



Eurozone

Highlights

- On the whole, the key Eurozone economic indicators that have been published over the past month have disappointed and suggest that the region's fragile economic recovery failed to gather much, if any, momentum in Q2. For instance, in June the Eurozone PMI fell for a second month running, reflecting a broad-based slowdown by country. Although the index still points to stronger GDP growth in Q2 than Q1, other indicators paint a less upbeat picture.
- In Q2 we see Eurozone GDP growth rising by about 0.2%, broadly in line with the average quarterly gains recorded in the preceding three or four quarters. We still expect the pace of growth to pick up in H2, thanks in part to a reacceleration in German GDP growth in the second half of the year. On balance though, we have reduced our forecast for Eurozone GDP growth in 2014, from 1.1% to 1.0%. Our 2015 forecast remains unchanged at 1.5%.
- This modest acceleration in growth assumes that household spending will steadily increase in response to small rises in household income growth. Investment should also continue to recover, particularly if the ECB's TLTRO scheme increases the supply of bank finance to firms. And although the euro remains a weight around exporters' necks, a gradual fall in the currency, coupled with strengthening global demand, imply that export growth will also pick up over the next couple of years.
- Nonetheless, with austerity set to continue and households likely to deleverage in parts of the region, a burst of rapid growth is unlikely, implying that there will remain plenty of slack in the economy for the foreseeable future. Given this and the fact that CPI inflation was just 0.5% in June, a period of deflation in the Eurozone remains a risk. However, our central forecast is still for a sustained period of below target inflation.

Forecast for Eurozone

(Annual percentage changes unless specified)

	2012	2013	2014	2015	2016	2017
Domestic Demand	-2.2	-0.9	0.8	1.3	1.4	1.5
Private Consumption	-1.4	-0.6	0.6	1.4	1.4	1.5
Fixed Investment	-3.8	-2.8	1.5	2.4	2.5	2.5
Stockbuilding (% of GDP)	0.0	0.0	0.1	0.1	0.1	0.1
Government Consumption	-0.6	0.1	0.2	0.3	0.5	0.6
Exports of goods and services	2.7	1.5	3.3	4.0	4.2	4.1
Imports of goods and services	-0.8	0.4	3.3	3.9	4.1	4.0
GDP	-0.6	-0.4	1.0	1.5	1.6	1.7
Industrial Production	-3.0	-1.0	1.9	2.6	2.2	1.9
Consumer Prices	2.5	1.3	0.7	1.3	1.5	1.6
Current Balance (% of GDP)	1.5	2.4	2.7	2.7	2.7	2.6
Government Budget (% of GDP)	-3.7	-3.0	-2.5	-2.0	-1.7	-1.4
Short-Term Interest Rates (%)	0.57	0.22	0.22	0.15	0.15	0.29
Long-Term Interest Rates (%)	3.92	3.00	2.32	2.44	2.71	3.23
Exchange rate (US\$ per Euro)	1.28	1.33	1.36	1.31	1.28	1.28
Exchange rate (YEN per Euro)	102.5	129.6	140.0	139.3	139.8	137.2



Research Briefing

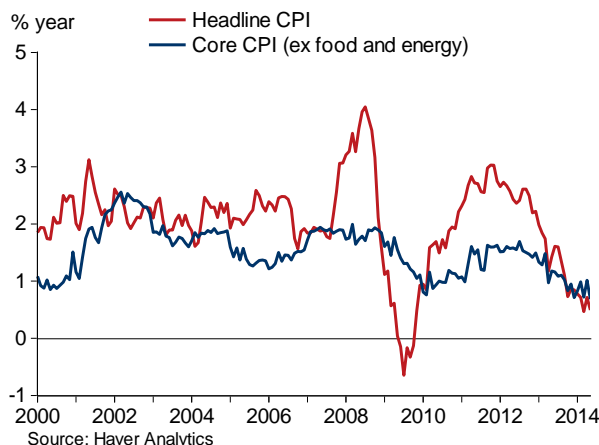
Unpicking deflation risk in the Eurozone

As annual inflation continues to sink towards zero, concerns persist that the Eurozone is vulnerable to slipping into a period of sustained price falls that would not only delay the recovery, but reprise the risk of debt defaults and Eurozone breakup. But how to assess whether the risk of a spell of deflation is rising or falling? We investigate using a Deflation Vulnerability Index, and find several peripherals remain at risk of deflation for the coming 2-3 years. The risk of a prolonged spell of deflation at the Eurozone level is consistent with our Global Scenario Service assumption of 10%.

Deflation risk increases...

As the Eurozone's existential crisis of 2011-12 has faded from memory, a new threat has emerged – the spectre of falling prices. With falling commodity prices and a widening degree of spare capacity, the annual rate of price growth in the Eurozone has slowed from close to 3% in late 2012 to 0.5% in June 2014. Core inflation has been trending gradually weaker even longer.

Eurozone: Inflation



With only a modest recovery in store, it seems likely that price pressures will get weaker in the very near term, possibly dipping into a period of falling prices. In turn, this could create a negative loop between actual price developments and household behaviour, where consumers postpone spending in the expectation of lower prices in the future. This would have a serious impact on the pace of recovery, and increase downward pressure on prices, generating a vicious cycle.

...but how to gauge how much?

Of course, a period of falling prices on the one hand or a gradual return to “normal” inflation are not the only plausible outcomes. A period of very low inflation (e.g. consistently below 1%), could also derail the recovery. But given that in this scenario nominal GDP (and therefore tax revenues) would at least be rising, this scenario would probably be less damaging than outright price falls. As such, we focus on the risk of outright price falls.

A framework developed by the IMF¹ allows us to estimate the likelihood of falling prices using a set of binary tests of whether key variables are behaving in a manner consistent with prices falling a year hence. Variables include the pace of money growth, the scale of asset price falls, the direction of travel and level of the output gap, price indices themselves, and more (details attached in an appendix to this Research Briefing).

In total, eleven key variables are included in the Deflation Vulnerability Index (DVI), with 1 denoting the variable is in the danger zone, and the total score out of 11 normalised to 1. Full details of the variables are set out in Appendix 1. We construct the DVI using latest data for the eleven largest members of the Eurozone² for the

¹ See *Deflation: Determinants, Risks and Policy Options – Findings of an Interdepartmental Task Force and Gauging Risks for Deflation* published by the IMF in 2003 and 2009 respectively.

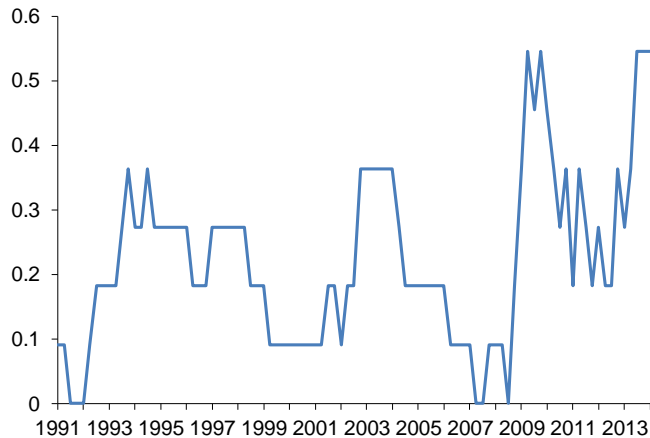
² Due to data constraints we exclude Cyprus, Estonia, Malta, Latvia, Luxembourg, Slovenia and Slovakia



period 1991-present, and present in the chart below. Over the long run the indicator averages around 0.2. But over the past twelve months, it has picked up sharply, reaching the joint-highest rate in the series' history at 0.54 (six of eleven indicators in the danger zone) as of 2014Q1.

Eurozone deflation vulnerability index

0=all indicators in safe territory, 1=all indicators in danger zone

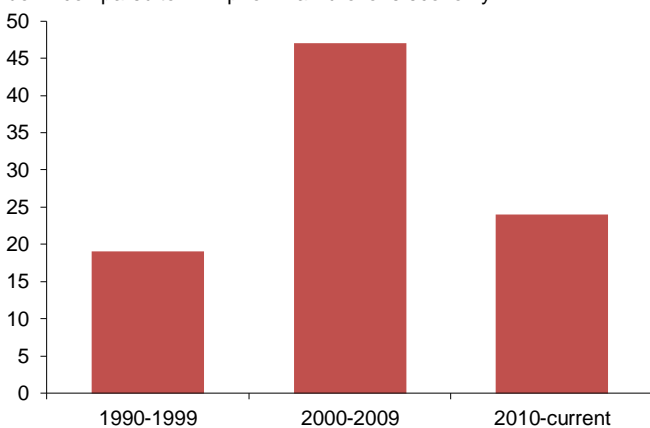


Source : Oxford Economics/Haver Analytics

Over this period, there were 90 instances of “deflation”³, with a heavy bias toward the period since 2000.

Deflationary episodes in the Eurozone

Quarters during which either GDP deflator or Consumer Price Index was down compared to 12m prior in a Eurozone economy



Source : Oxford Economics/Haver Analytics

³ Defined as the level of either the Consumer Price Index or the GDP deflator index (i.e. the “price” of total economic output) being lower a year hence than contemporaneously. It is also worth noting that we are treating each Eurozone economy as a separate time series, therefore each decade consists of 440 quarters.

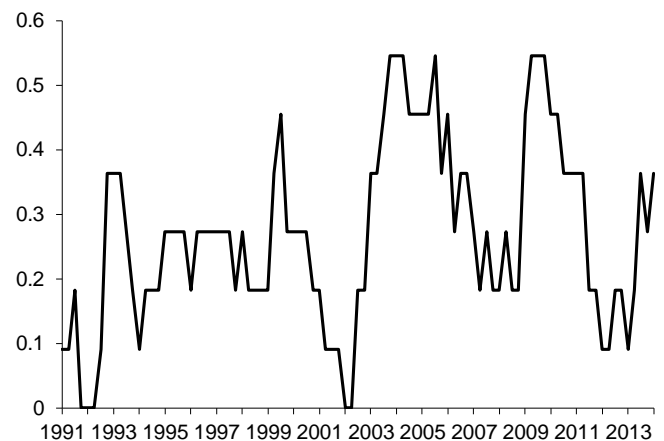
The DVI has a good fit with deflationary outcomes. The probability of a spell of falling prices broadly doubles with each additional 0.2 points from 0.2 onwards. The data imply a probability of prices being lower a year from now of around ten percent – although it should be noted that this probability represents the 0.4-0.59 band as a whole. With the reading at 0.54, it might be that the true probability is higher than this.

DVI	Quarters	Deflation	Probability
0-0.199	463	31	6.7%
0.2-0.399	331	20	6.0%
0.4-0.599	171	21	12.3%
0.6-0.799	54	16	29.6%
0.8-1	4	2	50.0%

Moreover, with latest PMI data suggesting the pace of recovery has eased a little, and CPI data for June coming in a little weaker than expected, it is possible these indicators (currently registering a zero in the first quarter) could flip from a 0 to 1 in the second quarter, pushing the DVI above 0.6. The picture differs by country, with “peripheral” economies more immediately at risk than “core”⁴ economies. We set out the readings across all 11 economies in Appendix 2, but the pattern across the four largest economies gives a good idea of the spread across countries.

Germany deflation vulnerability index

0=all indicators in safe territory, 1=all indicators in danger zone



Source : Oxford Economics/Haver Analytics

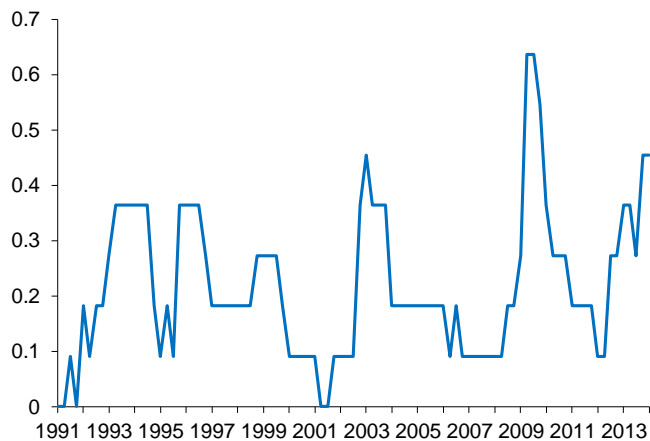
⁴ We have discussed in previous Research Briefings why “core-periphery” is a less relevant dichotomy than in the past, but nevertheless it remains appropriate here.



The DVI for Germany remains well below levels seen in 2009 or even prior to the economic crisis, but has nevertheless picked up in the past year, from 0.1 in 2013Q1 to 0.36 a year later. Germany's economy is close to full capacity (we estimate the output gap is close to zero), and recent inflation readings are at the top of Eurozone ranges, but, nevertheless, weak growth in monetary aggregates in particular imply a moderate risk of falling prices in the coming year, around 6% or so.

France deflation vulnerability index

0=all indicators in safe territory, 1=all indicators in danger zone

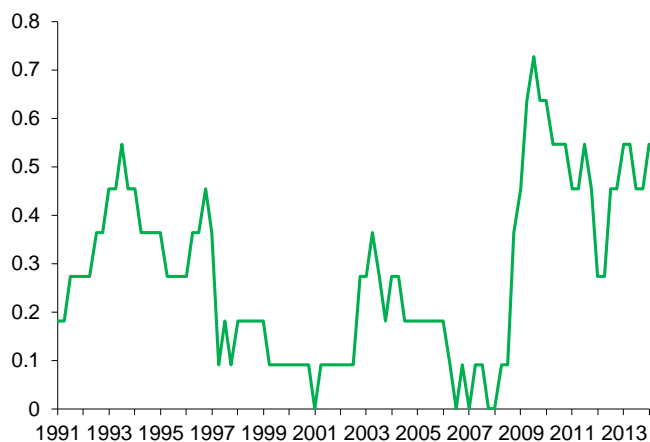


Source : Oxford Economics/Haver Analytics

France's DVI is slightly higher, at 0.45, reflecting a greater degree of spare capacity than in Germany. If France's second quarter GDP performance comes in as weak as expected, we think this the index could edge up further, to 0.54. This implies a 12% chance of falling prices according to our calculations, although the index would still be some way short of its peak, again reached during the depths of the global crisis in 2009.

Italy deflation vulnerability index

0=all indicators in safe territory, 1=all indicators in danger zone



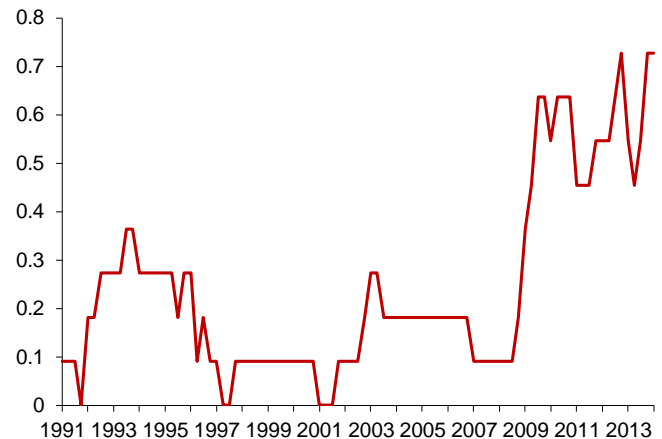
Source : Oxford Economics/Haver Analytics

Italy also remains some way short of peak levels of deflation risk, according to the DVI, although in contrast to both France and Germany deflation risk has pretty consistently been around 0.5 (equating to a 12% risk of falling prices) for the past four or five years. In common with France given the weakness of PMI data for Italy in April, May and June, it seems inevitable that deflation risk will pick up in the second quarter.

Finally we come to Spain, where prices have fallen month on month in six months over the last year⁵. With most of the other deflation metrics also in danger territory the DVI has topped 0.7, implying a 30% probability prices will continue to fall over the coming year (our forecast is for a very modest increase – around 0.4%).

Spain deflation vulnerability index

0=all indicators in safe territory, 1=all indicators in danger zone



Source : Oxford Economics/Haver Analytics

Having said that, PMI readings for the second quarter suggest the Spanish economy is recovering more quickly than much of the rest of the Eurozone – we anticipate growth of around 0.4% in Q2, and the ECB's Bank Lending Survey in April indicated a noticeable improvement in credit demand from Spanish firms. As such, in contrast to France and Italy, the next quarterly step in Spain's DVI might actually be a modest easing, albeit remaining at heightened levels.

How long will the deflation threat persist?

So the risk of at least a spell of falling prices in the Eurozone has increased quite substantially over the past

⁵ We have seasonally adjusted the Spain CPI using the appropriate function in Haver Analytics given the lack of an official SA series.



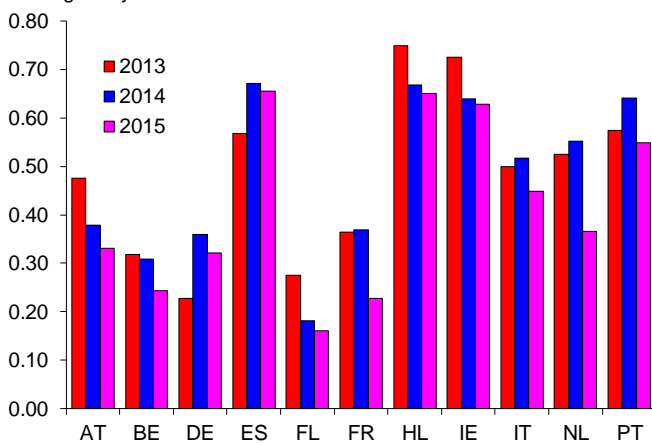
six months or so. But what does this mean for the risk of a prolonged spell of falling prices?

One way to do this would be to construct the DVI using our forecasts for the variables concerned. However, given that the DVI incorporates three price measures, this would clearly involve a degree of circularity – in essence, deflation risk goes down because inflation is assumed to pick up later this year and into 2015. This is clearly an unsatisfactory way to tackle the question.

An alternative might be to examine the degree to which deflationary conditions can be expected to continue over the coming year or two based on the historical relationship between the DVI and its values over the past four quarters. In this respect we find a high degree of persistence between current values of the DVI and its own lagged values (perhaps unsurprisingly, since many of them relate to performance over the past 2-3 years).

Inferred forward values of DVI

Average for year

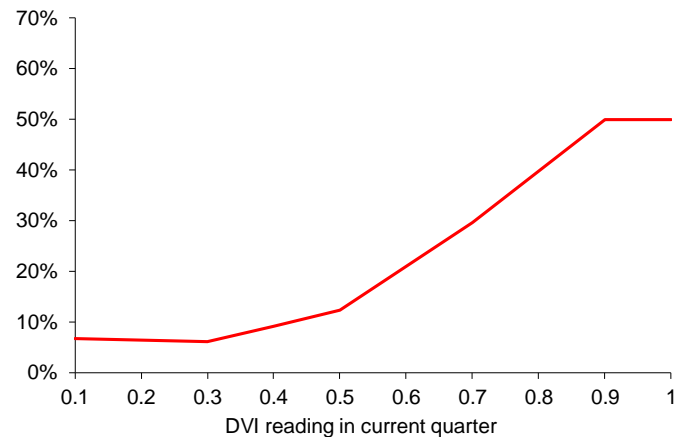


Source : Oxford Economics/Haver Analytics

On this basis the DVI is set to decline only gradually (if at all) over the coming year or two in most peripheral economies. This is consistent with our view on the pace of recovery – we expect large output gaps to persist in most economies and money and lending growth to not reach pre-crisis rates for some years.

DVI and deflation probability

Probability of deflation over the coming year (CPI or GDP deflator)



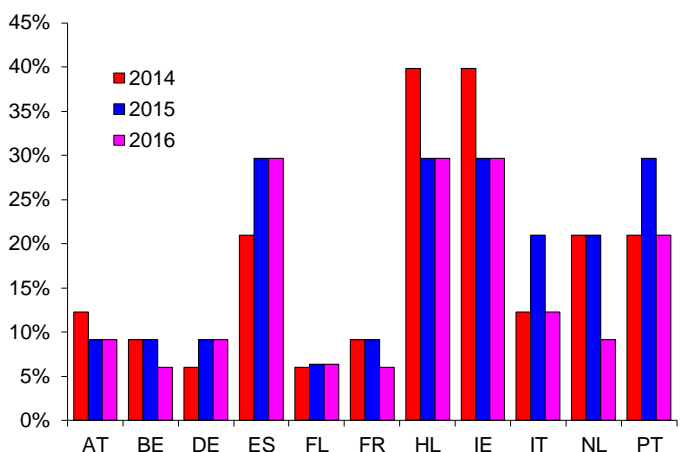
Source : Oxford Economics/Haver Analytics

We then combine these results with the relationship displayed between the DVI and deflationary outcomes over the history. We assume that the probabilities estimated from the historical data reflect the mid-point of the respective ranges, and that the probability at the end-point of the range is the average of the two midpoints either side (e.g. the probability of deflation given a DVI reading of 0.5 is 12.3%, and the probability given a reading of 0.6 is 21%).

Based on this relationship between the DVI (rounded to 1 decimal place) and the probability of deflation, we can infer the risk of a deflationary spell over the coming 2-3 years. This suggests the deflationary threat is unlikely to subside very substantially in the medium term, barring substantial positive surprises. In particular, Spain, Greece and Ireland will still be at around 30% risk of falling prices as far ahead as 2016

Probability of deflation as inferred from DVI

Percent



Source : Oxford Economics/Haver Analytics



Weighting together the inferred probabilities by countries' share of GDP (and indeed, assuming the probability of one country slipping into deflation is independent of another, at least in the 2-3 year time-frame), we estimate the probability of a spell of falling prices at the Eurozone level is 12% in 2014, 15% in 2015, falling back to 12% in 2016. This is consistent with our Global Scenarios Service view that the risk of a prolonged spell of price falls at the Eurozone level is around 10%.

Alternative uses for the DVI

Finally it is worth considering alternative uses for the Deflation Vulnerability Index. As we noted earlier, a period of low but positive inflation would also potentially derail (or at the very least delay) the Eurozone recovery. As such, in a forthcoming Research Briefing we will examine the relationship between the DVI and the rate of inflation in the coming couple of years in order to assess the probability distribution around our central inflation forecast.



Appendix 1 – details of DVI variables

This section briefly outlines the detailed tests used in the Deflation Vulnerability Index, as constructed by IMF staff. Data and scores by country are available from the author on request.

- I. Is CPI inflation < 0.5% over the past year?
- II. Is core CPI inflation < 0.5% over the past year?
- III. Is growth in the GDP deflator < 0.5% over the past year?
- IV. Has the output gap widened by more than 2pp of potential GDP over the past year?
- V. Is the latest output gap greater (negatively) than negative 2 percent?
- VI. Was average GDP growth in the past 3 years less than 2/3 of the average in the previous 10 years?
- VII. Has the stock market index fallen by more than 30% in the past 3 years?
- VIII. Has the real effective exchange rate appreciated by more than 4% over the past year?
- IX. Is annual growth in private sector credit less than the growth in nominal GDP?
- X. Has cumulative growth in private credit been less than 10% over the past 3 years?
- XI. Has broad money grown slower than base money over the past 2 years?

Appendix 2 – Latest DVI readings across Eurozone economies

	2013q3	2013q4	2014q1
AT	0.50	0.50	0.40
BE	0.36	0.45	0.36
DE	0.36	0.27	0.36
ES	0.55	0.73	0.73
FL	0.30	0.30	0.20
FR	0.27	0.45	0.45
HL	0.78	0.67	0.67
IE	0.70	0.90	0.60
IT	0.45	0.45	0.55
NL	0.50	0.60	0.60
PT	0.60	0.60	0.70

Appendix 3 – recent Oxford Economics analysis on the deflation-monetary policy nexus

Alongside this research briefing, readers might find the following Oxford Economics publications useful in understanding issues around deflation and monetary policy in the Eurozone:

- *Standing pat for now*, ECB Watch, 1 July 2014
- *ECB to continue dovish talk*, Eurozone Weekly Briefing, 26 June 2014
- *Deflationary pressures remain a concern*, Eurozone Data Insight, 16 June 2014
- *What if there really was a single European labour market*, Eurozone Weekly Briefing, 6 June 2014
- *ECB primed for action*, Research Briefing, 2 June 2014
- *Eurozone Money Supply – no worse than expected*, 28 May 2014
- *How close is the ECB to unleashing quantitative easing?* Eurozone Weekly Briefing, 22 May 2014
- *What use negative interest rates*, Research Briefing, 19 May 2014
- *Inflation in Germany to help avoid wider Eurozone deflation*, Research Briefing, 16 May 2014

This article was originally published on 2 July as a Research Briefing for our Global Macro Service (Europe).



Forecast Overview

Recovery to have remained subdued in Q2...

The Eurozone economy may have lost some momentum in the course of Q2, based on business surveys for the period. Admittedly, the falls in the composite PMI in May and June were pretty small and on past form the PMIs still point to slightly stronger quarterly GDP growth than the 0.2% recorded in Q1. But given the sharp falls in German, French, Italian and Spanish industrial production in May and subdued Eurozone retail sales figures for the first two months of the quarter we suspect that Eurozone GDP growth is unlikely to have picked up in Q2. Based on this, we have nudged down our 2014 GDP forecast slightly from 1.1% to 1.0%.

...and will only accelerate gradually in H2

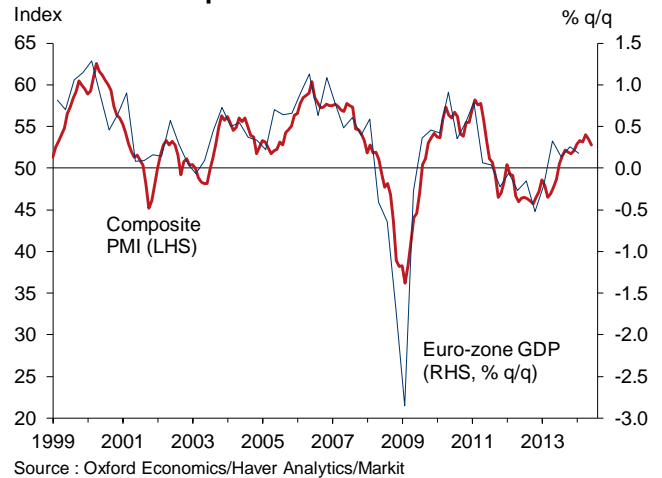
That said our central forecast is still for growth to accelerate in the second half of the year. For a start, we expect Eurozone growth in Q2 to have been depressed by a fall in German GDP last quarter, which we doubt will be repeated in Q3. In addition, the pick-up in the Sentix measure of investor sentiment in July provides some hope that the recent slowdown in business sentiment may have been just a blip.

Our central premise remains that household spending will pick up, thanks mainly to the easing fiscal squeeze and the modest improvement in the labour market. Meanwhile, we expect investment to continue to creep higher, particularly next year if the ECB's TLTRO programme proves effective. And export growth should gradually rise too as global demand increases.

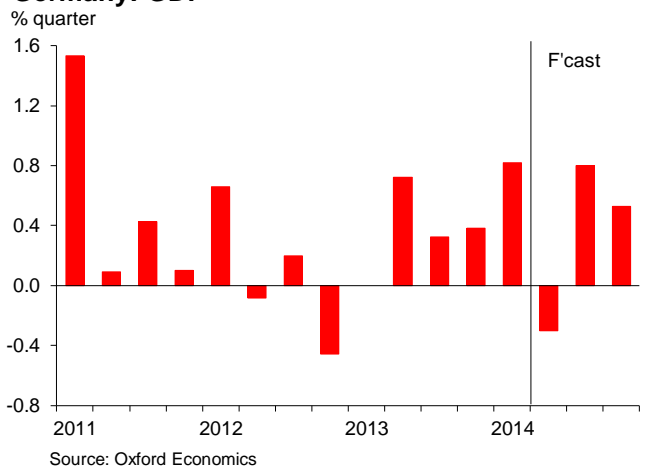
Nonetheless, there remain a number of reasons why the recovery is likely to be steady rather than spectacular as well as variable from country to country:

- **Competitiveness** – although economic reforms and subdued or negative wage growth in response to sky-high levels of unemployment have resulted in some economies, such as Spain, improving their competitive positions, others, most notably Italy, France and Belgium have seen costs stagnate or rise. As a result, the latter group of economies in particular may struggle to generate robust export growth.
- **Fiscal policy** – the worst of the fiscal squeeze may now be over but in the Eurozone as a whole fiscal policy will continue to restrain growth, albeit by less

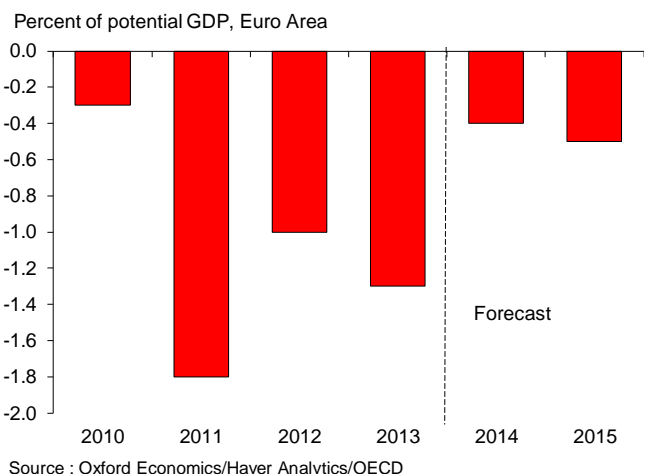
Eurozone Composite PMI & GDP



Germany: GDP



Stimulus/drag from fiscal policy





than a year or two ago. And for some economies, such as France, the reduction in the fiscal squeeze will be small.

- Household spending power to remain weak** – although unemployment may be falling, the labour market recovery remains subdued and the region as a whole will face years of labour market slack. Indeed, for economies such as Spain and Greece it may take several years for the unemployment rate to fall below 20%. Against this backdrop, wage growth will be subdued. In addition, high levels of household debt in some economies, such as Spain, Portugal and the Netherlands, will prompt deleveraging in the household sector, further limiting the pace of spending growth.

Overall, we expect the Eurozone to grow by an average of 1.5% or so per year in the medium term, around 0.8 percentage points slower than in the decade to 2007.

Deflation remains a risk

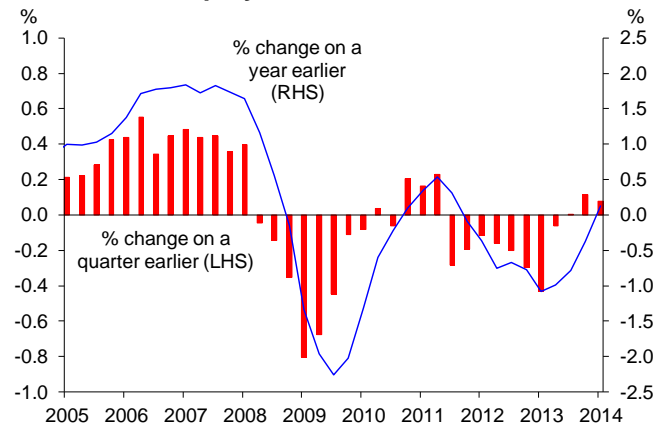
Given this and the current low rate of inflation, the Eurozone and, in particular, the peripheral economies are still at risk of experiencing a bout of deflation. Clearly, a prolonged period of falling prices and costs could have potentially serious knock-on implications on public and private sector balance sheets and activity.

Admittedly, in the near term at least, the risk of deflation has probably recently decreased a bit. After all, the ECB's recent actions have reduced both short and long-term interest rates. And while the response of the euro to the ECB's policy actions has probably been a bit disappointing for the Central Bank, the trade-weighted exchange rate is still about 2% below its recent high and we expect further falls over the coming quarters.

The fact that some of the disinflationary forces from food and energy prices and the exchange rate are more likely to ease rather than worsen suggests that inflation may gradually pick up from an average of about 0.7% this year to 1.3% in 2015.

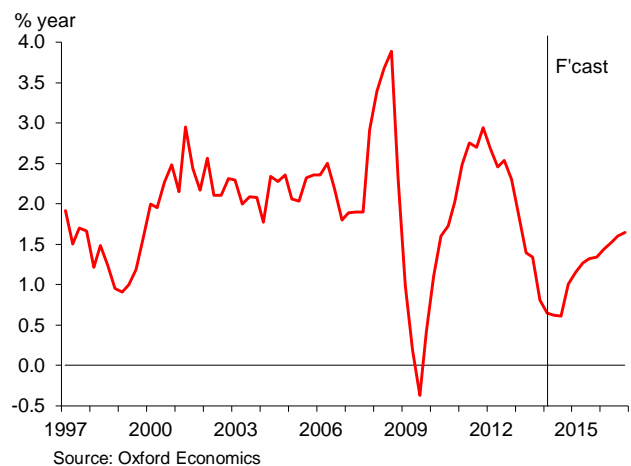
Given this and the fact that it may be at least another six months or so before the effects of the TLTROs are discernable, our central scenario remains that the ECB will not undertake quantitative easing. Nonetheless, we expect a long period of pretty weak inflation, implying that the ECB is unlikely to raise interest rates as soon as the Bank of England or the Fed.

Eurozone: Employment



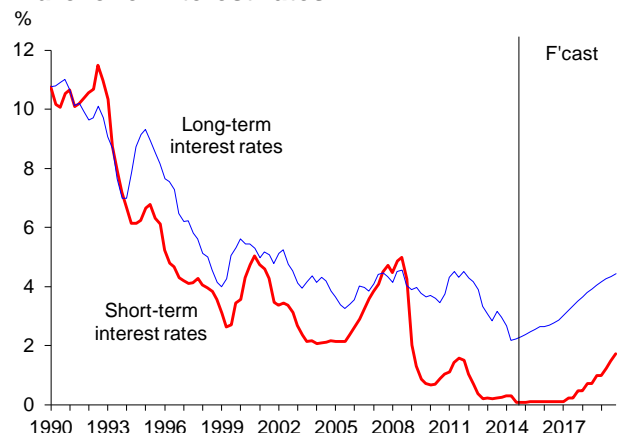
Source : Oxford Economics/Haver Analytics

Eurozone: Consumer price inflation



Source: Oxford Economics

Eurozone: Interest rates



Source: Oxford Economics



Long-Term Prospects

Very slow recovery from crises

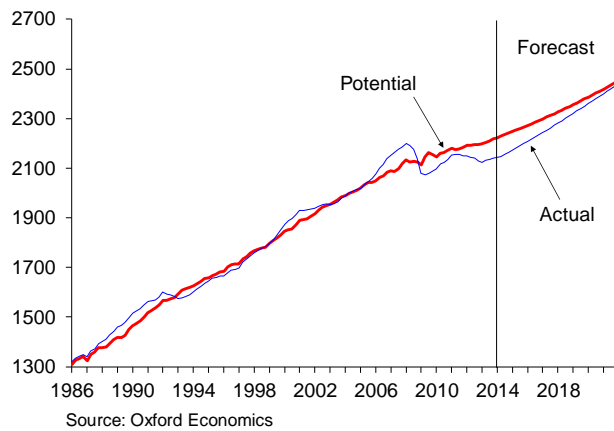
The global and Eurozone crises will leave their mark on growth for years to come. We estimate that the Eurozone's potential growth rate is only 1.2%. This compares with 1.3% in the past decade, itself significantly affected by the crisis, and 1.8% in the 10 years to 2008.

The slow restructuring of the banking sector means that credit availability will be limited for a long time, hindering investment and affecting the efficiency of capital allocation in the economy. Moreover, high unemployment for a prolonged period, especially among the young, will have long-lasting negative effects on skill levels and ability to work. Combined with a shrinking population of working age, despite increases in the retirement age, these factors imply that availability and quality of labour will be constrained compared with the pre-crisis period. These factors will only be partly offset by further increases in the participation rate.

Some of the reforms implemented in the peripheral countries should help raise the economy's productivity growth to at least what it was before 2008. But much more will be needed to offset other negative trends.

Eurozone: Actual & potential output

Euro bn 2005 prices



Potential GDP and Its Components Average Percentage Growth

	1999-2008	2008-2018
Potential GDP*	1.85	0.97
Employment at NAIRU	0.98	0.14
Capital Stock	2.13	1.22
Total Factor Productivity	0.47	0.46

$$*\ln(\text{Potential GDP})=0.65*\ln(\text{Employment at NAIRU})+0.35*\ln(\text{Capital Stock})+\ln(\text{Total Factor Productivity})$$

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	1.7	-0.1	0.9	1.5
Investment	3.5	-3.6	1.2	2.1
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	3.1	3.2
Unemployment (%)	8.7	9.7	11.3	9.7
Consumer Prices	2.2	2.1	1.3	1.6
Current Balance (% of GDP)	0.2	0.0	2.6	2.6
Exchange Rate (US\$ per Euro)	1.25	1.37	1.31	1.26
General Government Balance (% of GDP)	-2.1	-4.5	-2.1	-0.8
Short-term Interest Rates (%)	2.8	1.7	0.2	2.4
Long-term Interest Rates (%)	4.0	4.0	2.7	4.5
Working Population	0.4	0.1	0.0	-0.2
Labour Supply	1.0	0.4	0.0	0.0
Participation Ratio	74.3	75.7	76.0	76.8
Labour Productivity	1.0	0.1	0.9	1.3



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, Estonia the 17th in January 2011 and Latvia the 18th at the start of 2014.

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. 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, Slovenia 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 remain very high. Changes to the Eurozone's structure and institutions are likely to be slow and erratic.



Data & Forecasts

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)
Jun	-0.3	12.0	1.6	-0.7	-18.7	-3.0	-5.1	15.8
Jul	-1.8	11.9	1.6	-0.5	-17.3	3.2	0.5	18.2
Aug	-1.7	12.0	1.3	-0.2	-15.5	-5.7	-7.3	7.2
Sep	0.2	12.0	1.1	-0.2	-14.8	3.0	1.3	11.5
Oct	0.5	11.9	0.7	0.0	-14.4	1.4	-2.9	16.8
Nov	2.6	11.9	0.9	0.3	-15.3	-1.9	-4.9	17.1
Dec	1.5	11.8	0.8	0.3	-13.5	3.8	1.1	14.1
2014								
Jan	1.9	11.8	0.8	0.2	-11.7	1.2	-2.6	0.8
Feb	1.7	11.7	0.7	0.4	-12.7	3.4	0.3	14.4
Mar	0.4	11.7	0.5	0.4	-9.3	-0.6	2.8	16.7
Apr	1.1	11.6	0.7	0.3	-8.6	-1.5	-2.7	15.7
May	0.4	11.6	0.5	0.4	-7.1	-	-	-
Jun	-	-	0.5	0.2	-7.5	-	-	-

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
Jun	0.21	3.07	2.4	1.32	1.17	106.3	2603	-14.3
Jul	0.22	3.10	2.1	1.31	1.16	106.5	2768	6.9
Aug	0.23	3.10	2.3	1.33	1.16	107.2	2721	-0.3
Sep	0.22	3.41	2.0	1.33	1.19	106.7	2893	-19.3
Oct	0.23	3.16	1.4	1.36	1.18	107.8	3068	20.4
Nov	0.22	3.17	1.5	1.35	1.19	107.4	3087	-19.8
Dec	0.27	3.31	1.0	1.37	1.19	108.8	3109	-9.7
2014								
Jan	0.29	3.21	1.1	1.36	1.21	108.3	3014	-9.1
Feb	0.29	3.09	1.3	1.37	1.21	108.2	3149	30.8
Mar	0.31	2.89	1.0	1.38	1.20	109.1	3162	-22.7
Apr	0.33	2.61	0.7	1.38	1.21	108.7	3198	-18.6
May	0.32	2.55	1.0	1.37	1.23	107.8	3245	-
Jun	0.24	2.28	-	1.36	1.24	106.9	3228	-



EURO ZONE

TABLE 1 SUMMARY ITEMS

Annual Percentage Changes, Unless Otherwise Specified

	CONSUMERS EXPENDITURE	GROSS FIXED INVESTMENT	DOMESTIC DEMAND	REAL GDP	INDUSTRIAL PRODUCTION	UNEMPLOY- MENT RATE (%)	AVERAGE EARNINGS	WHOLE ECONOMY PRODUCT- IVITY (GDP/ET)	MONEY SUPPLY M3	PRODUCER PRICES	CONSUMER PRICES
	(C)	(IF)	(DOMD)	(GDP)	(IP)	(UP)	(ER)	(GDP/ET)	(MON)	(PPI)	(CPI)
YEARS BEGINNING Q1											
2012	-1.4	-3.8	-2.2	-0.6	-3.0	11.3	1.8	0.0	2.8	2.5	2.5
2013	-0.6	-2.8	-0.9	-0.4	-1.0	12.0	1.7	0.4	1.4	-0.4	1.3
2014	0.6	1.5	0.8	1.0	1.9	11.5	1.3	0.7	1.1	-1.2	0.7
2015	1.4	2.4	1.3	1.5	2.6	11.3	2.2	1.1	2.9	1.2	1.3
2016	1.4	2.5	1.4	1.6	2.2	11.1	2.6	1.1	3.4	1.8	1.5
2017	1.5	2.5	1.5	1.7	1.9	10.8	2.6	1.1	3.6	1.8	1.6
2012											
I	-1.2	-2.7	-1.7	-0.2	-2.6	10.8	2.2	0.2	3.0	3.4	2.7
II	-1.2	-3.8	-2.3	-0.5	-3.0	11.2	1.9	0.2	3.0	2.3	2.5
III	-1.6	-4.0	-2.4	-0.7	-2.9	11.4	1.9	0.0	2.5	2.4	2.5
IV	-1.4	-4.7	-2.3	-1.0	-3.5	11.7	1.4	-0.2	2.9	2.1	2.3
2013											
I	-1.4	-5.2	-2.0	-1.1	-2.8	12.0	1.7	-0.1	2.1	0.7	1.9
II	-0.7	-3.4	-1.3	-0.6	-1.4	12.0	1.6	0.4	1.7	-0.4	1.4
III	-0.4	-2.4	-0.4	-0.3	-1.1	12.0	1.7	0.5	1.5	-0.8	1.3
IV	0.1	-0.1	0.2	0.5	1.2	11.9	1.7	0.9	0.4	-1.2	0.8
2014											
I	0.4	1.9	0.7	0.9	2.2	11.8	1.3	0.8	0.8	-1.5	0.6
II	0.5	1.2	0.8	0.7	1.4	11.5	1.3	0.6	0.6	-1.2	0.6
III	0.7	1.5	0.7	1.0	1.9	11.4	1.2	0.7	1.3	-1.3	0.6
IV	0.9	1.4	1.1	1.2	2.1	11.4	1.6	0.9	1.9	-0.6	1.0
2015											
I	1.2	1.6	1.1	1.4	2.3	11.4	1.7	1.0	2.5	0.1	1.1
II	1.4	2.8	1.5	1.6	3.0	11.3	2.1	1.2	2.9	1.2	1.2
III	1.4	2.6	1.4	1.6	2.7	11.3	2.3	1.1	3.0	1.6	1.3
IV	1.5	2.5	1.3	1.6	2.6	11.3	2.5	1.1	3.2	1.8	1.3
2016											
I	1.4	2.5	1.4	1.6	2.4	11.2	2.5	1.2	3.3	1.8	1.4
II	1.4	2.6	1.4	1.6	2.3	11.1	2.6	1.1	3.4	1.8	1.5
III	1.4	2.5	1.4	1.6	2.2	11.1	2.6	1.1	3.5	1.8	1.6
IV	1.5	2.5	1.5	1.6	2.1	11.0	2.6	1.1	3.6	1.8	1.6
2017											
I	1.5	2.5	1.5	1.6	2.0	10.9	2.6	1.1	3.6	1.8	1.6
II	1.5	2.5	1.5	1.6	1.9	10.8	2.6	1.1	3.6	1.8	1.6
III	1.5	2.4	1.5	1.7	1.9	10.7	2.6	1.2	3.6	1.9	1.6
IV	1.4	2.4	1.5	1.7	1.9	10.6	2.5	1.2	3.5	1.9	1.5

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EURO ZONE

TABLE 2 SUMMARY ITEMS

	TRADE BALANCE (EURO BN)	CURRENT ACCOUNT (EURO BN)	CURRENT ACCOUNT (% OF GDP)	GOVERNMENT FINANCIAL BALANCE (EURO BN)	GOVERNMENT FINANCIAL BALANCE (% OF GDP)	SHORT-TERM INTEREST RATE	LONG-TERM INTEREST RATE	REAL SHORT-TERM INTEREST RATE (Note 1)	REAL LONG-TERM INTEREST RATE (Note 1)	US DOLLAR PER EURO (RXD)	EFFECTIVE RATE (1995=100)
	(BVI)	(BCU)	(BCU*100 /GDP)	(GB)	(GB*100 /GDP)	(RSH)	(RLG)	(Note 1)	(Note 1)	(RXD)	(RX)
YEARS BEGINNING Q1											
2012	86.5	138.6	1.46	-350.7	-3.69	0.57	3.92	-1.92	1.42	1.29	115.5
2013	158.8	230.2	2.40	-290.1	-3.02	0.22	3.00	-1.13	1.65	1.33	120.8
2014	186.4	261.3	2.67	-246.6	-2.52	0.22	2.32	-0.50	1.60	1.36	124.0
2015	200.2	272.5	2.70	-200.3	-1.99	0.15	2.44	-1.12	1.18	1.31	120.6
2016	212.4	277.5	2.67	-170.4	-1.64	0.15	2.72	-1.40	1.17	1.28	119.7
2017	226.8	283.8	2.64	-143.9	-1.34	0.29	3.23	-1.31	1.63	1.28	119.6
2012											
I	13.0	21.3	0.90	-91.6	-3.86	1.04	4.29	-1.64	1.61	1.31	116.9
II	18.6	32.9	1.39	-89.8	-3.78	0.69	4.17	-1.77	1.71	1.28	115.9
III	26.5	43.1	1.81	-86.8	-3.65	0.36	3.89	-2.18	1.35	1.25	113.3
IV	28.4	41.3	1.74	-82.5	-3.47	0.20	3.32	-2.11	1.02	1.30	115.8
2013											
I	38.4	52.2	2.19	-78.0	-3.27	0.21	3.06	-1.64	1.20	1.32	118.8
II	40.9	61.8	2.57	-74.0	-3.08	0.21	2.82	-1.19	1.43	1.31	119.2
III	35.7	49.9	2.07	-70.5	-2.93	0.22	3.15	-1.12	1.80	1.32	121.7
IV	43.7	66.3	2.75	-67.6	-2.80	0.24	2.97	-0.57	2.16	1.36	123.7
2014											
I	44.1	66.0	2.72	-66.2	-2.72	0.30	2.66	-0.35	2.01	1.37	125.6
II	46.0	70.4	2.89	-62.5	-2.56	0.30	2.18	-0.33	1.55	1.37	125.0
III	48.9	62.6	2.55	-60.9	-2.48	0.15	2.20	-0.45	1.60	1.35	123.3
IV	47.4	62.3	2.52	-57.1	-2.31	0.15	2.26	-0.66	1.25	1.33	122.2
2015											
I	53.3	80.8	3.24	-55.2	-2.22	0.15	2.33	-1.00	1.18	1.32	121.5
II	46.1	67.2	2.68	-50.6	-2.02	0.15	2.41	-1.10	1.16	1.31	120.8
III	50.6	61.2	2.42	-49.0	-1.94	0.15	2.47	-1.17	1.15	1.30	120.3
IV	50.2	63.2	2.48	-45.5	-1.78	0.15	2.55	-1.19	1.21	1.29	119.9
2016											
I	56.3	81.9	3.19	-46.5	-1.81	0.15	2.61	-1.29	1.17	1.29	119.8
II	49.0	68.1	2.63	-43.6	-1.68	0.15	2.67	-1.37	1.15	1.28	119.7
III	53.5	62.6	2.40	-42.1	-1.61	0.15	2.74	-1.45	1.15	1.28	119.6
IV	53.6	64.8	2.46	-38.1	-1.45	0.15	2.84	-1.49	1.20	1.28	119.6
2017											
I	59.8	82.5	3.11	-39.2	-1.48	0.15	2.98	-1.49	1.34	1.28	119.7
II	52.7	69.4	2.59	-36.5	-1.36	0.25	3.15	-1.38	1.52	1.28	119.7
III	57.1	65.0	2.41	-35.9	-1.33	0.25	3.33	-1.34	1.74	1.28	119.6
IV	57.2	66.9	2.46	-32.3	-1.19	0.50	3.47	-1.05	1.93	1.28	119.6

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

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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	-0.4	1.0	1.5	1.6	1.7	1.7	1.7	1.7	1.7	1.6	1.4
Consumption	0.8	-1.0	1.0	0.3	-1.4	-0.6	0.6	1.4	1.4	1.5	1.5	1.5	1.5	1.5	1.5	1.2
Investment	-0.1	-12.8	-0.6	1.7	-3.8	-2.8	1.5	2.4	2.5	2.5	2.4	2.2	2.1	2.0	1.9	1.6
Government Consumption	1.4	2.6	0.6	-0.1	-0.6	0.1	0.2	0.3	0.5	0.6	0.8	1.0	1.1	1.2	1.3	0.7
Exports of Goods and Services	3.7	-12.3	11.4	6.7	2.7	1.5	3.3	4.0	4.2	4.1	3.8	3.5	3.2	2.9	2.8	3.3
Imports of Goods and Services	3.3	-10.9	9.8	4.7	-0.8	0.4	3.3	3.9	4.1	4.0	3.8	3.5	3.2	2.9	2.7	3.2
Unemployment (%)	9.2	9.6	10.1	10.1	11.3	12.0	11.5	11.3	11.1	10.8	10.4	10.0	9.7	9.3	9.0	10.5
Consumer Prices	2.1	0.3	1.6	2.7	2.5	1.3	0.7	1.3	1.5	1.6	1.5	1.6	1.6	1.7	1.8	1.5
Current Balance (% of GDP)	0.1	-0.2	0.1	0.1	1.5	2.4	2.7	2.7	2.7	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Exchange Rate (US\$ per Euro)	1.31	1.39	1.33	1.39	1.28	1.33	1.36	1.31	1.28	1.28	1.27	1.27	1.26	1.26	1.25	1.29
General Government Balance (% of GDP)	-3.3	-6.3	-6.2	-4.1	-3.7	-3.0	-2.5	-2.0	-1.7	-1.4	-1.1	-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	0.2	0.2	0.2	0.3	0.8	1.4	2.4	3.4	4.0	1.3
Long-term Interest Rates (%)	4.0	3.8	3.6	4.4	3.9	3.0	2.3	2.4	2.7	3.2	3.8	4.3	4.6	4.8	5.0	3.6
Working Population	0.3	0.0	0.0	0.0	0.2	0.1	0.0	0.0	0.0	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.1
Labour Supply	0.7	0.2	0.1	0.3	0.7	-0.1	-0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.0	-0.1	0.0
Participation Ratio (%)	75.0	75.5	75.6	75.8	76.1	76.0	75.8	75.9	76.1	76.3	76.4	76.6	76.8	76.9	77.1	76.4
Labour productivity	0.6	-2.6	2.4	1.3	0.0	0.4	0.7	1.1	1.1	1.1	1.2	1.2	1.3	1.3	1.3	1.1
Employment	0.4	-1.9	-0.5	0.3	-0.6	-0.8	0.2	0.4	0.5	0.5	0.5	0.5	0.4	0.4	0.3	0.3
Output gap (% of potential GDP)	-0.1	-3.0	-1.9	-1.2	-2.4	-3.4	-3.6	-3.2	-2.7	-2.2	-1.7	-1.3	-1.0	-0.7	-0.4	-2.0



Key Facts

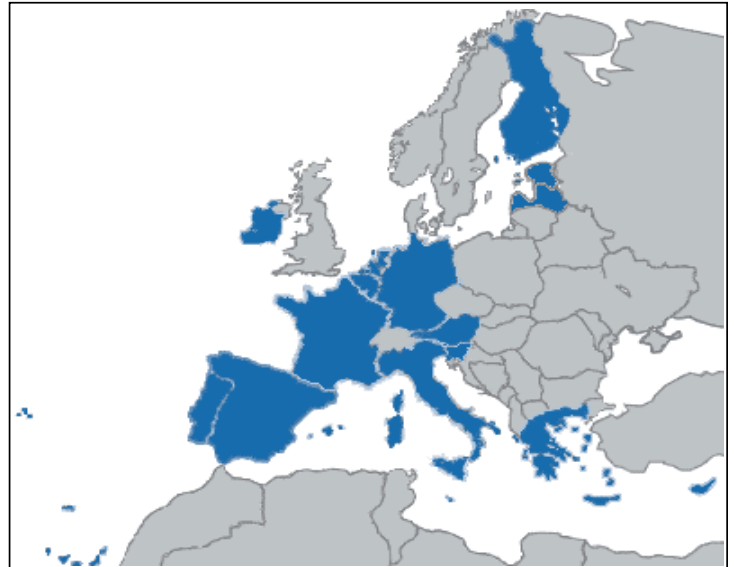
Politics

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

Long-term economic & social development

	1980	1990	2000	2012*
GDP per capita (US\$)	-	18088	19881	36678
Inflation (%)	9.9	4.2	2.2	2.5
Population (mn)	287	305	315	332
Urban population (% of total)	69.7	70.9	72.4	75.8
Life expectancy (years)	73.6	76.0	78.3	81.3

Source : Oxford Economics & World Bank



Source : ECB

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

Structure of GDP by output

	2010
Agriculture	1.6%
Industry	26.3%
Services	72.0%

Source : WDI

* 2012 or latest available year

Corruption perceptions index 2013

	Score
Developed economies (average)	74.5
Emerging economies (average)	37.3
Eurozone	66.5

Source: Transparency International

Scoring system 100 = highly clean, 0 = highly corrupt

Structural economic indicators

	1990	1995	2000	2012*
Current account (US\$ billion)	10	54	-95	178
Trade balance (US\$ billion)	-23	63	-27	106
FDI (US\$ billion)	-	-	-25	-97
Govt budget (% of GDP)	-4.1	-7.5	-0.1	-3.7
Govt debt (% of GDP)	13.5	67.4	67.1	91.4
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	9611

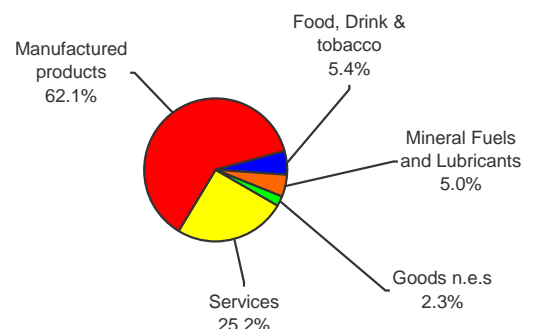
Source : Oxford Economics / World Bank / EIA / ECB

Destination of goods' exports (2012)

Eurozone	46.3%
UK	6.6%
US	6.4%
China	3.4%
Switzerland	3.3%
Poland	2.6%

Source : Eurostat \ Haver Analytics

Composition of extra-EMU goods & services exports, 2012



Source : Eurostat \ Haver Analytics