OXFORD ECONOMICS

Eurozone

Highlights and Key Issues

- We interpret the recent correction in Eurozone financial markets as volatility that can typically be expected in a weak growth environment. While the risk of a Eurozone breakup has greatly diminished, our view remains that the Eurozone is heading for a 'lost decade'. We forecast GDP will grow by only 1.4% a year in 2014-22 after a 0.3% decline this year. In this context, negative surprises and volatility are to be expected.
- If sustained, the appreciation of the euro would deepen this year's recession. But for now, we think that its impact will be blunted by the fact that it comes at a time when the economic environment is stabilising, which should enable some companies to resume investment and recruitment.
- The countries that could suffer most from the rise in the euro are the peripherals, as it is undoing part of the hard work undertaken to restore competitiveness. But once uncertainty about the US fiscal stance is cleared and the pick-up in growth there and in emerging markets becomes more secure, we expect the euro to depreciate again, towards US$1.25/€ by the end of the year.
- However, a stronger euro poses a new risk to the Eurozone. Those looking to the ECB to reverse the appreciation of the euro will be disappointed. As was made clear at its press conference on 7 February, the ECB would need to see a significant negative impact on activity stemming from the euro's behaviour before it intervenes.

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	-1.2	-0.6	0.6	1.1	1.3
Fixed Investment	1.6	-3.8	-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	4.8	5.1	5.2	5.2
GDP	1.5	-0.5	-0.3	1.1	1.4	1.5
Industrial Production	2.7	-2.9	-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	1.1	1.5	1.4	1.3	1.3
Government Budget (% of GDP)	-4.1	-3.3	-2.6	-2.1	-1.6	-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	3.2	3.4	3.6	4.0
Exchange rate (US$ per Euro)	1.39	1.28	1.30	1.21	1.17	1.17
Exchange rate (YEN per Euro)	111.0	102.5	122.3	118.2	116.8	116.9

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Overview

Stabilisation of economy on track…

- Eurozone financial markets have reversed in recent days, with signs of tensions such as rises in bond spreads in the peripheral countries and falls in share prices appearing again. These movements have largely been driven by political tensions in Spain and Italy. But they do raise questions about the degree to which the earlier improvement in investor confidence regarding the Eurozone's future was sustainable. We think that this kind of volatility is to be expected in an environment where Eurozone growth is flat at best and unemployment rates keep on rising.

- We maintain our forecast that Eurozone GDP will contract further this year, by 0.3%. And while we currently put the probability of a Eurozone breakup at only around 15% – significantly lower than priced in financial markets during last year – our view remains that the Eurozone is heading for a 'lost decade'. We forecast GDP growth will average only 1.4% a year in 2014-22; this means that the level of output will not reach its pre-crisis peak until late 2015.

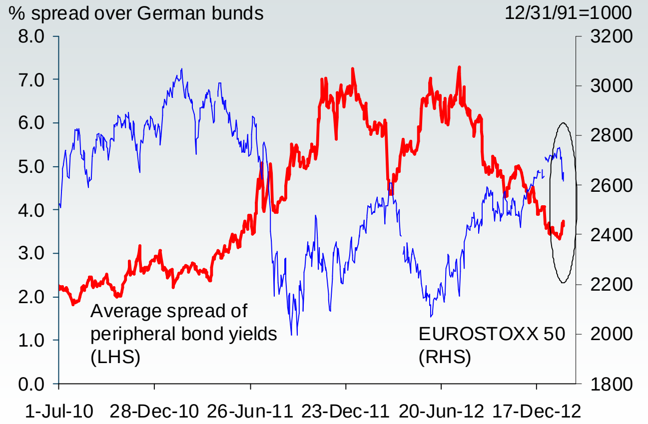
…but still means a 'lost decade'

- The key factors that will hold up the recovery for several years to come include ongoing fiscal tightening, deleveraging in the private sector and the long-term impact of high unemployment rates:

  Decade-long fiscal tightening – we estimate that currently announced fiscal tightening measures for 2013 amount to 1.2% of Eurozone GDP. According to our Global Economic Model, this will shave around 1% point off GDP growth. From next year onwards, the pace of tightening will lessen somewhat. Leaders in core countries seem increasingly aware of the counter-productive impact of seeking to achieve very stringent nominal deficit targets. Peripheral countries will probably be given more time to restructure their public finances. Nevertheless, fiscal policy will remain tight and will continue to be a drag on growth for years to come.

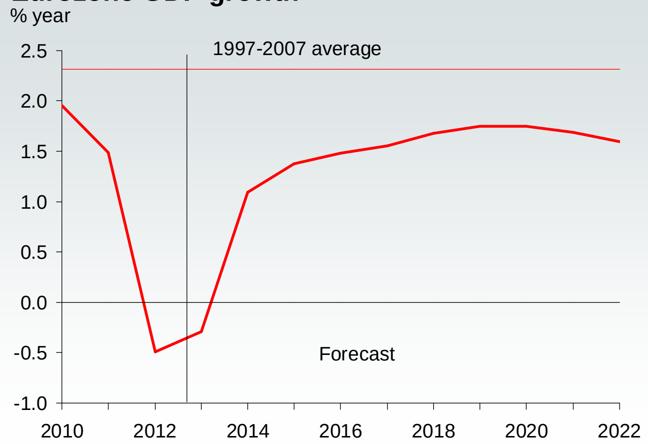
  Private-sector deleveraging yet to start – while much focus has been on reducing public sector debt, high private sector debt also needs to be addressed before the economy can sustain robust growth. Unlike in the US, and to a lesser extent the UK,

Eurozone: financial indicators



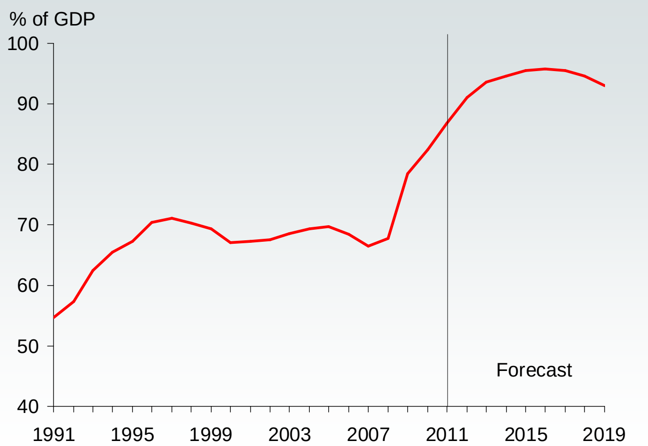
Source : Oxford Economics/ Reuters

Eurozone GDP growth



Source : Oxford Economics

Eurozone: Government debt



Source: Oxford Economics

Eurozone private debt has yet to be reduced. For instance, the debt of non-financial companies stood at 136% of GDP in 2012, compared with 77% in the US and up from 113% ten years ago. With a risk-averse banking sector hesitant to lend, debt will need to be lowered, which will constrain spending.

Lost generation – governments and private sector companies are still in staff-restructuring mode and unemployment is forecast to continue to rise until the end of 2013 at least, to 12.4%. In December, youth unemployment stood at 24% in the Eurozone on average, and more than 55% in Spain and Greece. And the share of long-term (more than one year) unemployed has risen from 33% in early 2009 to 47% in 2012Q3. These developments raise concerns about a 'lost generation', whereby new entrants to the labour market do not get the necessary experience at the start of their career to gain skills and flexibillity to find new jobs or become tomorrow's managers. This will have a negative impact on growth in the Eurozone in the medium term.

Euro rise not yet a major threat…

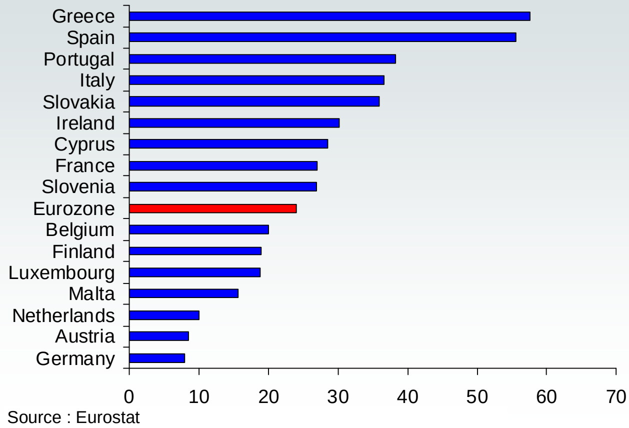
- The appreciation of the euro is a new risk that the Eurozone needs to deal with. In effective trade-weighted terms, the euro is 8.5% stronger than in mid 2012. Our Global Economic Model suggests that a sustained 10% appreciation against the US$ (around 5% in effective terms) reduces Eurozone GDP by 0.5-0.7% within one year.

- This would be a significant blow to already very weak economic conditions. But we think that in the current circumstances the impact of the appreciation will be mitigated by the fact that it comes in a more stable environment, which will enable some companies at least, probably mainly in the core Eurozone, to start investing and hiring again.

- Although their export sectors are much smaller – with the exception of Ireland – the countries that could suffer most from the appreciation of the euro are the peripherals. Exports have been the only source of growth in these economies over the past couple of years and are expected to partly offset the ongoing recessions in domestic demand. But the exchange rate movements are undoing in a few weeks part of the painful work undertaken to try to restore competitiveness.

Unemployment rates, under 25s

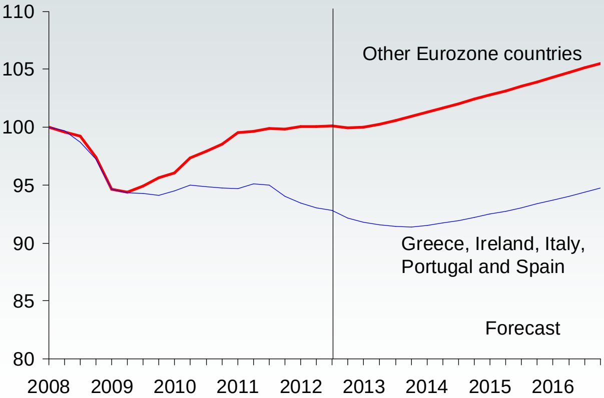
% under 25 labour force



Source : Eurostat

Eurozone GDP

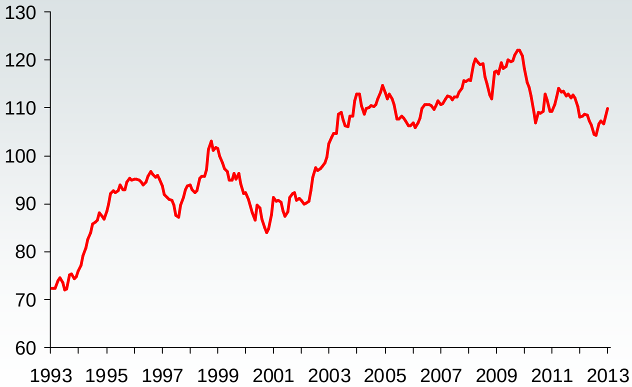
2008Q1=100, constant prices



Source : Oxford Economics

Euro effective exchange rate

1999 Q1=100



Source: Reuters

Key Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

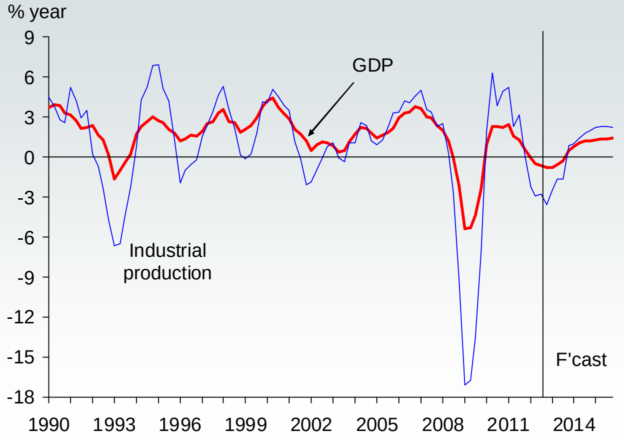
	Industrial production (% yr)	Unemploy-ment (% point)	CPI (% yr)	Business confidence (% balance)	Consumer confidence (% balance)	Exports (% yr)	Imports (% yr)	Trade balance (€ bn)
Jan	-1.4	10.8	2.7	-0.1	-20.6	10.8	4.2	-8.9
Feb	-1.6	10.9	2.7	-0.1	-20.1	10.9	7.4	1.4
Mar	-1.6	11.0	2.7	-0.2	-18.9	4.6	0.1	7.8
Apr	-2.5	11.2	2.6	-0.5	-19.7	6.1	-0.2	4.1
May	-2.5	11.3	2.4	-0.7	-19.1	6.1	0.5	7.1
Jun	-1.7	11.4	2.4	-0.9	-19.6	12.0	2.8	13.2
Jul	-2.5	11.4	2.4	-1.2	-21.3	11.0	2.7	14.2
Aug	-2.1	11.5	2.6	-1.2	-24.4	10.1	2.2	4.8
Sep	-2.7	11.6	2.6	-1.3	-25.7	1.0	-4.2	8.8
Oct	-3.4	11.7	2.5	-1.6	-25.5	14.2	7.4	9.3
Nov	-3.5	11.7	2.2	-1.2	-26.7	5.4	-0.3	13.7
Dec	-	11.7	2.2	-1.1	-26.3	-	-	-
2013								
Jan	-	-	2.0	-1.1	-23.9	-	-	-

Financial Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

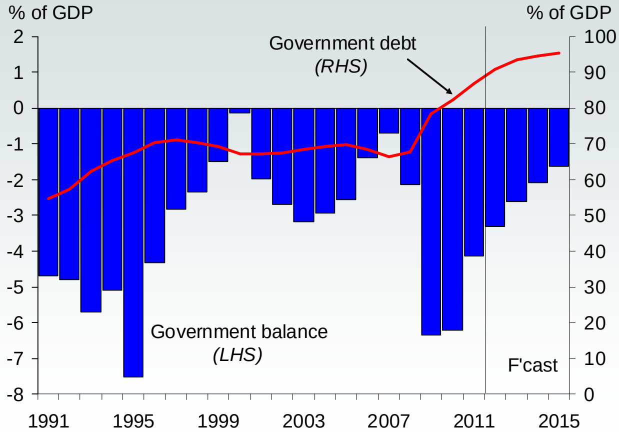
	Short rate %	Long rate %	Money Supply (M3)	Exchange rate $/€ avg.	Exchange rate €/£	Nominal effective exch. rate	Share price DJ STOXX	Net FDI € bn
Jan	1.22	3.92	2.0	1.290	1.203	101.6	2416.7	0.3
Feb	1.05	3.75	2.5	1.322	1.194	102.9	2512.1	5.7
Mar	0.86	3.29	2.9	1.320	1.198	103.4	2477.3	-9.4
Apr	0.74	3.39	2.3	1.316	1.216	102.8	2306.4	-3.5
May	0.68	3.53	2.9	1.279	1.244	100.8	2118.9	8.2
Jun	0.66	3.41	3.0	1.253	1.242	99.7	2264.7	-21.0
Jul	0.50	3.25	3.6	1.229	1.269	97.6	2325.7	-5.8
Aug	0.33	3.01	2.9	1.240	1.268	97.7	2440.7	14.7
Sep	0.25	2.43	2.6	1.286	1.252	99.9	2454.3	-34.6
Oct	0.21	2.31	3.9	1.297	1.239	100.8	2503.6	-10.6
Nov	0.19	2.25	3.8	1.283	1.244	100.3	2575.3	14.1
Dec	0.19	2.10	3.3	1.312	1.231	102.0	2635.9	-
2013								
Jan	0.20	2.40	-	1.329	1.200	104.2	2703.0	-

Eurozone: GDP and industrial production



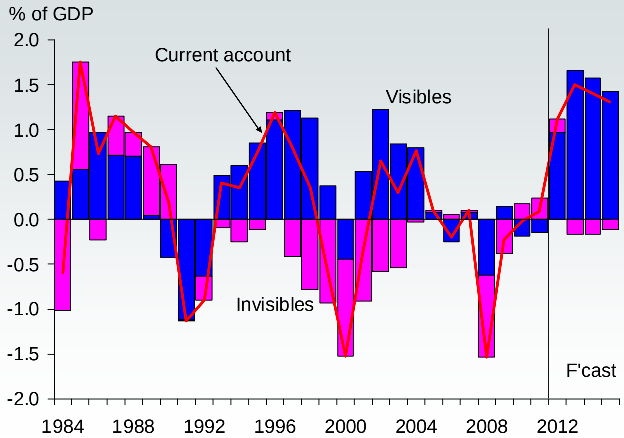
Source: Oxford Economics

Eurozone: Government finances



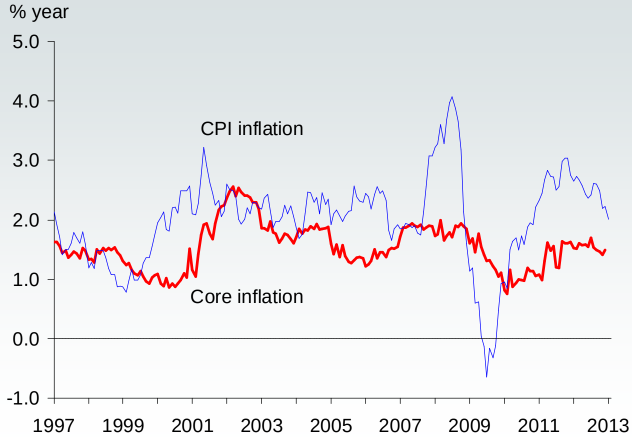
Source: Oxford Economics

Eurozone: Current account



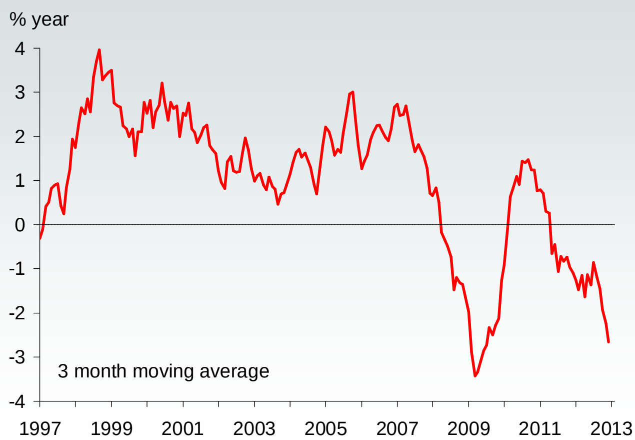
Source: Oxford Economics

Eurozone: Headline Inflation



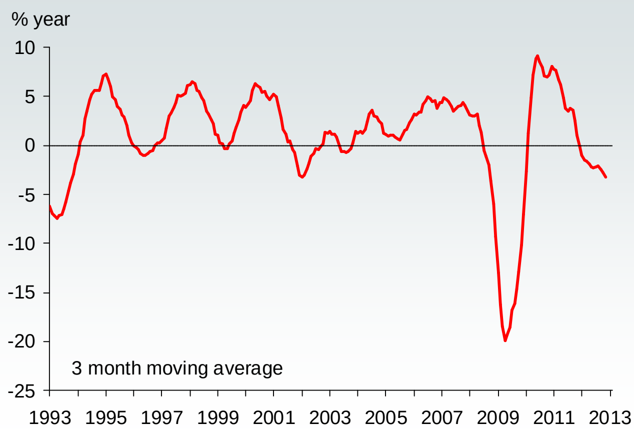
Source: Haver Analytics

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	-1.2	-3.8	-2.0	-0.5	-2.9	11.3	1.6	0.3	2.8	2.5	2.5
2013	-0.6	-1.7	-0.9	-0.3	-1.2	12.2	1.1	0.7	2.0	2.0	1.9
2014	0.6	2.1	0.8	1.1	1.6	12.3	1.7	1.2	2.7	2.0	1.5
2015	1.1	2.9	1.3	1.4	2.3	12.0	2.1	1.2	3.3	2.0	1.3
2016	1.3	2.8	1.4	1.5	2.2	11.7	2.3	1.2	3.6	1.9	1.3
2011											
I	0.9	3.6	1.6	2.4	5.2	9.9	2.1	2.1	0.1	6.4	2.5
II	0.3	1.4	0.8	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	-0.7	0.6	0.1	10.6	2.4	0.7	2.3	4.7	2.9
2012											
I	-1.1	-2.5	-1.6	-0.1	-2.2	10.9	2.1	0.4	2.9	3.4	2.7
II	-1.1	-3.9	-2.3	-0.5	-2.9	11.3	1.6	0.3	2.9	2.1	2.5
III	-1.4	-4.2	-2.3	-0.6	-2.8	11.5	1.7	0.1	2.4	2.2	2.5
IV	-1.2	-4.6	-2.0	-0.8	-3.6	11.7	1.2	0.2	2.8	2.3	2.3
2013											
I	-1.1	-3.7	-1.7	-0.8	-2.4	12.0	1.0	0.2	2.4	1.7	2.0
II	-0.7	-2.1	-1.1	-0.6	-1.6	12.2	1.1	0.6	1.9	2.0	1.9
III	-0.5	-1.2	-0.7	-0.3	-1.6	12.3	1.1	0.7	2.2	2.1	1.9
IV	0.0	0.3	0.1	0.5	0.9	12.4	1.4	1.2	1.7	2.2	1.8
2014											
I	0.3	1.3	0.5	0.8	1.0	12.4	1.5	1.2	2.2	1.9	1.6
II	0.6	2.0	0.8	1.1	1.5	12.3	1.6	1.2	2.6	2.0	1.5
III	0.8	2.5	0.9	1.2	1.8	12.2	1.8	1.2	2.9	2.0	1.4
IV	0.9	2.7	1.1	1.3	2.1	12.2	1.9	1.1	3.0	2.1	1.4
2015											
I	1.0	2.8	1.2	1.3	2.2	12.1	1.9	1.1	3.2	2.1	1.4
II	1.1	2.9	1.3	1.4	2.3	12.0	2.0	1.2	3.3	2.1	1.3
III	1.2	2.9	1.4	1.4	2.3	11.9	2.1	1.2	3.4	2.0	1.3
IV	1.2	2.9	1.4	1.4	2.3	11.9	2.2	1.2	3.4	2.0	1.3
2016											
I	1.2	2.8	1.4	1.4	2.3	11.8	2.2	1.2	3.5	1.9	1.3
II	1.3	2.8	1.4	1.5	2.2	11.7	2.3	1.2	3.5	1.9	1.3
III	1.3	2.7	1.4	1.5	2.2	11.6	2.3	1.3	3.6	1.9	1.3
IV	1.4	2.7	1.4	1.5	2.1	11.5	2.4	1.3	3.6	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	-14	9	0.1	-389	-4.1	1.39	4.41	-1.33	1.69	1.39	1208
2012	92	107	1.1	-314	-3.3	0.57	4.02	-1.92	1.52	1.28	1154
2013	159	144	1.5	-243	-2.5	0.24	3.18	-1.63	1.30	1.29	1184
2014	154	137	1.4	-192	-2.0	0.33	3.38	-1.17	1.88	1.21	1135
2015	143	132	1.3	-157	-1.6	0.41	3.62	-0.91	2.31	1.17	1105
2016	148	132	1.3	-130	-1.3	0.47	3.99	-0.85	2.67	1.17	1102
2011											
I	-8.3	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	-6.5	1.1	0.05	-91.2	-3.86	1.56	4.30	-1.14	1.60	1.41	121.2
IV	9.8	12.8	0.54	-84.3	-3.57	1.50	4.53	-1.45	1.59	1.35	120.4
2012											
I	10.5	21.6	0.91	-94.0	-3.97	1.04	4.39	-1.64	1.70	1.31	116.8
II	20.4	26.6	1.12	-68.8	-2.90	0.69	4.27	-1.76	1.82	1.28	115.8
III	26.2	30.2	1.27	-77.3	-3.25	0.36	3.99	-2.18	1.45	1.25	113.3
IV	34.7	28.2	1.19	-73.7	-3.10	0.20	3.41	-2.11	1.11	1.30	115.8
2013											
I	39.0	58.0	2.44	-65.4	-2.75	0.22	3.12	-1.75	1.16	1.33	120.4
II	39.3	31.9	1.34	-65.9	-2.76	0.23	3.17	-1.62	1.32	1.31	119.3
III	37.8	22.3	0.93	-60.4	-2.51	0.25	3.19	-1.62	1.32	1.28	117.5
IV	43.3	31.4	1.30	-51.2	-2.12	0.27	3.23	-1.55	1.41	1.26	116.4
2014											
I	42.7	59.2	2.44	-50.8	-2.09	0.29	3.30	-1.34	1.66	1.23	115.0
II	38.5	30.2	1.24	-51.8	-2.12	0.32	3.36	-1.20	1.84	1.22	114.1
III	33.8	19.1	0.77	-48.8	-1.98	0.34	3.40	-1.08	1.98	1.20	113.0
IV	39.3	29.0	1.17	-41.0	-1.65	0.36	3.45	-1.05	2.04	1.19	111.8
2015											
I	39.4	57.5	2.30	-39.8	-1.59	0.38	3.50	-0.97	2.15	1.17	110.5
II	35.0	28.4	1.13	-42.7	-1.70	0.40	3.56	-0.90	2.26	1.17	110.5
III	31.3	18.0	0.71	-41.3	-1.63	0.41	3.66	-0.89	2.36	1.17	110.5
IV	37.7	28.1	1.10	-32.9	-1.29	0.43	3.76	-0.86	2.46	1.17	110.5
2016											
I	38.9	56.8	2.21	-32.6	-1.27	0.45	3.86	-0.86	2.55	1.17	110.4
II	35.6	28.2	1.09	-36.0	-1.39	0.46	3.95	-0.86	2.63	1.17	110.2
III	33.2	18.5	0.71	-35.0	-1.34	0.48	4.04	-0.85	2.72	1.17	110.3
IV	40.6	28.9	1.10	-26.4	-1.01	0.49	4.13	-0.85	2.79	1.17	110.1

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

Potential output growth 1.0%pa

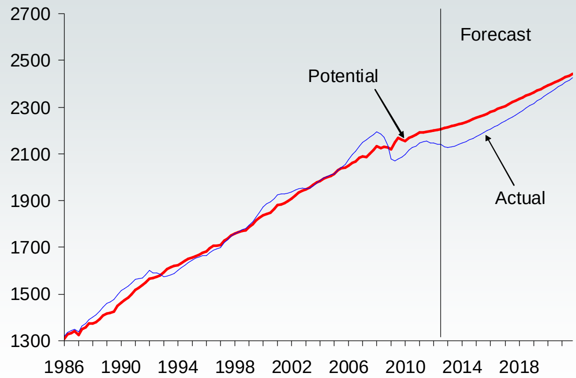
- Potential output is projected to rise by 1.0%pa over the next 10 years, a slightly lower rate than in the previous decade. GDP is set to contract by 0.5% in 2012, having grown by 1.5% in 2011 and to be significantly below potential growth at -0.3% in 2013. As a result, the large output gap of 2.0% in 2011 will expand in 2012 to 3.0% and increase in 2013 to 4.0%, 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

Euro bn 2005 prices



Source: Oxford Economics

Potential GDP and Its Components Average Percentage Growth	2002-2011	2012-2021
Potential GDP*	1.49	1.04
Employment at NAIRU	0.66	0.03
Capital Stock	2.15	1.49
Total Factor Productivity	0.31	0.50

*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	11.9	10.5
Consumer Prices	2.2	2.0	1.7	1.6
Current Balance (% of GDP)	0.3	-0.3	1.3	1.3
Exchange Rate (US$ per Euro)	1.16	1.39	1.23	1.18
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	3.6	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	75.9
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	2.0	1.5	-0.5	-0.3	1.1	1.4	1.5	1.6	1.7	1.7	1.7	1.7	1.2
Consumption	1.0	0.4	-0.9	0.9	0.1	-1.2	-0.6	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	-3.8	-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	1.2	1.3	0.5
Exports of Goods and Services	3.6	0.9	-12.4	11.0	6.5	3.0	2.5	4.0	4.3	4.1	3.9	3.6	3.3	3.0	2.8	3.5
Imports of Goods and Services	3.3	0.7	-11.0	9.5	4.3	-0.5	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	11.3	12.2	12.3	12.0	11.7	11.3	11.0	10.5	10.1	9.7	11.2
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	1.1	1.5	1.4	1.3	1.3	1.3	1.3	1.3	1.4	1.4	1.3
Exchange Rate (US$ per Euro)	1.28	1.47	1.39	1.33	1.39	1.28	1.30	1.21	1.17	1.17	1.17	1.17	1.17	1.18	1.19	1.20
General Government Balance (% of GDP)	-3.2	-2.1	-6.3	-6.2	-4.1	-3.3	-2.6	-2.1	-1.6	-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	1.3	2.2	2.9	3.4	1.2
Long-term Interest Rates (%)	4.1	4.3	3.8	3.6	4.4	4.0	3.2	3.4	3.6	4.0	4.3	4.5	4.6	4.7	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	0.6	0.2	-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	74.2	74.9	75.2	75.3	75.4	75.5	75.7	75.8	75.9	76.0	76.1	75.6
Labour productivity	0.6	-0.5	-2.6	2.5	1.2	0.2	0.7	1.2	1.2	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	0.3	0.3	0.3	0.3	0.3	0.0
Output gap (% of potential GDP)	0.1	2.0	-3.4	-2.4	-2.0	-3.0	-4.0	-3.8	-3.5	-3.1	-2.8	-2.3	-1.8	-1.3	-0.8	-2.6

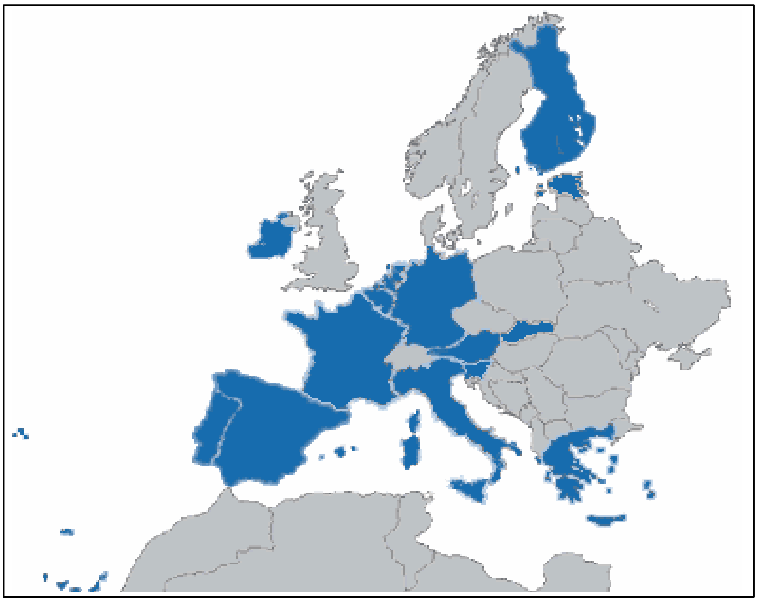
Background

- 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 measures proposed 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:
Jeroen Dijsselbloem



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	19886	39429
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)	38.0
Eurozone	66.6

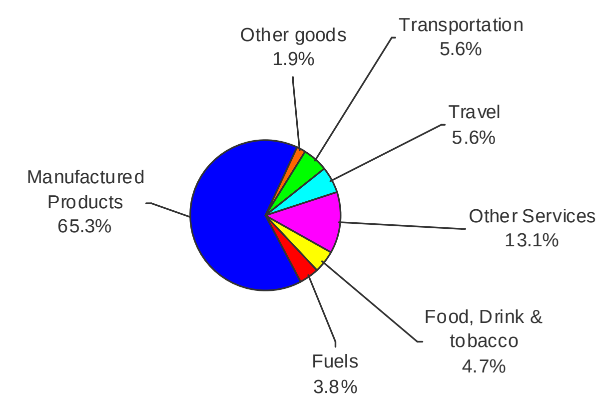
Source: Transparency International
Scoring system 10 = highly clean, 0 = highly corrupt

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	-96
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	216
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