Eurozone

Highlights

- Eurozone financial markets have proved relatively resilient over the last month, in the face of a further episode of political turmoil in Italy and growing concerns about the standoff over the budget and debt ceiling issues in the US.
- This relative stability confirms the pattern seen this year of reduced vulnerability to external shocks. This reflects, in our view, investors' confidence in the ECB as a backstop for Eurozone bond markets, and also reduced macroeconomic fragility now that the Eurozone has exited recession.
- Risks to the stability of the Eurozone have not entirely faded, however. Economic data continue to be mixed, with ongoing improvement in surveys but output data pointing to only marginal growth in Q3. Our forecast is unchanged from last month. We expect a 0.3% contraction in GDP in 2013 as a whole, followed by 1% growth in 2014. Expansion will remain constrained by fiscal tightening and the need for private sector deleveraging.
- One main source of downside risk relates to tightening credit conditions ahead of and in the aftermath of the ECB's Asset Quality Review. The ECB stands ready to offer another wave of long-term liquidity (LTRO) but it is not clear whether this would be enough to avoid a credit squeeze.
- One source of upside risk relates to the labour market. Unemployment has stabilised in recent months. We expect some renewed small rises but this could prove too pessimistic.

Forecast for Eurozone
(Annual percentage changes unless specified)

	2012	2013	2014	2015	2016	2017
Domestic Demand	-2.2	-1.0	0.5	1.2	1.4	1.5
Private Consumption	-1.4	-0.6	0.5	1.1	1.3	1.4
Fixed Investment	-3.7	-3.6	1.5	2.6	2.6	2.5
Stockbuilding (% of GDP)	0.0	-0.1	-0.1	-0.1	0.0	0.0
Government Consumption	-0.6	0.2	-0.2	0.3	0.5	0.8
Exports of goods and services	2.7	1.1	3.7	4.1	4.2	4.1
Imports of goods and services	-1.0	-0.4	2.9	4.0	4.2	4.0
GDP	-0.6	-0.3	1.0	1.4	1.6	1.7
Industrial Production	-2.9	-1.6	1.4	2.6	2.5	2.2
Consumer Prices	2.5	1.5	1.5	1.4	1.4	1.5
Current Balance (% of GDP)	1.3	2.2	2.3	2.1	2.1	2.1
Government Budget (% of GDP)	-3.7	-2.8	-2.6	-2.1	-1.6	-1.3
Short-Term Interest Rates (%)	0.57	0.22	0.26	0.31	0.34	0.56
Long-Term Interest Rates (%)	3.92	3.04	3.12	3.37	3.67	3.98
Exchange rate (US$ per Euro)	1.28	1.32	1.27	1.20	1.18	1.18
Exchange rate (YEN per Euro)	102.5	127.8	130.8	135.0	133.8	131.1

For further information contact Marie Diron (mdiron@oxfordeconomics.com)

Forecast Overview

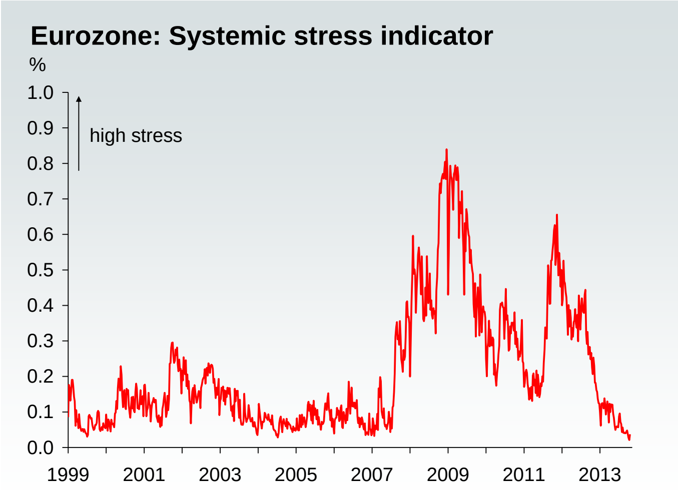
Eurozone resilient to shocks…

- Eurozone financial markets have proved resilient over the last month. Only rather limited movements in financial markets have been seen, despite both a further episode of political turmoil in Italy and growing concerns about the standoff over the budget and debt ceiling issues in the US. Notably, throughout the shocks of recent weeks, the ECB's measure of systemic stress on financial markets has continued to edge even lower, to the lowest level in the history of the indicator (which started in January 1999).
- This relative stability confirms the pattern seen this year of generally reduced vulnerability to external shocks. This reflects, in our view, investors' confidence in the ECB as a backstop for Eurozone bond markets, and also reduced macroeconomic fragility now that the Eurozone has exited recession.
- The PMI and other surveys generally continued to edge higher in September. But data on industrial output, orders and exports have been softer. Overall, this is consistent with our forecast that GDP growth in Q3 will be weaker than in Q2. We forecast a quarter-on-quarter rise of just 0.1%. With only a small improvement expected in Q4, Eurozone GDP is still forecast to contract by 0.3% in 2013 overall.

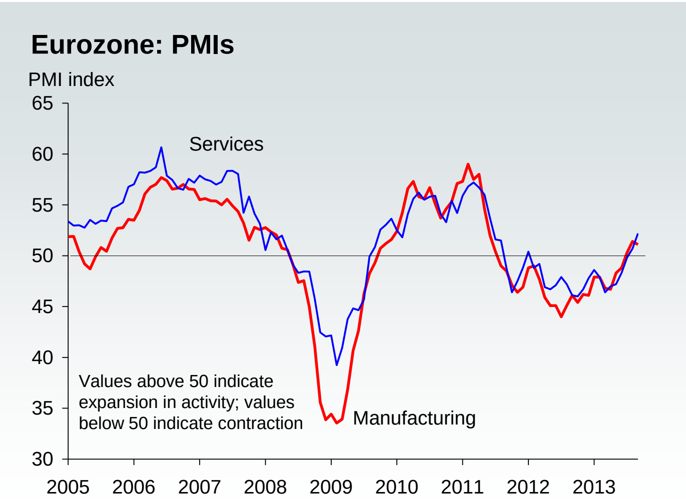
…but risk of further crisis remains

- The stability of the Eurozone so far this year does not mean that all downside risks have been removed. The issues that triggered the crisis have only been partially addressed. Significant hurdles to growth also remain. We forecast growth at 1% in 2014 and still only around 1.5% pa in 2015-18.
- The shift from recession to sustained, albeit weak, growth is mainly accounted for by a pick-up in foreign demand, feeding into investment, combined with a smaller drag from fiscal tightening and unemployment reaching a peak. But despite the relatively positive data recently, the factors that we have identified as hurdles to the recovery remain in place. These factors will constrain growth in 2014 and beyond. They include:

Restructuring of the banking sector – the extent and pace of which remains uncertain. There is tentative evidence that banks are pre-empting the



Source: ECB / Haver Analytics



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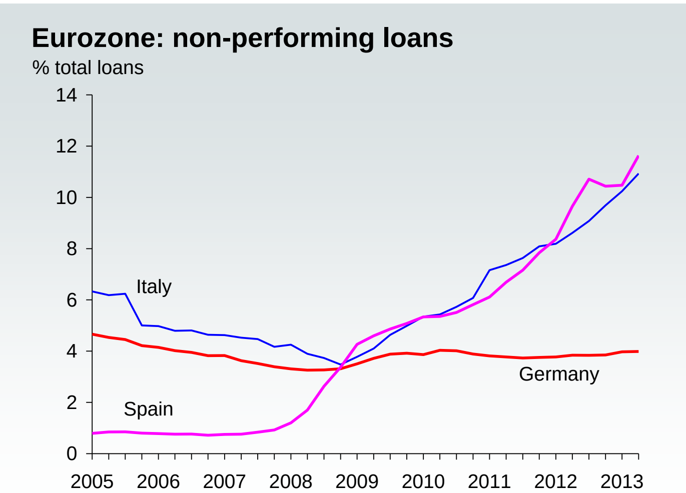


Source : Oxford Economics/Haver Analytics

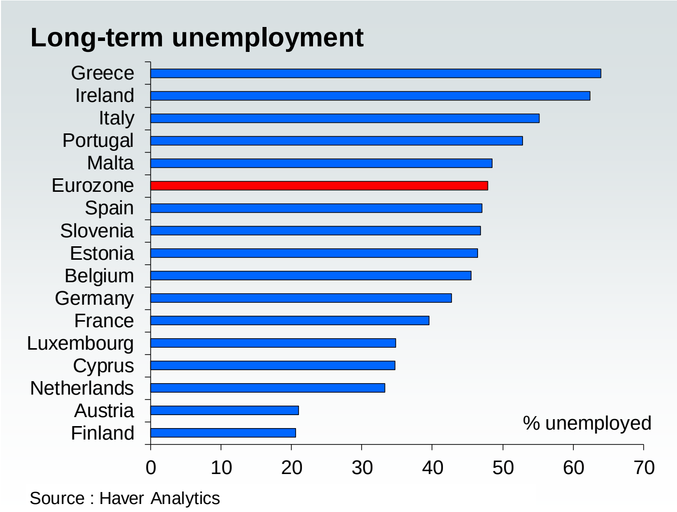
ECB's review of the quality of assets on their balance sheets by selling assets and reducing risk. This implies tight credit conditions for the foreseeable future, despite a gradually improving economic environment.

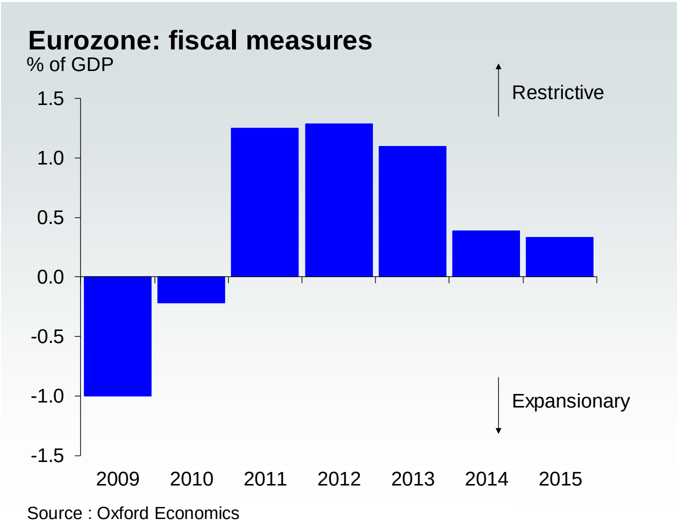
Private sector deleveraging – though much focus has been on reducing public sector debt, high private sector debt also needs to be addressed before the economy can sustain robust growth. Unlike the US, and to a lesser extent the UK, Eurozone private debt ratios have not yet fallen. For instance, the debts of non-financial companies stood at 137% of GDP in 2012, up from 113% a decade ago.

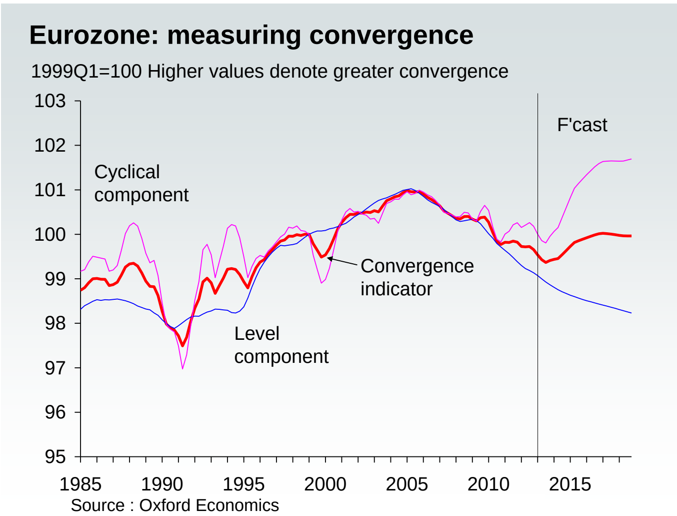
Unemployment remaining high – although unemployment has not risen as we had expected in recent months, we do not expect any significant fall before 2015 as companies take advantage of the return to positive growth to improve profitability and productivity. This means that the share of long-term (more than one year) unemployed will continue to rise from nearly 48% in Q4 2012. These developments imply significant long-lasting loss of skills which will hamper growth in the medium term. The measures to tackle youth unemployment announced at the European Council in June are too little, too late.

Less, but still some, fiscal tightening – while much reduced compared with the amount of fiscal tightening in 2012 and 2013, the Eurozone's fiscal stance will remain tight for the foreseeable future.

Persistent divergence – the process of convergence between Eurozone economies was reversed by the global financial crisis and then the Eurozone crisis. According to our indicator, the degree of convergence is at its lowest since the early 2000s. Our forecast implies some renewed convergence in cyclical terms as peripheral countries move out of recession, but the damage to income levels is such that income gaps will remain very large into the medium term. By 2018, Greek GDP per head is forecast at only 69% of the Eurozone average, compared with 68% today and 88% before the crisis. Lack of convergence hinders the effectiveness of monetary policy and slows down agreements on further integration (particularly in the areas of fiscal and banking union). By reducing the apparent benefits of participating in the monetary union it also raises the risk of a break-up as countries left behind may be tempted by the hope that they could achieve faster growth outside the Eurozone.







Key Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

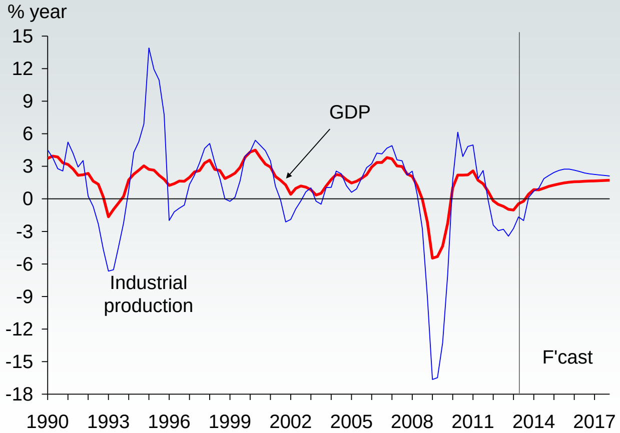
	Industrial production (% yr)	Unemploy-ment (% point)	CPI (% yr)	Business confidence (% balance)	Consumer confidence (% balance)	Exports (% yr)	Imports (% yr)	Trade balance (€ bn)
Sep	-2.7	11.6	2.6	-1.2	-25.7	1.2	-4.1	8.8
Oct	-3.1	11.7	2.5	-1.5	-25.5	14.6	7.6	9.2
Nov	-3.7	11.8	2.2	-1.1	-26.7	5.5	0.3	12.6
Dec	-2.3	11.9	2.2	-1.0	-26.3	-3.2	-5.3	10.1
2013								
Jan	-2.5	12.0	2.0	-1.0	-23.9	5.2	1.9	-4.7
Feb	-2.9	12.0	1.8	-0.7	-23.6	-1.2	-6.9	9.9
Mar	-1.6	12.0	1.7	-0.8	-23.5	0.2	-10.0	22.9
Apr	-0.8	12.1	1.2	-1.0	-22.2	9.1	1.7	14.0
May	-1.9	12.1	1.4	-0.8	-21.8	-0.1	-5.4	14.3
Jun	-0.5	12.1	1.6	-0.7	-18.8	-2.9	-5.6	16.5
Jul	-2.7	12.0	1.6	-0.5	-17.4	2.7	0.0	18.2
Aug	-	12.0	1.3	-0.2	-15.6	-	-	-
Sep	-	-	1.1	-0.2	-14.9	-	-	-

Financial Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

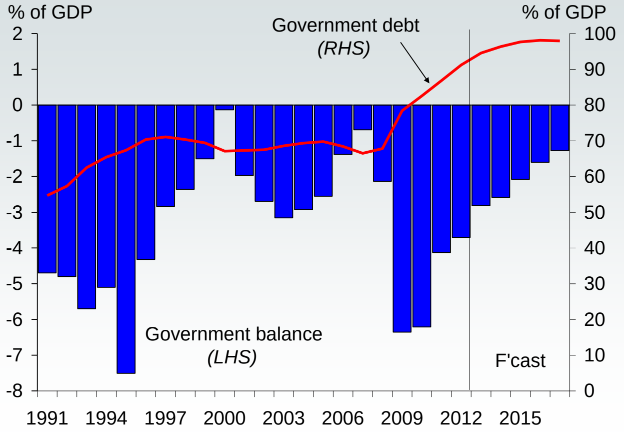
	Short rate %	Long rate %	Money Supply (M3)	Exchange rate $/€ avg.	Exchange rate €/£	Nominal effective exch. rate	Share price DJ STOXX	Net FDI € bn
Sep	0.25	2.43	2.8	1.29	1.25	99.9	2454	-20.0
Oct	0.21	2.31	3.9	1.30	1.24	100.8	2504	-7.7
Nov	0.19	2.25	3.7	1.28	1.24	100.3	2575	11.1
Dec	0.19	2.10	3.5	1.31	1.23	102.0	2636	-43.8
2013								
Jan	0.20	2.40	3.5	1.33	1.20	104.2	2703	-10.0
Feb	0.22	2.86	3.1	1.34	1.16	106.0	2634	11.0
Mar	0.21	3.03	2.6	1.30	1.16	104.5	2624	-24.6
Apr	0.21	2.86	3.2	1.30	1.18	105.0	2712	-6.9
May	0.20	2.69	2.9	1.30	1.18	105.5	2770	0.2
Jun	0.21	3.07	2.4	1.32	1.17	106.3	2603	-5.3
Jul	0.22	3.10	2.2	1.31	1.16	106.5	2768	-2.7
Aug	0.23	3.10	2.3	1.33	1.16	107.2	2721	-
Sep	0.22	3.41	-	1.33	1.19	106.7	2893	-

Eurozone: GDP and industrial production



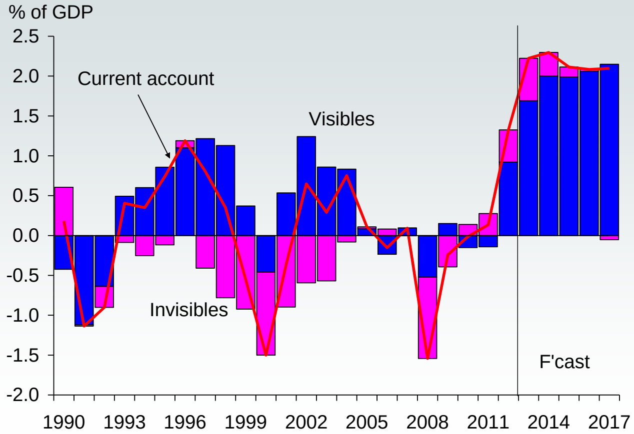
Source: Oxford Economics

Eurozone: Government finances



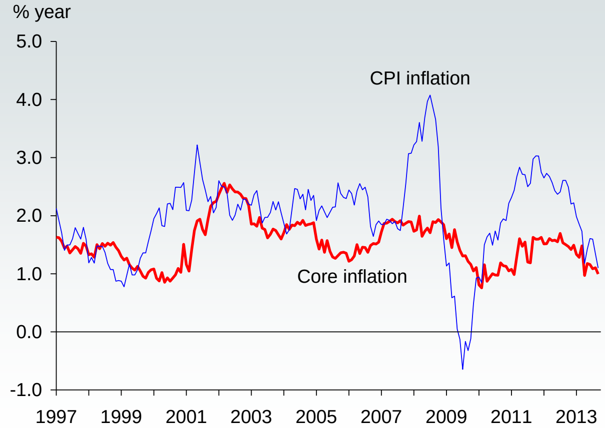
Source: Oxford Economics

Eurozone: Current account



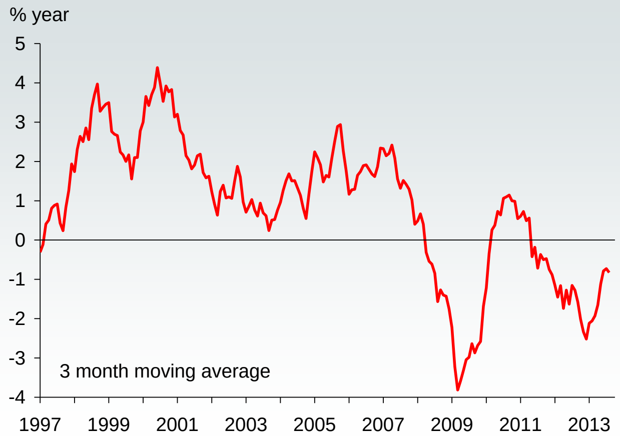
Source: Oxford Economics

Eurozone: Headline Inflation



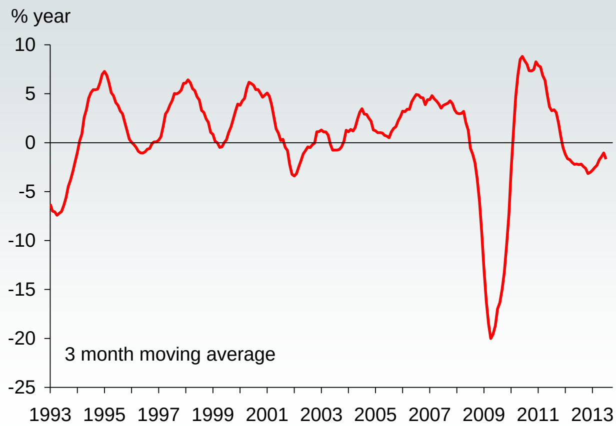
Source: Haver Analytics

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 (GDP/ET)	MONEY SUPPLY M3 (MON)	PRODUCER PRICES (PPI)	CONSUMER PRICES (CPI)
YEARS BEGINNING Q1											
2012	-1.4	-3.7	-2.2	-0.6	-2.9	11.4	1.7	0.1	2.8	2.6	2.5
2013	-0.6	-3.6	-1.0	-0.3	-1.6	12.1	1.6	0.5	1.9	0.1	1.5
2014	0.5	1.5	0.5	1.0	1.4	12.2	1.6	0.9	2.1	1.4	1.5
2015	1.1	2.6	1.2	1.4	2.6	12.0	2.1	1.1	2.9	1.8	1.4
2016	1.3	2.6	1.4	1.6	2.5	11.7	2.3	1.2	3.4	1.7	1.4
2017	1.4	2.5	1.5	1.7	2.2	11.4	2.4	1.2	3.5	1.6	1.5
2012											
I	-1.3	-2.6	-1.7	-0.2	-2.4	10.9	2.0	0.3	3.0	3.6	2.7
II	-1.3	-3.7	-2.4	-0.5	-2.9	11.3	1.8	0.3	3.0	2.4	2.5
III	-1.7	-3.9	-2.5	-0.7	-2.8	11.5	1.7	-0.1	2.5	2.4	2.5
IV	-1.5	-4.5	-2.3	-1.0	-3.4	11.8	1.4	-0.2	2.9	2.1	2.3
2013											
I	-1.3	-5.6	-2.0	-1.0	-2.7	12.0	1.8	0.0	2.1	0.8	1.9
II	-0.6	-3.5	-1.0	-0.5	-1.7	12.1	1.5	0.5	1.8	-0.3	1.4
III	-0.4	-3.3	-0.9	-0.2	-2.0	12.1	1.4	0.6	2.2	-0.3	1.3
IV	0.1	-1.9	-0.2	0.4	0.1	12.1	1.7	0.9	1.5	0.3	1.3
2014											
I	0.4	0.7	0.1	0.8	0.7	12.2	1.2	0.9	2.0	0.6	1.5
II	0.4	1.1	0.2	0.8	1.0	12.2	1.6	0.8	2.1	1.8	1.5
III	0.5	1.8	0.6	1.0	1.9	12.2	1.9	0.9	2.1	1.6	1.5
IV	0.7	2.2	0.8	1.2	2.2	12.1	1.8	0.9	2.4	1.6	1.4
2015											
I	0.9	2.5	1.0	1.3	2.4	12.1	1.9	1.0	2.6	1.7	1.4
II	1.0	2.6	1.2	1.4	2.6	12.0	2.0	1.0	2.8	1.9	1.4
III	1.1	2.6	1.3	1.5	2.7	12.0	2.1	1.1	3.0	1.9	1.4
IV	1.2	2.6	1.4	1.5	2.7	11.9	2.2	1.2	3.1	1.8	1.4
2016											
I	1.2	2.6	1.4	1.6	2.6	11.9	2.2	1.2	3.3	1.8	1.4
II	1.3	2.6	1.4	1.6	2.5	11.8	2.2	1.2	3.4	1.8	1.4
III	1.3	2.6	1.4	1.6	2.4	11.7	2.3	1.2	3.4	1.7	1.4
IV	1.4	2.6	1.5	1.6	2.3	11.6	2.3	1.2	3.5	1.7	1.4
2017											
I	1.4	2.6	1.5	1.7	2.3	11.5	2.3	1.2	3.5	1.7	1.5
II	1.4	2.6	1.5	1.7	2.2	11.5	2.4	1.2	3.6	1.7	1.5
III	1.5	2.5	1.5	1.7	2.2	11.4	2.4	1.2	3.5	1.6	1.5
IV	1.5	2.5	1.5	1.7	2.1	11.3	2.5	1.2	3.4	1.6	1.5

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											
2012	87.4	125.7	1.33	-351.4	-3.71	0.57	3.92	-1.92	1.42	1.29	115.5
2013	162.5	213.8	2.22	-270.9	-2.82	0.22	3.04	-1.26	1.56	1.32	120.1
2014	196.7	226.0	2.30	-254.3	-2.59	0.26	3.12	-1.23	1.63	1.27	118.9
2015	201.1	213.7	2.11	-210.7	-2.08	0.31	3.37	-1.07	1.99	1.20	115.3
2016	214.4	217.1	2.08	-167.0	-1.60	0.34	3.67	-1.08	2.25	1.18	113.6
2017	231.1	225.4	2.10	-137.4	-1.28	0.56	3.98	-0.92	2.50	1.18	113.2
2012											
I	12.9	20.9	0.88	-91.3	-3.86	1.04	4.29	-1.64	1.61	1.31	116.9
II	18.6	27.4	1.16	-88.9	-3.75	0.69	4.17	-1.76	1.71	1.28	115.9
III	26.8	34.9	1.47	-86.7	-3.65	0.36	3.89	-2.18	1.35	1.25	113.3
IV	29.1	42.5	1.79	-84.6	-3.56	0.20	3.32	-2.11	1.02	1.30	115.8
2013											
I	38.6	58.8	2.47	-79.5	-3.34	0.21	3.06	-1.64	1.20	1.32	118.8
II	42.2	61.7	2.57	-57.5	-2.39	0.21	2.82	-1.20	1.42	1.31	119.2
III	40.0	45.6	1.89	-71.0	-2.95	0.22	3.17	-1.12	1.82	1.32	121.7
IV	41.8	47.7	1.97	-63.0	-2.60	0.23	3.11	-1.09	1.78	1.33	120.8
2014											
I	50.0	71.8	2.95	-64.8	-2.66	0.24	3.10	-1.27	1.58	1.30	120.0
II	50.1	61.9	2.53	-67.9	-2.77	0.26	3.09	-1.23	1.59	1.28	119.3
III	48.9	45.6	1.85	-64.7	-2.62	0.27	3.13	-1.26	1.59	1.26	118.5
IV	47.7	46.7	1.88	-57.0	-2.30	0.28	3.18	-1.16	1.74	1.24	117.9
2015											
I	53.4	69.7	2.79	-54.6	-2.19	0.29	3.26	-1.11	1.86	1.22	116.5
II	50.5	57.2	2.27	-56.8	-2.25	0.30	3.33	-1.07	1.96	1.21	115.8
III	48.8	41.9	1.65	-54.4	-2.14	0.31	3.41	-1.04	2.05	1.19	114.8
IV	48.4	44.8	1.76	-45.0	-1.76	0.32	3.48	-1.06	2.10	1.18	114.2
2016											
I	55.3	69.5	2.70	-42.9	-1.67	0.33	3.56	-1.07	2.16	1.18	113.8
II	53.3	57.7	2.22	-45.5	-1.76	0.34	3.63	-1.08	2.22	1.18	113.7
III	52.8	43.3	1.66	-43.7	-1.67	0.35	3.71	-1.08	2.28	1.18	113.6
IV	53.0	46.7	1.77	-34.8	-1.32	0.35	3.78	-1.09	2.34	1.18	113.4
2017											
I	59.8	71.4	2.69	-34.4	-1.30	0.36	3.86	-1.10	2.40	1.18	113.3
II	57.5	59.7	2.23	-37.8	-1.41	0.37	3.94	-1.11	2.46	1.18	113.3
III	56.9	45.5	1.69	-36.8	-1.36	0.63	4.02	-0.86	2.53	1.18	113.2
IV	56.8	48.8	1.80	-28.4	-1.05	0.88	4.09	-0.62	2.59	1.18	113.1

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

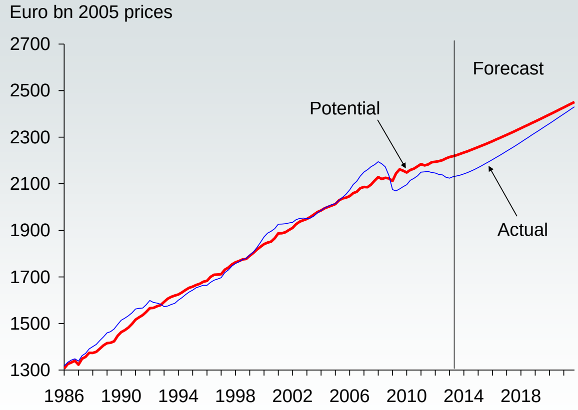
Potential output growth 1.1%pa

- Potential output is projected to rise by 1.1%pa over the next 10 years, a slightly lower rate than in the previous decade. GDP is set to contract by 0.3% in 2013, having shrunk by 0.6% in 2012 and to be slightly below potential growth at 1.0% in 2014. As a result, the large output gap of 2.9% in 2012 will expand in 2013 to 4.1% and increase in 2014 to 4.1%, 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 total factor productivity.

- The 0.07%pt contribution from expanding labour usage reflects the 0.1%pa fall in the working population over the next ten years and an increase in the participation rate which combine to boost the labour supply by 0.1%pa. For the capital stock's contribution of 0.4%pt, the main factor is significantly higher investment growth (at 1.6%pa) than in the previous decade. Finally, total factor productivity growth's slightly higher contribution of 0.7%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

	2003-2012	2013-2022
Potential GDP*	1.31	1.15
Employment at NAIRU	0.62	0.10
Capital Stock	1.49	1.08
Total Factor Productivity	0.39	0.70

*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)

	2003-2007	2008-2012	2013-2017	2018-2022
GDP	2.2	-0.3	1.1	1.7
Consumption	1.6	-0.1	0.7	1.6
Investment	3.4	-3.5	1.1	2.2
Government Consumption	1.8	1.0	0.3	1.1
Exports of Goods and Services	5.9	1.5	3.4	3.2
Imports of Goods and Services	6.2	0.4	2.9	3.2
Unemployment (%)	8.7	9.8	11.9	10.4
Consumer Prices	2.2	2.1	1.5	1.7
Current Balance (% of GDP)	0.2	-0.1	2.2	2.1
Exchange Rate (US$ per Euro)	1.25	1.37	1.23	1.19
General Government Balance (% of GDP)	-2.1	-4.5	-2.1	-0.7
Short-term Interest Rates (%)	2.8	1.7	0.3	2.8
Long-term Interest Rates (%)	4.0	4.0	3.4	4.7
Working Population	0.4	0.2	0.0	-0.1
Labour Supply	1.0	0.4	0.1	0.1
Participation Ratio	73.6	75.1	75.6	76.4
Labour Productivity	1.0	0.1	1.0	1.3

Long-Term Forecast for Eurozone

Annual percentage changes unless otherwise specified

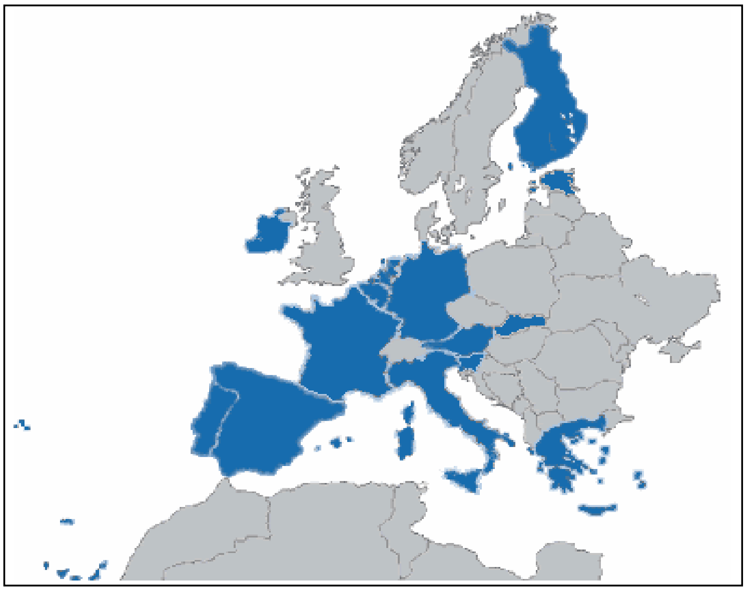
	2003-2012	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2013-2022
GDP	0.9	-4.4	1.9	1.6	-0.6	-0.3	1.0	1.4	1.6	1.7	1.8	1.7	1.7	1.7	1.7	1.4
Consumption	0.7	-0.9	1.0	0.3	-1.4	-0.6	0.5	1.1	1.3	1.4	1.5	1.6	1.6	1.6	1.6	1.2
Investment	-0.1	-12.7	-0.5	1.7	-3.7	-3.6	1.5	2.6	2.6	2.5	2.5	2.3	2.1	2.0	1.9	1.6
Government Consumption	1.4	2.6	0.6	-0.1	-0.6	0.2	-0.2	0.3	0.5	0.8	0.9	1.1	1.2	1.2	1.2	0.7
Exports of Goods and Services	3.7	-12.4	11.5	6.5	2.7	1.1	3.7	4.1	4.2	4.1	3.8	3.5	3.2	2.9	2.7	3.3
Imports of Goods and Services	3.2	-11.0	9.9	4.5	-1.0	-0.4	2.9	4.0	4.2	4.0	3.7	3.4	3.1	2.9	2.7	3.1
Unemployment (%)	9.2	9.6	10.1	10.2	11.4	12.1	12.2	12.0	11.7	11.4	11.1	10.8	10.5	10.1	9.8	11.2
Consumer Prices	2.1	0.3	1.6	2.7	2.5	1.5	1.5	1.4	1.4	1.5	1.5	1.6	1.7	1.8	1.8	1.6
Current Balance (% of GDP)	0.1	-0.2	0.0	0.1	1.3	2.2	2.3	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Exchange Rate (US$ per Euro)	1.31	1.39	1.33	1.39	1.28	1.32	1.27	1.20	1.18	1.18	1.18	1.18	1.19	1.19	1.21	1.21
General Government Balance (% of GDP)	-3.3	-6.4	-6.2	-4.1	-3.7	-2.8	-2.6	-2.1	-1.6	-1.3	-1.0	-0.9	-0.7	-0.6	-0.5	-1.4
Short-term Interest Rates (%)	2.3	1.2	0.8	1.4	0.6	0.2	0.3	0.3	0.3	0.6	1.3	2.3	2.9	3.4	3.9	1.6
Long-term Interest Rates (%)	4.0	3.8	3.6	4.4	3.9	3.0	3.1	3.4	3.7	4.0	4.3	4.5	4.7	4.9	5.0	4.0
Working Population	0.3	0.0	0.2	0.1	0.2	0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.1
Labour Supply	0.7	0.2	0.1	0.3	0.7	0.0	0.1	0.1	0.1	0.1	0.2	0.2	0.1	0.0	0.0	0.1
Participation Ratio (%)	74.3	75.0	74.9	75.1	75.4	75.3	75.5	75.6	75.8	75.9	76.1	76.3	76.4	76.5	76.6	76.0
Labour productivity	0.6	-2.6	2.4	1.3	0.1	0.5	0.9	1.1	1.2	1.2	1.2	1.2	1.3	1.4	1.3	1.1
Employment	0.4	-1.8	-0.5	0.3	-0.7	-0.8	0.1	0.3	0.4	0.5	0.5	0.5	0.4	0.4	0.3	0.3
Output gap (% of potential GDP)	-0.2	-3.1	-2.1	-1.6	-2.9	-4.1	-4.1	-3.8	-3.4	-2.9	-2.4	-1.9	-1.5	-1.0	-0.6	-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 Cyprus, 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 sever 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	2012*
GDP per capita (US$)	-	18088	19885	36577
Inflation (%)	9.9	4.2	2.2	2.5
Population (mn)	287	305	315	333
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

Structure of GDP by output

	2010
Agriculture	1.5%
Industry	26.5%
Services	72.0%

Source : WDI

* 2012 or latest available year

Corruption perceptions index 2012

	Score
Developed economies (average)	74.8
Emerging economies (average)	38.0
Eurozone	66.6

Source: Transparency International

Scoring system 100 = highly clean, 0 = highly corrupt

Structural economic indicators

	1990	1995	2000	2012*
Current account (US$ billion)	10	54	-94	161
Trade balance (US$ billion)	-23	63	-29	112
FDI (US$ billion)	-	-	-25	-109
Govt budget (% of GDP)	-4.1	-7.5	-0.1	-3.7
Govt debt (% of GDP)	13.5	67.3	67.1	91.2
Long-term interest rate	10.9	8.7	5.4	3.9
Oil production (000 bpd)	271	313	240	227
Oil consumption (000 bpd)	9715	10483	10927	9493

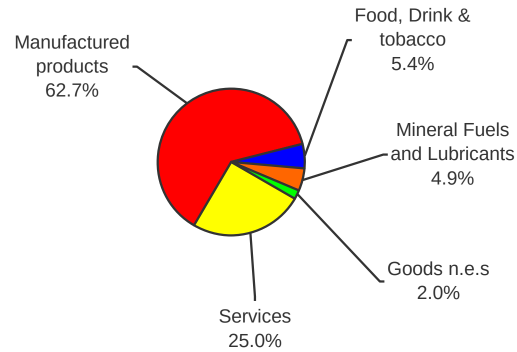
Source : Oxford Economics / World Bank / EIA / ECB

Destination of goods' exports (2012)

Eurozone	46.4%
UK	6.6%
US	6.4%
China	3.5%
Switzerland	3.3%
Poland	2.6%

Source : Eurostat \ Haver Analytics

Composition of extra-EMU goods & services exports, 2012



Source : Eurostat\ Haver Analytics