Chief Investment Office WM

January 2016

The future of Europe

Publication details

This report has been prepared by UBS AG and UBS Switzerland AG.
Please see important disclaimer and disclosures at the end of the document.

This report was published on 13 January 2016.

Authors
Ricardo Garcia (Editor in chief)
Roberto Ruiz-Scholtes
Patrik Ryff
Dean Turner
Thomas Wacker

Contributors
Andreas Höfert*
Bill O'Neill
Caroline Oehri
Fabio Trussardi

Desktop Publishing
Margrit Oppliger
Illustrations: Linda Sutter

Project Management
Joscelin Tosoni

Cover photo
iStock

Printer
Neidhart + Schön, Zurich

Languages
English, German, French, Italian and Spanish

Contact
ubs-cio-wm@ubs.com

Order or subscribe
UBS clients can subscribe to the print version of *The future of Europe* via their client advisor or the Printed & Branded Products Mailbox:
sh-iz-ubs-publikationen@ubs.com

Electronic subscription is also available via the Investment Views on the UBS e-banking platform.

SAP-Nr. 84545E-1601

Contents

The future of Europe

* **Andreas Höfert,** our Chief Global Economist, passed away on Tuesday, October 6, 2015. He contributed to the growth analysis just one day previously. We were fortunate to learn from his insight and originality over the years. He will be missed.

Themis Themistocleous

Ricardo Garcia

Dear readers,

"The wake-up call was brutal."

That's how Jean-Claude Juncker, president of the European Commission, characterized the European debt crisis. Europe's governance structure, patched up after the global financial crisis, was tested in the Greek crisis last year – and passed. But the recent refugee chaos and the coming UK referendum are reminders that the structure is not mature enough yet. The uncertainty hanging over Europe raises questions about where the continent is headed and what forces are shaping it.

Investor George Soros, speaking of negative internal forces, argues that the German chancellor "has always done the absolute minimum necessary to preserve the euro." The Eurozone has become a union of debtor and creditor nations with decades of both low growth and the threat of populism on its horizon. Given a safety net that remains too small, and huge internal economic imbalances, its governance structure is ill-prepared to handle major crises, in our view.

Among the positive forces at play, support for the euro, which is near all-time highs, is key. Greater public backing for the European project is set to solidify long term in response to geopolitical pressures arising from the demographic boom in Europe's neighboring regions. This should encourage the next quantum leap in integration, which historically has been driven by political rather than economic needs.

The continent's success depends on adopting deep structural reforms, improving the currency union's shock-absorbing capacity, putting broader fiscal support mechanisms in place and achieving greater democratic legitimacy at the European level. Members must become more integrated so they can rise above local interests. The answer is more Europe, not less. As former French President Nicolas Sarkozy remarked, without Europe and the euro, conflict would resurface on the continent. The stakes are high. We invite you to join us in exploring why we think Europe has a long-term future, albeit one filled with surprises along the way.

Themis Themistocleous
Head, European
Investment Office

Ricardo Garcia
Head, European
Macroeconomics

Balance of power and demographics

By 2050, the world population will increase by 2–3 billion, four to six times the entire population of the EU. The EU itself is expected to decline in population during this time, and will already lose its position as the world's biggest market by the next decade. Such facts imply a fall in the global standing of the EU, as well as lackluster economic growth and inflation. They may force the European Central Bank (ECB) to reduce its inflation target, which would have the side effect of allowing it to become less active. Institutional voting rules may enable Germany to retain its economic lead in Europe despite its expected loss of population. While low growth and inflation increase debt-sustainability risks, the EU has plenty of options for countering them. Structural reforms and immigration could double the European trend growth rate. But much stronger governance would be needed to manage local interest groups opposed to such remedies. In fact, the EU would need to admit twice the number of refugees it did last year on an annual basis to match the US labor force growth rate. What's more, the public's negative view of immigration during a time when the economy has been doing well suggests that the EU doesn't have this absorption capacity, despite the availability of sharply growing pools of labor in Africa and the Middle East. Structural reforms and better governance have to bear the burden of engendering more growth, which will require a more united and integrated Europe.

iStock

Europe's demographic decline

> "If Europe today accounts for just over 7% of the world's population, produces around 25% of global GDP and has to finance 50% of global social spending, then it's obvious that it will have to work very hard to maintain its prosperity and way of life."
>
> — Angela Merkel, German chancellor

2050: 2–3 billion more people globally, but EU population declines

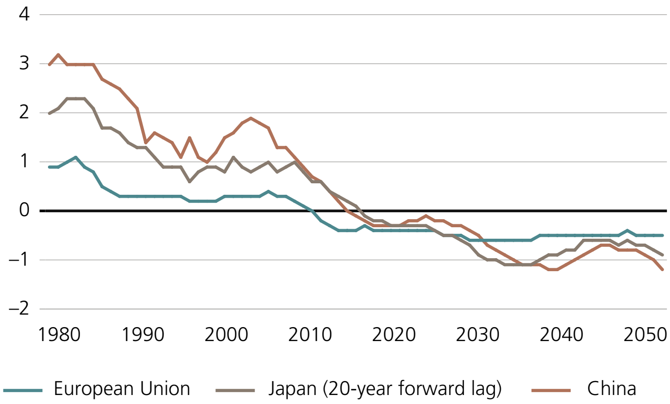
Aging populations, longer life expectancy and falling birth rates will dampen Europe's potential economic growth rate in the coming decades. According to UN estimates, the EU population, after peaking in the next decade, will fall by almost 10 million to below 500 million people by 2050. The UN expects global population during this time to grow by over 2–3 billion people, the size of humanity during World War II. More importantly, a lesser share of this smaller EU population will be of working age by 2050, which will push the dependency ratio[1] from around 50% today to a staggering 80% by 2050. Europe is not alone in facing these huge demographic changes. It will join such other rapidly aging nations as Japan and China. Unless entitlements change, they will place unprecedented burdens on shrinking labor forces in these countries.

Low growth and inflation might force the ECB to lower its inflation target

Economic theory says that changes in working-age population influence an economy's ability to grow. Europe's demographics will weigh on its trend growth rate, which is already low at around 1%. Downward pressure on inflation is also likely and will make it harder for central banks to achieve their targets without resorting to additional unconventional monetary policy tools, the ultimate success of which remains uncertain. Inflation undershooting 2%, particularly in the Eurozone, will likely remain the norm unless commodity prices rise long term. The ECB might have to reduce its target of below, but close to 2% inflation at some point, which would permit it to become less active.

Working-age population decline weighing on European, Chinese and Japanese growth

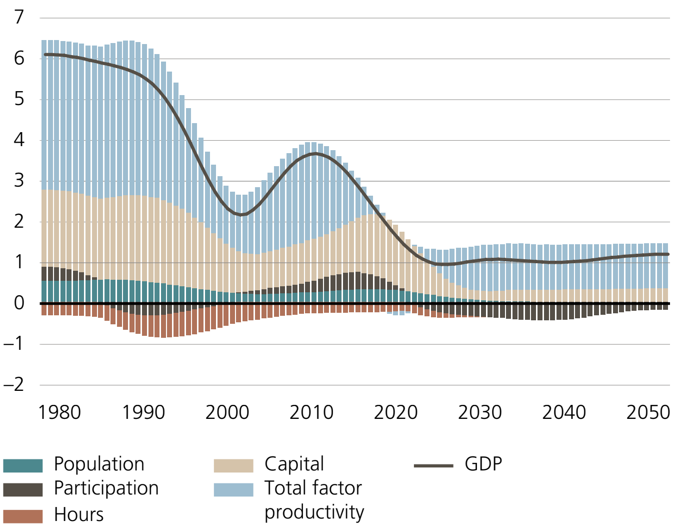
In %



Source: Haver Analytics, UN, UBS

Eurozone long-term trend growth rate to remain low

In %



Source: IMF WEO, UN, UBS
Note: smoothened

[1] The dependency ratio is calculated as the proportion of the population not of working age (children and retirees) as a percentage of the working-age population. A rising ratio is considered bad as the taxes paid by the working population will have to fund the welfare benefits of a rising proportion of those not working.

Immigration and structural reforms could double Europe's growth potential

Can anything be done to offset Europe's demographic decline? Given the scale of the challenge over the next 20–30 years and the poor growth prospects, more growth is critical to ensuring debt sustainability. There are two primary options for the citizens of Europe to maintain their relatively high degree of prosperity. One is immigration (covered in the subsequent section). The other is to significantly enhance productivity through reform. Structural reforms such as reducing the labor market segmentation between permanent and temporary employees, eliminating hurdles to launching a business, cutting red tape, liberalizing product markets even more and creating deeper capital markets could unleash productive potential. Some European governments have started to enact such measures, but the overall effort is well below what it could be. European governance needs to improve markedly to manage local interest groups opposed to immigration and deep reform. We will discuss this further in the context of the European treaties, the EU political model and the future of institutional governance in the following chapters. Indeed, strong governance has the potential to lift Europe's trend growth rate from 1% closer to 2% by boosting weak productivity and immigration.

Germany's population to decline long term, but institutional voting rules secure its power

At the country level, the UK recently overtook France as the second most-populous nation in the EU; with its population forecast to rise by about 10 million by 2050, it will overtake Germany, whose population is expected to decline by six million in this period, for the top spot. The other notable exception to the declining population outlook is France, whose census numbers are forecast to rise seven million by 2050, leaving it almost on par with Germany. Although a larger UK could prompt more liberal business regulation and a larger France more Eurozone integration, their impact would be muted at the institutional level. Germany's voting share within the European Stability Mechanism (ESM) might only drop from 27% to 26% by 2050, while that of France would climb from 20% to approximately 23%. Germany's Eurozone leadership looks set to remain in place for the foreseeable future, unless the UK adopts the euro at some point.

Immigration: From panacea to false hope

> "If we don't strengthen border controls, people will say: enough of Europe."
>
> — Manuel Valls, prime minister of France

Immigration within Europe exacerbates debt imbalances

An optimal currency area should be able to draw from qualified labor resources when and where needed to avoid labor shortages and price pressures. This flexibility could be secured by appropriate labor mobility across the currency area, which, if inadequate, could be backstopped by immigration from outside it. Since the global financial crisis, migrants are heading more than before to Germany, Austria, Belgium and the Nordic countries, with crisis-torn Spain and Ireland losing out. This harms the debt sustainability of the periphery. People on the move in the EU in recent years are typically young (41% were aged 15–29) and well educated (41% have tertiary education). But labor mobility across EU countries remains low compared to that of the US, due to language barriers and cultural differences. Between 2011 and 2012, 2.7% of Americans moved within the US compared to only 0.2% of EU residents. So EU labor mobility is still unable to function as a macroeconomic readjustment mechanism.

Europe's untapped competitive advantage: Green cards

The limited mobility of EU residents needn't apply to immigrants from outside the common market. Traditional immigration countries like the US, Australia and Canada rely on favorable immigration policies to attract high numbers of immigrants. In the US, approximately one million persons receive permanent resident status (a green card) every year for an indefinite time. The card permits its holders to move freely throughout the country to work for a company or to launch their own business. What's more, it is granted not only to family members and new employees but also to refugees. This strong open immigration policy represents a key competitive advantage for the US, for which the EU has no counterpart.

Immigration needs to double the number of 2015 refugees to match US labor force growth

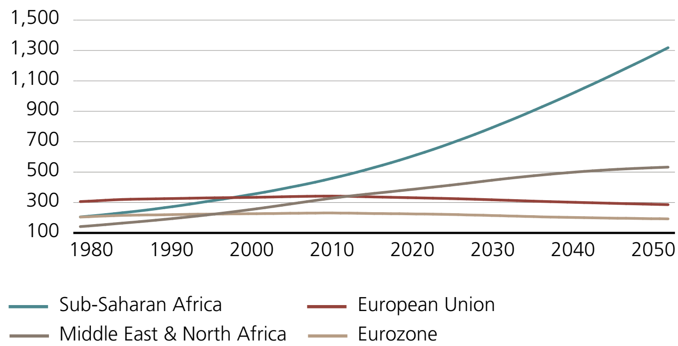
To match the US labor growth rate, the EU needs 1.8m additional immigrants (of working age) annually for the next 10 years, for example. This is substantially higher than the level of net immigration into the EU before the global financial crisis, and far above the net annual average of 0.6–0.7m immigrants since then. A clear change in immigration policies could address this situation. Global competition for qualified workers, who naturally seek the most attractive destinations, is growing. Unfortunately, the initial measures the EU took to reverse its weak immigration policy following the global financial crisis by admitting refugees turned into a debacle. The dysfunctional reaction of Europe to the refugee crisis and the related chaos at its borders has not improved its image as a highly desirable destination for immigrants. What's more, our estimate that 1.8m additional net immigrants of working age are needed annually to match US labor growth dwarfs the number associated with the current European refugee crisis, estimated at one million last year.

Europe unlikely to fully leverage the huge labor pools in its neighborhood

Last spring 38% of the EU public was already citing immigration as the most important issue facing the EU; it overtook unemployment and the overall economic situation in that regard and was up from 21% a year earlier. Extra-EU immigration in particular has been provoking negative public reaction. Even if the public views qualified immigrants differently than it does refugees, the current crisis has illustrated the EU's limited capacity to absorb foreigners, despite an economy that is performing well. UK Prime Minister David Cameron made limits on immigration even from inside the EU a clear and fundamental condition for the UK staying in it. These facts suggest that the EU lies on a spectrum somewhere between the US and Japan in terms of openness and willingness to absorb immigrants on a large scale. This is unfortunate as Europe will need manpower for labor-intensive sectors, such as healthcare and the care of the elderly, where immigrants typically find jobs. Ironically, there won't be any shortage of labor in Europe's immediate neighborhood, i.e. the Middle East and Africa, in the coming decades. To make matters worse, the correlation between immigration and economic growth suggests a certain pro-cyclicality of immigration and thus continued limits in the European willingness to absorb large immigration numbers given its low-growth outlook.

Working-age population growth

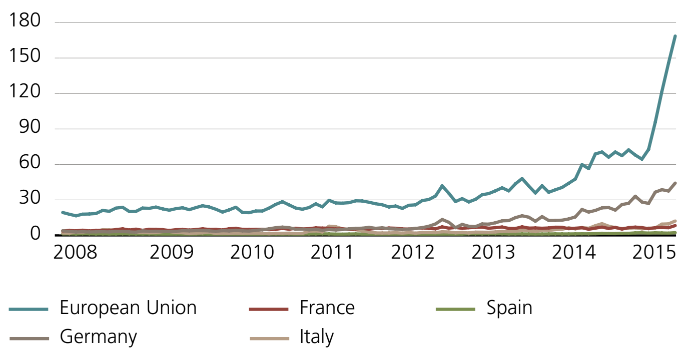
In millions



Source: Haver Analytics, UBS
Note: Middle East includes Turkey

Monthly asylum seekers

In thousands



Source: European Commission, as of September 2015, UBS

Global standing: Eclipse or phoenix rising from the ashes?

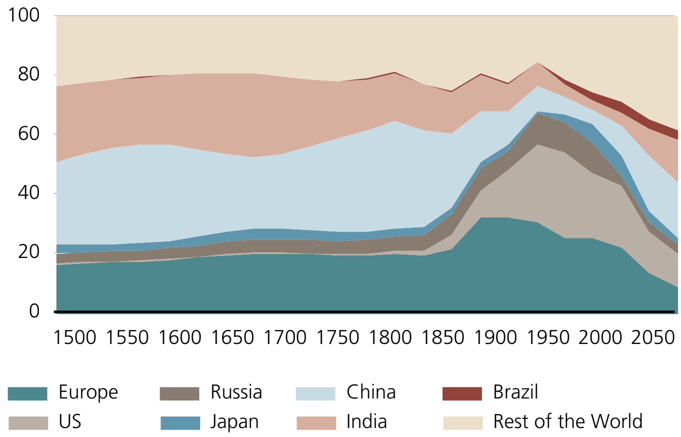
"If I want to call Europe, what number should I call?"

— Henry Kissinger, former US Secretary of State

EU set to lose position as world's biggest market by the next decade
The EU is the largest economic bloc in the world. It contributes one-quarter of global foreign exchange (FX) reserves through the euro alone. Its size and relative integration have enabled European companies to reach critical mass to compete globally. But Europe's share of the global economy has been declining for a number of years. Its lack of economic growth per se is not responsible; other countries have simply caught up to it. China's economy, based on current exchange rates, has already eclipsed Germany's by a factor of three. Furthermore, India might catch Italy in the next several years, while Brazil's economy now rivals Italy's in size and far outstrips Spain's. The US will surpass the EU by the next decade with a population not even two thirds as large. Higher rates of trend growth resulting from the US's more flexible economy and much more promising demographic trends suggest that the gap will only widen.

No shortage of options for lifting Europe's standing
To compete with larger nations and unleash its full economic potential, Europe needs to transform itself into something more than a single trading bloc. The immediate challenge is for European nations to pull together in multiple areas. A more "federal" EU that speaks with one voice on all political and economic matters, both domestic and foreign, has the greatest chance of maintaining its status worldwide. To achieve this, the commitment to the "ever-closer union" must become a reality. It must develop greater coordination to strengthen its efforts in the areas of foreign affairs and security policy. A unified voice is also needed for its dealings with international organizations like the IMF, G7 and G20. Furthermore, reaching a free trade agreement with the US would ensure that global regulatory standards and terms of trade continue to be set in the West for a long time, which would help the EU project its values worldwide. Its standing could also be enhanced if it were to reduce its huge dependence on imported oil and gas by diversifying its providers and adopting a more effective energy network among its own member countries. Ultimately, however, the biggest benefit of integration would come from strengthening the foundations of the single currency. Europe's destiny and standing are in its own hands. To unleash its full potential it might have to feel some external pressure though, which we will investigate further in Chapter 3 (political sustainability).

Western share of global GDP nose diving
Share of global GDP in %



Source: Angus Maddison, UBS
Note: Purchasing power parity based

Integration and popular support

After the EU's breathtaking expansion in recent decades, the specter of contraction has been raised of late, as illustrated by Greece and the UK. The landscape has changed in three ways. First, the euro is not perceived as irrevocable anymore. Second, the Eurozone has turned into a club with a first and a second tier of membership. And third, the euro has started to lead to conflict among governments. This is unfortunate as the common currency was never the end but the means to achieving enduring peace on the continent, and as support for it is high, particularly among the young. However, required changes that would address the shortcomings of the EU treaties remain far off, and the lack of action on this front is likely to increase the costs of the next crisis. To mitigate these issues, the Eurozone must improve its shock-absorbing capacity, the ECB must keep government bond yields low and the democratic legitimacy of decision making at the European-wide level needs to be enhanced. But the biggest long-term threat to the current European order stems from another factor. The fiscal straitjacket imposed by creditor nations on many other member states and the deflationary forces it unleashes have favored mushrooming populist political movements. Low economic growth promises a bright long-term future for them, accompanied by economic crises likely to boost their allure. Little noticed on a day-to-day basis, their rise and the reasons behind it become obvious when looking at their growth in recent years. Pursuing more economic expansion through greater integration will be key to containing this risk.

Keystone

Lessons learned

"The success of monetary union anywhere depends on its success everywhere."

— Mario Draghi, president of the European Central Bank

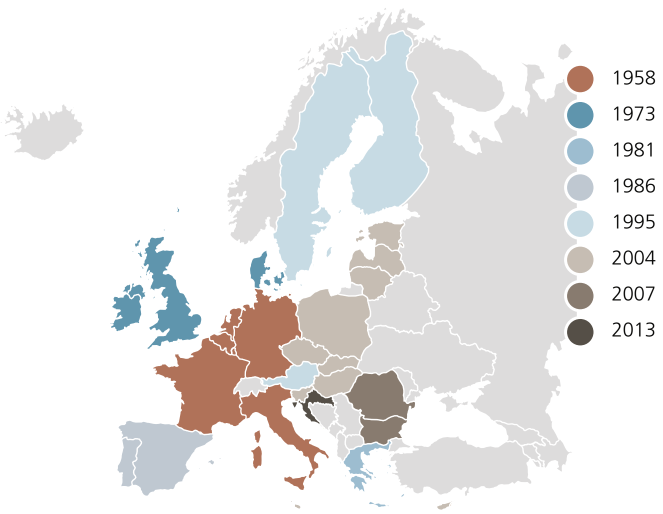
Holding it together is the new challenge following decades of expansion

The transformation of European integration from the original European Coal and Steel Community into the EU, which makes up the world's largest single market and covers a majority of the continent, is one of the most impressive feats of postwar history. While the shape of the EU can still change, its current size suggests that its expansion phase is set to slow drastically. Today the EU already shares over 2,300 kilometers of direct land border with Russia to the east. Farther south, Turkey, in the event that it joined the EU at some point, has an economy smaller than the Netherlands' that would only account for 10% of the EU's even 20 years from now. EU expansion has become a red flag. Only 39% of the public (and only 26% of the German public) now favors it. In truth, the turmoil in Greece and the forthcoming referendum on the UK's membership (see chapter 4) suggest that contraction is the more topical issue. This new situation raises questions about what lessons have been learned in recent years. In our view, there are three key developments that may have ramifications for the future.

The euro is no longer perceived as irrevocable

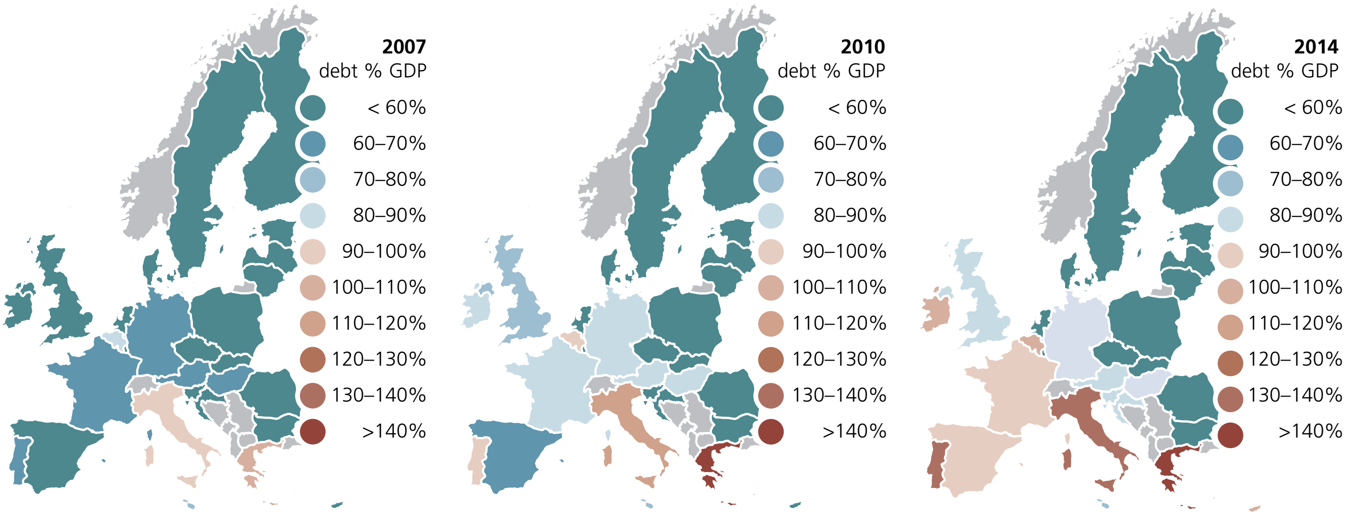
In 2013, the EU needed to issue an ultimatum to Cyprus to get it comply with European Monetary Union (EMU) rules. Last year a majority of Eurozone countries favored letting Greece leave the common currency, at least temporarily. Although legally impossible without departure from the EU itself, a Grexit would just have happened, as the Austrian Chancellor Werner Faymann said during the standoff. These experiences show that the Eurozone is no longer willing to hold its membership together at any price. The immediate question upon a departure would be: who is next? since markets usually attempt to sniff out the weakest link in the chain. So it is imperative that the shock-absorbing capacity of member states and the Eurozone as a whole be improved to manage the risks of a major country leaving. This could take the form of better coordination, fiscal

Bulk of EU expansion is over



Source: European Commission, UBS
Note: color coding refers to year of EU entry

Europe split by debt



Source: European Commission, UBS

backstops and/or faster decision-making processes at the European level.

New order: Europe split into a two-level hierarchy

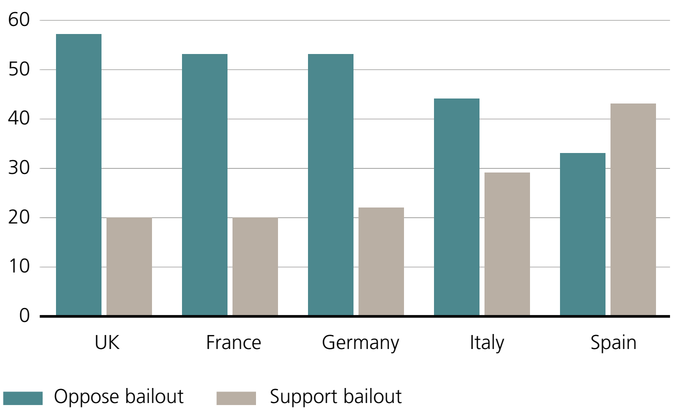
Europe has transformed into a union of debtors and creditors, with Germany as the economic hegemon. Fiscal rules dominate economic and fiscal policy making now, in particular in the Eurozone. Although recent studies have shown that greater debt and unemployment in one Eurozone country lessens confidence about the EU in other member states, the public generally doesn't support fiscal bailouts of member states. To make matters worse, economically weaker debtor countries have found themselves deprived of the ability to shore up their economies by means of currency devaluation. They become debtors in a foreign currency, with the creditors infringing on their sovereignty. To mitigate the breakup risks to the Eurozone, the ECB needs to keep government bond yields low. In addition, more solidarity mechanisms need to be implemented to avoid political backlash in debtor countries. They can take the form of fiscal backstops for specific situations as permanent fiscal transfers are not foreseen in the European treaties.

The euro pits governments against one another

The new order of the Eurozone pits governments against one another. The Greek standoff in 2015 is a case in point – as Angela Merkel put it, it was a "real confrontation." Any revolting member state disputing the new order in an effort to escape its deflationary forces runs the risk of being punished by financial markets. The concentration of power in the Eurozone also creates tensions between it and the other EU member states, which raises questions about democratic legitimacy. Such legitimacy must be strengthened by, for instance, moving the European Stability Mechanism (ESM) under the umbrella of the EU treaties and make it accountable to the European Parliament.

Support for sovereign bailouts low

In %



Source: M&G YouGov, as of August 2015

Populism and the European project

"Those who destroy Europe and the euro will bear responsibility for the resurgence of conflict and division on our continent."

— Nicolas Sarkozy, former president of France

New German mindset and populism in Europe

The established political order is under pressure from parties who stray from the political center in response to popular discontent spawned by crises. Germany's altered attitude toward Europe since its reunification may be responsible. In the early days of reunification, Germany was usually willing to take a bit less and give a bit more. As former Chancellor Helmut Kohl said: Germany didn't have an independent foreign policy, only a European one. Underscoring the shift in mindset was new Chancellor Angela Merkel's statement, following the global financial crisis that each EU member state must take care of its own banks and debt. The strict application of the no-bailout clause in the European treaties led to the fiscal straightjacket imposed on debtor countries and reinforced the allure of populist parties.

Populism is a giant growing in slow motion

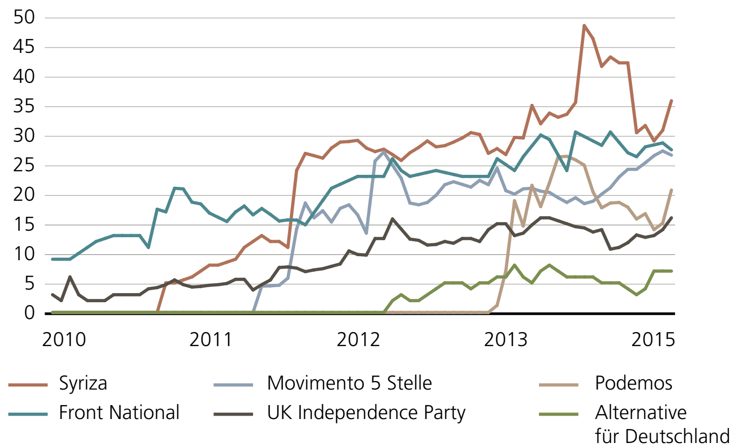
Low growth and high unemployment have further boosted populist parties. Because both will probably persist, the political polarization of late is likely to remain in place over the long term, however much the platforms and rhetoric of the individual parties in the various countries diverge. Populist parties scored large gains in the 2014 European Parliament elections. The next sign of their increasing strength would be one of them taking over a government in a large country, potentially in the wake of an economic shock. With sovereignty and power still residing mostly with member states themselves, a populist party takeover in a large country could fundamentally change Europe, with the new European order possibly backfiring and endangering the integrity of the EU in the process.

Populist breakthroughs are a key risk to the European order

European history offers plenty of examples of economic shocks leading to populist party breakthroughs. The most recent example is Syriza in Greece, which led to real confrontation with its lenders. It would be a mistake to simply assume that Europe could deal with a larger debtor country the same way it did with Greece. Not only are large countries of systemic importance, their liabilities are mostly in the hands of private investors. To illustrate: Italy for example boasts one of the biggest bond markets in the world. This contrasts with Greece, most of whose liabilities were shifted earlier to the public sector, limiting spillovers to financial markets. So the breakthrough of a populist party in a major country could shake up Europe.

Boom of populist parties since the global financial crisis

In %

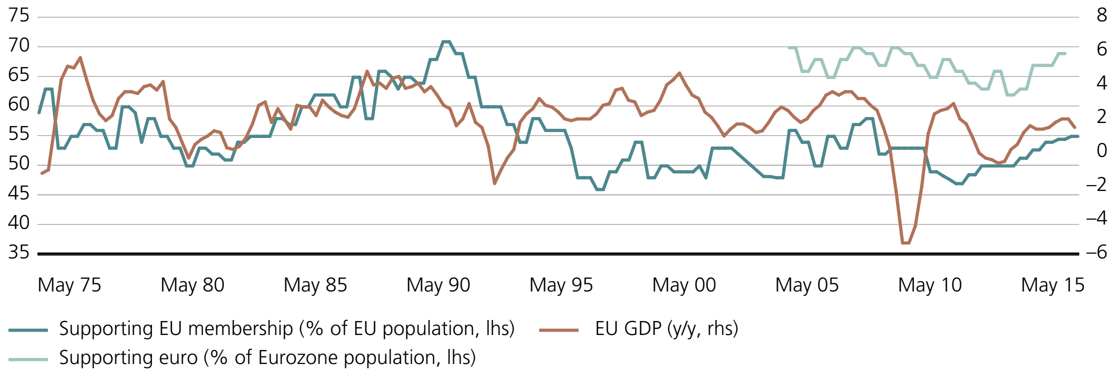


Source: Ipsos-Mori, Ukpollingreport, Sofres, Forsa, Phantis, Wikipedia (http://creativecommons.org/licenses/by-sa/3.0/), UBS

Support for euro is high despite generational changes
For all the concerns expressed, there have been a number of positive developments. Contrary to received wisdom, the generational changes since World War II do not necessarily mean that the support for the European project is bound to decline. Even if 46% of its citizens do not trust the EU as an institution, popular support for the euro is high, in particular among the young. Overall, 69% of Eurozone respondents are in favor of the economic and monetary union, close to the all-time high of 70%. Only 20% are opposed to it in Germany. This is an asset and forms part of Helmut Kohl's legacy, who thought a common currency would reinforce the bonds among Europeans. In the case of the Greek standoff last year, popular support for the euro was decisive in resolving the crisis. But the populist forces at work now probably mean that the Greek standoff won't be the last pushback from a debtor nation. So promoting greater integration to avoid such risks takes on greater urgency.

Support for euro and EU membership

In %



Source: Eurobarometer, ECB, Haver Analytics, UBS Note: EU GDP growth prior to 1996: proxied by Eurozone GDP

The visions of Europe and its treaties

"Markets did not read the treaties. They thought that our monetary union is in fact a federal state, and that everybody stands with and behind everybody."

— Jean-Claude Juncker, European Commission president

Today's Europe was built on two defining moments in politics
The dominant vision for Europe has swung in different directions since World War II. The founding Treaties of Paris (1951, European Coal and Steel Community) and the Treaty of Rome (1957) mirrored a decentralized vision for Europe and ultimately aimed for lasting peace following the defining moment of World War II. The disintegration of the Soviet Union and the reunification of Germany changed the European order again and marked another defining moment. With Kohl's support, the ensuing Maastricht Treaty (1992) turned the former European Community into a more centralized union, the EU. This was the era when a song on European integration even managed to win the Eurovision song contest in 1990 ("Insieme: 1992").

Europe is about the EU, not the euro
The ultimate result of this renewed push for integration in the 1990s was the euro. It was

introduced far too early given the economic and governance divergences among the member countries, though it was arguably necessary from a geopolitical point of view after Germany reunified to lock in its commitment to a united Europe. The euro was not meant to be the goal, only the means of securing enduring peace on the continent following centuries of war. It also solidified the crown jewel of the EU, the largest market in the world, which has become increasingly important to European integration. But all policy decisions are still made at the most local level possible (Principle of Subsidiarity) with European institutions required to act only to the minimum extent necessary (Principle of Proportionality). Hence, the key economic and fiscal decisions remain at the discretion of member states.

Europe needs a major treaty revision, but it may be far off

The European debt crisis that followed the euro optimism of the 1990s and early 2000s highlighted the flaws of the decentralized monetary union and led to a patchwork of fixes. Making the half-baked monetary union into a true, full-fledged one requires another quantum leap forward in the evolution of the European treaties, similar to those that took place in 1957 and 1992. The current Treaty of Lisbon, which amended those of Rome and Maastricht, has only limited scope left for improving governance. It took from 2001, when the treaty was announced, until 2009 for it to enter into force, given the difficult negotiations and several failed referenda. A new meaningful treaty that would balance authority with responsibility is likely far off given the time that drafting and approving one requires.

Source: Senate of Berlin

Moreover, for it to be effective, it would have to address highly contentious issues such as more sovereignty sharing through a central treasury and fiscal ministry, debt mutualization, provisions for government default among members, more authority for the European Parliament and increased power for the high representative for foreign affairs. Including the ESM in the treaty and making it accountable to the EU Parliament would also be necessary.

Outmoded EU treaties mean that the next crisis could hit Europe hard

Until another defining moment triggers another shift in mindset, the EU will probably continue to take arduous piecemeal steps toward greater integration under its current inadequate treaties. This is not to say that a great deal of progress hasn't been made, in particular during the euro crisis, but bold integration may require another crisis. And the next global shock could hit Europe particularly hard given its conflict of interests, complicated decision-making processes, stretched debt capacities and already high unemployment.

Keystone

Sustainability of Europe's model

The German export model has been hailed as a panacea for Europe's weak growth outlook. But the EU already is contributing to global trade imbalances with its large trade surpluses. In addition, lackluster long-term global growth won't permit the German model to be scaled up continent-wide. Although a new free trade agreement with the US should boost the EU's growth and standing, there is no genuine alternative to structural reforms to counter the trend of muted GDP expansion. Reaping the full benefits of the EU requires that Eurozone integration proceed apace, as the euro and its integrity remain at risk, given imbalances below the surface and the centrifugal forces of the currency. Spain and Portugal risk joining Cyprus and Greece in a growth shock. The odds of the Eurozone holding together are moderately good given the high popular support for the currency. It may even be possible to prolong today's decentralized Europe provided it can continuously adapt to new circumstances. Still, to boost growth, a fundamental change is needed in the public mindset – one that opens the way for a more federal Europe. History suggests that only politics, not merely economic need, can be the engine of this change. The trigger, long term, could be the population boom and geopolitical developments taking place in Europe's immediate neighborhood, with the EU's lack of a single foreign policy reinforcing the instability. But this required change in mindset could take decades to develop and expose Europe to the risk of political populism before it is ready to make the leap forward.

iStock

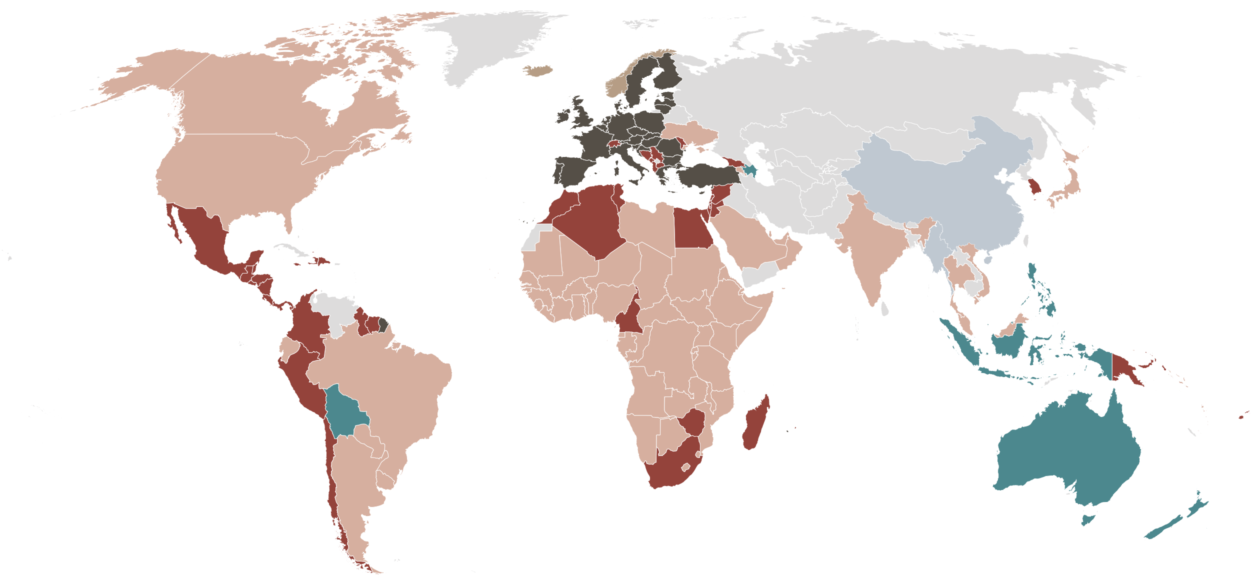
Europe's growth model

> "What worked for one medium-sized export driven economy such as Germany will not work for a huge economic bloc like the Eurozone."
>
> — George Soros, investor

Europe contributing to global imbalances through new export emphasis

The success of Germany's social and labor market reform "Agenda 2010," implemented between 2003 and 2005, greatly improved its competitiveness and boosted its export performance. The export model has since become dominant throughout the Eurozone. Policymakers regard it as a panacea, given the EU's poor long-term growth outlook and the forecasts that 90% of global growth will occur outside of Europe. The export model relies on Europe's core competence in trade. It is the world's largest trader of manufactured goods and services, and boasts a distinct competitive edge in high-value-added content. The export shift has resulted in the Eurozone's trade surplus rising to a staggering USD 428bn, despite the fact that member countries must import 87% of their oil needs. This performance has propelled the Eurozone's current account surplus to record highs, led by those of Germany and the Netherlands, and made it a key contributor to global imbalances.

EU actively deepening trade relationships



- EU and Customs union
- European economic area
- Countries with which the EU has a preferential trade agreement in place
- Countries with which the EU negotiates or has a preferential agreement that is not yet applied
- Countries with which the EU is negotiating a stand-alone investment agreement
- Countries with which the EU is considering opening preferential negotiations

Source: European Commission

New free trade agreement would cement trade leadership for decades

But more is likely to come. The Transatlantic Trade and Investment Partnership (TTIP) being negotiated with the US ranks at the top of the European Commission's (EC) priorities on the external front. It should ease access to the US market, simplify and harmonize standards, lessen bureaucracy in exports and reduce regulation on imports and exports. An independent study commissioned by the EC estimated that incremental GDP growth could be up to EUR 119bn per year once the TTIP is fully implemented. Wider trade, lower prices, greater options for consumers and more jobs would help mitigate Europe's demographic decline. Even if this estimate may be too optimistic, ensuring long-term dominance in trade worldwide along with the US by setting global standards would indeed support Europe's export ambitions. Pushing through this desired catalyst for the EU economy is likely to require more time, and the outcome remains uncertain.

Europe is not Golden Age Venice

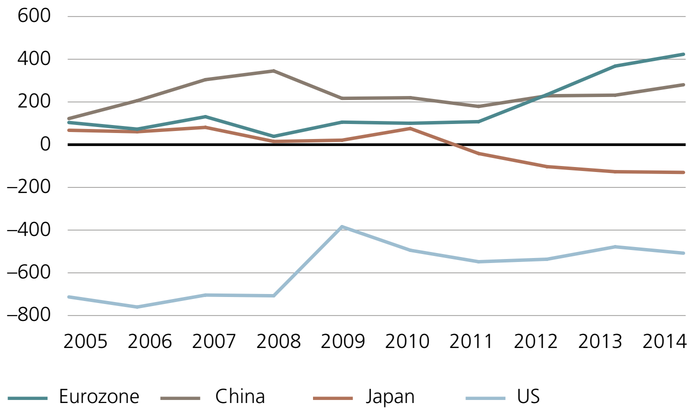
Any export-led growth model has its limits. It cannot replace domestic demand and alleviate, on its own, Europe's demographic decline. Exports are a zero-sum game at the global level. Any improvement in the already huge Eurozone trade surplus (USD 428bn) would have to be achieved at the expense of other trade partners. And imbalances worldwide have little scope to increase since they are on a declining trend. That said, as the trade surpluses of oil-exporting countries may dwindle and the US trade deficit (USD 508bn) may only worsen moderately with Japan already in deficit (USD 128bn), the only sizable targets left would be China's surplus (USD 284bn). But China's loss of competitiveness benefits other developing countries more than it does Europe due to the latter's focus on the higher part of the supply chain. In addition, following an export-led model for the EU as a whole is more difficult than for Germany alone. For over one millennium, European trade has been spearheaded by specific European states like Venice, The Netherlands and the UK, but not by the continent as a whole.

Exports cannot replace structural reforms amid declining global growth

The other important caveat to this model is that trend growth is declining almost everywhere, which limits the possibility for expanding global trade and, accordingly, European exports. The global working age population is expected to increase at half the rate of the previous two decades, while capital accumulation is weak and productivity is slowing. As a consequence, world real GDP growth may trend down long term. The implication is that EU growth has to rely chiefly on structural reforms to improve domestic demand as well as its growth outlook.

Eurozone following in China's footsteps

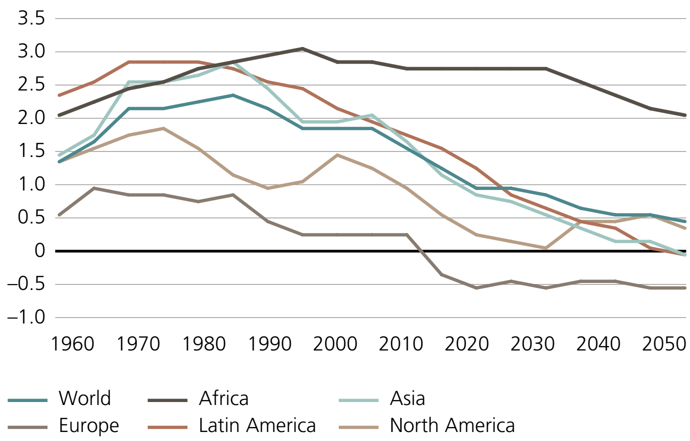
In USD billion



Source: Haver Analytics, IMF
Note: Excludes intra Eurozone trade

Global growth on downtrend given declining working-age population growth

In %



Source: UN population database

Internal economic imbalances

"Start with the idea that you can't repeal the laws of economics, even if they're inconvenient."

— Lawrence Summers, former US Secretary of the Treasury

Europe more resilient following improvements prompted by the debt crisis

Relying on global growth also means that a major drop in it could stagger Europe and endanger the cohesion of its monetary union. The European debt crisis brought about great improvements in member-country current account deficits[2] thanks to a normalization of peripheral imports. Current accounts are key when assessing the resilience of a financial market. To that effect, Europe moved from a large deficit to a large surplus in less than half a decade. Even when the current account is broken up into its private and public sector components, the improvement remains broad based, particularly in the periphery.

Euro still at risk given imbalances below the surface

Overall macroeconomic imbalances remain considerable, however, and leave Europe vulnerable to major economic shocks. The UBS CIO synthetic indicator of macroeconomic imbalances seeks to gauge key imbalances relevant to Eurozone cohesion. The bigger the imbalance, the higher the risk of that country leaving the Eurozone sooner or later. The imbalances among Eurozone countries indicated in the graphs suggest that the euro is not yet out of the woods. While the imbalances were relatively low pre-global financial crisis, the crisis tore peripheral countries away from the core, and the subsequent European debt crisis caused them to widen further. Debt capacities remain stretched: the average Eurozone government debt-to-GDP ratio exceeds 90%. Unemployment has fallen but is still high. In Spain, for instance, the jobless rate is close to five times that of Germany. Without the ability to devalue national currencies they no longer have, peripheral countries are condemned to adjust to shocks by means of painful internal devaluation, causing soaring and politically dangerous unemployment.

Spain and Portugal risk joining Cyprus and Greece in the medium term

Our indicator shows that a core around Germany and the Netherlands is pacing the Eurozone, while Cyprus and Greece struggle at the back with enormous imbalances. France has clearly fallen off the German pace since 2007. Given the weak starting position of Spain and Portugal, a shock could send them toward stragglers Cyprus and Greece. This, in turn, would draw a potential Eurozone breakup line more clearly, given how close Greece and Cyprus came to exiting. The worst thing that could probably happen is for a one-sided economic or political shock to rattle France, which would cause the drive shaft of the Eurozone – the Franco-German axis – to slip. So the Eurozone must integrate more swiftly if it is to survive this riskiest phase of its evolution.

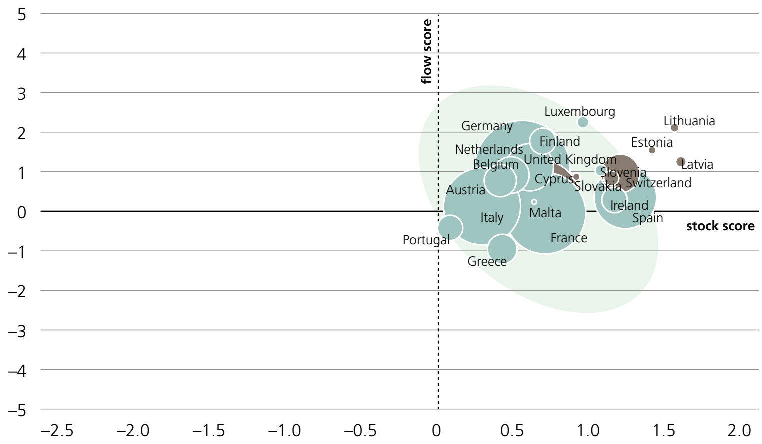
Marked popular support for the euro favors integrity of Eurozone

In sum, the continued presence of vast imbalances and the reluctance to keep the monetary union together at any cost as illustrated by the experience of Cyprus (2013) and Greece (2015) means that the Eurozone could lose one or more members in a global growth shock. Nonetheless, the past is not necessarily a guide to the future. Although a lot depends on who governs, the high popular support enjoyed by the euro should help to keep the Eurozone together, despite uncertainty remaining elevated.

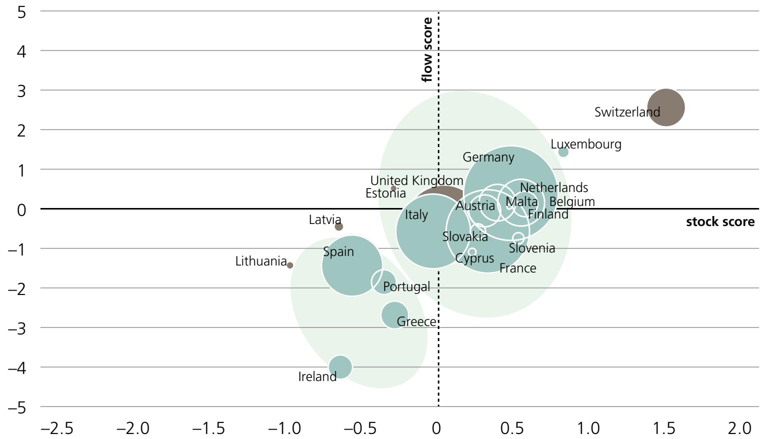
[2] The current account measures the changes in the net foreign financial position of all residents in a country. A current account surplus usually involves a trade surplus and vice versa. A current account surplus country exports capital thanks to its private and/or public sector and improves its net foreign financial position.

UBS CIO synthetic imbalance indicator[3]: Euro acting as centrifuge

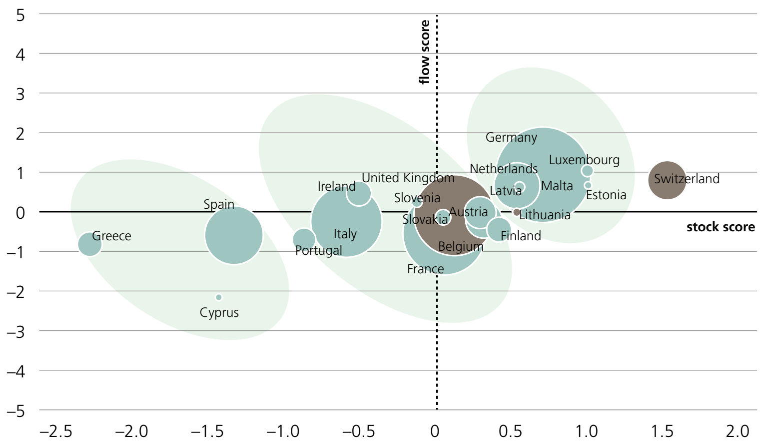
2007



2010



2014



Source: Haver Analytics, UBS
Note: Non eurozone members colored in brown

[3] The stock dimension is based on the debt-to-GDP ratio, the net international investment position (i.e. net foreign financial position of all residents in a country) and excess unemployment. The flow dimension is based on the government deficit, the current account balance and nominal GDP growth.

Political sustainability and sovereignty

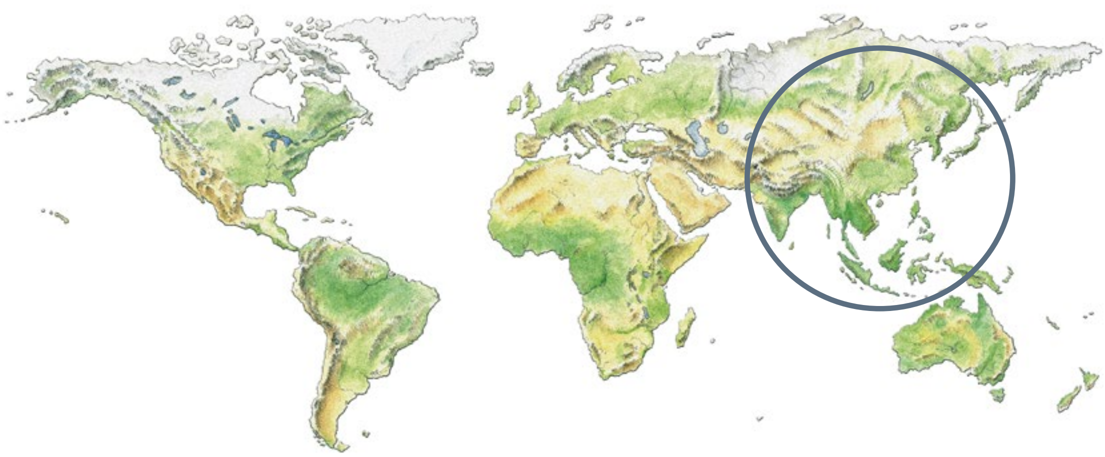
"In times when geopolitics is back in Europe, we need to be united and strong."

— Donald Tusk, European Council president

Europe's current political model: "Europe where necessary, national where possible"
The driving political force in the EU is not the European Commission but the European Council, which consists of the heads of states of the member countries. As David Cameron recently stated in connection with the UK's referendum, "Europe where necessary, national where possible." Indeed, the European operating model basically relies on maximizing the benefits of the world's largest market with stable prices, while retaining as much national sovereignty as is feasible. Following centuries of wars, this limited sharing of sovereignty was the least common denominator among European nations to ensure peace on the continent. In fact, this lack of sovereignty sharing is behind the missing central tax-raising institution, fiscal transfer mechanisms, Eurobonds, a single foreign policy and so forth. Ultimately, it reflects the mindset of Europeans, who feel more bound to their nation state than to the EU.

Economic reality hardly enough for national where necessary, Europe where possible
This current European operating model and its treaties were designed for an inward-looking Europe and were domestically driven. They stem from defining political moments such as World War II and German reunification. In the foreseeable future, changes outside of Europe, in our view, will be what affects the model and treaties. More economic integration is already required to compete with rising nations elsewhere, which warrants Europe adopting a more outward-oriented perspective. It is conceivable that the next leap forward in European integration involving

The future may be somewhere else: Majority of humanity living within this circle today

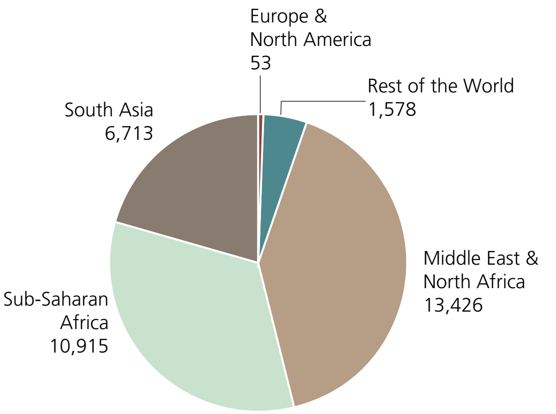


Source: United Nations, UBS

substantial sovereign sharing may be prompted by the outside world. But the history of the EU demonstrates that the leaps in integration were triggered by defining moments in the political sphere, rather than in recognition of economic realities. If that were not the case, something different, given the rise of other economies, would already be in place.

Geopolitics could drive the next leap in integration, but populism is a key risk
More major changes outside of Europe that have crucial geopolitical implications lie ahead. The number of African and Middle Eastern men and women of working age is set to reach six times that of the EU's in the coming few decades. The growth of this population has been a key driver behind recent crises such as the Arab Spring and the current immigration crisis. European politicians routinely highlight instability along the continent's borders. Unfortunately, the lack of a single EU foreign policy exacerbates it. Since the EU can only act abroad if there is unanimity among its member states, it is not clear to countries outside its borders how it will react to aggression and conflict or even whether it will. This essentially leads to mutually reinforcing instability on both sides of the EU's borders. Despite the danger this trend poses, it has the long-term potential to shift the European mindset and lead to a fundamental change in Europe's operating model. But even if the potential for a shift is there, it appears to be some way off. The demographic changes occurring along the EU's borders are a slow boat that will chug along for decades, carrying many risks with it. Chief among them may be the rise of European populism against the backdrop of low economic growth, which could stall or reverse the course of EU integration before a new mindset is able to take hold.

Number of terrorism-related deaths in 2014



Source: Institute for Economics and Peace, START Global Terrorism Database

European institutions

The leaders of the major European institutions aim to improve governance to the extent possible under the current EU treaties, extending the steps taken since the financial crisis. However, fundamental policies involving substantial sovereignty sharing remain vague. Since they require a meaningful EU treaty change, they have been put on the back burner, ostensibly to be brought forward after the UK referendum and the elections in France and Germany. Given the time required to effect a meaningful treaty change, the current institutional framework will remain in limbo for the foreseeable future, leaving Europe vulnerable to shocks. What's more, we don't think that the new bank bail-in rules will be fully applied to break the sovereign/bank nexus in a major crisis, nor for that matter, could the safety net in its current form withstand such an event. While the contours of such a crisis are unpredictable, the likelihood is high that the institutional framework must and will change in response. Leaders must use the remaining room for maneuver left in the current EU treaties to improve the institutional framework swiftly. In any event, European institutions are in the process of transforming themselves more and more into Eurozone institutions, while the Eurogroup is set to remain the rising star among them. The increasing dominance of the Eurozone has pushed the UK to call for measures to safeguard a multi-speed Europe, in what is yet another pushback against Europe after Greece. A UK departure from the EU would accelerate the end of a multi-speed Europe, as it would sharply increase the dominance of the Eurozone and its institutions. But even if the UK stays put, as we expect, its relationship with Eurozone countries will remain difficult, and force it either to reconsider exiting the EU or joining the Eurozone over the long run.

Keystone

The future of institutional governance: Stuck in the middle?

> "We cannot advocate a Europe of solidarity while believing that the economic policies of each euro area country are the business of that country's parliament alone."
>
> — Benoît Coeuré, ECB Executive Board member

Better governance: Leaders of the European institutions take the lead
At the Euro Summit in October 2014, European leaders expressed the need to "develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity" and "to prepare next steps on better economic governance in the euro area." On that basis, the presidents of the key European institutions, i.e. the European Commission, Eurogroup, European Council, European Central Bank (ECB) and European Parliament, drafted the "Five Presidents' Report." It laid out two phases of integration.

Phase 1: Pushing the current EU treaties to the limits
The long-term vision for the EU relies on common institutions, most of which already exist. But bringing the monetary union to full fruition entails new institutions. To this end, phase 1 includes "local competitiveness authorities" (offering guidance on local wage-setting negotiations), a "capital markets union" (deeper integration of bond and equity markets), an "advisory fiscal board" at the European level (budget advice at the European level) and the completion of the "banking union." The latter could mean serious

5 Presidents' Report: From rule-based cooperation to a genuine institutionalized union

2015 — 2017 — 2025

	Phase 1 Short-term steps within the current framework			**Phase 2** Completing the Eurozone architecture	
Economic Union	Create a system of local competitiveness authorities	Strengthen macroeconomic imbalance procedures	Strengthen coordination of economic policies	Define specific standards and indicators to formalize macroeconomic convergence	
Financial Union	Complete the Banking Union including a common deposit insurance scheme	Launch the Capital Markets Union	Reinforce macro-prudential oversight of the financial system		
Fiscal Union	Create an advisory European Fiscal Board			Introduce a Eurozone stabilization function to improve economic resilience	
Political Union	Revamp the framework for economic policy coordination	Reinforce the steering of the Eurogroup and strengthen parliamentary control and coordination	Integrate various pacts and treaties into EU law	Integrate European Stability Mechanism (ESM) into EU law	Set up a Eurozone treasury

Source: Completing Europe's Economic and Monetary Union, European Commission, 2015, UBS.

fiscal liabilities in the years ahead, so more time may be needed to hammer it together than is the case for most of the other new institutions. All in all, these institutional plans seek to exploit the remaining room for maneuver left within the current EU treaties. In our view, they put the finishing touches on the governance efforts that have been pursued since the global financial crisis, though on a smaller scale.

Phase 2: Delays to leave institutional framework in limbo

Phase 2 entails more fundamental change, but is quite vague and uncertain. It is to start after the UK referendum and the French and German elections. Even if the specified steps are incomplete, two new institutions are being mentioned in connection with it. The Eurozone "fiscal stabilization function" is intended to provide non-permanent fiscal support to governments in the event of shocks. This function would be new and enable governments to tap the fiscal resources of other members even prior to a crisis, improving the Eurozone's shock-absorbing capacity. What's more, the envisaged "Eurozone treasury" would drastically advance sovereignty sharing and complement the monetary union with collective decision making in fiscal matters, requiring a change in the EU treaties as well. Given the issues we discussed earlier regarding a treaty change, 2025 could prove too ambitious as the year it will come into effect. As the current institutional framework (including phase 1) isn't designed for large crises, the Eurozone institutional framework would remain in limbo and in jeopardy for the foreseeable future.

European institutions to turn into Eurozone institutions

Existing institutions should see their roles enhanced. The more complete the institutional framework in Europe becomes, the less the ECB, for one, will have to intervene to manage crises. But since the most important institutional changes require a treaty change, the ECB will retain its leading role for a long time. This is even more true as its risk-monitoring capabilities become enhanced. In the same vein, the European Council should remain the driving political force of the EU for at least as long as the current treaties remain in force. The Eurogroup in turn is set to remain the rising star among European institutions. The Five Presidents' Report discusses options such as granting it more power in the national budget-setting process, adopting a full-time presidency for it, awarding it more financial resources and preserving its European Stability Mechanism (ESM) as the only crisis backstop. The European Commission and European Parliament in turn hover between the worlds of the EU and the Eurozone. But the Five Presidents' Report makes it clear which path both, the latter in particular, are to take: "The European Parliament should organize itself to assume its role in matters pertaining especially to the euro area."

European institutions and the next crisis

"I have always believed that Europe will be made in times of crisis and that it is the sum of the solutions found in these crises."

— Jean Monnet, co-author of the Treaties of Rome

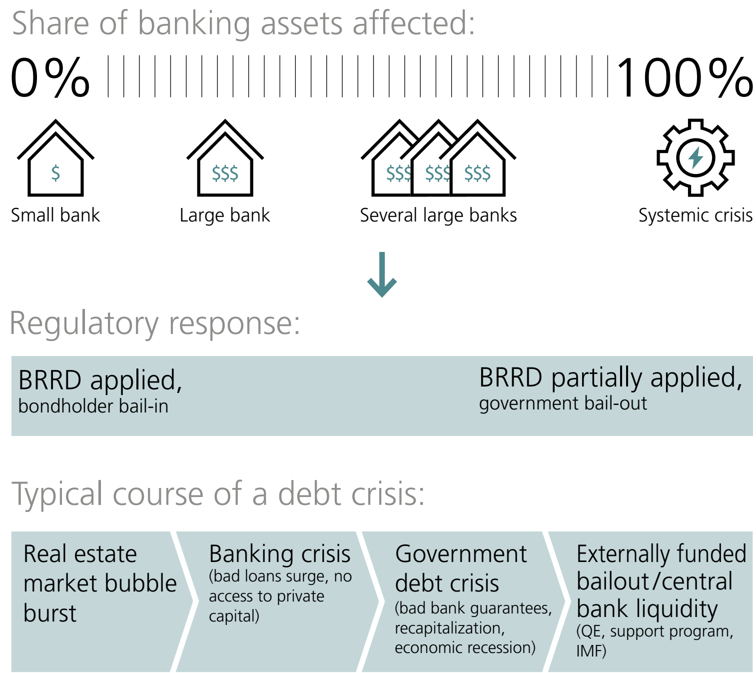
Next banking crisis: Bail-in unlikely to be fully implemented

Eighty percent of credit intermediation in the Eurozone is done via banks. The outcome of the next economic crisis will depend to a large extent on how the banking system functions. The introduction of a central regulatory body (the Single Supervisory Mechanism, or SSM) for large Eurozone banks at the ECB was the common currency area's main regulatory response to the housing bubbles and subsequent banking crises. Banks need to hold much more capital and adhere to many new liquidity and risk measures, which lowers the risk of a new banking crisis and reduces the cost to the public, should one occur, for stabilizing the sector. But the new laws to bail in share- and bondholders of a bank in trouble only work for individual cases, or if a small share of the sector is affected. For a systemic crisis, the new system is too complicated to respond quickly. The costs of such crises, e.g. market distortions, credit squeezes and deposit withdrawals, rise the longer the crisis lasts. Allocating the costs of bank failures to private investors often has a political dimension; it is highly likely to be challenged by lawsuits that drag on for years. Governments also still own large stakes in banks, which reduces the incentive to apply a bail-in framework. While the ECB can address liquidity risks, governments remain the only source of bank capital if private markets seize up and large parts of the banking system become unstable. The government-banks nexus has eased, but it has not been wholly abandoned.

Eurozone safety net is too small for a large crisis

If a highly indebted country faces a local crisis, targeted support is needed. It should come from the ESM, which financed the recapitalization of Spanish banks, the program for Cyprus and the new program for Greece. With some EUR 420bn left towards the end of this decade, the ESM remains an effective tool for covering smaller countries cut off from long-term funding markets. The annual average amount needed to finance the government of Greece or Portugal through an economic crisis would total around EUR 20bn each. Spain, with an annual funding requirement of EUR 150–170bn in a crisis, could be added for little more than a year, while Italy is well beyond the means of any such support vehicle. As we suggested earlier, the next economic shock to the Eurozone could push Spain and Portugal closer to the Cyprus/Greece group, endangering the viability of the ESM safety net. Indeed, only the ECB has the capacity to act on behalf of large countries. Its tool for doing so,

Banking crisis, bail in, government-banks nexus

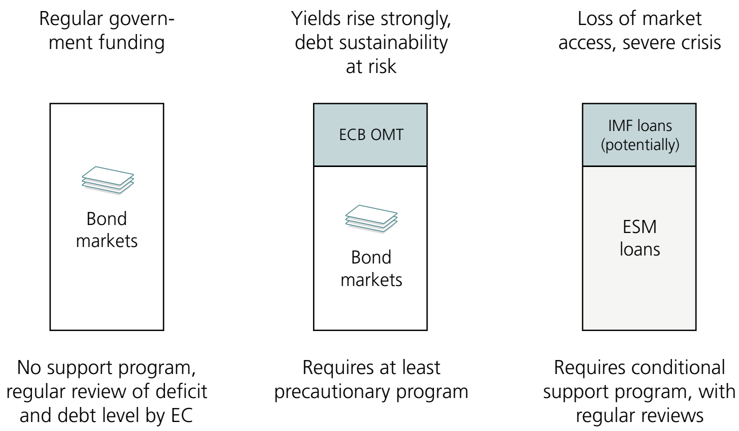


Source: UBS

called Outright Monetary Transactions (OMT), requires some form of European support-program agreement. But a sovereign nation usually waits until all other options are exhausted and its situation is desperate before requesting help and accepting the conditions imposed by external parties.

Large crisis may lead to new institutional framework
Even if the ECB is already engaged in quantitative easing (QE), a country needs to have at least one investment grade rating from a major agency or to pass all reviews under an adjustment program to receive its support. But what happens if a country is junk-rated and either has an uncooperative government or one that has lost its majority in parliament? Last summer demonstrated how such developments can push a country, in this case Greece, outside the European safety net to the brink of a Eurozone exit. Any member country in crisis can theoretically receive support, ultimately from the ECB, but it can also be forced to give up the euro if its government fails to secure the required agreements with the other Eurozone members and the ECB. Ultimately, the heavyweights France and Germany will tip the scales, their roles complicated by the quite different debt paths they are on. All in all, the current institutional framework will probably change in the next large crisis, as it wasn't designed to address them.

Government funding
(simplified)



Source: UBS

Multi-speed Europe: With or without the UK

"It's not time for exits in Europe, it's time for more cooperation."
— Alexis Tsipras, prime minister of Greece, with regard to a Brexit

Multi-speed Europe and populism
In contrast to the Eurogroup and the ECB, the European Parliament, the European Commission and the European Council have to balance the interests of the 19 Eurozone member states ("ins") and the nine remaining member states ("outs""). The UK is by far the dominant member of the "outs" and serves as its "spokesperson" since it boasts Europe's second-largest economy. The upcoming UK referendum on EU membership is yet another example of the populist forces at work in Europe and could fast-forward the appearance of the future EU structure by decades, relegating the "outs" to a small group of special cases like Switzerland and Norway. The Eurozone share of the EU, should the UK opt out of it, would amount to 82%, almost the same as the 86% that would result if the UK stayed put and the other "outs," except Denmark, joined the Eurozone in the coming decades.

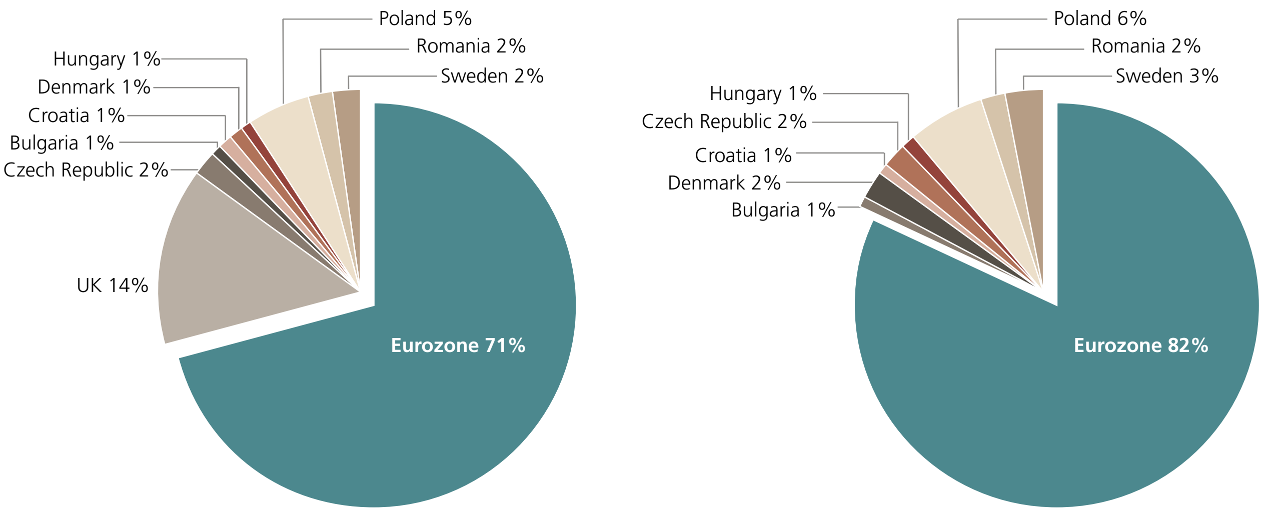
Scenario without UK: EU treaty change may be easier
The UK revoking its EU membership could have profound implications for the functioning of the union. Britain's exit would likely speed up the reorientation of the European Parliament, European Commission and European Council toward the Eurozone. Absent the UK, the rump of EU nations outside the single currency would be further overwhelmed by the "ins," given the fragmentation of the "outs" (eight countries whose economies in total equal the UK's) and the voting rules in the European Council and the European

Parliament. On one level, a UK exit could be seen to promote European integration. It would ensure that, contrary to Britain's demands, national parliaments wouldn't benefit from enhanced veto powers on legislative proposals from the European Parliament, and it may make an EU treaty change more feasible. On another level, it would lower the global standing of the EU and could lead to greater anti-EU sentiment among voters in the euro "outs" who feel their interests being swamped by the demands of the larger bloc.

Scenario with UK: Unlikely to be the last referendum
In the scenario in which the UK remains a member, it will do so under different terms in a changed EU. But it will not be without its own difficulties. The EU's aim is to integrate all "outs" into the Eurozone except the UK and Denmark, given their euro opt-out clauses, so the European Council, European Parliament and the European Commission will gradually transform themselves into Eurozone institutions like the ECB and the Eurogroup. But as time passes and every country but the UK and Denmark joins the Eurozone over the long term, the only two "outs" left would still be influencing Eurozone policy through the European institutions (albeit with declining effect) without being part of the Eurozone, and vice versa, potentially creating new tensions. In fact, the interests of the "ins" and "outs" may not always coincide. This structure may not work out in the long run, which could force the UK either to reconsider its EU membership or to join the euro.

A better deal inside the EU
The referendum will, in our view, most likely result in the UK remaining in the union. Nonetheless, it highlights the populist forces at work in Europe. After Greece last year, it is now the UK that wants a better deal from Europe. Ultimately, support for the EU is mainly driven by economic growth, which requires stronger European institutions. As we laid out in the editorial, the answer to achieving this growth is more Europe, not less.

The EU economy with and without the UK
In % of EU GDP



Source: UBS, Haver Analytics

The evolution of the EU: A timeline

1951	The signing of the Treaty of Paris by Belgium, France, Italy, Luxembourg, the Netherlands and West Germany sets up the European Coal and Steel Community.
1957	The European Economic Community (EEC) is launched with the signing of the Treaty of Rome (effective from 1958) by Belgium, France, Italy, Luxembourg, the Netherlands and West Germany.
1973	Denmark, Ireland and the UK join the EEC.
1975	The UK holds a referendum on EEC membership.
1979	The European Monetary System, which includes the Exchange Rate Mechanism (ERM) and the European Currency Unit (ECU), is launched. The first European Parliament elections take place.
1981	Accession of Greece.
1986	The Single European Act is signed and sets out a timetable for establishing a single market by 1992. Spain and Portugal join the EEC.
1990	German reunification.
1992	The Maastricht Treaty is signed, creating the EU. It establishes a timetable for the euro and introduces convergence criteria among member states. On Black Wednesday, the British government is forced to withdraw the pound sterling from the ERM.
1994	The European Monetary Institute (EMI), the forerunner of the European Central Bank (ECB), is created.
1995	Accession of Austria, Finland and Sweden.
1997	The Treaty of Amsterdam is signed and introduces the Stability and Growth Pact.
1998	The ECB formally replaces the EMI.
1999	The euro is launched as an accounting currency and adopted by Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.
2001	The Treaty of Nice is signed. Greece joins the euro.
2002	Euro notes and coins are introduced.
2004	Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia join the EU.
2007	EU member states sign the Treaty of Lisbon. It comes into force in December 2009. Bulgaria and Romania join the EU.
2010	The temporary European Financial Stability Facility (EFSF) is created.
2012	The permanent European Stability Mechanism (ESM) becomes operational. The fiscal compact is signed. ECB President Mario Draghi pledges to do whatever it takes to preserve the euro, and the ECB establishes its Outright Monetary Transactions (OMT) program.
2013	Croatia joins the EU.

Source: European Commission, UBS

Europe in numbers

	Unit	EU	Eurozone	United States	Japan	China
Population	millions	506.8	339.3	319.2	127.0	1360.7
Average real GDP growth over past decade	%	1.1	0.7	1.5	0.6	10.0
GDP (share of world GDP in PPP)	%	17.1	12.2	15.9	4.4	16.6
GDP per capita[1]	EUR thousands	27.4	29.8	42.1	28.2*	9.2*
Value added by economic activity						
Agriculture, fishing, forestry	% of total	1.6	1.6	1.2	1.2*	9.2
Industry (including constructions)	% of total	24.4	24.4	18.4	24.5*	42.6
Services (including non–market services)	% of total	73.9	73.9	80.4	74.3*	48.2
Unemployment rate (share of the labor force)	%	10.2	11.6	6.2	3.6	4.1
Labor force participation rate[2]	%	72.3	72.3	72.7	75.5	–
Employment rate[3]	%	64.9	63.8	68.1	72.8	–
Tertiary school enrollment	%	66.2*	68.1*	89.1*	61.5**	29.7*
General government[4]						
Surplus (+) or deficit (–)	% of GDP	–3.0	–2.6	–5.6*	–8.5*	–1.1
Gross debt[5]	% of GDP	86.8	92.1	96.0	222.0	41.1
Revenue	% of GDP	45.2	46.7	33.1*	33.9*	28.5
Expenditure[6]	% of GDP	48.2	48.9	38.7*	42.3*	29.6
External[7]						
Exports of goods	% of GDP	12.1	19.5	9.4	15.2	21.6
Exports of goods and services	% of GDP	17.4	26.5	13.5	18.8	23.8
Import of goods	% of GDP	12.1	17.0	13.7	17.4	17.4
Import of goods and services	% of GDP	16.3	23.3	16.4	21.5	21.1
Current account balance	% of GDP	0.9	2.4	–2.2	0.5	2.1

Sources: ECB, Eurostat, UN, BIS, IMF, Worldbank, Haver Analytics, OECD, Reuters and national sources. All data refer to 2014 unless otherwise noted.
* 2013 figures, ** 2012 figures

Notes:
1 Data for US, Japan and China are converted into euro at OECD purchasing power parities (PPPs).
2 Ratio of the labor force to the working age population (aged 15 to 64). US: the proportion of the civilian non-institutional population (aged 16 to 64) either at work or actively seeking work. Annual average.
3 Ratio of persons employed to the working age population (aged 15 to 64). US: the proportion of the civilian non-institutional population (aged 16 to 64) at work. Annual average.
4 General government data for China are not directly comparable with the other major economic areas.
5 General government debt consists of deposits, debt securities and loans outstanding at nominal value and is consolidated within the general government sector. Chinese data follow a different methodology and are not directly comparable.
6 European definition also for US and Japan.
7 Euro area: based on extra-euro area transactions.

Bibliography

Completing Europe's Economic and Monetary Union.
Juncker, J.-C. et al, European Commission Report, June 2015.

Drawing lessons from the crisis for the future of the euro area.
Coeuré, B., speech, 27 August 2015.

EU position in world trade.
European Commission Directorate-General for Trade, October 2014.

Exiting the EU: UK reform proposals, legal impact and alternatives to membership.
Miller, V. et al. House of Commons Library, Briefing Paper 7214, 4 August 2015.

External sources of growth: Progress report on EU trade and investment relationship with key economic partners.
European Commission Staff Working Document, July 2012.

Greek debt crisis: background and developments in 2015.
Harai, D., House of Commons Library, Briefing Paper 7114, 18 September 2015.

How will the refugee surge affect the European economy?
OECD Migration Policy Debates No. 8, November 2015.

Is this humanitarian crisis different?
OECD Migration Policy Debates No. 7, September 2015.

Preparing for next steps on better economic governance in the euro area.
Juncker, J.-C. et al, Informal European Council: Analytical Note, 12 February 2015.

The future of Europe: the Eurozone takes over – stronger integration.
Oerstroem Moeller, J., September 2015.

The grand divergence: Global and European current account surpluses.
Darvas, Z., Bruegel Working Paper, August 2015.

The huge geopolitical and security implications of TTIP.
Dempsey, J., Cato Institute, 3 October 2015.

The path to an upgraded EU foreign policy.
Vimont, P., Carnegie Europe, June 2015.

The roots of Europe's refugee crisis.
Lehne, S. et al, Carnegie Europe, 1 October 2015.

The tragedy of the European Union. Soros, G., 2014.

The world economy: A millennial perspective. Maddison, A., OECD, 2001.

Towards a political convergence process in the euro area.
Speech by Cœuré, B., at the Interparliamentary Conference
"Towards a Progressive Europe", Berlin, 16 October 2015.

UBS House View: Years ahead, World in transition, December 2015.

UBS Chief Investment Office WM's investment views are prepared and published by Wealth Management and Retail & Corporate or Wealth Management Americas, Business Divisions of UBS AG (regulated by FINMA in Switzerland), its subsidiary or affiliate ("UBS"). In certain countries UBS AG is referred to as UBS SA. This material is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this material were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS). All information and opinions as well as any prices indicated are current as of the date of this report, and are subject to change without notice. The market prices provided in performance charts and tables are closing prices on the respective principal stock exchange. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria. UBS and any of its directors or employees may be entitled at any time to hold long or short positions in investment instruments referred to herein, carry out transactions involving relevant investment instruments in the capacity of principal or agent, or provide any other services or have officers, who serve as directors, either to/for the issuer, the investment instrument itself or to/for any company commercially or financially affiliated to such issuers. At any time, investment decisions (including whether to buy, sell or hold securities) made by UBS and its employees may differ from or be contrary to the opinions expressed in UBS research publications. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Additional information will be made available upon request. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information. Tax treatment depends on the individual circumstances and may be subject to change in the future. UBS does not provide legal or tax advice and makes no representations as to the tax treatment of assets or the investment returns thereon both in general or with reference to specific client's circumstances and needs. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of our individual clients and we would recommend that you take financial and/or tax advice as to the implications (including tax) of investing in any of the products mentioned herein. This material may not be reproduced or copies circulated without prior authority of UBS. UBS expressly prohibits the distribution and transfer of this material to third parties for any reason. UBS accepts no liability whatsoever for any claims or lawsuits from any third parties arising from the use or distribution of this material. This report is for distribution only under such circumstances as may be permitted by applicable law. In developing the Chief Investment Office (CIO) economic forecasts, CIO economists worked in collaboration with economists employed by UBS Investment Research. Forecasts and estimates are current only as of the date of this publication and may change without notice. For information on the ways in which UBS CIO WM manages conflicts and maintains independence of its investment views and publication offering, and research and rating methodologies, please visit www.ubs.com/research. Additional information on the relevant authors of this publication and other CIO publication(s) referenced in this report; and copies of any past reports on this topic; are available upon request from your client advisor.

External Asset Managers / External Financial Consultants: In case this research or publication is provided to an External Asset Manager or an External Financial Consultant, UBS expressly prohibits that it is redistributed by the External Asset Manager or the External Financial Consultant and is made available to their clients and/or third parties. **Australia:** 1) **Clients of UBS Wealth Management Australia Ltd:** This notice is issued by UBS Wealth Management Australia Ltd ABN 50 005 311 937 (Holder of Australian Financial Services Licence No. 231127): This Document is general in nature and does not constitute personal financial product advice. The Document does not take into account any person's objectives, financial situation or needs, and a recipient should obtain advice from an independent financial adviser and consider any relevant offer or disclosure document prior to making any investment decisions. 2) **Clients of UBS AG:** This notice is issued by UBS AG ABN 47 088 129 613 (Holder of Australian Financial Services Licence No 231087): This Document is issued and distributed by UBS AG. This is the case despite anything to the contrary in the Document. The Document is intended for use only by "Wholesale Clients" as defined in section 761G ("Wholesale Clients") of the Corporations Act 2001 (Cth) ("Corporations Act"). In no circumstances may the Document be made available by UBS AG to a "Retail Client" as defined in section 761G of the Corporations Act. UBS AG's research services are only available to Wholesale Clients. The Document is general information only and does not take into account any person's investment objectives, financial and taxation situation or particular needs. **Bahamas:** This publication is distributed to private clients of UBS (Bahamas) Ltd and is not intended for distribution to persons designated as a Bahamian citizen or resident under the Bahamas Exchange Control Regulations. **Bahrain:** UBS is a Swiss bank not licensed, supervised or regulated in Bahrain by the Central Bank of Bahrain and does not undertake banking or investment business activities in Bahrain. Therefore, Clients have no protection under local banking and investment services laws and regulations. **Brazil:** Prepared by UBS Brasil Administradora de Valores Mobiliários Ltda, entity regulated by Comissão de Valores Mobiliários ("CVM") **Canada:** In Canada, this publication is distributed to clients of UBS Wealth Management Canada by UBS Investment Management Canada Inc.. **Dubai:** Research is issued by UBS AG Dubai Branch within the DIFC, is intended for professional clients only and is not for onward distribution within the United Arab Emirates. **France:** This publication is distributed by UBS (France) S.A., French "société anonyme" with share capital of € 125.726.944, 69, boulevard Haussmann F-75008 Paris, R.C.S. Paris B 421 255 670, to its clients and prospects. UBS (France) S.A. is a provider of investment services duly authorized according to the terms of the "Code Monétaire et Financier", regulated by French banking and financial authorities as the "Autorité de Contrôle Prudentiel et de Résolution." **Germany:** The issuer under German Law is UBS Deutschland AG, Bockenheimer Landstrasse 2–4, 60306 Frankfurt am Main. UBS Deutschland AG is authorized and regulated by the "Bundesanstalt für Finanzdienstleistungsaufsicht". **Hong Kong:** This publication is distributed to clients of UBS AG Hong Kong Branch by UBS AG Hong Kong Branch, a licensed bank under the Hong Kong Banking Ordinance and a registered institution under the Securities and Futures Ordinance. **India:** Distributed by UBS Securities India Private Ltd. 2/F, 2 North Avenue, Maker Maxity, Bandra Kurla Complex, Bandra (East), Mumbai (India) 400051. Phone: +912261556000. SEBI Registration Numbers: NSE (Capital Market Segment): INB230951431, NSE (F&O Segment) INF230951431, BSE (Capital Market Segment) INB010951437. **Indonesia:** This research or publication is not intended and not prepared for purposes of public offering of securities under the Indonesian Capital Market Law and its implementing regulations. Securities mentioned in this material have not been, and will not be, registered under the Indonesian Capital Market Law and Regulations. **Israel:** UBS AG is registered as a Foreign Dealer in cooperation with UBS Wealth Management Israel Ltd, a wholly owned UBS subsidiary. UBS Wealth Management Israel Ltd is a licensed Portfolio Manager which engages also in Investment Marketing and is regulated by the Israel Securities Authority. This publication shall not replace any investment advice and/or investment marketing provided by a relevant licensee which is adjusted to your personal needs. **Italy:** This publication is distributed to the clients of UBS (Italia) S.p.A., via del vecchio politecnico 3, Milano, an Italian bank duly authorized by Bank of Italy to the provision of financial services and supervised by "Consob" and Bank of Italy. **Jersey:** UBS AG, Jersey Branch, is regulated and authorized by the Jersey Financial Services Commission for the conduct of banking, funds and investment business. **Luxembourg:** This publication is not intended to constitute a public offer under Luxembourg law, but might be made available for information purposes to clients of UBS (Luxembourg) S.A., 33A avenue J.F. Kennedy, L-1855 Luxembourg, R.C.S. Luxembourg B 11142, a regulated bank under the joint supervision of the European Central bank and the "Commission de Surveillance du Secteur Financier" (CSSF), to which this publication has not been submitted for approval. **Mexico:** This document has been distributed by UBS Asesores México, S.A. de C.V., a company which is not part of UBS Grupo Financiero, S.A. de C.V. or of any other Mexican financial group and whose obligations are not guaranteed by any third party. UBS Asesores México, S.A. de C.V. does not guarantee any yield whatsoever. **Netherlands:** This publication is not intended to constitute a public offering or a comparable solicitation under Dutch law, but might be made available for information purposes to clients of UBS Bank (Netherlands) B.V., a regulated bank under the supervision of "De Nederlansche Bank" (DNB) and "Autoriteit Financiële Markten" (AFM), to which this publication has not been submitted for approval. **New Zealand:** This notice is distributed to clients of UBS Wealth Management Australia Limited ABN 50 005 311 937 (Holder of Australian Financial Services Licence No. 231127), Chifley Tower, 2 Chifley Square, Sydney, New South Wales, NSW 2000, by UBS Wealth Management Australia Ltd. You are being provided with this UBS publication or material because you have indicated to UBS that you are a client certified as a wholesale investor and/or an eligible investor ("Certified Client") located in New Zealand. This publication or material is not intended for clients who are not Certified Clients ("Non-Certified Clients"), and if you are a Non-Certified Client you must not rely on this publication or material. If despite this warning you nevertheless rely on this publication or material, you hereby (i) acknowledge that you may not rely on the content of this publication or material and that any recommendations or opinions in this publication or material are not made or provided to you, and (ii) to the maximum extent permitted by law (a) indemnify UBS and its associates or related entities (and their respective directors, officers, agents and advisers (each a "Relevant Person") for any loss, damage, liability or claim any of them may incur or suffer as a result of, or in connection with, your unauthorised reliance on this publication or material and (b) waive any rights or remedies you may have against any Relevant Person for (or in respect of) any loss, damage, liability or claim you may incur or suffer as a result of, or in connection with, your unauthorised reliance on this publication or material. **Saudi Arabia:** This publication has been approved by UBS Saudi Arabia (a subsidiary of UBS AG), a Saudi Arabian closed joint stock company incorporated in the Kingdom of Saudi Arabia under commercial register number 1010257812 having its registered office at Tatweer Towers, P.O. Box 75724, Riyadh 11588, Kingdom of Saudi Arabia. UBS Saudi Arabia is authorized and regulated by the Capital Market Authority of Saudi Arabia. **Singapore:** Please contact UBS AG Singapore branch, an exempt financial adviser under the Singapore Financial Advisers Act (Cap. 110) and a wholesale bank licensed under the Singapore Banking Act (Cap. 19) regulated by the Monetary Authority of Singapore, in respect of any matters arising from, or in connection with, the analysis or report. **Spain:** This publication is distributed to clients of UBS Bank, S.A. by UBS Bank, S.A., a bank registered with the Bank of Spain. **Taiwan:** This material is provided in accordance with laws of Taiwan, in agreement with or at the request of clients. **UAE:** This research report is not intended to constitute an offer, sale or delivery of shares or other securities under the laws of the United Arab Emirates (UAE). The contents of this report have not been and will not be approved by any authority in the United Arab Emirates including the UAE Central Bank or Dubai Financial Authorities, the Emirates Securities and Commodities Authority, the Dubai Financial Market, the Abu Dhabi Securities market or any other UAE exchange. **UK:** Approved by UBS AG, authorised and regulated by the Financial Market Supervisory Authority in Switzerland. In the United Kingdom, UBS AG is authorised by the Prudential Regulation Authority and subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. A member of the London Stock Exchange. This publication is distributed to private clients of UBS London in the UK. Where products or services are provided from outside the UK, they will not be covered by the UK regulatory regime or the Financial Services Compensation Scheme. **USA:** This document is not intended for distribution into the US and / or to US persons. UBS Securities LLC is a subsidiary of UBS AG and an affiliate of UBS Financial Services Inc., UBS Financial Services Inc. is a subsidiary of UBS AG.

Version 01/2016.