# Eurozone

## Highlights and Key Issues

- The agreement on a bailout of Spanish banks was the bare minimum necessary to keep the Eurozone together for now. While the injection of money may give Spanish banks and therefore the Eurozone some breathing room, this plan does not address fundamental problems. The risk of a further escalation of this crisis, possibly ending in a break-up, remains.
- This means that the ECB will probably need to intervene again. We now assume that interest rates will be cut by 50bp to 0.5% in July. Further action may include a new long-term refinancing operation and a shift to full-blown quantitative easing. Such measures could give space for governments to discuss and hopefully agree on longer-term 'structural' solutions.
- Our baseline forecast assumes that the Eurozone remains in its current shape. In this scenario, we expect Eurozone GDP to shrink by 0.6% this year, including a significant contraction in Q2 when austerity and uncertainty about the Eurozone's future are likely to have had a severe negative impact on spending by businesses and households.
- We also present our estimates of the cost of a Eurozone break-up. We think that the GDP of the remaining countries would be cut by around 6% by 2013. The risk of such dire outcomes will encourage policymakers to 'do what it takes' to keep the Eurozone together – but probably not before the crisis reaches an even more critical stage.

**Forecast for Eurozone**
(Annual percentage changes unless specified)

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **Domestic Demand** | 0.5 | -1.8 | 0.1 | 1.7 | 1.9 | 2.0 |
| **Private Consumption** | 0.2 | -0.7 | 0.1 | 1.2 | 1.6 | 1.7 |
| **Fixed Investment** | 1.6 | -3.0 | 0.6 | 3.3 | 3.7 | 3.4 |
| **Stockbuilding (% of GDP)** | 0.4 | -0.2 | -0.2 | 0.0 | 0.1 | 0.1 |
| **Government Consumption** | -0.3 | -0.5 | -0.6 | 0.4 | 0.9 | 1.1 |
| **Exports of goods and services** | 6.3 | 1.4 | 3.1 | 5.4 | 5.5 | 5.1 |
| **Imports of goods and services** | 4.1 | -1.2 | 2.4 | 5.8 | 5.7 | 5.3 |
| **GDP** | 1.5 | -0.6 | 0.4 | 1.7 | 2.0 | 2.0 |
| **Industrial Production** | 2.8 | -2.2 | 1.2 | 3.5 | 3.3 | 2.6 |
| **Consumer Prices** | 2.7 | 2.4 | 1.9 | 1.8 | 1.8 | 1.9 |
| **Current Balance (% of GDP)** | 0.0 | 0.4 | 1.0 | 1.0 | 1.0 | 1.0 |
| **Government Budget (% of GDP)** | -4.1 | -3.5 | -2.5 | -2.0 | -1.5 | -1.1 |
| **Short-Term Interest Rates (%)** | 1.39 | 0.69 | 0.50 | 0.86 | 1.99 | 2.99 |
| **Long-Term Interest Rates (%)** | 4.41 | 4.14 | 4.12 | 4.22 | 4.41 | 4.79 |
| **Exchange rate (US$ per Euro)** | 1.39 | 1.27 | 1.28 | 1.27 | 1.24 | 1.24 |
| **Exchange rate (YEN per Euro)** | 110.96 | 103.72 | 113.16 | 117.70 | 118.40 | 120.75 |

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# Overview

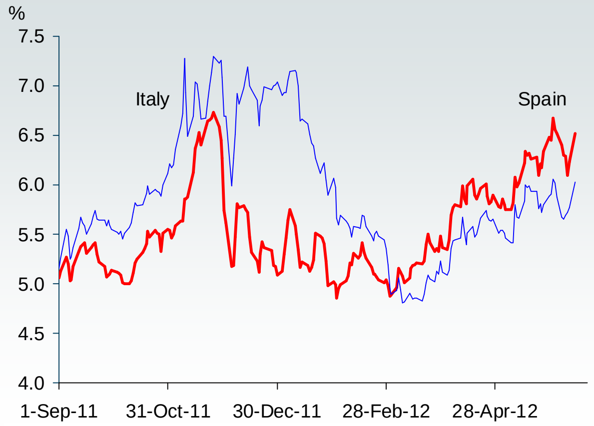
## Minimal agreement keeps Eurozone muddling through…

- The agreement on a bailout of Spanish banks is the bare minimum necessary to keep the Eurozone together for now. On the plus side, the proposed loan of €100bn exceeds previous estimates of banks' needs by the Spanish government – which were unrealistically low. However, the Spanish government will still shoulder responsibility for this debt, which means that the toxic link between banks and the sovereign has not been severed.
- Moreover, financial markets are concerned about the degree of 'seniority' of these bailout loans in the case of a Spanish default; if the new loans are to rank ahead of existing bonds, bondholders may demand even higher yields to compensate, or just reduce their holdings. Partly as a result of these concerns, there was only a brief rally in financial markets after the loan deal was announced and Spanish 10-year bond yields have risen back to over 6.5%.
- Overall, while the injection of money may give Spanish banks and thereby the Eurozone some breathing space, this plan does not address fundamental problems in the region. It is not clear that the plan will be enough to stem the outflow of deposits from Spanish banks. In April, before the first Greek election, deposits with Spanish banks were down 6% compared with a year earlier. More comprehensive reforms are needed, including moves towards a banking union. But political opposition to this is high and radical reforms to the Eurozone structures are unlikely in the near future.

## …shifting the onus onto the ECB

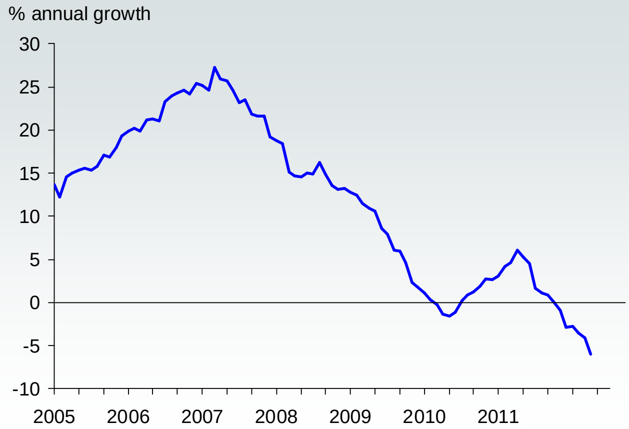
- This means that the ECB is likely to need to intervene again as tensions on financial markets will probably remain high and the possibility of Eurozone break-up will remain for some time. At its press conference on 6 June, the ECB hinted at the possibility of a rate cut. It is not certain yet, but we now assume in our baseline forecast that interest rates will be cut by 50bp in July to 0.5% and kept at this level until mid-2014. Lowering policy rates will have a limited impact, since interbank rates are already low. But it would be a signal that the ECB sees the risk of a deep recession and is willing to use all the tools at its disposal.

**Ten-year bond yields**




Source : Oxford Economics

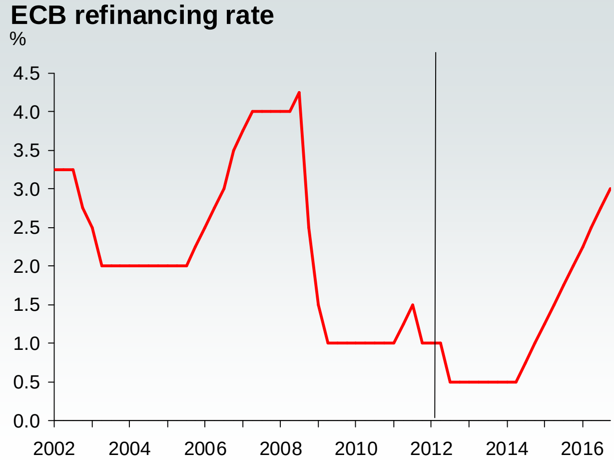
**Retail deposits at Spanish banks***




* Non-MFIs excluding central government

Source : Oxford Economics/ECB

**ECB refinancing rate**




Source : Oxford Economics/Haver Analytics

- Further action may include a new long-term refinancing operation (LTRO). It will probably have a smaller impact than the previous LTRO, but it would help provide essential liquidity to banks while governments discuss and hopefully agree on longer-term solutions. And since some banks are running out of eligible collateral to access liquidity at these operations, the ECB should consider full-blown quantitative easing to ensure that a liquidity crisis does not become a solvency crisis.

## Baseline forecast has 17 countries in

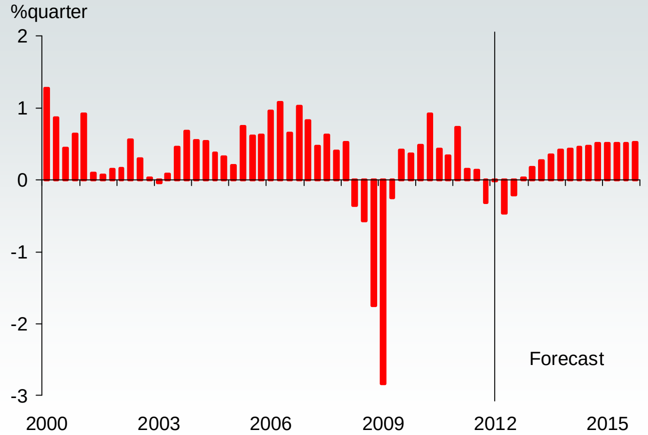
- Our baseline forecast assumes that the Eurozone remains in its current shape. This requires a number of changes to the Eurozone institutions with strong commitment to a move towards closer financial and fiscal integration. In this scenario, we expect Eurozone GDP to shrink by 0.6% this year. This entails a significant contraction in Q2 (of 0.4% on the quarter) when austerity packages were stepped up in the peripheral countries and uncertainty about the Eurozone's future is likely to have had a severe negative impact on spending by businesses and households. That is the impression conveyed by surveys such as the PMI. In May, both manufacturing and services PMIs edged down further into contraction territory.

## But probability of a Greek exit is high

- Our June forecast is published before the Greek elections on 17 June. If anti-bailout parties win, the risks of Greece leaving the Eurozone will rise dramatically. It seems likely that the new government will try to negotiate a more lenient bailout with the rest of the Eurozone, but it is far from clear that Greece's creditors will be willing to give enough ground to make continued euro membership viable.

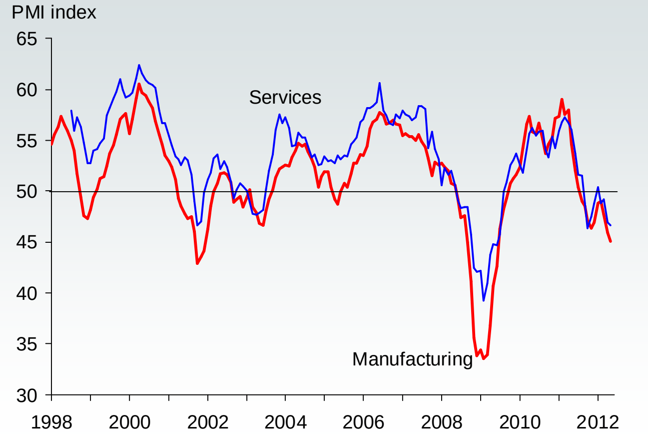
- If Greece leaves, pressure on the other peripheral countries will mount and avoiding further exits will be very difficult (and potentially very costly). In this context, we are also presenting our estimates of the economic impact of a Eurozone break-up, where not only Greece but also Portugal, Ireland, Spain and Italy exit the euro. In this scenario, we estimate that GDP in the residual Eurozone would be down around 6% in 2013 and 10% in 2014 compared to the baseline case. The risk of such a dire outcome will encourage policymakers to 'do what it takes' to keep the Eurozone together, but probably not before this crisis reaches an even more critical stage.

**Eurozone: GDP**



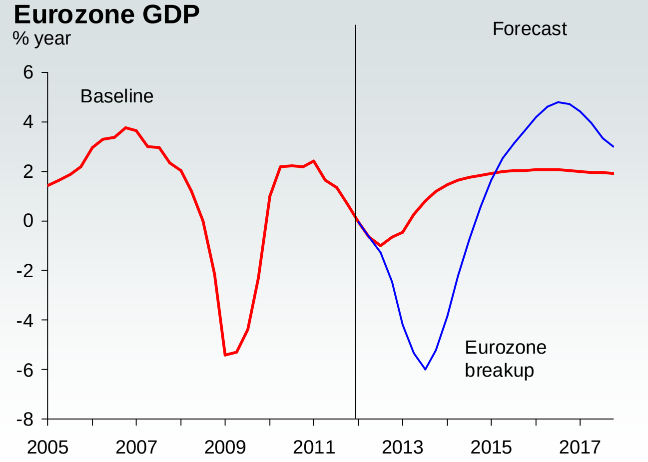

Source: Oxford Economics

**Eurozone: PMIs**




Source : Markit

**Eurozone GDP**




Source : Oxford Economics/Haver Analytics

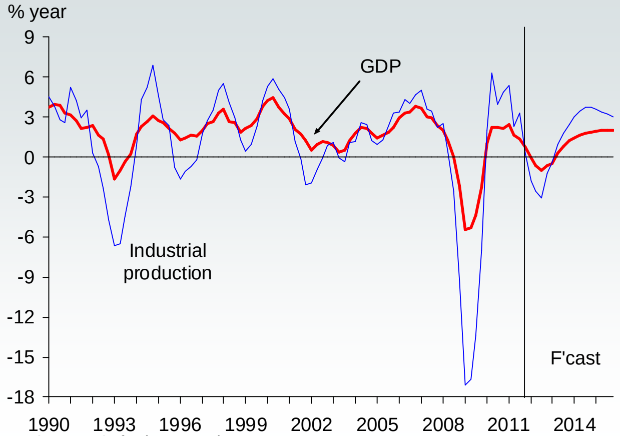
## Key Indicators: Eurozone
Percentage changes on a year earlier unless otherwise stated

| | Industrial production (% yr) | Unemploy-ment (% point) | CPI (% yr) | Business confidence (% balance) | Consumer confidence (% balance) | Exports (% yr) | Imports (% yr) | Trade balance (€ bn) |
|---|---|---|---|---|---|---|---|---|
| May | 3.8 | 10.0 | 2.7 | 1.0 | -10.2 | 22.5 | 18.3 | -1.1 |
| Jun | 2.7 | 10.0 | 2.7 | 0.9 | -10.0 | 3.7 | 4.0 | 0.0 |
| Jul | 4.4 | 10.1 | 2.6 | 0.4 | -11.5 | 5.4 | 7.8 | 2.1 |
| Aug | 5.1 | 10.2 | 2.5 | 0.1 | -16.8 | 14.1 | 13.0 | -5.7 |
| Sep | 2.2 | 10.3 | 3.0 | -0.1 | -19.3 | 9.8 | 8.7 | 1.9 |
| Oct | 1.1 | 10.5 | 3.0 | -0.2 | -20.1 | 5.8 | 8.2 | -0.1 |
| Nov | 0.0 | 10.6 | 3.0 | -0.4 | -20.5 | 10.3 | 4.7 | 5.5 |
| Dec | -1.4 | 10.7 | 2.7 | -0.3 | -21.3 | 9.3 | 1.4 | 9.0 |
| 2012 | | | | | | | | |
| Jan | -1.4 | 10.8 | 2.7 | -0.2 | -20.7 | 11.0 | 4.2 | -8.3 |
| Feb | -1.5 | 10.9 | 2.7 | -0.2 | -20.3 | 11.0 | 7.1 | 2.3 |
| Mar | -1.6 | 11.0 | 2.7 | -0.3 | -19.1 | 4.4 | -0.4 | 8.6 |
| Apr | -2.1 | 11.0 | 2.6 | -0.5 | -19.9 | - | - | - |
| May | - | - | 2.4 | -0.8 | -19.3 | - | - | - |

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

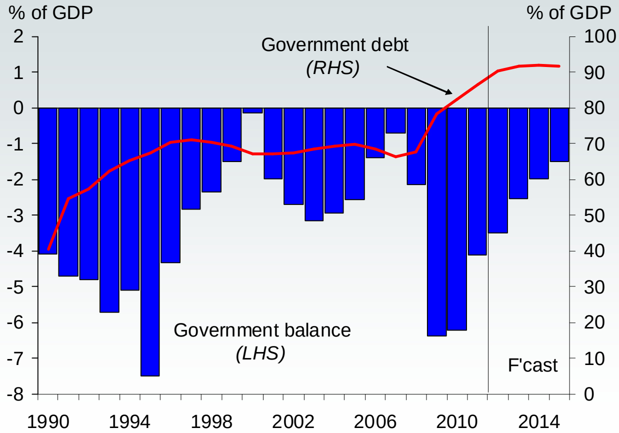
| | Short rate % | Long rate % | Money Supply (M3) | Exchange rate $/€ avg. | Exchange rate €/£ | Nominal effective exch. rate | Share price DJ STOXX | Net FDI € bn |
|---|---|---|---|---|---|---|---|---|
| May | 1.43 | 4.37 | 2.3 | 1.435 | 1.140 | 109.4 | 2861.9 | -4.2 |
| Jun | 1.49 | 4.37 | 1.9 | 1.439 | 1.126 | 109.5 | 2848.5 | 3.6 |
| 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 | 2.8 | 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 | -6.5 |
| Nov | 1.48 | 4.41 | 1.9 | 1.356 | 1.166 | 105.6 | 2330.4 | -42.6 |
| Dec | 1.43 | 4.11 | 1.5 | 1.318 | 1.184 | 103.6 | 2316.6 | -8.2 |
| 2012 | | | | | | | | |
| Jan | 1.22 | 3.92 | 2.3 | 1.290 | 1.203 | 101.6 | 2416.7 | -6.4 |
| Feb | 1.05 | 3.75 | 2.7 | 1.322 | 1.194 | 102.9 | 2512.1 | -3.4 |
| Mar | 0.86 | 3.29 | 3.1 | 1.320 | 1.198 | 103.4 | 2477.3 | -18.4 |
| Apr | 0.74 | 3.39 | 2.5 | 1.316 | 1.216 | 102.8 | 2306.4 | - |
| May | 0.68 | 3.53 | - | 1.279 | 1.244 | 100.8 | 2118.9 | - |

## Eurozone: GDP and industrial production



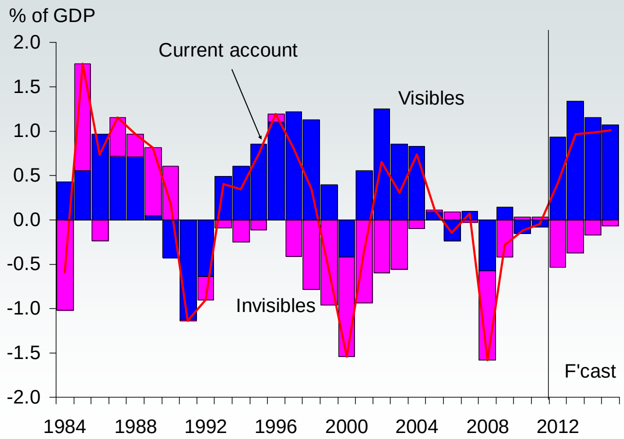

Source: Oxford Economics

## Eurozone: Government finances




Source: Oxford Economics

## Eurozone: Current account

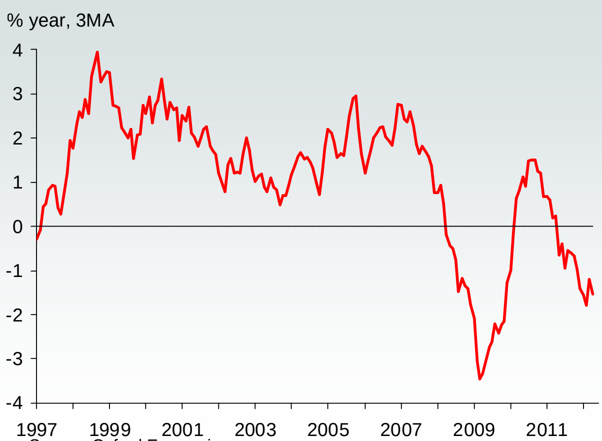



Source: Oxford Economics

## Dollar/euro exchange rate

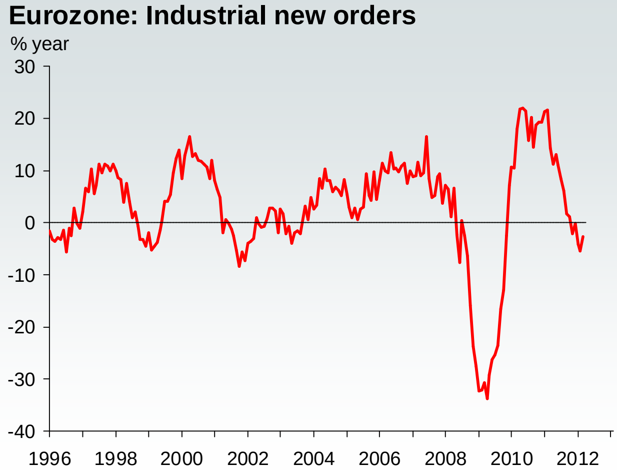

Source: Oxford Economics

## 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 | 2.5 | 1.4 | 2.7 | 5.6 | 2.7 |
| 2012 | -0.7 | -3.0 | -1.8 | -0.6 | -2.2 | 11.4 | 1.9 | 0.4 | 2.3 | 2.9 | 2.4 |
| 2013 | 0.1 | 0.6 | 0.1 | 0.5 | 1.2 | 11.9 | 2.1 | 1.1 | 2.8 | 2.3 | 1.9 |
| 2014 | 1.2 | 3.3 | 1.7 | 1.7 | 3.5 | 11.6 | 2.3 | 1.4 | 4.1 | 2.2 | 1.8 |
| 2015 | 1.6 | 3.7 | 1.9 | 2.0 | 3.3 | 10.9 | 2.6 | 1.3 | 4.2 | 2.2 | 1.9 |
| 2016 | 1.8 | 3.4 | 2.0 | 2.1 | 2.6 | 10.3 | 2.7 | 1.4 | 4.1 | 2.1 | 1.9 |
| 2011 | | | | | | | | | | | |
| I | 0.8 | 3.5 | 1.6 | 2.4 | 5.4 | 9.9 | 2.3 | 2.2 | 2.7 | 6.4 | 2.5 |
| II | 0.3 | 1.2 | 0.8 | 1.6 | 2.3 | 10.0 | 2.5 | 1.3 | 2.4 | 5.8 | 2.8 |
| III | 0.2 | 0.8 | 0.4 | 1.4 | 3.3 | 10.2 | 2.6 | 1.1 | 3.5 | 5.4 | 2.7 |
| IV | -0.7 | 1.0 | -0.6 | 0.7 | 0.2 | 10.6 | 2.4 | 0.9 | 2.3 | 4.7 | 2.9 |
| 2012 | | | | | | | | | | | |
| I | -0.6 | -2.2 | -1.5 | -0.1 | -1.8 | 10.9 | 2.1 | 0.4 | 3.1 | 3.1 | 2.7 |
| II | -0.5 | -3.2 | -2.0 | -0.7 | -2.6 | 11.2 | 1.7 | 0.3 | 2.4 | 2.6 | 2.4 |
| III | -1.0 | -3.4 | -2.1 | -1.0 | -3.1 | 11.6 | 1.9 | 0.3 | 1.6 | 2.8 | 2.2 |
| IV | -0.6 | -3.0 | -1.5 | -0.7 | -1.2 | 11.9 | 2.0 | 0.7 | 2.3 | 3.0 | 2.2 |
| 2013 | | | | | | | | | | | |
| I | -0.5 | -1.4 | -1.0 | -0.5 | -0.4 | 11.9 | 1.9 | 0.7 | 2.2 | 2.5 | 2.0 |
| II | 0.0 | 0.3 | -0.2 | 0.3 | 0.9 | 11.9 | 2.1 | 1.1 | 2.5 | 2.1 | 1.9 |
| III | 0.4 | 1.4 | 0.5 | 0.8 | 1.8 | 11.9 | 2.2 | 1.2 | 3.1 | 2.2 | 1.9 |
| IV | 0.7 | 2.2 | 1.0 | 1.2 | 2.4 | 11.8 | 2.2 | 1.3 | 3.5 | 2.2 | 1.7 |
| 2014 | | | | | | | | | | | |
| I | 0.9 | 2.8 | 1.4 | 1.5 | 3.0 | 11.8 | 2.3 | 1.4 | 3.9 | 2.2 | 1.8 |
| II | 1.1 | 3.2 | 1.7 | 1.6 | 3.5 | 11.6 | 2.3 | 1.4 | 4.2 | 2.2 | 1.8 |
| III | 1.3 | 3.5 | 1.8 | 1.8 | 3.7 | 11.5 | 2.3 | 1.4 | 4.2 | 2.2 | 1.8 |
| IV | 1.4 | 3.7 | 1.9 | 1.9 | 3.8 | 11.3 | 2.4 | 1.4 | 4.2 | 2.2 | 1.9 |
| 2015 | | | | | | | | | | | |
| I | 1.5 | 3.8 | 1.9 | 1.9 | 3.6 | 11.2 | 2.5 | 1.3 | 4.3 | 2.2 | 1.8 |
| II | 1.6 | 3.8 | 1.9 | 2.0 | 3.4 | 11.0 | 2.5 | 1.3 | 4.2 | 2.2 | 1.8 |
| III | 1.7 | 3.7 | 1.9 | 2.0 | 3.2 | 10.8 | 2.6 | 1.3 | 4.2 | 2.2 | 1.9 |
| IV | 1.7 | 3.6 | 1.9 | 2.0 | 3.0 | 10.7 | 2.6 | 1.4 | 4.2 | 2.1 | 1.9 |
| 2016 | | | | | | | | | | | |
| I | 1.7 | 3.5 | 2.0 | 2.1 | 2.8 | 10.6 | 2.7 | 1.4 | 4.2 | 2.1 | 1.9 |
| II | 1.8 | 3.5 | 2.0 | 2.1 | 2.7 | 10.4 | 2.7 | 1.4 | 4.1 | 2.1 | 1.9 |
| III | 1.8 | 3.3 | 2.0 | 2.1 | 2.5 | 10.2 | 2.7 | 1.4 | 4.1 | 2.1 | 1.9 |
| IV | 1.8 | 3.2 | 2.0 | 2.0 | 2.3 | 10.1 | 2.7 | 1.4 | 4.0 | 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 | -7.6 | -4.3 | -0.05 | -386.5 | -4.11 | 1.39 | 4.41 | -1.33 | 1.69 | 1.39 | 120.8 |
| 2012 | 88.8 | 38.6 | 0.41 | -331.1 | -3.49 | 0.69 | 4.14 | -1.67 | 1.78 | 1.27 | 114.4 |
| 2013 | 129.5 | 93.3 | 0.96 | -244.9 | -2.53 | 0.50 | 4.12 | -1.36 | 2.26 | 1.28 | 116.6 |
| 2014 | 115.0 | 98.4 | 0.98 | -199.4 | -1.99 | 0.86 | 4.22 | -0.97 | 2.39 | 1.27 | 116.6 |
| 2015 | 111.7 | 104.8 | 1.01 | -156.7 | -1.51 | 1.98 | 4.41 | 0.14 | 2.56 | 1.24 | 115.0 |
| 2016 | 114.3 | 109.6 | 1.01 | -120.9 | -1.12 | 2.98 | 4.79 | 1.12 | 2.93 | 1.24 | 115.1 |
| 2011 | | | | | | | | | | | |
| I | -8.5 | -2.3 | -0.10 | -112.6 | -4.82 | 1.10 | 4.32 | -1.38 | 1.84 | 1.37 | 119.4 |
| II | -6.9 | -6.1 | -0.26 | -99.9 | -4.25 | 1.42 | 4.51 | -1.34 | 1.75 | 1.44 | 122.4 |
| III | -4.2 | -0.1 | 0.00 | -90.3 | -3.82 | 1.56 | 4.30 | -1.14 | 1.60 | 1.41 | 121.2 |
| IV | 12.0 | 4.2 | 0.18 | -83.7 | -3.55 | 1.50 | 4.53 | -1.45 | 1.59 | 1.35 | 120.4 |
| 2012 | | | | | | | | | | | |
| I | 13.7 | 11.6 | 0.49 | -92.1 | -3.89 | 1.04 | 4.39 | -1.61 | 1.73 | 1.31 | 116.8 |
| II | 18.4 | 12.7 | 0.54 | -89.8 | -3.80 | 0.70 | 3.92 | -1.66 | 1.56 | 1.28 | 114.8 |
| III | 24.6 | 12.0 | 0.51 | -82.8 | -3.50 | 0.50 | 4.10 | -1.70 | 1.91 | 1.23 | 112.2 |
| IV | 32.1 | 2.3 | 0.10 | -66.5 | -2.79 | 0.50 | 4.13 | -1.73 | 1.90 | 1.25 | 113.7 |
| 2013 | | | | | | | | | | | |
| I | 33.1 | 37.8 | 1.58 | -62.2 | -2.60 | 0.50 | 4.11 | -1.46 | 2.15 | 1.27 | 115.3 |
| II | 30.0 | 27.5 | 1.14 | -64.0 | -2.66 | 0.50 | 4.12 | -1.38 | 2.24 | 1.28 | 116.3 |
| III | 30.6 | 19.5 | 0.80 | -63.0 | -2.60 | 0.50 | 4.13 | -1.38 | 2.25 | 1.28 | 117.1 |
| IV | 35.8 | 8.6 | 0.35 | -55.8 | -2.28 | 0.50 | 4.12 | -1.24 | 2.38 | 1.29 | 117.6 |
| 2014 | | | | | | | | | | | |
| I | 33.7 | 41.8 | 1.69 | -51.3 | -2.08 | 0.50 | 4.16 | -1.30 | 2.36 | 1.29 | 117.9 |
| II | 25.4 | 28.0 | 1.12 | -53.0 | -2.13 | 0.53 | 4.21 | -1.27 | 2.41 | 1.27 | 117.0 |
| III | 24.7 | 19.1 | 0.76 | -52.2 | -2.08 | 1.07 | 4.24 | -0.77 | 2.39 | 1.26 | 116.1 |
| IV | 31.3 | 9.5 | 0.37 | -42.9 | -1.69 | 1.36 | 4.27 | -0.52 | 2.39 | 1.25 | 115.5 |
| 2015 | | | | | | | | | | | |
| I | 30.3 | 43.0 | 1.68 | -39.8 | -1.56 | 1.61 | 4.31 | -0.22 | 2.48 | 1.24 | 115.1 |
| II | 24.2 | 29.6 | 1.15 | -42.3 | -1.64 | 1.86 | 4.35 | 0.02 | 2.51 | 1.24 | 115.0 |
| III | 25.1 | 21.1 | 0.81 | -42.4 | -1.62 | 2.11 | 4.44 | 0.26 | 2.59 | 1.24 | 115.0 |
| IV | 32.2 | 11.2 | 0.43 | -32.2 | -1.22 | 2.36 | 4.52 | 0.50 | 2.66 | 1.24 | 115.0 |
| 2016 | | | | | | | | | | | |
| I | 31.4 | 44.4 | 1.67 | -30.4 | -1.14 | 2.61 | 4.63 | 0.75 | 2.76 | 1.24 | 115.0 |
| II | 25.1 | 30.8 | 1.15 | -34.0 | -1.27 | 2.86 | 4.73 | 1.00 | 2.87 | 1.24 | 115.1 |
| III | 25.5 | 22.3 | 0.82 | -33.5 | -1.24 | 3.11 | 4.85 | 1.25 | 2.98 | 1.24 | 115.1 |
| IV | 32.4 | 12.1 | 0.44 | -22.9 | -0.83 | 3.36 | 4.95 | 1.49 | 3.09 | 1.24 | 115.2 |

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

## Potential output growth 1.2%pa

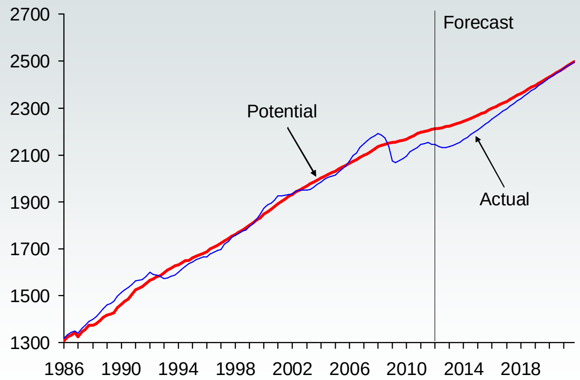
- Potential output is projected to rise by 1.2%pa over the next 10 years, a slightly lower rate than in the previous decade. GDP is set to contract by 0.6% in 2012, having grown by 1.5% in 2011 and to be significantly below potential growth at 0.4% in 2013. As a result, the large output gap of 2.1% in 2011 will expand in 2012 to 3.3% and increase in 2013 to 3.5%, 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 0.07%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<br>Average Percentage Growth | 2002-2011 | 2012-2021 |
|---|---|---|
| Potential GDP* | 1.44 | 1.21 |
| Employment at NAIRU | 0.66 | 0.11 |
| Capital Stock | 2.18 | 1.64 |
| Total Factor Productivity | 0.25 | 0.56 |

*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 | 0.8 | 1.6 |
| **Investment** | 2.1 | -1.7 | 1.6 | 2.4 |
| **Government Consumption** | 1.9 | 1.5 | 0.3 | 1.4 |
| **Exports of Goods and Services** | 5.0 | 2.1 | 4.1 | 3.6 |
| **Imports of Goods and Services** | 5.0 | 1.5 | 3.6 | 3.7 |
| **Unemployment (%)** | 8.9 | 9.0 | 11.2 | 8.8 |
| **Consumer Prices** | 2.2 | 2.0 | 2.0 | 1.9 |
| **Current Balance (% of GDP)** | 0.3 | -0.4 | 0.9 | 0.9 |
| **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 | 1.4 | 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 | 0.5 | 0.0 | -0.1 |
| **Participation Ratio** | 72.4 | 73.9 | 74.7 | 75.6 |
| **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 | -4.4 | 1.9 | 1.5 | -0.6 | 0.4 | 1.7 | 2.0 | 2.0 | 2.0 | 1.9 | 1.8 | 1.8 | 1.6 | 1.5 |
| **Consumption** | 0.9 | 0.4 | -1.1 | 0.9 | 0.2 | -0.7 | 0.1 | 1.2 | 1.6 | 1.7 | 1.7 | 1.6 | 1.6 | 1.5 | 1.5 | 1.2 |
| **Investment** | 0.2 | -1.3 | -12.4 | -0.2 | 1.6 | -3.0 | 0.6 | 3.3 | 3.7 | 3.4 | 3.0 | 2.7 | 2.4 | 2.1 | 1.9 | 2.0 |
| **Government Consumption** | 1.7 | 2.3 | 2.6 | 0.7 | -0.3 | -0.5 | -0.6 | 0.4 | 0.9 | 1.1 | 1.2 | 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 | 1.4 | 3.1 | 5.3 | 5.5 | 5.1 | 4.5 | 4.0 | 3.6 | 3.2 | 2.8 | 3.9 |
| **Imports of Goods and Services** | 3.3 | 0.7 | -11.4 | 9.4 | 4.1 | -1.2 | 2.4 | 5.8 | 5.7 | 5.3 | 4.7 | 4.1 | 3.7 | 3.3 | 2.9 | 3.6 |
| **Unemployment (%)** | 9.0 | 7.7 | 9.6 | 10.1 | 10.2 | 11.4 | 11.9 | 11.5 | 10.9 | 10.3 | 9.7 | 9.2 | 8.7 | 8.4 | 8.0 | 10.0 |
| | | | | | | | | | | | | | | | | |
| **Consumer Prices** | 2.1 | 3.3 | 0.3 | 1.6 | 2.7 | 2.4 | 1.9 | 1.8 | 1.8 | 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 | 0.4 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 |
| **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 | -1.5 | -1.1 | -0.8 | -0.6 | -0.6 | -0.6 | -0.6 | -1.4 |
| **Short-term Interest Rates (%)** | 2.5 | 4.6 | 1.2 | 0.8 | 1.4 | 0.7 | 0.5 | 0.9 | 2.0 | 3.0 | 3.9 | 4.1 | 4.1 | 4.1 | 4.1 | 2.7 |
| **Long-term Interest Rates (%)** | 4.1 | 4.3 | 3.8 | 3.6 | 4.4 | 4.1 | 4.1 | 4.2 | 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 | 0.1 | 0.2 | 0.2 | -0.1 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | -0.1 | -0.1 | 0.0 |
| **Participation Ratio (%)** | 73.1 | 73.9 | 74.0 | 73.9 | 74.1 | 74.4 | 74.6 | 74.7 | 74.9 | 75.1 | 75.2 | 75.4 | 75.6 | 75.7 | 75.9 | 75.2 |
| **Labour productivity** | 0.6 | -0.5 | -2.6 | 2.4 | 1.4 | 0.4 | 1.1 | 1.4 | 1.3 | 1.4 | 1.3 | 1.3 | 1.4 | 1.5 | 1.5 | 1.3 |
| **Employment** | 0.5 | 0.8 | -1.8 | -0.5 | 0.1 | -1.0 | -0.6 | 0.3 | 0.6 | 0.7 | 0.6 | 0.6 | 0.4 | 0.3 | 0.2 | 0.2 |
| | | | | | | | | | | | | | | | | |
| **Output gap (% of potential GDP)** | -0.7 | 1.2 | -3.9 | -2.8 | -2.1 | -3.3 | -3.5 | -2.8 | -2.1 | -1.5 | -1.0 | -0.7 | -0.4 | -0.1 | 0.0 | -1.6 |

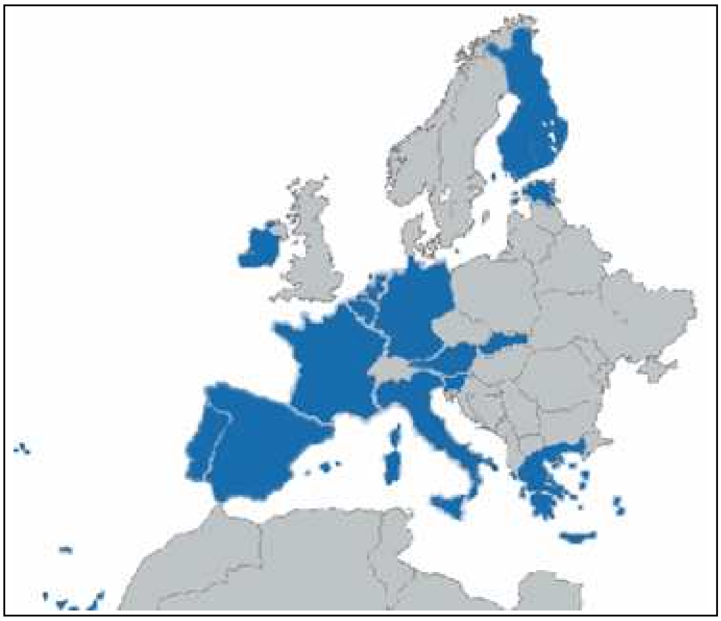
# Background

- 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:
Jean-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 | 39415 |
| 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

* 2011 or latest available year

## Structure of GDP by output

| | 2009 |
|---|---|
| Agriculture | 0.9% |
| Industry | 22.5% |
| Services | 76.6% |

Source : Eurostat

## Corruption perceptions index 2011

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

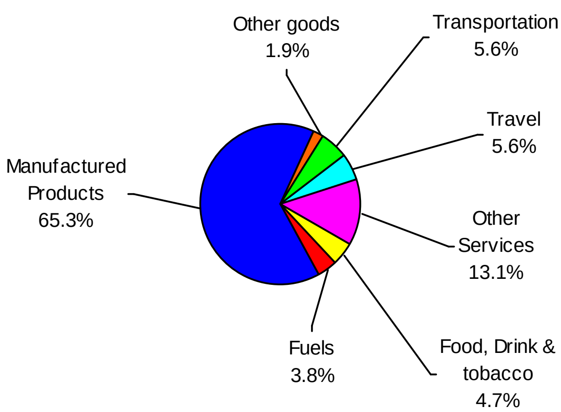
Source: Transparency International
Scoring system 10 = highly clean, 0 = highly corrupt

## Structural economic indicators

| | 1990 | 1995 | 2000 | 2011* |
|---|---|---|---|---|
| Current account (US$ billion) | 11 | 54 | -97 | -6 |
| Trade balance (US$ billion) | -25 | 63 | -26 | -11 |
| FDI (US$ billion) | - | - | 30 | -93 |
| Govt budget (% of GDP) | -4.1 | -7.5 | -0.1 | -4.1 |
| Govt debt (% of GDP) | 40.3 | 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 | 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