

European Outlook

Huw Pill

Chief European Economist

Huw.Pill@gs.com

+44 20 7774 8736

Goldman Sachs International

April 2014

Global recovery remains intact ...

<i>GDP Growth, %yoy</i>	2012	2013	2014		2015	
			GS	Consensus*	GS	Consensus*
USA	2.8	1.9	2.8	2.8	3.2	3.1
Japan	1.4	1.5	1.0	1.4	1.3	1.3
Euro Area	-0.6	-0.4	1.2	1.1	1.5	1.4
UK	0.3	1.8	2.9	2.7	2.7	2.5
Brazil	1.0	2.3	2.4	1.8	2.9	2.1
China	7.7	7.7	7.3	7.4	7.6	7.3
India	4.6	4.7	5.2	4.7	6.2	5.4
Russia	3.4	1.5	1.0	1.3	3.0	2.1
<i>BRICs</i>	5.4	5.3	4.9	4.9	5.7	5.3
<i>Advanced Economies</i>	1.4	1.3	2.2	2.2	2.5	2.4
<i>World</i>	3.1	2.9	3.4	3.3	3.9	3.7

Source: Consensus Economics, Goldman Sachs Global Investment Research

Note: * Consensus forecasts refer to February 2014

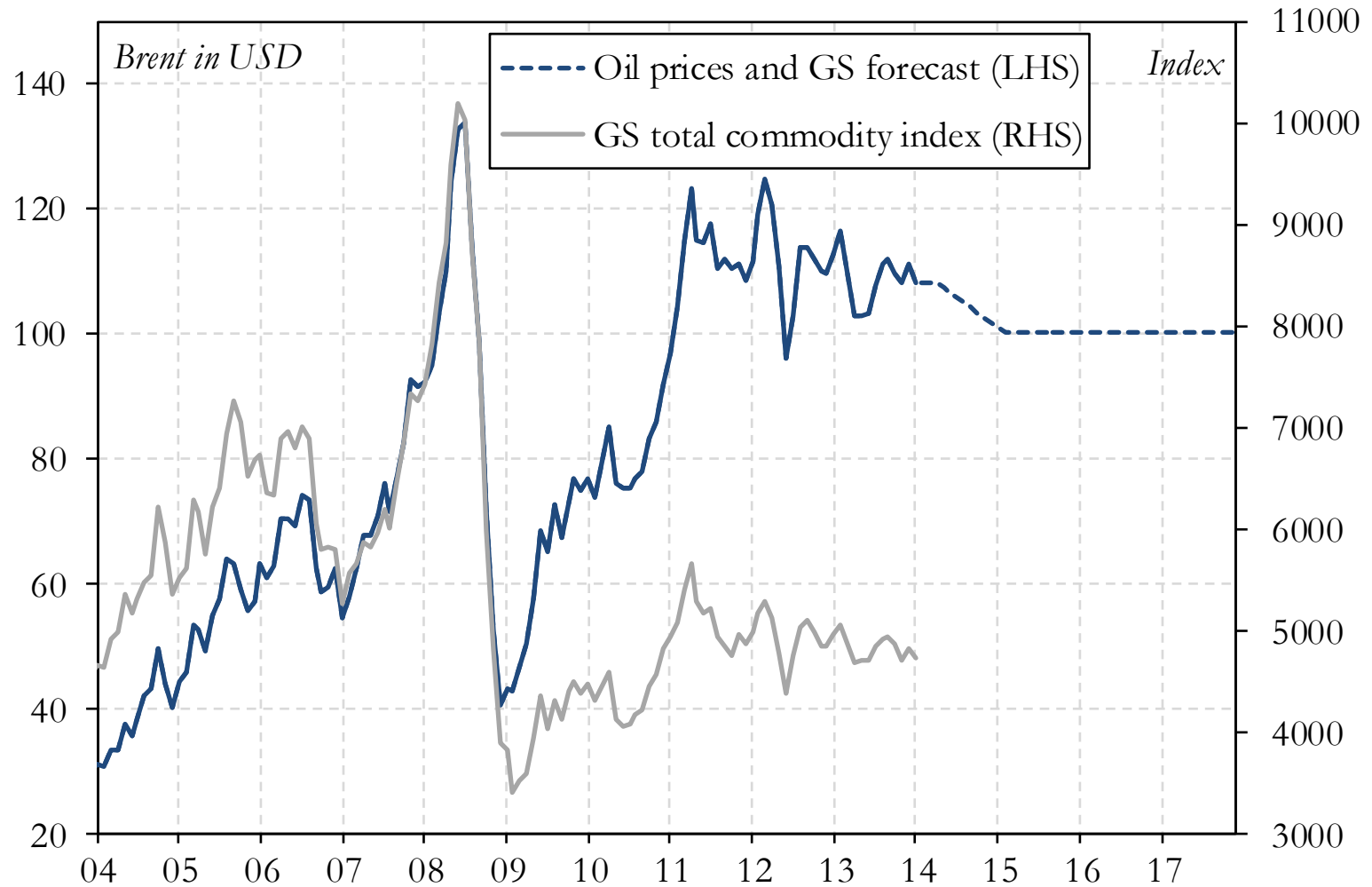
The baseline outlook for global inflation appears benign, given the extent of slack ...

<i>Inflation, %yoy</i>	2012	2013	2014		2015	
			GS	Consensus*	GS	Consensus*
USA	2.1	1.5	1.6	1.7	1.9	2.0
Japan	0.0	0.4	2.6	2.6	1.7	1.7
Euro Area	2.5	1.4	0.9	0.9	1.5	1.3
UK	2.8	2.6	1.7	2.0	1.7	2.2
Brazil	5.4	6.2	6.0	6.0	5.8	5.6
China	2.7	2.6	2.6	2.9	3.0	3.2
India	7.5	6.3	6.5	6.1	6.1	5.9
Russia	5.1	6.6	5.8	5.8	4.2	5.1
<i>BRICs</i>	4.7	4.8	5.8	5.5	5.2	5.0
<i>Advanced Economies</i>	2.0	1.4	1.5	1.6	1.8	1.8
<i>World</i>	3.2	2.8	3.4	3.3	3.3	3.2

Source: Consensus Economics, Goldman Sachs Global Investment Research

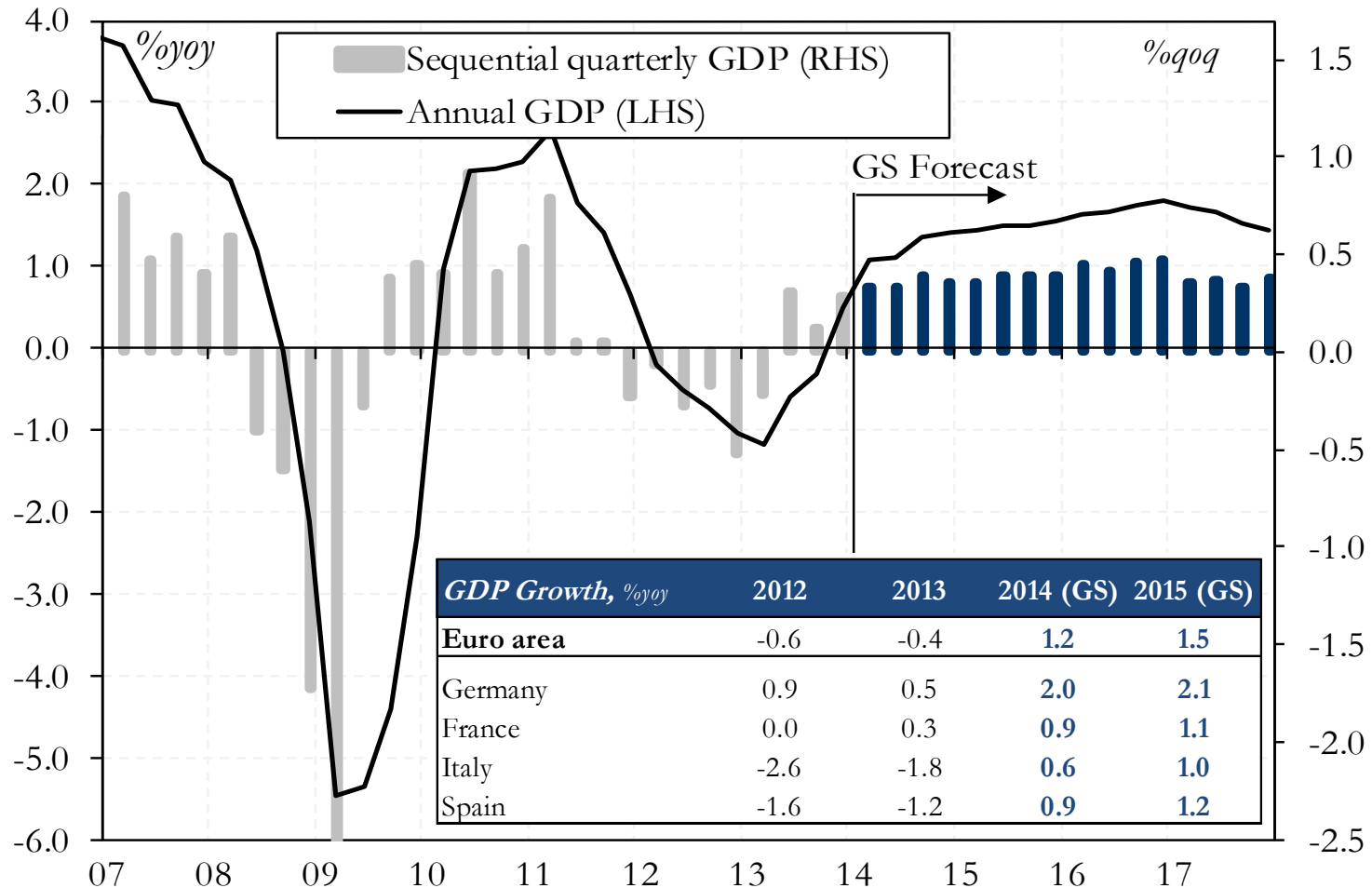
Note: * Consensus forecasts refer to February 2014

... and our expectation that oil and commodity prices will fall from here



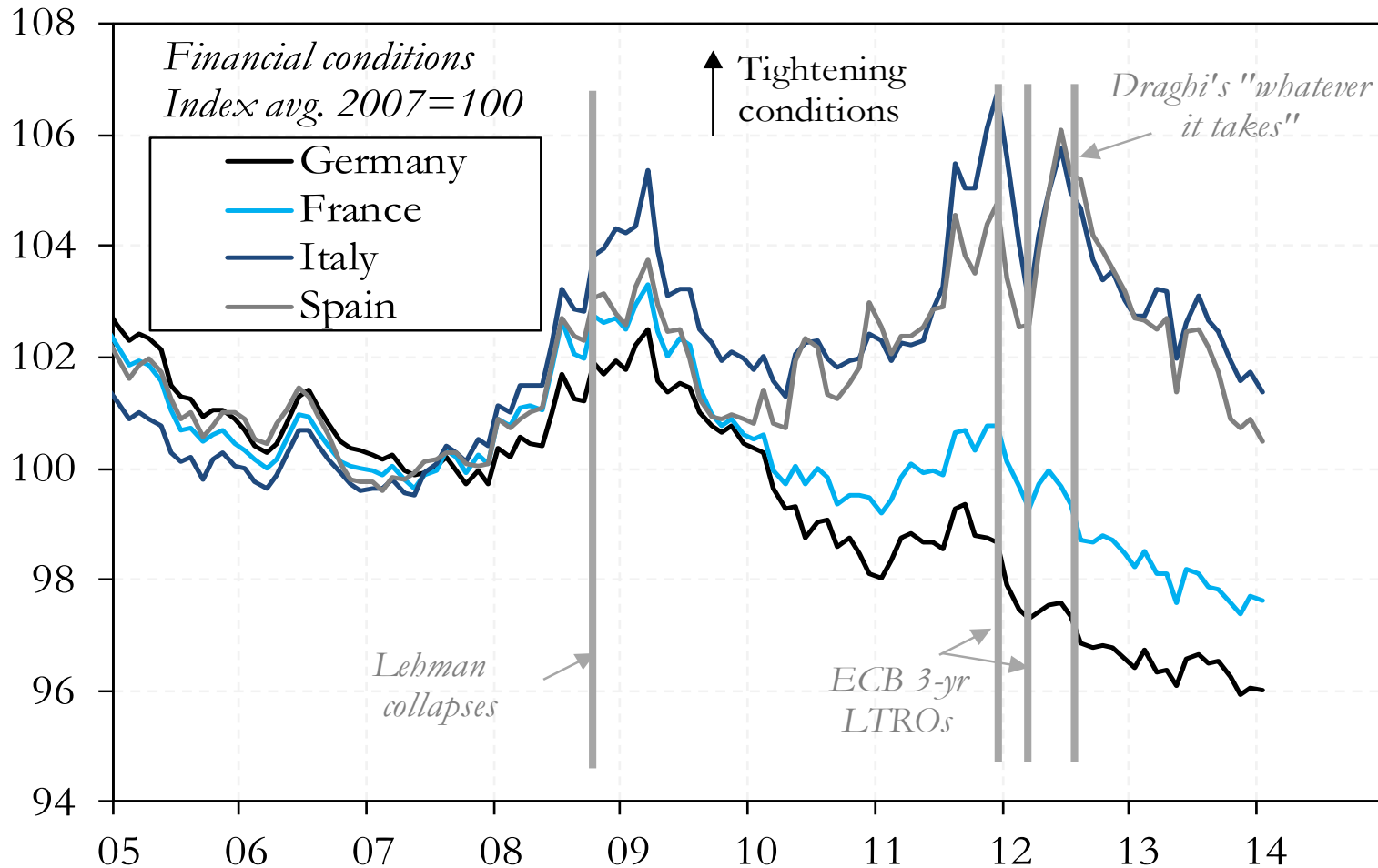
Source: Datastream, Goldman Sachs Global Investment Research

We expect a below-trend recovery for Euro area economic activity ...



Source: Eurostat, Goldman Sachs Global Investment Research

... as financial conditions improve, despite remaining cross-country differences ...

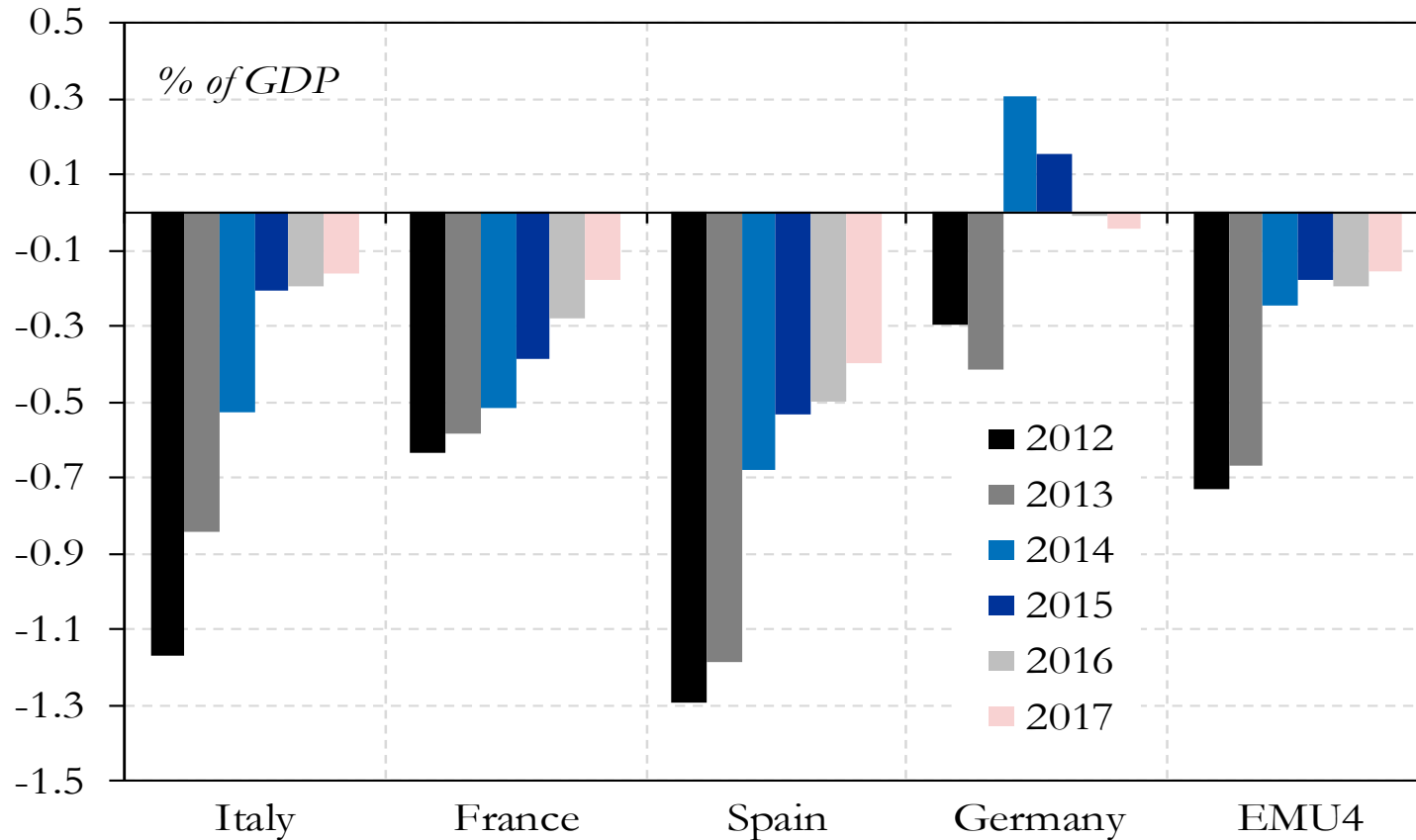


^^ average of Italy and Spain

The index includes four variables: real 3-month interest rates, real long-term interest rates, real trade-weighted value of the exchange rate and equity market performances

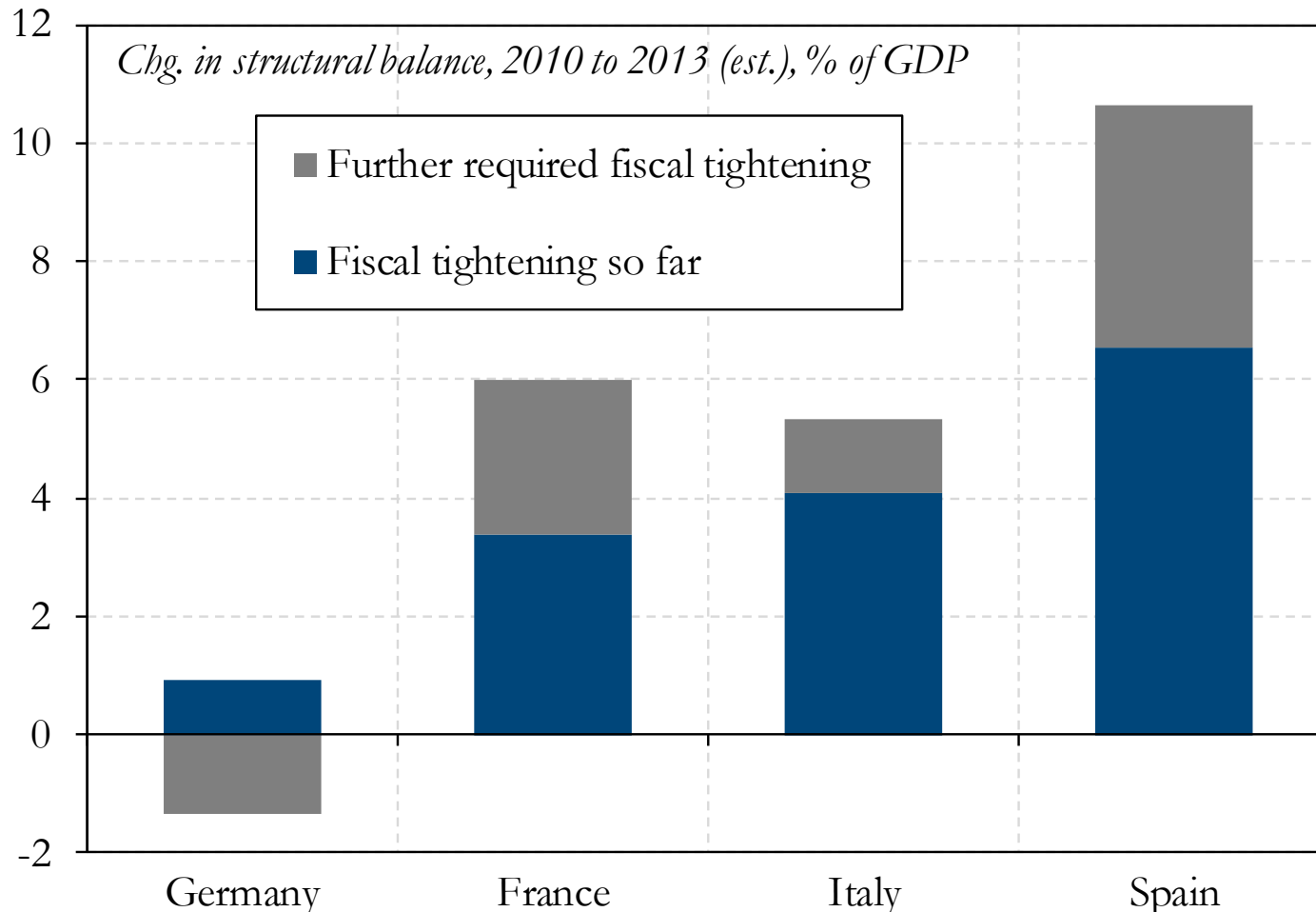
Source: Goldman Sachs Global Investment Research, ECB

... and the fiscal drag on growth diminishes as the pace of austerity eases ...



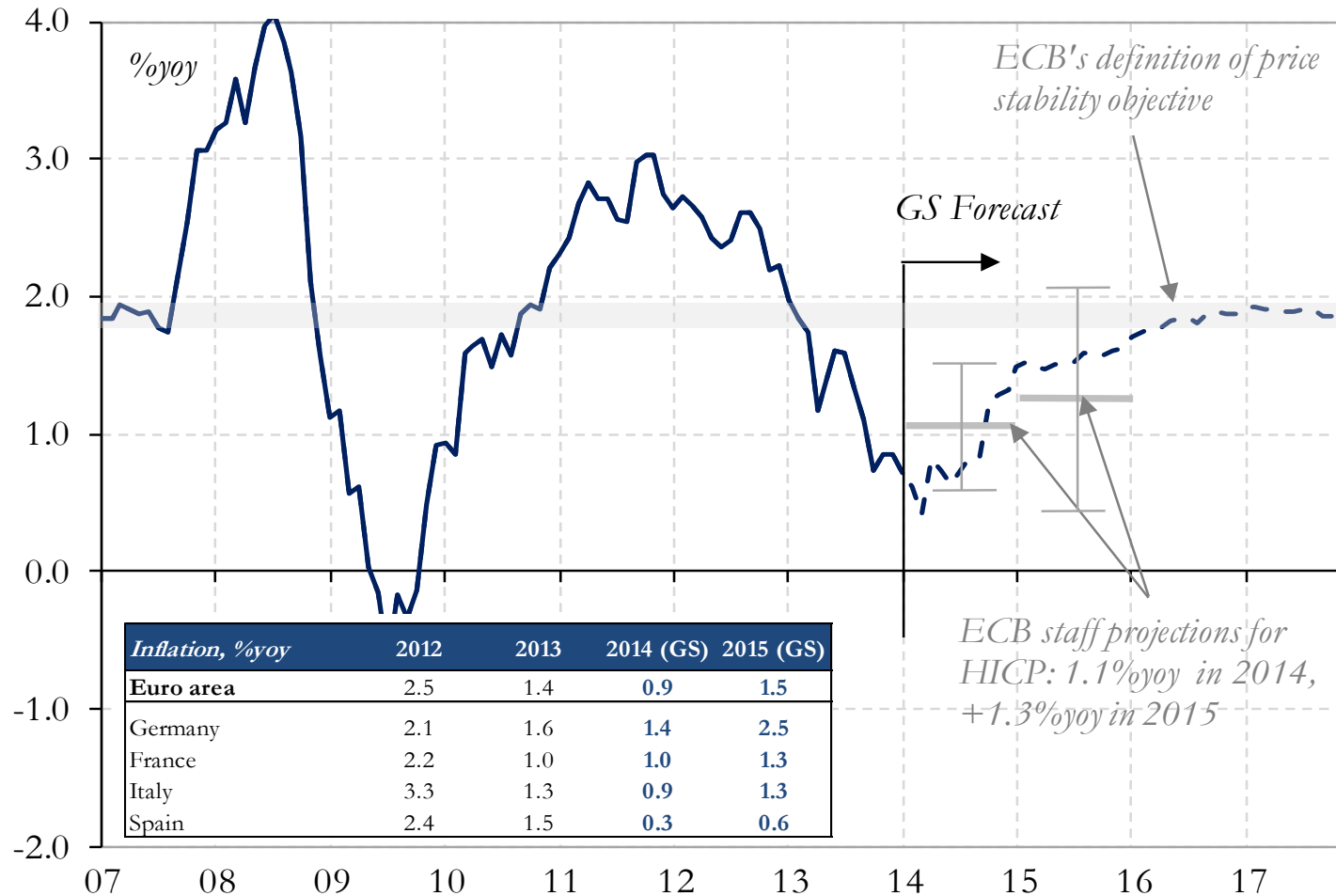
Source: Goldman Sachs Global Investment Research

... despite a significant need for further fiscal consolidation in several countries



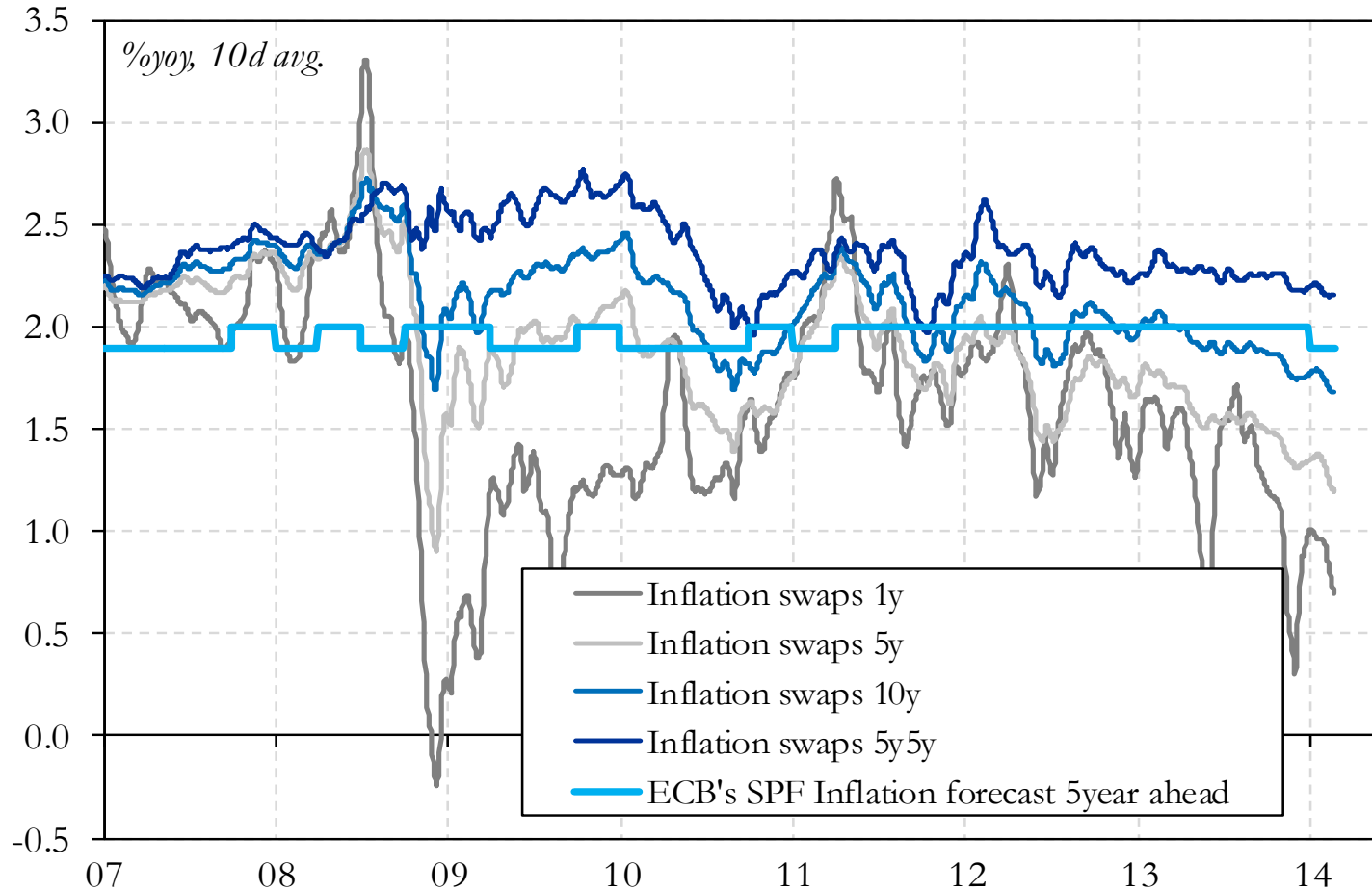
Required improvement in structural budget balance to reach a level of debt-to-GDP of 60% over a 20 year period, starting from projected debt peaks.
 Source: Goldman Sachs Global Investment Research, ECB

Deflationary pressures are in focus, but remain modest at the area-wide level over medium term ...



Source: Eurostat, Goldman Sachs Global Investment Research

ECB drawing comfort from anchoring of medium- to long-term inflation expectations



Source: Eurostat, Goldman Sachs Global Investment Research

Banking systems in the periphery are being 'red-lined' as Euro markets segment

Pre-Lehman, Euro interbank markets were highly integrated
 (cross-border bank claims as a percentage of lending country quarterly GDP, 2008Q1)

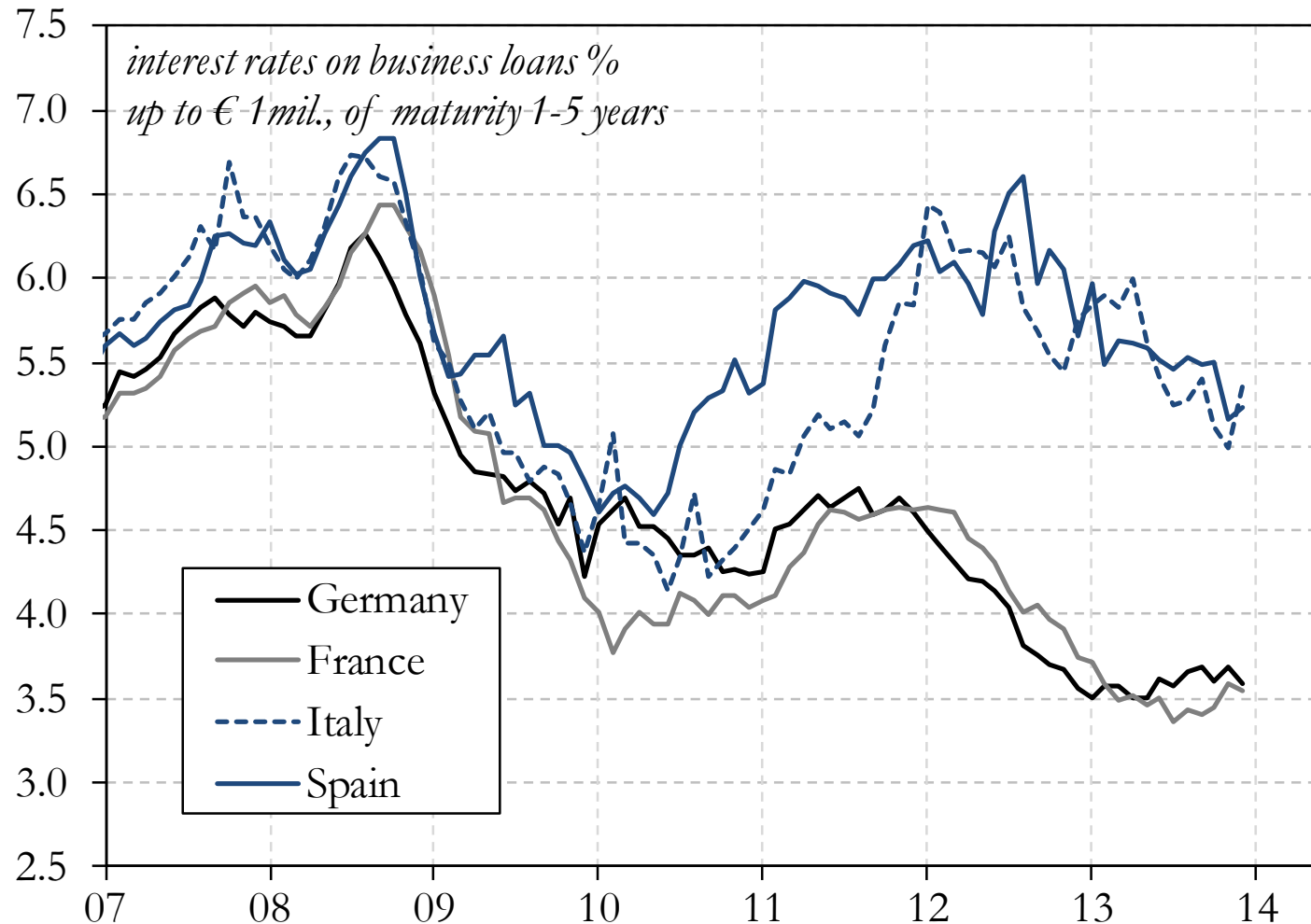
	Lending to							
	GER	NETH	FRA	ITA	SPA	POR	IRE	GRE
GER		19.5	27.9	28.9	33.8	5.4	24.6	4.8
NETH	93.6		85.7	70.2	57.7	7.2	22.0	9.8
FRA	40.3	22.1		74.9	30.2	4.8	13.6	10.4
ITA	72.3	6.3	11.6		5.4	1.4	5.6	1.5
SPA	14.0	15.7	15.5	11.1		20.7	5.7	0.3
POR	11.5	7.9	9.8	8.3	49.5		9.5	11.2
IRE	78.0	29.6	44.3	80.2	54.4	7.5		14.7
GRE	2.0	1.2	1.8	0.5	0.2	0.1	0.5	

With the financial crisis, segmentation has emerged
 (cross-border bank claims as a percentage of lending country quarterly GDP, 2013Q1)

	Lending to							
	GER	NETH	FRA	ITA	SPA	POR	IRE	GRE
GER		17.3	21.6	14.1	14.0	2.4	8.8	2.8
NETH	95.5		41.4	16.5	26.2	2.2	7.4	1.2
FRA	28.0	22.7		49.5	14.9	2.4	5.6	0.5
ITA	45.8	3.5	7.9		3.8	0.3	2.0	0.2
SPA	16.6	5.9	10.6	8.0		20.6	1.7	0.2
POR	2.4	16.0	10.6	6.3	42.4		13.3	12.7
IRE	2.6	3.6	8.9	1.3	5.9	0.7		0.2
GRE	4.7	1.2	2.1	0.7	0.5	0.0	0.8	

Source: BIS, Goldman Sachs Global Investment Research

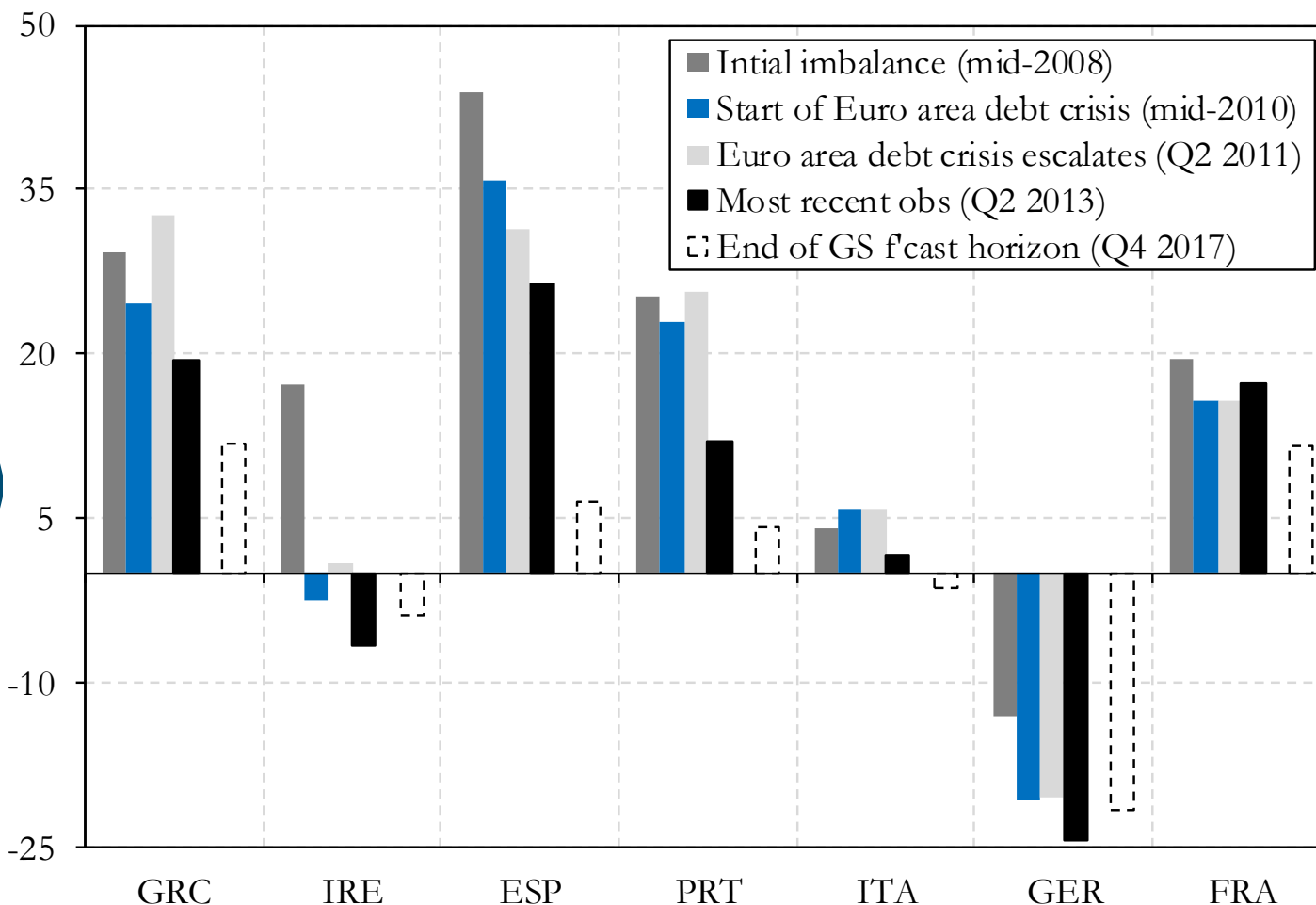
Prima facie, the 'monetary pillar' points to downside risks to price stability ...



Source: ECB

Absent significant restructuring, required internal devaluation is large ...

Required real exchange rate adjustment sizable within the Euro area*

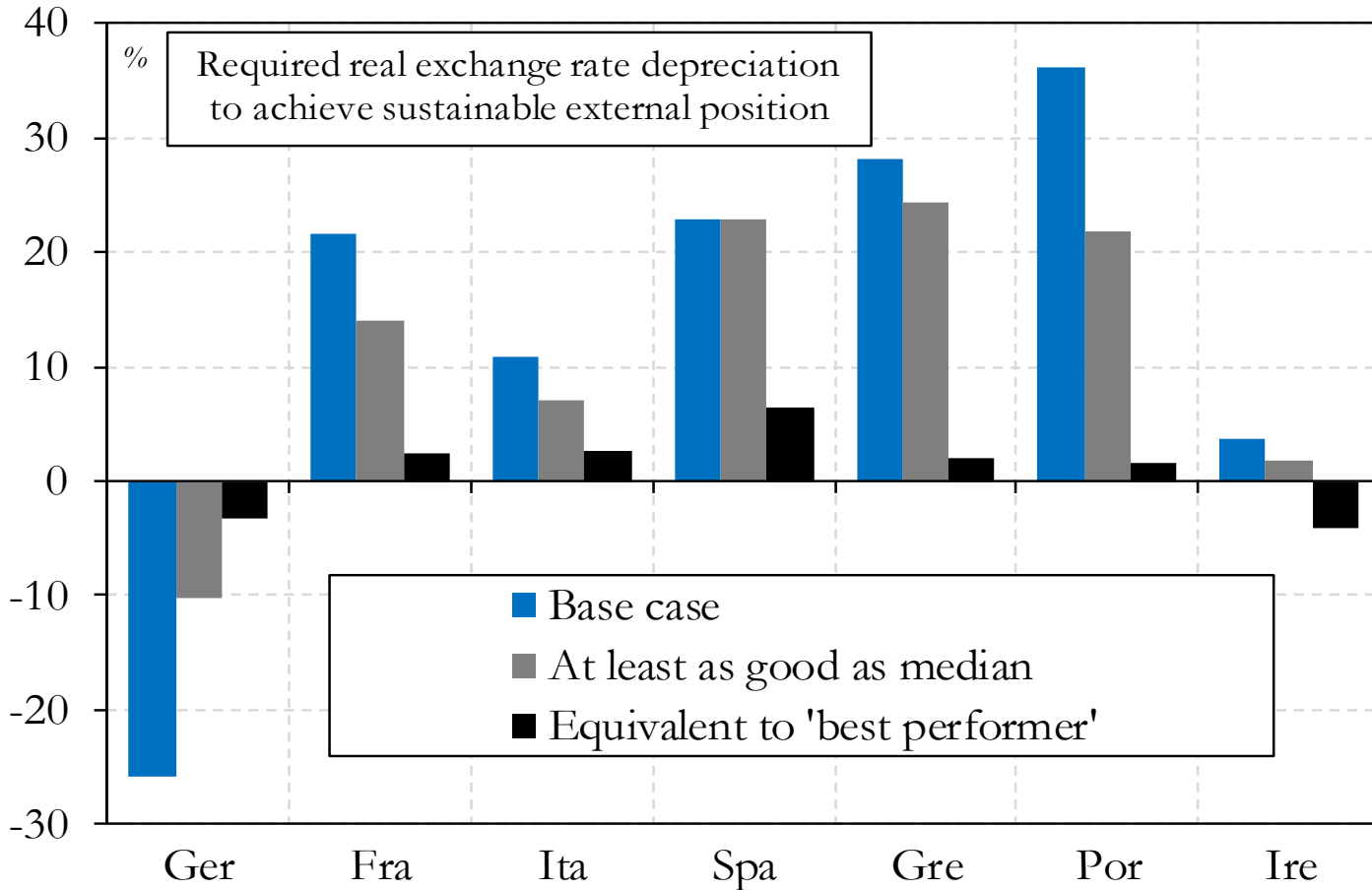


macro model
assuming no structural change and economies at potential

NIIP : Net International Investment Position: external financial assets minus liabilities

Source: Eurostat, Goldman Sachs Global Investment Research

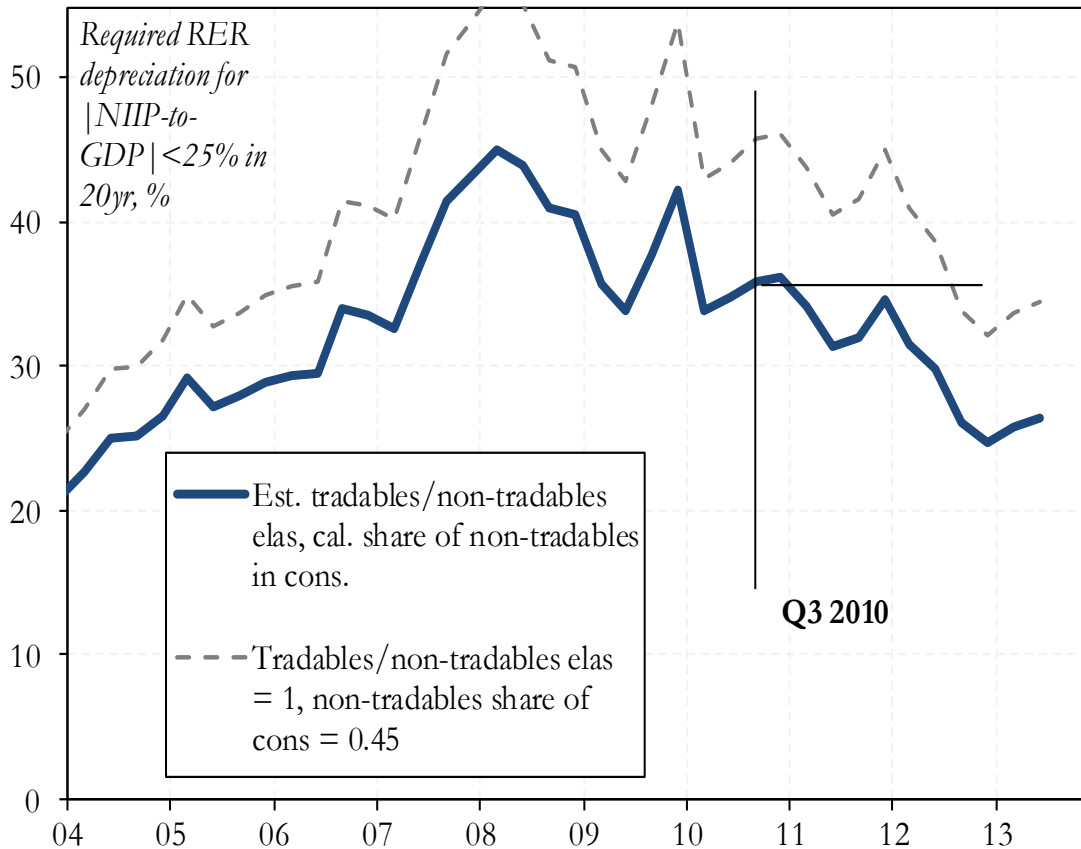
... although this can be significantly reduced by well-designed structural change



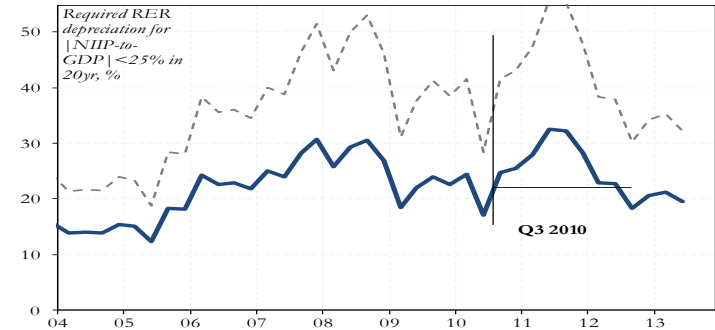
Source: Eurostat, Goldman Sachs Global Investment Research

Significant progress is being made in (some parts of) the periphery ...

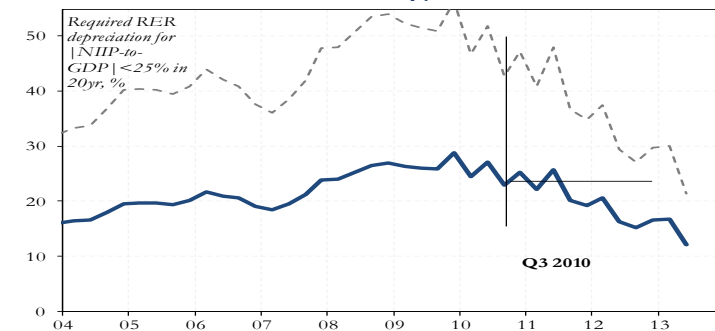
Spain



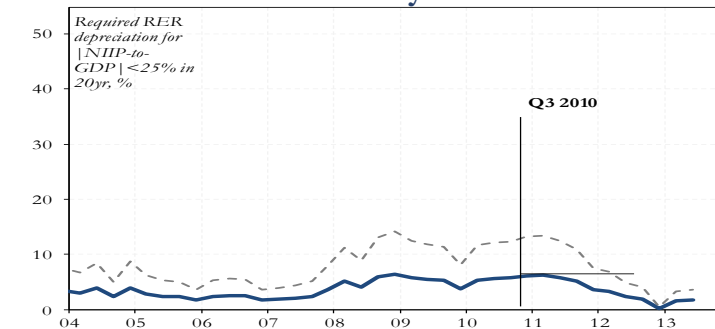
Greece



Portugal

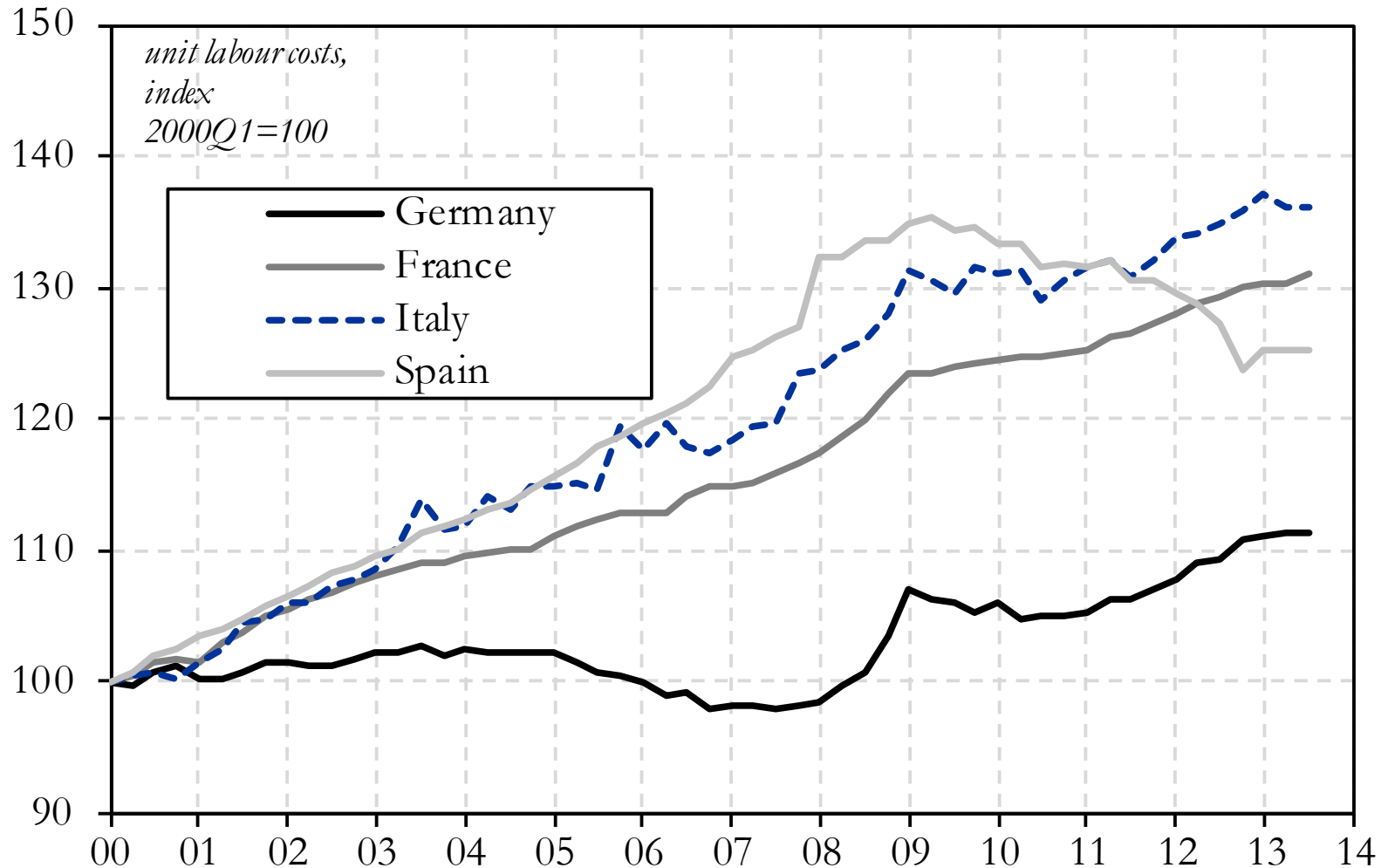


Italy



Source: Goldman Sachs Global Investment Research

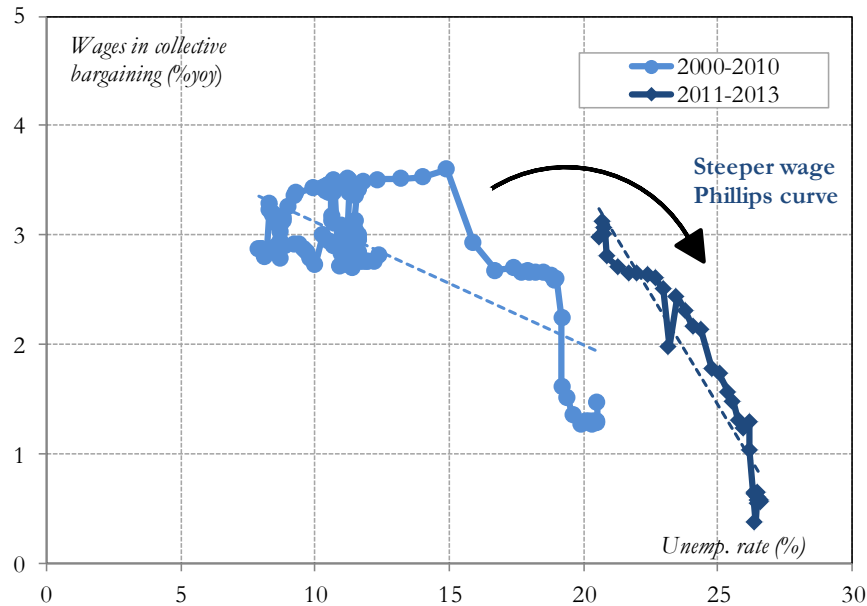
... in part as a result of changes in economic structure, although cyclical effects important



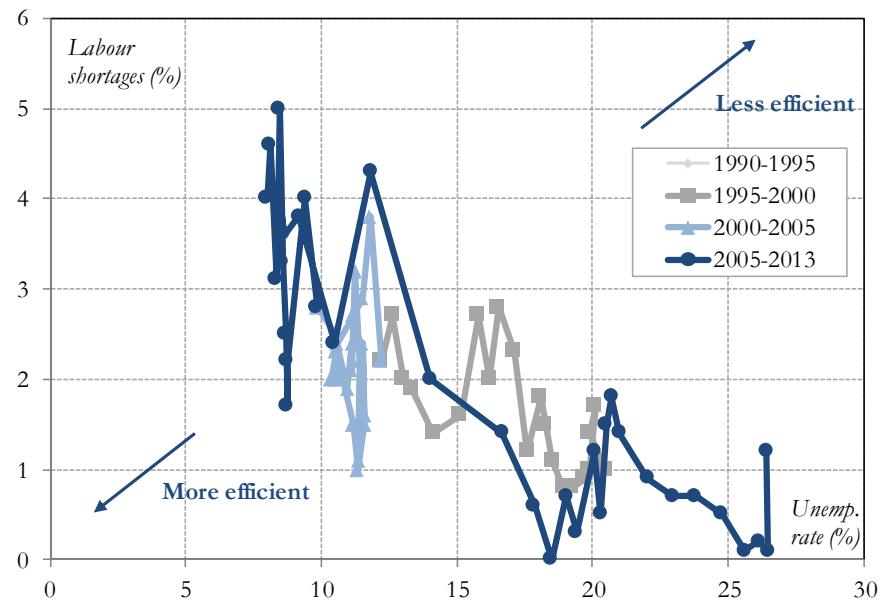
Source: Markit, Ministerio de Vivienda, Statistisches Bundesamt, Eurostat, Goldman Sachs Global Investment Research

Spain's labour market reform is 'best in class' – unemployment more effective in moderating pay

Wage Phillips curve has steepened – especially since the 2012 labour market reform



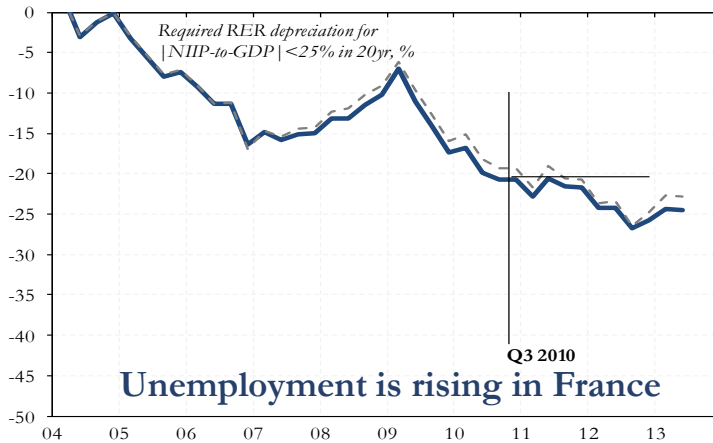
Beveridge curve shows high structural unemployment and mismatch may have risen



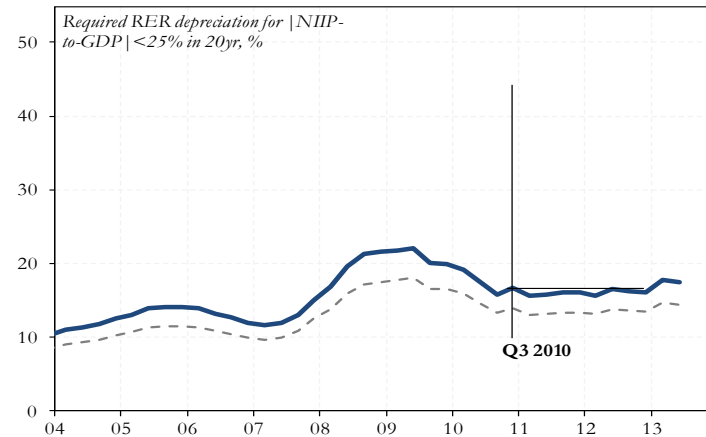
Source: Eurostat, EC, Ministerio de Trabajo e Inmigración, Goldman Sachs Global Investment Research

Germany and France will become focus of intra-Euro area adjustment

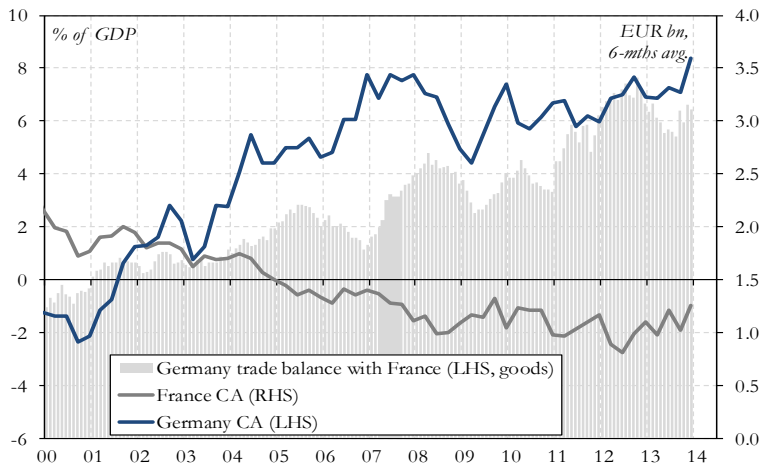
Germany



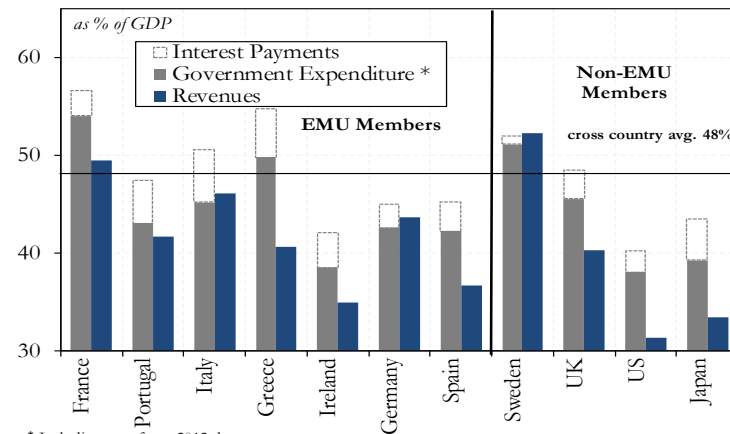
France



Germany's current account is high



The French public sector is large

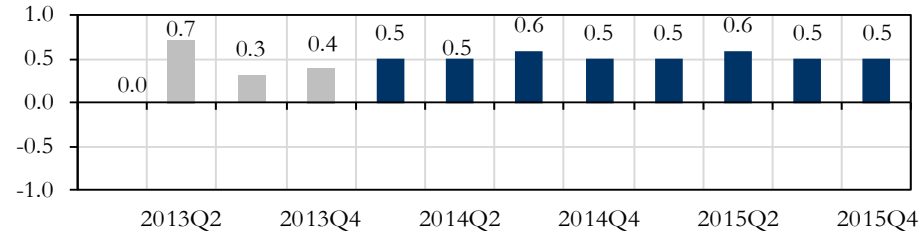


* Including transfers, 2012 data

Continued divergence across countries: Germany outperforms, periphery weak

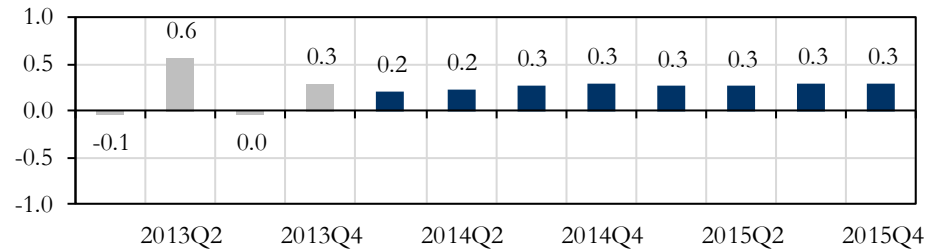
Germany

GDP growth, % qoq



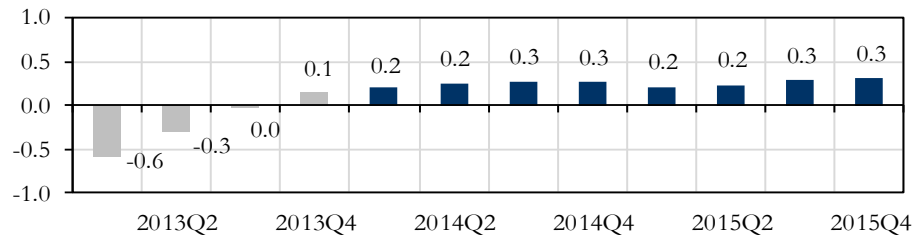
France

GDP growth, % qoq



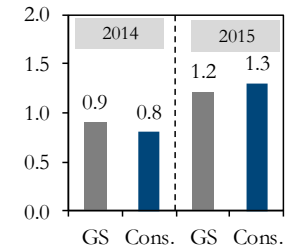
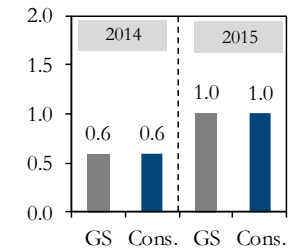
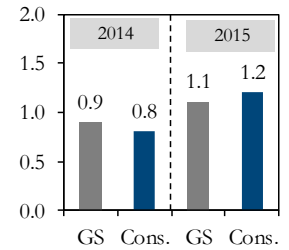
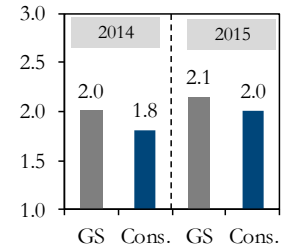
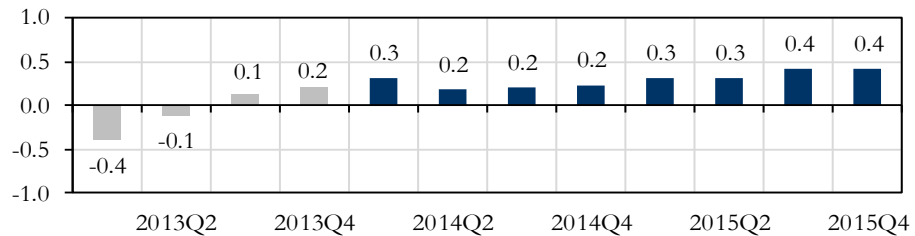
Italy

GDP growth, % qoq



Spain

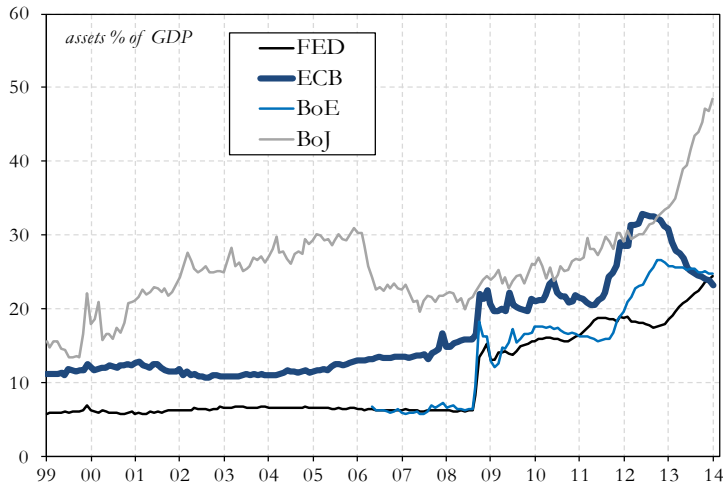
GDP growth, % qoq



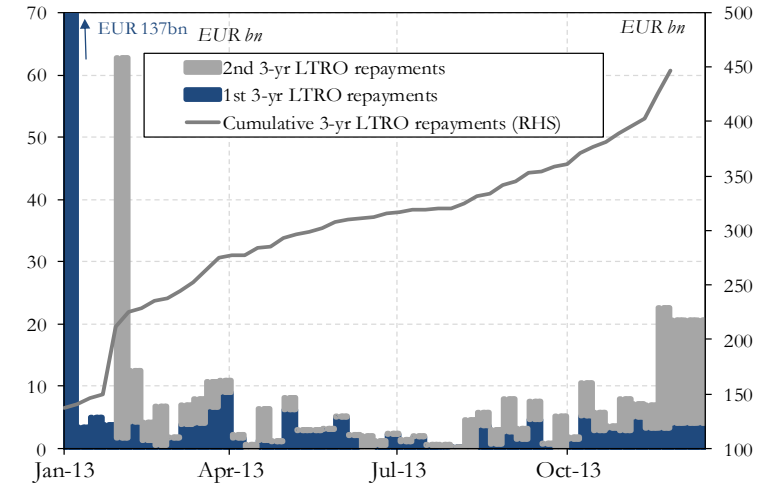
Source: Eurostat, Goldman Sachs Global Investment Research

ECB's balance sheet is shrinking and less excess liquidity puts pressure on EONIA

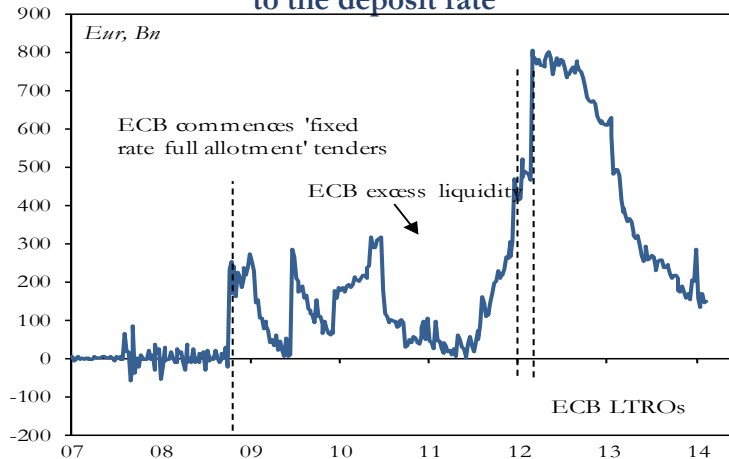
The size of ECB balance sheet is diminishing...



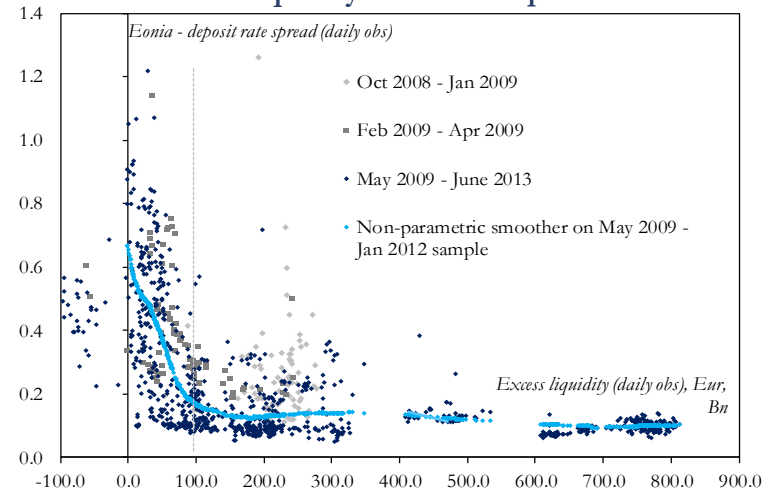
...as LTRO repayments take place



With excess reserves over €100bn, EONIA remains close to the deposit rate



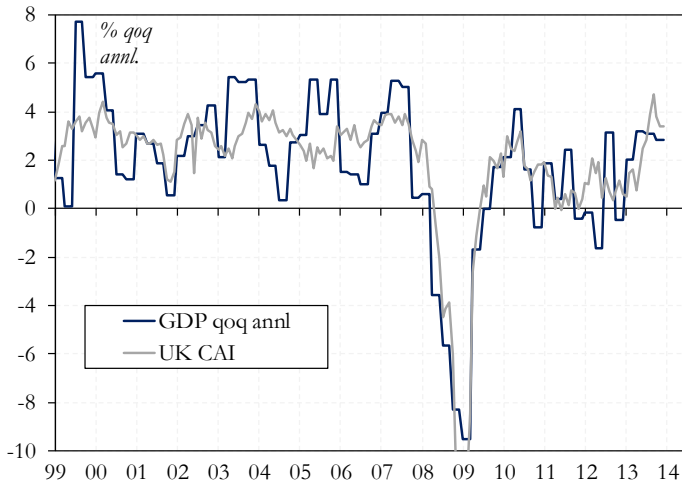
While the EONIA is rising owing to LTRO repayments, liquidity remains ample



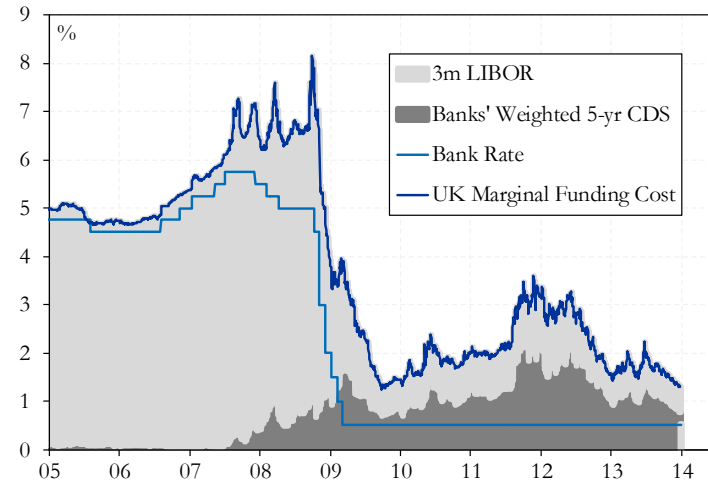
Source: ECB, Goldman Sachs Global Investment Research

UK overview – stronger growth, but puzzling productivity developments

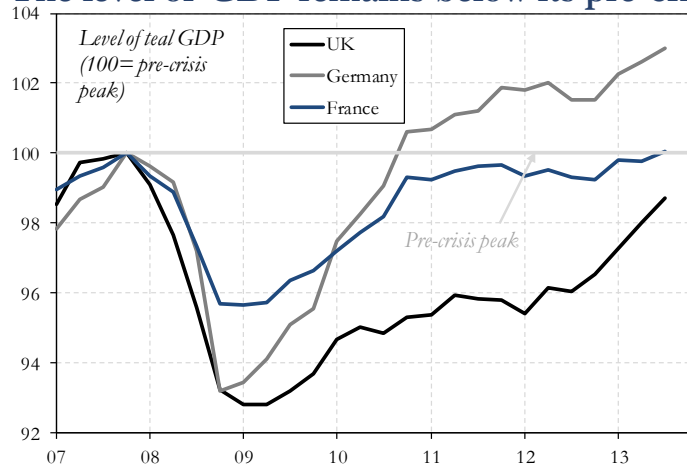
Activity data have improved significantly



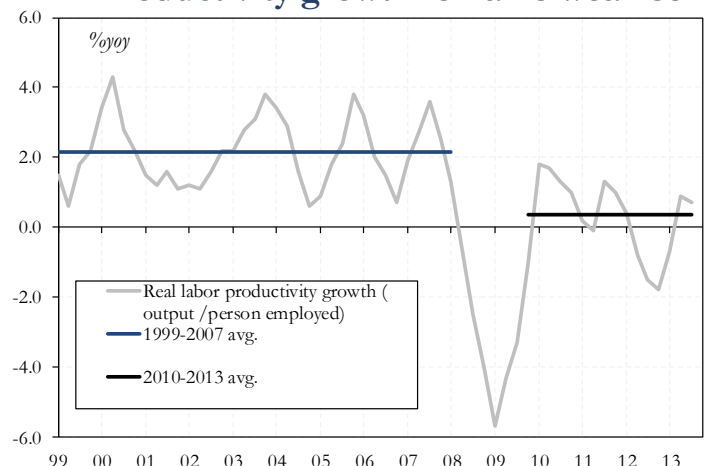
Funding costs are low



The level of GDP remains below its pre-crisis peak

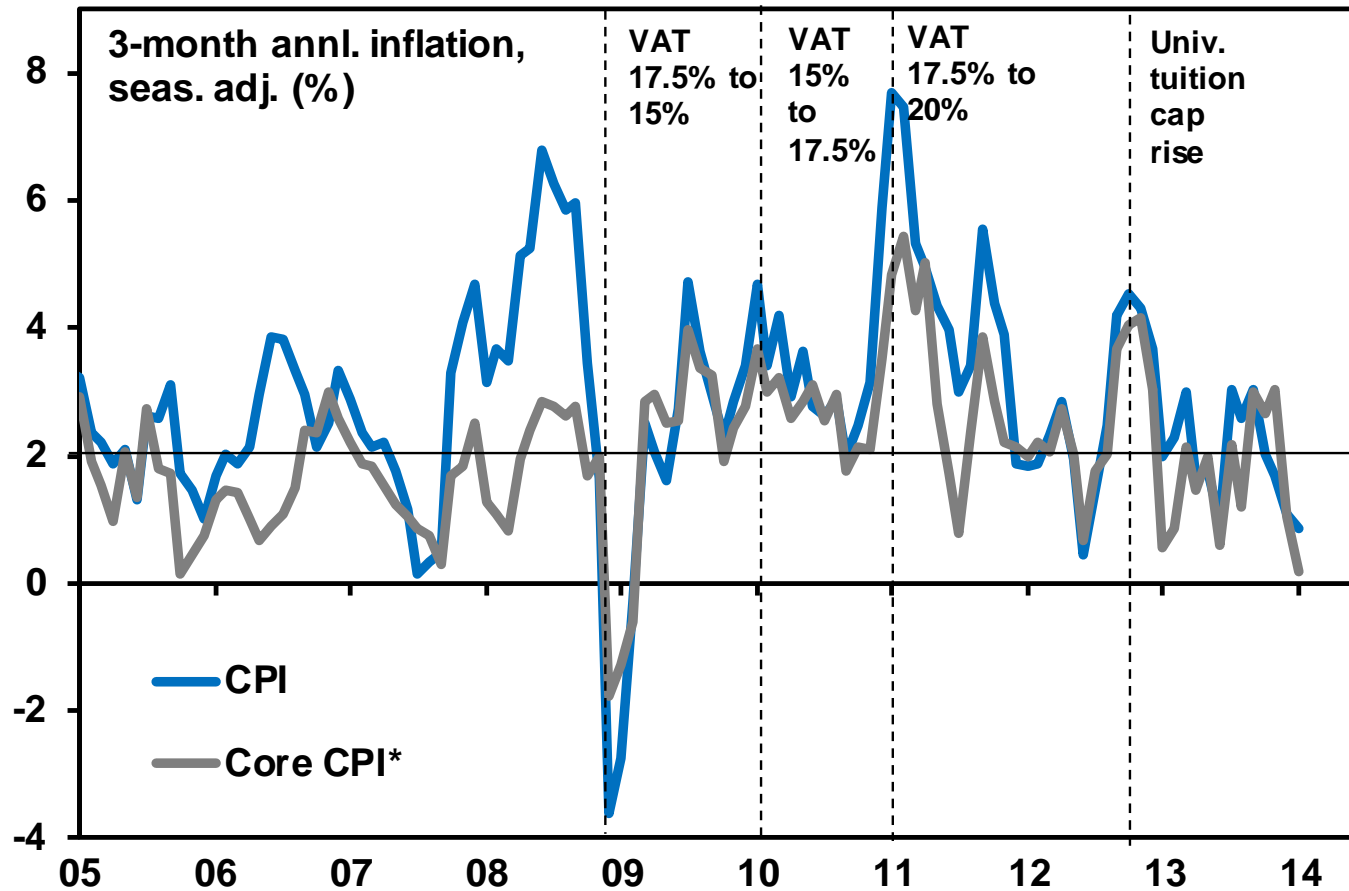


Productivity growth remains weak so far



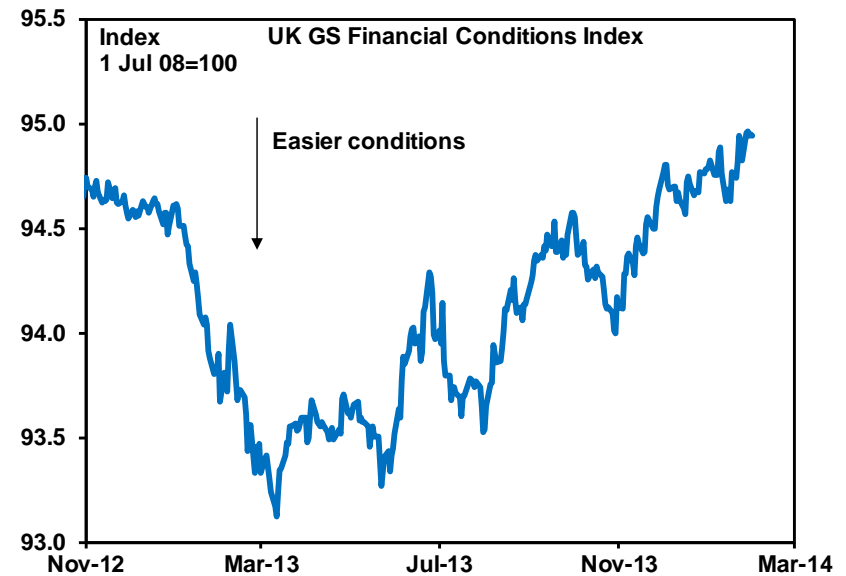
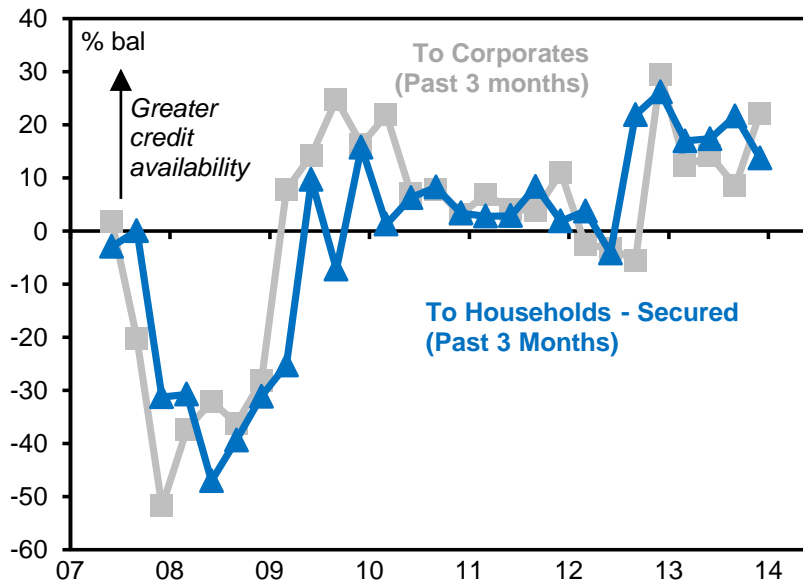
Source: Bloomberg, Eurostat, GS Global Investment Research

UK inflation running below 2% on a sequential basis



Source: ONS, Goldman Sachs Global Investment Research; *ex ex-energy, food, alc. & tob

UK credit availability has eased, although other elements of financial conditions are tightening



Source: Bank of England, Goldman Sachs Global Investment Research

Goldman Sachs rates forecasts

<i>Interest rates</i>			3-month horizon		6-month horizon		12-month horizon	
			Current*	Forward	Forecast	Forward	Forecast	Forward
US	3M	0.2	0.3	0.3	0.3	0.3	0.4	0.3
	10Y	2.7	2.8	3.0	2.9	3.2	3.1	3.4
Canada	3M	1.2	1.2	1.5	1.2	1.6	1.2	1.6
	10Y	2.4	2.6	3.0	2.7	3.2	2.8	3.3
Australia	3M	2.6	2.7	2.4	2.7	2.6	3.0	2.9
	10Y	4.1	4.2	4.2	4.3	4.2	4.4	4.4
Japan	3M	0.1	0.1	0.3	0.1	0.3	0.1	0.3
	10Y	0.6	0.6	0.9	0.7	1.0	0.8	1.1
Euro area	3M	0.3	0.3	0.2	0.3	0.2	0.4	0.2
	10Y	1.6	1.7	2.1	1.8	2.2	1.9	2.5
UK	3M	0.5	0.6	0.5	0.6	0.5	0.9	0.5
	10Y	2.7	2.8	3.1	2.9	3.2	3.0	3.4
Sweden	3M	0.9	0.9	1.1	0.9	1.1	1.0	1.3
	10Y	2.1	2.2	2.7	2.2	2.7	2.4	2.9
Switzerland	3M	0.1	0.0	0.0	0.0	0.0	0.0	0.0
	10Y	1.0	1.0	1.3	1.1	1.4	1.1	1.7

Close 19 February 14

Source: Goldman Sachs Global Investment Research

Goldman Sachs FX forecasts

<i>Exchange rates</i>	Current*	3-months		6-months		12-months	
		Forward	Forecast	Forward	Forecast	Forward	Forecast
EUR/\$	1.37	1.37	1.38	1.37	1.40	1.38	1.40
\$/¥	102.52	102.47	103.00	102.42	107.00	102.24	110.00
EUR/¥	140.91	140.84	142.14	140.78	149.80	140.59	154.00
EUR/CHF	1.22	1.22	1.25	1.22	1.28	1.21	1.28
CHF/¥	115.58	115.62	113.71	115.65	117.03	115.72	120.31
\$/CHF	0.89	0.89	0.91	0.89	0.91	0.88	0.91
EUR/£	0.83	0.83	0.82	0.83	0.83	0.83	0.85
£/\$	1.66	1.66	1.68	1.66	1.69	1.66	1.65
£/¥	170.66	170.46	173.34	170.24	180.48	169.63	181.18
£/CHF	1.48	1.47	1.52	1.47	1.54	1.47	1.51
EUR/NOK	8.35	8.38	8.10	8.41	7.70	8.47	7.50
EUR/SEK	8.97	8.99	8.70	9.00	8.50	9.03	8.40
A\$/	0.90	0.89	0.90	0.89	0.88	0.88	0.85
NZ\$/	0.83	0.82	0.81	0.82	0.80	0.80	0.76
\$/C\$	1.11	1.12	1.07	1.12	1.10	1.12	1.14
\$/CNY	6.12	6.13	6.10	6.13	6.08	6.14	6.05

* Close 21 February 14

Source: Goldman Sachs Global Investment Research

Disclaimer

We, Huw Pill and Andrew Benito, hereby certify that all of the views expressed in this report accurately reflect my/our personal views, which have not been influenced by considerations of the firm's business or client relationships.

Global product; distributing entities

The Global Investment Research Division of Goldman Sachs produces and distributes research products for clients of Goldman Sachs on a global basis. Analysts based in Goldman Sachs offices around the world produce equity research on industries and companies, and research on macroeconomics, currencies, commodities and portfolio strategy. This research is disseminated in Australia by Goldman Sachs Australia Pty Ltd (ABN 21 006 797 897); in Brazil by Goldman Sachs do Brasil Corretora de Títulos e Valores Mobiliários S.A.; in Canada by Goldman, Sachs & Co. regarding Canadian equities and by Goldman, Sachs & Co. (all other research); in Hong Kong by Goldman Sachs (Asia) L.L.C.; in India by Goldman Sachs (India) Securities Private Ltd.; in Japan by Goldman Sachs Japan Co., Ltd.; in the Republic of Korea by Goldman Sachs (Asia) L.L.C., Seoul Branch; in New Zealand by Goldman Sachs New Zealand Limited; in Russia by OOO Goldman Sachs; in Singapore by Goldman Sachs (Singapore) Pte. (Company Number: 198602165W); and in the United States of America by Goldman, Sachs & Co. Goldman Sachs International has approved this research in connection with its distribution in the United Kingdom and European Union.

European Union: Goldman Sachs International authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, has approved this research in connection with its distribution in the European Union and United Kingdom; Goldman Sachs AG and Goldman Sachs International Zw eigniederlassung Frankfurt, regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht, may also distribute research in Germany.

General disclosures

This research is for our clients only. Other than disclosures relating to Goldman Sachs, this research is based on current public information that we consider reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. We seek to update our research as appropriate, but various regulations may prevent us from doing so. Other than certain industry reports published on a periodic basis, the large majority of reports are published at irregular intervals as appropriate in the analyst's judgment.

Goldman Sachs conducts a global full-service, integrated investment banking, investment management, and brokerage business. We have investment banking and other business relationships with a substantial percentage of the companies covered by our Global Investment Research Division. Goldman, Sachs & Co., the United States broker dealer, is a member of SIPC (<http://www.sipc.org>).

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients and our proprietary trading desks that reflect opinions that are contrary to the opinions expressed in this research. Our asset management area, our proprietary trading desks and investing businesses may make investment decisions that are inconsistent with the recommendations or views expressed in this research.

The analysts named in this report may have from time to time discussed with our clients, including Goldman Sachs salespersons and traders, or may discuss in this report, trading strategies that reference catalysts or events that may have a near-term impact on the market price of the equity securities discussed in this report, which impact may be directionally counter to the analysts' published price target expectations for such stocks. Any such trading strategies are distinct from and do not affect the analysts' fundamental equity rating for such stocks, which rating reflects a stock's return potential relative to its coverage group as described herein.

We and our affiliates, officers, directors, and employees, excluding equity and credit analysts, will from time to time have long or short positions in, act as principal in, and buy or sell, the securities or derivatives, if any, referred to in this research.

This research is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Clients should consider whether any advice or recommendation in this research is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice. The price and value of investments referred to in this research and the income from them may fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Fluctuations in exchange rates could have adverse effects on the value or price of, or income derived from, certain investments.

Certain transactions, including those involving futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors. Investors should review current options disclosure documents which are available from Goldman Sachs sales representatives or at <http://www.theocc.com/about/publications/character-risks.jsp>. Transaction costs may be significant in option strategies calling for multiple purchase and sales of options such as spreads. Supporting documentation will be supplied upon request.

In producing research reports, members of the Global Investment Research Division of Goldman Sachs Australia may attend site visits and other meetings hosted by the issuers the subject of its research reports. In some instances the costs of such site visits or meetings may be met in part or in whole by the issuers concerned if Goldman Sachs Australia considers it is appropriate and reasonable in the specific circumstances relating to the site visit or meeting.

All research reports are disseminated and available to all clients simultaneously through electronic publication to our internal client websites. Not all research content is redistributed to our clients or available to third-party aggregators, nor is Goldman Sachs responsible for the redistribution of our research by third party aggregators. For all research available on a particular security, please contact your sales representative or go to <http://360.gs.com>.

Disclosure information is also available at <http://www.gs.com/research/hedge.html> or from Research Compliance, 200 West Street, New York, NY 10282.

© 2014 Goldman Sachs.

No part of this material may be (i) copied, photocopied or duplicated in any form by any means or (ii) redistributed without the prior written consent of The Goldman Sachs Group, Inc.