Eurozone

Highlights and Key Issues

- The Eurozone financial market rally that lasted throughout the summer partly reversed in the second half of September. This is consistent with our view that the ECB's recent policy moves, while very important, are not enough to solve all the problems facing the Eurozone. Even if the Eurozone stays in its current shape, it will probably only achieve very low growth during the next decade.
- Recent data show that the Eurozone is still in recession, and there are few signs that the downturn is easing. We think that the recession that started in Q4 2011 will continue throughout 2012; for the year as a whole, we now forecast a 0.6% fall in GDP.
- Domestic demand is expected to contract much more sharply than GDP, down 1.9% this year. And the contraction will continue into 2013, while overall GDP stagnates.
- In this environment we would have expected inflation to fall sharply, but instead it has proven surprisingly sticky, running at an annual rate of 2.7% in September. This partly reflects VAT hikes and energy and food price rises, although core inflation has also fallen more slowly than might have been expected.
- We expect inflation to fall towards 1.5% as margins are adjusted down in the face of protracted demand weakness. But if inflation does not fall, the squeeze on real incomes would be even larger, compounding the social costs of reforms and thereby further raising the threat to the stability of the Eurozone.

Forecast for Eurozone
(Annual percentage changes unless specified)

	2011	2012	2013	2014	2015	2016
Domestic Demand	0.5	-1.9	-0.6	0.9	1.3	1.4
Private Consumption	0.1	-0.9	-0.3	0.7	1.1	1.3
Fixed Investment	1.6	-3.2	-0.8	2.4	2.9	2.9
Government Consumption	-0.1	0.0	-0.7	-0.1	0.4	0.6
Net exports (% of GDP)	2.8	4.1	4.6	4.8	4.9	5.0
GDP	1.5	-0.6	-0.1	1.1	1.4	1.5
Industrial Production	2.7	-3.0	0.0	2.7	2.9	2.3
Consumer Prices	2.7	2.5	1.9	1.6	1.3	1.3
Current Account (% of GDP)	0.0	0.8	1.3	1.1	1.0	0.9
Government Budget (% of GDP)	-4.1	-3.4	-2.5	-2.1	-1.6	-1.1
Short-Term Interest rate (%)	1.4	0.6	0.3	0.3	0.4	0.5
Long-Term Interest Rates (%)	4.4	4.0	3.6	3.7	3.9	4.2
Exchange rate (US$ per Euro)	1.39	1.28	1.24	1.17	1.12	1.13
Exchange rate (YEN per Euro)	111.0	102.3	108.7	110.1	107.2	109.6

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

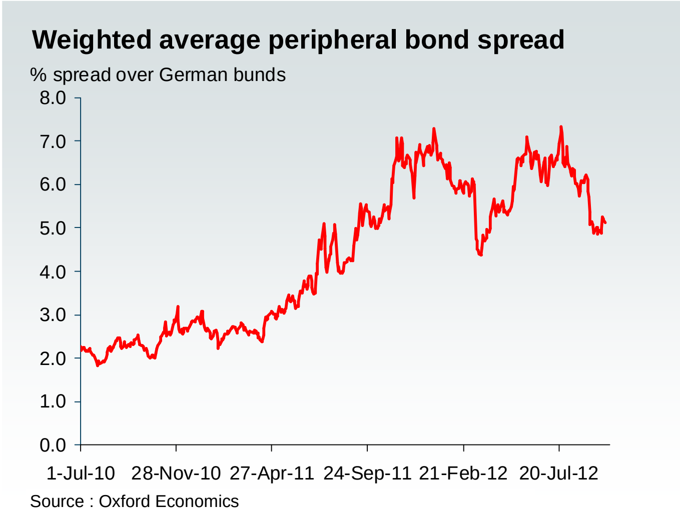
Overview

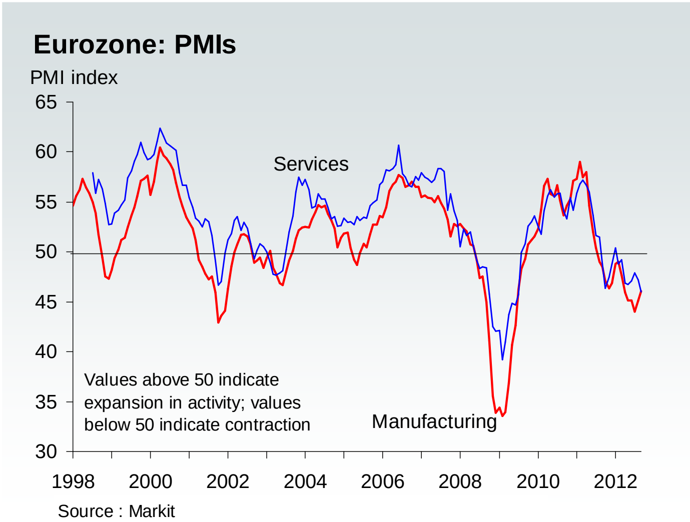
Financial market rally stalls

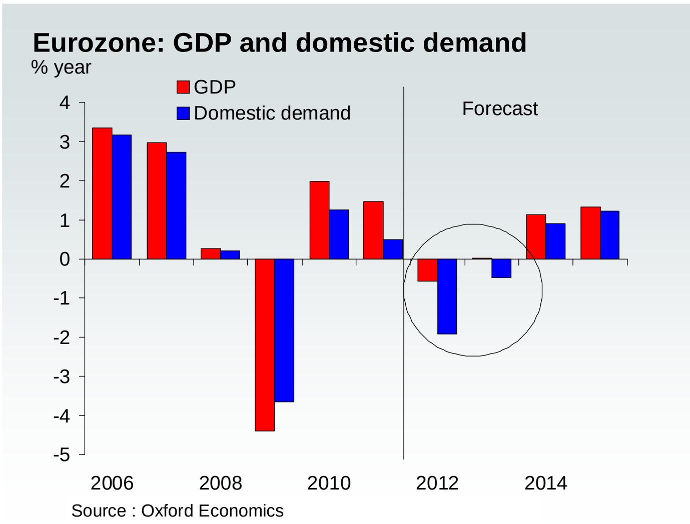
- The Eurozone financial market rally that began in the summer showed signs of stalling towards the end of September. This is consistent with our view that the ECB's recent policy moves, while very important, are not enough to solve all the serious problems the Eurozone faces. Even if the Eurozone stays in its current shape, it will probably only achieve very low growth (below 1.5% a year) during the next decade.
- Recent data show that the Eurozone is still in recession, and there are few signs that the downturn is easing. The manufacturing PMI rose slightly in September, boosted by better readings for Germany, but remained in contraction territory. Moreover, the volume of German manufacturing orders in August was down 5.2% compared with a year earlier, suggesting that output weakness is likely to persist. And in the service sector, the September PMI reading indicated that the pace of contraction worsened.

Domestic recession to last into 2013

- We think that the recession that started in Q4 2011 will continue throughout 2012, and we now forecast a 0.6% fall in GDP this year. Domestic demand is expected to contract much more, by 1.9%, and domestic activity will continue to lag overall GDP next year. We expect domestic demand to continue to contract by 0.6% in 2013, while GDP as a whole stagnates.
- It is unusual for there to be such a gap between overall GDP and domestic demand growth. In 2009 for instance, the fall in domestic demand was less severe than that of GDP as a whole. Now though, the focus of the shock is domestic rather than external, centring on the public and banking sectors but spilling over into the wider domestic economy.
- Household purchasing power will fall for the third consecutive year in 2012, hit by low nominal wage increases, falls in employment, cuts in government subsidies and persistently high inflation. As a result, we forecast a 1% fall in private consumption in 2012, about as steep a decline as in 2009 – which was the worst fall in consumer spending since at least the early 1970s. And we forecast a further slight fall in purchasing power in 2013, leading to lower spending next year as well. Investment is likely to fall even

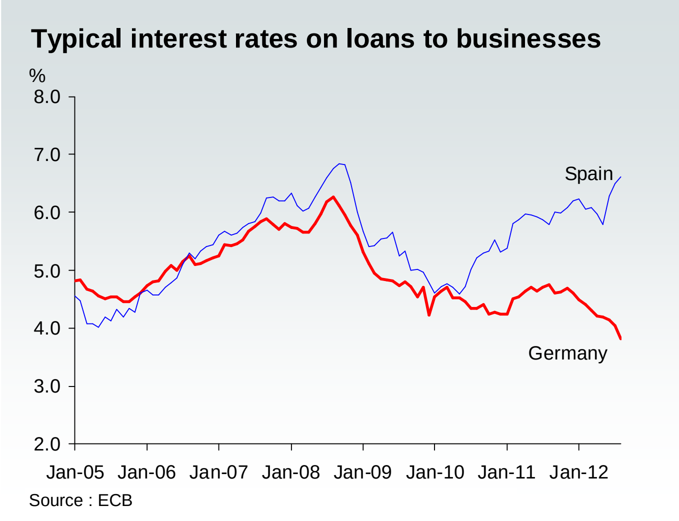






more sharply, by over 3% this year and by a further 0.8% in 2013. Corporate profits – as proxied by national accounts data – did not grow at all in Q2, after rising by around 5% in 2011. Moreover, confidence surveys show a continued deterioration in business sentiment, which has led to the postponement of all but essential investment.

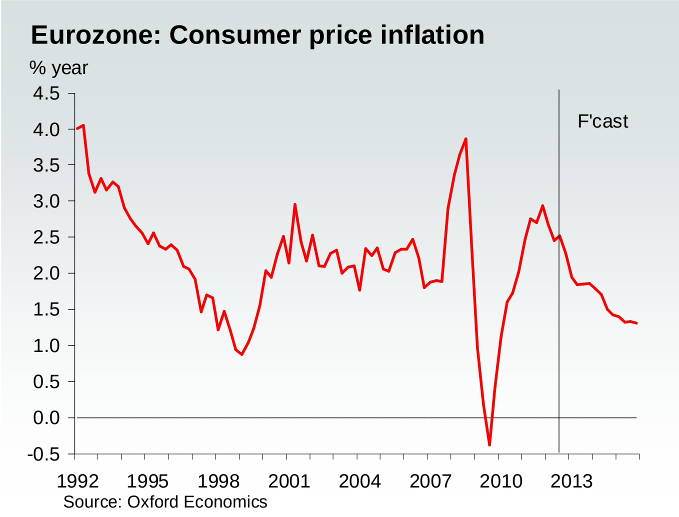
- And while interest rates are low on average, financing conditions are very mixed across different Eurozone countries, sectors and companies. In August, while German companies were charged an average interest rate of 3.8% for new loans, their Spanish counterparts were paying 6.6% – the highest level since mid 2008, when ECB interest rates were 300bp higher than they are now.



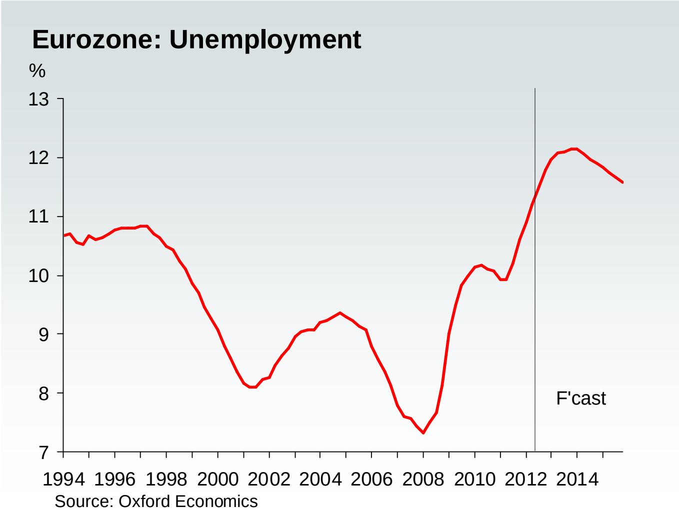
Inflation not falling as fast as hoped

- In the current depressed economic environment, we would have expected inflation to fall sharply – perhaps even moving into negative territory. However, inflation was 2.7% in September, comfortably above the ECB's official target ceiling of 2% (although we do not expect any action as a result).

- About half a percentage point of the current inflation rate is accounted for by increases in indirect taxes. Energy price inflation has also risen, to close to 10% in September from around 6% in July, on the back of high oil prices. Moreover, unfavourable weather conditions have pushed up food price inflation. But even excluding these three factors, core inflation has fallen more slowly than might have been expected; CPI inflation ex-food and energy was 1.7% in August, compared to around 2% at the start of 2012.



- This implies the existence of significant price rigidities in the Eurozone. We think that these rigidities will gradually be eroded in the face of a protracted period of very weak demand and high unemployment. This process is arguably already under way in some of the peripheral countries, where wage growth has slowed sharply or even turned negative – although inflation rates have proved stickier so far. We forecast that Eurozone inflation will fall below 2% during 2013 and then drop to less than 1.5% as margins are adjusted downwards in the face of prolonged weakness in demand. If this fall in inflation does not occur, the squeeze on real incomes would be even larger, adding to the already high social cost of reforms and further undermining Eurozone prospects.

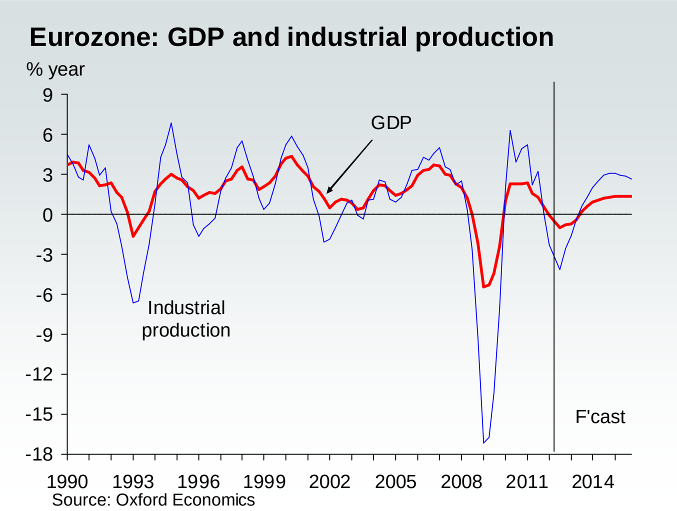


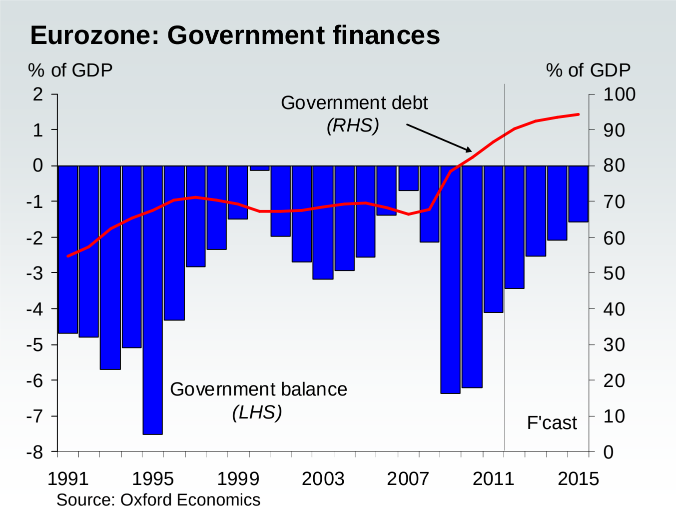
Key Indicators: Eurozone
Percentage changes on a year earlier unless otherwise stated

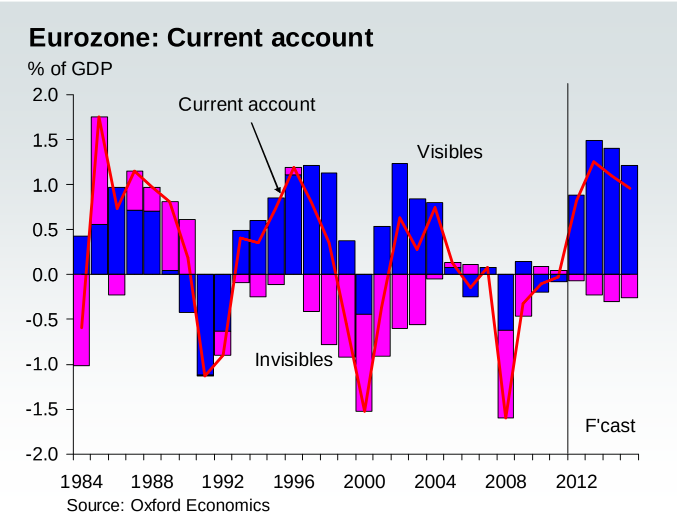
	Industrial production (% yr)	Unemploy-ment (% point)	CPI (% yr)	Business confidence (% balance)	Consumer confidence (% balance)	Exports (% yr)	Imports (% yr)	Trade balance (€ bn)
Sep	2.1	10.3	3.0	-0.1	-19.1	10.2	8.8	2.4
Oct	1.0	10.5	3.0	-0.2	-19.9	5.9	8.1	0.3
Nov	0.0	10.6	3.0	-0.4	-20.4	10.5	4.8	5.5
Dec	-1.5	10.7	2.7	-0.3	-21.3	9.9	1.8	9.2
2012								
Jan	-1.5	10.8	2.7	-0.2	-20.7	10.9	4.2	-8.6
Feb	-1.7	10.9	2.7	-0.1	-20.3	11.1	7.6	1.5
Mar	-1.8	11.0	2.7	-0.3	-19.1	4.7	0.6	7.4
Apr	-2.6	11.2	2.6	-0.5	-19.9	6.0	0.1	4.2
May	-2.5	11.3	2.4	-0.8	-19.3	5.8	0.4	7.1
Jun	-1.9	11.4	2.4	-0.9	-19.8	12.4	3.2	13.6
Jul	-2.7	11.4	2.4	-1.3	-21.5	11.3	2.1	15.6
Aug	-	11.4	2.6	-1.2	-24.6	-	-	-
Sep	-	-	2.7	-1.3	-25.9	-	-	-

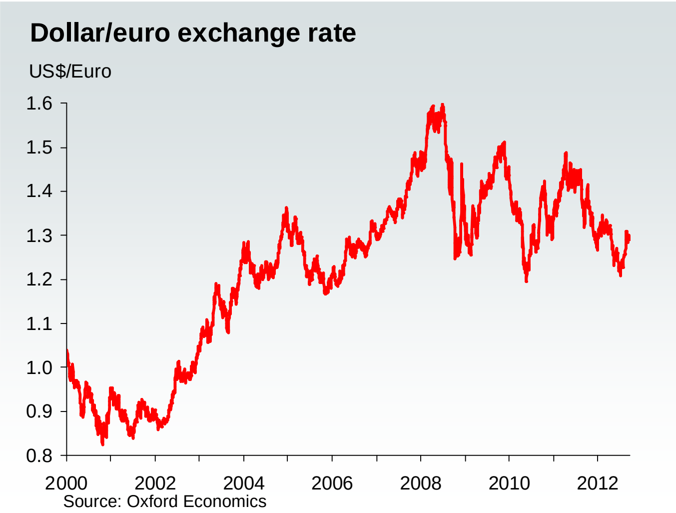
Financial Indicators: Eurozone
Percentage changes on a year earlier unless otherwise stated

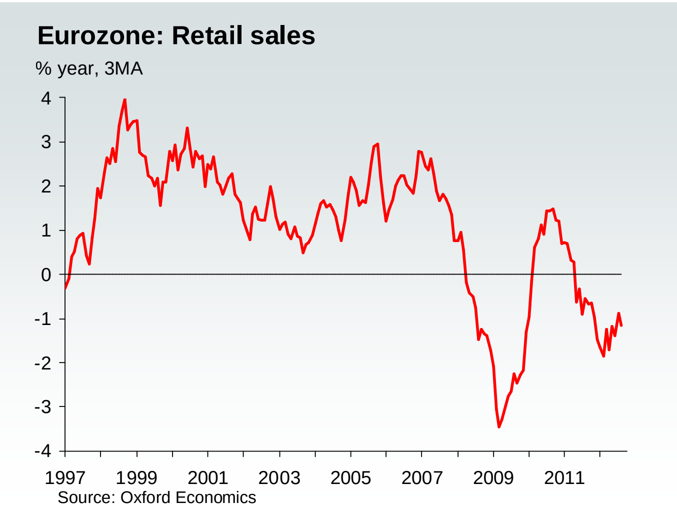
	Short rate %	Long rate %	Money Supply (M3)	Exchange rate $/€ avg.	Exchange rate €/£	Nominal effective exch. rate	Share price DJ STOXX	Net FDI € bn
Sep	1.54	4.04	1.7	1.377	1.147	106.3	2179.7	-9.0
Oct	1.58	4.09	1.4	1.371	1.149	106.5	2385.2	-5.6
Nov	1.48	4.41	1.5	1.356	1.166	105.6	2330.4	-45.0
Dec	1.43	4.11	1.5	1.318	1.184	103.6	2316.6	-4.3
2012								
Jan	1.22	3.92	2.0	1.290	1.203	101.6	2416.7	3.6
Feb	1.05	3.75	2.5	1.322	1.194	102.9	2512.1	-0.2
Mar	0.86	3.29	2.9	1.320	1.198	103.4	2477.3	-8.8
Apr	0.74	3.39	2.4	1.316	1.216	102.8	2306.4	-9.6
May	0.68	3.53	2.9	1.279	1.244	100.8	2118.9	9.9
Jun	0.66	3.41	3.1	1.253	1.242	99.7	2264.7	-19.7
Jul	0.50	3.25	3.6	1.229	1.269	97.6	2325.7	-6.7
Aug	0.33	3.01	2.9	1.240	1.268	97.7	2440.7	-
Sep	0.25	2.43	-	1.286	1.252	99.9	2454.3	-

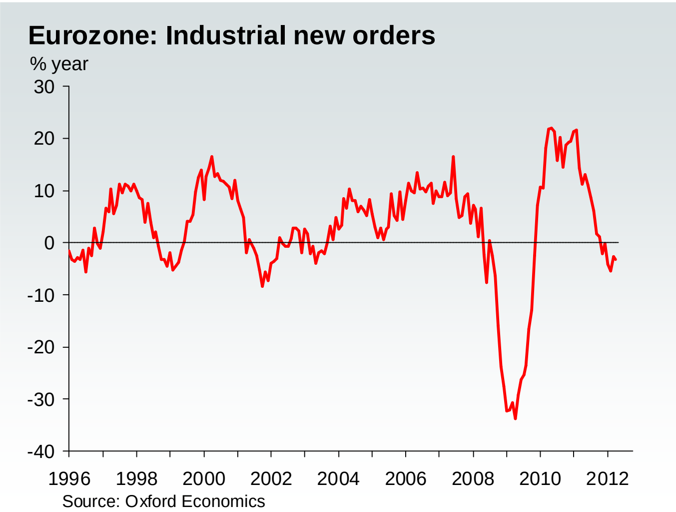

Eurozone: GDP and industrial production
% year
9
6
3
0
-3
-6
-9
-12
-15
-18
GDP
Industrial production
F'cast
1990
1993
1996
1999
2002
2005
2008
2011
2014
Source: Oxford Economics


Eurozone: Government finances
% of GDP
% of GDP
Government debt (RHS)
Government balance (LHS)
F'cast
1991
1995
1999
2003
2007
2011
2015
Source: Oxford Economics


Eurozone: Current account
% of GDP
Current account
Visibles
Invisibles
F'cast
1984
1988
1992
1996
2000
2004
2008
2012
Source: Oxford Economics


Dollar/euro exchange rate
US$/Euro
2000
2002
2004
2006
2008
2010
2012
Source: Oxford Economics


Eurozone: Retail sales
% year, 3MA
1997
1999
2001
2003
2005
2007
2009
2011
Source: Oxford Economics


Eurozone: Industrial new orders
% year
1996
1998
2000
2002
2004
2006
2008
2010
2012
Source: Oxford Economics

EURO ZONE — TABLE 1 SUMMARY ITEMS

Annual Percentage Changes, Unless Otherwise Specified

	CONSUMERS EXPENDITURE (C)	GROSS FIXED INVESTMENT (IF)	DOMESTIC DEMAND (DOMD)	REAL GDP (GDP)	INDUSTRIAL PRODUCTION (IP)	UNEMPLOYMENT RATE (%) (UP)	AVERAGE EARNINGS (ER)	WHOLE ECONOMY PRODUCTIVITY (GDPIET)	MONEY SUPPLY M3 (MON)	PRODUCER PRICES (PPI)	CONSUMER PRICES (CPI)
YEARS BEGINNING Q1											
2011	0.1	1.6	0.5	1.5	2.7	10.2	2.4	1.2	1.6	5.6	2.7
2012	-1.0	-3.2	-1.9	-0.6	-3.0	11.4	1.6	0.1	2.3	2.4	2.5
2013	-0.3	-0.8	-0.6	-0.1	0.0	12.1	1.2	0.7	1.8	1.3	1.9
2014	0.7	2.4	0.9	1.1	2.7	12.0	1.9	1.2	3.2	1.7	1.6
2015	1.1	2.9	1.3	1.4	2.9	11.7	2.2	1.2	3.6	1.8	1.3
2016	1.4	2.9	1.4	1.5	2.4	11.4	2.4	1.2	3.7	1.8	1.3
2011											
I	0.9	3.4	1.6	2.4	5.3	9.9	2.2	2.1	0.1	6.4	2.5
II	0.3	1.3	0.8	1.6	2.3	9.9	2.4	1.2	1.6	5.8	2.8
III	0.2	0.7	0.3	1.3	3.3	10.2	2.4	1.0	2.4	5.4	2.7
IV	-0.8	0.9	-0.8	0.6	0.1	10.6	2.4	0.7	2.3	4.7	2.9
2012											
I	-1.0	-2.4	-1.6	-0.1	-2.3	10.9	2.0	0.4	2.9	3.4	2.7
II	-0.7	-3.0	-2.1	-0.5	-3.1	11.2	1.7	0.2	2.9	2.1	2.5
III	-1.2	-3.6	-2.3	-1.0	-4.1	11.5	1.6	-0.2	1.9	2.1	2.5
IV	-0.9	-3.6	-1.7	-0.8	-2.6	11.8	1.2	0.0	1.5	2.0	2.3
2013											
I	-0.8	-2.5	-1.4	-0.7	-1.6	12.0	1.0	0.1	1.4	1.1	1.9
II	-0.6	-1.5	-1.0	-0.4	-0.4	12.1	1.1	0.5	1.2	1.3	1.8
III	-0.2	0.0	-0.3	0.2	0.6	12.1	1.4	1.0	2.1	1.2	1.8
IV	0.2	1.0	0.2	0.7	1.4	12.1	1.6	1.2	2.5	1.5	1.9
2014											
I	0.5	1.8	0.6	0.9	2.0	12.1	1.7	1.2	2.9	1.6	1.8
II	0.7	2.3	0.9	1.1	2.5	12.1	1.8	1.2	3.1	1.7	1.7
III	0.8	2.6	1.1	1.2	3.0	12.0	1.9	1.2	3.3	1.8	1.5
IV	0.9	2.8	1.2	1.3	3.1	11.9	2.0	1.2	3.5	1.8	1.4
2015											
I	1.0	2.9	1.3	1.4	3.1	11.8	2.1	1.2	3.6	1.8	1.4
II	1.1	2.9	1.3	1.4	3.0	11.7	2.2	1.2	3.6	1.8	1.3
III	1.2	3.0	1.4	1.4	2.8	11.7	2.2	1.2	3.6	1.8	1.3
IV	1.2	3.0	1.4	1.4	2.7	11.6	2.3	1.2	3.7	1.8	1.3
2016											
I	1.3	2.9	1.4	1.4	2.6	11.5	2.4	1.2	3.7	1.8	1.3
II	1.3	2.9	1.4	1.5	2.4	11.4	2.4	1.2	3.7	1.8	1.3
III	1.4	2.9	1.4	1.5	2.3	11.4	2.4	1.3	3.7	1.8	1.4
IV	1.4	2.8	1.4	1.5	2.1	11.3	2.5	1.3	3.7	1.8	1.4

EURO ZONE — TABLE 2 SUMMARY ITEMS

	TRADE BALANCE (EURO BN) (BVI)	CURRENT ACCOUNT (EURO BN) (BCU)	CURRENT ACCOUNT (% OF GDP) (BCU*100/GDP!)	GOVERNMENT FINANCIAL BALANCE (EURO BN) (GB)	GOVERNMENT FINANCIAL BALANCE (% OF GDP) (GB*100/GDP!)	SHORT-TERM INTEREST RATE (RSH)	LONG-TERM INTEREST RATE (RLG)	REAL SHORT-TERM INTEREST RATE (Note 1)	REAL LONG-TERM INTEREST RATE (Note 1)	US DOLLAR PER EURO (RXD)	EFFECTIVE RATE (1995=100) (RX)
YEARS BEGINNING Q1											
2011	-7.4	-3.1	-0.03	-386.5	-4.10	1.39	4.41	-1.33	1.69	1.39	120.8
2012	84.0	77.8	0.82	-325.5	-3.43	0.59	4.02	-1.90	1.53	1.28	115.3
2013	143.2	120.7	1.26	-243.4	-2.54	0.27	3.63	-1.60	1.76	1.24	114.2
2014	138.0	107.7	1.10	-205.3	-2.09	0.33	3.71	-1.28	2.11	1.17	110.3
2015	122.7	96.4	0.95	-159.3	-1.58	0.41	3.88	-0.94	2.54	1.12	106.7
2016	132.7	98.2	0.95	-116.2	-1.12	0.47	4.18	-0.87	2.84	1.13	107.2
2011											
I	-7.0	-1.8	-0.08	-112.6	-4.81	1.10	4.32	-1.38	1.84	1.37	119.4
II	-7.5	-6.0	-0.25	-99.9	-4.24	1.42	4.51	-1.34	1.75	1.44	122.4
III	-5.2	-1.1	-0.05	-90.3	-3.82	1.56	4.30	-1.14	1.60	1.41	121.2
IV	12.3	5.8	0.25	-83.7	-3.54	1.50	4.53	-1.45	1.59	1.35	120.4
2012											
I	11.3	16.8	0.71	-85.0	-3.59	1.04	4.39	-1.64	1.70	1.31	116.8
II	20.9	30.1	1.27	-88.6	-3.73	0.69	4.27	-1.76	1.82	1.28	115.8
III	17.7	17.7	0.75	-83.6	-3.53	0.36	3.79	-2.16	1.27	1.25	113.1
IV	34.0	13.2	0.56	-68.3	-2.88	0.25	3.62	-2.03	1.34	1.28	115.5
2013											
I	36.0	46.1	1.94	-63.5	-2.67	0.27	3.62	-1.67	1.68	1.26	114.9
II	35.3	31.8	1.33	-65.6	-2.75	0.27	3.61	-1.56	1.77	1.25	114.7
III	31.6	25.0	1.04	-60.1	-2.50	0.27	3.63	-1.57	1.79	1.23	114.2
IV	40.3	17.9	0.74	-54.2	-2.24	0.27	3.66	-1.58	1.80	1.21	113.0
2014											
I	39.4	46.1	1.90	-53.3	-2.19	0.29	3.68	-1.49	1.89	1.20	112.3
II	33.4	27.0	1.10	-54.7	-2.23	0.32	3.71	-1.39	2.00	1.18	111.0
III	28.7	20.6	0.84	-53.6	-2.17	0.34	3.73	-1.16	2.22	1.16	109.6
IV	36.5	14.0	0.56	-43.7	-1.76	0.36	3.75	-1.06	2.32	1.14	108.2
2015											
I	34.3	41.8	1.67	-40.7	-1.63	0.38	3.78	-1.02	2.39	1.12	106.6
II	28.2	23.1	0.92	-43.2	-1.72	0.40	3.83	-0.93	2.50	1.12	106.7
III	25.0	18.8	0.74	-43.0	-1.70	0.41	3.91	-0.92	2.58	1.12	106.7
IV	35.2	12.7	0.50	-32.4	-1.27	0.43	4.00	-0.88	2.68	1.12	106.7
2016											
I	35.2	41.1	1.60	-29.9	-1.16	0.45	4.07	-0.88	2.74	1.12	106.9
II	30.1	22.9	0.88	-33.0	-1.28	0.46	4.14	-0.87	2.80	1.12	107.0
III	28.2	19.8	0.76	-32.1	-1.23	0.48	4.21	-0.87	2.87	1.13	107.4
IV	39.3	14.4	0.55	-21.2	-0.81	0.49	4.29	-0.87	2.93	1.13	107.5

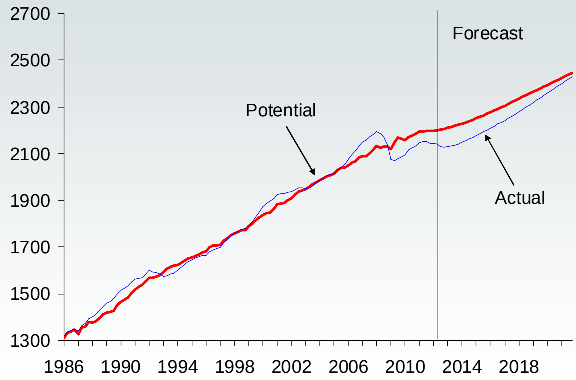
Note 1 : REAL INTEREST RATES = Nominal interest rate (RSH or RLG) - % change in CPI

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 0.6% in 2012, having grown by 1.5% in 2011 and to be significantly below potential growth at -0.1% in 2013. As a result, the large output gap of 2.2% in 2011 will expand in 2012 to 3.0% and increase in 2013 to 3.7%, and it is not forecast to close fully until 2024.
- The main contribution to growth in potential output over the coming decade comes from expanding capital usage.
- The 0.01%pt contribution from expanding labour usage reflects the 0.3%pa fall in the working population over the next ten years and an increase in the participation rate which combine to reduce the labour supply by 0.0%pa. For the capital stock's contribution of 0.6%pt, the main factor is significantly higher investment growth (at 1.5%pa) than in the previous decade. Finally, total factor productivity growth's slightly higher contribution of 0.5%pt reflects the better contribution to potential growth from factors influencing production other than labour and capital over the coming decade.

Eurozone: Actual & potential output

Euro bn 2005 prices



Source: Oxford Economics

Potential GDP and Its Components
Average Percentage Growth

	2002-2011	2012-2021
Potential GDP*	1.50	1.04
Employment at NAIRU	0.66	0.02
Capital Stock	2.15	1.58
Total Factor Productivity	0.32	0.48

*ln(Potential GDP)=0.65*ln(Employment at NAIRU) +0.35*ln(Capital Stock)+ln(Total Factor Productivity)

Long-Term Forecast for Eurozone
(Average annual percentage change unless otherwise stated)

	2002-2006	2007-2011	2012-2016	2017-2021
GDP	1.8	0.4	0.7	1.7
Consumption	1.5	0.4	0.4	1.5
Investment	2.1	-1.8	0.8	2.2
Government Consumption	1.9	1.5	0.0	1.1
Exports of Goods and Services	5.0	2.1	3.8	3.5
Imports of Goods and Services	5.0	1.6	3.1	3.4
Unemployment (%)	8.9	9.0	11.7	10.3
Consumer Prices	2.2	2.0	1.7	1.6
Current Balance (% of GDP)	0.3	-0.4	1.0	1.2
Exchange Rate (vs US$)	1.2	1.4	1.2	1.2
General Government Balance (% of GDP)	-2.5	-3.9	-2.2	-0.5
Short-term Interest Rates (%)	2.6	2.5	0.4	2.1
Long-term Interest Rates (%)	4.1	4.1	3.9	4.7
Working Population	0.5	0.2	-0.3	-0.3
Labour Supply	1.0	0.5	0.0	-0.1
Participation Ratio	72.5	74.0	75.2	75.8
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	-4.4	2.0	1.5	-0.6	-0.1	1.1	1.4	1.5	1.5	1.7	1.7	1.8	1.7	1.2
Consumption	1.0	0.4	-1.0	1.0	0.1	-0.9	-0.3	0.7	1.1	1.3	1.4	1.5	1.6	1.5	1.6	1.0
Investment	0.1	-1.4	-12.7	-0.3	1.6	-3.2	-0.8	2.4	2.9	2.9	2.6	2.4	2.2	2.0	1.8	1.5
Government Consumption	1.7	2.3	2.6	0.8	-0.1	0.0	-0.7	-0.1	0.4	0.6	0.8	1.0	1.2	1.3	1.3	0.6
Exports of Goods and Services	3.5	0.9	-12.4	10.9	6.3	2.6	2.9	4.6	4.7	4.4	4.1	3.8	3.5	3.2	2.8	3.7
Imports of Goods and Services	3.3	0.8	-10.9	9.3	4.1	-0.4	1.9	4.5	4.9	4.5	4.0	3.8	3.4	3.0	2.8	3.2
Unemployment (%)	9.0	7.7	9.6	10.1	10.2	11.3	12.1	12.0	11.7	11.4	11.1	10.7	10.3	9.8	9.4	11.0
Consumer Prices	2.1	3.3	0.3	1.6	2.7	2.5	1.9	1.6	1.3	1.3	1.4	1.5	1.6	1.7	1.8	1.7
Current Balance (% of GDP)	0.0	-1.6	-0.3	-0.1	0.0	0.8	1.3	1.1	1.0	0.9	1.0	1.1	1.2	1.2	1.3	1.1
Exchange Rate (per $)	1.3	1.5	1.4	1.3	1.4	1.3	1.2	1.2	1.1	1.1	1.1	1.1	1.2	1.2	1.2	1.2
General Government Balance (% of GDP)	-3.2	-2.1	-6.4	-6.2	-4.1	-3.4	-2.5	-2.1	-1.6	-1.1	-0.7	-0.5	-0.4	-0.3	-0.4	-1.3
Short-term Interest Rates (%)	2.5	4.6	1.2	0.8	1.4	0.6	0.3	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	3.6	3.7	3.9	4.2	4.4	4.5	4.6	4.8	5.0	4.3
Working Population	0.3	0.4	0.1	0.1	-0.1	-0.2	-0.3	-0.3	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Labour Supply	0.7	0.8	0.2	0.1	0.3	0.6	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	0.0
Participation Ratio (%)	73.2	73.9	74.0	74.0	74.3	74.9	75.1	75.2	75.3	75.4	75.5	75.7	75.8	75.9	76.1	75.5
Labour productivity	0.6	-0.5	-2.6	2.5	1.2	0.1	0.7	1.2	1.2	1.2	1.3	1.4	1.4	1.4	1.4	1.1
Employment	0.5	0.8	-1.8	-0.5	0.2	-0.7	-0.7	-0.1	0.2	0.2	0.3	0.3	0.4	0.3	0.3	0.1
Output gap (% of potential GDP)	0.0	1.9	-3.5	-2.6	-2.2	-3.0	-3.7	-3.5	-3.2	-3.0	-2.7	-2.3	-1.8	-1.3	-0.9	-2.5

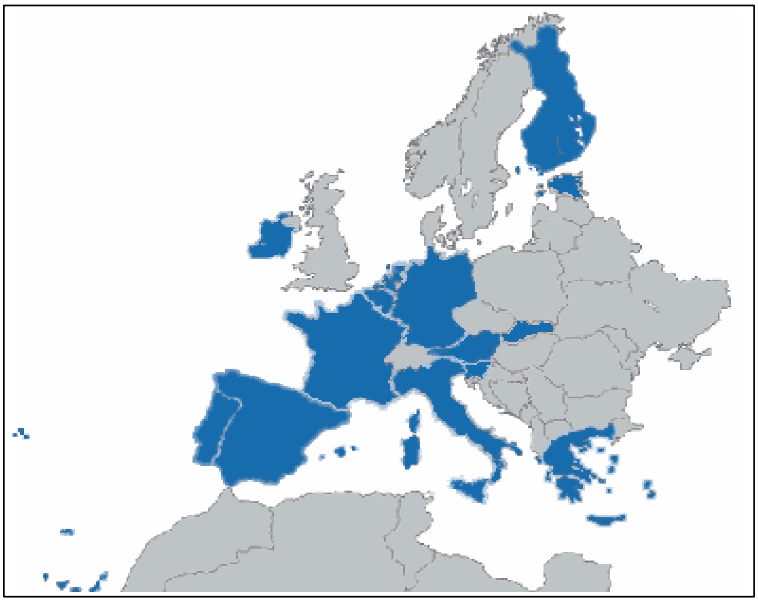
Background

- The creation of a single European currency was achieved in 1999, with notes and coins being introduced in 2002. The eleven initial members were Germany, France, Italy, Finland, Ireland, Netherlands, Belgium, Luxembourg, Austria, Portugal and Spain, with Greece joining European Monetary Union (EMU) in 2001 and introducing notes and coins at the same time as the other countries. Slovenia was the 13th member in January 2007, Malta and Cyprus joined a year later, Slovakia became the 16th member in January 2009 and Estonia the 17th in January 2011.
- To qualify for membership of the Eurozone, countries have to pass a number of nominal convergence criteria set out in the Maastricht Treaty: the inflation rate should not exceed by more than 1.5% points the average inflation rate of the three EU countries with the lowest inflation; the government deficit should not exceed 3% of GDP and gross government debt should be no higher than 60% of GDP; countries should have been members of ERM II and have not devalued their currency in the previous two years; and long-term interest rates should not be more than 2% points higher than the average in the three EU countries with the lowest inflation. In practice, these conditions were applied quite loosely to the original EMU members, with elements of the fiscal criteria being selectively overlooked for Italy and Belgium (and then Greece) and with little attention as to whether the budget deficit was below 3% of GDP on a sustainable basis. However, the narrow failure of Lithuania to win approval for adopting the euro in 2007 suggests that the convergence criteria will be applied much more strictly to new EU members.
- Joining EMU sees the member country pass control of its monetary policy to the European Central Bank (ECB). The ECB is one of the most independent central banks in the world and was built on the lines of the German Bundesbank. Not only does the ECB have ‘operational’ independence – allowing it to set interest rates free from political control – but it also has ‘goal’ independence to set its own targets. The ECB objective is to achieve price stability and this is pursued through economic and monetary analysis; the ECB targets inflation of close to, but not exceeding, 2%, and maintains a reference target of 4.5% for M3 money supply growth. The two components of analysis were to act as a crosscheck, but economic analysis has taken precedence in recent years, with monetary targeting slipping into the background. Since 2008, the ECB has increasingly focused on providing liquidity to banks, with in particular two sets of three-year loans granted in December 2011 and February 2012.
- National governments retain control of fiscal policy, although there are limits to their freedom in this area as specified in the Growth and Stability Pact, which essentially applies the fiscal requirements of the Maastricht Treaty on an ongoing basis. However, even before the global crisis, a number of Eurozone countries had difficulty keeping their budget deficits below 3% of GDP and debt below 60% of GDP on a sustained basis and faced sanctions by the EC. However, the effectiveness of the Growth and Stability Pact against the major Eurozone economies of Germany, France and Italy proved limited, while smaller countries such as the Netherlands made painful adjustments when their deficit exceeded the 3% of GDP threshold and others observed the requirements stringently. This forced a re-interpretation of the Pact, which is now applied over the economic cycle.
- The fallout from the financial crisis, and in particular the troubled fiscal situation faced by Greece, Italy, Ireland, Portugal and Spain, showed the limitations of the fiscal framework behind the single currency. The possibility of a debt default by Greece, coupled with the threat of contagion to Italy and Spain, has put Eurozone leaders under immense pressure to come up with a rescue plan that would prevent the collapse of the single currency. However, there are significant difference of opinion among the largest members regarding who should carry the burden and what mechanisms should be used to provide financial support to the European banking system. The core of the discussions focuses a reform of the European Union Treaty in order to impose tougher rules regarding budget and fiscal discipline. Other measures include a move towards a banking union that would severe the links between banks and their sovereigns. However, political hurdles to closer integration and debt burden sharing remains very high. So significant changes are unlikely to be agreed upon in the near future.

Key Facts

Politics

President of the ECB: Mario DRAGHI
Vice president of the ECB: Vítor CONSTANCIO
EC commissioner for Economic and Monetary Affairs:
Olli Rehn
Chairman of Euro Group of Finance Ministers:
Claude Juncker



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

Long-term economic & social development

	1980	1990	2000	2011*
GDP per capita (US$)	-	19175	19886	39460
Inflation (%)	9.9	4.2	2.2	2.7
Population (mn)	286	305	315	332
Urban population (% of total)	69.9	71.0	72.3	73.9
Life expectancy (years)	-	76.2	78.5	80.9

Source : Oxford Economics & World Bank

Structure of GDP by output

	2009
Agriculture	0.9%
Industry	22.5%
Services	76.6%

Source : Eurostat

* 2011 or latest available year

Corruption perceptions index 2011

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

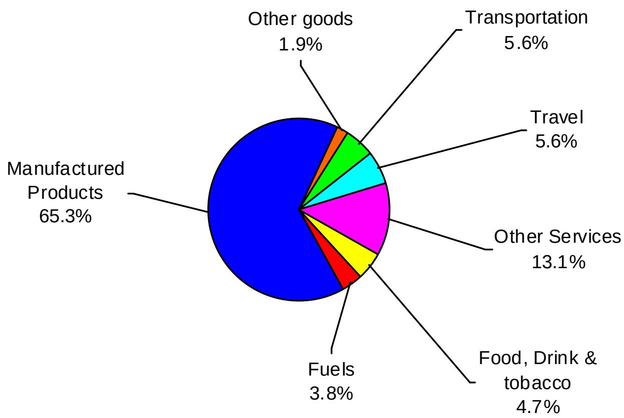
Source: Transparency International
Scoring system 10 = highly clean, 0 = highly corrupt

Structural economic indicators

	1990	1995	2000	2011*
Current account (US$ billion)	11	54	-95	-4
Trade balance (US$ billion)	-25	63	-28	-10
FDI (US$ billion)	-	-	30	-83
Govt budget (% of GDP)	-4.1	-7.5	-0.1	-4.1
Govt debt (% of GDP)	13.5	67.3	67.1	86.7
Long-term interest rate	10.9	8.7	5.4	4.4
Oil production (000 bpd)	271	313	240	214
Oil consumption (000 bpd)	9715	10483	10916	9959

Source : Oxford Economics / World Bank / EIA / ECB

Composition of extra-EMU goods & services exports, 2008



Source : Eurostat

Destination of goods' exports (2009)

Eurozone	50.4%
UK	6.8%
United States	5.9%
Switzerland	3.1%
China	2.7%
Poland	2.6%

Source : Eurostat