Video transcript

Europe: they think it's all over ...

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Two long-awaited events in Europe have finally happened. The eurozone, after a year and a half in deep recession, has returned to growth. That's a reason for celebration. Companies might start hiring again, lowering unemployment rates and supporting a more broad-based recovery.

Germany has finally had its long-awaited election. A lot of those decisions which have been queuing up over the last year, particularly on eurozone issues, may now be able to be taken. But unfortunately it's not that straight forward. Germany needs to form a government first, and despite Chancellor Angela Merkel's very high popularity, she still needs to win the support, most likely, of the social democrats.

The last time the two parties formed a coalition, it took two months. This time it could be longer, but we hope not because in late November some key decisions need to be taken on banking union and then there is a very short window during which legislation can be passed, because the European Parliamentary elections are due to be held in May and parliament will break.

Even more pressing is the need to keep the recovery on track because the recovery at this stage still looks set to be relatively feeble. This is one of those rare periods when we've actually made upward revisions to our growth forecasts but we still only see real GDP growth in 2014 for the eurozone at 0.8 per cent. And that's with Germany growing at more than double that growth rate. So it's still a relatively feeble outlook elsewhere. And indeed we expect this growth outlook still to be largely export-led, which means it's likely to be a little bit volatile over the coming quarters.

In the report we do look at the possibilities of some stronger domestically led growth to come through. We did get some domestic growth in the second quarter but we were surprised at how much of that was actually driven by government spending. On the investment outlook we only see a significant revival coming through in Germany. And on the consumer outlook, while we are seeing some improvement in private-sector employment, we don't see scope for a significant re-leveraging of the eurozone consumer, only slightly so in Germany and France, elsewhere in the eurozone the ongoing problems in the banking sector are more likely to continue to constrain credit growth as banks continue to load up their balance sheet with government bonds. And indeed banks are more likely to continue to do so ahead of next year's asset quality review by the ECB.

So this combination of weak growth, of low inflation and potentially higher interest rates is not really a combination that's going to stabilise government debt burdens. But the markets continue to remain relatively calm since Mario Draghi's infamous speech in which he promised to do whatever it takes in the middle of 2012.

What could bring the pressure back? Well, Fed tapering is still a risk as we see it. We're not expecting an emerging market reversal of capital flows to affect the eurozone, but we still see a risk of potentially higher interest rates actually starting to come through, which could be a further constraint on growth and the further inability to reduce government deficits.

We also see a large number of political risks, not just in the core because potential tensions between, for instance, France and Germany could still affect decision-making on integration issues but there's still a large element of political risk in Southern Europe. If we look at Greece or Italy or Spain or Portugal, they are all countries where there are governments with narrowing majorities.

And as for the ECB, how should they respond to these challenges that lie ahead? We are now in the midst of at least some kind of cyclical upturn so it now seems very unlikely that the ECB will cut interest rates again this year despite the continued strength of the euro. If we get further policy this year, we think it will come in the form of liquidity provision so we expect another LTRO (long-term refinancing operations) quite likely at some kind of fixed rate which would enhance their forward guidance policy. But given our expectation that growth will still be relatively weak in 2014 and inflation will still be under downward pressure, we don't rule out the possibility of a further rate cut in 2014.

So yes, the eurozone recovery may have begun; that is a reason for celebration, but because we expect that recovery to be weak and inflation to continue to move lower, we think that the ECB's job is far from over.