OXFORD ECONOMICS

Eurozone

Highlights and Key Issues

- Just as Eurozone financial markets were starting to get out of control again, ECB President Draghi restored some calm by pledging that the ECB will “do what it takes” to save the Eurozone. At the latest press conference Draghi stated that the ECB was considering substantial bond purchases, which would be aimed at lowering government bond yields and reducing the pressure on public finances and the real economies of the ‘peripheral’ countries.
- Markets have responded positively, encouraged by indications that the ECB will drop its demand for seniority over private investors. However, such rallies have petered out quickly in the past and markets will need to see concrete action for the improvement to be sustained. One possible stumbling block is that Draghi made it clear that bond purchases by the ECB would only happen once a country applied to the Eurozone’s rescue funds for assistance and accepted “strict and effective conditionality”.
- We have slightly reduced our forecast for GDP growth for both core and peripheral economies. The revision to core countries was prompted by disappointing data, showing in particular that the manufacturing sector may be shrinking more rapidly than expected. In the periphery, the revision is mainly accounted for by Spain implementing yet another stringent austerity package. Overall, Eurozone GDP is now forecast to fall by 0.6% in 2012, before expanding 0.2% in 2013. GDP will only return to pre-crisis levels at the end of 2014.

Forecast for Eurozone

(Annual percentage changes unless specified)

	2011	2012	2013	2014	2015	2016
Domestic Demand	0.5	-2.2	-0.3	1.5	2.0	2.1
Private Consumption	0.2	-0.8	0.0	1.1	1.6	1.8
Fixed Investment	1.6	-3.6	0.3	3.2	3.7	3.5
Government Consumption	-0.3	-0.4	-0.9	0.1	0.8	1.1
Net exports (% of GDP)	2.9	4.4	4.8	4.9	5.0	5.0
GDP	1.5	-0.6	0.2	1.6	2.0	2.1
Industrial Production	2.8	-2.6	0.9	3.3	3.3	2.6
Consumer Prices	2.7	2.3	1.8	1.8	1.9	1.9
Current Account (% of GDP)	0.0	0.7	1.2	1.1	1.1	1.2
Government Budget (% of GDP)	-4.1	-3.5	-2.5	-2.0	-1.6	-1.2
Short-Term Interest rate (%)	1.4	0.8	0.8	1.0	2.0	3.0
Long-Term Interest Rates (%)	4.4	4.1	4.0	4.1	4.4	4.8
Exchange rate (US$ per Euro)	1.39	1.27	1.28	1.27	1.24	1.24
Exchange rate (YEN per Euro)	111.0	101.4	110.7	117.7	118.4	120.8

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Overview

Stability restored by ECB words…

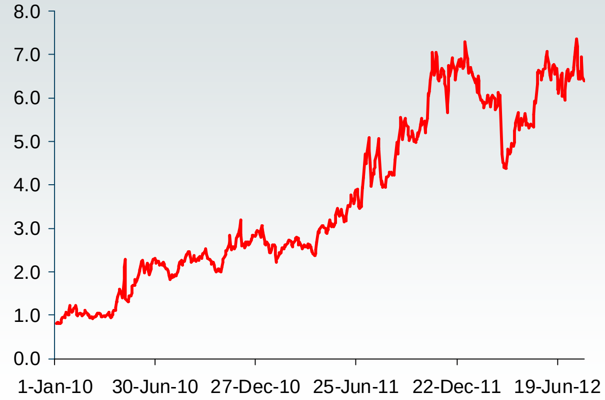
- Just as the situation in Eurozone financial markets seemed to be getting out of control again, with rising bond yields in peripheral countries and sharp falls in share prices and the euro, ECB President Draghi restored some calm by pledging that the ECB will "do what it takes" to save the Eurozone. This statement was followed up at the latest ECB press conference by confirmation that the ECB is considering restarting its Secondary Market bond Purchase (SMP) programme.
- Substantial bond purchases by the ECB would be aimed at lowering government bond yields in the 'peripheral' countries, which the ECB now considers embody an unacceptable premium related to convertibility risk, i.e. the possibility that countries could leave the euro. Lower yields would in turn reduce the pressure on public finances and the real economy in the 'peripherals', with banks able to pass on lower funding costs to their customers (who have seen rising retail loan costs) and under less pressure to restrict credit to shore up their balance sheets.
- The initial market reaction has been positive, helped by indications from Draghi that the ECB may drop its demands for seniority over other bond investors. Yields at the short-end of the curve in Spain and Italy have dropped sharply. Longer-term yields have also fallen, although they remain uncomfortably high at just below 7% in Spain and just below 6% in Italy. The underperformance of longer-term bonds in recent days reflects Draghi's statement that ECB bond purchases would be likely to focus on the short-end of the yield curve.

…but action needs to follow

- A bond purchase programme by the ECB features prominently in our list of actions needed to preserve the Eurozone because it can give governments time to introduce structural reforms that will put the single currency area on a firmer footing. This is especially necessary given the often lengthy decision making process in the Eurozone in which several summits and other meetings are needed to agree on new measures.
- In addition, the ECB can in principle purchase an unlimited quantity of assets, allowing it to have a far bigger impact on financial markets than bailout funds

Weighted average peripheral bond spread

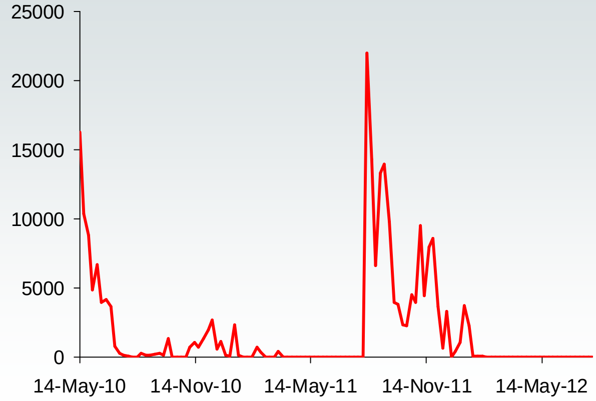
% spread over German bunds



Source : Oxford Economics

ECB's government bond purchases

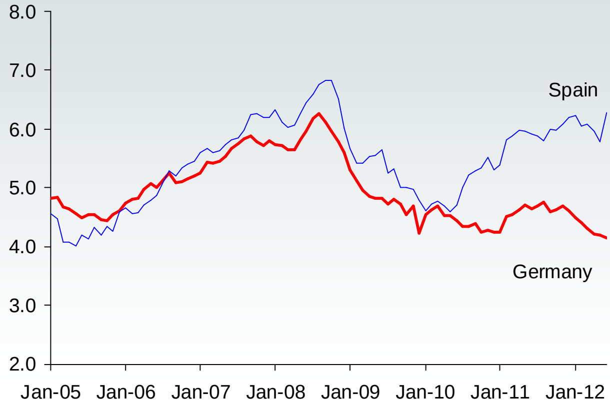
€ Mn



Source : ECB

Typical interest rates on loans to businesses

%



Source : ECB

such as the ESM, whose funding is currently capped at €500bn (some of which has already been pledged for other purposes).

- However, financial market rallies following announcements by Eurozone policymakers have petered out quickly in the past and markets will need to see concrete action for the recent improvement to be sustained.
- One possible stumbling block is that Draghi emphasised at the August press conference that to qualify for further ECB bond purchases a country would have to apply for assistance from the Eurozone's rescue funds and accept "strict and effective conditionality". It is unclear whether Spain and Italy would be prepared to accept this.

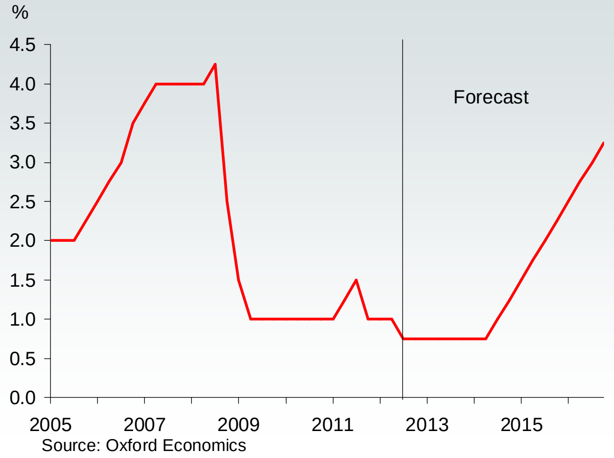
Downward revisions to the core…

- ECB bond purchases formed part of our baseline forecast prior to Draghi's comments, and therefore this announcement does not itself trigger a forecast revision.
- Data on economic activity in the core countries has been weaker than expected, however. The manufacturing sector in particular has been shrinking rapidly. In July the Eurozone manufacturing PMI fell to 44.0, its lowest level since June 2009. Even countries like Germany have been experiencing a sharp contraction in this sector.
- As a result, we have slightly reduced our 2013 forecast for GDP growth in the core Eurozone countries (our definition of 'core' excludes Greece, Italy, Spain, Portugal and Ireland). We now expect GDP to grow by 0.2% this year, and 0.9% in 2013.

…and peripheral regions

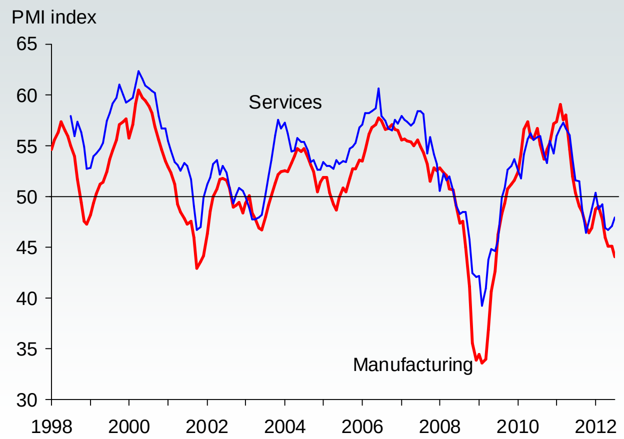
- We have also revised our forecast for 'peripheral' countries down a little, mainly to account for the latest austerity package implemented in Spain, which will dent growth even more than we had thought. We expect Spanish GDP to fall 1.4% this year, worsening to a 2.1% contraction next. We think that the worst is not over yet for Spain as the country absorbs the impact of very large austerity packages and the restructuring of its banking sector.
- Overall, Eurozone GDP is forecast to fall by 0.6% in 2012, before rising 0.2% in 2013 (down from 0.5% last month). GDP will only return to pre-crisis levels at the end of 2014.

Eurozone: ECB refinancing rate



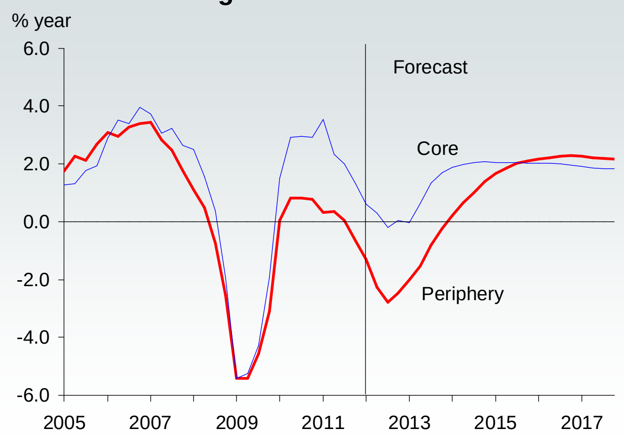
Source: Oxford Economics

Eurozone: PMIs



Source : Markit

Eurozone: GDP growth



Source : Oxford Economics

Key Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

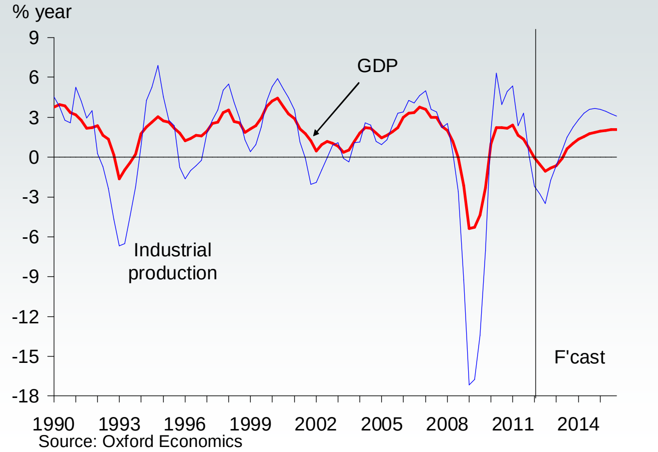
	Industrial production (% yr)	Unemploy-ment (% point)	CPI (% yr)	Business confidence (% balance)	Consumer confidence (% balance)	Exports (% yr)	Imports (% yr)	Trade balance (€ bn)
Jul	4.3	10.1	2.6	0.5	-11.5	5.4	7.8	2.1
Aug	5.1	10.2	2.5	0.1	-16.8	14.1	13.1	-5.8
Sep	2.2	10.4	3.0	-0.1	-19.3	9.9	8.8	2.0
Oct	1.1	10.5	3.0	-0.2	-20.1	5.8	8.2	0.0
Nov	0.0	10.6	3.0	-0.4	-20.5	10.3	4.7	5.5
Dec	-1.5	10.7	2.7	-0.3	-21.3	9.7	1.9	8.8
2012								
Jan	-1.4	10.8	2.7	-0.2	-20.7	11.1	4.2	-8.7
Feb	-1.5	10.9	2.7	-0.2	-20.3	11.1	7.2	1.9
Mar	-1.6	11.0	2.7	-0.3	-19.1	4.5	0.5	7.2
Apr	-2.4	11.1	2.6	-0.5	-19.9	5.9	-0.1	3.7
May	-2.5	11.2	2.4	-0.8	-19.3	5.6	0.2	6.9
Jun	-	11.2	2.4	-1.0	-19.8	-	-	-
Jul	-	-	2.4	-1.3	-21.5	-	-	-

Financial Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

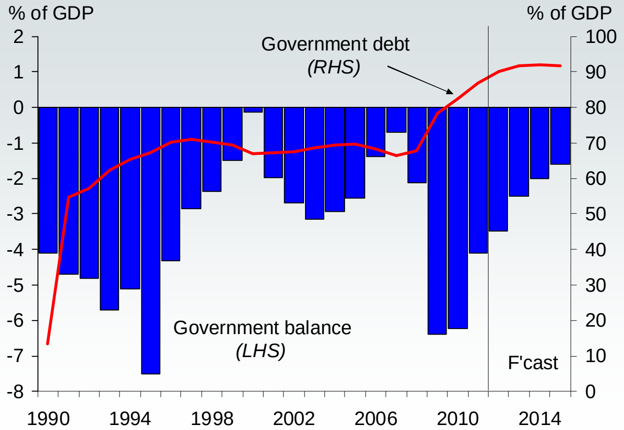
	Short rate %	Long rate %	Money Supply (M3)	Exchange rate $/€ avg.	Exchange rate €/£	Nominal effective exch. rate	Share price DJ STOXX	Net FDI € bn
Jul	1.60	4.59	2.0	1.426	1.131	108.2	2670.4	-17.3
Aug	1.55	4.21	2.7	1.434	1.142	107.6	2302.1	7.2
Sep	1.54	4.04	2.9	1.377	1.147	106.3	2179.7	-9.0
Oct	1.58	4.09	2.6	1.371	1.149	106.5	2385.2	-5.6
Nov	1.48	4.41	1.9	1.356	1.166	105.6	2330.4	-45.0
Dec	1.43	4.11	1.5	1.318	1.184	103.6	2316.6	-4.3
2012								
Jan	1.22	3.92	2.5	1.290	1.203	101.6	2416.7	3.6
Feb	1.05	3.75	2.8	1.322	1.194	102.9	2512.1	-0.2
Mar	0.86	3.29	3.2	1.320	1.198	103.4	2477.3	-8.8
Apr	0.74	3.39	2.6	1.316	1.216	102.8	2306.4	-9.6
May	0.68	3.53	3.1	1.279	1.244	100.8	2118.9	10.6
Jun	0.66	3.41	3.2	1.253	1.242	99.7	2264.7	-
Jul	0.50	3.25	-	1.229	1.269	97.6	2325.7	-

Eurozone: GDP and industrial production



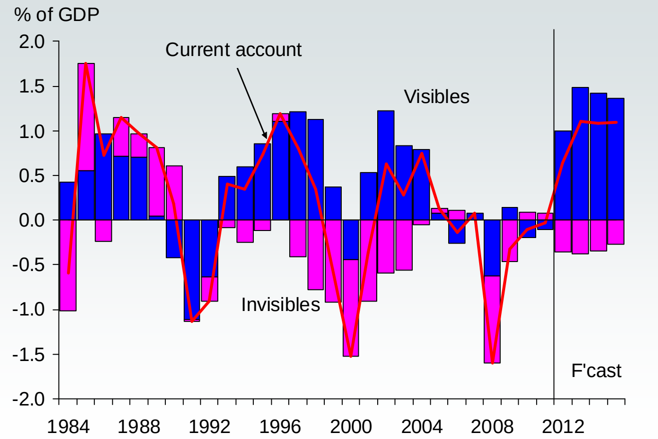
Source: Oxford Economics

Eurozone: Government finances



Source: Oxford Economics

Eurozone: Current account

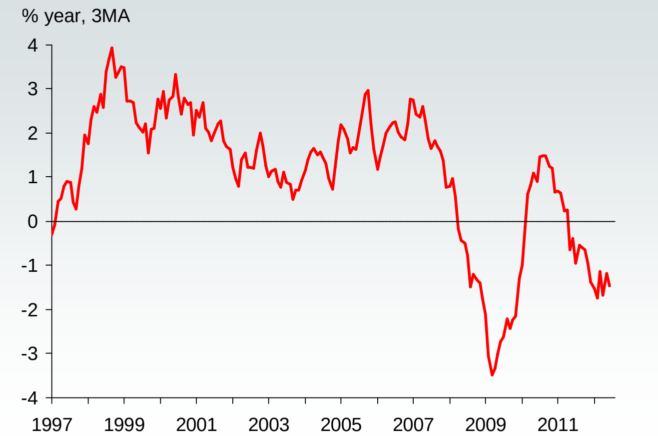


Source: Oxford Economics

Dollar/euro exchange rate

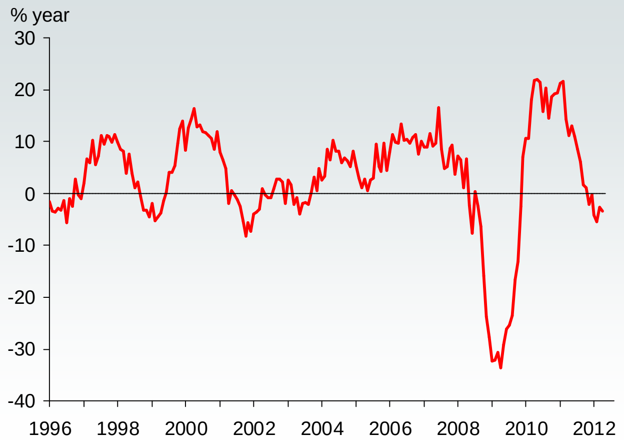
Source: Oxford Economics

Eurozone: Retail sales



Source: Oxford Economics

Eurozone: Industrial new orders



Source: Oxford Economics

EURO ZONE — **TABLE 1 SUMMARY ITEMS**

Annual Percentage Changes, Unless Otherwise Specified

	CONSUMERS EXPENDITURE (C)	GROSS FIXED INVESTMENT (IF)	DOMESTIC DEMAND (DOMD)	REAL GDP (GDP)	INDUSTRIAL PRODUCTION (IP)	UNEMPLOY-MENT RATE (%) (UP)	AVERAGE EARNINGS (ER)	WHOLE ECONOMY PRODUCT-IVITY (GDP/ET)	MONEY SUPPLY M3 (MON)	PRODUCER PRICES (PPI)	CONSUMER PRICES (CPI)
YEARS BEGINNING Q1											
2011	0.2	1.6	0.5	1.5	2.8	10.2	2.4	1.4	2.7	5.6	2.7
2012	-0.8	-3.6	-2.2	-0.6	-2.6	11.3	1.8	0.1	2.8	1.8	2.3
2013	0.0	0.3	-0.3	0.2	0.9	11.9	1.9	0.9	3.3	1.5	1.8
2014	1.1	3.2	1.5	1.6	3.3	11.7	2.2	1.5	4.4	2.2	1.8
2015	1.6	3.7	2.0	2.0	3.3	11.1	2.5	1.5	4.5	2.2	1.9
2016	1.8	3.5	2.1	2.1	2.6	10.4	2.7	1.5	4.2	2.1	1.9
2011											
I	1.0	3.7	1.6	2.4	5.3	9.9	2.2	2.2	2.7	6.4	2.5
II	0.2	1.2	0.8	1.7	2.3	10.0	2.4	1.3	2.4	5.8	2.8
III	0.2	0.8	0.4	1.3	3.3	10.2	2.6	1.2	3.5	5.4	2.7
IV	-0.7	0.7	-0.7	0.7	0.1	10.6	2.4	0.9	2.3	4.7	2.9
2012											
I	-0.7	-2.6	-1.7	0.0	-2.2	10.9	2.0	0.4	3.2	3.1	2.7
II	-0.6	-3.7	-2.3	-0.6	-2.8	11.1	1.5	0.0	2.8	1.7	2.4
III	-1.2	-4.2	-2.7	-1.1	-3.5	11.4	1.7	-0.2	2.2	1.1	2.1
IV	-0.8	-3.7	-2.0	-0.8	-1.8	11.7	1.8	0.1	2.9	1.2	1.9
2013											
I	-0.7	-2.1	-1.5	-0.7	-0.7	11.8	1.7	0.2	3.0	0.7	1.7
II	-0.2	-0.1	-0.6	-0.1	0.5	11.9	2.0	0.8	2.9	1.2	1.7
III	0.2	1.4	0.3	0.6	1.5	11.9	2.0	1.2	3.5	2.1	1.8
IV	0.6	2.2	0.8	1.1	2.2	11.9	2.0	1.4	3.9	2.2	1.8
2014											
I	0.8	2.7	1.1	1.3	2.8	11.9	2.1	1.5	4.2	2.2	1.8
II	1.1	3.0	1.5	1.6	3.3	11.7	2.2	1.5	4.4	2.2	1.8
III	1.2	3.3	1.7	1.7	3.6	11.6	2.2	1.5	4.5	2.2	1.8
IV	1.4	3.5	1.8	1.9	3.7	11.5	2.3	1.5	4.6	2.2	1.8
2015											
I	1.5	3.7	1.9	2.0	3.6	11.3	2.4	1.5	4.6	2.2	1.9
II	1.6	3.8	1.9	2.0	3.4	11.2	2.5	1.5	4.5	2.2	1.9
III	1.7	3.7	2.0	2.1	3.2	11.0	2.6	1.4	4.5	2.2	1.8
IV	1.7	3.7	2.0	2.1	3.1	10.8	2.6	1.4	4.4	2.1	1.8
2016											
I	1.8	3.6	2.1	2.1	2.9	10.7	2.7	1.5	4.4	2.1	1.9
II	1.8	3.6	2.1	2.1	2.7	10.5	2.7	1.5	4.3	2.1	1.9
III	1.8	3.5	2.1	2.1	2.5	10.3	2.7	1.5	4.2	2.1	1.9
IV	1.8	3.4	2.1	2.1	2.4	10.2	2.7	1.5	4.1	2.0	1.9

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	-10.3	-3.1	-0.03	-386.5	-4.11	1.39	4.41	-1.33	1.69	1.39	120.8
2012	96.0	64.1	0.68	-330.1	-3.49	0.81	4.11	-1.47	1.83	1.27	115.0
2013	147.2	110.9	1.15	-239.2	-2.48	0.75	4.02	-1.01	2.26	1.28	117.5
2014	147.4	112.5	1.13	-200.0	-2.01	0.99	4.12	-0.82	2.31	1.27	117.8
2015	146.3	119.0	1.15	-163.4	-1.58	1.99	4.36	0.13	2.51	1.24	116.1
2016	149.6	126.8	1.18	-128.8	-1.20	2.99	4.79	1.12	2.93	1.24	116.2
2011											
I	-7.8	-1.8	-0.08	-112.6	-4.82	1.10	4.32	-1.38	1.84	1.37	119.4
II	-8.4	-6.0	-0.26	-99.9	-4.25	1.42	4.51	-1.34	1.75	1.44	122.4
III	-5.8	-1.1	-0.05	-90.3	-3.82	1.56	4.30	-1.14	1.60	1.41	121.2
IV	11.6	5.8	0.25	-83.7	-3.55	1.50	4.53	-1.45	1.59	1.35	120.4
2012											
I	11.2	16.8	0.71	-88.2	-3.73	1.04	4.39	-1.61	1.73	1.31	116.8
II	23.0	20.1	0.85	-89.2	-3.77	0.69	4.27	-1.75	1.83	1.28	115.8
III	24.1	16.2	0.69	-84.0	-3.55	0.75	3.90	-1.35	1.80	1.24	113.0
IV	37.8	10.9	0.46	-68.7	-2.90	0.75	3.87	-1.17	1.95	1.25	114.2
2013											
I	33.3	39.1	1.64	-63.8	-2.68	0.75	3.93	-0.97	2.21	1.27	116.0
II	33.4	33.2	1.38	-65.3	-2.72	0.75	4.03	-0.93	2.35	1.28	117.2
III	35.2	22.9	0.95	-58.9	-2.43	0.75	4.06	-1.04	2.27	1.29	118.2
IV	45.3	15.7	0.64	-51.2	-2.10	0.75	4.06	-1.09	2.22	1.29	118.8
2014											
I	38.7	42.9	1.74	-50.4	-2.05	0.75	4.07	-1.02	2.31	1.29	119.1
II	33.0	32.5	1.31	-52.8	-2.13	0.78	4.11	-1.06	2.27	1.27	118.2
III	32.9	21.5	0.86	-52.8	-2.11	1.07	4.13	-0.75	2.31	1.26	117.2
IV	42.8	15.6	0.62	-44.0	-1.74	1.36	4.16	-0.46	2.34	1.25	116.6
2015											
I	36.2	43.0	1.68	-41.3	-1.62	1.61	4.22	-0.26	2.35	1.24	116.2
II	32.3	33.7	1.31	-44.0	-1.71	1.86	4.29	0.01	2.44	1.24	116.1
III	33.7	24.2	0.93	-44.1	-1.69	2.11	4.40	0.27	2.56	1.24	116.1
IV	44.1	18.1	0.69	-34.0	-1.29	2.36	4.52	0.51	2.67	1.24	116.1
2016											
I	37.7	45.2	1.70	-32.2	-1.21	2.61	4.63	0.75	2.76	1.24	116.1
II	33.4	35.6	1.33	-36.0	-1.34	2.86	4.73	0.99	2.87	1.24	116.2
III	34.2	26.2	0.97	-35.6	-1.32	3.11	4.85	1.26	2.99	1.24	116.2
IV	44.3	19.8	0.72	-25.0	-0.92	3.36	4.95	1.49	3.09	1.24	116.3

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

Potential output growth 1.3%pa

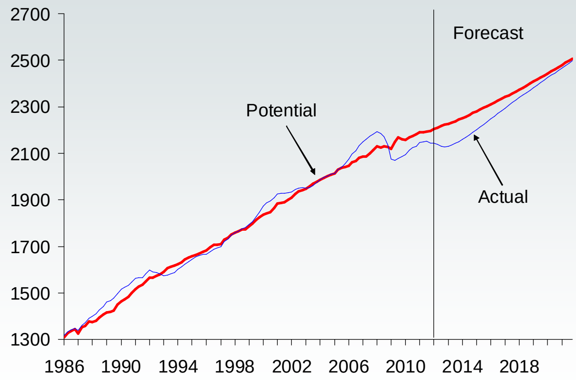
- Potential output is projected to rise by 1.3%pa over the next 10 years, a slightly lower rate than in the previous decade. GDP is set to contract by 0.6% in 2012, having grown by 1.5% in 2011 and to be significantly below potential growth at 0.2% in 2013. As a result, the large output gap of 2.1% in 2011 will expand in 2012 to 3.6% and increase in 2013 to 4.4%, and it is not forecast to close fully until 2023.

- The main contribution to growth in potential output over the coming decade comes from expanding capital usage.

- The 0.09%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 2%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

Euro bn 2005 prices



Source: Oxford Economics

Potential GDP and Its Components Average Percentage Growth	2002-2011	2012-2021
Potential GDP*	1.49	1.29
Employment at NAIRU	0.65	0.13
Capital Stock	2.15	1.73
Total Factor Productivity	0.31	0.60

*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	1.1	1.8
Consumption	1.5	0.4	0.7	1.6
Investment	2.1	-1.7	1.4	2.6
Government Consumption	1.9	1.5	0.2	1.4
Exports of Goods and Services	5.0	2.1	4.1	3.7
Imports of Goods and Services	5.0	1.5	3.4	3.8
Unemployment (%)	8.9	9.0	11.3	8.9
Consumer Prices	2.2	2.0	1.9	1.9
Current Balance (% of GDP)	0.3	-0.4	1.1	1.1
Exchange Rate (vs US$)	1.2	1.4	1.3	1.3
General Government Balance (% of GDP)	-2.5	-3.9	-2.1	-0.7
Short-term Interest Rates (%)	2.6	2.5	1.5	4.1
Long-term Interest Rates (%)	4.1	4.1	4.3	5.1
Working Population	0.5	0.2	-0.3	-0.3
Labour Supply	1.0	0.4	0.0	-0.1
Participation Ratio	72.5	73.9	75.0	75.7
Labour Productivity	0.8	0.4	1.1	1.4

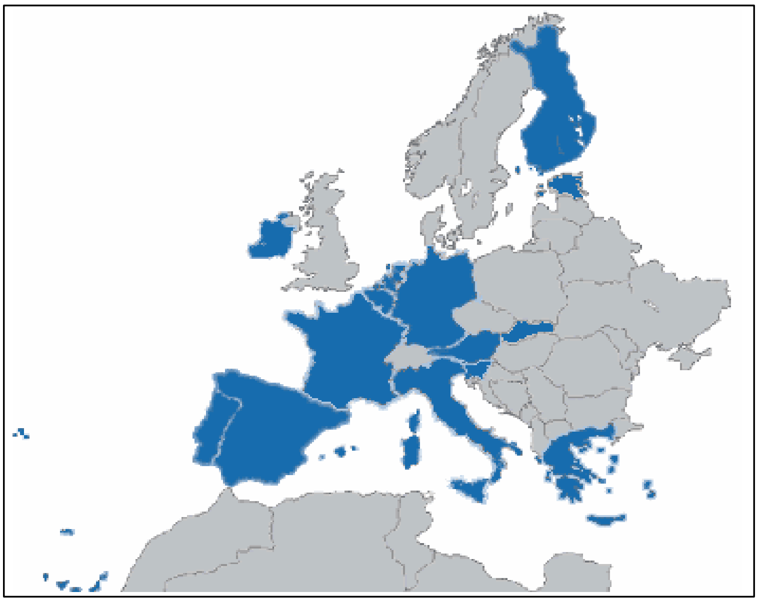
Long-Term Forecast for Eurozone Annual percentage changes unless otherwise specified	2002-2011	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
GDP	1.1	0.3	-4.4	1.9	1.5	-0.6	0.2	1.6	2.0	2.1	2.0	1.9	1.8	1.8	1.7	1.5
Consumption	0.9	0.3	-1.1	0.9	0.2	-0.8	0.0	1.1	1.6	1.8	1.8	1.7	1.6	1.5	1.5	1.2
Investment	0.2	-1.3	-12.4	-0.2	1.6	-3.6	0.3	3.2	3.7	3.5	3.2	2.9	2.6	2.2	2.0	2.0
Government Consumption	1.7	2.3	2.6	0.7	-0.3	-0.4	-0.9	0.1	0.8	1.1	1.3	1.3	1.4	1.4	1.5	0.8
Exports of Goods and Services	3.5	0.8	-12.7	11.0	6.3	1.7	3.0	5.5	5.6	5.1	4.5	4.1	3.6	3.2	2.9	3.9
Imports of Goods and Services	3.3	0.7	-11.4	9.4	4.1	-1.8	2.2	5.7	5.8	5.4	4.8	4.3	3.8	3.3	2.9	3.6
Unemployment (%)	9.0	7.7	9.6	10.1	10.2	11.3	11.9	11.7	11.1	10.4	9.8	9.3	8.8	8.4	8.0	10.1
Consumer Prices	2.1	3.3	0.3	1.6	2.7	2.3	1.8	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Current Balance (% of GDP)	0.0	-1.6	-0.3	-0.1	0.0	0.7	1.2	1.1	1.1	1.2	1.2	1.1	1.1	1.1	1.1	1.1
Exchange Rate (per $)	1.3	1.5	1.4	1.3	1.4	1.3	1.3	1.3	1.2	1.2	1.2	1.2	1.3	1.3	1.3	1.3
General Government Balance (% of GDP)	-3.2	-2.1	-6.4	-6.2	-4.1	-3.5	-2.5	-2.0	-1.6	-1.2	-0.9	-0.7	-0.6	-0.6	-0.6	-1.4
Short-term Interest Rates (%)	2.5	4.6	1.2	0.8	1.4	0.8	0.8	1.0	2.0	3.0	3.9	4.1	4.1	4.1	4.1	2.8
Long-term Interest Rates (%)	4.1	4.3	3.8	3.6	4.4	4.1	4.0	4.1	4.4	4.8	5.1	5.1	5.1	5.1	5.1	4.7
Working Population	0.3	0.4	0.1	0.1	-0.1	-0.2	-0.3	-0.3	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Labour Supply	0.7	0.8	0.2	0.0	0.2	0.4	0.0	-0.1	-0.1	-0.1	0.0	0.0	-0.1	-0.1	-0.2	0.0
Participation Ratio (%)	73.2	73.9	74.0	74.0	74.1	74.6	74.8	75.0	75.1	75.2	75.4	75.6	75.7	75.9	76.0	75.3
Labour productivity	0.6	-0.5	-2.6	2.5	1.4	0.1	0.9	1.5	1.5	1.5	1.4	1.4	1.4	1.4	1.5	1.2
Employment	0.5	0.8	-1.8	-0.6	0.1	-0.7	-0.7	0.1	0.6	0.6	0.6	0.5	0.4	0.3	0.2	0.2
Output gap (% of potential GDP)	0.0	2.0	-3.4	-2.6	-2.1	-3.6	-4.4	-3.9	-3.2	-2.5	-1.8	-1.3	-1.0	-0.7	-0.5	-2.3

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 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 to 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 EU Treaty in order to impose tougher rules regarding budget and fiscal discipline. Other measures 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. 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	19887	39410
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

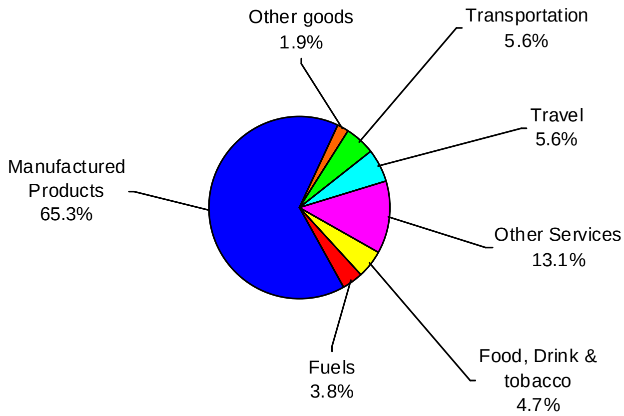
Source: Transparency International
Scoring system 10 = highly clean, 0 = highly corrupt

Structural economic indicators

	1990	1995	2000	2011*
Current account (US$ billion)	11	54	-95	-4
Trade balance (US$ billion)	-25	63	-28	-14
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	86.8
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	10005

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

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