Eurozone

Highlights

- There are encouraging signs that the Eurozone economy is starting to stabilise. Industrial production rebounded in April after a poor Q1 and the May manufacturing PMI was up to its highest level for 15 months. The improvements in manufacturing conditions were particularly significant in the peripherals, although they remained in contractionary territory.
- This supports our view that Eurozone GDP will stop falling and start to grow in 2013H2, albeit very slowly. We forecast a fall of 0.6% in GDP this year.
- The European Commission's (EC) country-specific assessment of fiscal policy and structural reforms provides further support for our forecast. These reports, published at the end of May, are in line with our view that fiscal policy will be allowed to be relaxed from 2014. A number of countries have been given more time to reduce their deficits to 3% of GDP and instead the EC has emphasised the need to make progress with structural reforms. We had anticipated this move and had already assumed less stringent austerity in the forecast.
- One disappointment relates to the ECB's likely monetary policy measures. At its early June press conference, the ECB downplayed any plans to foster lending to small and medium-sized enterprises (SMEs). Instead, the ECB seemed to focus on cleaning up banks' balance sheets. Whilst necessary in the medium term, this effort to restructure the banking sector could be damaging to growth in the short term.

Forecast for Eurozone
(Annual percentage changes unless specified)

	2012	2013	2014	2015	2016	2017
Domestic Demand	-2.2	-1.3	0.7	1.4	1.5	1.5
Private Consumption	-1.3	-0.8	0.5	1.1	1.3	1.5
Fixed Investment	-3.9	-3.0	2.1	2.9	2.7	2.6
Government Consumption	-0.3	-0.6	-0.3	0.3	0.6	0.8
Net exports (% of GDP)	4.3	5.0	5.2	5.3	5.4	5.5
GDP	-0.5	-0.6	0.9	1.4	1.5	1.6
Industrial Production	-2.9	-0.7	1.9	2.4	2.2	2.0
Consumer Prices	2.5	1.5	1.4	1.4	1.4	1.4
Current Account (% of GDP)	1.3	1.7	1.7	1.5	1.5	1.5
Government Budget (% of GDP)	-3.7	-2.8	-2.4	-1.9	-1.5	-1.2
Short-Term Interest rate (%)	0.6	0.2	0.3	0.3	0.3	0.6
Long-Term Interest Rates (%)	4.0	3.0	3.1	3.3	3.6	4.0
Exchange rate (US$ per Euro)	1.28	1.30	1.21	1.17	1.17	1.17
Exchange rate (YEN per Euro)	102.5	125.9	127.5	131.6	132.3	129.8

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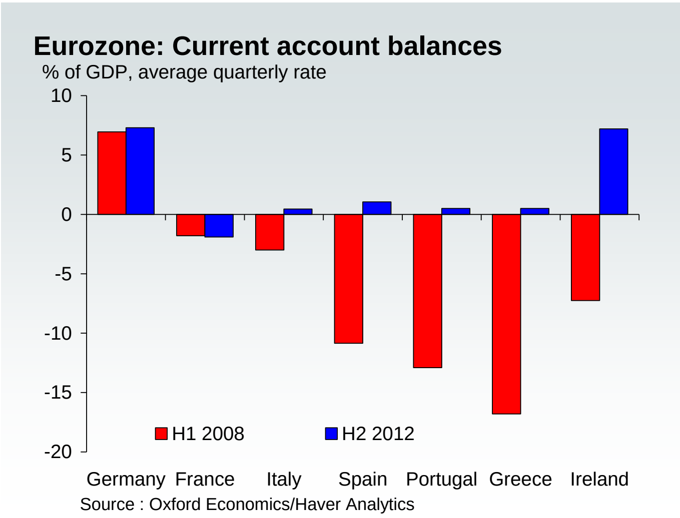
Special Focus: Fragile Eurozone external balance improvements

One of the more positive developments in the Eurozone in recent years has been the improvement of external balances. The Eurozone as a whole has moved decisively into an unprecedentedly-wide current account surplus. Much of the surplus comes from the peripheral countries. But while this is partly because exports have risen as competitiveness has improved, it is mostly due to falling imports, highlighting the fragility of this improvement.

Eurozone current account balances have improved…



One of the few surprising and positive developments in the Eurozone in recent years has been the improvement in current account balances since the financial crisis and the Eurozone sovereign debt crises began. For the Eurozone as a whole, this means that the current account balance, which for the past 20 years has oscillated in a fairly narrow band between -1.5% and +1% of GDP, in the last few years has broken out of this range on the upside, reaching a high of 2.3% of GDP in 2013Q1. This is good news in that if the Eurozone as a whole has a surplus of savings over investment (which is what the current account shows), its domestic sectors can run a financial surplus as well. Because sectoral financial balances are a zero-sum game, a Eurozone current account surplus is needed to allow domestic sectors to deleverage.

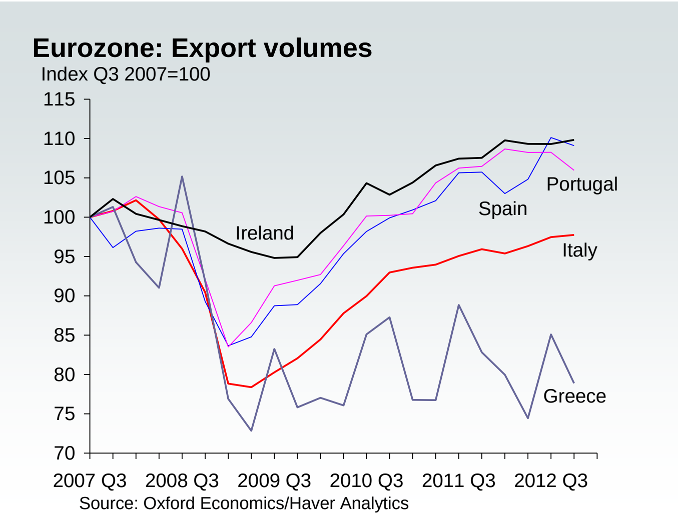
…driven by surpluses in peripheral countries

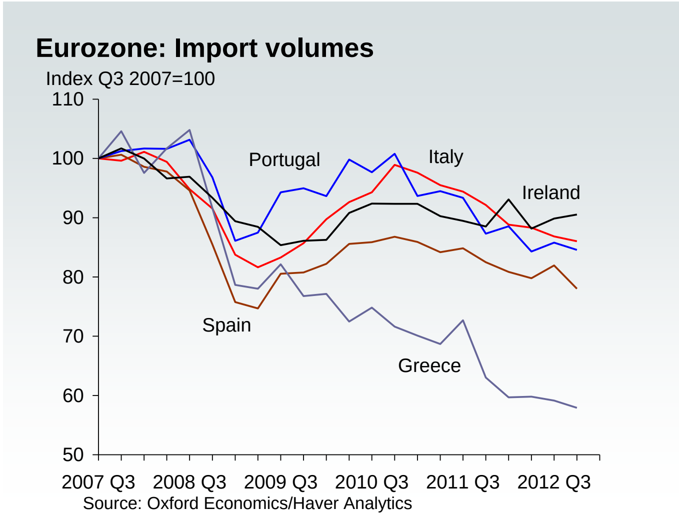
But what is perhaps more interesting is what is driving this improvement. That Germany continues to run a current account surplus is perhaps not surprising. In fact, given the internal Eurozone imbalances between savers and spenders, this is more of a problem than a benefit. Moreover, the German current account surplus, at 7% of GDP in 2013Q1, is if anything too large. Traditionally, it has been felt that a current account surplus in excess of 5% of GDP in a non-commodity exporter is destabilising and a sign of excess export dependence. The German current account surplus has consistently exceeded this level since 2009Q2.

But it is the improvement in the distressed periphery countries which is surprising. From large current account deficits (averaging an unweighted 10.6% of GDP) in 2008H1, Italy, Spain, Portugal and Greece all showed small surpluses by 2012H2. Ireland went from a current account deficit of over 7% to a surplus of a similar size. This contrasts favourably with France where the current account deficit widened over the period, and with developments in export-dependent economies such as Belgium and Finland.

Thanks to strong exports…

The most important factors behind these changes are trade developments. However, the picture is slightly more complicated than that. We can – somewhat arbitrarily – date the beginning of the financial crisis to August 2007, when BNP Paribas halted withdrawals from three of its hedge funds due to the drying up of liquidity. Using trade data from the national accounts to capture the volume change in both goods and services, we find that Spain, Portugal and Ireland saw their exports grow by between 6% and 10% from 2007Q3 to 2012Q4. That is not quite up to Germany's 13% growth over the same period, but it is close enough. By contrast, Italian exports were minimally down over the period and those of Greece were down by one-fifth.





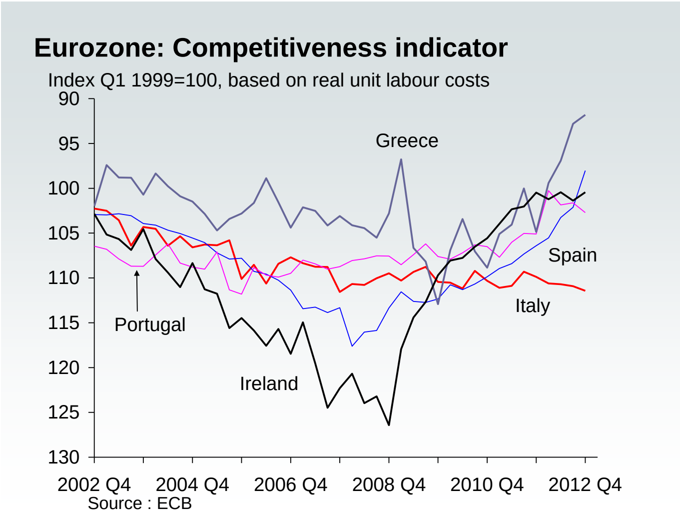
…but even more to collapsing imports

Even in the countries where exports grew, this is not enough to explain the improved balance of payments position. A key part of the explanation therefore comes from the import side. In every case, these countries have seen their imports tumble since 2007, by as little as 9% in Ireland to as much as 42% in Greece. Worryingly, this trend seems to be continuing.

Looking at the data in constant Euro terms, Ireland is the only distressed country where exports have risen by more than imports have fallen since 2007Q3. At the end of last year, Irish exports were €3.9bn higher than in mid-2007, while imports were €3.21bn lower. By contrast, while Spanish exports were up €6.8bn, imports fell by €21bn. Portuguese exports rose €1bn but imports were down €2.8bn. In Italy and Greece both exports and imports fell, but the fall in exports (down €2.6bn in Italy and €2.5bn in Greece) was smaller than the fall in imports (€15.4bn and €7.9bn respectively).

Competitiveness needs to improve further

The obvious concern here is that while external balances improve if imports collapse, (and rising exports obviously help) this is not the same as a lasting improvement in competitiveness. The ECB's harmonised competitiveness indicator shows that competitiveness improved in real terms from 2009 onwards in Spain, Portugal, Greece and Ireland, but not in Italy. Much of the improvement in competitiveness is related to job cuts, which is not sustainable. Unemployment is already a major social concern and it is not clear whether these countries can simultaneously raise employment and improve productivity.



Since early 2012, Irish and Portuguese competitiveness has stopped improving, and in Italy it is deteriorating. At some stage, domestic demand in these countries will pick up, and their external balances will deteriorate again (although we expect competitiveness to improve too, helping to offset this).

Moreover, as ECB President Mario Draghi noted at his press conference on 6 June, countries that do not improve their competitiveness are eventually likely to be punished by markets. This is more serious as much of the increase in distressed country exports is to countries outside the Eurozone (as can also be deduced from the wider Eurozone balance of payments surplus). A Eurozone recovery, accompanied by a stronger euro, is therefore a further threat to the prospects of the crisis countries.

In spite of the very welcome improvement in some Eurozone countries' current account balances, therefore, their outlook remains fragile. In particular, much remains to be done to improve competitiveness and to implement structural reforms. The risk is that the easing of austerity policies – which has already begun – coupled with a more benign global environment and further improving external balances will lead to the postponement of unpopular measures.

Risks on the upside and on the downside

Our central forecast is for the Italian current account to remain in a minimal surplus (less than 0.5% of GDP) until 2015 and then move back into deficit. For the smaller economies – Spain, Portugal, Greece and Ireland – the baseline scenario envisages little change over the next few years. This is also true for the Eurozone as a whole, where the current account surplus is forecast to oscillate around 1.5% of GDP.

However, the developments outlined in this analysis contain both an upside and a downside risk to this forecast. The Eurozone – again as noted by President Draghi on 6 June – needs outside help to return to growth. The upside risk is that, if the rest of the world recovers more rapidly, the Eurozone current account surplus – and those of some of its members – will widen well beyond our baseline scenario. The downside risk is that this is neither a stable nor a steady state. Because the weak domestic demand in the distressed countries is a major cause of the external balance improvements, any favourable development in that demand is also likely to lead to a quick reversal in the external improvement.

Forecast Overview

Some signs of stabilisation

- There are some encouraging signs that the Eurozone economy may be starting to stabilise. Industrial production rose in April by 0.4% after a poor Q1, with notable improvements in Germany and France. Moreover, the manufacturing PMI rose to its highest level for 15 months in May. The improvement in manufacturing conditions was particularly significant in the peripheral countries, suggesting that their competitiveness gains are starting to bear fruit. Spain's and Greece's manufacturing PMIs reached 24-month and 23-month highs in May respectively.

- This supports our view that Eurozone GDP will stop falling and start to grow in 2013H2, albeit very slowly. We forecast that GDP will shrink 0.6% this year.

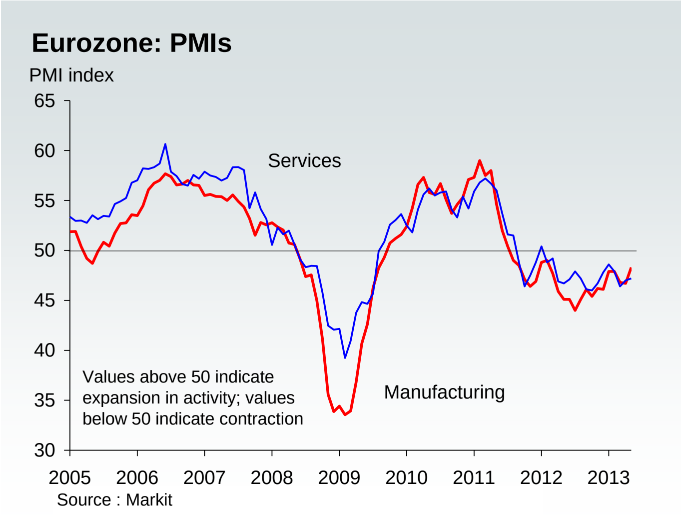
Less severe austerity sanctioned

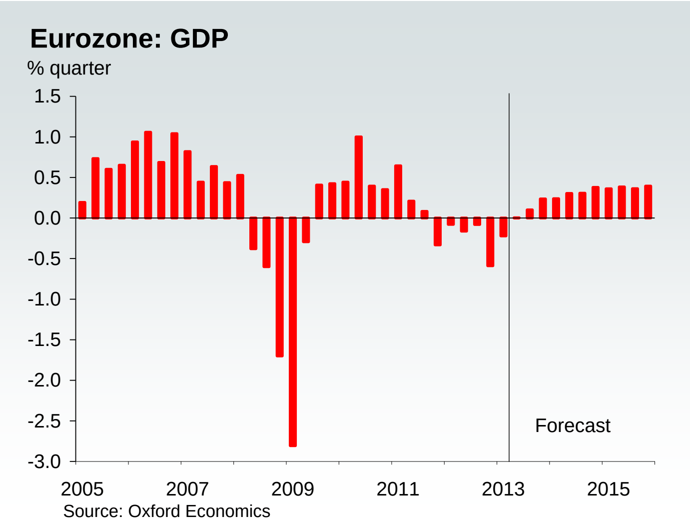
- The European Commission's (EC) latest country-specific assessment provides further support for our forecasts in that they suggest that fiscal policy will be allowed to be relaxed from 2014. A number of countries have been given more time to reduce their deficits to 3% of GDP and, instead, the EC emphasised the need for countries to make progress with structural reforms.

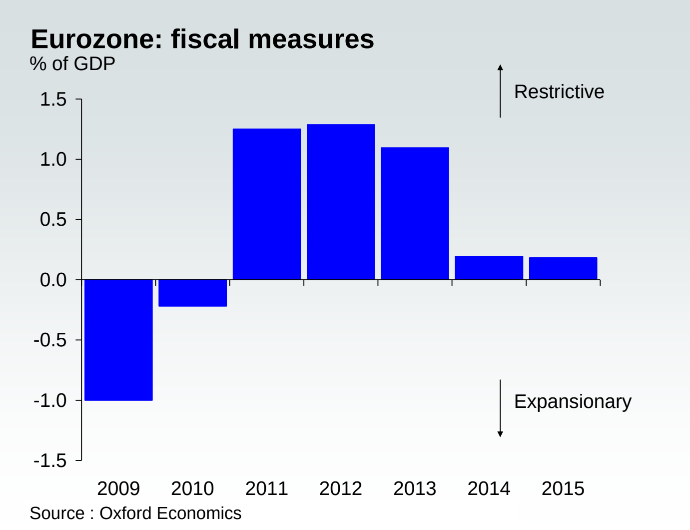
- We had anticipated this move and had already assumed less stringent austerity in the forecast period. Compared with a fiscal tightening of more than 1% of GDP this year, based on the measures that have been announced so far, aggregate fiscal tightening may be reduced to only 0.2% of GDP in 2014 and 2015. This is a major factor accounting for the improved growth outlook from 2014 onwards.

But monetary easing on back burner

- However, there has been disappointment regarding the ECB's likely monetary policy measures. At its press conference in early June, the ECB downplayed any plans to foster lending to small and medium-sized enterprises (SMEs). Instead, the ECB now seems to be focused on cleaning up banks' balance sheets. Whilst necessary in the medium term, this effort to restructure the banking sector could be damaging to growth in the short term.







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Reforms needed to avoid lost decade

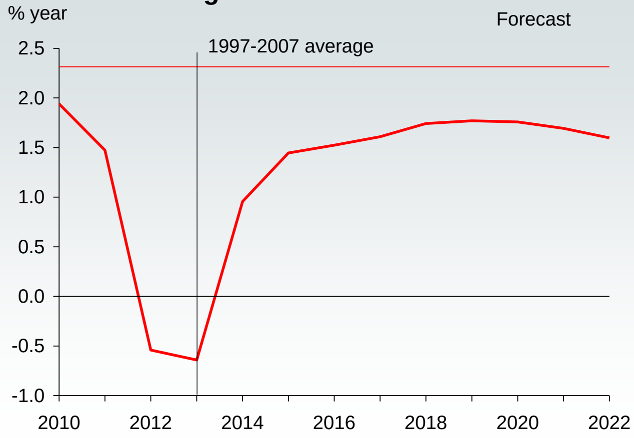
- We continue to think that the recovery from 2014 onwards will be very slow. Already some months ago, we described the Eurozone outlook as a 'lost decade'. We maintain this view. GDP growth is forecast at only 0.9% next year. Between 2015 and 2020, annual GDP growth is not expected to exceed 1.8%. The key factors that will dampen the pace of recovery for several years include ongoing fiscal tightening, deleveraging in the private sector and the long-term impact of high unemployment rates:

Decade-long fiscal tightening – whilst 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. The one measure that would help overcome this is a relaxation of fiscal policy in Germany. But when Chancellor Merkel proposed to increase spending a few weeks ago, she was met with a barrage of negative responses from within Germany. Nothing specific or credible will be announced before the September general elections.

Private sector deleveraging yet to start – 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.

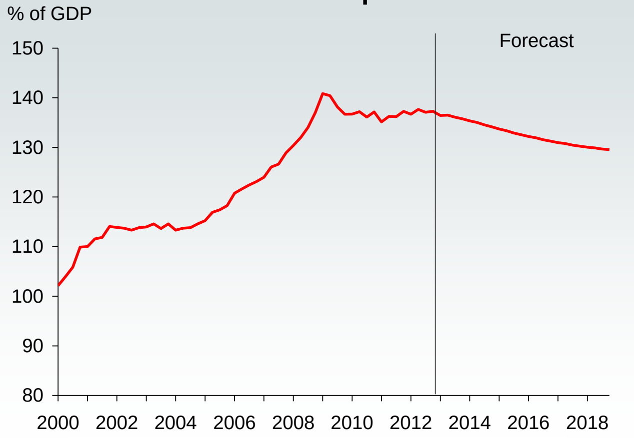
Lost generation – unemployment represents the main risk factor to the Eurozone's survival. The number of unemployed will likely reach 20 million in 2013H2, more than 3.5 million of which are under 25. The share of long-term (more than one year) unemployed has risen from 33% in early 2009 to 47.9% in 2012Q4. This means that governments will continue to face stiff protests against fiscal consolidation and other reforms that would cost jobs in the short term. These developments also raise concerns about a 'lost generation', whereby new entrants in the labour market do not get the necessary experience to gain the flexibillity to find new jobs and become tomorrow's managers. Eurozone governments have rightly made youth unemployment the focus of the next summit. But little is expected in terms of concrete and effective measures.

Eurozone GDP growth



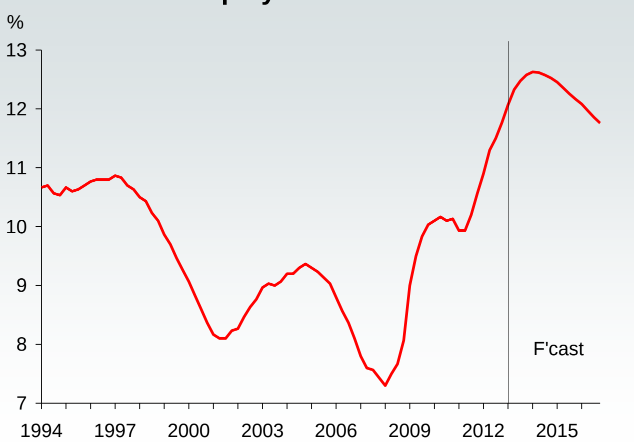
Source : Oxford Economics

Eurozone: non-financial corporate debt



Source : Oxford Economics/ ECB

Eurozone: Unemployment



Source: Oxford Economics

Key Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

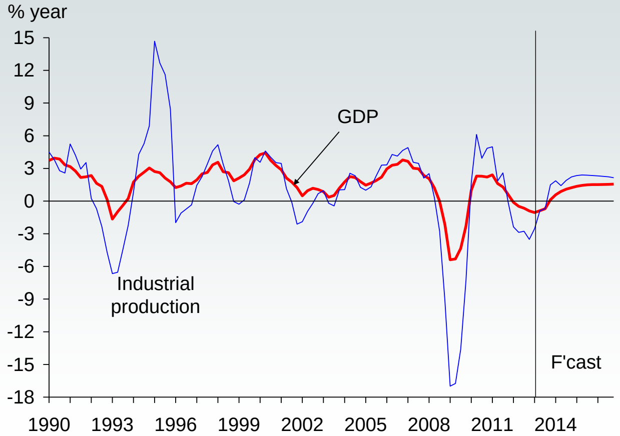
	Industrial production (% yr)	Unemploy-ment (% point)	CPI (% yr)	Business confidence (% balance)	Consumer confidence (% balance)	Exports (% yr)	Imports (% yr)	Trade balance (€ bn)
May	-2.3	11.3	2.4	-0.7	-19.1	6.3	0.9	6.6
Jun	-1.9	11.4	2.4	-0.8	-19.6	12.1	3.0	12.9
Jul	-2.5	11.4	2.4	-1.2	-21.3	11.2	3.1	13.8
Aug	-2.2	11.5	2.6	-1.1	-24.4	10.5	2.6	4.6
Sep	-2.7	11.6	2.6	-1.2	-25.7	1.2	-3.9	8.6
Oct	-3.1	11.7	2.5	-1.5	-25.5	14.6	7.5	9.2
Nov	-3.8	11.8	2.2	-1.1	-26.7	5.6	0.0	13.2
Dec	-2.4	11.8	2.2	-1.0	-26.3	-3.0	-5.4	10.4
2013								
Jan	-2.7	12.0	2.0	-1.0	-23.9	5.2	1.9	-4.9
Feb	-2.9	12.1	1.8	-0.7	-23.6	-1.1	-7.1	10.1
Mar	-1.6	12.1	1.7	-0.8	-23.5	0.1	-10.0	22.9
Apr	-0.6	12.2	1.2	-1.0	-22.3	-	-	-
May	-	-	1.4	-0.8	-21.9	-	-	-

Financial Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

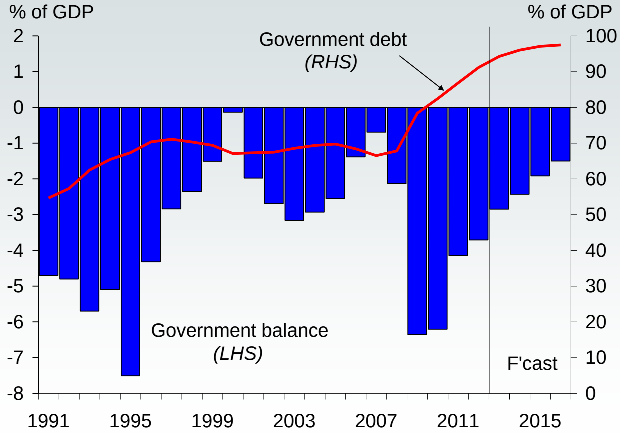
	Short rate %	Long rate %	Money Supply (M3)	Exchange rate $/€ avg.	Exchange rate €/£	Nominal effective exch. rate	Share price DJ STOXX	Net FDI € bn
May	0.68	3.53	2.9	1.28	1.24	100.8	2119	3.5
Jun	0.66	3.41	2.9	1.25	1.24	99.7	2265	-16.1
Jul	0.50	3.25	3.5	1.23	1.27	97.6	2326	2.5
Aug	0.33	3.01	2.7	1.24	1.27	97.7	2441	12.6
Sep	0.25	2.43	2.7	1.29	1.25	99.9	2454	-20.0
Oct	0.21	2.31	3.9	1.30	1.24	100.8	2504	-15.1
Nov	0.19	2.25	3.7	1.28	1.24	100.3	2575	21.4
Dec	0.19	2.10	3.5	1.31	1.23	102.0	2636	-27.6
2013								
Jan	0.20	2.40	3.5	1.33	1.20	104.2	2703	-8.3
Feb	0.22	2.86	3.1	1.34	1.16	106.0	2634	-2.4
Mar	0.21	3.03	2.6	1.30	1.16	104.5	2624	-14.4
Apr	0.21	2.86	3.2	1.30	1.18	105.0	2712	-
May	0.20	2.69	-	1.30	1.18	105.5	2770	-

Eurozone: GDP and industrial production



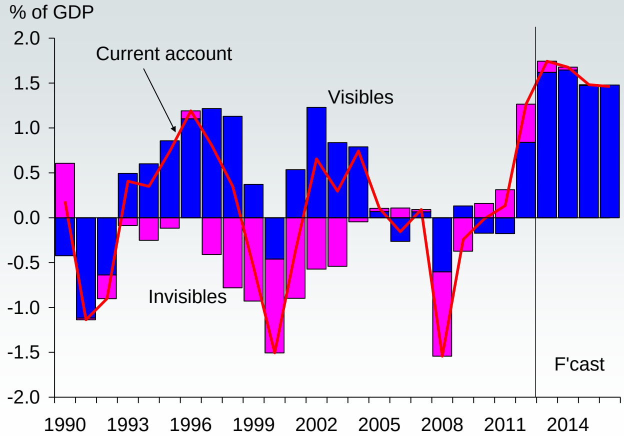
Source: Oxford Economics

Eurozone: Government finances



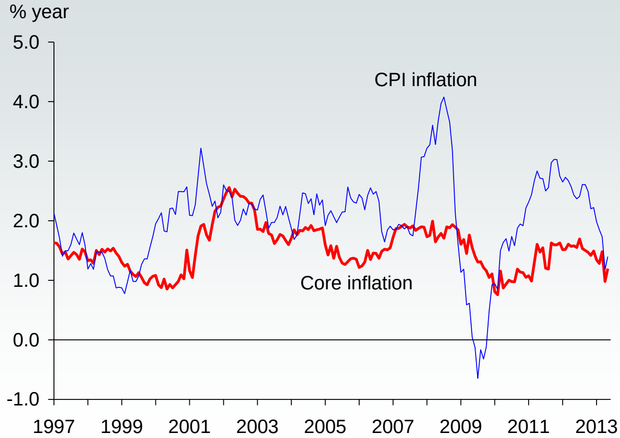
Source: Oxford Economics

Eurozone: Current account



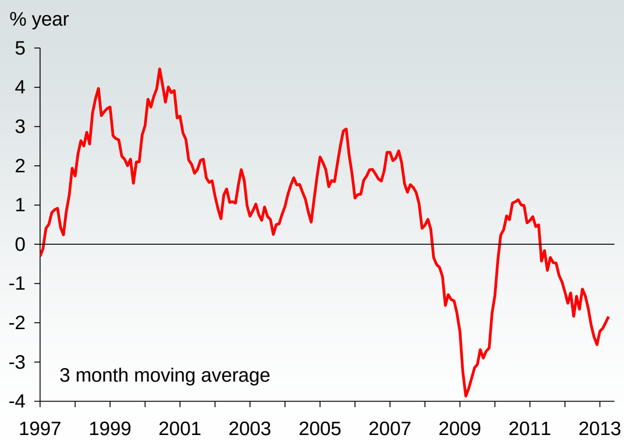
Source: Oxford Economics

Eurozone: Headline Inflation



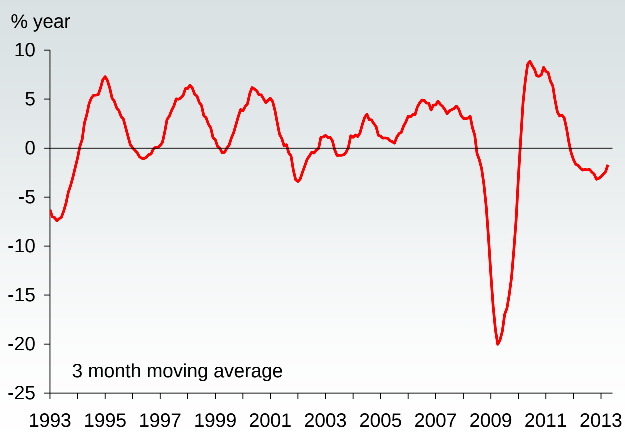
Source: Eurostat

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	-1.3	-3.9	-2.2	-0.5	-2.9	11.4	1.7	0.1	2.7	2.6	2.5
2013	-0.8	-3.0	-1.3	-0.6	-0.7	12.3	1.1	0.5	1.4	0.2	1.5
2014	0.5	2.1	0.7	0.9	1.9	12.6	1.7	1.1	2.0	1.5	1.4
2015	1.1	2.9	1.4	1.5	2.4	12.3	2.1	1.2	3.2	2.1	1.4
2016	1.3	2.7	1.5	1.5	2.2	11.9	2.3	1.2	3.6	1.9	1.4
2017	1.5	2.6	1.5	1.6	2.0	11.5	2.5	1.3	3.6	1.8	1.4
2012											
I	-1.1	-2.5	-1.6	-0.1	-2.4	10.9	2.0	0.3	2.9	3.6	2.7
II	-1.2	-3.9	-2.3	-0.5	-2.9	11.3	1.8	0.3	2.9	2.4	2.5
III	-1.6	-4.3	-2.5	-0.7	-2.8	11.5	1.7	-0.1	2.4	2.4	2.5
IV	-1.4	-4.9	-2.3	-0.9	-3.5	11.8	1.3	-0.2	2.8	2.1	2.3
2013											
I	-1.3	-5.3	-2.2	-1.0	-2.5	12.1	1.2	0.0	2.3	0.8	1.9
II	-0.9	-3.3	-1.6	-0.9	-0.9	12.3	0.9	0.3	1.4	-0.1	1.3
III	-0.7	-2.4	-1.1	-0.7	-0.7	12.4	1.0	0.5	1.4	-0.1	1.3
IV	-0.1	-0.8	-0.3	0.1	1.5	12.5	1.2	1.1	0.7	0.2	1.4
2014											
I	0.1	1.5	0.3	0.6	1.9	12.6	1.4	1.0	1.1	0.4	1.5
II	0.5	1.9	0.6	0.9	1.4	12.6	1.6	1.1	1.9	1.6	1.5
III	0.7	2.4	0.9	1.1	1.9	12.5	1.8	1.2	2.3	1.8	1.4
IV	0.8	2.7	1.1	1.2	2.2	12.5	1.9	1.2	2.6	2.1	1.4
2015											
I	1.0	2.9	1.2	1.4	2.3	12.4	1.9	1.2	3.0	2.2	1.4
II	1.1	2.9	1.3	1.4	2.4	12.3	2.0	1.2	3.2	2.1	1.4
III	1.1	2.9	1.4	1.5	2.4	12.2	2.1	1.2	3.4	2.0	1.4
IV	1.2	2.8	1.5	1.5	2.3	12.1	2.2	1.2	3.5	2.0	1.4
2016											
I	1.2	2.8	1.5	1.5	2.3	12.0	2.2	1.2	3.5	1.9	1.4
II	1.3	2.8	1.5	1.5	2.3	11.9	2.3	1.2	3.6	1.9	1.4
III	1.3	2.7	1.5	1.5	2.2	11.8	2.3	1.2	3.6	1.9	1.4
IV	1.4	2.7	1.5	1.6	2.1	11.7	2.4	1.2	3.7	1.9	1.4
2017											
I	1.4	2.6	1.5	1.6	2.1	11.6	2.4	1.3	3.7	1.8	1.4
II	1.5	2.6	1.5	1.6	2.0	11.5	2.5	1.3	3.7	1.8	1.4
III	1.5	2.6	1.5	1.6	1.9	11.4	2.5	1.3	3.6	1.8	1.4
IV	1.5	2.5	1.5	1.7	1.9	11.3	2.6	1.3	3.6	1.8	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	79.6	120.0	1.27	-351.8	-3.71	0.57	4.02	-1.92	1.52	1.29	115.5
2013	154.9	166.7	1.74	-272.1	-2.85	0.22	3.02	-1.26	1.55	1.30	118.9
2014	160.9	164.0	1.68	-237.6	-2.43	0.26	3.10	-1.18	1.66	1.21	115.8
2015	148.4	149.1	1.48	-192.8	-1.92	0.31	3.29	-1.09	1.89	1.17	112.6
2016	153.3	151.5	1.46	-155.7	-1.50	0.34	3.65	-1.04	2.27	1.17	111.7
2017	167.1	159.9	1.50	-126.6	-1.18	0.56	4.03	-0.88	2.59	1.17	111.1
2012											
I	9.3	20.8	0.88	-91.5	-3.87	1.04	4.39	-1.64	1.70	1.31	116.9
II	17.9	28.2	1.19	-89.0	-3.75	0.69	4.27	-1.76	1.82	1.28	115.9
III	25.1	34.8	1.46	-86.7	-3.64	0.36	3.99	-2.18	1.45	1.25	113.4
IV	27.3	36.2	1.53	-84.6	-3.57	0.20	3.41	-2.11	1.10	1.30	115.9
2013											
I	40.6	55.8	2.34	-67.9	-2.85	0.21	3.14	-1.64	1.28	1.32	118.8
II	36.2	39.1	1.64	-72.5	-3.04	0.21	2.85	-1.11	1.53	1.31	119.3
III	39.0	38.7	1.62	-69.7	-2.92	0.22	3.03	-1.13	1.68	1.29	118.9
IV	39.2	33.1	1.38	-62.0	-2.58	0.23	3.06	-1.15	1.69	1.27	118.5
2014											
I	47.9	66.3	2.74	-62.4	-2.58	0.24	3.08	-1.22	1.62	1.25	117.7
II	38.3	38.7	1.59	-63.5	-2.61	0.26	3.06	-1.24	1.57	1.22	116.2
III	38.2	34.2	1.40	-59.9	-2.44	0.27	3.10	-1.15	1.68	1.20	115.2
IV	36.5	24.8	1.00	-51.9	-2.10	0.28	3.16	-1.13	1.75	1.19	114.3
2015											
I	44.6	61.4	2.47	-49.6	-1.99	0.29	3.19	-1.12	1.78	1.17	113.1
II	34.6	34.0	1.36	-52.2	-2.08	0.30	3.25	-1.10	1.85	1.17	112.6
III	34.6	30.7	1.22	-50.0	-1.98	0.31	3.31	-1.08	1.92	1.17	112.5
IV	34.6	23.0	0.91	-41.0	-1.61	0.32	3.39	-1.06	2.02	1.17	112.1
2016											
I	44.4	61.1	2.38	-39.8	-1.55	0.33	3.49	-1.04	2.13	1.17	111.8
II	35.4	34.3	1.33	-42.8	-1.66	0.34	3.60	-1.04	2.22	1.17	111.8
III	36.4	31.7	1.22	-41.0	-1.58	0.35	3.70	-1.04	2.32	1.17	111.7
IV	37.1	24.4	0.93	-32.0	-1.22	0.35	3.80	-1.05	2.40	1.17	111.5
2017											
I	47.3	62.4	2.36	-31.4	-1.19	0.36	3.89	-1.05	2.48	1.17	111.3
II	38.4	36.0	1.35	-35.1	-1.32	0.37	3.98	-1.06	2.55	1.17	111.1
III	40.1	34.2	1.27	-34.3	-1.28	0.63	4.07	-0.82	2.62	1.17	111.0
IV	41.4	27.3	1.01	-25.8	-0.95	0.88	4.16	-0.58	2.70	1.17	111.0

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

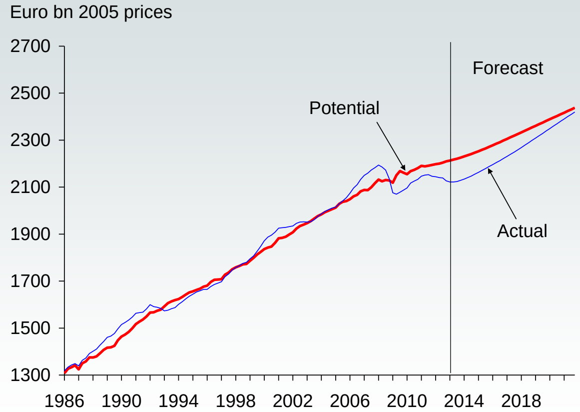
Potential output growth 1.1%pa

- 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 0.6% in 2013, having shrunk by 0.5% in 2012 and to be slightly below potential growth at 0.9% in 2014. As a result, the large output gap of 3.0% in 2012 will expand in 2013 to 4.4% and decrease in 2014 to 4.3%, 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 0.06%pt detraction from shrinking labour usage reflects the 0.4%pa fall in the working population over the next ten years and an increase in the participation rate which combine to reduce the labour supply by 0.1%pa. For the capital stock's contribution of 0.5%pt, the main factor is significantly higher investment growth (at 1.8%pa) than in the previous decade. Finally, total factor productivity growth's slightly higher contribution of 0.6%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*	1.35	1.08
Employment at NAIRU	0.65	-0.10
Capital Stock	1.97	1.47
Total Factor Productivity	0.24	0.63

*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	1.0	1.7
Consumption	1.6	-0.2	0.7	1.5
Investment	3.4	-3.5	1.4	2.1
Government Consumption	1.8	1.0	0.2	1.2
Exports of Goods and Services	5.9	1.4	3.2	3.1
Imports of Goods and Services	6.2	0.3	2.9	3.1
Unemployment (%)	8.7	9.8	12.1	10.2
Consumer Prices	2.2	2.1	1.4	1.7
Current Balance (% of GDP)	0.2	-0.1	1.6	1.6
Exchange Rate (US$ per Euro)	1.25	1.37	1.20	1.19
General Government Balance (% of GDP)	-2.1	-4.5	-2.0	-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	0.5	0.1	-0.3	-0.4
Labour Supply	1.0	0.4	0.0	-0.2
Participation Ratio	72.9	74.3	75.6	76.5
Labour Productivity	1.0	0.1	1.1	1.4

Long-Term Forecast for Eurozone

Annual percentage changes unless otherwise specified

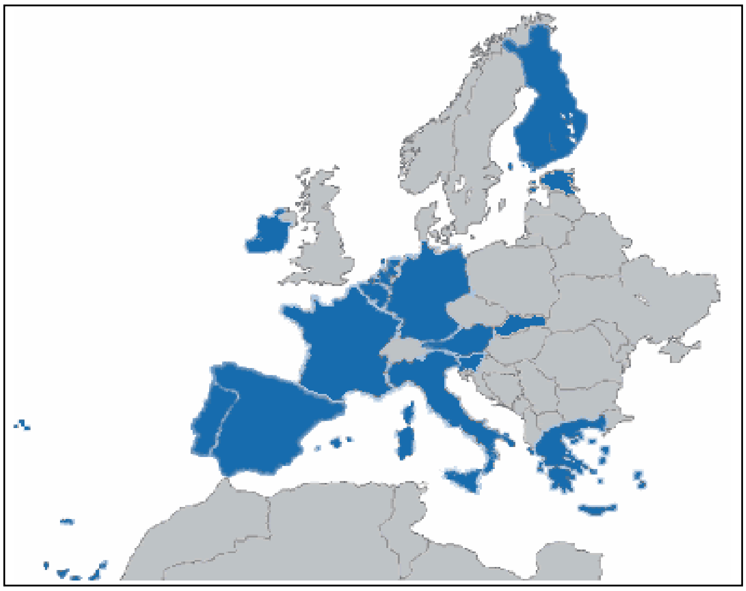
	2003-2012	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2013-2022
GDP	0.9	-4.3	1.9	1.5	-0.5	-0.6	0.9	1.4	1.5	1.6	1.7	1.8	1.8	1.7	1.6	1.3
Consumption	0.7	-0.9	1.0	0.1	-1.3	-0.8	0.5	1.1	1.3	1.5	1.6	1.6	1.6	1.5	1.5	1.1
Investment	-0.1	-12.7	-0.5	1.6	-3.9	-3.0	2.1	2.9	2.7	2.6	2.4	2.3	2.1	1.9	1.8	1.8
Government Consumption	1.4	2.6	0.8	-0.2	-0.3	-0.6	-0.3	0.3	0.6	0.8	1.0	1.1	1.2	1.3	1.3	0.7
Exports of Goods and Services	3.7	-12.4	11.0	6.4	2.9	0.4	3.3	4.2	4.2	3.9	3.6	3.3	3.0	2.8	2.7	3.1
Imports of Goods and Services	3.2	-11.0	9.5	4.3	-0.8	-1.1	3.1	4.4	4.3	3.9	3.6	3.3	2.9	2.8	2.7	3.0
Unemployment (%)	9.2	9.6	10.1	10.2	11.4	12.3	12.6	12.3	11.9	11.5	11.1	10.7	10.2	9.8	9.3	11.2
Consumer Prices	2.1	0.3	1.6	2.7	2.5	1.5	1.4	1.4	1.4	1.4	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	1.7	1.7	1.5	1.5	1.5	1.5	1.6	1.6	1.7	1.7	1.6
Exchange Rate (US$ per Euro)	1.31	1.39	1.33	1.39	1.28	1.30	1.21	1.17	1.17	1.17	1.17	1.17	1.18	1.19	1.21	1.19
General Government Balance (% of GDP)	-3.3	-6.4	-6.2	-4.1	-3.7	-2.8	-2.4	-1.9	-1.5	-1.2	-1.0	-0.8	-0.6	-0.5	-0.5	-1.3
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	4.0	3.0	3.1	3.3	3.6	4.0	4.3	4.5	4.7	4.9	5.0	4.1
Working Population	0.3	0.1	0.1	0.0	-0.3	-0.3	-0.2	-0.3	-0.4	-0.4	-0.3	-0.3	-0.4	-0.4	-0.5	-0.4
Labour Supply	0.7	0.2	0.1	0.3	0.7	0.0	0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	-0.1
Participation Ratio (%)	73.6	74.1	74.0	74.2	75.0	75.2	75.5	75.6	75.8	76.0	76.2	76.4	76.5	76.7	76.9	76.1
Labour productivity	0.6	-2.6	2.5	1.2	0.1	0.5	1.1	1.2	1.2	1.3	1.4	1.5	1.5	1.4	1.4	1.3
Employment	0.4	-1.8	-0.5	0.3	-0.6	-1.1	-0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.1
Output gap (% of potential GDP)	-0.3	-3.4	-2.4	-1.9	-3.0	-4.4	-4.3	-3.9	-3.5	-3.1	-2.6	-2.0	-1.5	-0.9	-0.5	-2.7

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$)	-	19175	19885	36596
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

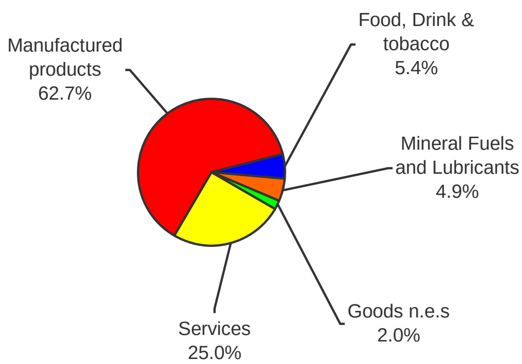
Source: Transparency International
Scoring system 10 = highly clean, 0 = highly corrupt

Structural economic indicators

	1990	1995	2000	2012*
Current account (US$ billion)	11	54	-94	154
Trade balance (US$ billion)	-25	63	-29	102
FDI (US$ billion)	-	-	30	-96
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	4.0
Oil production (000 bpd)	271	313	240	213
Oil consumption (000 bpd)	9715	10483	10927	9493

Source : Oxford Economics / World Bank / EIA / ECB

Composition of extra-EMU goods & services exports, 2012



Source : Eurostat\ Haver Analytics

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