European Economic Perspectives
Economic Outlook 2017-18

Economics

Europe including UK

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Slower Eurozone growth in 2017/18, driven by softening in domestic demand

This week, we publish updated economic forecasts for 2016-17 and present our 2018 projections for the first time. After GDP growth of 1.6% in 2016 (previously 1.5%), we expect a deceleration to 1.3% in 2017 (unchanged) and 1.2% in 2018. While we maintain a constructive growth outlook for the coming months, we believe the exceptionally strong support that Eurozone domestic demand has enjoyed in 2015/16 is likely to soften thereafter, as higher oil prices and inflation are likely to slow down the growth in household real incomes. Somewhat stronger exports and moderately supportive fiscal policy are unlikely to compensate for this. There is not yet a strong analyst consensus for Eurozone growth in 2018, but the 2018 projections by the ECB (1.6%), the European Commission (1.7%) and the IMF (1.6%) appear too high to us.

Inflation to pick up, driven by oil; ECB to start tapering in the fall of 2017

We expect headline inflation to accelerate from an average 0.2% y/y in 2016 to 1.4% in 2017 and 1.8% in 2018, mainly driven by base effects related to oil prices. Core inflation is likely to pick up more moderately, from 0.9% y/y in 2016 to 1.3% in 2018. We expect the ECB to extend QE by six months beyond March 2017 in its current form (€80bn monthly), but taper after September 2017, perhaps over the course of one year. We do not think ECB policy rates will be cut further, but rate hikes are unlikely before 2019. Normalising monetary policy over the medium term without triggering a "tantrum" in the markets will be a major challenge for the ECB.

Plenty of risks, downside and upside

Key downside risks to our forecasts could stem from new Chinese growth shocks, indirect consequences of changes to US politics, disruptive Fed tightening, a sharp rise in oil prices, uncertainty around the UK's EU exit, disruptive ECB tapering, or new Eurozone shocks. Positive deviations from our base-case forecasts could result from an acceleration in Eurozone structural reforms, a big fiscal initiative in the US or Europe, or simply by a swift reduction in uncertainty, which could result in faster investment and credit growth.

Slowdown in Germany and Spain; steady growth in France and Italy

Among the big Eurozone countries, we expect **Germany** to see a marked slowdown in GDP growth from 1.8% in 2016 to 1.3% in both 2017 and 2018, as the fiscal stimulus related to the large influx of refugees in 2015/16 moderates. For **France**, we expect largely steady growth of 1.3% in 2016 and 2017, followed by 1.4% in 2018. We also expect steady growth in **Italy** – although at more subdued rates of 0.7% in 2016 and 0.8% in 2017 and 2018. **Spain** should continue to enjoy the highest growth rate among the big-4 Eurozone countries, although we think that some deceleration is now inevitable, from 3.2% in 2016 (raised from 2.8%) to 2.3% in 2017 and 1.9% in 2018.

UK: Growth slowdown to trigger further monetary easing by mid-2017

The outlook for the UK will be crucially determined by the EU exit process, which we expect to start officially by the end of Q1 2017. We anticipate weaker investment and a softer labour market, with rising inflation squeezing real incomes and consumption. We expect the BoE to return to an easing bias as domestic demand slows, with a small cut in Bank Rate and a resumption of asset purchases by mid-2017.

Switzerland: Better growth, a bit more inflation, but SNB on hold until 2018

Following the franc appreciation in 2015, GDP growth has picked up to an estimated 1.5% in 2016. We project growth to slow to 1.3% in 2017 (partly due to weaker investment) before picking up to 1.6% in 2018. Although inflation is forecast to turn positive in early 2017, the SNB will likely keep policy rates unchanged until mid-2018.

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UBS Research THESIS MAP **2017-18 Outlook: growth to slow a bit, inflation to rise, temporary extension of QE**

PIVOTAL QUESTIONS

Q: What is the Eurozone growth outlook for 2017/18?

We expect a deceleration in GDP growth from 1.6% in 2016 to 1.3% in 2017 and 1.2% in 2018. Key will be the softening in domestic demand caused by recovering oil prices and higher inflation.

Q: Will Eurozone inflation recover?

Yes, but mainly driven by base effects related to oil prices. We expect headline inflation to accelerate from an average 0.2% y/y in 2016 to 1.4% in 2017, and 1.8% in 2018. Core inflation is likely to pick up more moderately, from 0.9% y/y in 2016 to 1.3% in 2018.

Q: How will the ECB react?

We expect the ECB to extend QE by six months beyond March 2017 in its current form (€80bn monthly), but to start tapering after September 2017 over the course of one year. We do not think ECB policy rates will be reduced further; rate hikes are unlikely before 2019.

UBS VIEW

While we remain constructive on the Eurozone's resilience over the coming months, we expect **domestic demand** – so far the driver of growth – **to decelerate in 2017/18**. We think Eurozone growth is still not self-sustaining, and is subject to downside risks, both domestic and external.

EVIDENCE

While Eurozone PMIs have held up well after the UK referendum, **the likely pick-up in oil prices and inflation is likely to cut into household purchasing power**. The external environment, while a bit better, is unlikely to pick up substantially. Game-changing fiscal initiatives in Europe appear unlikely.

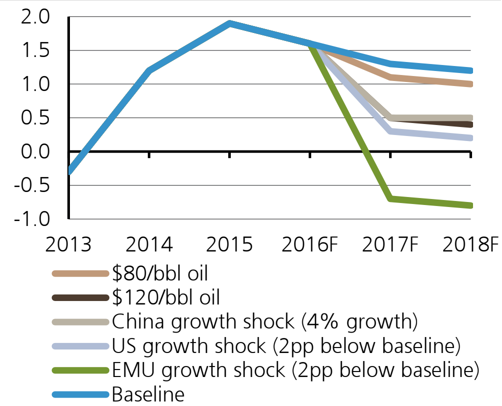
WHAT'S PRICED IN?

There is not yet a strong analyst consensus for Eurozone growth in 2018, but **the 2018 projections by the ECB (1.6%), the European Commission (1.7%) and the IMF (1.6%) appear too high to us**.

UPSIDE/DOWNSIDE RISKS:

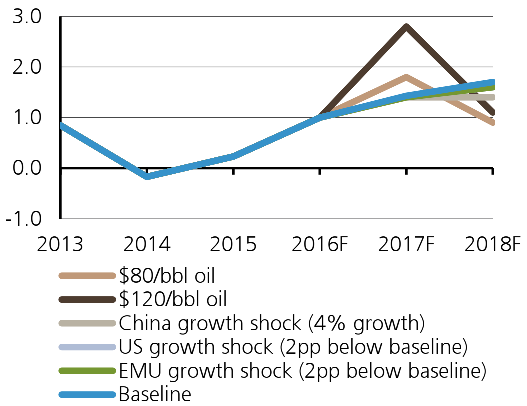
Key **downside risks** would be: a negative Chinese growth shock, indirect consequences of changes to US politics, disruptive Fed tightening, a sharp rise in oil prices, severe disruptions around the UK's EU exit process, disruptive ECB tapering, or new Eurozone shocks. **Positive risks** could come from an acceleration in Eurozone structural reforms, a big fiscal initiative in the US and/or Europe – or simply from a swift reduction in uncertainty.

Figure 1: Eurozone GDP growth scenarios



Source: Haver, UBS

Figure 2: Eurozone inflation scenarios



Source: Haver, UBS

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Euro Area

- **GDP growth to slow from 1.6% 2016 to 1.3% in 2017 and 1.2% in 2018 as support for domestic demand starts to soften**
- **ECB to extend QE by six months beyond March 2017 in its current form, but start tapering after Sep-17 as inflation moves closer to target**
- **Fiscal policy to remain accommodative, but no game-changer**

Eurozone has been resilient due to robust domestic demand

The Eurozone economy has shown a respectable degree of resilience in recent quarters, not least since the UK voted to leave the EU on 23 June. The key explanation is robust domestic demand, which has supported growth at a time when the external side was exposed to headwinds. Domestic demand benefited from a number of factors, including:

- the ECB's easy monetary policy;
- low oil and commodity prices;
- improving labour markets and solid real wage growth;
- moderately supportive fiscal policy; and
- the gradual recovery in credit.

Eurozone growth expected to slow from 1.6% in 2016 to 1.3% in 2017

According to our latest assessment, the Eurozone should grow by 1.6% in 2016 – or by 10bps more than we anticipated previously. For 2017, we continue to expect a slowdown to 1.3%. A key reason for the deceleration lies in the negative impact that the UK referendum is likely to have on Eurozone corporate fixed investment. Another reason is that the big fiscal stimulus that the German government unleashed in 2015/2016 to accommodate a large influx of refugees is unlikely to be repeated in the same way in 2017/18.

Support for domestic demand is likely to soften over time

We expect domestic demand (rather than foreign trade) to remain the key force behind GDP growth over the coming years. Yet some of the above-mentioned drivers of domestic demand are likely to lose steam in 2017, and more so in 2018.

Less support from oil prices, real wage growth, monetary conditions

First of all, **oil** is trading around US$45/bbl, up more than 60% from the lows in early 2016. Should oil prices continue to trade up in line with UBS forecasts ($52 for Q4-16), that would imply that the tailwind to household purchasing power will eventually turn into a (moderate) headwind. Second, the pick-up in headline **inflation** that is now under way is likely to lead to a deceleration in **real wage growth** in many Eurozone countries where labour-market conditions are not yet tight (exception: Germany). Also, **monetary conditions** might start to tighten once yields rise more visibly (as we expect), which could easily happen when the ECB signals a reduction in asset purchases from current levels (tapering) – a step we expect the ECB to take later in 2017.

Net exports to deliver only modest support to growth

Taking all these factors together, we expect **domestic demand to decelerate in 2017/18**, and hence to provide a smaller contribution to headline GDP growth than previously. **Net exports** are unlikely to compensate for this: it is true that parts of the EM universe should do a bit better as oil and commodity prices recover. However, while we acknowledge the potential upside risk from stronger US fiscal policy, we expect the US business cycle to enter its mature stage in 2017/18 and the structural deceleration of the Chinese economy to continue. As a result, we expect net exports to provide only a moderate contribution to Eurozone GDP growth.

Real GDP growth to decelerate to just 1.2% in 2018

All combined, we expect Eurozone GDP growth to decelerate from 1.3% in 2017 to 1.2% in 2018. As such, **we do not share the more constructive growth forecasts that have been presented by the ECB (1.6% for 2017 and 2018), the European Commission (1.5%/1.7% for 2017/18) or the IMF (1.5%/1.6% for 2017/18). Nominal GDP growth**, meanwhile, should accelerate from 2.4% in 2016 to 3% in 2017 and 2018.

Eurozone output to narrow, but with large country-specific differences

We would stress, though, that even at the reduced rates we project for 2017 and 2018, the Eurozone would still be growing above its potential of perhaps 1% – implying continued improvements in labour markets (albeit at a reduced pace) and a further narrowing of the **output gap.** According to European Commission forecasts, the Eurozone output gap should shrink towards -0.7% in 2017 and -0.2% in 2018. However, there is no such thing as "the" Eurozone output gap. Instead, output gaps will differ substantially among individual countries. For example, we think the output gap in Germany is closed already, while output gaps in many other Eurozone countries are still substantial.

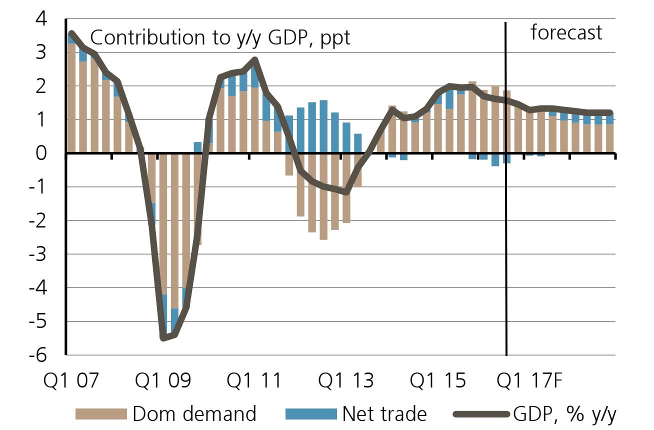
Potential impact of changes in US politics on the European outlook

It seem too early to draw strong conclusions on the impact of the Trump victory on the Eurozone economy, but we would highlight a number of potential transmission mechanisms

Overall, it seems too early in our view to draw strong conclusions on the impact of the Trump victory on the European growth outlook as too few details are known yet. We would list a number of potential implications, however, which could influence the risk profile around our baseline scenario.

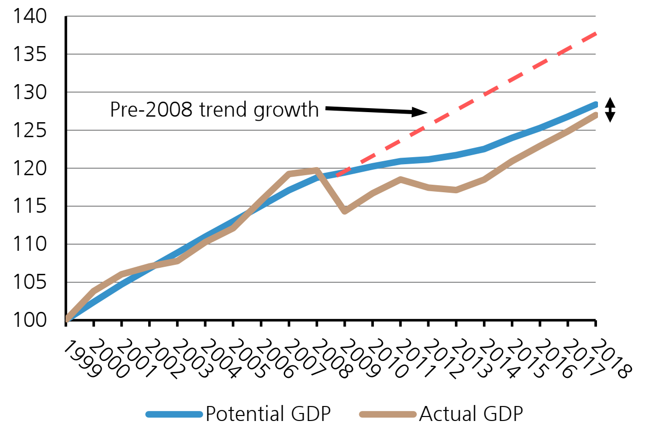
First, a large fiscal boost in the US would likely spill over to Europe and present cyclical upside risk. Second, higher US bond yields might lead to higher European bond yields, prompting an unwelcome tightening in financial conditions, which might have implications for ECB monetary policy. Third, restrictions on global trade could have an adverse impact on European exports. More broadly, as the policies of the new US administration become clearer, financial-market and private-sector confidence might be affected. Last but not least, upcoming political events in Europe might be scrutinized even more thoroughly – potentially leading some observers to fear adverse outcomes more than before.

Figure 3: Eurozone real GDP and contributions in ppt



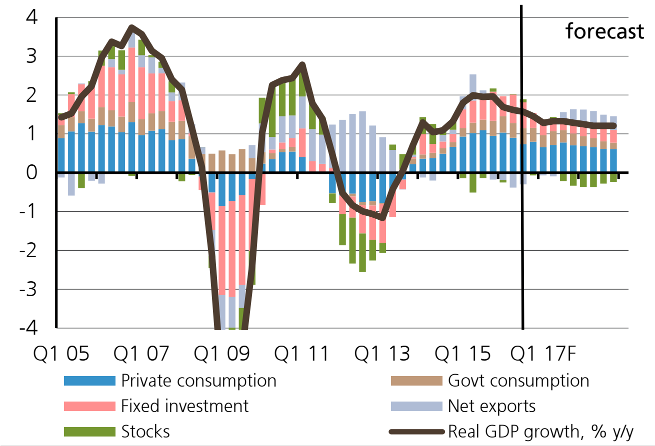
Source: Haver, UBS estimates

Figure 4: Eurozone actual and potential GDP growth



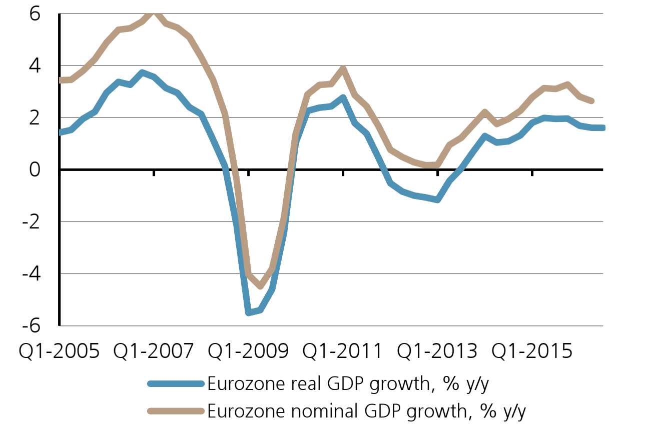
Source: Haver, Markit, UBS

Figure 5: Contributions to Eurozone GDP growth, ppt



Source: Haver, UBS

Figure 6: Nominal and real GDP growth



Source: Haver, UBS

Among the bigger Eurozone countries, we expect **Germany** to see a marked deceleration in growth from 1.8% in 2016 to 1.3% in both 2017 and 2018, partly because of a moderation of the fiscal stimulus related to the large influx of refugees in 2015/16. For **France**, we expect largely steady growth of 1.3% in both 2016 and 2017, followed by 1.4% in 2018. We also expect steady growth in **Italy** – although at more subdued rates of 0.7% in 2016 and 0.8% both in 2017 and 2018. **Spain** should continue to enjoy the highest growth rate among the big-4 Eurozone countries, although we think that some deceleration is now inevitable, following a number of years of strong growth. We forecast 3.2% for 2016 (raised from 2.9%), followed by 2.3% in 2017 and 1.9% in 2018.

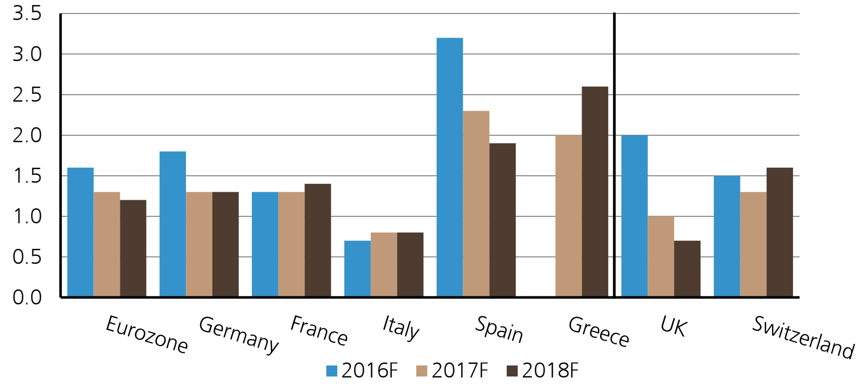
Outside the Eurozone, we expect **UK** GDP growth of 2.0% this year followed by 1.0% in 2017 and 0.7% in 2018. In **Switzerland**, we revise our 2016 GDP forecast 0.1pp higher to 1.5%, and expect 1.3% for 2017 and 1.6% for 2018.

Figure 7: New, old and consensus GDP growth forecasts, % y/y

	New forecasts			Old forecasts		Consensus		New vs Old forecasts		UBS vs Consensus	
	2016F	2017F	2018F	2016F	2017F	2016F	2017F	2016F	2017F	2016F	2017F
Eurozone	1.6	1.3	1.2	1.5	1.3	1.6	1.3	0.1	0.0	0.0	0.0
Germany	1.8	1.3	1.3	1.4	1.1	1.8	1.3	0.4	0.2	0.0	0.0
France	1.3	1.3	1.4	1.4	1.4	1.3	1.2	-0.1	-0.1	0.0	0.1
Italy	0.7	0.8	0.8	0.9	0.9	0.8	0.7	-0.2	-0.1	-0.1	0.1
Spain	3.2	2.3	1.9	2.8	1.9	3.1	2.1	0.4	0.4	0.1	0.2
Greece	0.0	2.0	2.6	-0.9	1.5	-0.6	1.1	0.9	0.5	0.6	0.9
UK	2.0	1.0	0.7	1.9	0.7	1.9	0.9	0.1	0.3	0.1	0.1
Switzerland	1.5	1.3	1.6	1.4	1.3	1.5	1.4	0.1	0.0	0.0	-0.1

Source: UBS estimates, 'Consensus Forecasts', Consensus Economics 10 October 2016.

Figure 8: Annual real GDP growth, %



Source: Haver, UBS estimates

Big fiscal expansion? Don't hold your breath!

Sluggish Eurozone growth, together with the perception that monetary policy is "maxed out", has led to growing demands that **fiscal policy** should "take over". Following the Trump victory in the US, the expectations on fiscal policy seem to have risen very sharply. However, we do not count on a new major fiscal initiative in the Eurozone that would be able to change the big picture. It should be noted that, relative to past years, policy is already expansionary, so governments would have to spend even more to make an additional growth impact.

Fiscal policy is likely to become more accommodative…

It is true that the signs are for fiscal policy to stay expansionary. First, the period of aggressive fiscal tightening under the pressure of IMF/EU adjustment programmes (2012-14) is now behind us (Figure 9). Second, the ECB's QE policy has important fiscal side effects as declining government bond yields grant governments some fiscal breathing space. Third, the election cycle – with elections/referendums looming in Italy, the Netherlands, France and Germany – would have implied stronger public spending in any event. And last but not least, following a slow start, the deployment of funds related to the €315bn Juncker Plan is now under way.

… but a *major* fiscal boost is unlikely

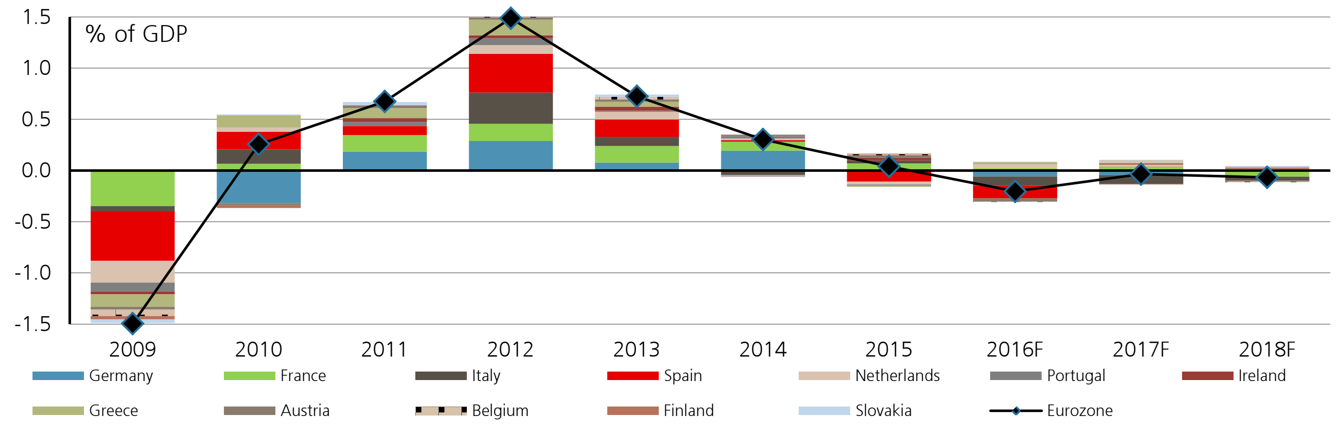
Nevertheless, we think of fiscal policy more as a source of incremental support than a major game-changer. Crucially, few governments have fiscal space. France, Spain and Portugal (as well as Greece, Croatia and the UK) are still in the EU's Excessive Deficit Procedure. Italy's debt stock is uncomfortably high, at 133% of GDP. Of the bigger Eurozone countries, only Germany has fiscal space (public debt below 70% of GDP and falling; balanced budget), but the government is hesitant to deploy it. (We would only expect this relatively conservative stance to change if the German economy were to suffer a marked slowdown.)

European Commission President Jean-Claude Juncker proposed that the "European fund for strategic investments" that carries his name should be doubled to €630bn. But even if this were to happen, the resulting stimulus to growth would likely unfold only slowly, as has been the case with the original Juncker Plan.

Last but not least, ultra-unorthodox concepts such as "helicopter money", where the ECB would directly fund expansionary fiscal policy, appear unlikely, given tight legal limits and strong political resistance. Overall, then, we think fiscal policy is likely to contribute moderately to Eurozone growth in 2017/18, but not more than 0.2-0.3pp per year.

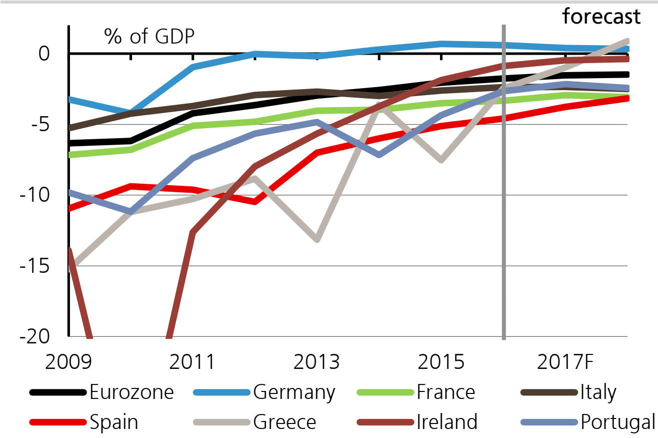
Of course, should the US stage a major fiscal stimulus under President Trump and thus lift US GDP growth, this should have positive growth implications for Europe as well: we estimate that European growth would rise by roughly 0.5pp for each 1pp rise in US growth.

Figure 9: 'Fiscal effort' (reduction in structural budget deficits) in the Eurozone (% of Eurozone GDP)*



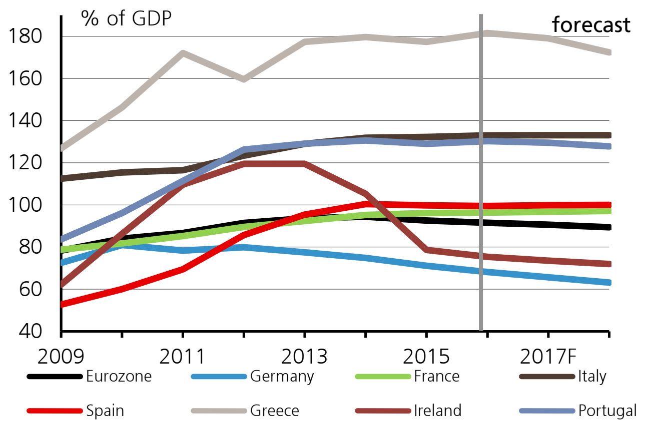
Source: European Commission, UBS Note: *Contribution from individual countries is GDP-weighted. Data based on budgets that national governments have submitted to the EU Commission. Where governments will spend more than budgeted, the fiscal effort would be lower / the fiscal impact larger than shown here.

Figure 10: Fiscal deficits, % of GDP



Source: European Commission, Haver, UBS estimates

Figure 11: General government debt, % of GDP



Source: European Commission, Haver, UBS estimates

Improving labour markets

Improving labour markets, decent real wage growth

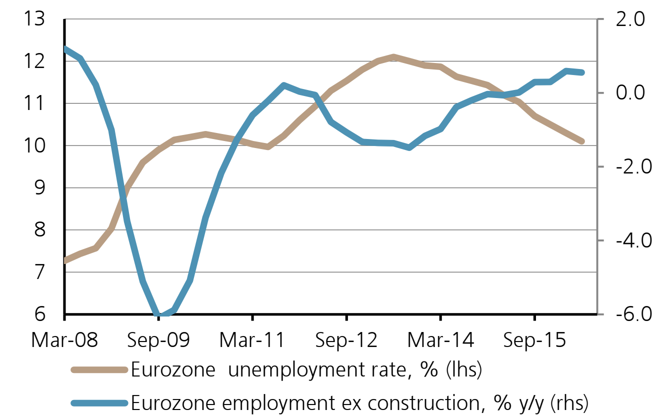
European **labour markets** are improving, with employment up by 0.8% p.a. over the past two years and unemployment down to 10% in September 2016 from 12% in mid-2013. Yet this average masks large country-specific differences between Greece (23.2%), Spain (19.3%), Italy (11.7%), Portugal (10.8%), France (10.2%) and Germany (4.1%). Wage growth has been running at close to 2% y/y recently – which, combined with very low inflation, meant similar rates of real wage growth. All of this has supported household disposable income.

Growth of real disposable income might start to decelerate

Looking forward, we would make the following distinctions: Countries where labour markets still have slack should continue to see employment gains. Nominal wage growth should remain moderate, so that real wage growth should decelerate as inflation picks up. In contrast, in countries where labour markets are getting tight (where unemployment is approaching or is already at or below its natural rate, e.g. Germany), further employment gains are likely to be small.

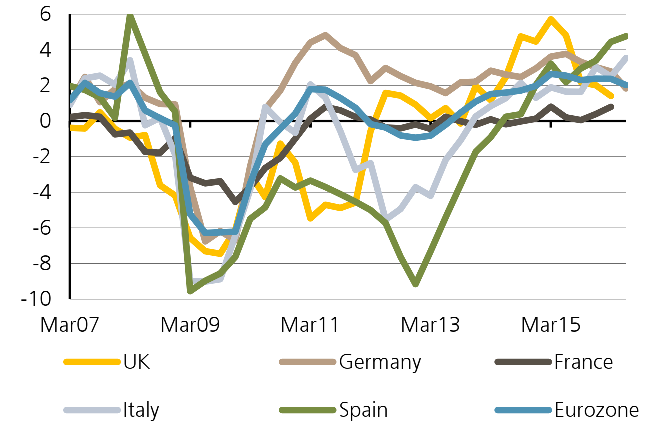
However, labour market tightness should give rise to stronger nominal wage growth, which should compensate partly or fully for rising inflation. Consequently, in both groups of countries, real disposable income (the combination of employment and real wages) should continue to grow, although some slowdown from 2015/16 seems realistic.

Figure 12: Eurozone unemployment rate and employment



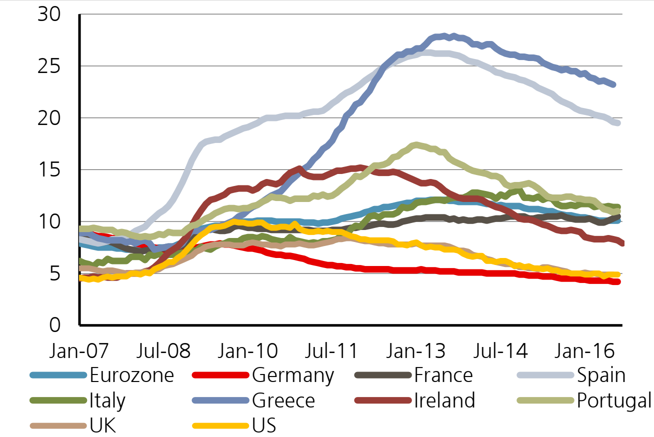
Source: Haver, UBS

Figure 13: Real wage bill, % y/y



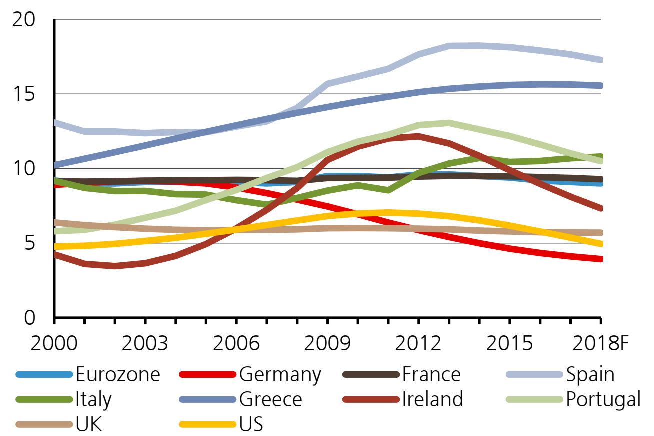
Source: Haver, UBS

Figure 14: Harmonised unemployment rates, %



Source: Haver, UBS

Figure 15: Structural rate of unemployment*



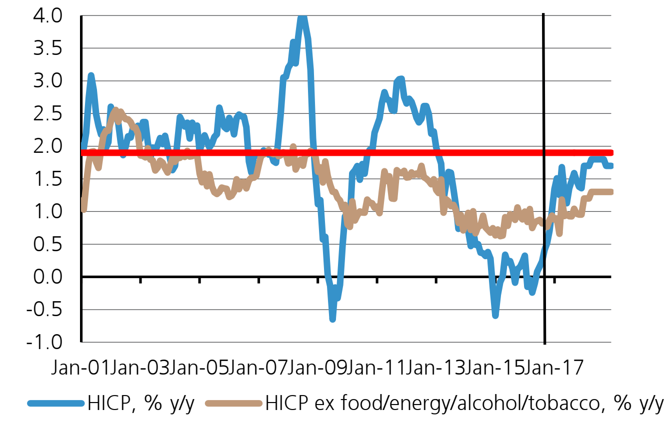
Source: European Commission estimates, Haver, UBS
*Non-accelerating wage rate of unemployment (NAWRU).

Inflation rising, driven by base effects related to oil prices

Inflation has been very low in recent quarters, but is now on its way up. Following a rate of 0.5% y/y in October, we project headline inflation (HICP) to rise to 1.0% y/y by end-2016, 1.3% by the end of Q1 2017, 1.4% by end-2017, and 1.7% y/y by end-2018. This would correspond to annual averages of 0.2% in 2016, 1.4% in 2017 and 1.8% in 2018. As such, inflation should come a lot closer to the ECB's target of "close to, but below, 2%" in 2017/2018. However, rising headline inflation is largely due to energy-related base effects, with food prices contributing moderately as well. In other words, HICP should be driven up mainly by non-core inflation. Core inflation, in contrast, should move up much more slowly, from an annual average of 0.9% in 2016 to 1.3% in 2018, driven by spillovers from non-core inflation and the gradual closing of the output gap.

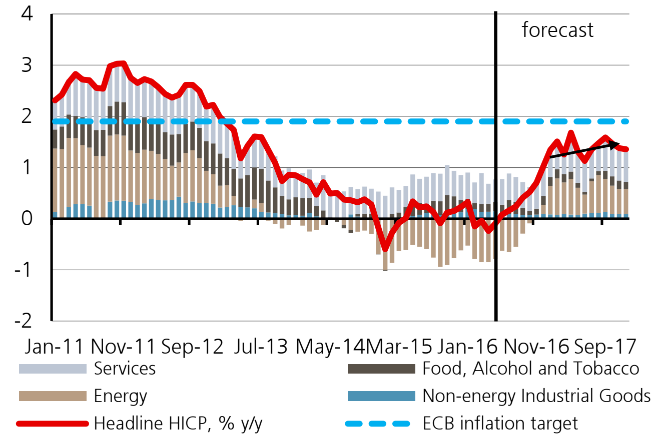
Inflation rising on the back of base effects related to energy prices

Figure 16: Eurozone headline and core HICP, % y/y



Source: Haver, UBS

Figure 17: Contributions to Eurozone HICP inflation, ppt

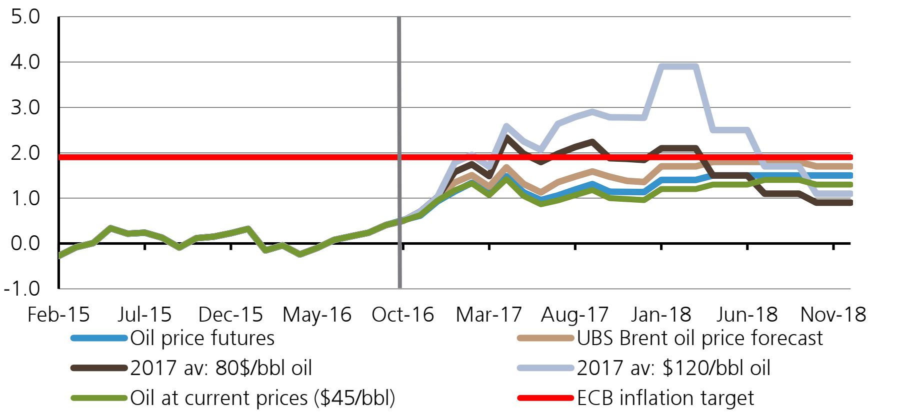


Source: Haver, UBS estimates

Inflation forecasts are subject to large two-way risk related to oil-price uncertainty

We would stress that our **inflation forecast is subject to substantial two-way risk** stemming from uncertainties related to future oil prices. Underlying our projection is the UBS oil price forecast of $60/bbl for 2017 and $70/bbl for 2018. However, should oil prices develop in accordance with the oil futures curve ($49/bbl for 2017 and $52/bbl for 2018), year-end inflation might only be 1.1% in 2017 and 1.5% in 2018. Also, if oil prices stay unchanged from current levels ($45/bbl), inflation might only go up to 1.0% by end-2017 and 1.3% by end-2018. Figure 18 shows the projected inflation trajectory under different oil-price assumptions.

Figure 18: Inflation (HICP) outlook under different oil-price scenarios



Source: UBS

Monetary policy: QE extension in Dec, but tapering should start later in 2017

We expect the QE programme to be extended by six months beyond March 2017

According to our base-case scenario, the ECB will, on 8 December, announce a six-month extension of QE beyond March 2017, with ongoing purchases of €80bn per month. We believe the ECB will also announce technical changes to the QE programme in order to widen the available pool of assets and hence give the QE extension credibility (although the recent rise in yields might have reduced the urgency of very aggressive technical changes).

The ECB's new staff macroeconomic forecasts for 2017-19 – and the inflation forecast for 2018/19 in particular – will form an important basis for the decision. Within this context, the ECB will have to judge whether the recovery in inflation (towards the target of "close to but below 2%") is "sustainable" and hence more than just driven by volatile oil prices.

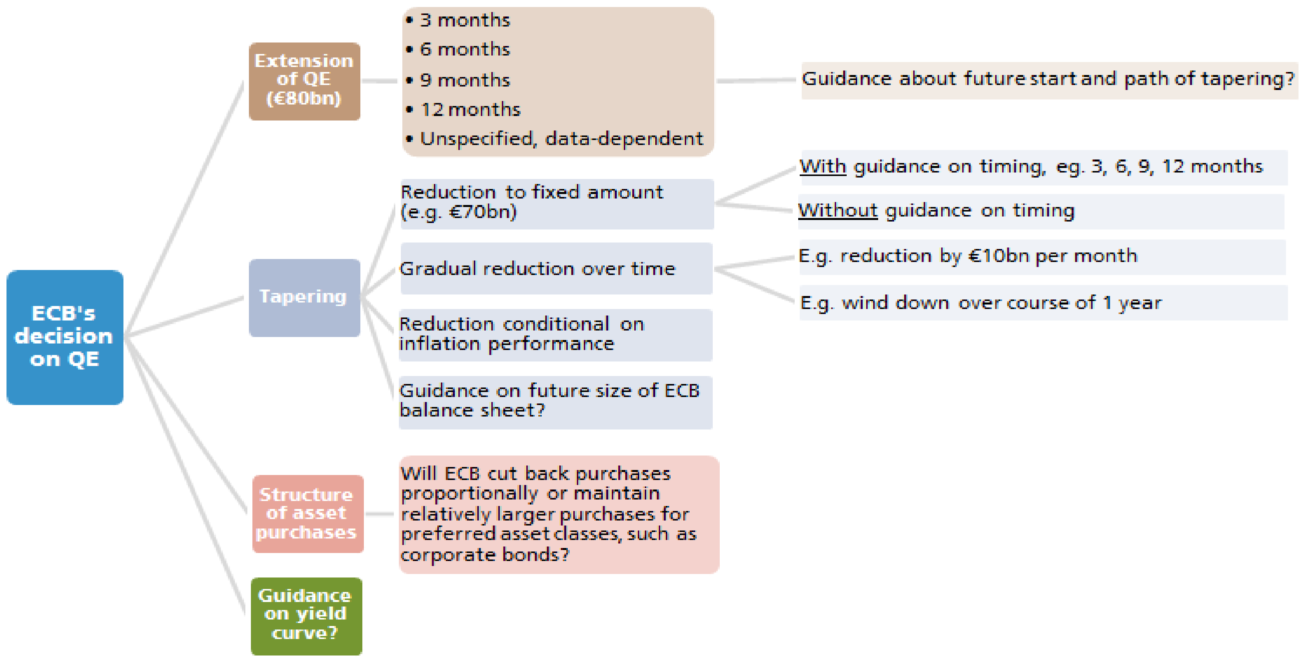
The ECB Governing Council will likely take a broad view

However, we think the members of the ECB Governing Council (GC) will have to take an even more comprehensive view, evaluate the broader balance of risks, and ask themselves whether the time is ripe for a reduction in monetary stimulus. They might also be forced to consider the implications of political events, such as the US elections or the Italian referendum on 4 December. Within this context, we would argue that the recent rise in European bond yields constitutes an unwelcome tightening in Eurozone financial conditions. Overall, we believe a majority of ECB GC members will lean towards the side of caution and vote to extend QE in its current form by another six months, to the end of September 2017.

We expect tapering to start after September 2017

After September 2017, however, we think the time will have come for the ECB to start scaling back the QE programme. We think the decision might potentially be taken by the ECB as early as **8 June 2017**, along with an updated set of macro forecasts for 2017-19. As we show in Figure 19, "tapering" could take various forms, with different speeds, degrees of flexibility, and strength of forward guidance – and hence hawkishness.

Figure 19: The ECB's choices on QE



Source: UBS

Will the ECB be able to avoid a "taper tantrum"?

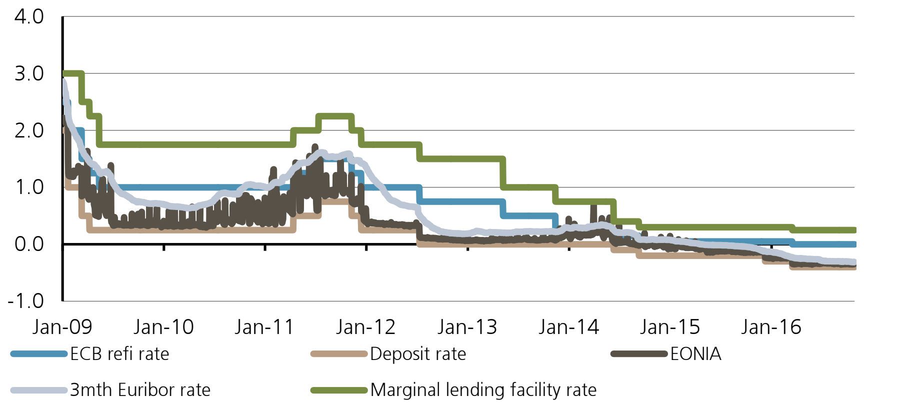
We believe how exactly the ECB manages the tapering process will depend crucially on how growth and inflation dynamics and the overall balance of risks are being evaluated when the decision comes close. Our base-case assumption is that the ECB would wind down the QE programme over the course of one year, from October 2017 to the fall of 2018. **If and when the tapering process starts, we think the ECB will have to take great care not to create a major "tantrum" in the financial markets**, with significant rises in bonds yields and losses in risk assets. Hence, we think the ECB will likely adopt a *flexible* framework where it does not commit too strongly to a pre-determined pattern of winding down QE.

No more rate cuts, but no quick rate hikes either

ECB policy rates unlikely to rise before 2019

How about ECB interest rates? Our base-case scenario implies that ECB policy rates have bottomed out, with the depo rate at -0.4%, the refi rate at zero, and the marginal lending rate at 0.25%. It's true that we cannot categorically rule out the risk scenario of a further depo cut – particularly if the EUR appreciated sharply – but we think that the resistance against further rate cuts is now very high. After all, the ECB is well aware of the negative side-effects that low rates generally and the negative deposit rate in particular inflict upon the financial sector. However, the ECB has explicitly stated that rate *hikes* should only be expected once the QE programme has come to an end. Assuming that QE will run until the fall of 2018, we think that ECB policy rates will remain at current levels until (at least) 2019.

Figure 20: ECB interest rates, EONIA and Euribor (%)



Source: Haver, UBS

ECB's options for eventual monetary policy normalisation

A broad menu for eventual policy normalisation/tightening

When considering the ECB's options for eventual monetary policy normalisation, one might be tempted to think only about the timing of exit from QE and subsequent interest-rate hikes. However, the ECB has access to a much more nuanced menu of choices, which we present in Figure 21. We broadly divide the ECB's choices into four areas:

1. Balance-sheet measures;
2. Ways to influence the yield/forward curve;
3. Liquidity and credit policy; and
4. Interest rates.

Figure 21: ECB's menu for monetary policy normalisation/tightening

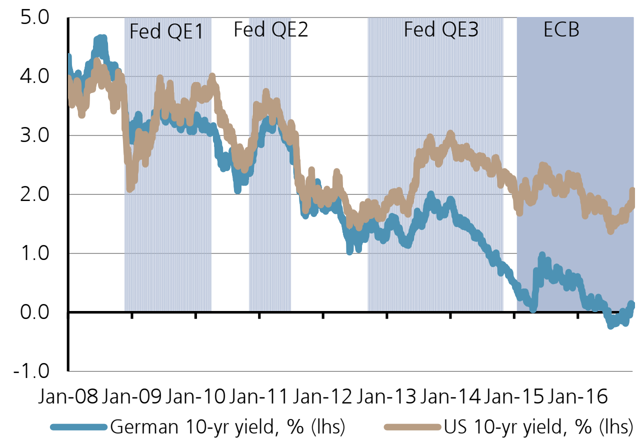
Source: UBS

Eurozone bond yields to rise, Euro to continue to appreciate

We expect bond yields to rise

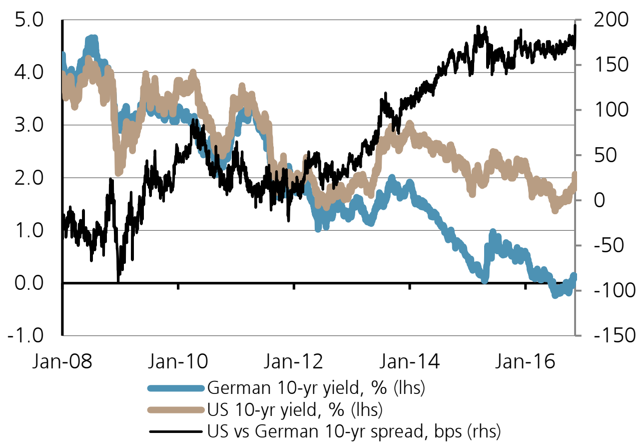
We believe the technical adjustments to the QE programme, higher inflation and gradual monetary policy normalisation will imply higher bond yields over time. We expect 10-year Bund yields to rise to 0.50% by end-2017 and 0.90% by end-2018.

Figure 22: German and US 10-year yields and QE phases



Source: Haver, Federal Reserve, ECB, UBS

Figure 23: German and US 10-year bond yields vs spread

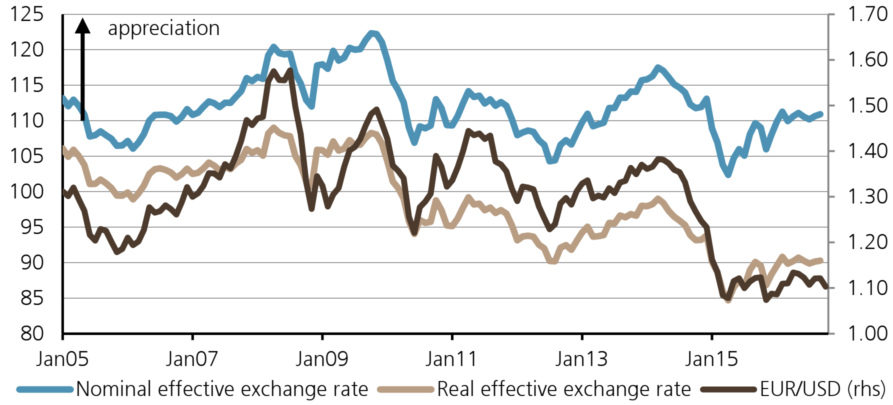


Source: Haver, UBS

Euro to strengthen against the dollar

We maintain our long-standing constructive view on the Euro. If the economic performance in the Eurozone remains reasonably stable, we think EUR/USD is likely to make further gains towards 1.10 by end-2016, 1.13 by end-2017 and 1.17 by end-2018. The trade-weighted exchange rate of the Euro is thus likely to appreciate further. Overall financial conditions are likely to tighten (moderately) in 2017/18.

Figure 24: Nominal and real effective exchange rate and EUR/USD



Source: Haver, UBS

Alternative scenarios for the ECB

Tapering decision in December would likely upset the markets

Tapering decision on 8 December 2016: We believe some hawks on the ECB Governing Council will push hard for some form of tapering. After all, Eurozone data has held up respectably since the UK referendum, inflation is now on the way up, and the discussion around the negative side-effects of low interest rates and bond yields is gaining momentum. As per our base-case scenario, we think the majority of the Governing Council will vote against tapering, but if we are wrong and tapering were to be announced on 8 December, we doubt that the markets would be well prepared for it.

How should the ECB react if oil prices lead to a significant pick-up in inflation?

Faster-than-expected pick-up in inflation. As we explained above, the inflation outlook is subject to significant two-way risk, stemming from oil price uncertainty. Should oil prices increase much faster than we anticipate, the return of inflation back to the target of "below, but close to, 2%" could happen faster. This could expose the ECB to a balancing act: should it tighten monetary policy faster or should it "look through" the pick-up in inflation, given that higher oil prices would likely imply weaker household consumption and hence lower growth over time – *in extremis* a stagflation scenario.

The case would be more straightforward for the ECB if the pick-up in inflation were unrelated to oil prices, but driven by the closing of the output gap. In this scenario, the case for monetary policy normalisation/tightening would be clearer.

ECB balance sheet

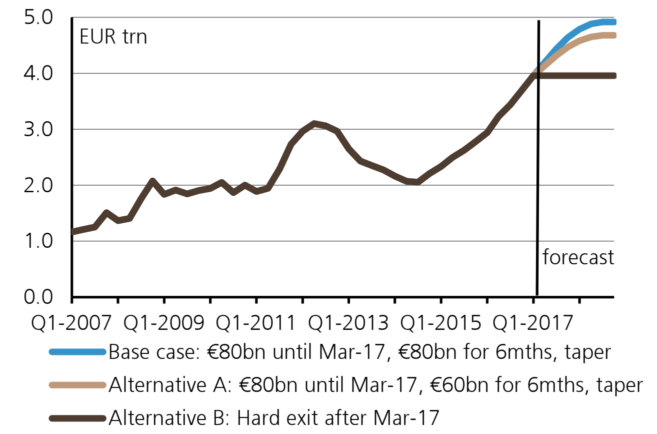
When the ECB started its QE programme in early 2015, it indicated that it wanted to bring its balance sheet back to the size it was in early 2012 – around €3tn or 30% of Eurozone GDP. As Figure 25 and Figure 26 (below) show, the ECB balance sheet has expanded well beyond that size.

But how is the **ECB balance sheet** likely to evolve from here? We look at three scenarios:

- **Base-case scenario:** QE will run in its current form of €80bn per month until September 2017, followed by a gradual reduction to zero over one year, i.e. until September 2018.
- **Alternative scenario (A)**: QE extension by six months, with a lower amount of €60bn; then a gradual reduction to zero over one year.
- **Alternative scenario (B):** Hard exit after March 2017 (highly unlikely).

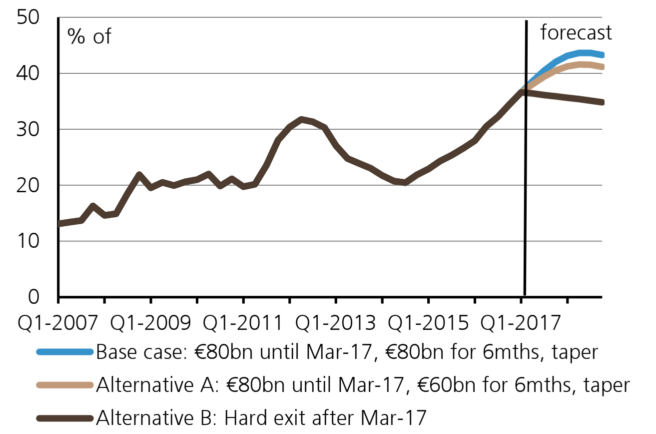
We assume in all three scenarios that the ECB will continue to reinvest maturing bonds and that the take-up of the TLTRO-2 auctions in December 2016 and March 2017 will be moderate and funds will only be paid back after four years. The balance sheet would then peak at around 43.6% of GDP (€4.9tn) under the base-case scenario and around 41.5% of GDP (€4.7trn) under Alternative Scenario A. Under the highly unlikely Scenario B, the balance would peak at 36.6% (€4.0trn) in March 2017.

Figure 25: ECB balance-sheet scenarios, EUR trn



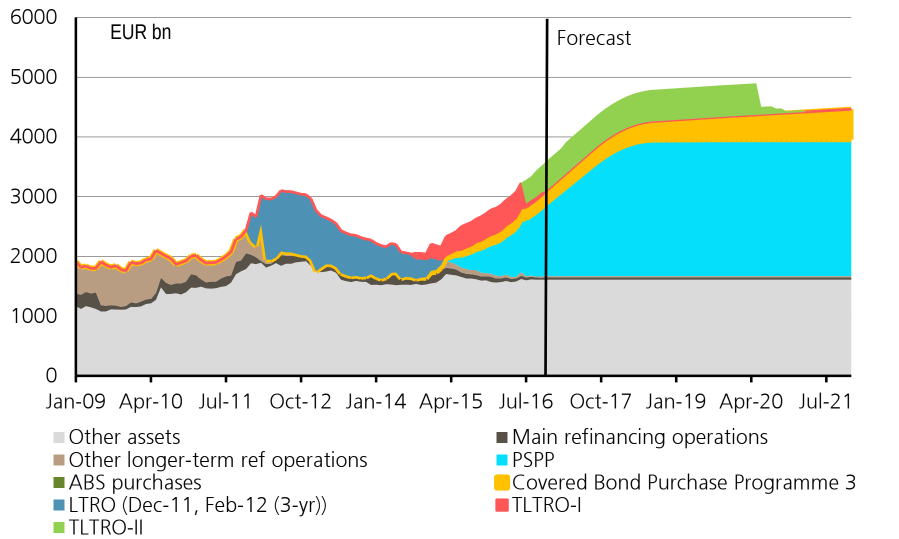
Source: ECB, Haver, UBS estimates

Figure 26: ECB balance-sheet scenarios, % of GDP



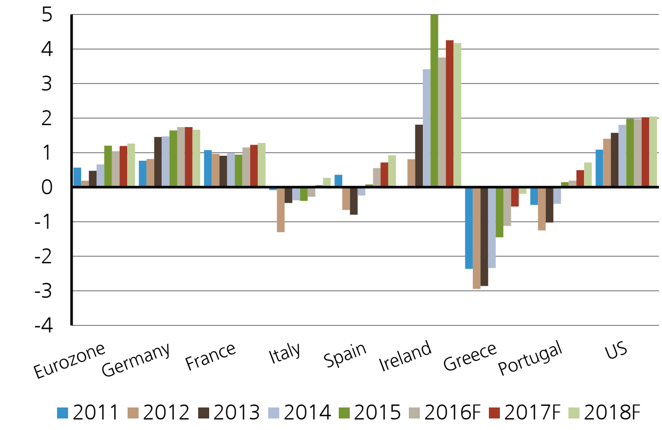
Source: ECB, Haver, UBS estimates

Figure 27: Balance sheet forecasts*



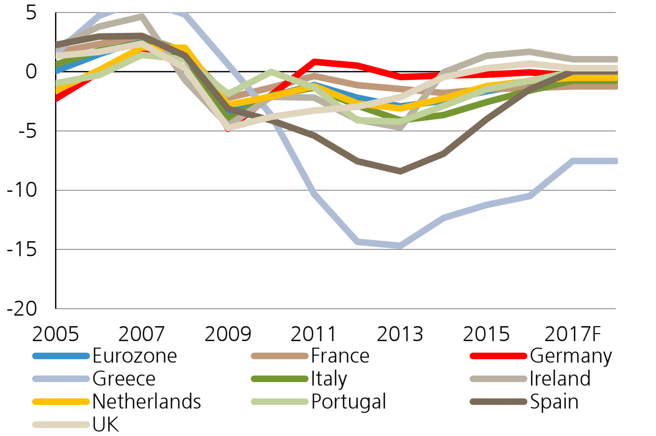
Source: Haver, ECB, UBS estimates. *Assumption: 6-months extension in QE beyond March 2017, followed by tapering over the course of one year; i.e. QE to end in the fall of 2018.

Figure 28: Potential real GDP growth, %



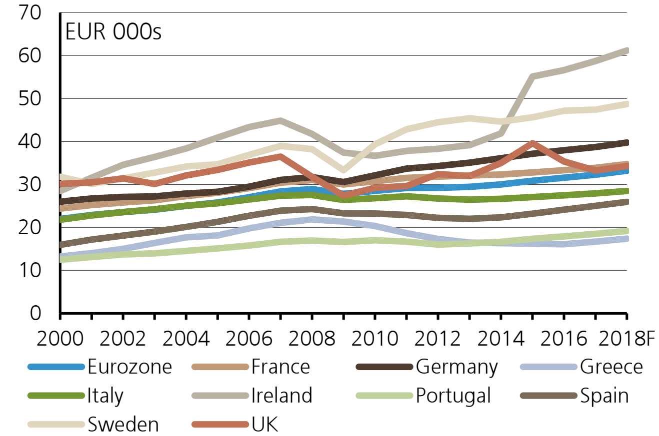
Source: Haver, UBS estimates

Figure 29: Output gap estimates (European Commission)



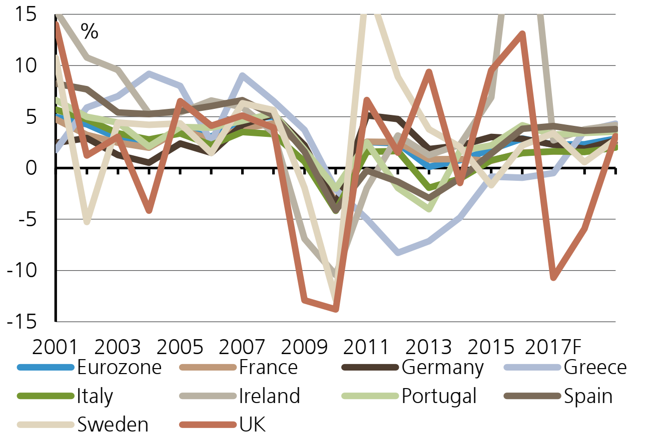
Source: European Commission estimates, UBS

Figure 30: Per capita GDP, EUR '000



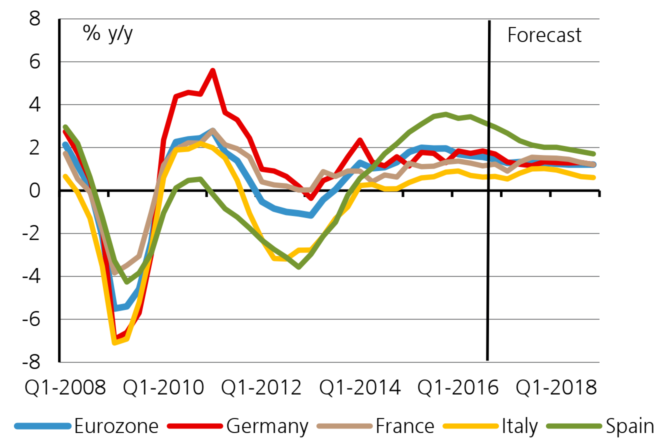
Source: European Commission, Haver, UBS

Figure 31: Per capita GDP growth, %



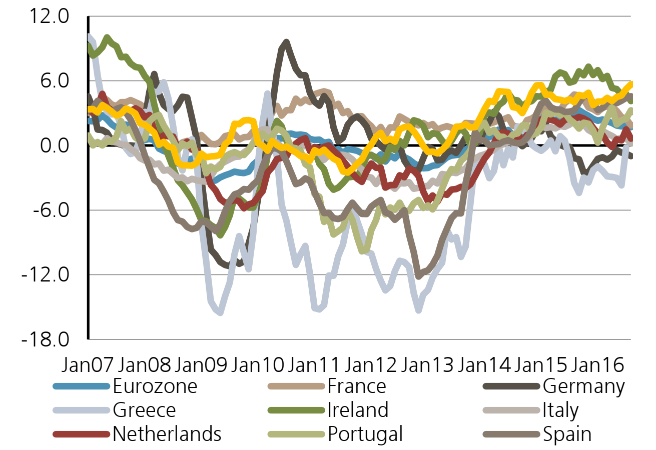
Source: European Commission, Haver, UBS

Figure 32: Real GDP growth, % y/y



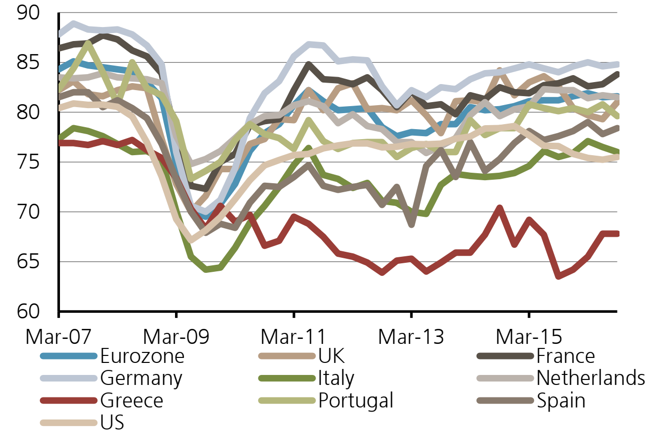
Source: Haver, UBS

Figure 33: European retail sales, % y/y 3mma



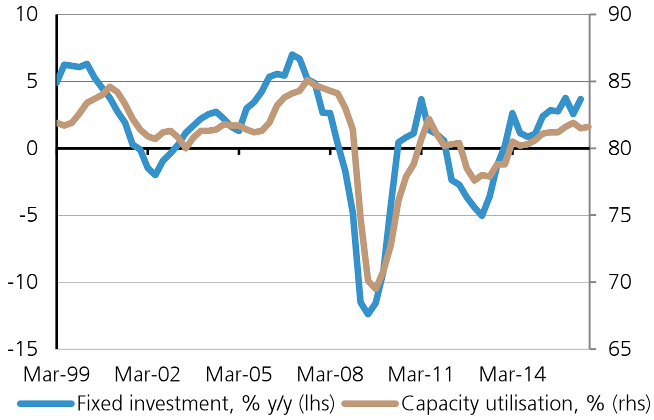
Source: Haver, Markit, UBS

Figure 34: European capacity utilisation, %



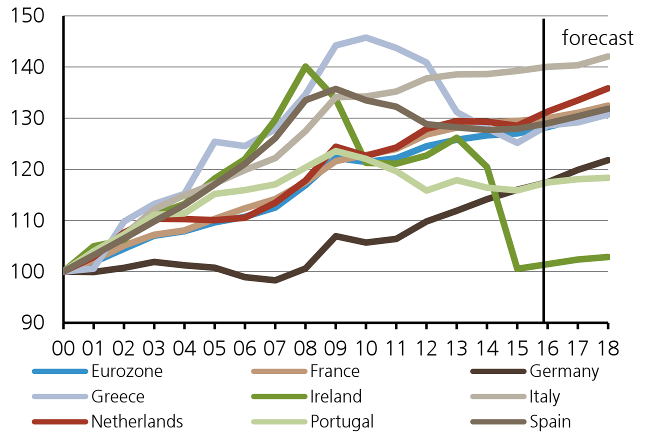
Source: Haver, UBS

Figure 35: Eurozone capacity utilisation and investment



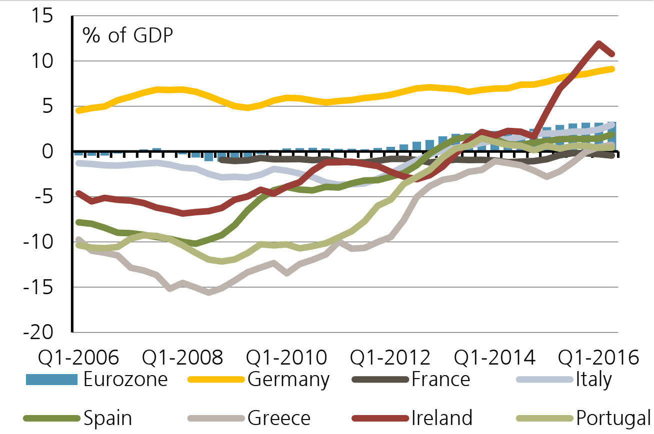
Source: Haver, UBS

Figure 36: Unit labour costs, Q1 2000 = 100



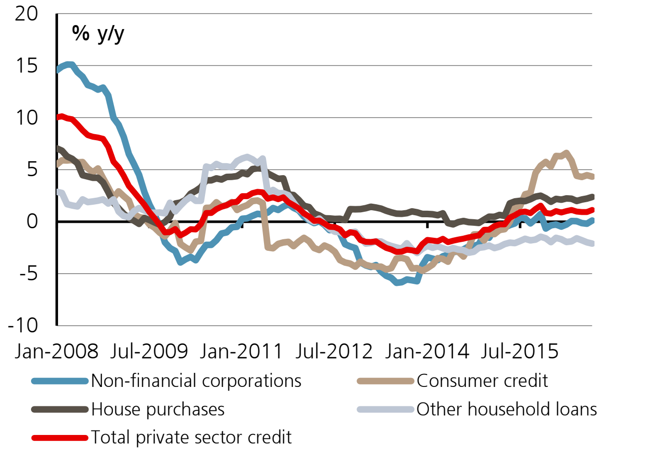
Source: Eurostat, Haver, UBS estimates

Figure 37: Current account balance, % of GDP



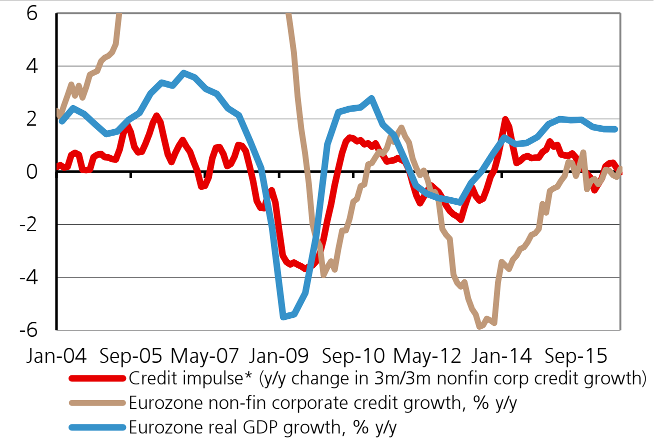
Source: Haver, UBS

Figure 38: Eurozone private sector credit growth



Source: Haver, UBS

Figure 39: Credit impulse*, credit growth and GDP



Source: Haver, UBS. * Year-on-year change in 3m/3m credit stock growth, where credit stock measures total outstanding non-financial corporations credit.

Figure 40: Eurozone economic forecasts

EUROZONE	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	9795	9836	9937	10140	10452	10707	11026	11372
GDP, USD bn	13631	12646	13198	13472	11597	11904	12336	13136
GDP per capita, USD	40605	37574	39140	39869	34226	35008	36187	38419
Real GDP growth, %	1.5	-0.9	-0.3	1.2	1.9	1.6	1.3	1.2
Private consumption, % y/y	-0.1	-1.2	-0.5	0.8	1.8	1.6	1.3	1.1
Government consumption, % y/y	-0.1	-0.3	0.3	0.6	1.4	1.8	1.4	1.0
Gross Fixed Capital formation, % y/y	1.7	-3.3	-2.5	1.4	2.9	3.1	1.4	1.8
Exports, % y/y	6.7	2.9	2.2	4.4	6.2	2.4	2.7	2.8
Imports, % y/y	4.6	-0.6	1.4	4.9	6.2	3.1	3.0	2.6
Domestic demand, cont. to growth, pp	0.7	-2.3	-0.6	1.2	1.7	1.7	1.3	1.2
Net exports, cont. to growth, pp	0.9	1.4	0.4	0.0	0.3	-0.2	0.0	0.2
Unemployment rate, %	10.3	11.5	12.0	11.5	10.8	10.3	10.0	9.8
Industrial Production (%)	2.4	-3.0	-0.9	0.7	0.6	1.3	1.2	1.3
Prices, interest rates and money								
HICP inflation, % y/y (average)	2.7	2.5	1.4	0.4	0.0	0.2	1.4	1.8
HICP inflation, % y/y (year-end)	2.8	2.2	0.8	-0.2	0.2	1.0	1.4	1.7
Core HICP, % y/y (average)	1.4	1.5	1.1	0.8	0.8	0.9	1.1	1.3
Broad money M2, % y/y (end-year)	2.2	4.5	2.4	5.3	5.3	5.0	5.8	6.5
Domestic private credit, % y/y	1.3	-1.8	-2.2	-0.8	0.8	1.2	1.8	2.1
Domestic bank credit/GDP	113.6	111.2	107.3	104.7	102.1	101.0	100.0	99.1
Policy rate, % (end-year)	1.00	0.75	0.25	0.05	0.05	0.00	0.00	0.00
10 year bund yield, % (year-end)	2.10	1.30	1.90	0.60	0.60	0.15	0.50	0.90
EUR/USD (year-end)	1.29	1.32	1.38	1.21	1.09	1.10	1.13	1.17
Fiscal accounts								
General government budget balance, % GDP	-4.2	-3.7	-3.0	-2.6	-2.1	-2.0	-1.7	-1.5
Revenue, % GDP	44.9	46.1	46.6	46.8	46.6	46.5	46.6	46.7
Expenditure, % GDP	49.1	49.7	49.6	49.3	48.6	48.5	48.3	48.2
of which interest expenditure, % GDP	3.0	3.0	2.8	2.7	2.4	2.3	2.2	2.4
Primary balance, % GDP	-1.2	-0.6	-0.2	0.1	0.3	0.3	0.5	0.9
Public sector debt (gross),% GDP	86.7	91.3	93.4	94.4	92.9	92.5	91.5	90.7
Public debt held by the central bank, % GDP	11.8	14.6	10.2	8.3	21.2	38.9	46.1	47.1
Balance of payments								
Trade balance, EUR bn	22	123	211	242	352	370	363	340
Exports, EUR bn	1741	1885	1918	1969	2104	2085	2113	2140
Imports, EUR bn	1719	1762	1707	1726	1752	1715	1750	1800
Current account balance, EUR bn	20	122	215	244	327	343	331	318
as % of GDP	0.2	1.2	2.2	2.4	3.1	3.2	3.0	2.8
Foreign direct investment (net), EUR bn	95	45	27	63	246	54	55	57
Total FX reserves, EUR bn	667	689	542	612	644	724	715	719
Foreign exchange reserves excl gold, EUR bn	245	252	240	270	307	311	295	279
Total FX reserves, % GDP	6.8	7.0	5.5	6.0	6.2	6.8	6.5	6.3
Total external debt, % GDP	110.0	122.4	115.7	110.3	122.1	124.7	121.0	114.3
Net International Investment Position, % GDP	-15.9	-15.0	-13.9	-11.0	-10.3	-8.2	-8.1	-7.8
Credit ratings								
Moody's	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
S&P	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fitch	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Source: Haver, Eurostat, European Commission, IMF, UBS estimates

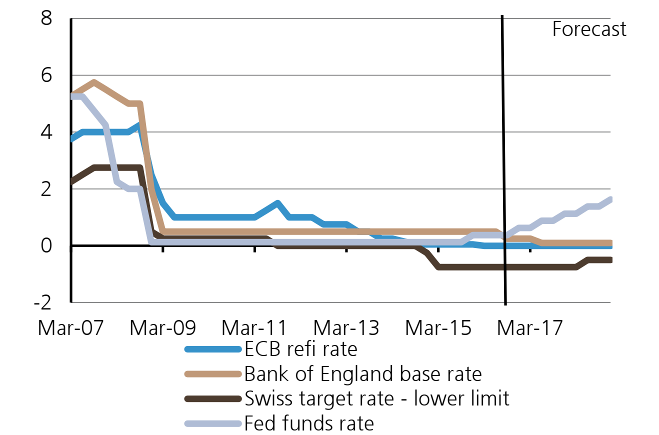
UBS forecasts for FX, short-term rates and bond yields

Figure 41: UBS forecasts

	Current	Dec-15	Dec-16	Dec-17	Dec-18
FX rates					
EUR/USD	1.09	1.09	1.10	1.13	1.17
EUR/JPY	116.4	131.1	107.0	100.0	110.0
EUR/GBP	0.88	0.73	0.90	1.00	1.00
GBP/USD	1.25	1.48	1.22	1.13	1.17
EUR/CHF	1.08	1.08	1.08	1.11	1.13
Interest rates					
ECB refi rate, %	0.00	0.05	0.00	0.00	0.00
BoE bank rate, %	0.25	0.50	0.25	0.10	0.10
SNB 3mth Libor target rate, %	-0.75	-0.75	-0.75	-0.75	-0.50
Fed funds rate, %	0.38	0.38	0.63	1.13	1.63
German 10- yr bund yield, %	0.20	0.59	0.15	0.50	0.90
UK 10-yr gilt yield, %	1.27	2.02	1.20	1.40	1.65
Swiss 10-yr bond yield, %	-0.21	-0.09	-0.20	-0.05	0.15
US 10-yr treasury yield, %	2.15	2.27	1.80	2.25	2.50

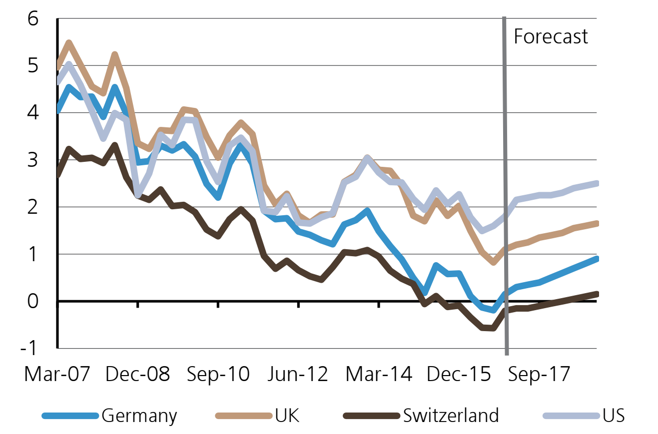
Source: Haver, UBS estimates

Figure 42: Central bank policy rates and UBS forecasts



Source: Haver, UBS estimates

Figure 43: Long-term government bond yield forecasts



Source: Haver, UBS estimates

Eurozone in 2017/18: Risk scenarios

Base-case scenario

- GDP growth to decelerate from 1.6% in 2016 to 1.3% in 2017 and 1.2% in 2018
- Inflation to rise from 0.2% in 2016 to 1.4% in 2017 and 1.8% in 2018 (annual average)
- ECB to extend QE purchases of €80bn by six months to September 2017, then "taper" over 12 months

Negative risk scenarios

US

- **Disruptive Fed tightening**
  - Bond yields to rise globally, risk assets to sell off, US dollar to rally, EUR to soften
- **US growth slowdown**
  - Eurozone corporate (and consumer) confidence to weaken
  - European exports to the US to suffer
  - ECB to accommodate further, with more/longer QE, perhaps another small deposit rate cut
  - More fiscal spending likely
  - Eurozone-US growth elasticity of c.0.5 => slowdown in US-growth by 1pp to reduce Eurozone growth by c.0.5pp
- **Negative indirect consequences of changes to US politics**

Chinese growth shock

- Chinese/EM imports to slow
- Commodity prices to fall
- Eurozone inflation lower for longer
- ECB to accommodate further, with more/longer QE, perhaps another small deposit rate cut
- More fiscal spending likely
- Eurozone-Chinese growth elasticity of 0.2-0.4 => slowdown in Chinese growth by 1pp to reduce Eurozone growth by 0.2-0.4pp

Oil price shocks

- **US$80/barrel**
  - Eurozone GDP growth moderately weaker (1.1% in 2017, 1.0% in 2018)
  - ECB might be forced to start normalising monetary policy earlier than under base-case scenario
- **US$120/barrel**
  - Eurozone GDP growth a lot weaker (0.5% in 2017, 0.4% in 2018)
  - ECB would likely look through this shock in anticipation of growth and inflation slowdown

UK: Disruptions around EU exit process

- Politically divisive Art. 50 procedure to lead to greater fallout on exports and business confidence
- Some UK-bound investment redirected to Eurozone, but insufficient to offset adverse growth impact

New Eurozone shocks

- **Financial sector shock**
  - Systemic concerns, sharp tightening of financial conditions, damage to private-sector confidence
  - Crisis resolution hampered by untested bailout framework (BRRD, SRM) and political disagreements in Europe
  - ECB response restricted by political objections (buying bank bonds, softening of capital key)
- **Political uncertainty**
  - Constitutional referendum in **Italy** (4 December 2016) and general election by May 2018
  - General elections in the **Netherlands** (15 March 2017) and **Germany** (September 2017)
  - Presidential election in **France** (May 2017)
- **Sovereign shocks (likely in combination with political uncertainty)**
  - Sovereign bailout (ESM) hampered by political disagreement in Europe
  - Political sensitivities to limit ECB's crisis response (OMT, more QE)

ECB tapering shock

- Stronger-than-expected inflation/growth to prompt the ECB to normalise policy faster than anticipated
- Alternatively: disagreement in ECB Governing Council/political resistance from key EMU countries to prevent further QE, forcing ECB to normalise earlier than anticipated
- Bond yields to rise, risk assets to sell off, EUR to strengthen

Resumption of substantial refugee inflows

- More fiscal spending to support growth…
- … but new doubts about viability of Schengen agreement (open borders), new political frictions around immigration in and between EU countries

Positive risk scenarios

Eurozone structural reform acceleration

- Italy after electoral/constitutional reform?
- France after presidential election?

Big fiscal package, in Europe or the US

- Doubling of Juncker Plan (€315bn), big fiscal stimulus in individual EU countries
- Growth impact positive – but likely to unfold only gradually (as before)
- Fiscal expansion under US President Trump, with positive spillovers to Europe

Upside from absence of shocks?

- If concerns related to global environment and/or European challenges do not materialize….
- General confidence boost if political uncertainty vanishes with no disruptions along the way
  - Fixed investment and credit growth to accelerate faster than under central scenario
  - Eurozone employment and household confidence to recover faster than expected

Germany

- **GDP growth to slow from 1.8% in 2016 to 1.3% in both 2017 and 2018**
- **Domestic demand to continue as main driver, but headwinds increase**
- **Inflationary pressures increase**

GDP growth well above potential

The German economy performed exceptionally well in H1 2016 with annualized growth of around 2% – well above the potential growth rate of less than 1.5% – driving down the unemployment rate further to below 5%. We expect growth to hold up well for the remainder of 2016, as business confidence has risen and consumption has remained robust overall. We expect GDP growth of 1.8% this year – the strongest since 2011 and more than we expected right after the UK vote to leave the EU (1.4%).

Exceptionally favourable conditions for private consumption

The likely solid 2016 growth outcome reflects an exceptional combination of low oil prices, sharply increased public spending largely due to the influx of refugees, income gains from increased employment and a booming real estate market, supported by low interest rates. This combination of factors benefits consumption in particular: household consumption is set to rise by 1.5% in 2016 – well above its long-term average of less than 1% growth. At 3.6%, public spending growth this year is likely to be the strongest since 1993. Strong private and public consumption has helped the economy to more than offset a weaker external environment and to weather the uncertainty shock from the UK referendum result.

Some moderation of growth is in store and current account surplus should remain at high levels

Going forward, we expect some moderation in growth as the tailwind from low oil prices fades and public spending growth ebbs due to the decline in refugee inflows. A further tightening in the labour market (accompanied by stronger wage growth) and some income tax cuts ahead of the general election in September 2017 are likely to support household consumption, but may not fully offset those headwinds. Business investment may pick up somewhat from its fairly subdued levels, but we also expect it to suffer from political uncertainty (more so than consumption) in the run-up to the general election and also from uncertainty regarding the negotiations on the UK's departure from the EU. Adding uninspiring growth in export markets to the mix implies that German growth is set to moderate from here on, in our view. The current account surplus – already the world’s largest in nominal terms – is set to moderate only slightly as higher oil prices boost imports. Overall, we project the surplus to remain at relatively high levels of around 8% of GDP, unless corporate (and public) investment increases much more forcefully going forward, which we do not anticipate.

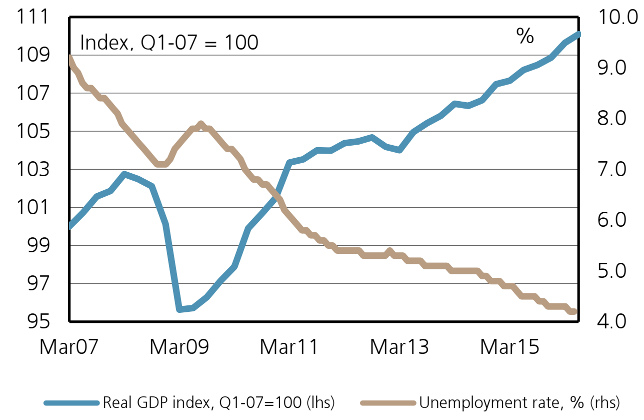
Growth in line with potential in 2017/18, wages to accelerate

We project GDP growth of 1.3% in both 2017 and 2018 – broadly in line with Germany’s potential growth rate. We expect the decline in unemployment to moderate – not least reflecting inflows of unemployed refugees. Given the tightness of the labour market, we project wage growth to accelerate, helped by a 4% increase in the statutory minimum wage in 2017. This should also drive up the inflation rate, which has thus far remained only just above the Eurozone average.

Political uncertainty and external factors are downside risks; increased corporate and public investment is an upside risk

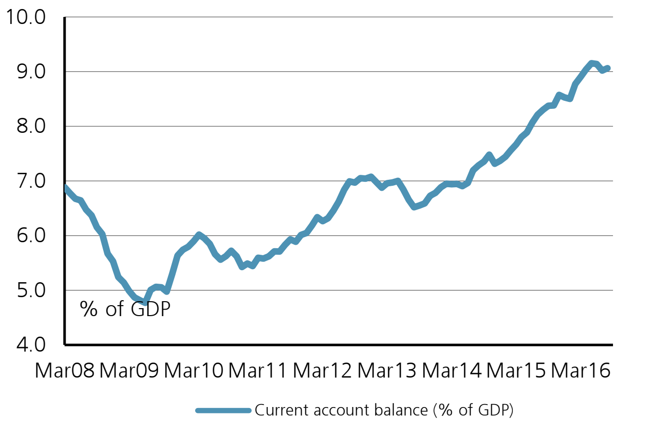
Risks remain tilted to the downside: apart from domestic political uncertainty, the external environment could become more of a headwind than otherwise assumed – including the impact of the EU/UK negotiations and indirect consequences to changes to US politics. A more forceful upswing in corporate investment and a substantial increase in public spending on infrastructure are sources of upside risk to our forecasts.

Figure 44: Growth and the labour market



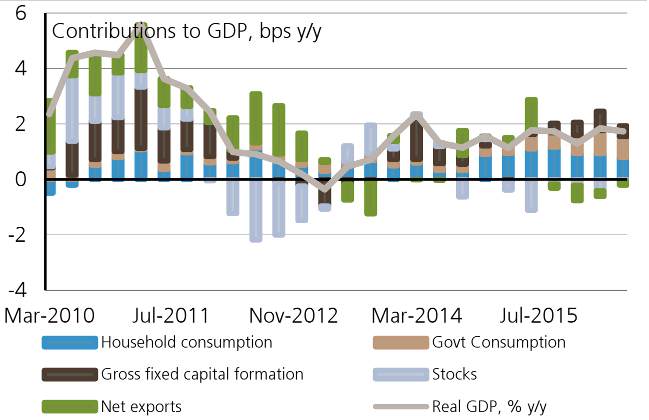
Source: Haver, UBS

Figure 45: Current account balance



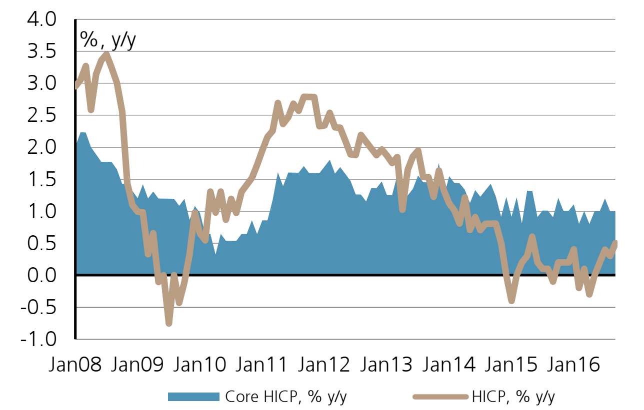
Source: Haver, UBS

Figure 46: GDP growth components



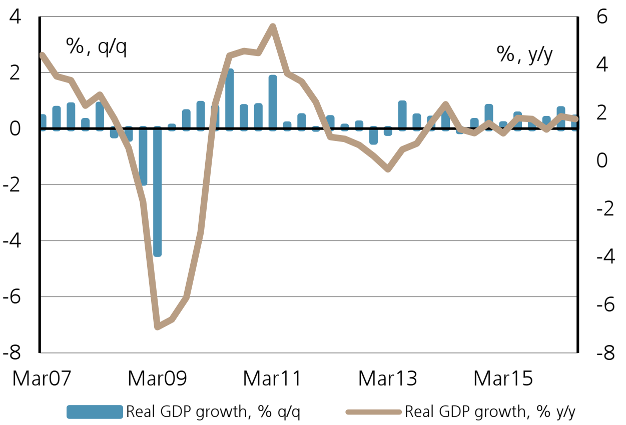
Source: Haver, UBS

Figure 47: Inflation



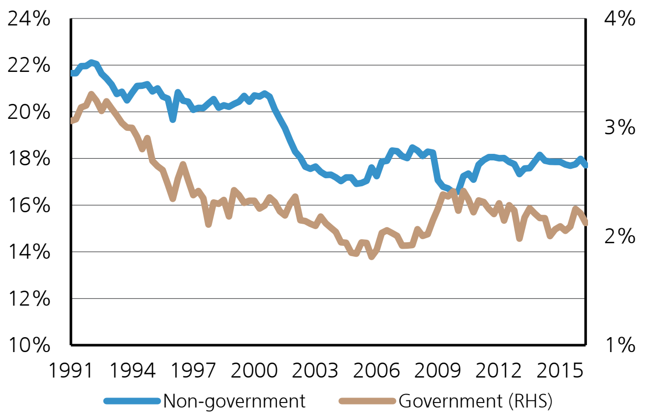
Source: Haver, UBS

Figure 48: Real GDP growth



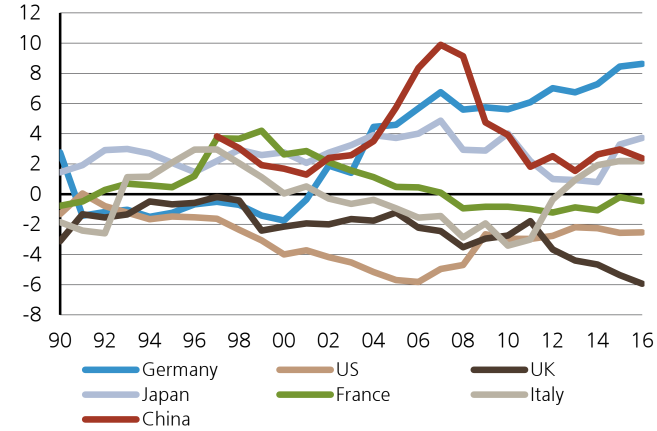
Source: Haver, UBS

Figure 49: Investment ratio



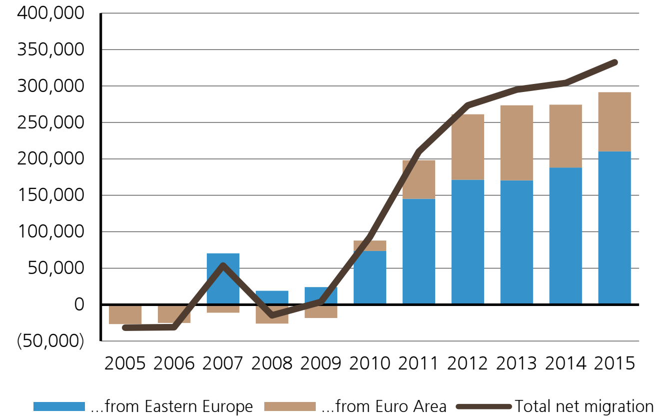
Source: Haver, UBS

Figure 50: Current account balance, % of GDP



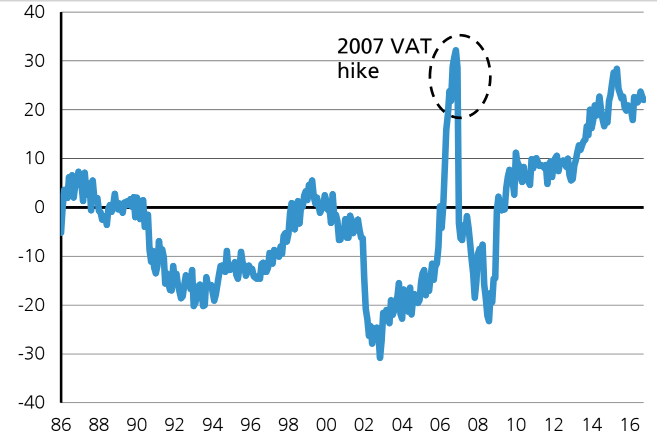
Source: Haver, UBS

Figure 51: Immigration from other EU countries



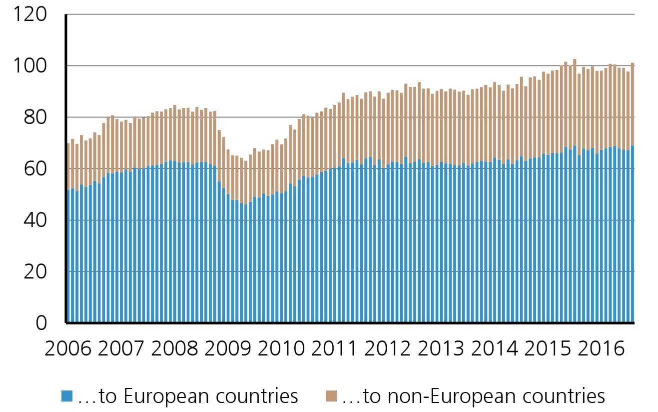
Source: Destatis, UBS

Figure 52: Consumer confidence – propensity to make major purchases



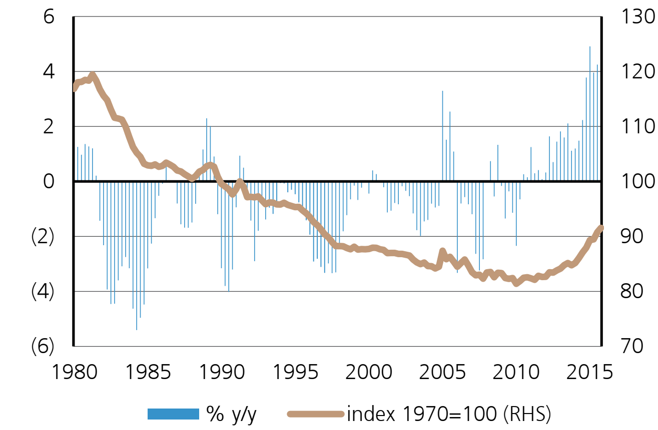
Source: Haver, UBS

Figure 53: German exports (billion Euros)



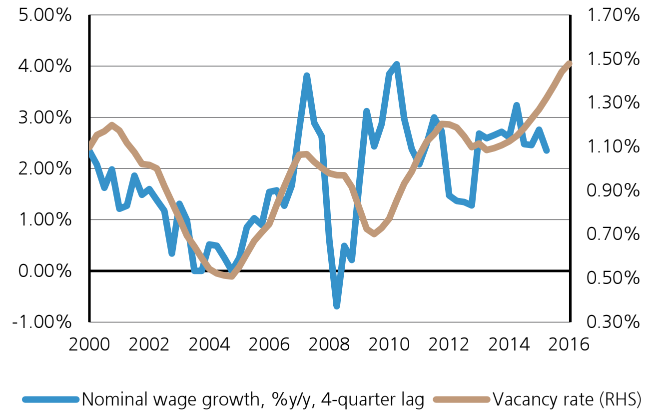
Source: Haver, UBS

Figure 54: Germany – real house prices



Source: BIS, UBS

Figure 55: Wage growth and vacancies



Source: Haver, UBS

Figure 56: German economic forecasts

GERMANY	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	2699	2759	2831	2928	3030	3132	3220	3320
GDP, USD bn	3756	3547	3760	3890	3362	3482	3603	3835
GDP per capita, USD	46794	44107	46623	48036	41220	42315	43658	46330
Real GDP growth, %	3.7	0.7	0.6	1.6	1.5	1.8	1.3	1.3
Private consumption, % y/y	1.3	1.3	0.9	1.0	1.9	1.5	1.4	1.2
Government consumption, % y/y	0.9	1.0	1.2	1.2	2.8	3.6	1.7	1.1
Gross Fixed Capital formation, % y/y	7.3	-0.1	-1.1	3.4	1.1	2.1	1.5	2.5
Exports, % y/y	8.4	3.5	2.0	4.0	4.6	2.8	2.3	2.5
Imports, % y/y	7.2	0.4	3.2	4.0	5.0	2.9	2.5	2.7
Domestic demand, cont. to growth, pp	2.8	-0.7	0.9	1.4	1.3	1.6	1.1	1.2
Net exports, cont. to growth, pp	0.9	1.4	-0.3	0.3	0.1	0.2	0.0	0.2
Unemployment rate, %	5.9	5.4	5.2	5.0	4.6	4.3	4.3	4.4
Industrial Production (%)	7.4	-0.4	0.1	1.5	0.5	1.1	0.9	0.8
Prices, interest rates and money								
HICP inflation, % y/y (average)	2.5	2.1	1.6	0.8	0.1	0.4	1.3	1.8
HICP inflation, % y/y (year-end)	2.3	2.0	1.3	0.0	0.2	1.3	1.3	1.8
Core HICP, % y/y (average)	1.2	1.3	1.2	1.1	1.1	1.1	1.1	1.5
Broad money M2, % y/y (end-year)	6.8	7.6	2.9	5.0	8.6	4.0	5.0	5.0
Domestic private credit, % y/y	1.1	0.8	0.2	0.6	2.3	2.7	2.3	2.2
Domestic bank credit/GDP	101.3	99.4	96.6	93.6	92.0	91.5	91.1	90.7
Policy rate, % (end-year)	1.00	0.75	0.25	0.05	0.05	0.00	0.00	0.00
10 year bond yield, % (year-end)	1.74	1.29	1.92	0.50	0.59	0.15	0.50	0.90
USD/EUR (year-end)	1.29	1.32	1.38	1.21	1.09	1.10	1.13	1.17
Fiscal accounts								
General government budget balance, % GDP	-1.0	-0.1	-0.1	0.3	0.7	0.2	0.1	0.2
Revenue, % GDP	43.8	44.4	44.4	44.6	44.6	44.5	44.6	44.5
Expenditure, % GDP	44.7	44.5	44.5	44.3	43.9	44.3	44.5	44.3
of which interest expenditure, % GDP	2.5	2.3	2.0	1.8	1.6	1.4	1.3	1.2
Primary balance, % GDP	1.5	2.2	1.8	2.1	2.3	1.6	1.4	1.4
Public sector debt (gross),% GDP	78.3	79.6	77.2	74.7	71.2	68.6	66.3	63.6
% domestic public debt held by non-residents	51.6	61.3	61.1	61.0	58.7	n/a	n/a	n/a
Balance of payments								
Trade balance, EUR bn	161	202	214	228	261	279	279	279
Exports, EUR bn	1025	1074	1084	1118	1177	1225	1252	1280
Imports, EUR bn	865	872	870	890	916	940	966	987
Current account balance, EUR bn	163	195	192	216	258	279	271	271
as % of GDP	6.0	7.1	6.8	7.4	8.5	8.9	8.4	8.2
Foreign direct investment (net), EUR bn	7.5	26.4	21.6	79.4	56.4	21.9	22.5	23.2
Total external debt, % GDP	162.7	165.4	150.2	153.6	148.3	154.0	155.0	155.0
Net International Investment Position, % GDP	23.3	28.0	33.7	40.1	48.7	54.3	60.1	65.7
Credit ratings								
Moody's	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa	n/a	n/a
S&P	AAA	AAA	AAA	AAA	AAA	AAA	n/a	n/a
Fitch	AAA	AAA	AAA	AAA	AAA	AAA	n/a	n/a

Source: Haver, Eurostat, European Commission, Reuters Eikon, IMF, UBS estimates

France

- **Moderate GDP growth of 1.3% in 2016 and 2017, 1.4% in 2018**
- **Domestic demand is key driver of growth**
- **Presidential election in May 2017 a key focus**

A continuing gradual recovery

The French economy is continuing its gradual recovery. After a solid Q1, growth stagnated in Q2 but accelerated again to 0.2% q/q in Q3 2016. As in other Eurozone countries, the UK referendum has had no visible adverse effects on the growth momentum.

Domestic demand to remain key driver

Lower oil prices and favourable financing conditions have helped domestic demand, but there is also visible improvement in the labour market. The unemployment rate looks likely to have peaked at 10.5% in 2015 and we expect it to have fallen by around half a percentage point by the end of 2016, supporting household income. Gains in employment should continue to benefit from public support aimed at lowering labour costs through the Competitiveness and Employment Tax Credit (CICE) and the Responsibility and Solidarity Pact.

A mixed outlook for corporate investment

Looking ahead, we see growth continuing at its current pace. As elsewhere, the tailwind of lower commodity prices on consumption will likely fade. However, continued employment gains and some fiscal support provide a degree of offset. The outlook for investment is more mixed: on the one hand, our UBS Evidence Lab survey of corporate investment intentions continues to show that France is lagging other Eurozone economies; on the other hand, business confidence readings have improved recently and there remains some catch-up potential for the construction sector, where investment has fallen continuously since 2008 and has hit its lowest level relative to GDP since the early 1980s. Some rebound may be in store as sentiment in the sector has improved.

Fiscal space to support growth is limited

On the fiscal side, the budget deficit has remained above the 3%-of-GDP threshold since 2008 and France has been in the European Commission's "Excessive Deficit Procedure" since 2009. The government's plan is to lower the deficit from 3.5% in 2015 to 2.7% in 2017, implying that fiscal scope to support growth is very limited even if interest costs decline further.

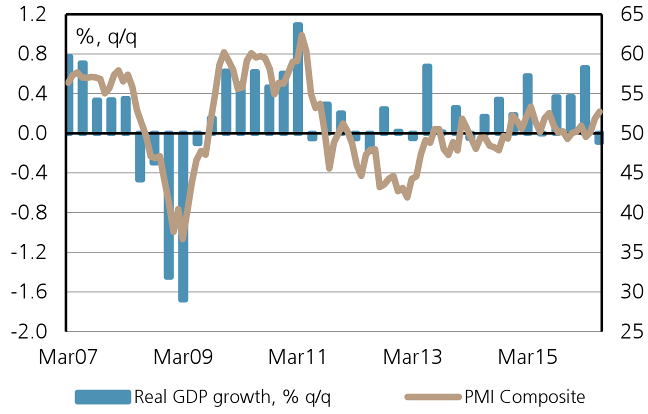
Some progress has been made in structural reforms

Our projection of resilient growth ahead is also driven by progress on structural reforms, which should support potential growth somewhat. In particular, as part of the *loi travail*, some decision-making has been shifted further to the company level and could help to better adjust working time and wage costs to local needs, thus in turn improving the economy's competitiveness. Also, it is worth pointing out that the demographic outlook is in better shape in France than in the other core Eurozone countries, which points to a higher trend growth rate.

Political uncertainty is a downside risk

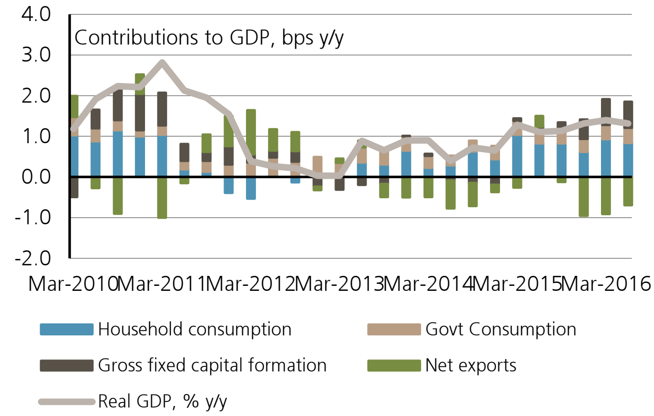
A key uncertainty is the presidential election, scheduled for May 2017. Over the coming months, primaries in the Socialist and Republican parties will be held, giving a clearer picture as to who the contenders will be; we expect the election campaign to start in earnest then. Uncertainty about the election outcome could weigh on corporate investment in the first months of 2017. At the same time, increased fiscal support may emerge ahead of the election, which would be a plus for cyclical growth prospects, notably consumption.

Figure 57: GDP growth and composite PMI



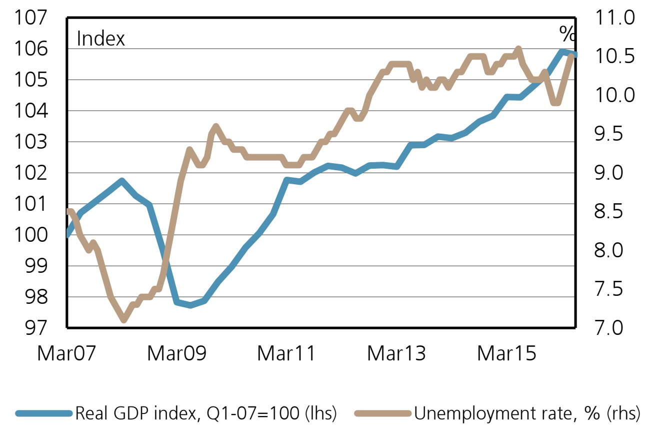
Source: Haver, UBS

Figure 58: GDP growth by components



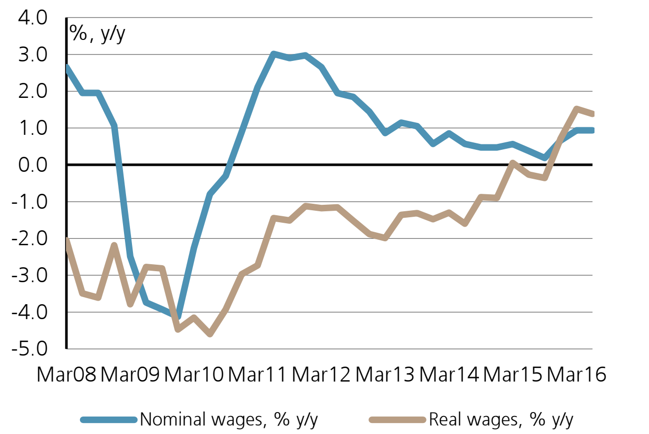
Source: Haver, UBS

Figure 59: Real GDP and unemployment



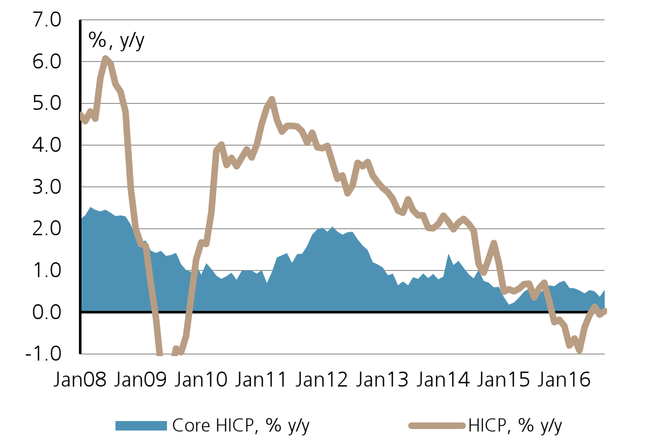
Source: Haver, UBS

Figure 60: Wage growth



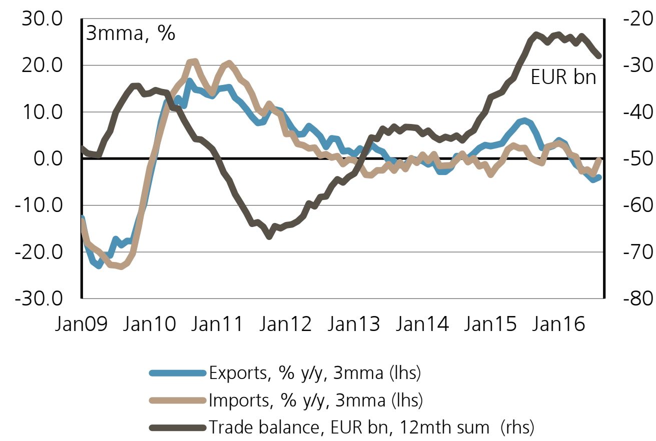
Source: Haver, UBS

Figure 61: Inflation



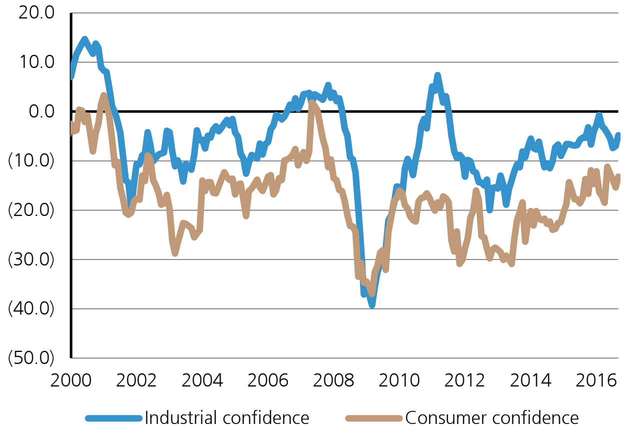
Source: Haver, UBS

Figure 62: Exports and imports



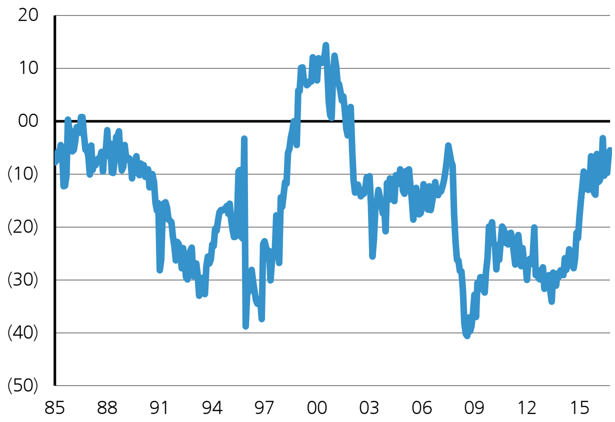
Source: Haver, UBS

Figure 63: EC sentiment indicators for France



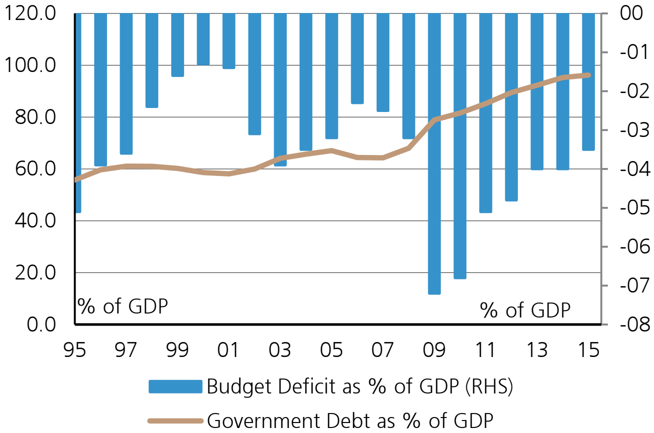
Source: Haver, UBS

Figure 64: Consumer confidence – propensity to make major purchases



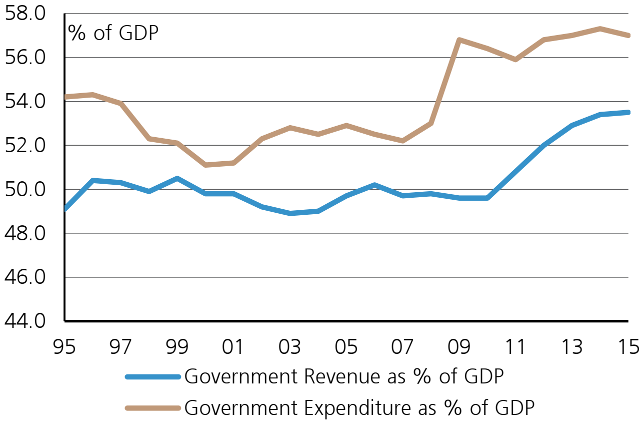
Source: Haver, UBS

Figure 65: Government finances



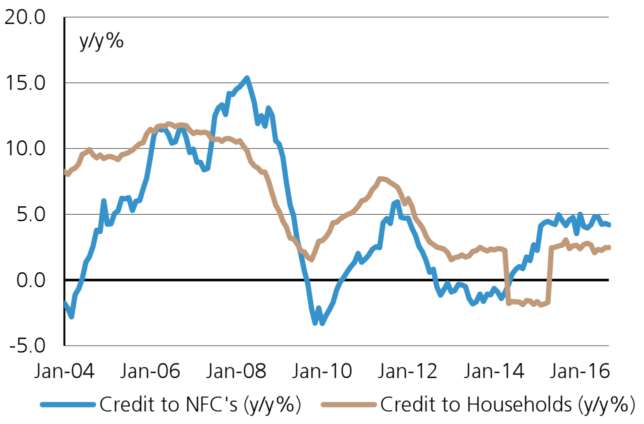
Source: Haver, UBS

Figure 66: Government revenues and expenditures



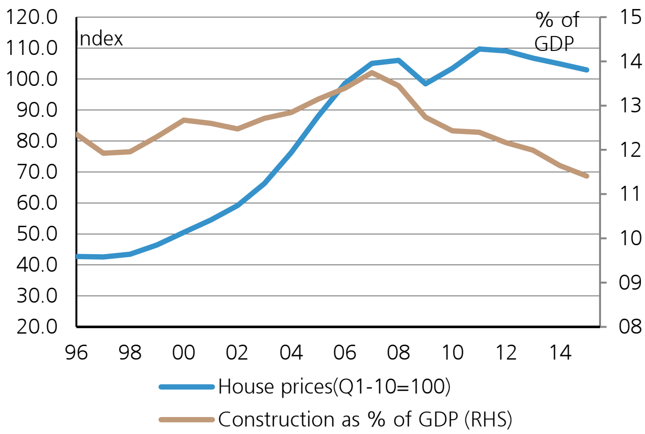
Source: Haver, UBS

Figure 67: Credit growth



Source: Haver, UBS

Figure 68: House prices and construction



Source: Haver, UBS

Figure 69: French economic forecasts

FRANCE	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	2058	2087	2116	2141	2181	2227	2291	2371
GDP, USD bn	2865	2683	2811	2845	2420	2476	2563	2739
GDP per capita, USD	43872	40901	42662	43000	36399	37061	38194	40613
Real GDP growth, %	2.1	0.2	0.6	0.7	1.2	1.3	1.3	1.4
Private consumption, % y/y	0.4	-0.2	0.6	0.7	1.5	1.4	1.4	1.5
Government consumption, % y/y	1.1	1.6	1.5	1.2	1.4	1.6	1.4	0.4
Gross Fixed Capital formation, % y/y	2.1	0.4	-0.7	-0.4	0.9	2.7	1.2	2.5
Exports, % y/y	7.1	2.7	1.9	3.4	6.0	1.0	3.0	3.0
Imports, % y/y	6.6	0.8	2.2	4.8	6.4	2.9	3.6	3.0
Domestic demand, cont. to growth, pp	2.1	-0.3	0.7	1.1	1.5	1.9	1.6	1.5
Net exports, cont. to growth, pp	0.0	0.5	-0.1	-0.5	-0.3	-0.6	-0.3	-0.1
Unemployment rate, %	8.8	9.4	9.9	9.9	10.1	9.7	9.5	9.4
Industrial Production (%)	3.0	-2.3	-0.5	-0.9	1.5	0.3	1.0	1.2
Prices, interest rates and money								
HICP inflation, % y/y (average)	2.3	2.2	1.0	0.6	0.1	0.3	1.4	1.6
HICP inflation, % y/y (year-end)	2.7	1.5	0.8	0.1	0.3	0.9	1.5	1.6
Broad money M2, % y/y (end-year)	4.0	5.7	2.8	3.8	4.6	5.1	5.4	6.0
Domestic private credit, % y/y	5.3	1.0	0.8	0.1	3.0	3.5	3.9	4.3
Domestic bank credit/GDP	104.2	104.4	104.1	102.9	103.9	104.5	105.3	106.1
ECB refi rate, % (end-year)	1.00	0.75	0.25	0.05	0.05	0.00	0.00	0.00
10 year bond yield, % (year-end)	3.15	1.85	2.37	0.83	0.99	0.45	0.85	1.20
USD/EUR (year-end)	1.29	1.32	1.38	1.21	1.09	1.10	1.13	1.17
Fiscal accounts								
General government budget balance, % GDP	-5.1	-4.8	-4.0	-4.0	-3.5	-3.4	-3.1	-2.7
Revenue, % GDP	50.8	52.0	52.9	53.4	53.2	52.8	52.6	53.1
Expenditure, % GDP	55.9	56.8	57.0	57.3	56.8	56.2	55.7	55.8
of which interest expenditure, % GDP	2.6	2.6	2.3	2.2	2.0	1.9	1.7	1.5
Primary balance, % GDP	-2.5	-2.2	-1.8	-1.8	-1.5	-1.5	-1.4	-1.2
Public sector debt (gross),% GDP	85.2	89.6	92.4	95.4	95.8	96.4	97.0	98.0
% domestic public debt held by non-residents	59.0	63.5	63.8	61.2	61.9	n/a	n/a	n/a
Balance of payments								
Trade balance, EUR bn	-65	-54	-43	-40	-24	-24	-31	-36
Exports, EUR bn	422	436	438	438	461	465	479	493
Imports, EUR bn	487	491	481	478	485	497	521	539
Current account balance, EUR bn	-20.4	-25.5	-18.5	-22.8	-4.4	-13.6	-8.4	-13.4
as % of GDP	-1.0	-1.2	-0.9	-1.1	-0.2	-0.6	-0.4	-0.6
Foreign direct investment (net), EUR bn	14.2	15.1	-10.5	36.0	-1.9	-4.5	1.0	4.7
Total external debt, % GDP	200.8	200.0	193.9	209.7	209.7	215.0	220.0	220.0
Net International Investment Position, % GDP	-8.7	-12.8	-16.6	-16.9	-16.4	-17.0	-17.4	-17.6
Credit ratings								
Moody's	Aaa	Aa1	Aa1	Aa1	Aa2	Aa2	n/a	n/a
S&P	AAA	AA+	AA	AA	AA	AA	n/a	n/a
Fitch	AAA	AAA	AA+	AA	AA	AA	n/a	n/a

Source: Haver, Eurostat, European Commission, Reuters Eikon, IMF, UBS estimates

Italy

- **A continued domestic-demand-driven recovery**
- **Constitutional referendum implies political uncertainty**
- **Some fiscal support in short term supports consumption**

We project continued above-potential growth

The growth recovery in Italy has continued in 2016 with a projected GDP increase of 0.7% (lower than the 0.9% we projected previously), following 0.6% in 2015. While growth in Q2 2016 ground to a halt following 0.3% q/q in Q1, available indicators suggest that momentum returned in Q3. As in other Eurozone countries, domestic demand – and in particular household consumption – is the key driver. Net exports are expected to continue detracting from growth, reflecting only moderate export growth and rising imports. Looking ahead, we expect annual GDP growth to remain at 0.8% in both 2017 and 2018 as unemployment declines and household income increases. GDP growth should thus remain significantly above its potential rate, which we estimate is slightly above 0%.

Constitutional referendum in December key to watch for sentiment

Looking ahead, political uncertainty is a key focus, notably the referendum on constitutional reform, scheduled for 4 December. The referendum is part of the government's agenda to improve decision-making by reforming the Senate (Upper House of Parliament) and follows the passing of the reform of the Lower House earlier in 2016. Progress in reforming political decision-making could, in our view, be a first prerequisite for enacting structural reforms going forward, even though its importance in this regard should not be over-emphasized at this stage. The referendum is also a potential source of political uncertainty and driver of overall sentiment, given that the Prime Minister might step down if the government's proposals are rejected: opinion polls suggest the referendum is too close to call, with the share of undecided voters being particularly high.

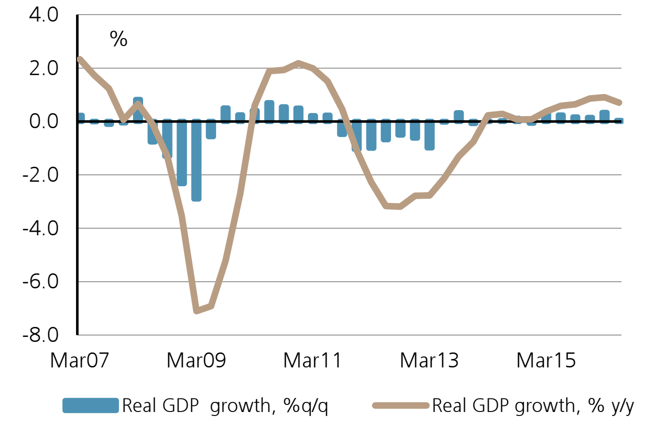
Fiscal policy to turn somewhat more expansionary

In the run-up to the referendum, more fiscal support for households is likely to be promised. Indeed, the government's 2017 budget proposal envisages a deficit of 2.3% of GDP compared to earlier plans of 1.8%, implying around 0.4% more stimulus than previously planned. This should provide some support for private consumption, such as tax relief and increases in pension benefits. A cut in Italy's corporate tax rate is also part of the budget plan. Still, we expect investment to moderate somewhat going forward, owing to political uncertainty.

Political uncertainty is there to stay until the general election in 2018

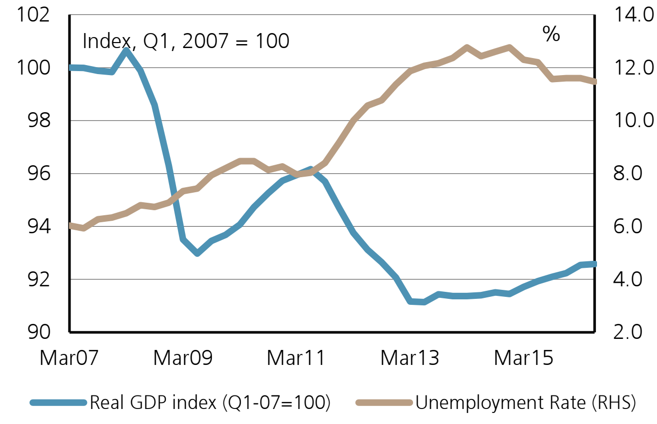
We stress, however, that pre-referendum uncertainty is unlikely to disappear altogether, even if the referendum results in a "Yes" vote, as the next general election needs to take place by May 2018 at the latest and opinion polls point to a tight race. This implies that: (1) any government will be preoccupied with the election campaign after the referendum and is unlikely to embark on substantial structural reforms; and (2) there is a risk of a non-market-friendly party being elected, which, under the new electoral law, would be guaranteed a stable majority. If uncertainty were to be lifted earlier than we assume – perhaps because of early new elections resulting in the formation of a new government with a clear mandate – growth momentum could also pick up and create upside risk to our outlook.

Figure 70: Real GDP growth



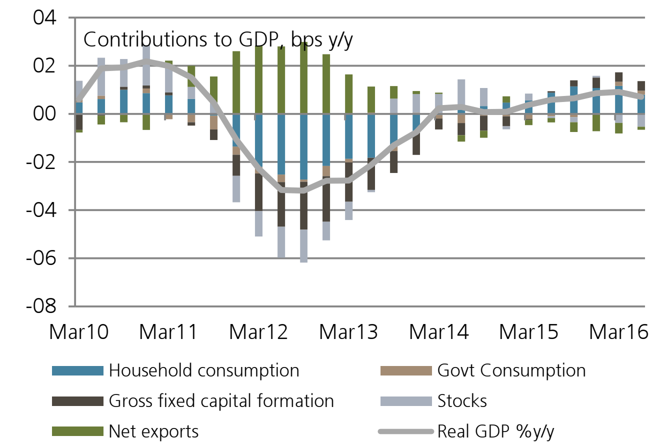
Source: Haver, UBS.

Figure 71: GDP and unemployment



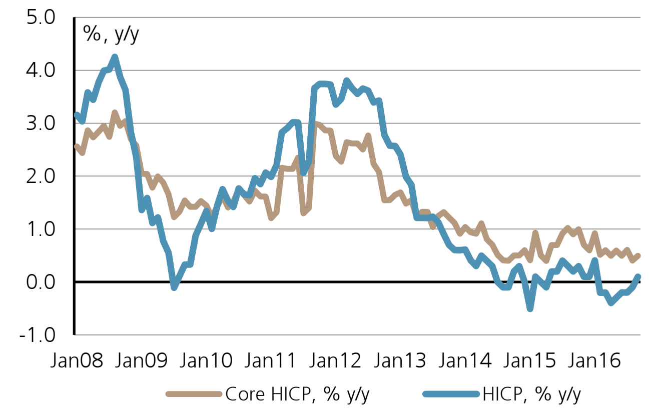
Source: Haver, UBS.

Figure 72: GDP growth contributions



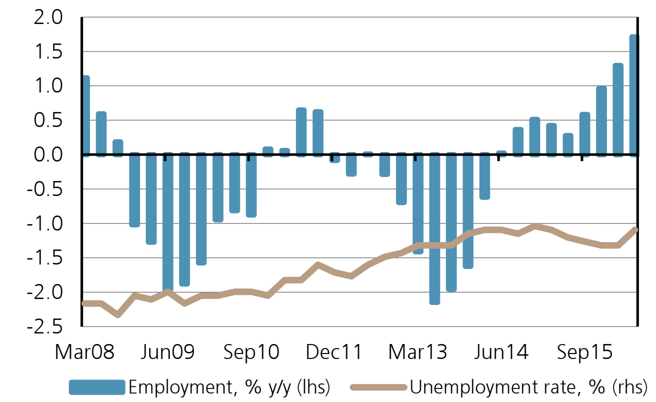
Source: Haver, UBS.

Figure 73: Inflation



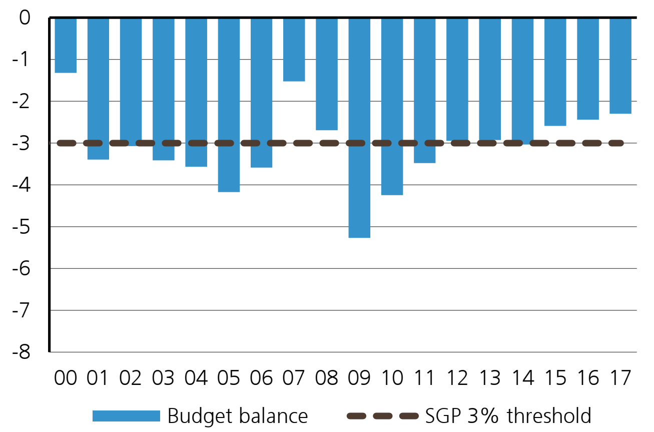
Source: Haver, UBS

Figure 74: Labour market



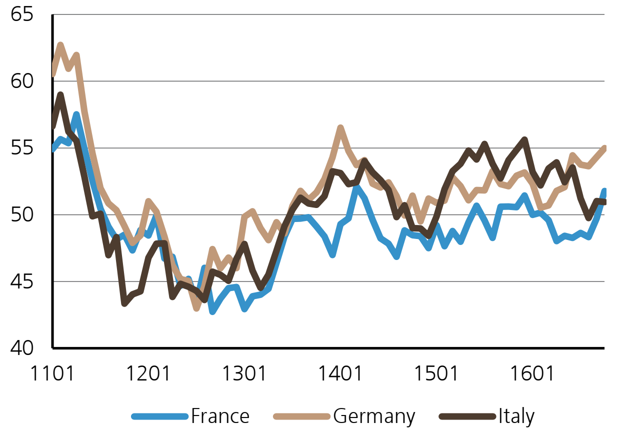
Source: Haver, UBS.

Figure 75: Budget balance



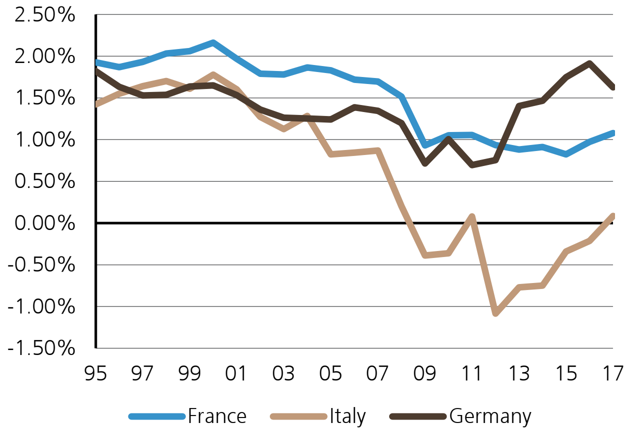
Source: Haver, UBS.

Figure 76: Manufacturing PMIs, selected countries



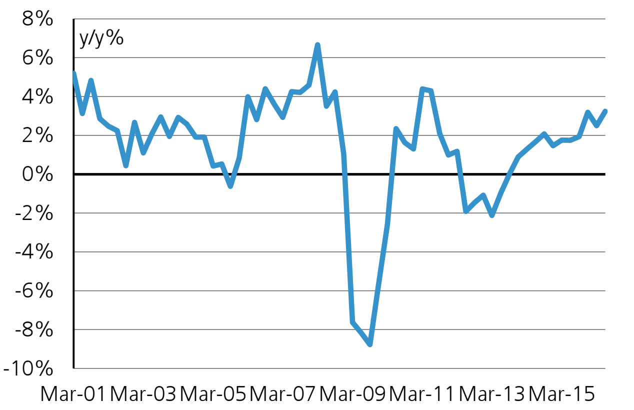
Source: Haver, UBS

Figure 77: Potential growth estimates



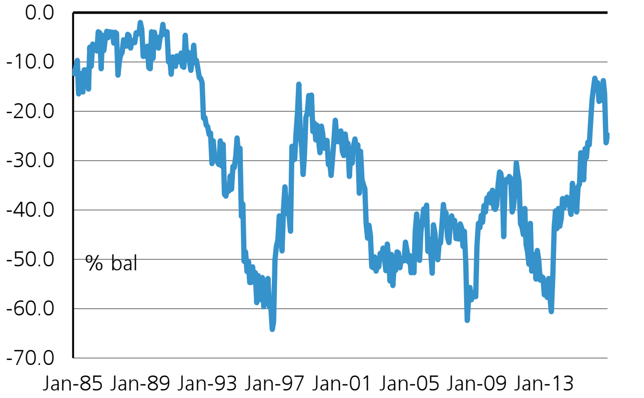
Source: Haver, European Commission, UBS

Figure 78: Nominal wage growth



Source: Haver, UBS

Figure 79: Consumer confidence – major purchases

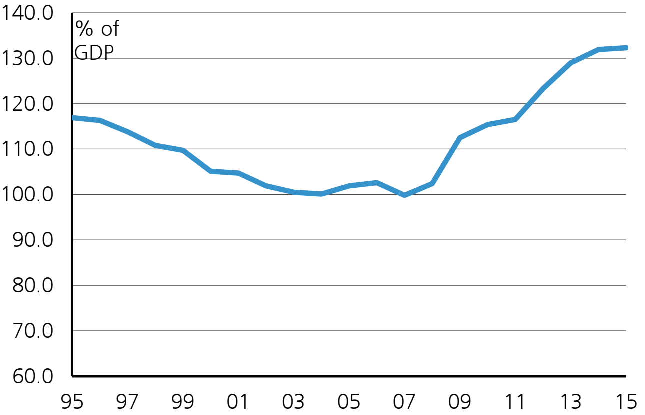


Source: Haver, UBS

Figure 80: Italian vs German government bond spread

Source: Haver, UBS

Figure 81: Government debt



Source: Haver, UBS

Figure 82: Italian economic forecasts

ITALY	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1638	1613	1604	1621	1642	1663	1691	1731
GDP, USD bn	2280	2074	2131	2154	1821	1849	1892	1999
GDP per capita, USD	37959	34375	35136	35440	29994	30433	31059	32717
Real GDP growth, %	0.7	-2.9	-1.7	0.2	0.6	0.7	0.8	0.8
Private consumption, % y/y	0.0	-4.0	-2.4	0.4	1.5	1.3	1.4	1.0
Government consumption, % y/y	-1.8	-1.4	-0.3	-0.9	-0.6	0.6	0.2	0.2
Gross Fixed Capital formation, % y/y	-1.7	-9.4	-6.6	-2.9	1.1	1.9	0.3	0.6
Exports, % y/y	6.1	2.0	1.0	2.6	4.0	1.4	2.2	2.6
Imports, % y/y	1.2	-8.3	-2.2	3.2	5.8	2.6	3.3	2.7
Domestic demand, cont. to growth, pp	-0.5	-5.6	-2.6	0.2	1.0	1.1	1.0	0.7
Net exports, cont. to growth, pp	1.2	2.8	0.8	-0.1	-0.4	-0.3	-0.3	0.0
Unemployment rate, %	8.4	10.7	12.2	12.7	11.9	11.5	11.2	10.8
Industrial Production (%)	1.3	-6.2	-3.0	-0.6	0.9	1.8	1.0	0.8
Prices, interest rates and money								
HICP inflation, % y/y (average)	2.9	3.3	1.2	0.2	0.1	-0.1	1.1	1.8
HICP inflation, % y/y (year-end)	3.7	2.6	0.6	0.0	0.1	0.2	1.4	1.8
Broad money M2, % y/y (end-year)	0.6	6.9	2.8	3.5	3.8	3.6	3.6	3.6
Domestic private credit, % y/y	3.5	-2.5	-4.1	-0.9	0.7	0.6	2.9	2.3
Domestic bank credit/GDP	108.8	108.7	105.2	103.8	103.2	101.8	103.0	106.0
Policy rate, % (end-year)	1.00	0.75	0.25	0.05	0.05	0.00	0.00	0.00
10 year bond yield, % (year-end)	6.98	4.53	4.17	1.92	1.62	1.75	2.00	2.20
USD/EUR (year-end)	1.29	1.32	1.38	1.21	1.09	1.10	1.13	1.17
Fiscal accounts								
General government budget balance, % GDP	-3.5	-2.9	-2.9	-3.0	-2.6	-2.4	-2.2	-1.3
Revenue, % GDP	45.7	47.8	48.1	48.2	47.9	47.2	46.0	45.8
Expenditure, % GDP	49.1	50.8	51.0	51.2	50.5	49.6	48.2	47.2
of which interest expenditure, % GDP	4.7	5.2	4.8	4.6	4.2	3.7	3.6	3.4
Primary balance, % GDP	1.2	2.2	1.9	1.6	1.6	1.3	1.4	2.1
Public sector debt (gross),% GDP	116.5	123.3	129.0	132.5	132.7	132.7	131.5	131.0
% domestic public debt held by non-residents	43.7	35.1	36.7	36.0	37.9	n/a	n/a	n/a
Balance of payments								
Trade balance, EUR bn	-19	17	36	47	54	56	50	47
Exports, EUR bn	364	377	379	390	405	411	420	431
Imports, EUR bn	382	361	343	342	353	354	370	384
Current account balance, EUR bn	-49.3	-5.8	15.4	30.5	26.6	33.3	28.8	29.4
as % of GDP	-3.0	-0.4	1.0	1.9	1.6	2.0	1.8	1.7
Foreign direct investment (net), EUR bn	12.4	5.3	0.6	2.3	0.9	2.0	2.0	2.0
Total external debt, % GDP	112.7	119.4	119.1	124.4	126.3	129.7	130.5	131.3
Net International Investment Position, % GDP	-19.2	-23.9	-25.3	-24.5	-23.6	-19.1	-18.3	-17.4
Credit ratings								
Moody's	A2	Baa2	Baa2	Baa2	Baa2	Baa2	n/a	n/a
S&P	A	BBB+	BBB	BBB-	BBB-	BBB-	n/a	n/a
Fitch	A+	A-	BBB+	BBB+	BBB+	BBB+	n/a	n/a

Source: Haver, Eurostat, European Commission, Reuters Eikon, IMF, UBS estimates

Spain

- **GDP growth to decelerate from 3.2% in 2016 (upgraded from 2.8%) to 2.3% in 2017 (previously 1.9%) and 1.9% in 2018**
- **Spain to remain the fastest growing of the major Eurozone countries**
- **Fiscal consolidation and labour-market reform remain key challenges**

Growth to decelerate, but remain high relative to the other big Eurozone countries

Economic momentum remains surprisingly strong thanks to an improving labour market, accommodative fiscal conditions and external trade supported by strong tourism. We have raised our GDP growth forecast from 2.8% to 3.2% for 2016 and from 1.9% to 2.3% for 2017. It is encouraging that the recent period of political uncertainty does not seem to have taken a substantial toll on growth. For 2018, we forecast a deceleration to 1.9%, driven by a number of factors. First, similar to other European countries, the pick-up in oil prices and inflation will likely create headwinds to household real income growth. Second, the improvement in labour markets is likely to lose some steam. Third, fiscal policy, which has been growth-supportive in recent years, will have to tighten. In more abstract terms, Spain has grown well above its potential output growth rate (estimated at less than 1%) in recent years. But, by definition, above-potential growth cannot be sustained forever; as such, a certain deceleration in Spanish growth seems almost inevitable – unless potential growth itself is being raised. But even then, Spain should be able to maintain the highest growth rate among the bigger Eurozone countries.

Spain has no fiscal policy margin

Fiscal policy is likely to be a headwind to growth over the coming years. Although the deadline for Spain to bring its budget deficit below 3% of GDP (and hence exit the European Commission's "Excessive Deficit Procedure") has already been postponed twice in recent years, the EC this year granted Spain another two-year extension, to 2018. Following a higher-than-targeted budget deficit of 5.1% of GDP in 2015, the Commission proposed amended budget deficit targets of 4.6% of GDP for 2016, 3.1% for 2017 and 2.2% of GDP in 2018. Consequently, the government will remain under pressure to consolidate public finances further. We think this will have to include a reduction in expenditure (relative to GDP), which has been avoided so far. In other words, Spain has no fiscal policy margin.

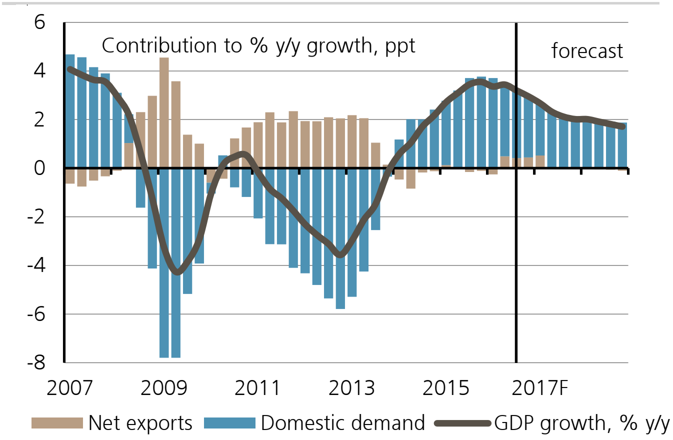
Can Spain achieve further declines in unemployment without new labour-market reforms?

A key question for economic performance going forward will be whether Spain can make further progress in reducing its very high unemployment rate. After all, labour-market trends are a major driver of household consumption, which represents 55% of GDP; obviously, this would also have a big impact on public finances. Unemployment dropped from 26% in 2013 to 19.5% in August 2016. Although the 2012 labour market reform will have contributed to this outcome, we feel that more reforms will be needed to sustain the trend of declining unemployment. According to IMF estimates, the level of *structural* unemployment in Spain is 16.5% – hence, a substantial decline in unemployment below this level cannot be achieved just by faster growth. Instead, greater flexibility in labour contracts, wage-setting and active labour-market policies will be required.

Downside risk: slow fiscal consolidation and related vulnerabilities

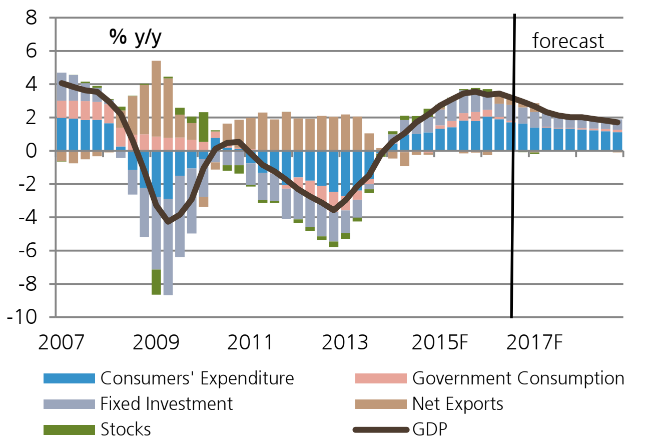
Key downside risks for the outlook, in our view, are slow progress in budget consolidation and structural reforms by a politically weak (minority) government. Given Spain's large stock of public debt (100% of GDP), this could expose Spanish markets to weakness in an environment of rising global yields. Upside risks could come from a better-than-expected external environment, for both tourism and good exports, or an ongoing, faster-than-expected decline in unemployment.

Figure 83: Real GDP (% y/y) and contributions (ppt)



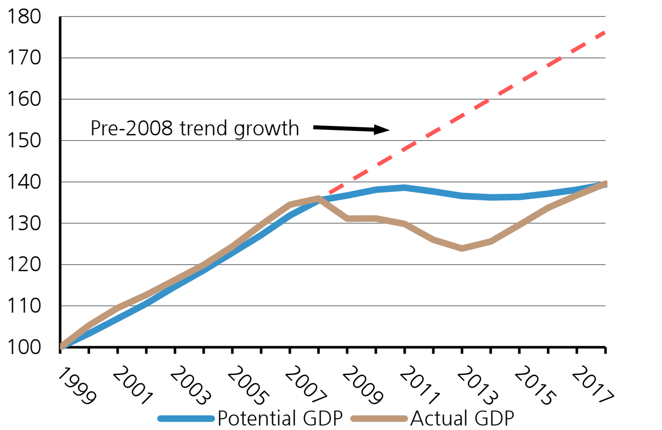
Source: Haver, UBS estimates

Figure 84: GDP (% y/y) and contributions to growth (ppt)



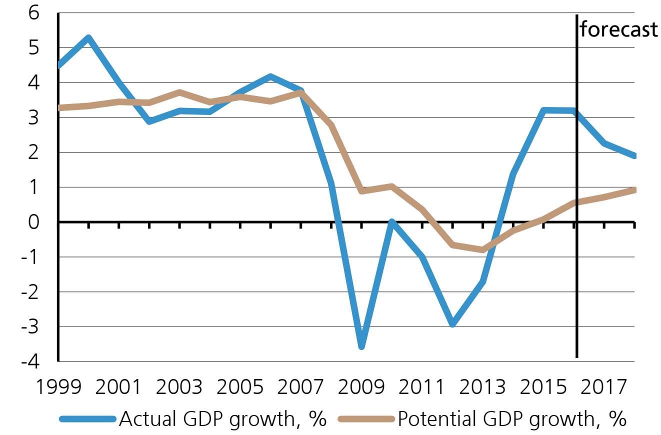
Source: Haver, UBS estimates

Figure 85: Actual and potential GDP (indexed, 1999 = 100)



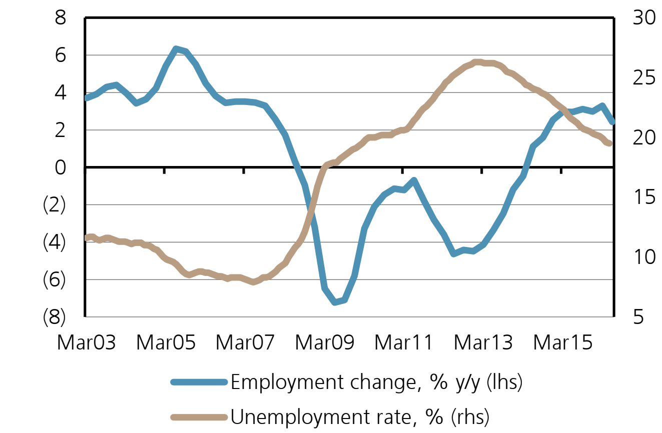
Source: European Commission estimates, Haver, UBS

Figure 86: Actual and potential real GDP growth (%)



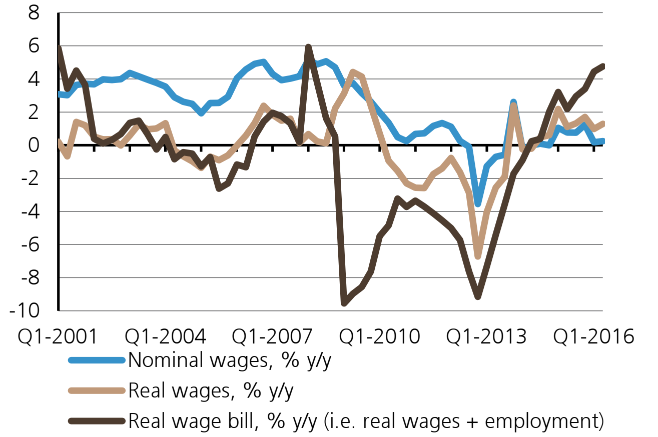
Source: European Commission estimates, Haver, UBS. UBS forecasts for actual GDP growth.

Figure 87: Employment growth and unemployment rate



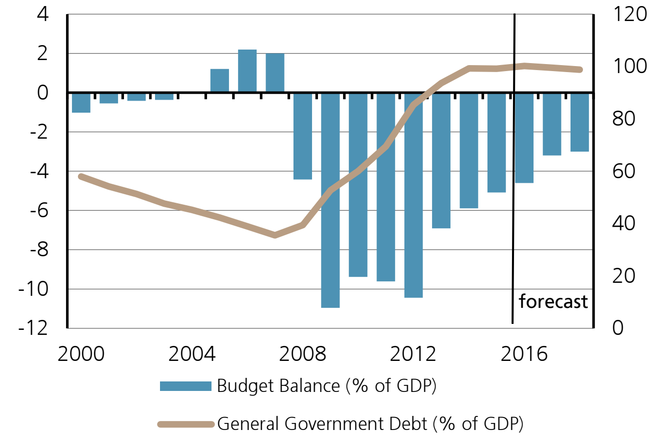
Source: Haver, UBS

Figure 88: Wage growth, nominal and real (% y/y)



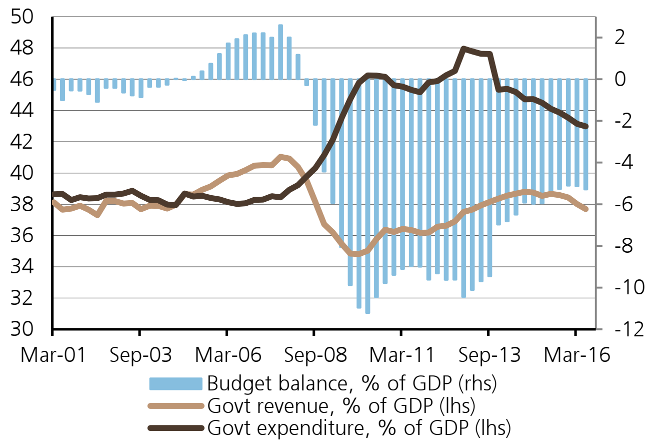
Source: Haver, UBS

Figure 89: Budget deficit and public debt



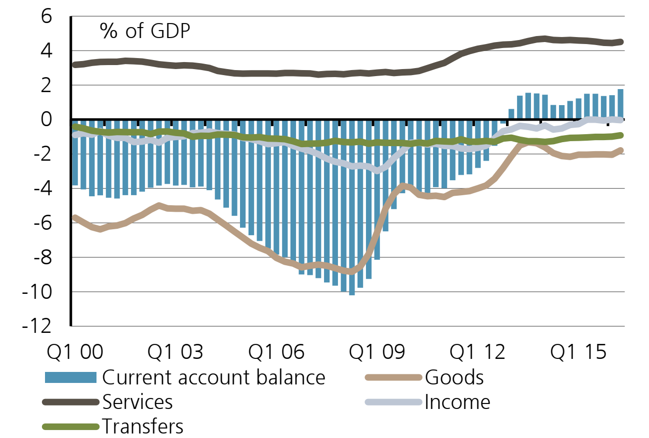
Source: Haver, UBS estimates

Figure 90: Government revenue, expenditure & balance



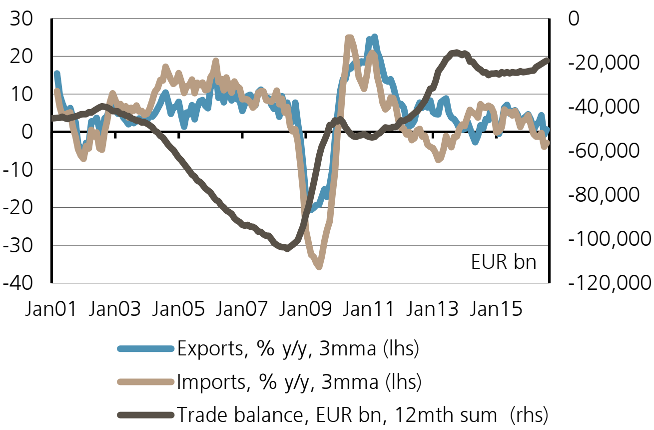
Source: Haver, UBS

Figure 91: Current account and sub-components



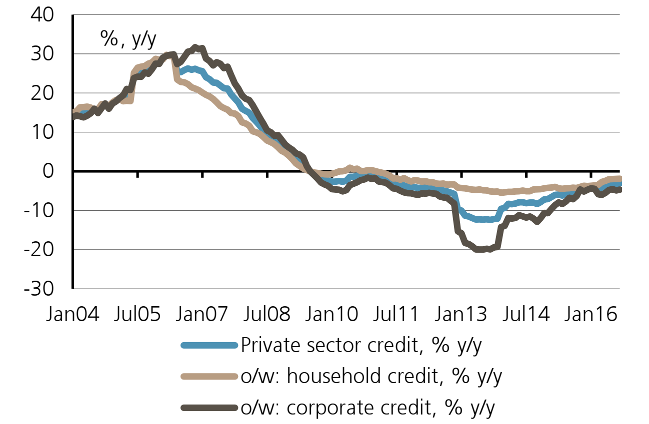
Source: Haver, UBS

Figure 92: Foreign trade



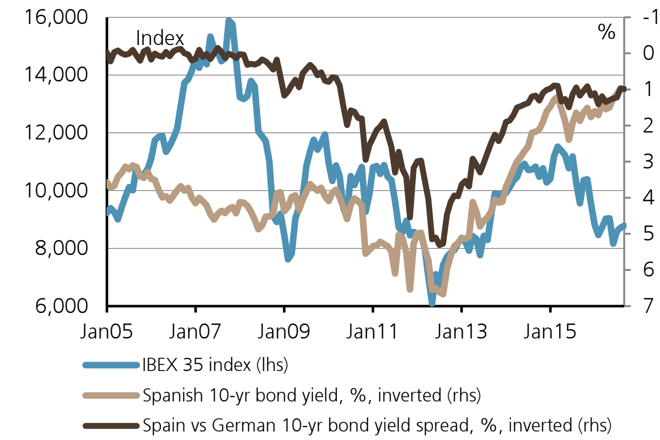
Source: European Commission estimates, UBS

Figure 93: Credit growth



Source: Haver, UBS

Figure 94: Stock market, bond yields and spreads



Source: Haver, UBS

Figure 95: Spanish economic forecasts

SPAIN	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1070	1040	1026	1037	1076	1119	1161	1206
GDP, USD bn	1490	1337	1362	1378	1193	1244	1299	1393
GDP per capita, USD	31876	28584	29236	29650	25706	26832	28060	30126
Real GDP growth, %	-1.0	-2.9	-1.7	1.4	3.2	3.2	2.3	1.9
Private consumption, % y/y	-2.4	-3.5	-3.1	1.6	2.9	3.3	2.5	2.2
Government consumption, % y/y	-0.3	-4.7	-2.1	-0.3	2.0	0.8	0.0	0.6
Gross Fixed Capital formation, % y/y	-6.9	-8.6	-3.4	3.8	6.0	4.4	3.7	2.9
Exports, % y/y	7.4	1.1	4.3	4.2	4.9	6.1	4.6	3.3
Imports, % y/y	-0.8	-6.4	-0.5	6.5	5.6	5.9	4.8	3.9
Domestic demand, cont. to growth, pp	-3.1	-5.1	-3.1	1.9	3.3	3.0	2.1	1.9
Net exports, cont. to growth, pp	2.1	2.0	1.4	-0.4	0.0	0.3	0.1	-0.1
Unemployment rate, %	21.4	24.8	26.1	24.4	22.1	19.9	18.4	17.3
Industrial Production (%)	-1.7	-6.8	-1.8	1.2	3.3	1.9	2.9	2.8
Prices, interest rates and money								
HICP inflation, % y/y (average)	3.0	2.4	1.5	-0.2	-0.6	-0.4	1.6	1.7
HICP inflation, % y/y (year-end)	2.3	3.0	0.3	-1.1	-0.1	1.0	1.3	1.7
Core HICP, % y/y (average)	1.2	1.3	1.3	-0.1	0.3	0.6	0.6	0.9
Broad money M2, % y/y (end-year)	-5.2	0.2	-1.7	2.6	7.3	8.0	8.4	8.5
Domestic private credit, % y/y	-4.1	-9.8	-9.6	-7.2	-4.2	-2.5	-0.5	0.5
Domestic bank credit/GDP	169.1	160.4	145.4	135.5	124.5	117.7	112.4	109.0
Policy rate, % (end-year)	1.00	0.75	0.25	0.05	0.05	0.00	0.00	0.00
10 year bond yield, % (year-end)	5.27	5.26	4.12	1.61	1.77	1.25	1.40	1.70
USD/EUR (year-end)	1.29	1.32	1.38	1.21	1.09	1.10	1.13	1.17
Fiscal accounts								
General government budget balance, % GDP	-9.6	-10.4	-6.9	-5.9	-5.1	-4.6	-3.2	-3.0
Revenue, % GDP	36.2	37.5	38.2	38.6	38.2	38.2	38.3	38.5
Expenditure, % GDP	45.8	48.0	45.1	44.5	43.3	42.8	41.5	41.5
of which interest expenditure, % GDP	2.5	3.0	3.4	3.4	3.1	2.9	2.7	2.7
Primary balance, % GDP	-7.2	-7.5	-3.5	-2.5	-2.0	-1.7	-0.5	-0.3
Public sector debt (gross),% GDP	69.5	85.4	93.7	99.3	99.2	100.2	99.5	98.8
% domestic public debt held by non-residents	42.6	29.1	40.0	42.5	50.4	n/a	n/a	n/a
Balance of payments								
Trade balance, EUR bn	-44	-29	-14	-22	-22	-19	-24	-26
Exports, EUR bn	216	224	236	239	250	259	267	276
Imports, EUR bn	260	253	250	261	272	278	291	301
Current account balance, EUR bn	-34.0	-2.4	15.6	11.2	14.7	16.8	15.6	13.0
as % of GDP	-3.2	-0.2	1.5	1.1	1.4	1.5	1.3	1.1
Foreign direct investment (net), EUR bn	9.2	-21.1	-18.5	8.0	29.4	15.7	12.0	12.0
Total external debt, % GDP	160.3	166.2	159.8	167.7	168.5	169.5	165.5	161.5
Net International Investment Position, % GDP	-91.9	-89.9	-94.3	-97.5	-89.9	-87.0	-84.0	-81.0
Credit ratings								
Moody's	A1	Baa3	Baa3	Baa2	Baa2	Baa2	n/a	n/a
S&P	AA-	BBB-	BBB-	BBB	BBB+	BBB+	n/a	n/a
Fitch	AA-	BBB	BBB	BBB+	BBB+	BBB+	n/a	n/a

Source: Haver, Eurostat, European Commission, Reuters Eikon, IMF, UBS estimates

UK

- **GDP growth to halve from 2.0% in 2016 to 1.0% in 2017, and to slow further to 0.7% in 2018**
- **Inflation to accelerate as a result of the weakness of the pound, with CPI averaging 2.8% in both 2017 and 2018**
- **Anaemic growth and a softening labour market to trigger more monetary easing around mid-2017**

Recovery continuing…so far

The UK economy has thus far continued the steady momentum that has seen fifteen consecutive quarters of positive growth, averaging +0.6% q/q, since the first quarter of 2013. The resilience of activity in the wake of the referendum on EU membership in June 2016 has been primarily a result of the very large depreciation of sterling, which has declined by 20% on a trade-weighted basis over the past year. While that has boosted net trade dynamics and benefitted domestic producers and retailers competing with international rivals, it is already showing up in rapidly accelerating producer prices, and is starting to feed through to CPI as well.

Rising CPI and a weaker labour market will squeeze the consumer

At the same time as consumer prices continue to rise more quickly next year, there is likely to be a softening of the domestic labour market, as companies activate the more defensive hiring plans they have warned of since the referendum. While some doubt remains about the timing and exact mechanisms through which the government will trigger Article 50 of the Lisbon Treaty and thus begin the formal two-year journey to the UK's exit from the EU, we still expect it to happen by the end of Q1 2017.

Mounting uncertainty will hit investment and hiring

This is the likely catalyst for hiring and investment to cool, and we forecast a gradual drift higher in unemployment from 5.0% at present to 5.5% in 2017 and 6.3% by the end of 2018. Nominal earnings are likely to stay soft in such an environment, and real wages should therefore be squeezed hard. Consumption and investment are both likely to slow next year, and are the key drivers of our expectation of weaker growth over the next two years.

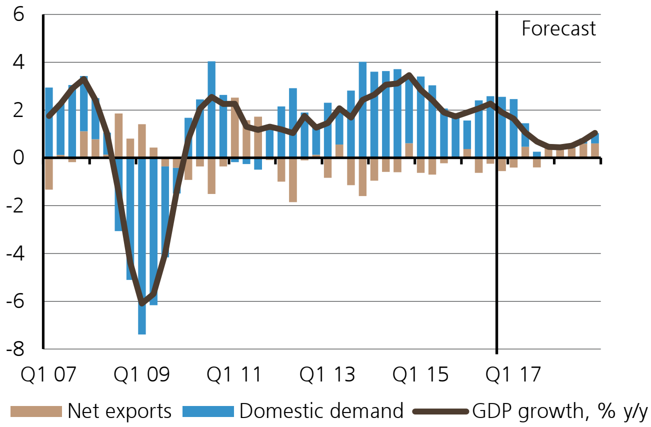
We expect more monetary easing to be required in 2017

Having eased monetary policy aggressively in the aftermath of the EU referendum, and signalled an expectation in August that more action would soon be needed, the MPC subsequently reverted to a neutral bias in November. The better outturn for growth in Q3, together with an upward revision to its CPI forecast, prompted this change of stance. However, we still view further easing as likely to be required by around the middle of 2017, and expect a cut in Bank Rate from 0.25% to 0.10% and a further £60bn of Gilt purchases to be endorsed. As in late 2011, when CPI was well above target but downside growth risks proliferated, we expect the MPC to focus on medium-term downside threats to its inflation target rather than be hamstrung by immediate and near-term upside price pressures.

Fiscal policy may be eased, but only modestly

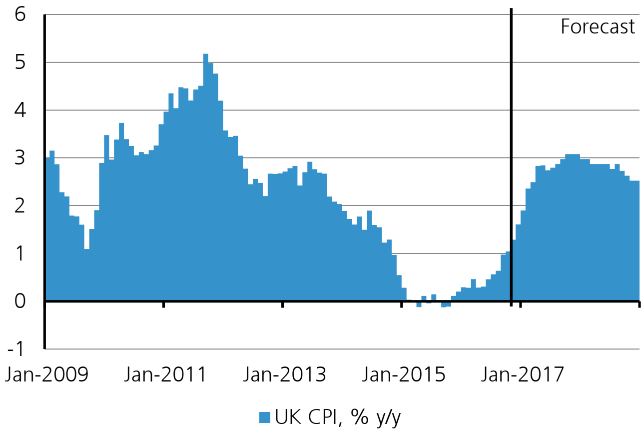
There are likely to be some changes made to the stance of fiscal policy too, but we expect any stimulus to be modest in scale, at least for the time being. The government continues to make clear its intention to eliminate the budget deficit when possible, even if it acknowledges a near-term need to allow automatic stabilisers to fully deploy and is open to the idea of a degree of front-loading of scheduled infrastructure spending. A more aggressive fiscal response is only likely to be considered if domestic growth slows more sharply than is currently expected.

Figure 96: Real GDP (% y/y) and contributions (ppt)



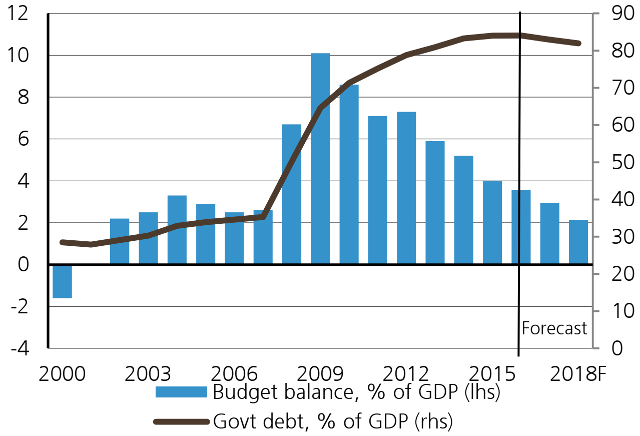
Source: ONS, UBS estimates

Figure 97: Inflation, % y/y



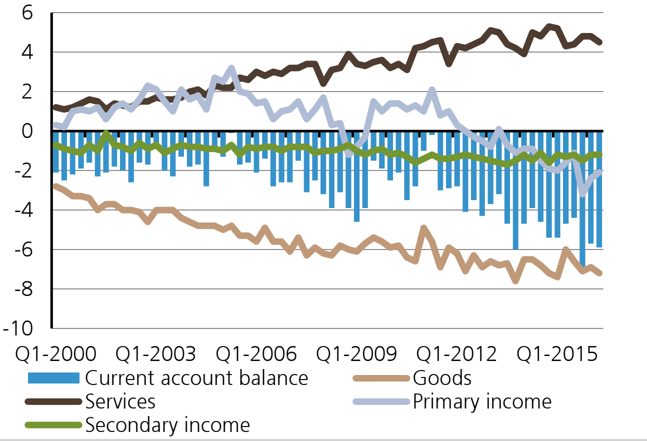
Source: Haver, UBS estimates

Figure 98: Budget deficit and public debt



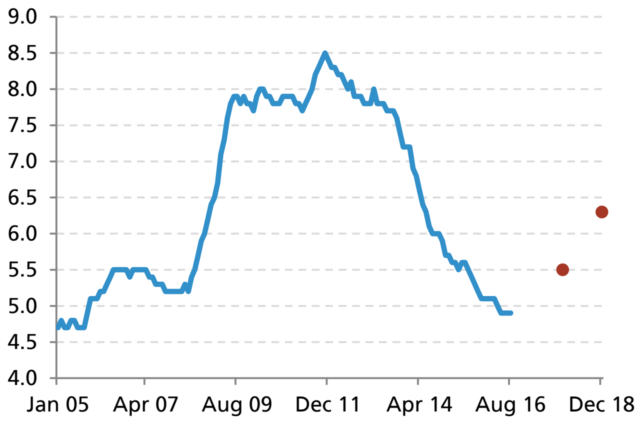
Source: Haver, UBS estimates

Figure 99: Current account and sub-components



Source: Haver, UBS

Figure 100: UK unemployment rate (%) and UBS forecasts

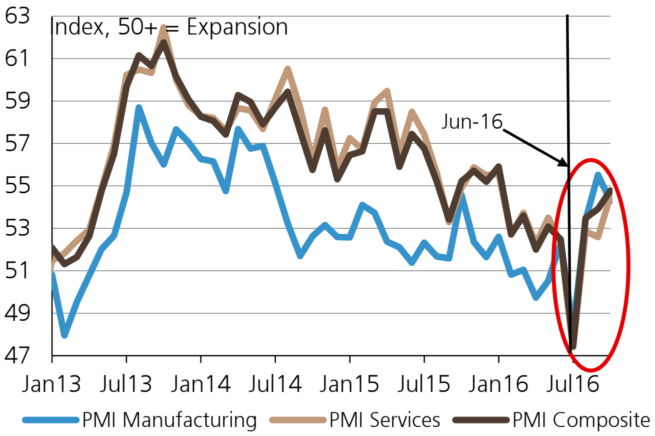


Source: ONS, UBS

Figure 101: Household saving ratio (% disposable income)

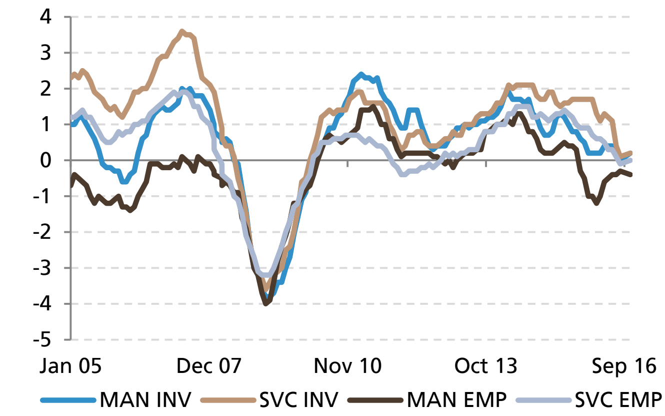
Source: ONS, UBS

Figure 102: Manufacturing and services PMI



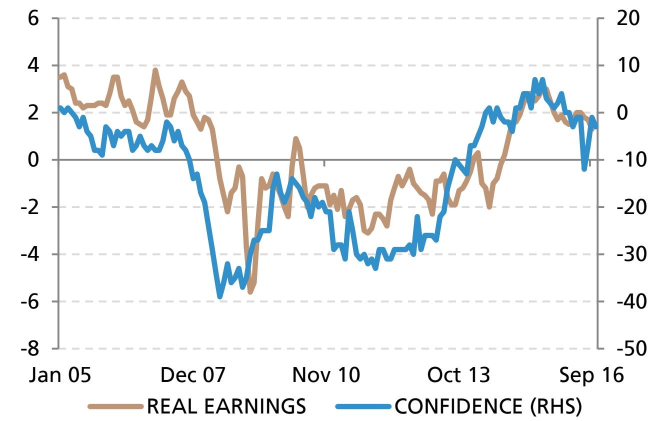
Source: Markit, Haver, UBS

Figure 103: Investment and employment intentions



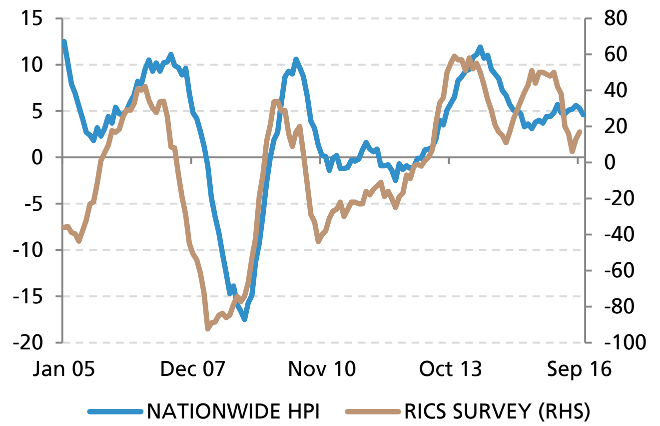
Source: Bank of England Agents' Scores, UBS

Figure 104: Consumer confidence and real earnings



Source: ONS, GfK, UBS

Figure 105: House prices (% y/y) and RICS survey

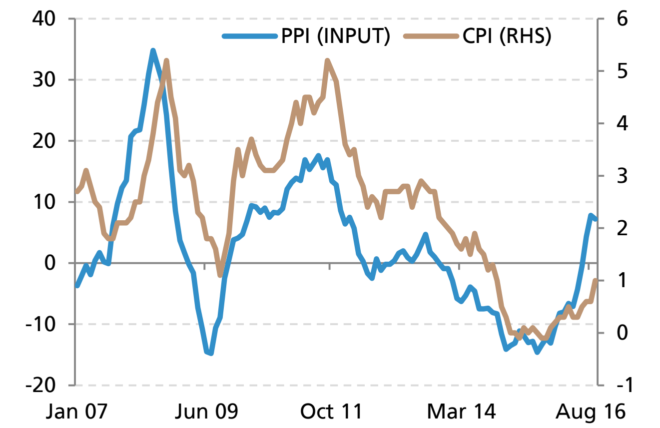


Source: Nationwide, RICS, UBS

Figure 106: Trade-weighted sterling index 2007-2016

Source: Bank of England, UBS

Figure 107: Input producer prices and CPI (% y/y)



Source: ONS, UBS

Figure 108: UK economic forecasts

UNITED KINGDOM	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1628	1675	1740	1822	1871	1941	2020	2091
GDP, USD bn	2569	2680	2743	2988	2831	2569	2350	2415
GDP per capita, USD	40602	42065	42791	46250	43488	39185	35595	36325
Real GDP growth, %	1.5	1.3	1.9	3.1	2.2	2.0	1.0	0.7
Private consumption, % y/y	-0.5	1.7	1.6	2.2	2.5	2.9	1.3	0.3
Government consumption, % y/y	0.2	1.7	0.3	2.3	1.5	1.4	2.0	2.0
Gross Fixed Capital formation, % y/y	1.9	2.3	3.2	6.7	3.4	1.1	0.6	-1.8
Exports, % y/y	5.8	0.6	1.1	1.5	4.5	2.5	1.7	2.0
Imports, % y/y	0.8	2.9	3.4	2.5	5.4	3.1	0.8	0.3
Domestic demand, cont. to growth, pp	0.1	2.0	2.7	3.4	2.5	2.2	0.9	0.2
Net exports, cont. to growth, pp	1.4	-0.7	-0.8	-0.4	-0.4	-0.3	0.0	0.5
Unemployment rate, %	8.1	8.0	7.6	6.2	5.4	5.0	5.5	6.3
Industrial Production (%)	-0.6	-2.7	-0.7	1.5	1.3	1.0	-0.1	0.8
Prices, interest rates and money								
CPI inflation, % y/y (average)	4.5	2.8	2.6	1.5	0.0	0.7	2.8	2.8
CPI inflation, % y/y (year-end)	4.6	2.7	2.1	0.9	0.1	1.3	3.1	2.6
Broad money M2, % y/y (end-year)	-2.2	0.4	1.7	0.1	2.5	7.0	5.2	4.4
Domestic private credit, % y/y	-1.5	-0.5	-0.7	0.8	2.2	4.0	3.6	3.4
Domestic bank credit/GDP	97.8	94.2	90.0	86.7	86.3	87.1	86.9	86.7
BoE Repo rate, % (end-year)	0.50	0.50	0.50	0.50	0.50	0.25	0.10	0.10
10 year bond yield, % (year-end)	2.28	1.81	2.79	2.07	1.88	1.20	1.40	1.65
GBPUSD (year-end)	1.55	1.62	1.65	1.56	1.48	1.22	1.13	1.17
EURGBP (year-end)	0.84	0.81	0.83	0.78	0.74	0.90	1.00	1.00
Fiscal accounts								
General government budget balance, % GDP	-7.1	-7.3	-5.9	-5.2	-4.0	-3.6	-2.9	-2.1
Revenue, % GDP	36.7	36.0	35.9	35.7	36.1	36.2	36.1	35.9
Expenditure, % GDP	43.8	43.2	41.8	41.0	40.1	39.7	39.0	38.0
of which interest expenditure, % GDP	3.2	2.9	2.9	2.7	2.3	2.3	2.2	2.1
Primary balance, % GDP	-4.7	-5.3	-4.0	-3.6	-2.4	-1.5	-1.2	-1.0
Public sector debt (gross),% GDP	75.2	78.8	80.9	83.3	84.0	84.1	82.9	82.0
% domestic public debt held by non-residents	27.3	31.9	29.7	28.4	30.9	n/a	n/a	n/a
Public debt held by the central bank, % GDP	15.9	22.7	22.1	21.3	21.4	23.2	25.8	24.9
Balance of payments								
Trade balance, GBP bn	-95	-111	-121	-123	-126	-127	-110	-102
Exports, GBP bn	308	302	303	293	283	293	300	307
Imports, GBP bn	403	413	424	415	410	419	410	409
Current account balance, GBP bn	-29.1	-61.4	-76.4	-85.0	-100.2	-104.7	-90.0	-82.0
as % of GDP	-1.8	-3.7	-4.4	-4.7	-5.4	-5.4	-4.5	-3.9
Foreign direct investment (net), GBP bn	-33.3	22.0	7.2	117.4	75.2	62.7	-40.0	-40.0
Total FX reserves, USD bn	94	105	109	109	130	147	151	155
Foreign exchange reserves excl gold, USD bn	78	89	97	97	120	134	137	140
Total FX reserves, % GDP	3.6	3.9	4.0	3.7	4.6	5.7	6.4	6.4
Total external debt, % GDP	385.8	374.1	340.8	325.5	297.8	305.0	308.0	312.0
Net International Investment Position, % GDP	-5.9	-22.4	-16.2	-17.6	-14.4	-13.9	-11.0	-8.4
Credit ratings								
Moody's	Aaa	Aaa	Aa1	Aa1	Aa1	Aa1	n/a	n/a
S&P	AAA	AAA	AAA	AAA	AAA	AA	n/a	n/a
Fitch	AAA	AAA	AA+	AA+	AA+	AA	n/a	n/a

Source: Haver, BoE, ONS, Reuters Eikon, IMF, UBS estimates

Switzerland

- **GDP to grow by 1.5% in 2016, 1.3% in 2017 and 1.6% in 2018**
- **Inflation projected to turn positive in 2017**
- **SNB to remain on hold until well into 2018**

Continued recovery and growth above the Eurozone in 2018

GDP growth in Switzerland has accelerated further since its recent low in Q1 2015, when the franc appreciated sharply and quarterly growth was negative. We expect real GDP to increase by 1.5% in 2016 – almost twice its rate in 2015. Improved growth in Switzerland's main trading partners, notably the Eurozone, and solid private consumption growth, are key drivers. Looking ahead, we expect some moderation in growth in 2017 to 1.3%, reflecting weaker investment due to the uncertainty regarding ongoing talks with the EU about potential restrictions on the free movement of labour, as well as the broader impact of negotiations on the UK's departure from the EU. In 2018, we expect growth to rise back to around its trend level of 1.6%. This would be the first time since 2014 that Switzerland has grown more strongly than the Eurozone, owing to its higher growth potential (an estimated 1.6-1.7%).

Inflation has risen in 2016 and should turn positive in early 2017

Inflation has risen rapidly in 2016, from -1.3% y/y in January to -0.2% in October, reflecting the fading impact of the franc's strengthening in 2015 and energy base effects. We expect inflation to turn positive around the turn of the year and to rise to around 1.2% by the end of 2018. The slight increase in unemployment that we expect for 2017, due to lagged effects of below-potential growth, should help to moderate the pace of underlying inflation somewhat.

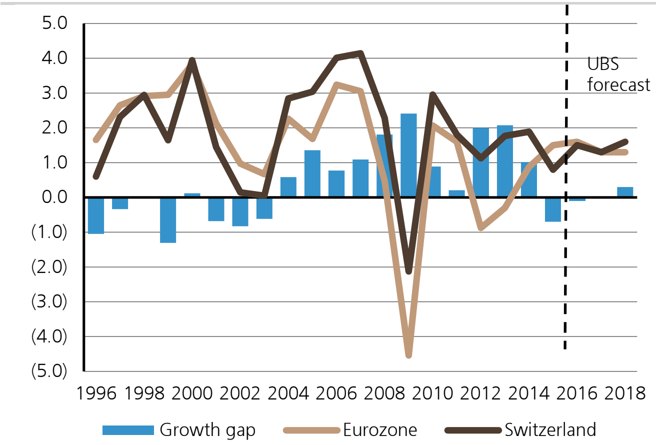
SNB to keep intervening and maintaining policy rates at current levels until 2018

The Swiss National Bank continues to charge the most negative policy interest rates on sight deposits across the central banks in the advanced economies. This policy is aimed at lowering appreciation pressures on the franc. The SNB regularly stresses that it views the currency as overvalued, and continues to intervene moderately in the foreign-exchange market to weaken it. Given increased evidence of the adverse side-effects of negative rates – such as increased demand for high-denomination cash – we view the hurdle for further SNB rate cuts as fairly high. In our view, this would only be an option if substantial interventions were necessary to prevent the franc from falling below the 1.05-1.07 range against the EUR. ECB policy is seen as a key determinant for the franc and we think appreciation pressure on the Swiss currency is unlikely to abate fully until the ECB has phased out its asset purchase program and starts normalising its policy stance. For this reason, we believe the first SNB rate hike is unlikely to occur before around the middle of 2018, by which time the ECB is expected to have tapered its QE program.

Uncertainty about prolonged Swiss-EU discussions on immigration restrictions could weigh on the outlook

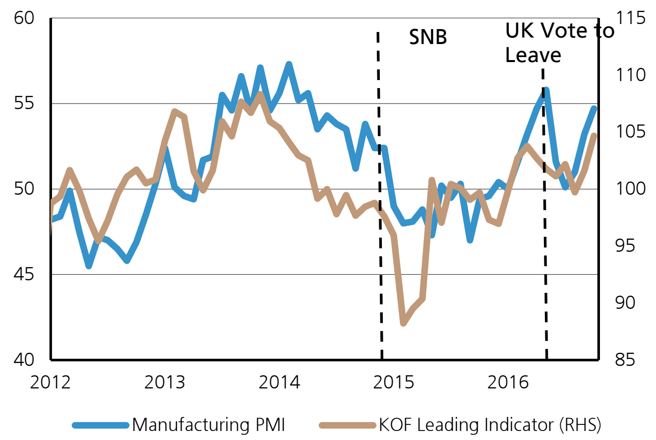
A key source of uncertainty regarding the outlook are the ongoing talks with the EU about potential restrictions on the free movement of labour. The 2014 referendum on restricting immigration into Switzerland envisaged a three-year timescale on implementing certain immigration limits. The latest Swiss proposal involves granting Swiss nationals slight advantages on the labour market, but thus far no mutually agreeable solution has been found. Business sentiment has not shown any signs of weakness so far, but a profound weakening of Swiss-EU relations would likely weigh on confidence and firms' investment plans. In addition, a pick-up in safe-haven flows into the franc, perhaps in response to a global shock event, would weigh on growth and complicate monetary policy-making.

Figure 109: Real GDP growth



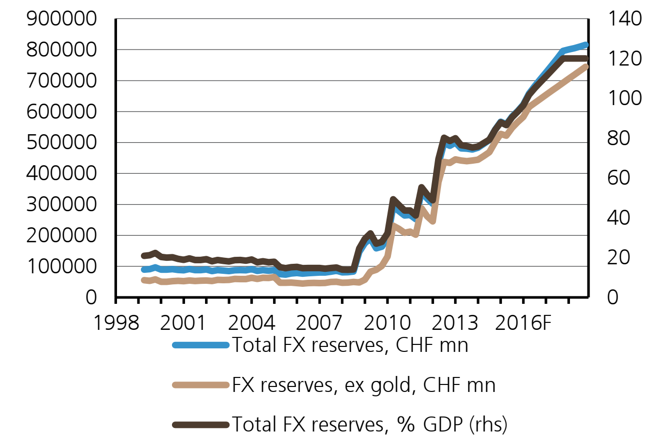
Source: Haver, UBS.

Figure 110: PMI and KOF leading indicator



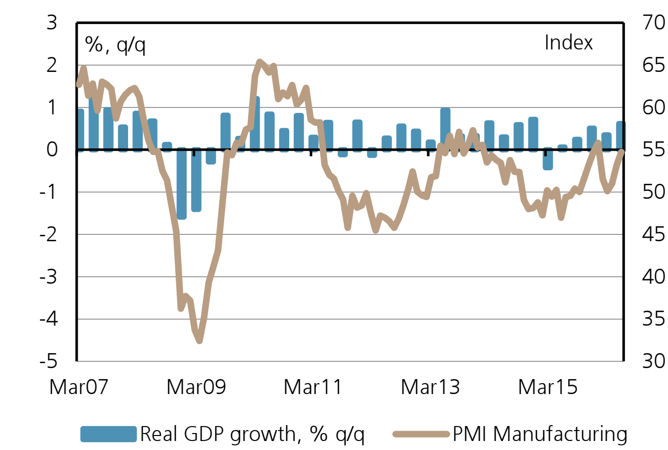
Source: Haver, UBS.

Figure 111: Switzerland – FX reserves



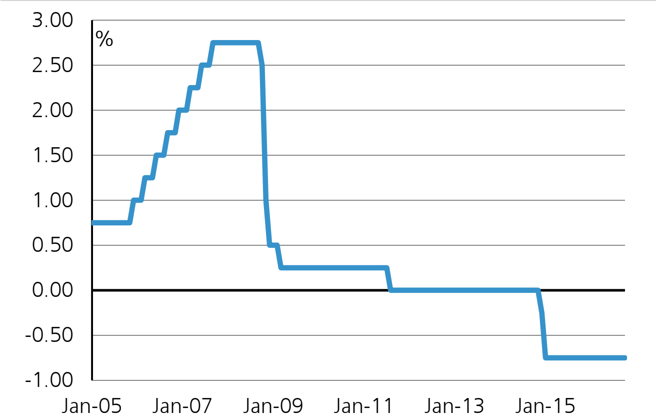
Source: Haver, UBS

Figure 112: GDP growth and PMI



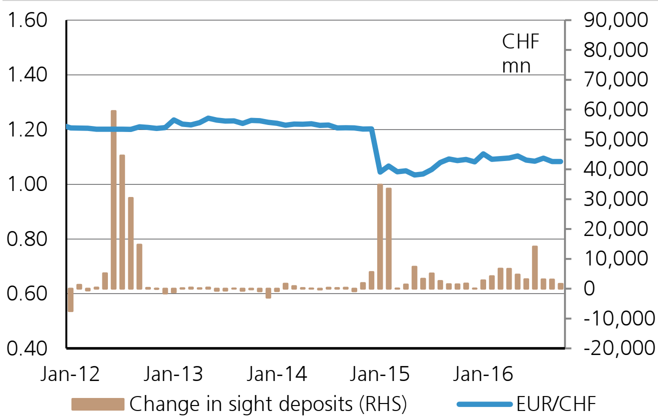
Source: Haver, UBS

Figure 113: SNB policy rate



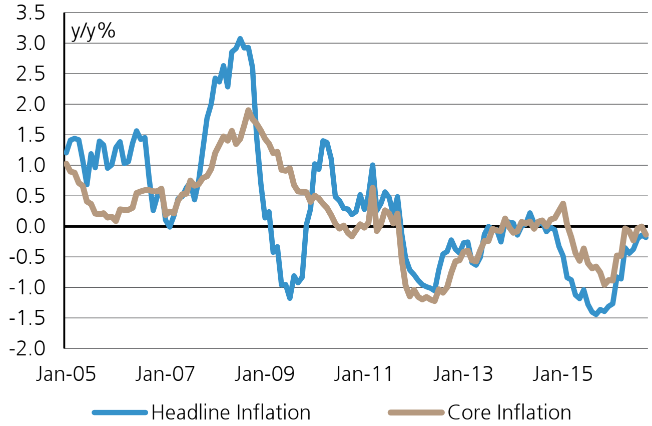
Source: Haver, UBS

Figure 114: Swiss franc and SNB interventions



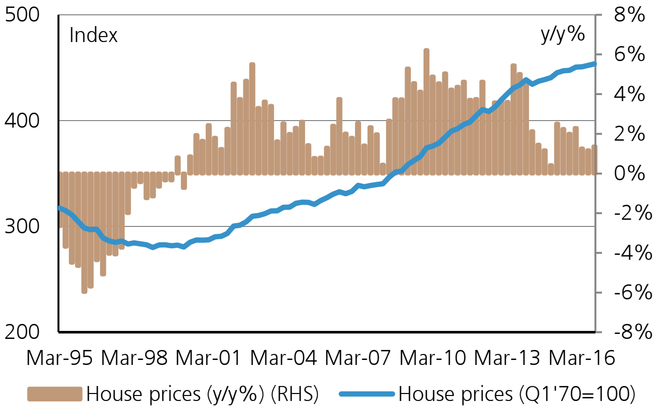
Source: Haver, UBS

Figure 115: Inflation



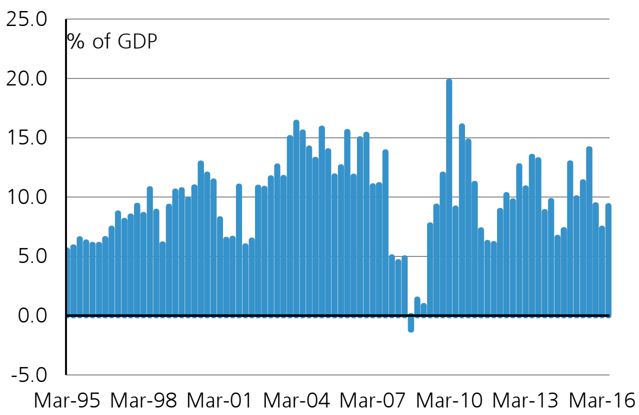
Source: Haver, UBS

Figure 116: House prices



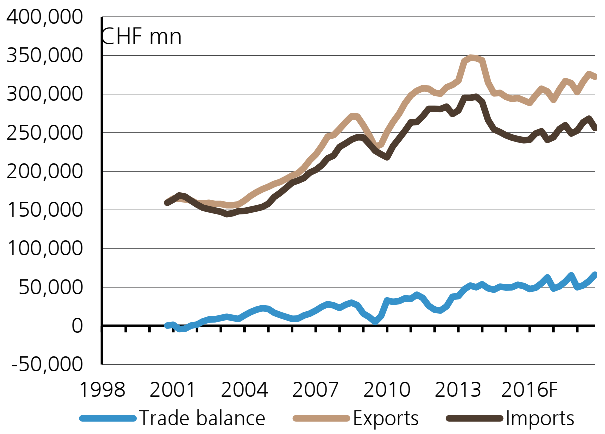
Source: Haver, UBS

Figure 117: Current account balance



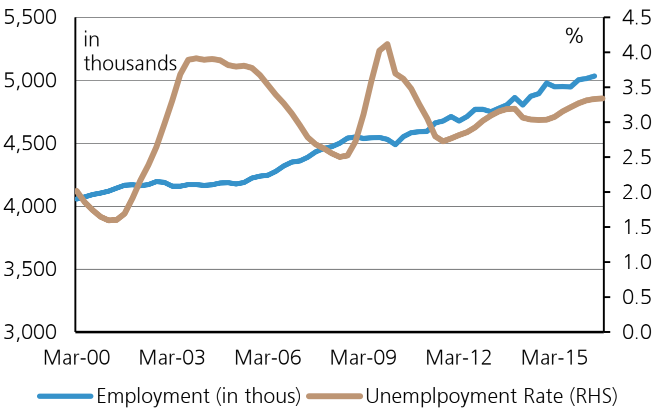
Source: Haver, UBS

Figure 118: Switzerland external sector



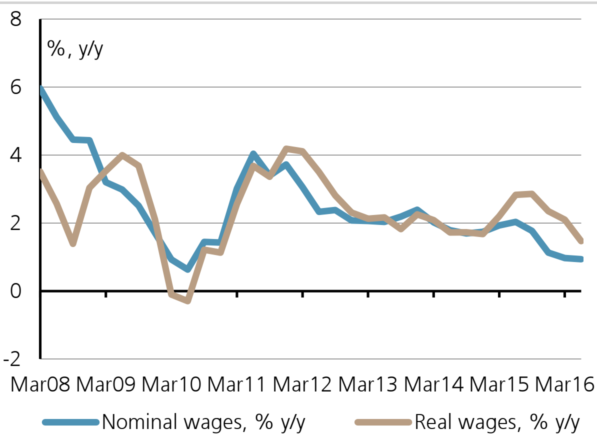
Source: Haver, UBS

Figure 119: Labour market



Source: Haver, UBS

Figure 120: Wage growth



Source: Haver, UBS

Figure 121: Swiss economic forecasts

SWITZERLAND	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	618	623	635	644	645	652	663	680
GDP, USD bn	698	665	685	704	671	665	679	699
GDP per capita, USD	88258	83164	84717	86000	81564	80509	81716	83286
Real GDP growth, %	1.9	1.1	1.8	2.0	0.8	1.5	1.3	1.6
Private consumption, % y/y	0.9	2.6	2.2	1.2	1.0	1.0	1.1	1.2
Government consumption, % y/y	2.1	2.1	2.3	1.5	2.2	2.3	1.2	0.9
Gross Fixed Capital formation, % y/y	4.3	2.9	1.2	2.8	1.5	2.3	0.6	2.5
Exports, % y/y	3.7	3.1	0.1	5.1	2.0	4.9	2.7	3.0
Imports, % y/y	4.9	4.5	1.5	3.1	2.8	3.1	2.6	3.2
Unemployment rate, %	2.8	3.0	3.2	3.0	3.3	3.4	3.5	3.4
Industrial Production (%)	3.6	2.6	0.8	1.4	-2.5	0.5	1.5	1.5
Prices, interest rates and money								
CPI inflation, % y/y (average)	0.2	-0.7	-0.2	0.0	-1.1	-0.4	0.4	0.9
CPI inflation, % y/y (year-end)	-0.7	-0.4	0.1	-0.3	-1.3	0.0	0.6	1.2
Broad money M2, % y/y (end-year)	9.7	10.3	3.1	2.6	1.4	3.5	3.9	4.3
Domestic private credit, % y/y								
Domestic bank credit/GDP	177.6	184.4	189.6	203.3	206.2	210.0	212.0	214.0
Policy rate, % (end-year)	0.00	0.00	0.00	-0.25	-0.75	-0.75	-0.75	-0.50
10 year bond yield, % (year-end)	0.69	0.46	1.09	0.37	-0.09	-0.20	-0.05	0.15
USD/CHF (year-end)	0.91	0.93	0.90	0.96	0.99	0.98	0.98	0.97
EUR/CHF (year-end)	1.23	1.21	1.23	1.20	1.08	1.08	1.11	1.13
Fiscal accounts								
General government budget balance, % GDP	0.5	0.0	-0.2	-0.2	-0.2	0.2	0.2	0.0
Revenue, % GDP	33.7	33.5	33.7	33.5	33.4	33.9	33.8	33.5
Expenditure, % GDP	32.9	33.3	34.0	33.7	33.7	33.7	33.6	33.5
of which interest expenditure, % GDP	0.8	0.7	0.6	0.6	0.6	0.1	0.1	0.2
Primary balance, % GDP	1.5	1.0	0.3	0.4	0.3	0.3	0.3	0.2
Public sector debt (gross),% GDP	46.0	46.6	46.4	45.7	45.7	44.7	43.7	42.6
of which domestic public debt, % GDP	37.3	32.4	32.3	27.2	23.7	23.7	20.7	18.1
of which external public debt,% GDP	8.8	14.3	14.0	18.4	22.0	21.0	23.0	24.5
% domestic public debt held by non-residents	7.4	8.3	10.5	10.6	11.2	12.5	13	13.5
Public debt held by the central bank, % GDP	1.3	1.3	1.3	1.4	1.3	1.4	1.4	1.4
Balance of payments								
Trade balance, CHF bn	26.1	37.7	49.8	50.8	51.6	62.8	65.4	66.2
Exports, CHF bn	307	312	346	302	292	303	314	322
Imports, CHF bn	281	274	297	251	240	241	249	256
Current account balance, CHF bn	47.4	64.3	73.2	58.5	71.9	60.2	59.4	60.8
as % of GDP	7.7	10.3	11.5	9.1	11.1	9.2	9.0	8.9
Foreign direct investment (net), CHF bn	17.5	25.6	34.6	-10.0	1.4	25.8	25.8	25.8
Total FX reserves, CHF bn	319	490	478	542	602	704	796	816
Foreign exchange reserves excl gold, CHF bn	262	434	442	502	566	641	693	745
Total FX reserves, % GDP	51.6	78.6	75.2	84.1	93.3	108.0	120.0	120.0
Total external debt, % GDP	220.8	238.4	234.0	247.9	259.4	256.0	258.0	261.0
Net International Investment Position, % GDP	133.4	124.7	102.1	103.6	94.5	103.7	112.7	121.6
Credit ratings								
Moody's	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa	n/a	n/a
S&P	AAA	AAA	AAA	AAA	AAA	AAA	n/a	n/a
Fitch	AAA	AAA	AAA	AAA	AAA	AAA	n/a	n/a

Source: Haver, European Commission, Reuters Eikon, IMF, UBS estimates

Political calendar

Country	Date	Political Event/Election	Outlook	Macro Implications
France	23 April 2017	Presidential elections (first round)	Attention now focuses on who will be the presidential candidates from the Republican and Socialist parties to run against Marine Le Pen from the Front National. Polling so far suggests that Le Pen is likely to win the first round.	The Front National in its programme calls for France to leave the Eurozone.
	7 May 2017	Presidential elections (second round)	Current polls suggest that the Republican candidate is likely to be best positioned to win the second and decisive round of the presidential election.	An election victory of Marine le Pen would likely result in a substantial increase in uncertainty over the future path of French politics, and France's role within the broader EU project.
Germany	5-7 December 2016	Party Congress CDU	Angela Merkel is set to announce whether she will run for Chancellor again in the September 2017 general election.	Angela Merkel's approval ratings have declined in recent months along with polling of her party, increasing uncertainty about whether she would be willing to run again. With no apparent alternative candidate from her party and given her importance for broader European discussions, the market is likely to pay close attention.
	14 May 2017	State Election - North Rhine-Westphalia	The state is currently governed by a SPD-Green coalition. Current polling suggests they will lose their majority. Important to watch will be how strong the anti-immigration AfD polls.	State elections in Germany's most populous state are likely to be seen as an important test-run in the run-up to the September general elections.
	September 2017	General/Parliamentary	The coalition of CDU/CSU and SPD has lost support, but according to current polls narrowly maintain their majority. Important to watch support for the anti-immigration AfD, which is not currently in parliament.	Should the current grand coalition lose its majority, there may be a need for a three-party coalition (possibly with the Green Party or the liberal Free Democrats). Main implication is likely to be at the European level as additional compromises would be necessary on foreign policy.
Italy	4 December 2016	Constitutional Referendum	Referendum is about a reform of the Senate (Upper House of Parliament) and part of a package is aimed at making the political system more stable and facilitating decision-making. Opinion polls suggest the result is too close to call.	PM Renzi has in the past suggested he might step down in case of a "No" vote, likely impacting sentiment negatively and increasing political uncertainty. However, even in case of a "Yes" vote, attention may then shift to the general election in 2018.
	May 2018 (at the latest)	General/Parliamentary election	Current polling sees the ruling PD party of PM Renzi close to the M5S Five Star Movement. If the constitutional referendum passes in December, the 2018 election will be the first one held under the new electoral law, which guarantees a majority premium for the party with the highest share of votes (potentially determined in a second-round run-off).	The M5S Five Star Movement has called for a referendum to leave the Eurozone.
Netherlands	15 March 2017	Elections for Lower House	Current coalition of VVD and PvdA holds 79 out of 150 parliamentary seats, but its support in the Ipsos polls for instance is down to 41 seats. Although VVD (the centre-right liberal party) remains the largest party with about 30 seats in the polls, the far-right PPV is now the second-largest party with 23 seats. The current polls suggest the number of parties required to form a coalition would be one of the largest in decades, which could complicate the formation of a government and subsequent governability.	The PVV's 'concept electoral program 2017-2021' calls, inter alia, for the Netherlands to leave the EU, to 'de-Islamize' the country, and to take the Netherlands out of the EU. Although several parties (e.g. CDA and PvdA) have ruled out joining PVV in any coalition, it cannot be fully ruled out that it forms part of a wider multi-party government. This may increase market concerns about a possible EU referendum in the Netherlands.

Source: UBS

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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