services excluding insurance and pension funds

(6.5% of UK GDP). In the Great Recession and subsequent initial recovery, output of these business services was much more highly correlated with UK manufacturing (10.4% of GDP). But, since 2011 professional and scientific service sector output et al has continued growing relatively strongly, against the backdrop of a financial sector that has continued to shrink and a manufacturing sector that has struggled to recovery.

Moreover, the UK experience in this area is very different to that of the euro area. This is not just true of the last few quarters, but was very much the case in the years running into the crisis as well.



Mention the need for the UK economy to rebalance post the crisis and most people will probably think of the need for manufacturing to increase its share of overall gross value added. However, arguably some of the relatively high value added business services that have been outperforming could be just as, if not more, important. And, being something the UK would appear to excel in, they are also important for the UK's trade performance, and may be expected to continue growing faster than GDP, as demand for these services grows internationally. Arithmetically, since Q4 2012 they have accounted for around 25% of the pick-up in GDP, an impressive performance for what is still a relatively small part of the economy.

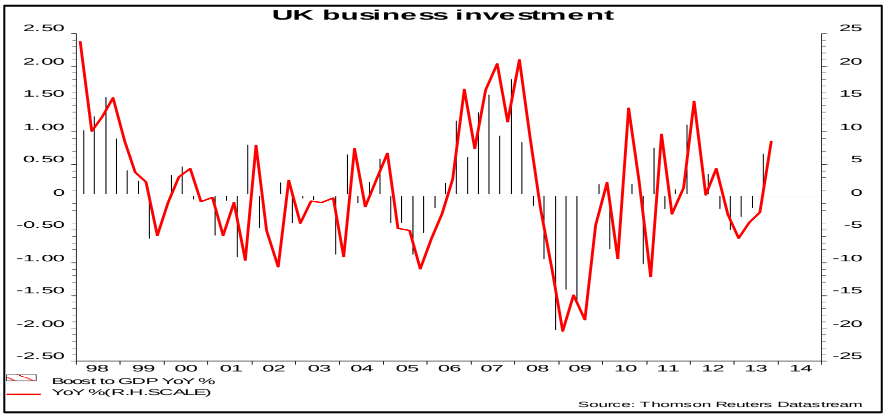
In comparison to the 7.3% rise in output of these business services in the year to Q4, real estate (7.8% of GDP) posted a 2.3% rise (house prices may be rising, but transactions remain relatively depressed). Wholesale and retail trade (8.6% of GDP) though did see a 6.2% rise, consistent with the story of consumption also being a key driver of growth (on the expenditure measure about half of the pick-up in GDP has been down to the consumer).

Concern that fiscal austerity had been the major factor holding back the recovery never quite squared with the fact that consumption had pretty much grown in line with the Office for Budget Responsibility's forecasts. Moreover, to argue that this is only because the saving ratio fell, misses the point that real household disposable incomes have actually been recovering.

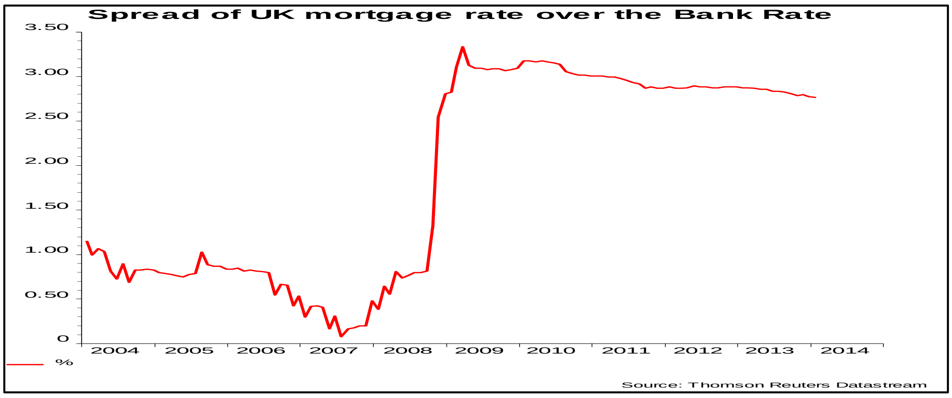
True, the saving ratio fell from 7.8% in Q3 2012 to 5.2% in Q4 2012, before declining to 3.6% in Q1 2013. However, as of Q3 2013 it was back at 5.4%; it is not as if the saving ratio has continued declining to underpin a stronger consumer. At the end of the day, despite the on-going weakness of wage inflation, stronger employment has fed through into the overall wages and salaries bill (with compensation per employee rising by 3.9% in the year to Q4), allowing household disposable incomes to record a 3.6% gain on the year in Q3 (0.3% once one adjusts for consumer price inflation).

If inflation continues to fall, this will further help underpin real household incomes, but it should also be noted that the improvement seen in the labour market is not just the result of private sector employment surprising on the upside. On the latest figures employment in the public sector is no longer declining. It remains to be seen whether this continues, but is counter to what the Office for Budget Responsibility was suggesting in only December.

Importantly, the history of business investment has been revised up with business investment now seen as making a meaningful contribution to GDP growth in the UK. Not only does this imply that the recovery is continuing to grow legs, but if companies are also beginning to substitute capital for labour so productivity may start accelerating as well. This could well start to move the policy debate in the UK on. If inflation then falls to below 1.5% what probability should we attach to the first rate rise being pushed out to 2016?



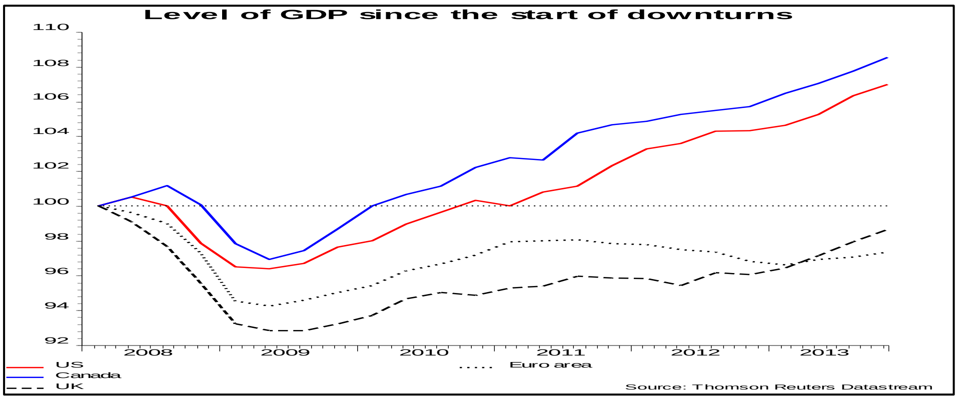
Finally, moving to Phase 3 of forward guidance in the UK, MPC members have been keen to stress that the new normal for the UK Bank Rate is no longer likely to be long-term nominal GDP in the UK (say 4.5%, assuming an inflation rate of 2% and 2.5% real GDP growth). A recent speech by external MPC Member David Miles stressed the point that post-crisis the risk free real interest rate was likely to be lower for a long time (to take account of the greater appreciation of tail-risk) and that the spread say between mortgage rates and the Bank Rate was higher (see chart). So, a 3% or 3.5% Bank Rate could be eventually seen as the new normal. However, as we stress what happens to UK inflation in the next year or so could prove to be the next big surprise, and have a meaningful impact on rate expectations.



In the great scheme of things the Budget does not significantly change the macro picture. The Office for Budget Responsibility (OBR) calculate that what was announced would in isolation amount to an easing of £550m in 2014-15, £560m in 2015-16, but tightenings of £225m in 2016-17, £635m in 2017-18 and £400m in 2018-19. £550m represents just over 0.3% of annual GDP. With perhaps one eye to the election the Chancellor was, despite lower North Sea oil revenues, able to take some advantage of an improving macro picture to unveil some largesse in the coming two fiscal years. But, it is also very important to recognize that fiscal policy is still being tightened, just that the Chancellor was able to throw some sweeteners into the mix, and with pensions and savings, give individuals more flexibility.

Indeed, excluding Royal Mail and APF transfers the OBR are looking for the cyclically adjusted primary balance (excluding debt service payments) to decline by 0.6 percentage points of GDP in 2014-15, 1.3 percentage points of GDP in 2015-16, 1.6 percentage points of GDP in 2016-17, 1.3 percentage points of GDP in 2017-18 and 0.9 percentage point of GDP in 2018-19. One can take issue with the degree to which fiscal policy will be tightened, but the general trend is clear. The plan is to tighten fiscal policy well beyond the life of this Parliament, and perhaps hope a stronger economy will enable the budget to improve faster than forecast. The coalition will also be hoping that the Chancellor will be able to offer more sweeteners in the Budget next March, two months ahead of the General Election.

In terms of the MPC's decision we see little reason to change our long held view that the first rate rise will occur in the second half of 2015, which just so happens to be after the next General Election. Even if inflation falls more than people are thinking the MPC's time horizon is 2-3 years, not the last release. However, if inflation does approach 1% it will take some pressure off the MPC to raise rates in the interim. Objectively, forward guidance in the US now looks similar to that in the UK. Moreover, the timing of rate rises looks similar, although given where we are in their respective economic cycles, it would seem sensible to assume that the US raise rates before the UK.



GLOBAL FIXED INCOME

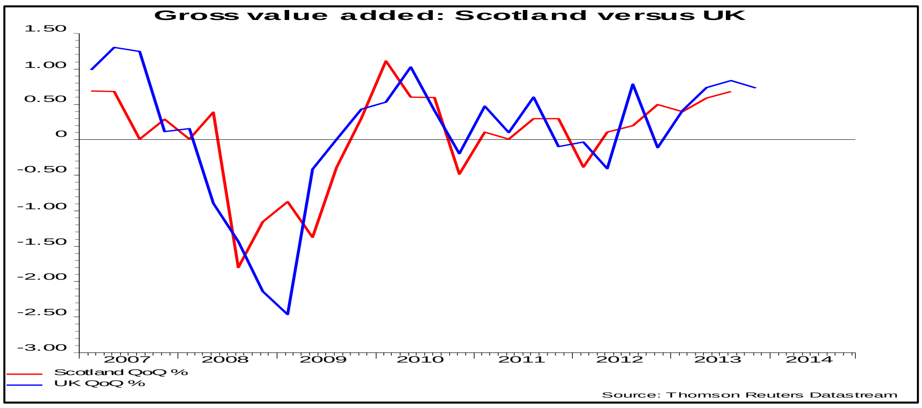
Scottish referendum should be more of a focus

One of our themes for 2014 was that the Scottish referendum when they decide on independence (18 September) should become more of a focus, given all the associated uncertainties associated with potential currency arrangements, along with suggestions that the Scots might not take on a "fair" share of the obligations. EMU membership is no longer an attractive option and there are question-marks about whether an independent Scotland would even be successful in applying to join the EU. Westminster, HMT and the BoE have effectively ruled out a currency union with the rest of the UK, and arguably for a currency board where the Scottish pound was pegged to sterling to work successful would require substantially more currency reserves (say 2 times Scottish GDP), a much smaller financial sector and Scotland's public finances to be in much better shape.

Anecdotally, there appears to be a widespread view that the Scottish referendum is pretty much a done deal, that the Scots will vote in favor to remain within the union. However, as the political analyst John Curtice has highlighted on his blog, once the Don't Knows are excluded from the latest ICM poll the Yes vote has seen a two point increase to 45%, compared to 40% last September. Moreover, despite all the attempts by Westminster, the Treasury and the BoE to raise awareness of the economic risks that a Yes vote might entail, according to ICM those thinking separation would be a good thing for the economy has risen to 38%. This is up from 35% in February and 31% last September. The five point gap with the 43% who now think a Yes vote would be bad for the economy is the lowest on record, down from 11 per cent last month and 17% last September. Based on this, the referendum could prove a lot closer than many think.

When we looked at the Scottish referendum last year "*Scottish independence: Straw man or something to worry about?*" dated 2 December, one of our conclusions was that interest rates in an independent Scotland would very likely be higher than the rest of the UK. This is before considering possible currency options and whether at the end of the day an independent Scotland took on its "fair" share of obligations.

Detailed GDP figures suggest that Scottish GDP effectively grew at the same rate as the UK as a whole in Q3 2013 (0.7% as opposed to 0.8% for the UK), but that a key driver was financial and insurance activities (9.3% of GDP as opposed to 9.5% for the UK). This rose by 3.7% on the quarter, (or by 4.8% on the year), and so arithmetically provided half the growth of the Scottish economy during the third quarter. Financial and insurance activities grew by a much more modest 0.5% for the UK as a whole, and was down 1.8% on year. So, the one sector arguably most likely to partly migrate south in the event of separation in Scotland, financial and insurance activities, (in contrast to the rest of the UK) is currently a significant driver of its growth.



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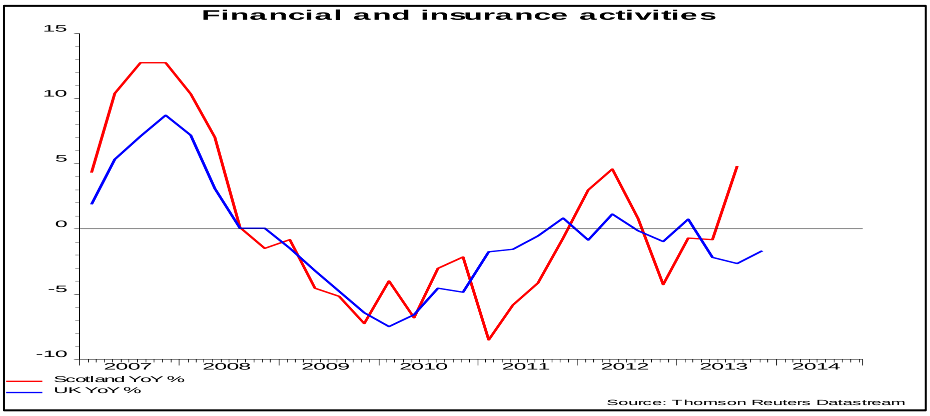
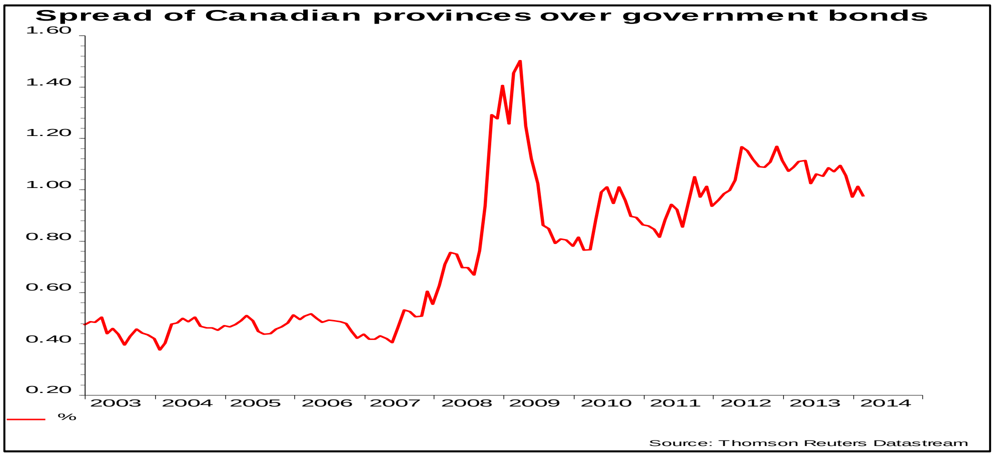


Another recent development was the announcement that oil revenues were less than previously estimated. So, including a geographical share of North Sea revenue Scotland's budget deficit was previously estimated at 2.6% of GDP in 2008-09, 10.7% of GDP in 2009-10, 8.1% of GDP in 2010-11 and 5% of GDP in 2011-12. These figures are now put at 2.9%, 10.7%, 8.5% and 5.8%, respectively, such that the deficit in 2011-12 was 0.8 percentage points of GDP higher than previously estimated. More importantly, the figure for 2012-13 was put at 8.3% of GDP (14% of GDP excluding North Sea revenue and 13.3% with a per capita share of North Sea revenue), representing a distinct deterioration from the year before.

Excluding North Sea revenue, and Scotland government's revenues rose from £46.3bn in 2011-12 to £47.6bn in 2012-13. But, include North Sea revenues as a geographical share and Scotland government's revenues fell from £56.3bn to £53.1bn, a £3.2bn deterioration. Hence, the deterioration in Scotland's overall budget position. If nothing else, this will further reinforce the view that Scotland's fiscal position is highly dependent on the oil price, as well as oil production, and that the starting point is an underlying large budget deficit, excluding oil.

As we highlighted in December, interest rates in an independent Scotland are very likely to be higher. As we argued then, taking Canada again as the template, we would be looking for Scottish bond yields to trade at least 100 basis points over the equivalent Gilt yield. And, that is in long-run equilibrium, after issues surrounding what currency arrangement they will adopt has been cleared up, along with issues of lender of last resort for their very large banking sector. If the Scots choose not to take on their 'fair' share of the obligations rates could be a lot higher.



Jefferies GDP Forecasts

Euro area													
	2012	**2013**	**2014**	**2015**	**2016**								
Year on Year	-0.6	-0.4	1.3	1.6	1.6								
	Q4 2012	**Q1 2013**	**Q2 2013**	**Q3 2013**	**Q4 2013**	**Q1 2014**	**Q2 2014**	**Q3 2014**	**Q4 2014**	**Q1 2015**	**Q2 2015**	**Q3 2015**	**Q4 2015**
Quarter on Quarter	-0.5	-0.2	0.3	0.1	0.3	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Germany	**2012**	**2013**	**2014**	**2015**	**2016**								
Year on Year	0.9	0.5	1.9	2.0	2.2								
	Q4 2012	**Q1 2013**	**Q2 2013**	**Q3 2013**	**Q4 2013**	**Q1 2014**	**Q2 2014**	**Q3 2014**	**Q4 2014**	**Q1 2015**	**Q2 2015**	**Q3 2015**	**Q4 2015**
Quarter on Quarter	-0.5	0.0	0.7	0.3	0.4	0.6	0.5	0.4	0.4	0.5	0.5	0.6	0.6
France	**2012**	**2013**	**2014**	**2015**	**2016**								
Year on Year	0.0	0.3	1.1	1.5	1.9								
	Q4 2012	**Q1 2013**	**Q2 2013**	**Q3 2013**	**Q4 2013**	**Q1 2014**	**Q2 2014**	**Q3 2014**	**Q4 2014**	**Q1 2015**	**Q2 2015**	**Q3 2015**	**Q4 2015**
Quarter on Quarter	-0.2	-0.1	0.6	0.0	0.3	0.2	0.3	0.4	0.4	0.4	0.3	0.3	0.5
Italy	**2012**	**2013**	**2014**	**2015**	**2016**								
Year on Year	-2.4	-1.8	0.6	1.2	1.6								
	Q4 2012	**Q1 2013**	**Q2 2013**	**Q3 2013**	**Q4 2013**	**Q1 2014**	**Q2 2014**	**Q3 2014**	**Q4 2014**	**Q1 2015**	**Q2 2015**	**Q3 2015**	**Q4 2015**
Quarter on Quarter	-0.9	-0.6	-0.3	-0.1	0.1	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.4
Spain	**2012**	**2013**	**2014**	**2015**	**2016**								
Year on Year	-1.6	-1.2	1.1	1.5	1.7								
	Q4 2012	**Q1 2013**	**Q2 2013**	**Q3 2013**	**Q4 2013**	**Q1 2014**	**Q2 2014**	**Q3 2014**	**Q4 2014**	**Q1 2015**	**Q2 2015**	**Q3 2015**	**Q4 2015**
Quarter on Quarter	-0.8	-0.3	-0.1	0.1	0.2	0.4	0.4	0.4	0.4	0.3	0.3	0.5	0.5
Netherlands	**2012**	**2013**	**2014**	**2015**	**2016**								
Year on Year	-1.3	-0.8	1.4	1.2	1.5								
	Q4 2012	**Q1 2013**	**Q2 2013**	**Q3 2013**	**Q4 2013**	**Q1 2014**	**Q2 2014**	**Q3 2014**	**Q4 2014**	**Q1 2015**	**Q2 2015**	**Q3 2015**	**Q4 2015**
Quarter on Quarter	-0.7	-0.3	0.1	0.3	0.7	0.2	0.3	0.4	0.2	0.3	0.3	0.3	0.4
UK	**2012**	**2013**	**2014**	**2015**	**2016**								
Year on Year	0.3	1.8	2.9	2.7	2.3								
	Q4 2012	**Q1 2013**	**Q2 2013**	**Q3 2013**	**Q4 2013**	**Q1 2014**	**Q2 2014**	**Q3 2014**	**Q4 2014**	**Q1 2015**	**Q2 2015**	**Q3 2015**	**Q4 2015**
Quarter on Quarter	-0.1	0.4	0.7	0.8	0.7	0.6	0.7	0.8	0.8	0.6	0.6	0.6	0.6

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