Highlights and Key Issues

- After a lull in the first few months of the year, financial tensions in the Eurozone are reappearing. Peripheral bond yields have risen significantly and share prices have fallen back from this year's highs. And the boost to investor confidence given by the ECB's loans to banks seems to be waning.
- Meanwhile, data on economic activity support our view that the Eurozone is in mild recession. We have maintained our forecast of negative GDP growth in Q1 and Q2 this year, leading to a 0.5% contraction in 2012 as a whole. And divergence within the Eurozone keeps deepening.
- Doubts remain about the Eurozone's ability to prevent or manage a serious crisis, should it require significant bailouts for countries as large as Spain or Italy. The extension of the Eurozone's firewall agreed on 30 March has been kept to the minimum that was acceptable to increasingly reluctant lender countries. The folding of the EFSF funds into the ESM is a welcome decision, but is not bold enough to remove any concern about the Eurozone's handling of future crises.
- Crisis prevention or management will continue to rely to a large extent on the ECB. No rate cuts seem to be on the ECB's agenda for the foreseeable future and we do not expect any unless the recession deepens. But we do not expect any rate rise before 2014 either. Monetary policy support will continue to focus on the banking sector.

Forecast for Eurozone

(Annual percentage changes unless specified)

	2010	2011	2012	2013	2014	2015
Domestic Demand	1.1	0.5	-1.4	0.4	1.6	1.9
Private Consumption	0.9	0.2	-0.8	0.4	1.3	1.6
Fixed Investment	-0.7	1.5	-1.6	1.5	3.6	3.7
Stockbuilding (% of GDP)	0.3	0.4	0.0	0.1	0.1	0.1
Government Consumption	0.5	0.0	-1.2	-0.7	0.4	0.9
Exports of goods and services	11.1	6.3	1.4	4.4	5.7	5.5
Imports of goods and services	9.4	3.9	-0.7	4.0	5.8	5.5
GDP	1.9	1.5	-0.5	0.7	1.7	2.0
Industrial Production	4.2	2.8	-1.7	1.6	3.5	3.2
Consumer Prices	1.6	2.7	2.3	1.8	1.8	1.8
Current Balance (% of GDP)	-0.5	-0.3	0.1	0.2	0.3	0.4
Government Budget (% of GDP)	-6.3	-4.3	-3.5	-2.5	-2.0	-1.5
Short-Term Interest Rates (%)	0.81	1.39	1.09	1.11	1.67	2.67
Long-Term Interest Rates (%)	3.62	4.41	4.07	4.31	4.63	4.88
Exchange rate (US$ per Euro)	1.33	1.39	1.29	1.30	1.27	1.24
Exchange rate (YEN per Euro)	116.35	110.96	107.35	116.60	117.75	118.14

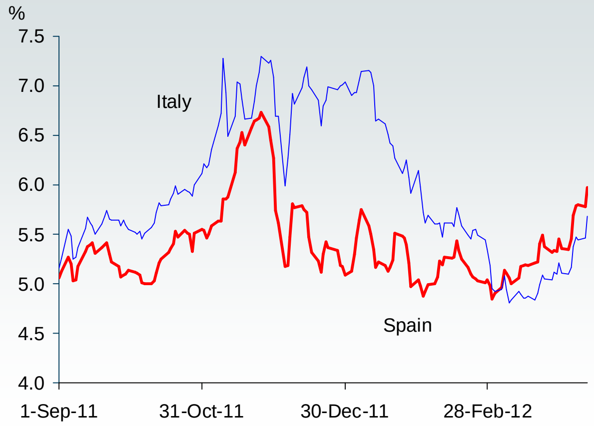
For further information contact Marie Diron (mdiron@oxfordeconomics.com)

Overview

Is the Eurozone summer over?

- After a lull in the first few months of the year, financial tensions are reappearing in the Eurozone as the boost to investor confidence from the ECB's loans to banks seems to be waning. And renewed concerns about the Spanish government's ability to rein in its public deficit have sent bond yields back up, not only for Spain but also (due to the now familiar contagion) for Italy. Although bond yields are still significantly lower than their peaks of last autumn, the trend seen in the past few weeks is a source of concern. Share prices have also fallen, down about 5-7% from their highs so far this year. Overall, we think that the beginning of the year was probably a short-lived relatively favourable period of financial calm.

Ten-year bond yields

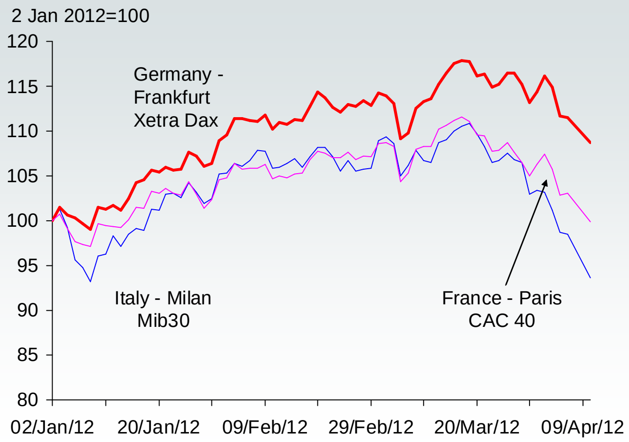


Source : Oxford Economics

Small recession, large divergence

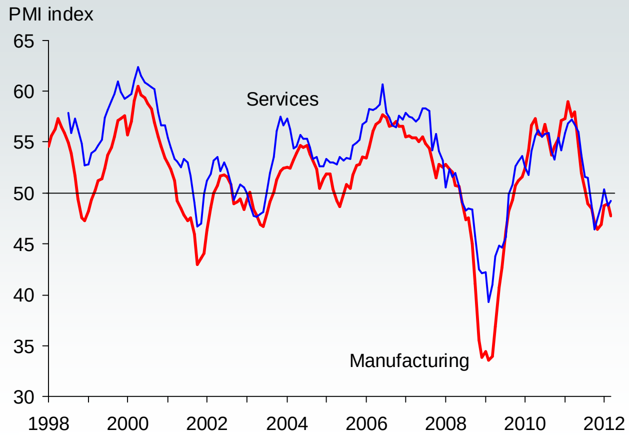
- Meanwhile, data on economic activity support our view that the Eurozone is in mild recession. In January and February, industrial production was 0.5% below the Q4 average. And the March results for the manufacturing PMI disappointed, with a significant fall that unwound gains in the previous two months. The picture given by consumption data is similar, with retail sales broadly flat in January and February compared with the Q4 average.
- We have maintained our forecast of negative GDP growth in Q1 and Q2 this year, leading to a 0.5% contraction for 2012 as a whole. Domestic demand is forecast to fall by 1.4% this year as fiscal austerity and rising unemployment dent households' budgets and propensity to consume. This will be only partly offset by a positive contribution to growth from net exports. Reasonably solid global growth means that demand for Eurozone exports will continue to rise.
- But the main beneficiaries of robust external demand are countries that need it least, namely the core or northern Eurozone countries. Our forecast shows a marked deepening in divergence within the Eurozone. While by the end of last year, GDP in the core Eurozone countries was back to its early 2008 levels, in the periphery, GDP was still nearly 7% down. And the gap is expected to widen further; while core Eurozone GDP is expected to rise by around 3% over the next two years, peripheral GDP is forecast to shrink by a further 2%.

Eurozone: Stockmarkets



Source: Oxford Economics

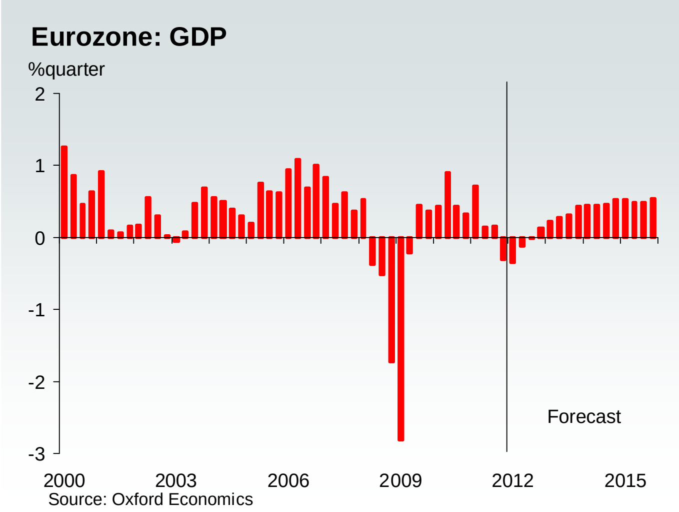
Eurozone: PMIs

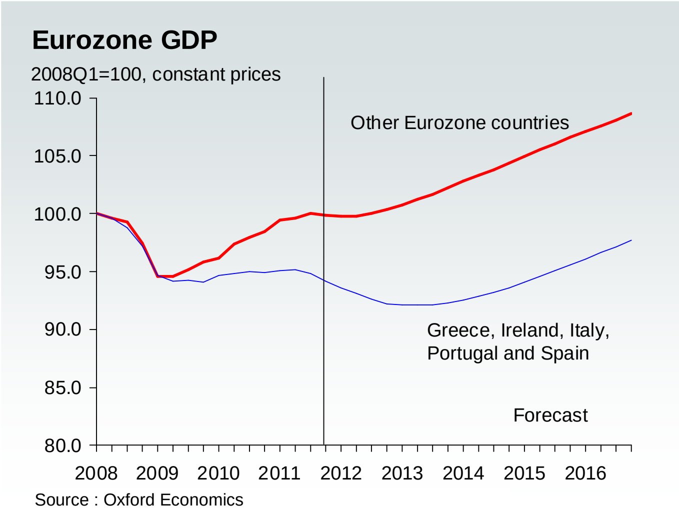


Source : Markit

Minimal strengthening of firewall

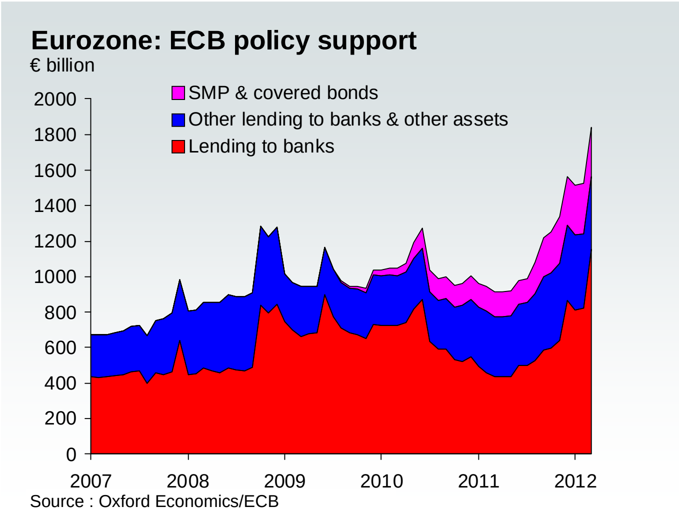
- News of weak or negative growth will continue to fuel concerns about public finances and the Eurozone's ability to deal with possible renewed crises. Indeed, doubts remain about the Eurozone's ability to prevent or manage a serious crisis if it were to require significant bailouts for countries as large as Spain or Italy. Despite the headline-catching announcement that the European Stability Mechanism (ESM) has been boosted to €800 billion following the agreement signed on 30 March, the reality is that the extension of the Eurozone's firewall has been kept to the minimum that was acceptable to increasingly reluctant lender countries. Furthermore, the €800 billion headline figure is misleading in several ways. First, it includes around €100 billion of funds already lent to Greece. Second, at no point in time will there be €800 billion (or even €700 billion) available to lend to countries in need. Instead, the unused funds of the current EFSF are put in the ESM until the latter reaches full capacity. So the maximum lending capacity will be €500 billion.
- The ESM will probably be used for a second bailout for Portugal, which is unlikely to be able to return to financial markets in mid-2013 when the first bailout (of €78 billion) expires. And it seems increasingly likely that Spain will need a bailout too. Over the next couple of years, further bailouts could also be needed for Greece and Ireland. In short, the folding of the EFSF funds into the ESM is a welcome decision but is not bold enough to remove any concern about the Eurozone's handling of future crises.





ECB very unlikely to cut rates

- Crisis prevention or management will continue to rely to a large extent on the ECB. The ECB left interest rates unchanged at 1% at its meeting on 4 April, as had been widely expected. Moreover, the tone of the statement and press conference suggests that no rate cuts are on the agenda for the foreseeable future. We do not expect any cuts unless the recession deepens. But we do not expect any rate rise before 2014 either. Monetary policy support will probably continue to focus on the banking sector. However, we hope that the ECB will tolerate higher inflation in some of the core Eurozone countries, like Germany, which would help the peripheral countries to regain some competitiveness.



Key Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

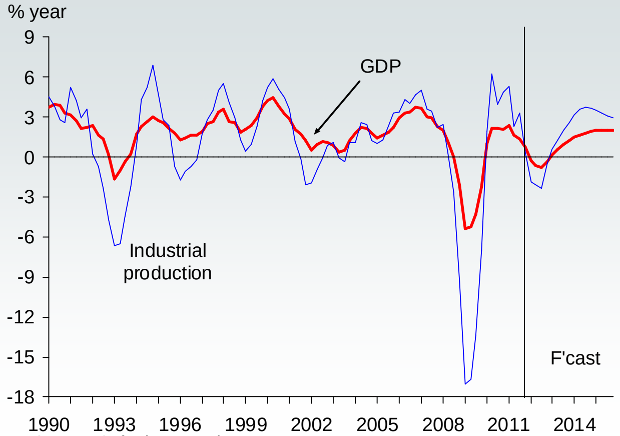
	Industrial production (% yr)	Unemploy-ment (% point)	CPI (% yr)	Business confidence (% balance)	Consumer confidence (% balance)	Exports (% yr)	Imports (% yr)	Trade balance (€ bn)
Mar	6.0	10.0	2.7	1.4	-11.0	16.3	17.1	1.1
Apr	5.1	9.9	2.8	1.3	-12.0	14.6	17.5	-4.3
May	3.8	10.0	2.7	1.0	-10.2	22.4	18.0	-0.8
Jun	2.7	10.0	2.7	0.9	-10.0	3.3	3.8	-0.2
Jul	4.4	10.1	2.6	0.4	-11.5	5.1	7.5	2.1
Aug	5.0	10.2	2.5	0.1	-16.8	13.9	12.8	-5.6
Sep	2.0	10.3	3.0	-0.1	-19.3	9.9	8.8	1.8
Oct	1.2	10.4	3.0	-0.2	-20.1	5.8	8.2	0.1
Nov	0.0	10.5	3.0	-0.4	-20.5	10.2	4.2	6.0
Dec	-1.3	10.6	2.7	-0.3	-21.3	8.9	0.9	9.1
2012								
Jan	-1.3	10.7	2.7	-0.2	-20.7	10.9	3.6	-7.6
Feb	-	10.8	2.7	-0.2	-20.3	-	-	-
Mar	-	-	2.6	-0.3	-19.1	-	-	-

Financial Indicators: Eurozone

Percentage changes on a year earlier unless otherwise stated

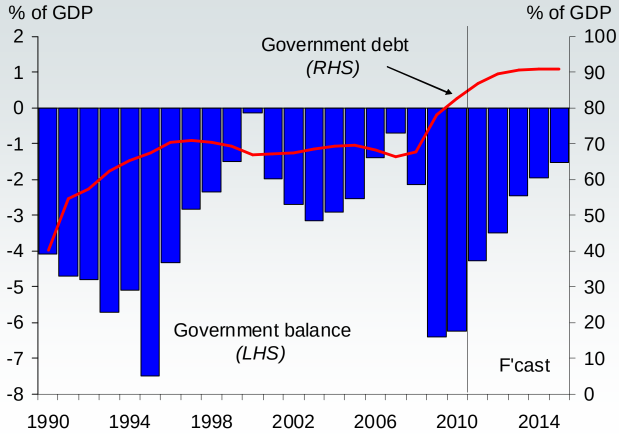
	Short rate %	Long rate %	Money Supply (M3)	Exchange rate $/€ avg.	Exchange rate €/£	Nominal effective exch. rate	Share price DJ STOXX	Net FDI € bn
Mar	1.18	4.49	2.2	1.400	1.153	108.4	2910.9	6.3
Apr	1.32	4.66	1.9	1.444	1.133	110.7	3011.3	-29.8
May	1.43	4.37	2.3	1.435	1.140	109.4	2861.9	-5.0
Jun	1.49	4.37	2.0	1.439	1.126	109.5	2848.5	5.8
Jul	1.60	4.59	2.0	1.426	1.131	108.2	2670.4	-17.2
Aug	1.55	4.21	2.7	1.434	1.142	107.6	2302.1	7.7
Sep	1.54	4.04	2.9	1.377	1.147	106.3	2179.7	-7.0
Oct	1.58	4.09	2.6	1.371	1.149	106.5	2385.2	-7.6
Nov	1.48	4.41	1.9	1.356	1.166	105.6	2330.4	-8.0
Dec	1.43	4.11	1.6	1.318	1.184	103.6	2316.6	-0.1
2012								
Jan	1.22	3.92	2.5	1.290	1.203	101.6	2416.7	-6.2
Feb	1.05	3.75	2.8	1.322	1.194	102.9	2512.1	-
Mar	0.86	3.29	-	1.320	1.198	103.4	2477.3	-

Eurozone: GDP and industrial production



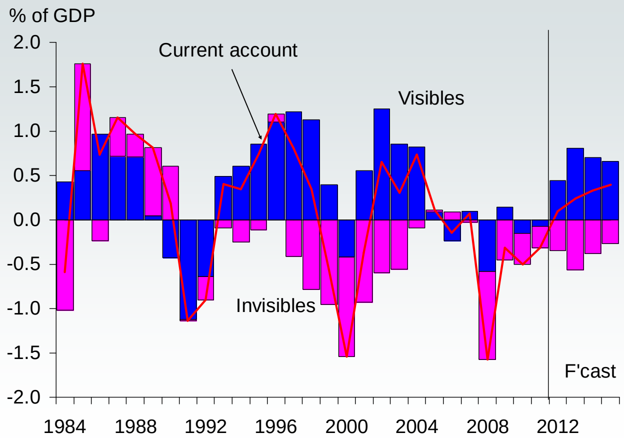
Source: Oxford Economics

Eurozone: Government finances



Source: Oxford Economics

Eurozone: Current account

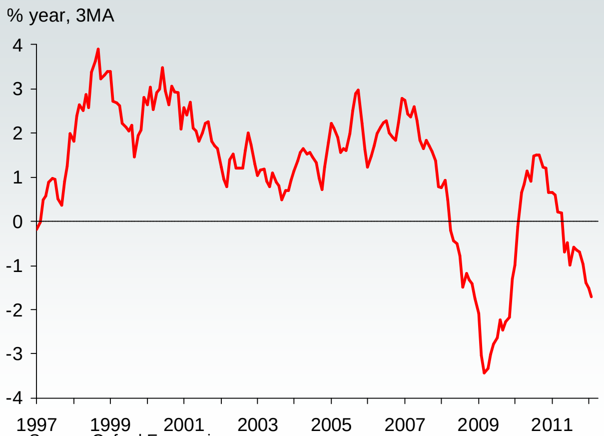


Source: Oxford Economics

Dollar/euro exchange rate

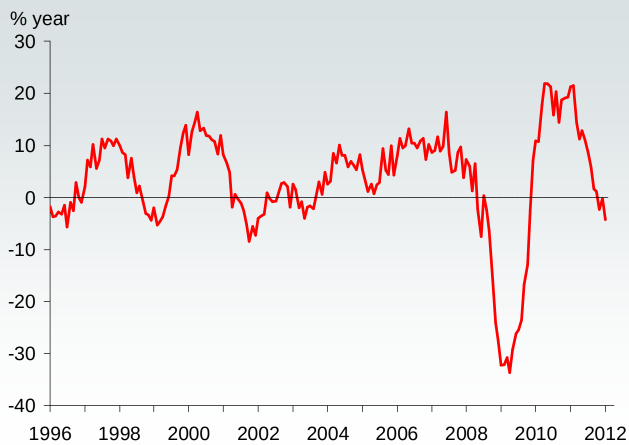
Source: Oxford Economics

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 (GDPIET)	MONEY SUPPLY M3 (MON)	PRODUCER PRICES (PPI)	CONSUMER PRICES (CPI)
YEARS BEGINNING Q1											
2010	0.9	-0.7	1.1	1.9	4.2	10.1	1.6	2.3	0.6	3.2	1.6
2011	0.2	1.5	0.5	1.5	2.8	10.2	2.3	1.2	2.7	5.6	2.7
2012	-0.8	-1.6	-1.4	-0.5	-1.7	11.2	1.4	0.5	1.8	2.8	2.3
2013	0.4	1.5	0.4	0.7	1.6	11.5	2.0	1.1	3.1	2.2	1.8
2014	1.3	3.6	1.6	1.7	3.5	11.1	2.7	1.3	4.3	2.2	1.8
2015	1.6	3.7	1.9	2.0	3.2	10.5	3.0	1.3	4.4	2.2	1.8
2010											
I	0.5	-4.7	-0.1	1.0	1.9	10.1	1.5	2.4	-1.0	0.3	1.1
II	0.7	-0.1	1.6	2.2	6.2	10.2	1.8	2.8	0.1	3.4	1.6
III	1.0	0.8	1.4	2.1	3.9	10.1	1.6	2.3	1.0	4.2	1.7
IV	1.2	1.1	1.7	2.1	4.9	10.1	1.5	1.9	2.1	4.9	2.0
2011											
I	0.9	3.2	1.6	2.4	5.3	10.0	2.3	2.1	2.7	6.4	2.5
II	0.3	1.1	0.7	1.6	2.3	10.0	2.4	1.1	2.4	5.8	2.8
III	0.2	0.8	0.3	1.3	3.3	10.2	2.4	1.0	3.5	5.4	2.7
IV	-0.7	0.8	-0.7	0.7	0.3	10.5	2.3	0.7	2.3	4.7	2.9
2012											
I	-1.0	-1.6	-1.6	-0.3	-1.9	10.9	1.2	0.2	2.7	3.2	2.7
II	-0.7	-1.9	-1.6	-0.6	-2.1	11.1	1.3	0.4	1.7	2.5	2.3
III	-1.0	-1.9	-1.6	-0.8	-2.4	11.4	1.3	0.4	1.1	2.7	2.1
IV	-0.5	-1.2	-0.9	-0.4	-0.5	11.5	1.5	0.8	1.9	2.9	2.2
2013											
I	-0.1	0.0	-0.3	0.2	0.5	11.5	1.9	1.0	2.3	2.3	1.8
II	0.3	1.1	0.2	0.6	1.3	11.5	1.9	1.1	2.9	2.1	1.8
III	0.6	2.1	0.7	0.9	2.0	11.4	2.1	1.1	3.4	2.2	1.8
IV	0.8	2.8	1.1	1.3	2.6	11.4	2.3	1.2	3.9	2.2	1.7
2014											
I	1.0	3.3	1.3	1.5	3.2	11.3	2.5	1.3	4.2	2.2	1.8
II	1.2	3.6	1.5	1.7	3.6	11.2	2.6	1.3	4.3	2.2	1.8
III	1.4	3.7	1.7	1.8	3.8	11.0	2.7	1.4	4.4	2.2	1.8
IV	1.5	3.8	1.8	1.9	3.7	10.9	2.8	1.4	4.5	2.2	1.9
2015											
I	1.6	3.8	1.8	2.0	3.5	10.7	2.9	1.4	4.5	2.2	1.8
II	1.6	3.7	1.9	2.0	3.3	10.5	3.0	1.4	4.5	2.2	1.8
III	1.7	3.7	1.9	2.0	3.1	10.4	3.0	1.3	4.4	2.2	1.8
IV	1.7	3.6	1.9	2.0	2.9	10.2	3.0	1.3	4.2	2.1	1.8

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											
2010	-14.2	-45.6	-0.50	-572.1	-6.25	0.81	3.62	-0.81	2.00	1.33	120.2
2011	-6.5	-29.3	-0.31	-402.4	-4.28	1.39	4.41	-1.33	1.69	1.39	120.8
2012	41.9	8.9	0.09	-331.0	-3.49	1.09	4.07	-1.22	1.76	1.29	116.2
2013	78.6	23.5	0.24	-238.8	-2.46	1.11	4.31	-0.68	2.52	1.30	119.3
2014	70.7	32.9	0.33	-196.8	-1.96	1.67	4.63	-0.15	2.80	1.27	117.0
2015	68.7	41.1	0.39	-159.6	-1.53	2.67	4.88	0.85	3.06	1.24	115.2
2010											
I	-1.4	-3.1	-0.14	-143.8	-6.37	0.66	3.69	-0.46	2.57	1.38	125.0
II	-7.2	-14.0	-0.61	-144.7	-6.33	0.69	3.60	-0.92	1.99	1.27	118.1
III	-3.3	-7.5	-0.33	-143.5	-6.24	0.87	3.44	-0.86	1.71	1.29	117.6
IV	-2.3	-21.0	-0.91	-140.2	-6.07	1.02	3.74	-1.00	1.72	1.36	120.0
2011											
I	-9.0	-10.2	-0.44	-112.7	-4.82	1.10	4.32	-1.38	1.84	1.37	119.4
II	-6.7	-13.3	-0.57	-79.6	-3.39	1.42	4.51	-1.34	1.75	1.44	122.4
III	-3.9	-1.7	-0.07	-103.3	-4.37	1.56	4.30	-1.14	1.60	1.41	121.2
IV	13.1	-4.1	-0.17	-106.9	-4.53	1.50	4.53	-1.45	1.59	1.35	120.4
2012											
I	7.8	14.7	0.62	-94.3	-4.00	1.04	4.17	-1.64	1.49	1.31	116.8
II	4.5	5.2	0.22	-88.9	-3.76	1.11	3.94	-1.19	1.64	1.29	115.5
III	10.8	3.5	0.15	-80.7	-3.40	1.11	4.06	-0.99	1.96	1.27	115.7
IV	18.8	-14.6	-0.61	-67.1	-2.82	1.11	4.12	-1.07	1.95	1.28	116.9
2013											
I	21.5	20.8	0.87	-60.3	-2.51	1.11	4.20	-0.71	2.38	1.29	118.1
II	16.4	8.8	0.36	-61.9	-2.56	1.11	4.29	-0.71	2.47	1.30	119.2
III	17.7	5.3	0.22	-61.2	-2.52	1.11	4.33	-0.73	2.50	1.31	120.0
IV	22.9	-11.4	-0.46	-55.5	-2.26	1.11	4.41	-0.56	2.75	1.31	120.0
2014											
I	21.5	22.9	0.92	-49.5	-2.00	1.36	4.49	-0.42	2.71	1.29	118.6
II	14.3	11.1	0.44	-51.3	-2.06	1.61	4.61	-0.20	2.80	1.27	117.4
III	14.6	7.6	0.30	-51.8	-2.06	1.86	4.67	0.02	2.83	1.26	116.3
IV	20.3	-8.6	-0.34	-44.2	-1.74	1.86	4.74	-0.01	2.87	1.25	115.6
2015											
I	19.9	25.4	0.99	-39.6	-1.54	2.11	4.81	0.30	3.00	1.24	115.3
II	13.5	13.5	0.52	-41.7	-1.61	2.36	4.86	0.54	3.04	1.24	115.2
III	14.5	9.7	0.37	-43.5	-1.66	2.86	4.93	1.04	3.10	1.24	115.2
IV	20.7	-7.5	-0.29	-34.9	-1.32	3.36	4.93	1.53	3.10	1.24	115.2

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

Potential output growth 1.2%pa

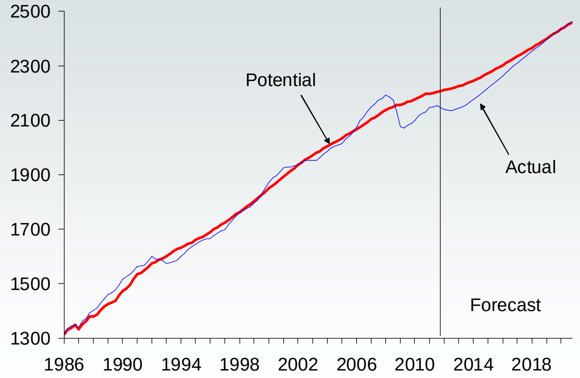
- Potential output is projected to rise by 1.2%pa over the next 10 years, a slightly lower rate than in the previous decade. GDP is set to contract by 0.5% in 2012, having grown by 1.5% in 2011 and to be slightly below potential growth at 0.7% in 2013. As a result, the large output gap of 1.9% in 2011 will expand in 2012 to 3.0% and increase in 2013 to 3.0%, and it is not forecast to close fully until 2020.

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

- The 0.08%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 2.2%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*	1.42	1.21
Employment at NAIRU	0.70	0.12
Capital Stock	2.18	1.73
Total Factor Productivity	0.20	0.53

*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	1.2	1.7
Consumption	1.5	0.4	0.8	1.5
Investment	2.1	-1.8	2.1	2.3
Government Consumption	1.9	1.5	0.1	1.3
Exports of Goods and Services	5.0	2.1	4.4	3.5
Imports of Goods and Services	5.0	1.5	3.9	3.5
Unemployment (%)	8.9	9.0	10.8	8.3
Consumer Prices	2.2	2.0	1.9	1.8
Current Balance (% of GDP)	0.3	-0.5	0.3	0.4
Exchange Rate (vs US$)	1.2	1.4	1.3	1.3
General Government Balance (% of GDP)	-2.5	-4.0	-2.1	-0.8
Short-term Interest Rates (%)	2.6	2.5	2.1	4.1
Long-term Interest Rates (%)	4.1	4.1	4.6	4.8
Working Population	0.5	0.2	-0.3	-0.3
Labour Supply	1.0	0.5	0.0	-0.1
Participation Ratio	72.3	73.8	74.8	75.7
Labour Productivity	0.8	0.3	1.1	1.4

Long-Term Forecast for Eurozone

Annual percentage changes unless otherwise specified

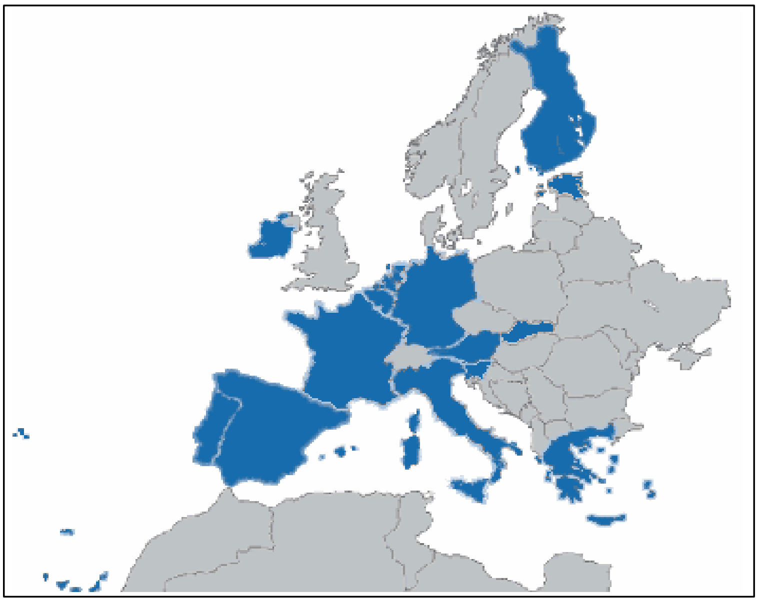
	2002-2011	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
GDP	1.1	0.3	-4.3	1.9	1.5	-0.5	0.7	1.7	2.0	2.1	2.0	1.9	1.7	1.6	1.5	1.5
Consumption	0.9	0.3	-1.2	0.9	0.2	-0.8	0.4	1.3	1.6	1.7	1.7	1.6	1.5	1.3	1.4	1.2
Investment	0.2	-1.3	-12.0	-0.7	1.5	-1.6	1.5	3.6	3.7	3.4	2.9	2.5	2.2	1.9	1.7	2.2
Government Consumption	1.7	2.3	2.6	0.5	0.0	-1.2	-0.7	0.4	0.9	1.1	1.2	1.2	1.2	1.3	1.4	0.7
Exports of Goods and Services	3.5	0.8	-12.7	11.1	6.3	1.4	4.4	5.7	5.5	4.9	4.4	3.9	3.4	3.0	2.6	3.9
Imports of Goods and Services	3.2	0.7	-11.6	9.4	3.9	-0.7	4.0	5.8	5.5	4.9	4.4	3.9	3.5	3.0	2.7	3.7
Unemployment (%)	9.0	7.6	9.6	10.1	10.2	11.2	11.5	11.1	10.4	9.8	9.1	8.5	8.2	7.9	7.7	9.5
Consumer Prices	2.1	3.3	0.3	1.6	2.7	2.3	1.8	1.8	1.8	1.8	1.8	1.8	1.9	1.8	1.8	1.9
Current Balance (% of GDP)	-0.1	-1.6	-0.3	-0.5	-0.3	0.1	0.2	0.3	0.4	0.4	0.4	0.3	0.3	0.3	0.4	0.3
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	-6.3	-4.3	-3.5	-2.5	-2.0	-1.5	-1.2	-1.0	-0.9	-0.8	-0.7	-0.7	-1.5
Short-term Interest Rates (%)	2.5	4.6	1.2	0.8	1.4	1.1	1.1	1.7	2.7	4.0	4.1	4.1	4.1	4.1	4.1	3.1
Long-term Interest Rates (%)	4.1	4.3	3.8	3.6	4.4	4.1	4.3	4.6	4.9	4.9	4.9	4.8	4.8	4.8	4.8	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	0.1	0.3	0.3	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.2	0.0
Participation Ratio (%)	73.1	73.8	73.8	73.8	74.1	74.5	74.6	74.8	75.0	75.2	75.4	75.6	75.7	75.9	76.0	75.3
Labour productivity	0.6	-0.5	-2.5	2.3	1.2	0.5	1.1	1.3	1.3	1.3	1.2	1.3	1.4	1.4	1.5	1.2
Employment	0.5	0.8	-1.9	-0.5	0.3	-1.0	-0.3	0.4	0.7	0.8	0.7	0.6	0.3	0.2	0.0	0.2
Output gap (% of potential GDP)	-0.7	1.1	-4.0	-2.8	-1.9	-3.0	-3.0	-2.4	-1.8	-1.2	-0.8	-0.4	-0.2	0.0	0.0	-1.3

Background

- The creation of a single European currency was achieved in 1999, with notes and coins being introduced in 2002. The eleven initial members were Germany, France, Italy, Finland, Ireland, Netherlands, Belgium, Luxembourg, Austria, Portugal and Spain, with Greece joining European Monetary Union (EMU) in 2001 and introducing notes and coins at the same time as the other countries. Slovenia was the 13th member in January 2007, Malta and Cyprus joined a year later, Slovakia became the 16th member in January 2009 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. It could be argued that the subsequent friction between Germany, France and Italy and the European Commission (EC) can be traced back to this failing. 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. While the idea proposals made by France and Germany have been accepted by all the members in the single currency area, other non-Euro partners have voiced their opposition to changes in the EU treaty. Eurozone leaders approved a draft of the new fiscal framework in March 2012. It remains to be seen how these new rules will be implemented.

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	2010*
GDP per capita (US$)	-	19175	19888	36590
Inflation (%)	9.9	4.2	2.2	1.6
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

* 2010 or latest available year

Corruption perceptions index 2011

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

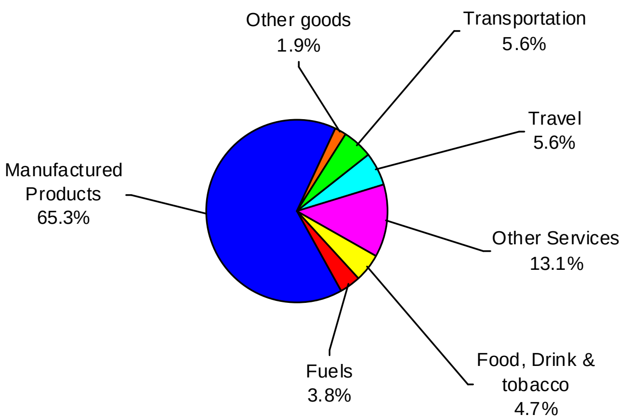
Source: Transparency International
Scoring system 10 = highly clean, 0 = highly corrupt

Structural economic indicators

	1990	1995	2000	2010*
Current account (US$ billion)	11	54	-96	-60
Trade balance (US$ billion)	-25	63	-26	-19
FDI (US$ billion)	-	-	30	-162
Govt budget (% of GDP)	-4.1	-7.5	-0.1	-6.3
Govt debt (% of GDP)	40.3	67.3	67.0	82.5
Long-term interest rate	10.9	8.7	5.4	3.6
Oil production (000 bpd)	271	313	240	205
Oil consumption (000 bpd)	9715	10483	10916	10321

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