Eurozone

Highlights and Key Issues

- The outturn for Q2 GDP was broadly in line with expectations, down 0.2% in the quarter. We think that further declines in activity will follow in the second half of this year, leading to a 0.5% contraction for 2012 as a whole. Most countries are expected to fall back into recession, or at best stagnate.
- With governments and the private sector attempting to reduce debt while incomes are dampened by weak activity, any significant upturn in growth is unlikely next year. We expect the economy to remain very sluggish in 2013, with growth close to zero.
- The ECB did not disappoint in its decision to start a vast bond purchase programme. This move towards a more activist role for the ECB is necessary to preserve the Eurozone in its current form.
- However, ECB action alone is not sufficient to kick-start growth. But we expect that other important measures, such as progress towards banking and fiscal union, will progress in a piecemeal and slow fashion.
- The most likely outlook for the Eurozone is a 'lost decade' for growth. Slow policy progress and a protracted dampening effect on activity from deleveraging have led us to revise down our medium-term forecast. We now expect GDP growth to remain below 1.5% until 2017-18, having previously expected it to pick up to around 2%. This means that unemployment will continue to rise until at least 2014.
- With such a large social cost for keeping the Eurozone together, there is a high risk of a breakup at some point in the next five years.

Forecast for Eurozone

(Annual percentage changes unless specified)

	2011	2012	2013	2014	2015	2016
Domestic Demand	0.5	-1.9	-0.4	0.9	1.2	1.3
Private Consumption	0.1	-0.8	-0.1	0.7	1.0	1.2
Fixed Investment	1.6	-3.1	-0.3	2.3	2.7	2.7
Government Consumption	-0.1	0.0	-0.7	-0.1	0.4	0.7
Net exports (% of GDP)	2.8	4.1	4.6	4.8	4.9	5.0
GDP	1.5	-0.5	0.1	1.1	1.3	1.4
Industrial Production	2.7	-3.0	0.3	2.7	2.8	2.3
Consumer Prices	2.7	2.3	1.7	1.4	1.3	1.3
Current Account (% of GDP)	0.0	0.8	1.1	1.0	0.9	0.9
Government Budget (% of GDP)	-4.1	-3.4	-2.5	-1.9	-1.4	-1.0
Short-Term Interest rate (%)	1.4	0.8	0.8	0.8	0.9	0.9
Long-Term Interest Rates (%)	4.4	4.1	3.7	3.8	4.0	4.3
Exchange rate (US$ per Euro)	1.39	1.27	1.24	1.17	1.12	1.13
Exchange rate (YEN per Euro)	111.0	101.6	107.6	109.6	107.2	109.6

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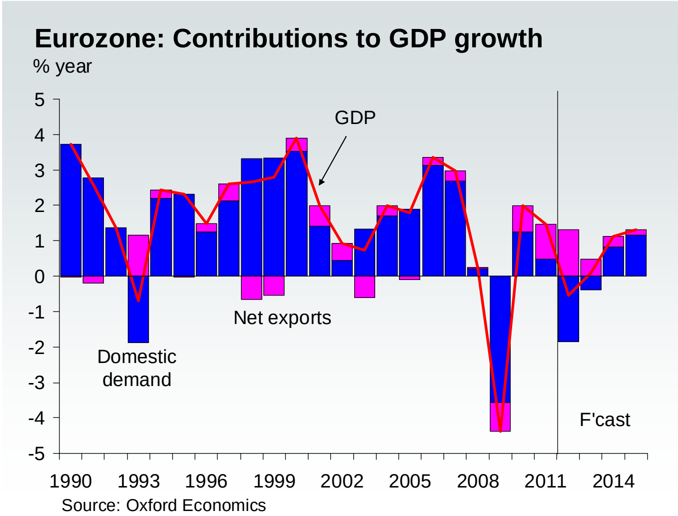
Overview

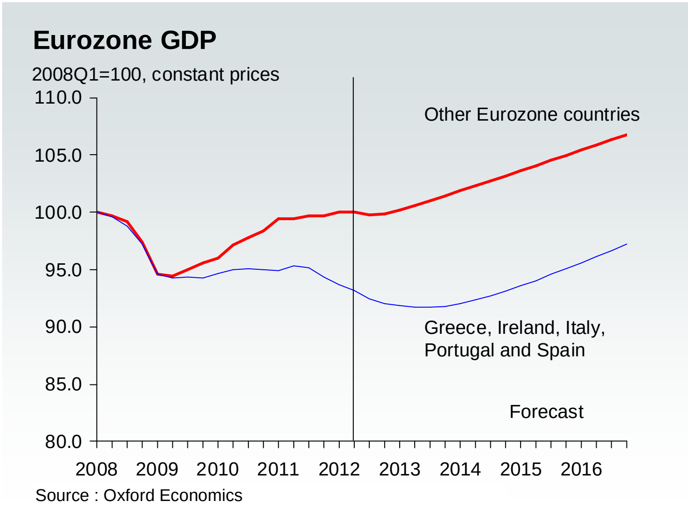
No growth for at least two years

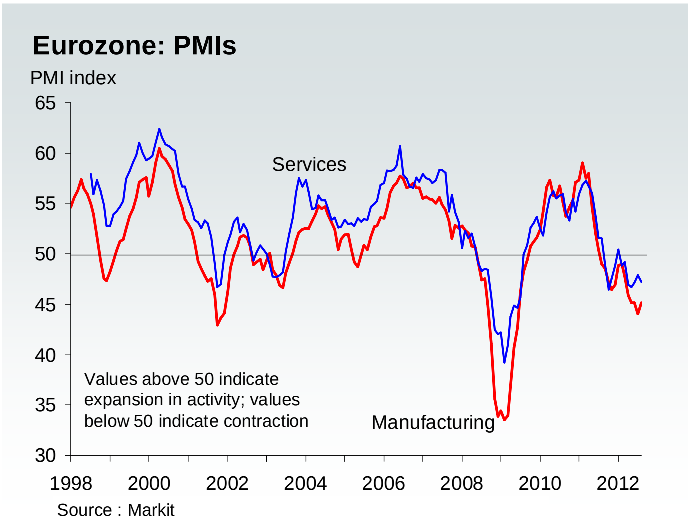
- The outturn for Q2 GDP was broadly in line with expectations, down 0.2% in the quarter. Domestic demand contracted even more, by 0.4% in Q2, with falls in both private consumption and investment. This means that the level of domestic demand was 2.1% lower than a year earlier, not quite as severe an adjustment as in 2008-09 but a very significant one compared with previous downturns. An even deeper contraction was avoided thanks to a robust rise in export volumes, up 1.3% quarter-on-quarter.
- We think that further declines in GDP will follow in H2 this year, leading to a 0.5% contraction for 2012 as a whole. With governments and the private sector attempting to reduce debt while incomes are dampened by weak activity, any significant upturn in growth is unlikely next year. We expect the economy to stagnate in 2013.

ECB delivers…

- The ECB did not disappoint in its decision to start a vast bond purchase programme. While we had little doubt that such a programme would be announced, some of the details went beyond our expectations. President Draghi used strong words, speaking of "severe distortions" in financial markets that were threatening the "singleness of monetary policy". By stressing the issue of monetary policy transmission, the ECB made this programme something that it '*had'* to undertake rather than something it may '*be led'* to undertake by circumstances beyond its control. Draghi called fears of a breakup "unfounded" and asserted that the ECB had the means to implement a "fully effective backstop".
- Still, as expected, bond purchases will not be a blank cheque to Eurozone governments. Conditions will be attached, which the IMF will be asked to set and monitor. Interestingly, such an EU-IMF programme may be 'precautionary'. This is clearly a door opened to Spain and Italy – which may be reluctant to go for a bailout programme but may accept some kind of precautionary programme.
- One other important and somewhat surprising element of this programme is that the ECB will be treated on a par with other investors. This departs from what happened in the Greek debt restructuring.





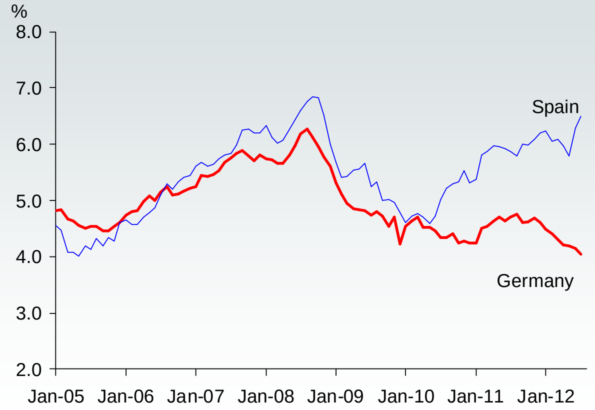


It was most likely a controversial point within the ECB council and testifies that the majority of ECB Council members strongly believe that further debt restructuring can be avoided – quite a show of confidence in Eurozone governments. And unlike the Securities Market Programme, the country breakdown of bond purchases will be published. Such a high degree of transparency is welcome. Publishing the country breakdown will probably enhance the effectiveness of the bond purchases since the publication will flag where the ECB sees the largest distortions.

…but not enough to avoid lost decade

- We welcome the ECB's decisions as we have long seen a more activist ECB as a necessary condition for keeping the Eurozone in its current form. But ECB action alone is not enough to kick-start growth. Other important measures such as progress towards banking and fiscal union will probably progress in a piecemeal and slow fashion.
- Slow policy progress and a protracted dampening effect on activity from deleveraging have led us to revise down our medium-term economic forecasts. Debt reduction has barely started yet; indeed, we estimate that government debt will reach a new high of 90% of GDP this year despite significant austerity programmes that have now been in place for two years. And while we disagree with those that argue for more austerity in the short term, we think that fiscal austerity will become the "new normal" for most of the Eurozone and for most of the decade.
- For private sector deleveraging also, most of the work is still to come. We estimate that non-financial company debt is currently around 138% of GDP, down from a peak at 140% of GDP but well up on the levels at the start of the last decade (around 110%).
- In this context, we think that the most likely outlook for the Eurozone is some kind of 'lost decade'. GDP growth is now expected to remain below 1.5% until 2017-18.
- This means that unemployment will continue to rise until at least 2014. With such high social costs associated with keeping the Eurozone together, the risk of a breakup at some point in the next five years or so is very high.

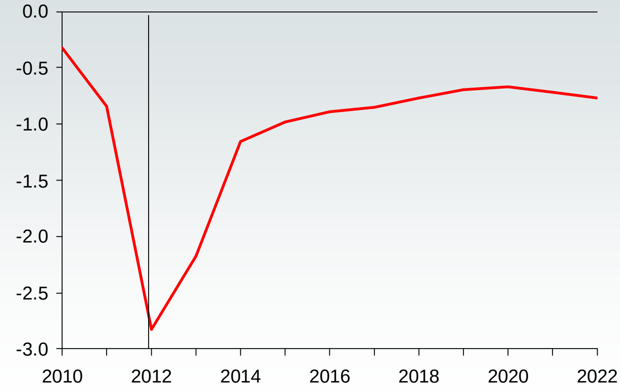
Typical interest rates on loans to businesses



Source : ECB

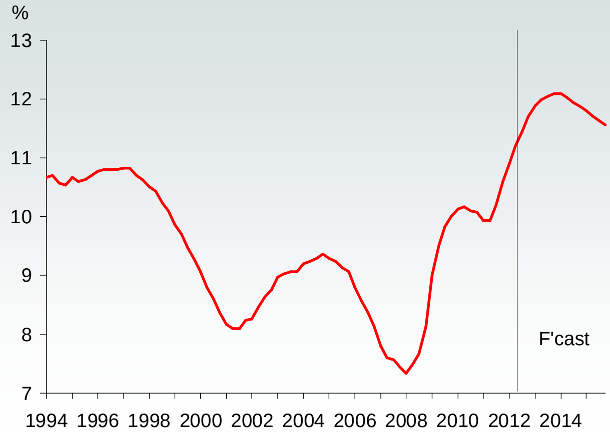
Eurozone GDP growth

% point difference from historical average (2.3% pa)



Source : Oxford Economics

Eurozone: Unemployment



Source: Oxford Economics

Key Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

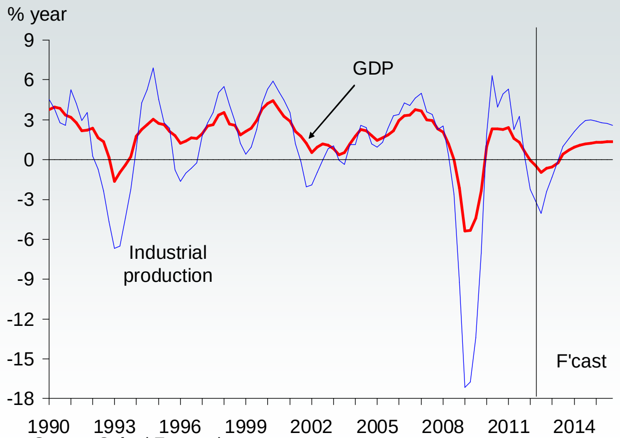
	Industrial production (% yr)	Unemploy-ment (% point)	CPI (% yr)	Business confidence (% balance)	Consumer confidence (% balance)	Exports (% yr)	Imports (% yr)	Trade balance (€ bn)
Aug	5.0	10.2	2.5	0.1	-16.8	14.3	13.2	-5.7
Sep	2.1	10.3	3.0	-0.1	-19.3	10.2	8.8	2.4
Oct	1.0	10.5	3.0	-0.2	-20.1	6.0	8.1	0.3
Nov	0.0	10.6	3.0	-0.4	-20.5	10.4	4.8	5.5
Dec	-1.5	10.7	2.7	-0.3	-21.3	9.9	1.8	9.2
2012								
Jan	-1.5	10.8	2.7	-0.2	-20.7	10.9	4.2	-8.6
Feb	-1.7	10.9	2.7	-0.1	-20.3	11.0	7.4	1.7
Mar	-1.8	11.0	2.7	-0.3	-19.1	4.6	0.6	7.2
Apr	-2.6	11.1	2.6	-0.5	-19.9	5.9	0.2	3.9
May	-2.5	11.2	2.4	-0.8	-19.3	5.7	0.4	7.1
Jun	-2.0	11.3	2.4	-1.0	-19.8	12.3	2.1	14.9
Jul	-2.6	11.3	2.4	-1.3	-21.5	-	-	-
Aug	-	-	2.6	-1.2	-24.6	-	-	-

Financial Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

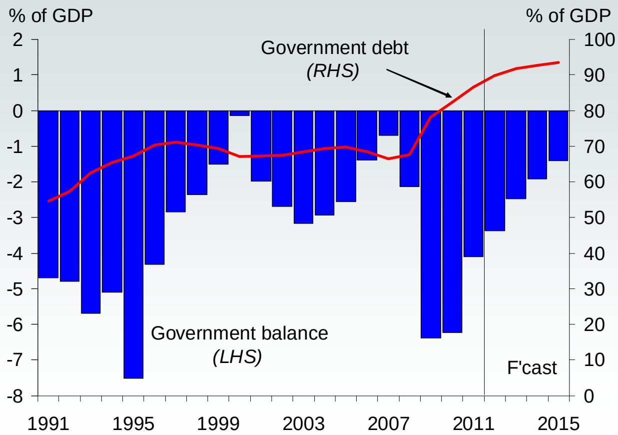
	Short rate %	Long rate %	Money Supply (M3)	Exchange rate $/€ avg.	Exchange rate €/£	Nominal effective exch. rate	Share price DJ STOXX	Net FDI € bn
Aug	1.55	4.21	2.7	1.434	1.142	107.6	2302.1	7.2
Sep	1.54	4.04	2.9	1.377	1.147	106.3	2179.7	-9.0
Oct	1.58	4.09	2.6	1.371	1.149	106.5	2385.2	-5.6
Nov	1.48	4.41	1.9	1.356	1.166	105.6	2330.4	-45.0
Dec	1.43	4.11	1.5	1.318	1.184	103.6	2316.6	-4.3
2012								
Jan	1.22	3.92	2.5	1.290	1.203	101.6	2416.7	3.6
Feb	1.05	3.75	2.8	1.322	1.194	102.9	2512.1	-0.2
Mar	0.86	3.29	3.2	1.320	1.198	103.4	2477.3	-8.8
Apr	0.74	3.39	2.6	1.316	1.216	102.8	2306.4	-9.6
May	0.68	3.53	3.1	1.279	1.244	100.8	2118.9	9.9
Jun	0.66	3.41	3.2	1.253	1.242	99.7	2264.7	-30.6
Jul	0.50	3.25	3.8	1.229	1.269	97.6	2325.7	-
Aug	0.33	3.01	-	1.240	1.268	97.7	2440.7	-

Eurozone: GDP and industrial production



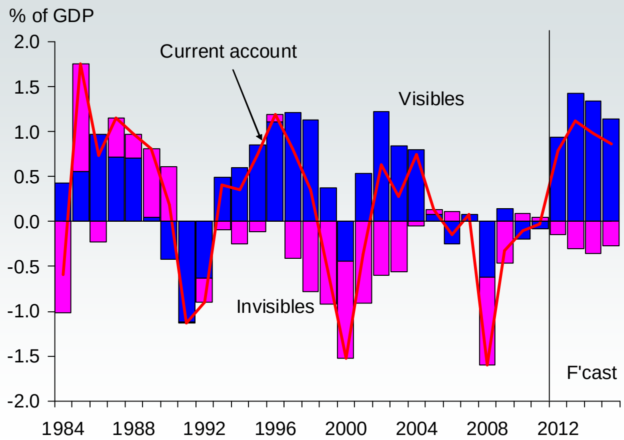
Source: Oxford Economics

Eurozone: Government finances



Source: Oxford Economics

Eurozone: Current account

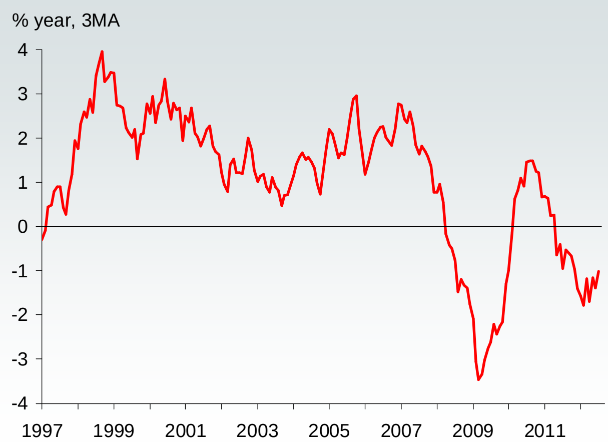


Source: Oxford Economics

Dollar/euro exchange rate

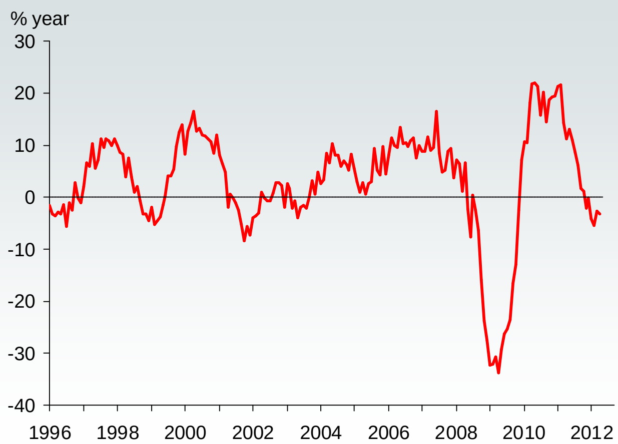
Source: Oxford Economics

Eurozone: Retail sales



Source: Oxford Economics

Eurozone: Industrial new orders



Source: Oxford Economics

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											
2011	0.1	1.6	0.5	1.5	2.7	10.2	2.4	1.3	2.7	5.6	2.7
2012	-0.8	-3.1	-1.9	-0.5	-3.0	11.3	1.6	0.0	2.6	2.2	2.3
2013	-0.1	-0.3	-0.4	0.1	0.3	12.0	1.4	0.8	2.7	1.1	1.7
2014	0.7	2.3	0.9	1.1	2.7	12.0	1.8	1.2	3.5	1.7	1.4
2015	1.0	2.7	1.2	1.3	2.8	11.7	2.1	1.1	3.7	1.8	1.3
2016	1.2	2.7	1.3	1.4	2.3	11.4	2.4	1.2	3.7	1.8	1.3
2011											
I	0.9	3.4	1.6	2.4	5.3	9.9	2.2	2.2	2.7	6.4	2.5
II	0.3	1.3	0.8	1.6	2.3	9.9	2.4	1.3	2.4	5.8	2.8
III	0.2	0.7	0.3	1.3	3.2	10.2	2.6	1.1	3.5	5.4	2.7
IV	-0.8	0.8	-0.7	0.6	0.1	10.6	2.4	0.8	2.3	4.7	2.9
2012											
I	-1.0	-2.4	-1.6	0.0	-2.2	10.9	2.0	0.4	3.2	3.4	2.7
II	-0.7	-3.0	-2.1	-0.5	-3.2	11.2	1.5	0.0	2.9	2.1	2.5
III	-1.1	-3.7	-2.3	-1.0	-4.1	11.4	1.5	-0.4	1.8	1.8	2.2
IV	-0.6	-3.5	-1.6	-0.7	-2.4	11.7	1.3	-0.1	2.5	1.7	2.0
2013											
I	-0.5	-2.2	-1.2	-0.6	-1.3	11.9	1.1	0.1	2.5	0.8	1.7
II	-0.3	-1.0	-0.8	-0.2	0.0	12.0	1.3	0.6	2.3	1.0	1.6
III	0.0	0.5	0.0	0.4	1.0	12.1	1.4	1.1	2.9	1.2	1.7
IV	0.2	1.3	0.3	0.7	1.6	12.1	1.6	1.2	3.2	1.5	1.7
2014											
I	0.4	1.9	0.6	1.0	2.1	12.1	1.7	1.2	3.4	1.6	1.6
II	0.6	2.3	0.8	1.1	2.6	12.0	1.8	1.2	3.5	1.7	1.5
III	0.8	2.5	1.0	1.2	2.9	11.9	1.8	1.2	3.6	1.8	1.4
IV	0.9	2.6	1.1	1.3	3.0	11.9	1.9	1.1	3.7	1.8	1.3
2015											
I	1.0	2.7	1.1	1.3	2.9	11.8	2.0	1.1	3.7	1.8	1.3
II	1.0	2.7	1.2	1.3	2.8	11.7	2.1	1.1	3.6	1.8	1.3
III	1.1	2.7	1.3	1.3	2.7	11.6	2.2	1.1	3.7	1.8	1.3
IV	1.1	2.7	1.3	1.3	2.6	11.6	2.2	1.1	3.7	1.8	1.3
2016											
I	1.1	2.7	1.3	1.4	2.5	11.5	2.3	1.1	3.6	1.8	1.3
II	1.2	2.7	1.3	1.4	2.3	11.4	2.4	1.2	3.7	1.8	1.3
III	1.2	2.7	1.3	1.5	2.2	11.3	2.4	1.2	3.7	1.8	1.3
IV	1.3	2.6	1.3	1.5	2.1	11.3	2.5	1.2	3.7	1.8	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	-7.4	-3.1	-0.03	-386.5	-4.10	1.39	4.41	-1.33	1.69	1.39	120.8
2012	88.9	74.9	0.79	-320.7	-3.38	0.81	4.07	-1.53	1.74	1.27	115.0
2013	137.2	108.1	1.12	-237.6	-2.47	0.75	3.75	-0.93	2.07	1.24	114.0
2014	132.0	96.2	0.98	-189.6	-1.92	0.80	3.80	-0.64	2.35	1.17	110.0
2015	115.2	87.3	0.86	-142.7	-1.41	0.86	3.97	-0.42	2.70	1.12	106.4
2016	118.1	90.9	0.87	-100.6	-0.97	0.86	4.30	-0.46	2.98	1.13	107.2
2011											
I	-7.1	-1.8	-0.08	-112.6	-4.81	1.10	4.32	-1.38	1.84	1.37	119.4
II	-7.4	-6.0	-0.26	-99.9	-4.24	1.42	4.51	-1.34	1.75	1.44	122.4
III	-5.5	-1.1	-0.05	-90.3	-3.82	1.56	4.30	-1.14	1.60	1.41	121.2
IV	12.6	5.8	0.25	-83.7	-3.55	1.50	4.53	-1.45	1.59	1.35	120.4
2012											
I	11.4	16.8	0.71	-86.7	-3.66	1.04	4.39	-1.64	1.70	1.31	116.8
II	22.1	28.5	1.20	-87.1	-3.67	0.69	4.27	-1.76	1.82	1.28	115.8
III	19.9	18.0	0.76	-81.5	-3.44	0.75	3.89	-1.45	1.69	1.24	113.0
IV	35.6	11.7	0.49	-65.4	-2.75	0.75	3.75	-1.27	1.72	1.26	114.4
2013											
I	32.7	40.0	1.68	-61.9	-2.59	0.75	3.76	-0.98	2.03	1.25	114.5
II	31.1	30.0	1.25	-64.4	-2.68	0.75	3.73	-0.88	2.11	1.25	114.9
III	31.3	22.9	0.95	-59.2	-2.46	0.75	3.75	-0.94	2.06	1.23	114.0
IV	42.1	15.2	0.63	-52.2	-2.15	0.75	3.75	-0.91	2.10	1.21	112.7
2014											
I	36.0	40.8	1.67	-49.9	-2.04	0.75	3.76	-0.81	2.20	1.20	112.0
II	28.8	25.4	1.03	-50.8	-2.07	0.78	3.79	-0.75	2.27	1.18	110.8
III	28.4	18.4	0.75	-49.5	-2.00	0.82	3.80	-0.55	2.44	1.16	109.4
IV	38.8	11.6	0.46	-39.4	-1.58	0.86	3.82	-0.46	2.50	1.14	108.0
2015											
I	31.2	37.1	1.48	-36.5	-1.46	0.86	3.86	-0.46	2.55	1.12	106.3
II	24.0	22.0	0.87	-39.0	-1.55	0.86	3.92	-0.39	2.67	1.12	106.4
III	24.9	17.2	0.68	-38.9	-1.53	0.86	4.01	-0.41	2.74	1.12	106.4
IV	35.1	11.0	0.43	-28.3	-1.11	0.86	4.10	-0.42	2.83	1.12	106.4
2016											
I	29.8	37.0	1.44	-25.9	-1.01	0.86	4.19	-0.44	2.89	1.12	106.7
II	23.4	22.2	0.86	-29.2	-1.12	0.86	4.27	-0.45	2.96	1.12	107.0
III	25.5	18.6	0.71	-28.2	-1.08	0.86	4.34	-0.47	3.01	1.13	107.4
IV	39.4	13.0	0.50	-17.4	-0.66	0.86	4.41	-0.49	3.07	1.13	107.5

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

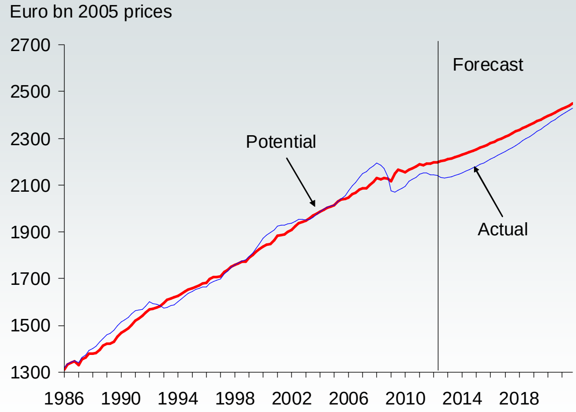
Potential output growth 1.1%pa

- 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 0.5% in 2012, having grown by 1.5% in 2011 and to be significantly below potential growth at 0.1% in 2013. As a result, the large output gap of 1.8% in 2011 will expand in 2012 to 2.9% and increase in 2013 to 3.6%, 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 0.03%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 boost 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 1.5%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*	1.47	1.08
Employment at NAIRU	0.66	0.04
Capital Stock	2.15	1.56
Total Factor Productivity	0.29	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	0.7	1.7
Consumption	1.5	0.4	0.4	1.5
Investment	2.1	-1.8	0.8	2.2
Government Consumption	1.9	1.5	0.1	1.1
Exports of Goods and Services	5.0	2.1	3.9	3.5
Imports of Goods and Services	5.0	1.6	3.1	3.4
Unemployment (%)	8.9	9.0	11.7	10.2
Consumer Prices	2.2	2.0	1.6	1.6
Current Balance (% of GDP)	0.3	-0.4	0.9	1.1
Exchange Rate (vs US$)	1.2	1.4	1.2	1.2
General Government Balance (% of GDP)	-2.5	-3.9	-2.0	-0.3
Short-term Interest Rates (%)	2.6	2.5	0.8	2.3
Long-term Interest Rates (%)	4.1	4.1	4.0	4.8
Working Population	0.5	0.2	-0.3	-0.3
Labour Supply	1.0	0.4	0.1	-0.1
Participation Ratio	72.5	73.9	75.2	75.9
Labour Productivity	0.8	0.4	0.8	1.3

Long-Term Forecast for Eurozone

Annual percentage changes unless otherwise specified

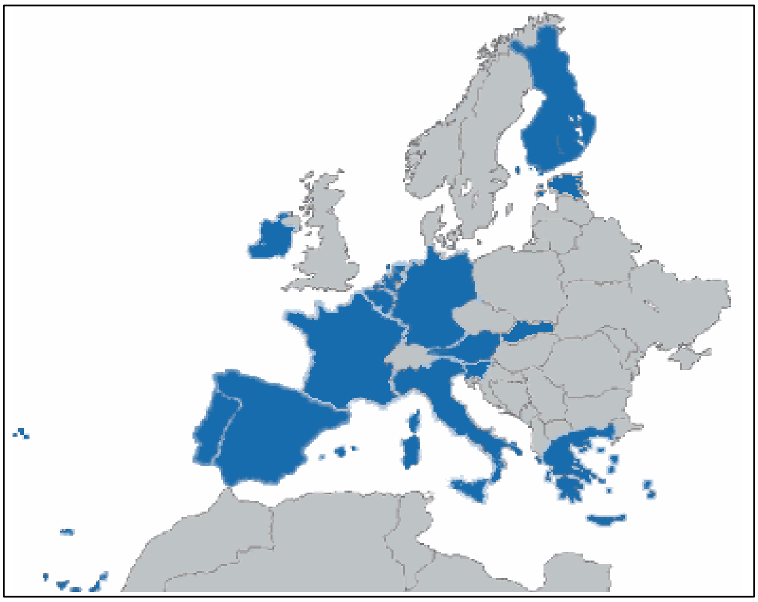
	2002-2011	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
GDP	1.1	0.3	-4.4	2.0	1.5	-0.5	0.1	1.1	1.3	1.4	1.5	1.7	1.7	1.8	1.7	1.2
Consumption	1.0	0.4	-1.0	1.0	0.1	-0.8	-0.1	0.7	1.0	1.2	1.3	1.5	1.5	1.5	1.6	0.9
Investment	0.1	-1.4	-12.7	-0.3	1.6	-3.1	-0.3	2.3	2.7	2.7	2.5	2.3	2.2	2.0	1.8	1.5
Government Consumption	1.7	2.3	2.6	0.8	-0.1	0.0	-0.7	-0.1	0.4	0.7	0.9	1.0	1.2	1.3	1.3	0.6
Exports of Goods and Services	3.5	0.9	-12.4	10.9	6.3	2.7	3.0	4.7	4.7	4.4	4.1	3.8	3.5	3.2	2.9	3.7
Imports of Goods and Services	3.3	0.8	-10.9	9.3	4.1	-0.4	2.2	4.5	4.8	4.4	4.0	3.7	3.4	3.0	2.8	3.2
Unemployment (%)	9.0	7.7	9.6	10.1	10.2	11.3	12.0	12.0	11.7	11.4	11.0	10.6	10.2	9.7	9.3	10.9
Consumer Prices	2.1	3.3	0.3	1.6	2.7	2.3	1.7	1.4	1.3	1.3	1.4	1.5	1.6	1.7	1.8	1.6
Current Balance (% of GDP)	0.0	-1.6	-0.3	-0.1	0.0	0.8	1.1	1.0	0.9	0.9	1.0	1.0	1.1	1.2	1.3	1.0
Exchange Rate (per $)	1.3	1.5	1.4	1.3	1.4	1.3	1.2	1.2	1.1	1.1	1.1	1.1	1.2	1.2	1.2	1.2
General Government Balance (% of GDP)	-3.2	-2.1	-6.4	-6.2	-4.1	-3.4	-2.5	-1.9	-1.4	-1.0	-0.6	-0.4	-0.3	-0.2	-0.3	-1.2
Short-term Interest Rates (%)	2.5	4.6	1.2	0.8	1.4	0.8	0.8	0.8	0.9	0.9	1.0	1.5	2.5	3.1	3.6	1.6
Long-term Interest Rates (%)	4.1	4.3	3.8	3.6	4.4	4.1	3.7	3.8	4.0	4.3	4.5	4.6	4.8	5.0	5.1	4.4
Working Population	0.3	0.4	0.1	0.1	-0.1	-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	0.8	0.2	0.0	0.2	0.7	0.1	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.2	0.0
Participation Ratio (%)	73.2	73.9	74.0	74.0	74.1	74.8	75.1	75.2	75.3	75.5	75.6	75.8	75.9	76.1	76.2	75.6
Labour productivity	0.6	-0.5	-2.6	2.6	1.3	0.0	0.8	1.2	1.1	1.2	1.2	1.3	1.3	1.4	1.4	1.1
Employment	0.5	0.8	-1.8	-0.6	0.1	-0.5	-0.7	0.0	0.2	0.3	0.3	0.4	0.4	0.4	0.3	0.1
Output gap (% of potential GDP)	0.1	2.0	-3.4	-2.4	-1.8	-2.9	-3.6	-3.4	-3.2	-2.9	-2.7	-2.3	-1.8	-1.3	-0.9	-2.5

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 difference 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 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. So significant changes are unlikely to be agreed upon in the near future.

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	19886	39460
Inflation (%)	9.9	4.2	2.2	2.7
Population (mn)	286	305	315	332
Urban population (% of total)	69.9	71.0	72.3	73.9
Life expectancy (years)	-	76.2	78.5	80.9

Source : Oxford Economics & World Bank

Structure of GDP by output

	2009
Agriculture	0.9%
Industry	22.5%
Services	76.6%

Source : Eurostat

* 2011 or latest available year

Corruption perceptions index 2011

	Score
Developed economies (average)	7.70
Emerging economies (average)	3.44
Eurozone	6.81

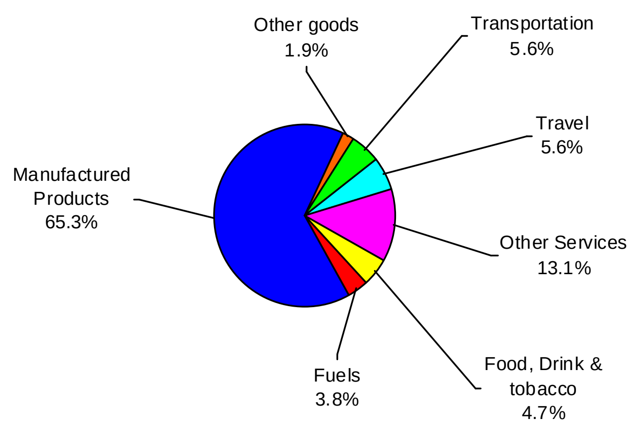
Source: Transparency International
Scoring system 10 = highly clean, 0 = highly corrupt

Structural economic indicators

	1990	1995	2000	2011*
Current account (US$ billion)	11	54	-95	-4
Trade balance (US$ billion)	-25	63	-28	-10
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	86.7
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