OXFORD ECONOMICS

Eurozone

Highlights and Key Issues

- At the start of 2013, the Eurozone seems much more secure than a year ago. The risk of an imminent break-up or a major credit crunch has diminished significantly and the external environment looks more stable than in early 2012.
- This means that we are more confident in our baseline forecast. To the extent that businesses also perceive a reduction in downside risks, this should help to boost investment, at least by cash-rich companies, compared with 2012.
- But the Eurozone continues to face major challenges that will prevent a swift recovery. We are still forecasting a small 0.2% contraction in GDP this year and only modest growth of about 1% in 2014. First, while the banking sector no longer looks to be on the edge of an abyss, it is still precariously placed and in no position to contribute to growth by providing increased credit to the real economy. Second, even after sharp increases during 2012, unemployment will probably rise further this year as companies need to restore productivity.
- Moreover, fiscal policy will be tightened again in 2013 and this will hit the economy as hard as in the last couple of years, subtracting around 1% point from Eurozone GDP growth.
- In this environment, monetary policy will remain expansionary. The reduction of downside risks means that another rate cut may not be necessary but we do not expect any increase in rates before 2017.

Forecast for Eurozone
(Annual percentage changes unless specified)

	2011	2012	2013	2014	2015	2016
Domestic Demand	0.5	-2.0	-0.9	0.8	1.3	1.4
Private Consumption	0.1	-1.1	-0.4	0.6	1.1	1.3
Fixed Investment	1.6	-3.7	-1.7	2.1	2.9	2.8
Government Consumption	-0.1	-0.2	-0.9	-0.3	0.3	0.6
Net exports (% of GDP)	2.8	4.3	4.9	5.2	5.3	5.3
GDP	1.5	-0.5	-0.2	1.1	1.4	1.5
Industrial Production	2.7	-2.7	-1.2	1.6	2.3	2.2
Consumer Prices	2.7	2.5	1.9	1.5	1.3	1.3
Current Account (% of GDP)	0.1	1.0	1.4	1.3	1.2	1.2
Government Budget (% of GDP)	-4.1	-3.3	-2.6	-2.1	-1.7	-1.3
Short-Term Interest rate (%)	1.4	0.6	0.2	0.3	0.4	0.5
Long-Term Interest Rates (%)	4.4	4.0	3.3	3.5	3.7	4.1
Exchange rate (US$ per Euro)	1.39	1.28	1.27	1.21	1.17	1.17
Exchange rate (YEN per Euro)	111.0	102.5	112.4	113.5	112.0	114.0

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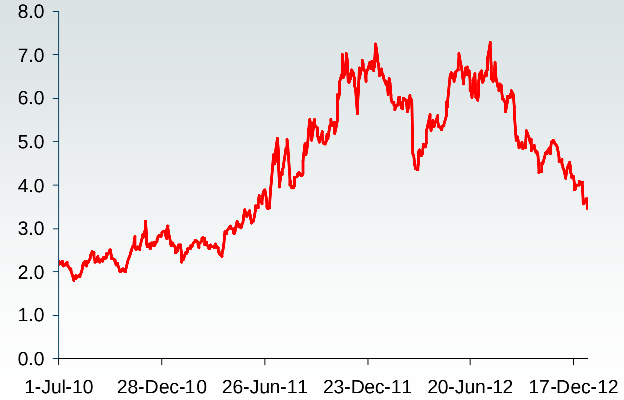
Overview

Eurozone looking more secure…

- The Eurozone seems much more secure at the start of 2013 than a year earlier. Risks of an imminent breakup or a major credit crunch have significantly diminished. Substantial policy actions by the ECB (via its long-term refinancing operations and its commitment to buy government bonds under certain conditions) and by governments (renegotiation of the Greek bailout deal to avoid default and starting on the path towards a banking union) have helped boost sentiment that a Eurozone break-up is now much less likely. We now think that the chances of a break-up this year are very low.
- This is illustrated by the behaviour of the average bond yield spread of the troubled peripheral countries over German bunds – one way of measuring the intensity of Eurozone tensions. In the first half of January, the average bond yield spread across peripheral countries was around 350bp, half the level seen at the worst points in 2012.
- Moreover, the external environment looks more stable than in early 2012. Some positive signs have appeared in emerging markets and the US economy seems very likely to avoid the bulk of what could have been a drastic fiscal tightening. This will help ensure a steady, albeit not buoyant, flow of export revenues and encourage some exporting companies to invest and hire.

Weighted average peripheral bond spread

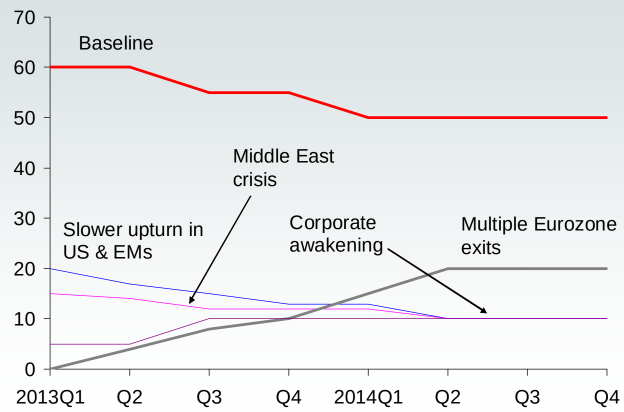
% spread over German bunds



Source : Oxford Economics/ Reuters

Scenario probabilities

%



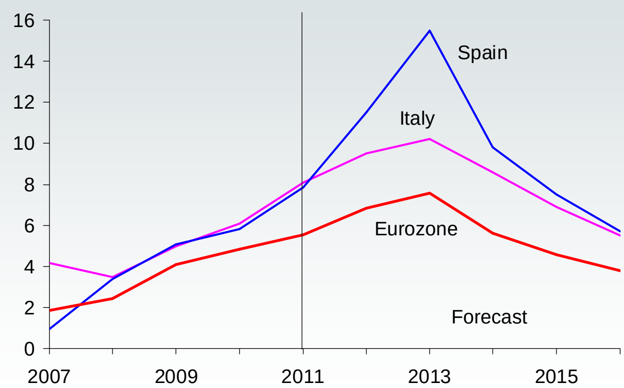
Source : Oxford Economics

…will help normal business resume...

- This means that we are more confident in our baseline forecast than we have been for a long time. To the extent that businesses also perceive a reduction in downside risks, they should be able to resume more normal business operations that were paralysed by the unusually high uncertainty during 2012. With Eurozone corporates cash-rich on average, especially in the core Eurozone, business investment plans should come back onto the agenda.

Eurozone Non-performing bank loans

% total loans



Source : Oxford Economics/World Bank

…but headwinds to growth remain

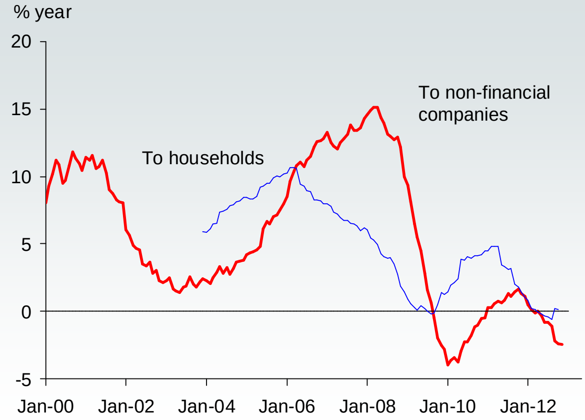
- However, the Eurozone still faces significant headwinds to growth. First, while the banking sector no longer looks to be on the edge of an abyss, it is still precariously placed and in no position to contribute to growth by providing increased credit to the real economy. Lending surveys show ongoing falls in the stock of loans to businesses and banks continue to report that they are tightening credit standards even further. This tight credit environment will prevail for some time. We forecast further increases in non-performing loans as ongoing weak growth and recessions in parts of the Eurozone weigh on the ability of households and companies to meet their debt obligations.

- Second, even after sharp increases during 2012, unemployment will probably rise further this year. In the private sector, the adjustment of payrolls to more sustainable and profitable levels is not yet over. Productivity was broadly flat in 2012, at an aggregate level only marginally higher than in 2007. And in the public sector, further job cuts are in the pipeline. We expect the unemployment rate to rise for another year, peaking at around 12.5% at the end of 2013 or early in 2014.
- Moreover, fiscal policy will be tightened again in 2013 and this will hit the economy as hard as in the last couple of years, subtracting around 1% point from Eurozone GDP growth, a similar impact to what we estimated for 2012. Finally, businesses and households in a number of countries have yet to reduce debt, which will impinge on spending for some time to come.
- Overall, we maintain our forecast of a small 0.2% contraction in Eurozone GDP this year, followed by muted growth of only some 1-1.5% in the following few years.

Rates at record lows until 2017

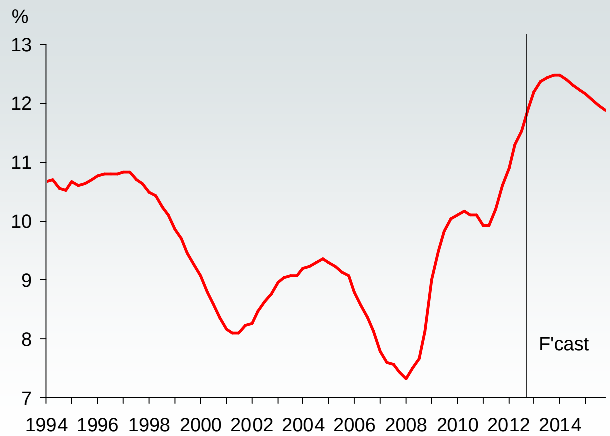
- The weak growth environment will keep downward pressure on wages and prices and will result in low inflation, barring any spike in commodity prices or VAT-related price increases.
- But while at the end of 2012 it seemed possible that the ECB would cut rates this year, now that the extreme downside risks are less likely we do not think that lower interest rates will be on the agenda. We expect the policy interest rate to remain at the current record low (of 0.75%) until 2017. For companies and households with strong balance sheets, and hence high creditworthiness, this means that financing costs will be very low for years to come.

Eurozone: lending to the private sector



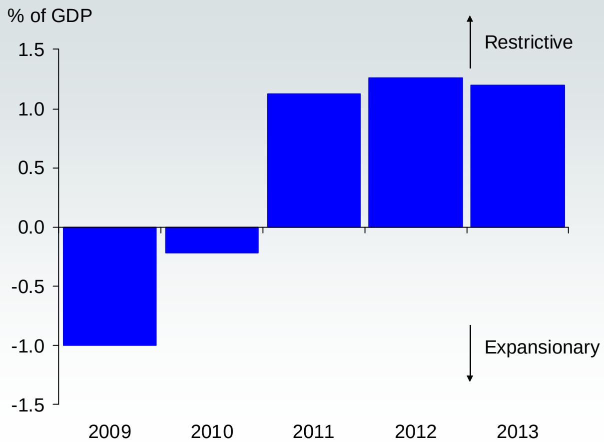
Source : Oxford Economics

Eurozone: Unemployment



Source: Oxford Economics

Eurozone: fiscal measures



Source : Oxford Economics

Key Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

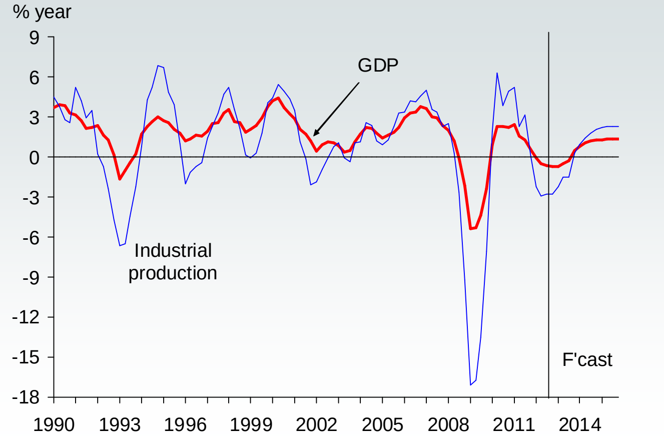
	Industrial production (% yr)	Unemploy-ment (% point)	CPI (% yr)	Business confidence (% balance)	Consumer confidence (% balance)	Exports (% yr)	Imports (% yr)	Trade balance (€ bn)
Dec	-1.5	10.7	2.7	-0.3	-21.3	9.7	2.5	8.0
2012								
Jan	-1.5	10.8	2.7	-0.2	-20.7	10.8	4.2	-8.9
Feb	-1.7	10.9	2.7	-0.1	-20.3	10.9	7.5	1.4
Mar	-1.7	11.0	2.7	-0.2	-19.1	4.6	0.2	7.6
Apr	-2.6	11.2	2.6	-0.5	-19.9	6.1	-0.3	4.2
May	-2.5	11.3	2.4	-0.7	-19.3	6.1	0.4	7.3
Jun	-1.8	11.4	2.4	-0.9	-19.8	12.0	2.7	13.5
Jul	-2.5	11.4	2.4	-1.2	-21.5	11.0	2.6	14.3
Aug	-2.1	11.5	2.6	-1.2	-24.6	10.0	2.0	5.0
Sep	-2.7	11.6	2.6	-1.3	-25.9	1.3	-4.5	9.5
Oct	-3.9	11.7	2.5	-1.6	-25.7	14.3	6.9	10.2
Nov	-	11.8	2.2	-1.2	-26.9	-	-	-
Dec	-	-	2.2	-1.1	-26.5	-	-	-

Financial Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

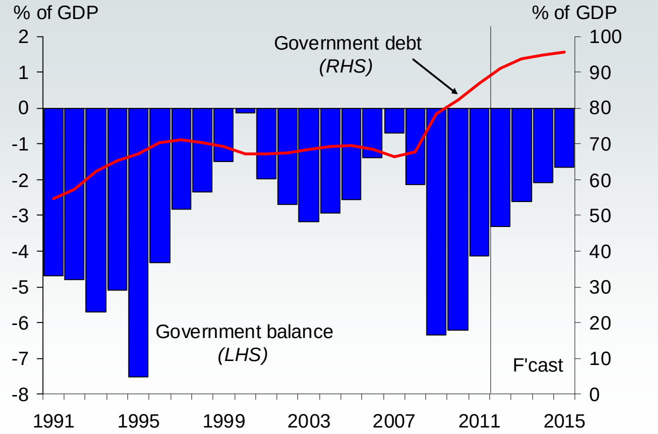
	Short rate %	Long rate %	Money Supply (M3)	Exchange rate $/€ avg.	Exchange rate €/£	Nominal effective exch. rate	Share price DJ STOXX	Net FDI € bn
Dec	1.43	4.11	1.5	1.318	1.184	103.6	2316.6	10.9
2012								
Jan	1.22	3.92	2.0	1.290	1.203	101.6	2416.7	0.3
Feb	1.05	3.75	2.5	1.322	1.194	102.9	2512.1	5.7
Mar	0.86	3.29	2.9	1.320	1.198	103.4	2477.3	-9.4
Apr	0.74	3.39	2.3	1.316	1.216	102.8	2306.4	-0.8
May	0.68	3.53	2.9	1.279	1.244	100.8	2118.9	10.1
Jun	0.66	3.41	3.0	1.253	1.242	99.7	2264.7	-19.1
Jul	0.50	3.25	3.6	1.229	1.269	97.6	2325.7	-7.2
Aug	0.33	3.01	2.9	1.240	1.268	97.7	2440.7	-12.1
Sep	0.25	2.43	2.6	1.286	1.252	99.9	2454.3	-15.9
Oct	0.21	2.31	3.9	1.297	1.239	100.8	2503.6	-13.0
Nov	0.19	2.25	3.8	1.283	1.244	100.3	2575.3	-
Dec	0.19	2.10	-	1.312	1.231	102.0	2635.9	-

Eurozone: GDP and industrial production



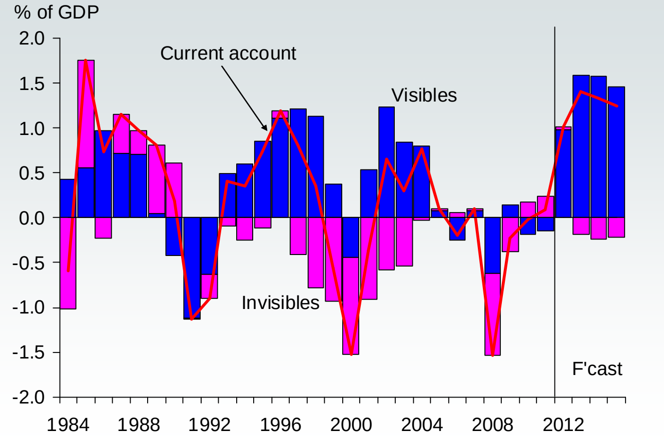
Source: Oxford Economics

Eurozone: Government finances



Source: Oxford Economics

Eurozone: Current account

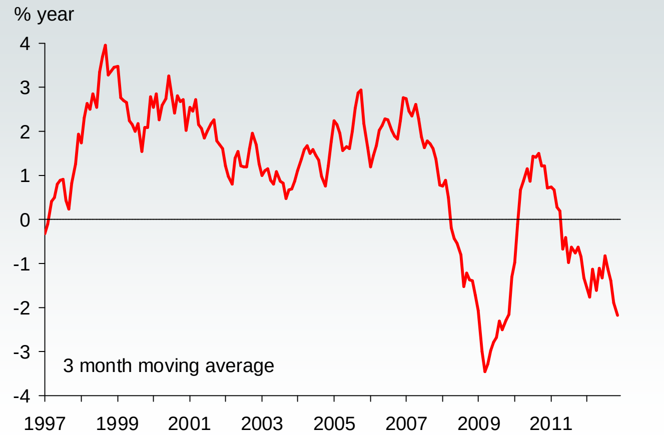


Source: Oxford Economics

Dollar/euro exchange rate

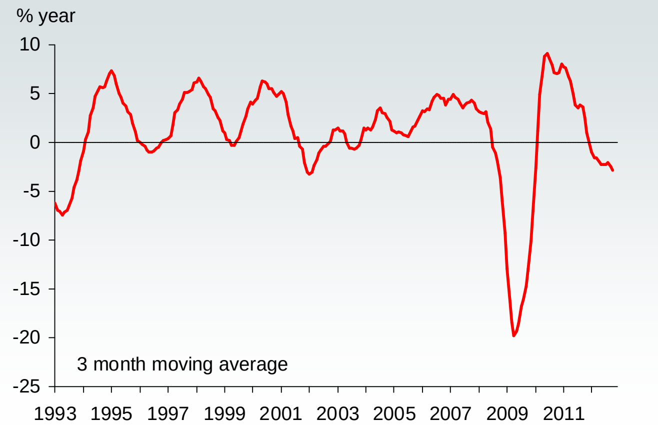
Source: Oxford Economics

Eurozone: Retail sales



Source: Oxford Economics

Eurozone: Industrial production



Source: Haver Analytics

EURO ZONE — TABLE 1 SUMMARY ITEMS

Annual Percentage Changes, Unless Otherwise Specified

	CONSUMERS EXPENDITURE (C)	GROSS FIXED INVESTMENT (IF)	DOMESTIC DEMAND (DOMD)	REAL GDP (GDP)	INDUSTRIAL PRODUCTION (IP)	UNEMPLOY-MENT RATE (%) (UP)	AVERAGE EARNINGS (ER)	WHOLE ECONOMY PRODUCT-IVITY (GDPET)	MONEY SUPPLY M3 (MON)	PRODUCER PRICES (PPI)	CONSUMER PRICES (CPI)
YEARS BEGINNING Q1											
2011	0.1	1.6	0.5	1.5	2.7	10.2	2.3	1.2	1.6	5.6	2.7
2012	-1.1	-3.7	-2.0	-0.5	-2.7	11.4	1.6	0.2	2.5	2.5	2.5
2013	-0.4	-1.7	-0.9	-0.2	-1.2	12.4	1.1	0.7	1.9	1.7	1.9
2014	0.6	2.1	0.8	1.1	1.6	12.4	1.7	1.2	3.3	2.0	1.5
2015	1.1	2.9	1.3	1.4	2.3	12.1	2.1	1.1	3.6	2.0	1.3
2016	1.3	2.8	1.4	1.5	2.2	11.8	2.3	1.2	3.7	1.9	1.3
2011											
I	0.9	3.5	1.6	2.4	5.3	9.9	2.2	2.1	0.1	6.4	2.5
II	0.2	1.4	0.9	1.6	2.3	9.9	2.3	1.1	1.6	5.8	2.8
III	0.2	0.7	0.4	1.3	3.2	10.2	2.4	1.0	2.4	5.4	2.7
IV	-0.8	0.8	-0.8	0.6	0.1	10.6	2.4	0.7	2.3	4.7	2.9
2012											
I	-1.1	-2.3	-1.6	-0.1	-2.2	10.9	2.1	0.4	2.9	3.4	2.7
II	-1.1	-3.8	-2.3	-0.5	-2.9	11.3	1.6	0.3	2.9	2.1	2.5
III	-1.3	-4.2	-2.3	-0.6	-2.8	11.5	1.6	0.1	2.4	2.2	2.5
IV	-1.0	-4.6	-1.9	-0.7	-2.8	11.9	1.2	0.2	1.8	2.3	2.3
2013											
I	-0.9	-3.8	-1.7	-0.7	-2.2	12.2	0.9	0.2	1.6	1.4	2.0
II	-0.5	-2.1	-1.1	-0.5	-1.5	12.4	1.0	0.6	1.4	1.7	1.8
III	-0.4	-1.1	-0.6	-0.2	-1.5	12.5	1.1	0.7	1.9	1.8	1.9
IV	0.1	0.3	0.1	0.5	0.3	12.5	1.4	1.2	2.6	1.9	1.8
2014											
I	0.4	1.3	0.5	0.8	1.0	12.5	1.5	1.2	3.0	1.9	1.6
II	0.6	2.0	0.7	1.1	1.4	12.5	1.6	1.2	3.2	2.0	1.5
III	0.8	2.5	0.9	1.2	1.8	12.4	1.8	1.2	3.4	2.0	1.4
IV	0.9	2.7	1.1	1.3	2.1	12.3	1.9	1.1	3.5	2.1	1.4
2015											
I	1.0	2.8	1.2	1.3	2.3	12.2	1.9	1.1	3.6	2.1	1.4
II	1.1	2.9	1.3	1.4	2.3	12.1	2.0	1.1	3.6	2.1	1.3
III	1.1	2.9	1.3	1.4	2.3	12.0	2.1	1.2	3.7	2.0	1.3
IV	1.2	2.9	1.4	1.4	2.3	12.0	2.2	1.2	3.7	2.0	1.3
2016											
I	1.2	2.8	1.4	1.4	2.3	11.9	2.2	1.2	3.7	1.9	1.3
II	1.3	2.8	1.4	1.5	2.2	11.8	2.3	1.2	3.7	1.9	1.3
III	1.3	2.7	1.4	1.5	2.2	11.7	2.3	1.3	3.7	1.9	1.3
IV	1.4	2.7	1.4	1.5	2.1	11.7	2.4	1.3	3.7	1.9	1.3

EURO ZONE — TABLE 2 SUMMARY ITEMS

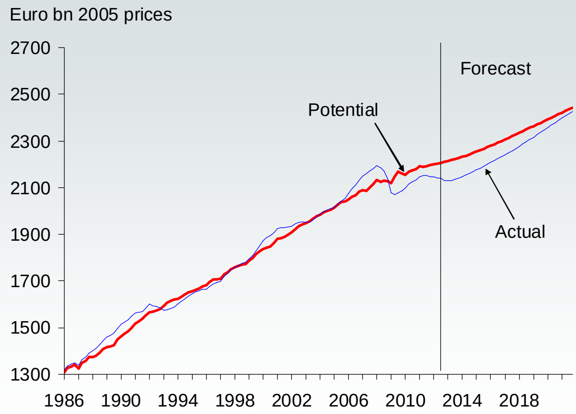
	TRADE BALANCE (EURO BN) (BVI)	CURRENT ACCOUNT (EURO BN) (BCU)	CURRENT ACCOUNT (% OF GDP) (BCU*100 /GDP!)	GOVERNMENT FINANCIAL BALANCE (EURO BN) (GB)	GOVERNMENT FINANCIAL BALANCE (% OF GDP) (GB*100 /GDP!)	SHORT-TERM INTEREST RATE (RSH)	LONG-TERM INTEREST RATE (RLG)	REAL SHORT-TERM INTEREST RATE (Note 1)	REAL LONG-TERM INTEREST RATE (Note 1)	US DOLLAR PER EURO (RXD)	EFFECTIVE RATE (1995=100) (RX)
YEARS BEGINNING Q1											
2011	-13.9	8.7	0.09	-389.5	-4.14	1.39	4.41	-1.33	1.69	1.39	120.8
2012	92.0	95.1	1.00	-315.0	-3.32	0.57	3.99	-1.92	1.49	1.28	115.4
2013	149.3	131.5	1.37	-251.6	-2.62	0.22	3.25	-1.63	1.40	1.27	115.4
2014	151.3	127.2	1.29	-204.1	-2.08	0.31	3.47	-1.19	1.97	1.21	112.9
2015	144.1	122.2	1.21	-167.0	-1.65	0.39	3.70	-0.92	2.39	1.17	110.1
2016	151.9	123.2	1.19	-133.6	-1.29	0.46	4.05	-0.86	2.73	1.17	110.0
2011											
I	-8.0	0.7	0.03	-113.1	-4.83	1.10	4.32	-1.38	1.84	1.37	119.4
II	-8.9	-5.9	-0.25	-100.8	-4.29	1.42	4.51	-1.34	1.75	1.44	122.4
III	-6.9	1.1	0.05	-91.2	-3.86	1.56	4.30	-1.14	1.60	1.41	121.2
IV	9.9	12.8	0.54	-84.3	-3.57	1.50	4.53	-1.45	1.59	1.35	120.4
2012											
I	10.7	21.6	0.91	-79.6	-3.36	1.04	4.39	-1.64	1.70	1.31	116.8
II	20.9	28.0	1.18	-84.4	-3.56	0.69	4.27	-1.76	1.82	1.28	115.8
III	26.6	17.0	0.71	-77.5	-3.26	0.36	3.99	-2.18	1.45	1.25	113.3
IV	33.8	28.5	1.20	-73.5	-3.09	0.20	3.29	-2.11	0.99	1.30	115.8
2013											
I	36.8	57.9	2.43	-66.9	-2.81	0.20	3.23	-1.75	1.28	1.29	116.4
II	36.3	33.7	1.41	-68.4	-2.86	0.21	3.24	-1.59	1.44	1.27	115.6
III	34.8	9.6	0.40	-62.8	-2.61	0.23	3.25	-1.64	1.38	1.26	115.1
IV	41.4	30.4	1.26	-53.5	-2.21	0.25	3.30	-1.56	1.49	1.25	114.5
2014											
I	42.0	59.6	2.45	-53.0	-2.18	0.28	3.38	-1.36	1.75	1.23	114.0
II	37.8	32.7	1.33	-54.8	-2.24	0.30	3.45	-1.24	1.91	1.22	113.5
III	32.5	6.8	0.27	-52.6	-2.14	0.32	3.50	-1.10	2.08	1.20	112.5
IV	39.1	28.2	1.14	-43.7	-1.76	0.34	3.54	-1.06	2.14	1.19	111.4
2015											
I	39.8	57.9	2.32	-42.9	-1.72	0.36	3.59	-0.99	2.24	1.17	110.1
II	35.2	31.0	1.23	-45.4	-1.81	0.38	3.64	-0.91	2.35	1.17	110.1
III	30.8	5.8	0.23	-43.7	-1.73	0.40	3.74	-0.90	2.43	1.17	110.1
IV	38.4	27.5	1.08	-35.0	-1.37	0.42	3.83	-0.87	2.54	1.17	110.1
2016											
I	40.1	57.4	2.24	-34.5	-1.34	0.43	3.93	-0.87	2.62	1.17	110.0
II	36.5	30.9	1.19	-37.5	-1.45	0.45	4.01	-0.87	2.70	1.17	109.9
III	33.4	6.4	0.25	-35.6	-1.36	0.47	4.10	-0.86	2.77	1.17	110.0
IV	41.9	28.5	1.08	-26.1	-0.99	0.48	4.18	-0.86	2.84	1.17	109.9

Note 1 : REAL INTEREST RATES = Nominal interest rate (RSH or RLG) - % change in CPI

Potential output growth 1.0%pa

- Potential output is projected to rise by 1.0%pa over the next 10 years, a slightly lower rate than in the previous decade. GDP is set to contract by 0.5% in 2012, having grown by 1.5% in 2011 and to be significantly below potential growth at -0.2% in 2013. As a result, the large output gap of 2.0% in 2011 will expand in 2012 to 3.0% and increase in 2013 to 3.9%, and it is not forecast to close fully until 2024.
- The main contribution to growth in potential output over the coming decade comes from expanding capital usage.
- The 0.02%pt contribution from expanding labour usage reflects the 0.3%pa fall in the working population over the next ten years and an increase in the participation rate which combine to reduce the labour supply by 0.0%pa. For the capital stock's contribution of 0.5%pt, the main factor is significantly higher investment growth (at 1.3%pa) than in the previous decade. Finally, total factor productivity growth's slightly higher contribution of 0.5%pt reflects the better contribution to potential growth from factors influencing production other than labour and capital over the coming decade.

Eurozone: Actual & potential output



Source: Oxford Economics

Potential GDP and Its Components Average Percentage Growth	2002-2011	2012-2021
Potential GDP*	1.49	1.05
Employment at NAIRU	0.66	0.03
Capital Stock	2.15	1.49
Total Factor Productivity	0.31	0.51

*ln(Potential GDP)=0.65*ln(Employment at NAIRU) +0.35*ln(Capital Stock)+ln(Total Factor Productivity)

Long-Term Forecast for Eurozone
(Average annual percentage change unless otherwise stated)

	2002-2006	2007-2011	2012-2016	2017-2021
GDP	1.8	0.4	0.6	1.7
Consumption	1.5	0.4	0.3	1.5
Investment	2.1	-1.8	0.4	2.2
Government Consumption	1.9	1.5	-0.1	1.1
Exports of Goods and Services	5.0	2.2	3.6	3.3
Imports of Goods and Services	5.0	1.7	2.7	3.3
Unemployment (%)	8.9	9.0	12.0	10.6
Consumer Prices	2.2	2.0	1.7	1.6
Current Balance (% of GDP)	0.3	-0.3	1.2	1.3
Exchange Rate (vs US$)	1.2	1.4	1.2	1.2
General Government Balance (% of GDP)	-2.5	-3.9	-2.2	-0.6
Short-term Interest Rates (%)	2.6	2.5	0.4	2.1
Long-term Interest Rates (%)	4.1	4.1	3.7	4.6
Working Population	0.5	0.2	-0.2	-0.3
Labour Supply	1.0	0.5	0.1	-0.1
Participation Ratio	72.5	74.0	75.3	76.0
Labour Productivity	0.8	0.3	0.9	1.4

Long-Term Forecast for Eurozone

Annual percentage changes unless otherwise specified

	2002-2011	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
GDP	1.1	0.3	-4.3	1.9	1.5	-0.5	-0.2	1.1	1.4	1.5	1.5	1.7	1.8	1.8	1.7	1.2
Consumption	1.0	0.4	-0.9	0.9	0.1	-1.1	-0.4	0.6	1.1	1.3	1.4	1.5	1.6	1.6	1.5	0.9
Investment	0.1	-1.6	-12.7	-0.3	1.6	-3.7	-1.7	2.1	2.9	2.8	2.5	2.3	2.1	2.1	1.9	1.3
Government Consumption	1.7	2.3	2.6	0.7	-0.1	-0.2	-0.9	-0.3	0.3	0.6	0.8	1.0	1.2	1.3	1.3	0.5
Exports of Goods and Services	3.6	0.9	-12.4	11.0	6.5	3.0	2.6	4.1	4.4	4.1	3.8	3.6	3.3	3.0	2.8	3.5
Imports of Goods and Services	3.3	0.7	-11.0	9.4	4.3	-0.6	1.5	3.7	4.5	4.2	3.8	3.5	3.3	2.9	2.8	3.0
Unemployment (%)	9.0	7.7	9.6	10.1	10.2	11.4	12.4	12.4	12.1	11.8	11.4	11.1	10.6	10.2	9.8	11.3
Consumer Prices	2.1	3.3	0.3	1.6	2.7	2.5	1.9	1.5	1.3	1.3	1.4	1.5	1.6	1.7	1.8	1.7
Current Balance (% of GDP)	0.0	-1.5	-0.2	0.0	0.1	1.0	1.4	1.3	1.2	1.2	1.2	1.3	1.3	1.4	1.4	1.3
Exchange Rate (per $)	1.3	1.5	1.4	1.3	1.4	1.3	1.3	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
General Government Balance (% of GDP)	-3.2	-2.1	-6.3	-6.2	-4.1	-3.3	-2.6	-2.1	-1.7	-1.3	-0.9	-0.7	-0.6	-0.5	-0.5	-1.4
Short-term Interest Rates (%)	2.5	4.6	1.2	0.8	1.4	0.6	0.2	0.3	0.4	0.5	0.6	1.2	2.2	2.9	3.4	1.2
Long-term Interest Rates (%)	4.1	4.3	3.8	3.6	4.4	4.0	3.3	3.5	3.7	4.1	4.3	4.5	4.6	4.8	4.9	4.1
Working Population	0.3	0.4	0.1	0.1	0.0	-0.2	-0.3	-0.3	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Labour Supply	0.7	0.9	0.2	0.1	0.3	0.7	0.3	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	0.0
Participation Ratio (%)	73.2	74.0	74.0	74.0	74.3	74.9	75.3	75.4	75.5	75.6	75.7	75.8	76.0	76.1	76.2	75.7
Labour productivity	0.6	-0.5	-2.6	2.5	1.2	0.2	0.7	1.2	1.1	1.2	1.3	1.4	1.4	1.4	1.4	1.1
Employment	0.5	0.8	-1.8	-0.5	0.3	-0.7	-0.9	-0.1	0.2	0.2	0.2	0.3	0.4	0.3	0.3	0.0
Output gap (% of potential GDP)	0.1	2.0	-3.4	-2.4	-2.0	-3.0	-3.9	-3.7	-3.4	-3.1	-2.8	-2.3	-1.8	-1.3	-0.8	-2.6

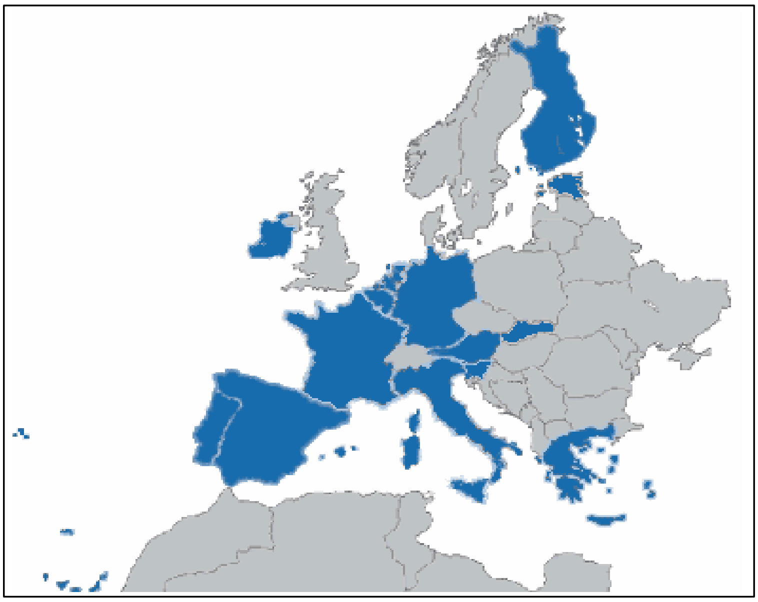
Background

- The creation of a single European currency was achieved in 1999, with notes and coins being introduced in 2002. The eleven initial members were Germany, France, Italy, Finland, Ireland, Netherlands, Belgium, Luxembourg, Austria, Portugal and Spain, with Greece joining European Monetary Union (EMU) in 2001 and introducing notes and coins at the same time as the other countries. Slovenia was the 13th member in January 2007, Malta and Cyprus joined a year later, Slovakia became the 16th member in January 2009 and Estonia the 17th in January 2011.
- To qualify for membership of the Eurozone, countries have to pass a number of nominal convergence criteria set out in the Maastricht Treaty: the inflation rate should not exceed by more than 1.5% points the average inflation rate of the three EU countries with the lowest inflation; the government deficit should not exceed 3% of GDP and gross government debt should be no higher than 60% of GDP; countries should have been members of ERM II and have not devalued their currency in the previous two years; and long-term interest rates should not be more than 2% points higher than the average in the three EU countries with the lowest inflation. In practice, these conditions were applied quite loosely to the original EMU members, with elements of the fiscal criteria being selectively overlooked for Italy and Belgium (and then Greece) and with little attention as to whether the budget deficit was below 3% of GDP on a sustainable basis. However, the narrow failure of Lithuania to win approval for adopting the euro in 2007 suggests that the convergence criteria will be applied much more strictly to new EU members.
- Joining EMU sees the member country pass control of its monetary policy to the European Central Bank (ECB). The ECB is one of the most independent central banks in the world and was built on the lines of the German Bundesbank. Not only does the ECB have 'operational' independence – allowing it to set interest rates free from political control – but it also has 'goal' independence to set its own targets. The ECB objective is to achieve price stability and this is pursued through economic and monetary analysis; the ECB targets inflation of close to, but not exceeding, 2%, and maintains a reference target of 4.5% for M3 money supply growth. The two components of analysis were to act as a crosscheck, but economic analysis has taken precedence in recent years, with monetary targeting slipping into the background. Since 2008, the ECB has increasingly focused on providing liquidity to banks, with in particular two sets of three-year loans granted in December 2011 and February 2012.
- National governments retain control of fiscal policy, although there are limits to their freedom in this area as specified in the Growth and Stability Pact, which essentially applies the fiscal requirements of the Maastricht Treaty on an ongoing basis. However, even before the global crisis, a number of Eurozone countries had difficulty keeping their budget deficits below 3% of GDP and debt below 60% of GDP on a sustained basis and faced sanctions by the EC. However, the effectiveness of the Growth and Stability Pact against the major Eurozone economies of Germany, France and Italy proved limited, while smaller countries such as the Netherlands made painful adjustments when their deficit exceeded the 3% of GDP threshold and others observed the requirements stringently. This forced a re-interpretation of the Pact, which is now applied over the economic cycle.
- The fallout from the financial crisis, and in particular the troubled fiscal situation faced by Greece, Italy, Ireland, Portugal and Spain, showed the limitations of the fiscal framework behind the single currency. The possibility of a debt default by Greece, coupled with the threat of contagion to Italy and Spain, has put Eurozone leaders under immense pressure to come up with a rescue plan that would prevent the collapse of the single currency. However, there are significant differences of opinion among the largest members regarding who should carry the burden and what mechanisms should be used to provide financial support to the European banking system. The core of the discussions focuses on a reform of the European Union Treaty in order to impose tougher rules regarding budget and fiscal discipline. Other measures include a move towards a banking union that would severe the links between banks and their sovereigns. However, political hurdles to closer integration and debt burden sharing remains very high. Changes to the Eurozone's structure and institutions are likely to be slow and erratic.

Key Facts

Politics

President of the ECB: Mario DRAGHI
Vice president of the ECB: Vítor CONSTANCIO
EC commissioner for Economic and Monetary Affairs:
Olli Rehn
Chairman of Euro Group of Finance Ministers:
Claude Juncker



Source : ECB
Member countries: Germany, France, Italy, Finland, Ireland, Netherlands, Belgium, Luxembourg, Austria, Portugal, Spain, Greece, Slovenia, Malta, Cyprus, Slovakia & Estonia

Long-term economic & social development

	1980	1990	2000	2011*
GDP per capita (US$)	-	19175	19885	39428
Inflation (%)	9.9	4.2	2.2	2.7
Population (mn)	287	305	315	332
Urban population (% of total)	69.7	70.9	72.4	75.5
Life expectancy (years)	73.7	76.0	78.3	80.7

Source : Oxford Economics & World Bank

* 2011 or latest available year

Structure of GDP by output

	2010
Agriculture	1.5%
Industry	26.5%
Services	72.0%

Source : WDI

Corruption perceptions index 2012

	Score
Developed economies (average)	74.8
Emerging economies (average)	37.8
Eurozone	66.6

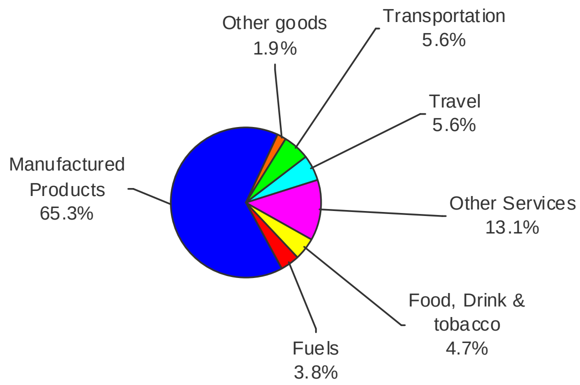
Source: Transparency International
Scoring system 10 = highly clean, 0 = highly corrupt

Structural economic indicators

	1990	1995	2000	2011*
Current account (US$ billion)	11	54	-95	12
Trade balance (US$ billion)	-25	63	-28	-19
FDI (US$ billion)	-	-	30	-83
Govt budget (% of GDP)	-4.1	-7.5	-0.1	-4.1
Govt debt (% of GDP)	13.5	67.3	67.1	86.8
Long-term interest rate	10.9	8.7	5.4	4.4
Oil production (000 bpd)	271	313	240	214
Oil consumption (000 bpd)	9715	10483	10916	9959

Source : Oxford Economics / World Bank / EIA / ECB

Composition of extra-EMU goods & services exports, 2008



Source : Eurostat

Destination of goods' exports (2009)

Eurozone	50.4%
UK	6.8%
United States	5.9%
Switzerland	3.1%
China	2.7%
Poland	2.6%

Source : Eurostat