



Highlights and Key Issues

- Financial markets have largely shrugged off the initial volatility triggered by the unclear outcome of the Italian elections. We believe that as long as the new government in Italy does not reverse the fiscal consolidation and economic reforms, Eurozone markets will remain benign and the situation will not pose a threat to the monetary union's existence.
- The euro has not regained its pre-election levels and remains at around \$1.30/€. This is positive as excessive euro strength was threatening the success of the policies implemented by peripheral countries aimed at restoring competitiveness.
- But this does not mean that the economy is set to bounce back on a par with the equity market rally. Instead, we maintain our view that the Eurozone is heading for a 'lost decade'. We have lowered our GDP forecast further, to a fall of 0.5% in 2013 and growth of just 1% in 2014. The factors affecting growth over the medium term will be ongoing fiscal consolidation, deleveraging by the private sector and very high unemployment rates.
- The downward revision to growth is due to weaker than expected data for a number of peripheral economies at end-2012 and a downgrade to our Italy forecast as firms and households are likely to postpone spending until the policy environment is clarified.
- The ECB continues to see outright monetary transactions (OMT) as its best tool to stabilise the Eurozone, putting the focus on governments to apply for a programme.

Forecast for Eurozone						
(Annual percentage changes unless specified)						
	2011	2012	2013	2014	2015	2016
Domestic Demand	0.5	-2.0	-1.0	0.9	1.4	1.5
Private Consumption	0.1	-1.3	-0.7	0.7	1.1	1.3
Fixed Investment	1.6	-4.0	-2.0	2.1	2.9	2.8
Government Consumption	-0.1	-0.1	-0.7	-0.3	0.3	0.6
Net exports (% of GDP)	2.8	4.3	4.8	5.0	5.0	5.0
GDP	1.5	-0.5	-0.5	1.0	1.4	1.5
Industrial Production	2.6	-2.9	-1.1	1.6	2.3	2.2
Consumer Prices	2.7	2.5	1.7	1.6	1.4	1.4
Current Account (% of GDP)	0.1	1.2	1.6	1.4	1.3	1.3
Government Budget (% of GDP)	-4.1	-3.3	-2.5	-1.9	-1.5	-1.2
Short-Term Interest rate (%)	1.4	0.6	0.2	0.3	0.4	0.5
Long-Term Interest Rates (%)	4.4	4.0	3.1	3.3	3.5	3.9
Exchange rate (US\$ per Euro)	1.39	1.28	1.28	1.21	1.17	1.17
Exchange rate (YEN per Euro)	111.0	102.5	120.9	118.2	116.8	116.9

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Forecast Overview

Markets shrug off Italian election...

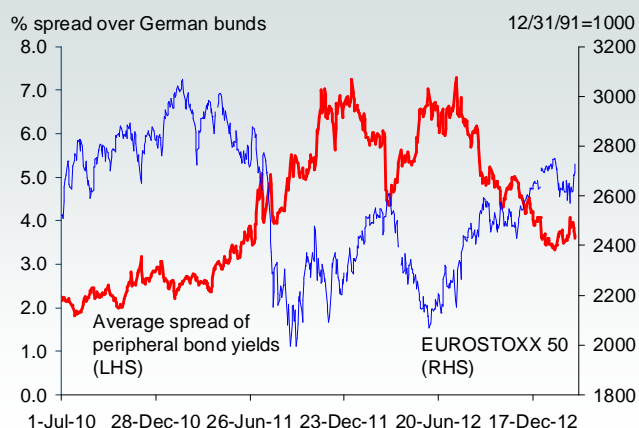
- Financial markets have largely shrugged off the initial volatility triggered by the unclear outcome of the Italian elections. As of 8 March, the EURO STOXX 50 was back well above its pre-election levels and up 8.5% on a year earlier.
- The euro has not regained its pre-election levels and remains at around \$1.30/€. This is positive for the economy as excessive euro strength was threatening the success of the policies implemented by peripheral countries to restore competitiveness.
- We believe that as long as the new Italian government does not reverse fiscal consolidation and economic reforms, Eurozone markets will remain benign and the situation will not pose a threat to the monetary union's existence.
- But this does not mean that the region's economy is set to bounce back on a par with the equity market rally. Instead, we maintain our view that the Eurozone is headed for a 'lost decade'. We have lowered our GDP forecasts to a decline of 0.5% this year and growth of just 1% in 2014.
- The downward revision is accounted for by weaker than expected data for a number of peripheral economies at the end of 2012 and by a downgrade of our Italian forecast as businesses and households there are likely to postpone spending until the policies of the new government are clear.

...but 'lost decade' outlook remains

- Besides short-term fluctuations, the medium-term outlook for the Eurozone remains consistent with our 'lost decade' view. The key factors that will dampen the pace of recovery for several years include fiscal tightening, deleveraging in the private sector and the long-term impact of high unemployment rates:

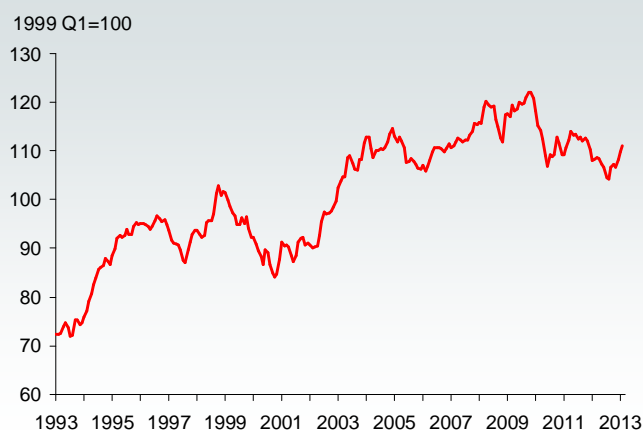
Decade-long fiscal tightening – we estimate that currently-announced fiscal tightening measures for 2013 amount to 1.2% of Eurozone GDP. According to our Global Economic Model, this will shave around 1% point off GDP growth. From 2014 onwards, the pace of tightening will likely lessen somewhat, as leaders in core countries seem increasingly aware of the negative impact of seeking to achieve very stringent deficit targets. Peripheral countries will

Eurozone: financial indicators



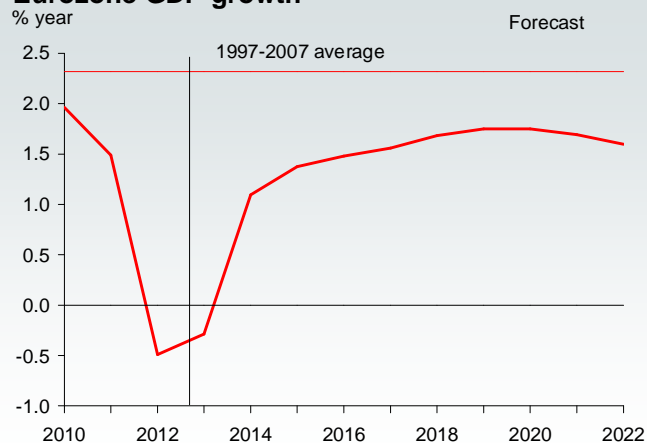
Source : Oxford Economics/ Reuters

Euro effective exchange rate



Source: Reuters

Eurozone GDP growth



Source : Oxford Economics

probably be given more time to restructure their public finances. Nevertheless, fiscal policy will remain tight and will continue to be a drag on growth for years to come.

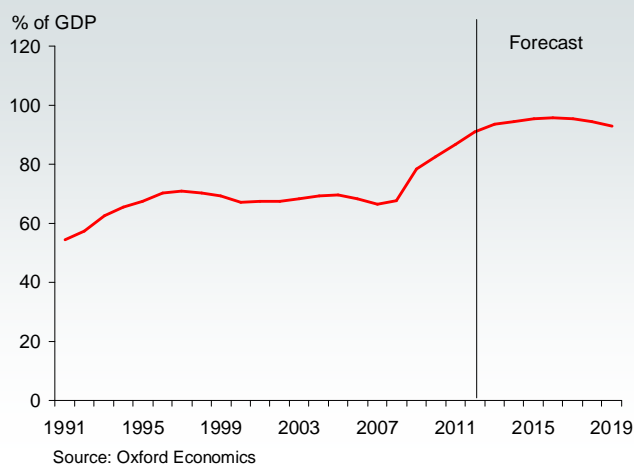
Private-sector deleveraging yet to start – while much focus has been on reducing public sector debt, high private sector debt also needs to be addressed before the economy can sustain robust growth. Unlike the US, and to a lesser extent the UK, Eurozone private debt ratios have not been reduced yet. For instance, debt of non-financial companies stood at 138% of GDP in 2012, compared with 77% in the US and up from 113% a decade ago.

Lost generation – unemployment is forecast to continue to rise until the end of 2013 to 12.4%, with the number of unemployed at close to 20m. Youth unemployment stands at 24% in the Eurozone, and more than 55% in Spain and Greece. The share of long-term (more than one year) unemployed has risen from 33% in early 2009 to 47% in 2012Q3. These developments raise concerns about a 'lost generation', whereby new entrants in the labour market do not get the necessary experience at the start of their career to gain the flexibility to find new jobs and become tomorrow's managers. This will have a negative impact on growth in the Eurozone.

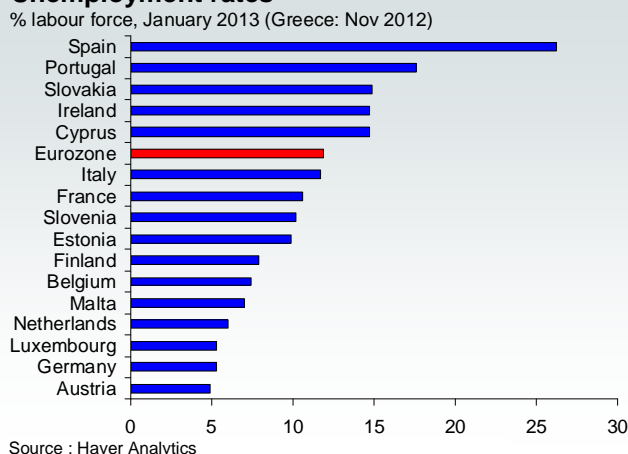
OMT still seen as main monetary tool

- The ECB continues to see outright monetary transactions (OMT) as its best tool to stabilise the Eurozone. At its press conference on 7 March, it attempted to shift the focus onto governments, explaining that it was up to them to apply for the programme.
- We think that Spain and Italy are likely to apply for some precautionary programme that will be enough to trigger bond purchases by the ECB and thereby secure affordable financing of their debt. However, these programmes will probably not involve more fiscal austerity than currently planned. Instead, the EU and ECB will probably accept that enough is being done and that these plans just need to be implemented in full. The Italian vote indicated the unpopularity of the current fiscal consolidation programmes. Trying to impose even deeper cuts and further tax increases would threaten the viability of governments and thereby of the Eurozone.

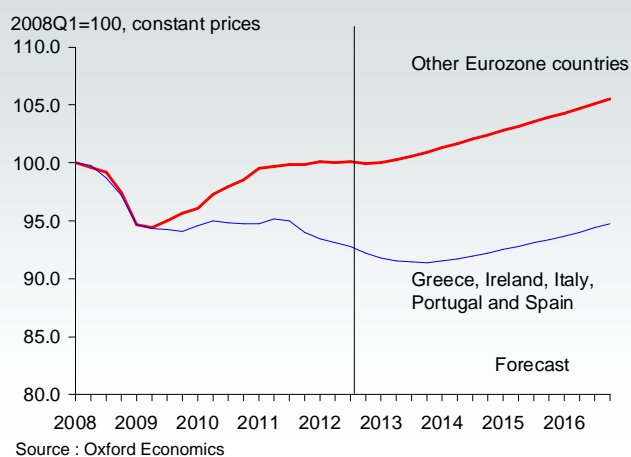
Eurozone: Government debt



Unemployment rates



Eurozone GDP



Key Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

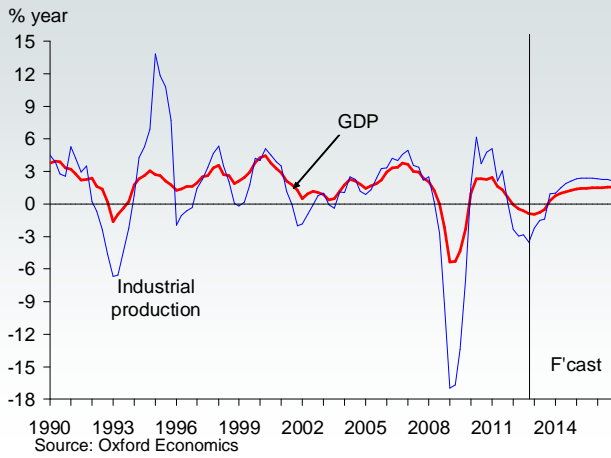
	Industrial production (% yr)	Unemploy- ment (% point)	CPI (% yr)	Business confidence (% balance)	Consumer confidence (% balance)	Exports (% yr)	Imports (% yr)	Trade balance (€ bn)
Feb	-1.7	10.9	2.7	-0.1	-20.1	10.9	7.6	1.2
Mar	-1.6	11.0	2.7	-0.2	-18.9	4.5	0.6	7.0
Apr	-2.5	11.2	2.6	-0.5	-19.7	6.0	0.1	3.6
May	-2.6	11.2	2.4	-0.7	-19.1	6.2	1.0	6.6
Jun	-1.7	11.4	2.4	-0.9	-19.6	12.1	3.3	12.7
Jul	-2.5	11.4	2.4	-1.2	-21.3	11.2	3.3	13.6
Aug	-2.2	11.5	2.6	-1.2	-24.4	10.3	2.8	4.2
Sep	-2.8	11.6	2.6	-1.3	-25.7	1.1	-3.9	8.3
Oct	-3.4	11.7	2.5	-1.6	-25.5	14.3	7.8	9.0
Nov	-4.0	11.8	2.2	-1.2	-26.7	5.3	0.0	13.0
Dec	-2.2	11.8	2.2	-1.1	-26.3	-3.1	-5.9	11.7
2013								
Jan	-	11.9	2.0	-1.1	-23.9	-	-	-
Feb	-	-	1.8	-0.7	-23.6	-	-	-

Financial Indicators: Eurozone

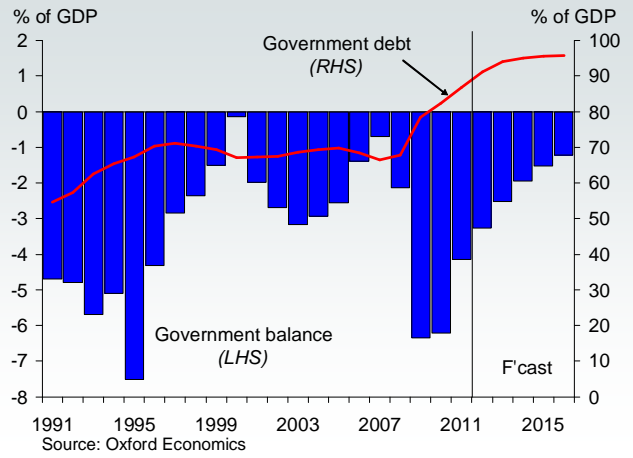
Percentage changes on a year earlier unless otherwise stated

	Short rate %	Long rate %	Money Supply (M3)	Exchange rate \$/€ avg.	Exchange rate €/£	Nominal effective exch. rate	Share price DJ STOXX	Net FDI € bn
Feb	1.05	3.75	2.5	1.32	1.19	102.9	2512	5.7
Mar	0.86	3.29	2.9	1.32	1.20	103.4	2477	-9.4
Apr	0.74	3.39	2.3	1.32	1.22	102.8	2306	-3.5
May	0.68	3.53	2.9	1.28	1.24	100.8	2119	8.2
Jun	0.66	3.41	3.0	1.25	1.24	99.7	2265	-21.0
Jul	0.50	3.25	3.6	1.23	1.27	97.6	2326	-5.8
Aug	0.33	3.01	2.9	1.24	1.27	97.7	2441	14.7
Sep	0.25	2.43	2.6	1.29	1.25	99.9	2454	-34.6
Oct	0.21	2.31	3.9	1.30	1.24	100.8	2504	-10.6
Nov	0.19	2.25	3.8	1.28	1.24	100.3	2575	13.7
Dec	0.19	2.10	3.4	1.31	1.23	102.0	2636	-8.6
2013								
Jan	0.20	2.40	3.5	1.33	1.20	104.2	2703	-
Feb	0.22	2.86	-	1.34	1.16	106.0	2634	-

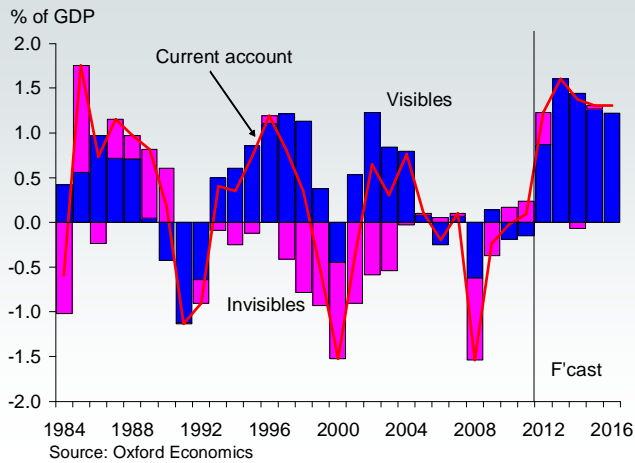
Eurozone: GDP and industrial production



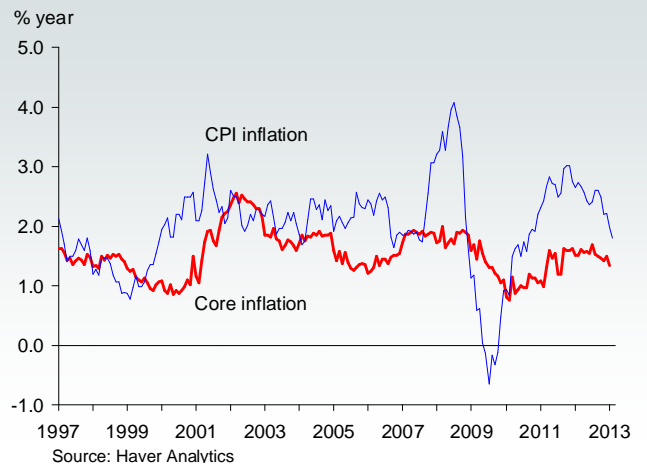
Eurozone: Government finances



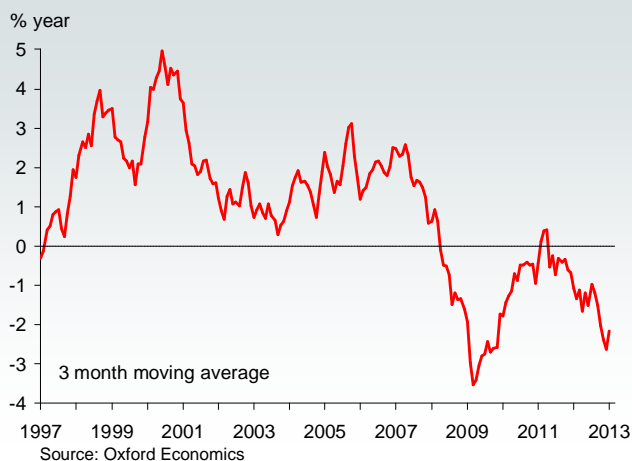
Eurozone: Current account



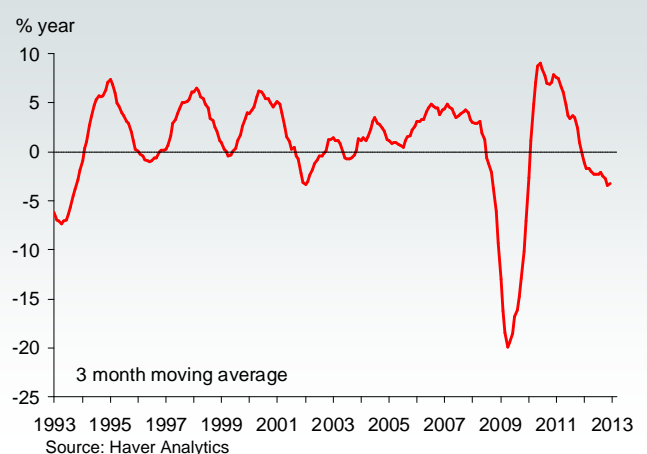
Eurozone: Headline Inflation



Eurozone: Retail sales



Eurozone: Industrial production



EURO ZONE		TABLE 1 SUMMARY ITEMS Annual Percentage Changes, Unless Otherwise Specified									
	CONSUMERS EXPENDITURE	GROSS FIXED INVESTMENT	DOMESTIC DEMAND	REAL GDP	INDUSTRIAL PRODUCTION	UNEMPLOYMENT RATE (%)	AVERAGE EARNINGS	WHOLE ECONOMY PRODUCTIVITY (GDP/ET)	MONEY SUPPLY M3	PRODUCER PRICES	CONSUMER PRICES
	(C)	(IF)	(DOMD)	(GDP)	(IP)	(UP)	(ER)	(GDP/ET)	(MON)	(PPI)	(CPI)
YEARS BEGINNING Q1											
2011	0.1	1.6	0.5	1.5	2.6	10.2	2.3	1.2	1.6	5.5	2.7
2012	-1.3	-4.0	-2.0	-0.5	-2.9	11.4	1.7	0.2	2.8	2.4	2.5
2013	-0.7	-2.0	-1.0	-0.5	-1.1	12.3	1.1	0.6	1.9	1.9	1.7
2014	0.7	2.1	0.9	1.0	1.6	12.4	1.7	1.2	2.6	2.0	1.6
2015	1.1	2.9	1.4	1.4	2.3	12.0	2.1	1.2	3.4	2.0	1.4
2016	1.3	2.8	1.5	1.5	2.2	11.6	2.4	1.2	3.7	1.9	1.4
2011											
I	0.9	3.5	1.6	2.4	5.1	9.9	2.1	2.1	0.1	6.4	2.5
II	0.2	1.4	0.8	1.6	2.1	9.9	2.3	1.1	1.6	5.8	2.8
III	0.2	0.7	0.4	1.3	3.1	10.2	2.4	1.0	2.4	5.4	2.7
IV	-0.8	0.8	-0.7	0.6	0.1	10.6	2.4	0.7	2.3	4.7	2.9
2012											
I	-1.1	-2.5	-1.6	-0.1	-2.3	10.9	2.1	0.4	2.9	3.4	2.7
II	-1.1	-3.9	-2.3	-0.5	-3.0	11.3	1.6	0.3	2.9	2.1	2.5
III	-1.4	-4.2	-2.3	-0.6	-2.8	11.5	1.7	0.1	2.4	2.2	2.5
IV	-1.4	-5.3	-2.0	-0.9	-3.5	11.7	1.3	0.1	2.8	2.0	2.3
2013											
I	-1.3	-4.1	-1.9	-0.9	-2.2	12.0	0.9	0.1	2.3	1.5	1.8
II	-0.9	-2.5	-1.3	-0.7	-1.5	12.3	1.1	0.5	1.8	1.8	1.7
III	-0.7	-1.7	-0.9	-0.5	-1.4	12.4	1.1	0.7	2.1	1.9	1.7
IV	0.0	0.5	-0.1	0.3	0.9	12.4	1.2	1.1	1.6	2.4	1.7
2014											
I	0.4	1.3	0.5	0.7	1.0	12.5	1.5	1.2	2.2	1.9	1.6
II	0.6	1.9	0.8	1.0	1.5	12.4	1.6	1.2	2.5	2.0	1.6
III	0.8	2.4	1.0	1.1	1.8	12.4	1.8	1.2	2.8	2.0	1.5
IV	0.9	2.7	1.1	1.3	2.1	12.3	1.9	1.2	3.1	2.1	1.5
2015											
I	1.0	2.8	1.3	1.4	2.3	12.2	2.0	1.2	3.3	2.1	1.5
II	1.1	2.9	1.4	1.4	2.4	12.1	2.1	1.2	3.4	2.1	1.4
III	1.2	2.9	1.5	1.5	2.4	12.0	2.2	1.2	3.5	2.0	1.4
IV	1.2	2.9	1.5	1.5	2.3	11.8	2.2	1.2	3.6	2.0	1.4
2016											
I	1.2	2.9	1.5	1.5	2.3	11.7	2.3	1.2	3.6	1.9	1.4
II	1.3	2.8	1.5	1.5	2.3	11.6	2.3	1.2	3.7	1.9	1.4
III	1.3	2.8	1.5	1.5	2.2	11.5	2.4	1.2	3.7	1.9	1.4
IV	1.4	2.7	1.5	1.5	2.1	11.4	2.4	1.2	3.7	1.9	1.4

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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	REAL LONG-TERM INTEREST RATE	US DOLLAR PER EURO (R/X)	EFFECTIVE RATE (1995=100)
	(B/V)	(BCU)	(BCU*100 /GDP%)	(GB)	(GB*100 /GDP%)	(RSH)	(RLG)	(Rate 1)	(Rate 1)	(R/X)	(RX)
YEARS BEGINNING Q1											
2011	-13.9	8.7	0.09	-389.5	-4.14	1.39	4.41	-1.32	1.70	1.39	120.9
2012	82.4	116.2	1.23	-310.3	-3.27	0.57	4.02	-1.92	1.52	1.29	115.5
2013	153.0	153.0	1.60	-239.4	-2.50	0.24	3.14	-1.49	1.41	1.28	119.0
2014	141.4	134.4	1.37	-189.7	-1.94	0.33	3.30	-1.22	1.74	1.21	114.3
2015	127.8	131.4	1.31	-153.8	-1.53	0.41	3.50	-0.98	2.11	1.17	110.7
2016	127.0	135.1	1.30	-126.7	-1.22	0.47	3.88	-0.91	2.51	1.17	110.4
2011											
I	-8.3	0.7	0.03	-113.1	-4.83	1.10	4.32	-1.38	1.84	1.37	119.5
II	-8.9	-5.9	-0.25	-100.8	-4.29	1.42	4.51	-1.34	1.76	1.44	122.5
III	-6.4	1.1	0.05	-91.2	-3.86	1.56	4.30	-1.14	1.60	1.41	121.3
IV	9.8	12.8	0.54	-84.3	-3.57	1.50	4.53	-1.44	1.60	1.35	120.5
2012											
I	9.4	21.6	0.91	-94.6	-4.00	1.04	4.39	-1.64	1.70	1.31	116.9
II	18.9	26.6	1.12	-69.2	-2.92	0.69	4.27	-1.76	1.82	1.28	115.9
III	24.6	30.2	1.27	-75.8	-3.19	0.36	3.99	-2.18	1.45	1.25	113.4
IV	29.6	37.8	1.59	-70.7	-2.98	0.20	3.41	-2.11	1.10	1.30	115.9
2013											
I	39.4	62.2	2.62	-64.4	-2.71	0.21	3.09	-1.63	1.25	1.32	120.3
II	38.9	35.6	1.50	-65.1	-2.73	0.22	3.12	-1.48	1.41	1.29	120.0
III	37.1	25.8	1.08	-59.6	-2.49	0.24	3.14	-1.46	1.44	1.27	118.5
IV	37.6	29.4	1.22	-50.3	-2.09	0.28	3.21	-1.39	1.54	1.25	117.2
2014											
I	41.9	60.6	2.50	-50.0	-2.07	0.30	3.24	-1.35	1.59	1.23	116.2
II	35.7	29.2	1.20	-51.1	-2.10	0.32	3.28	-1.26	1.70	1.22	114.9
III	31.3	19.4	0.79	-48.1	-1.96	0.34	3.31	-1.16	1.81	1.20	113.7
IV	32.4	25.2	1.02	-40.4	-1.64	0.36	3.35	-1.12	1.87	1.19	112.4
2015											
I	36.9	58.2	2.34	-39.2	-1.57	0.38	3.39	-1.07	1.94	1.17	111.1
II	31.8	27.8	1.11	-42.1	-1.68	0.40	3.45	-0.98	2.07	1.17	110.6
III	28.6	19.2	0.76	-40.5	-1.61	0.42	3.54	-0.95	2.17	1.17	110.6
IV	30.4	26.2	1.03	-32.1	-1.26	0.44	3.63	-0.92	2.28	1.17	110.6
2016											
I	36.0	58.7	2.29	-31.7	-1.24	0.45	3.73	-0.92	2.36	1.17	110.5
II	31.4	29.0	1.12	-35.1	-1.36	0.47	3.83	-0.91	2.46	1.17	110.3
III	28.6	20.3	0.78	-34.1	-1.31	0.48	3.94	-0.90	2.56	1.17	110.4
IV	30.9	27.2	1.04	-25.8	-0.98	0.49	4.03	-0.90	2.64	1.17	110.2

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

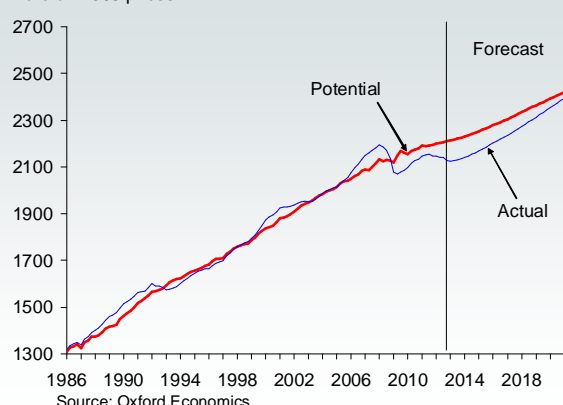
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Potential output growth 1.0%pa

- Potential output is projected to rise by 1.0%pa over the next 10 years, a slightly lower rate than in the previous decade. GDP is set to contract by 0.5% in 2012, having grown by 1.5% in 2011 and to be significantly below potential growth at -0.5% in 2013. As a result, the large output gap of 1.9% in 2011 will expand in 2012 to 3.0% and increase in 2013 to 4.1%, and it is not forecast to close fully until 2024.
- The main contribution to growth in potential output over the coming decade comes from expanding total factor productivity.
- The 0.00%pt contribution from expanding 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 1.3%pa) than in the previous decade. Finally, total factor productivity growth's slightly higher contribution of 0.5%pt reflects the better contribution to potential growth from factors influencing production other than labour and capital over the coming decade.

Eurozone: Actual & potential output

Euro bn 2005 prices



Potential GDP and Its Components Average Percentage Growth

	2002-2011	2012-2021
Potential GDP*	1.49	1.04
Employment at NAIRU	0.66	0.00
Capital Stock	2.15	1.47
Total Factor Productivity	0.30	0.52

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

Long-Term Forecast for Eurozone

(Average annual percentage change unless otherwise stated)

	2002-2006	2007-2011	2012-2016	2017-2021
GDP	1.8	0.4	0.6	1.7
Consumption	1.5	0.4	0.2	1.5
Investment	2.1	-1.8	0.3	2.2
Government Consumption	1.9	1.5	0.0	1.1
Exports of Goods and Services	5.0	2.2	3.3	3.3
Imports of Goods and Services	5.0	1.7	2.5	3.3
Unemployment (%)	8.9	9.0	11.9	10.2
Consumer Prices	2.2	2.0	1.7	1.6
Current Balance (% of GDP)	0.3	-0.3	1.4	1.4
Exchange Rate (US\$ per Euro)	1.16	1.39	1.22	1.18
General Government Balance (% of GDP)	-2.5	-3.9	-2.1	-0.7
Short-term Interest Rates (%)	2.6	2.5	0.4	2.1
Long-term Interest Rates (%)	4.1	4.1	3.6	4.5
Working Population	0.5	0.2	-0.4	-0.5
Labour Supply	1.0	0.5	0.1	-0.2
Participation Ratio	72.5	74.0	75.5	76.6
Labour Productivity	0.8	0.3	0.9	1.4

Long-Term Forecast for Eurozone

Annual percentage changes unless otherwise specified

	2002-2011	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
GDP	1.1	0.3	-4.3	2.0	1.5	-0.5	-0.5	1.0	1.4	1.5	1.6	1.7	1.8	1.7	1.7	1.1
Consumption	1.0	0.4	-0.9	0.9	0.1	-1.3	-0.7	0.7	1.1	1.3	1.5	1.5	1.6	1.6	1.5	0.9
Investment	0.1	-1.6	-12.7	-0.3	1.6	-4.0	-2.0	2.1	2.9	2.8	2.5	2.4	2.2	2.0	1.9	1.3
Government Consumption	1.7	2.3	2.6	0.7	-0.1	-0.1	-0.7	-0.3	0.3	0.6	0.8	1.0	1.2	1.2	1.3	0.5
Exports of Goods and Services	3.6	0.9	-12.4	11.0	6.5	2.7	1.8	3.7	4.3	4.1	3.8	3.6	3.3	3.0	2.8	3.3
Imports of Goods and Services	3.3	0.7	-11.0	9.5	4.3	-0.7	0.7	3.7	4.5	4.4	3.9	3.6	3.3	2.9	2.8	2.9
Unemployment (%)	9.0	7.7	9.6	10.1	10.2	11.4	12.3	12.4	12.0	11.6	11.1	10.7	10.2	9.7	9.2	11.1
Consumer Prices	2.1	3.3	0.3	1.6	2.7	2.5	1.7	1.6	1.4	1.4	1.4	1.5	1.6	1.7	1.8	1.7
Current Balance (% of GDP)	0.0	-1.5	-0.2	0.0	0.1	1.2	1.6	1.4	1.3	1.3	1.3	1.3	1.4	1.4	1.4	1.4
Exchange Rate (US\$ per Euro)	1.28	1.47	1.39	1.33	1.39	1.28	1.28	1.21	1.17	1.17	1.17	1.17	1.17	1.18	1.19	1.20
General Government Balance (% of GDP)	-3.2	-2.1	-6.3	-6.2	-4.1	-3.3	-2.5	-1.9	-1.5	-1.2	-1.0	-0.8	-0.6	-0.5	-0.5	-1.4
Short-term Interest Rates (%)	2.5	4.6	1.2	0.8	1.4	0.6	0.2	0.3	0.4	0.5	0.6	1.3	2.2	2.9	3.4	1.2
Long-term Interest Rates (%)	4.1	4.3	3.8	3.6	4.4	4.0	3.1	3.3	3.5	3.9	4.2	4.3	4.5	4.7	4.9	4.0
Working Population	0.3	0.4	0.1	0.1	-0.2	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.5	-0.5	-0.4
Labour Supply	0.7	0.9	0.2	0.1	0.3	0.6	0.1	-0.1	-0.2	-0.2	-0.2	-0.1	-0.1	-0.2	-0.3	-0.1
Participation Ratio (%)	73.3	74.0	74.0	74.0	74.4	75.0	75.3	75.5	75.7	75.9	76.1	76.3	76.6	76.8	77.0	76.0
Labour productivity	0.6	-0.5	-2.6	2.5	1.2	0.2	0.6	1.2	1.2	1.2	1.2	1.4	1.4	1.4	1.4	1.1
Employment	0.5	0.8	-1.8	-0.5	0.3	-0.7	-1.0	-0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.0
Output gap (% of potential GDP)	0.1	2.0	-3.4	-2.4	-1.9	-3.0	-4.1	-4.0	-3.6	-3.3	-2.9	-2.5	-1.9	-1.4	-0.9	-2.8

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

Long-term economic & social development

	1980	1990	2000	2011*
GDP per capita (US\$)	-	19571	19886	39420
Inflation (%)	9.9	4.2	2.2	2.7
Population (mn)	287	299	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

* 2011 or latest available year

Structural economic indicators

	1990	1995	2000	2011*
Current account (US\$ billion)	11	54	-95	12
Trade balance (US\$ billion)	-25	63	-28	-19
FDI (US\$ billion)	-	-	30	-96
Govt budget (% of GDP)	-4.1	-7.5	-0.1	-4.1
Govt debt (% of GDP)	13.5	67.3	67.1	86.8
Long-term interest rate	10.9	8.7	5.4	4.4
Oil production (000 bpd)	271	313	240	216
Oil consumption (000 bpd)	9715	10483	10927	9960

Source : Oxford Economics / World Bank / EIA / ECB

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



Source : ECB

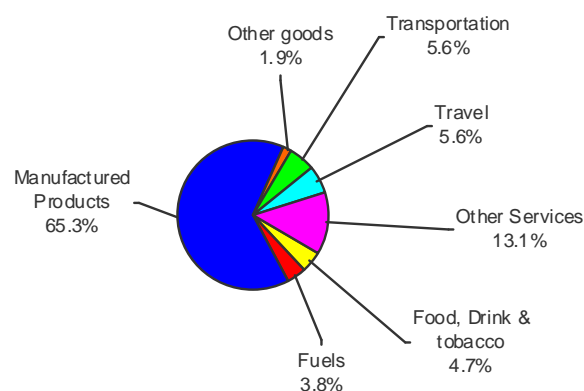
Member countries: Germany, France, Italy, Finland, Ireland, Netherlands, Belgium, Luxembourg, Austria, Portugal, Spain, Greece, Slovenia, Malta, Cyprus, Slovakia & Estonia

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

Composition of extra-EMU goods & services exports, 2008



Source : Eurostat