Eurozone

Ernst & Young Eurozone Forecast

Summer edition – June 2012

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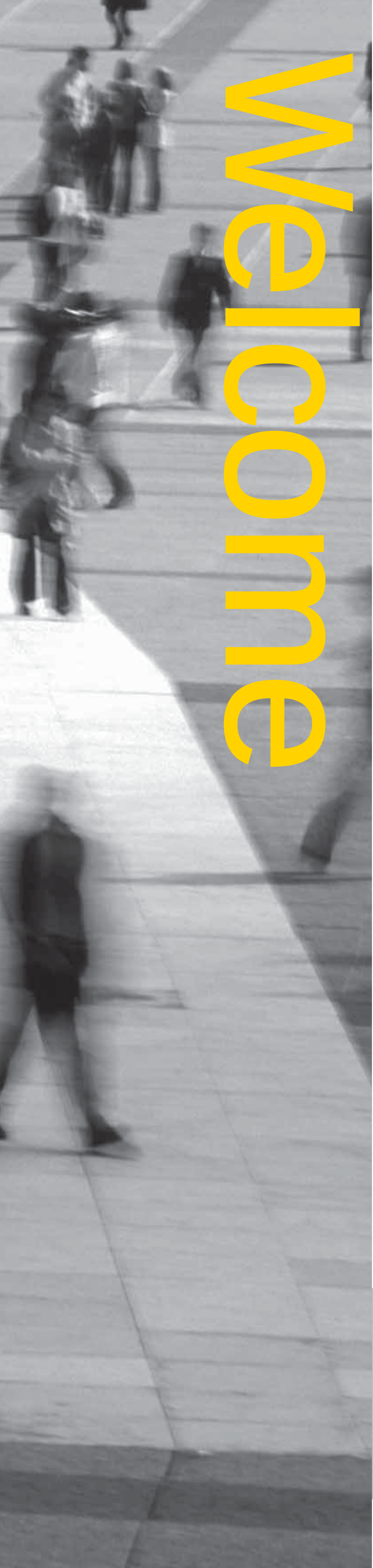
Welcome



Mark Otty
Area Managing Partner, Europe, Middle East, India and Africa

Confidence is a keyword for the future of the Eurozone, perhaps even more so now than ever. The crisis is two-fold: there is a need to restore sound public finances in the Eurozone, but there is also a need to restore confidence in the idea and future of the Eurozone as a monetary union. At the time of writing, the outcome of the second Greek election has avoided a hard-hit on the zone, but there is still a great deal of uncertainty about the new Government's possibilities to balance the domestic political turmoil and the demands from the rest of the EU to fulfil the fiscal conditions.

Meanwhile, this quarter has also seen a deal to recapitalize Spain's banks and the election of a new President in France. François Hollande's victory invigorated the debate on how to stimulate economic growth. Hollande calls for €120b of extra investment Europe-wide in infrastructure, renewable energy and new technologies, funded by the European Investment Bank (EIB) and EU structural funds. If political pressure has driven the move to focus on growth, pressure from the market requires that policy-makers demonstrate they have a credible, coherent plan to steer the Eurozone out of crisis. Part of this plan appears to be a move toward aligning members' fiscal and wider economic policies.

Restoring confidence

During the course of the Eurozone crisis, European policy-makers have demonstrated greater decisiveness in seeking common and strong solutions. Last winter, a European pact for tighter fiscal and policy monitoring was put in place. And in order to strengthen the authority framework to manage the single currency, the European leaders have tried to solve one of the basic problems of how the euro was set up when it was introduced.

On the launch day of our forecast, the EU Council will hopefully take yet another step to save the euro, as it holds a summit focusing on restructuring the banking sector. I hope that this summit will generate a clear direction going forward. The plan to move toward not only a monetary union, but also a fiscal and banking union, is a step in the right direction. Even though it will take time to mature, there is a need for policy-makers to show the market that there is a clear sense of direction supported by the decisiveness to act both collectively and locally. While the long-term refinancing operation (LTRO) has, for the moment, reduced the risk of another credit crunch, the sector still needs to go through a deep and prolonged restructuring that will limit the availability of credit for some time.

Pursuing the growth agenda

Based on our latest forecast, we believe that the situation will slowly turn to the better from 2013. And with this outlook in mind, the theme of economic policy debate has shifted from austerity to the need to foster growth. But there is no agreement as to what this would entail. Moreover, a growth agenda is sometimes presented as incompatible with fiscal adjustment. I believe this is a mistake — confidence in fiscal sustainability is a cornerstone for financial stability and a banking sector that can finance growth. Credibility in public finances also enables firms and households to drive spending and investment. That said, there are elements of

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fiscal policy that can be adjusted in a growth-friendly manner. The composition of government spending can be changed at the national level to stimulate growth, shifting from current to capital expenditure. Those parts of the Eurozone that are more fiscally sound could relax their consolidation plans in order to boost domestic demand, helping spur activity elsewhere in the Eurozone. There are also important steps that need to be taken to decrease the substantial disparities between the "north" and "south" of Europe, boosting productivity and reforming wage indexation mechanisms, so that they link to productivity rather than to prices.

Need for labor market reforms

Labor market reform is a key topic in the debate on growth and competitiveness. Given the uncertain outlook and with more countries in recession, businesses are reluctant to invest in staff. Unemployment is rising, especially across the southern periphery. A quarter of Spaniards do not have a job. This rate is higher among younger people. Many businesses in Europe are calling for measures that prove a disincentive to recruitment, such as guaranteed redundancy payments, to be eased as part of a drive to create a more flexible labor market. However, a balance must be struck. Making workers less secure about their jobs is not an effective way to boost productivity. In the short term, unemployment further depresses domestic demand and hampers government attempts to close fiscal deficits. Long-term unemployment brings with it crippling welfare and social costs. Boosting employment is therefore an urgent priority.

Caution and the courage to invest

With sufficient political will, backed by action, the confidence of citizens and investors will be restored, and in this edition of our forecast we predict that a modest recovery is expected to begin in the Eurozone as a whole in 2013. This would have important implications for many leading businesses. During 2012, leaders of many companies have struggled to find the right balance between caution and investment. As a result, companies have often been deferring strategic decisions and hoarding cash. Many have ample funds available for development, either through organic growth or acquisition. Businesses that identify opportunities could quickly turn on the investment tap and resume hiring.

Gaining control through acting together

Balancing the demand for national sovereignty and being a part of the world's largest market is a huge task for European policy-makers, causing domestic political conflicts in many European countries. But, as I pointed out earlier this year, many political leaders have started to realize what sovereignty is about. It is not about being free to agree your own policies, but about having power to control the consequences for your citizens. The European leadership can gain a greater control of events if they act as one. In this case, leaders believe that giving up power to tax and spend freely will deliver the benefits of a more stable currency.

Faced with the fiscal squeeze, consumer caution and uncertainty in the future of the Eurozone, businesses are putting investments on hold. But those investments are part of the necessary solution. A key ingredient for any Eurozone growth strategy is broadening trade with rapid-growth countries. Germany is already showing the way ahead by exporting more to these markets. But for others to follow, they must become more competitive. In order to improve competitiveness in the southern periphery countries, higher wage and price inflation may be necessary in Germany. German policy-makers appear open to this approach as a short-term measure, but it is far from certain that this acceptance will endure.

Building a future for the Eurozone

Businesses must play their part, but it is incumbent on policy-makers to establish the foundation for the Eurozone's future. Over the past few months, we have seen more detail around the plans. Fiscal convergence, banking integration, investment in infrastructure and structural reforms are key pillars. But more political resolve and determination are required to ensure that the new structure is cemented together and stands stable.

I believe that an effective Eurozone currency area benefits both the European and global business community in the long term. The single currency was intended to reduce the cost of doing business across borders in Europe, to increase the degree of transparency for consumers, and to drive the process of structural change across the European economy. From a business perspective, I believe that the idea of a common currency area is desirable and Europe has seen many tangible benefits, but the mechanism by which the currency is governed needs an overhaul.
I hope that the EU Summit starting on 28 June will give clear direction on the future of the banking sector, as one step in the right direction. It is, however, important that it is not just the politicians who are actively discussing what they can do to solve the crisis — the debate also needs to happen within the boardrooms of companies that operate across Europe.

I would like to conclude with an African saying that I believe reflects the Eurozone: "If you want to travel fast, travel alone. If you want to travel far, travel as a group." It will take time to restructure the Eurozone, but it will be worthwhile.

Ernst & Young's quarterly *Eurozone Forecasts* have repeatedly drawn attention to the efforts and concerns of policy-makers and business, and our aim is to continue to draw a comprehensive and timely picture of developments for you to follow.

Visit our dedicated website:
http://www.ey.com/eurozone
for additional information on the *Ernst & Young Eurozone Forecast* and the 17 individual country forecasts it comprises.
Also, visit our dedicated rapid-growth markets website:
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where you will find comments and updates on developments in the fastest-growing markets in the world.

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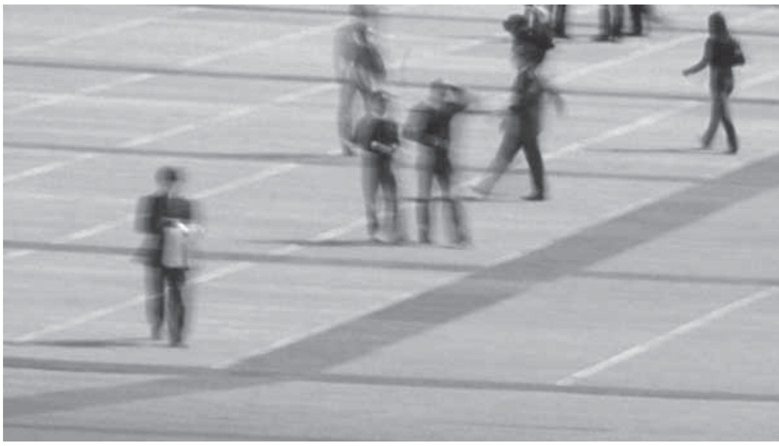


There is a palpable sense of tension around the Eurozone. Concerns over a possible Greek exit intensified during the second quarter of 2012. Spain secured help to recapitalize its banks, but markets continue to fret about its outlook. Members of the European Union (EU) are talking of measures to stimulate growth, to ensure austerity doesn't become a downward spiral. Businesses that navigate skillfully through this exceptional period of uncertainty, correctly assessing risk and potential rewards, will position themselves well for the recovery that we believe will ultimately come.

The threat of a systemic crisis continues to overshadow the quarterly *Ernst & Young Eurozone Forecast*. Businesses operating within, or trading with, the 17-member currency zone have been obliged to cope with a mounting sense of uncertainty during the second quarter. Yet overall the economic slowdown in the first quarter proved even more modest than expected. We now forecast a mild contraction in the Eurozone this year, with GDP falling by 0.6% in 2012, marginally worse than the 0.5% decline we predicted in our last report published in March. A gentle recovery is expected to ensue in 2013, with growth across the Eurozone of 0.4%, accelerating thereafter.

But the pattern is far from uniform. A core of nine Eurozone countries continues to experience growth. Germany's economy, clearly the strongest motor for the Eurozone, is expected to expand by 0.7% during 2012. Slovakia takes the crown, with forecast growth of 1.7%. But Austria and Finland, with expected GDP growth of 0.6% and 1.3% respectively, also maintain welcome momentum. France, the second-biggest economy, is expected to avoid recession — just.

Though Ireland and the Netherlands are set for a gentle contraction, the pain is mainly in the south, with Greece suffering a 7.2% contraction, Spain 1.8%, Portugal 3.4% and Italy 2.3%.

For pan-European businesses, the overall contraction this year, followed by slow recovery, may set the tone for trading. But company performance could vary widely according to the location and type of activities.

The past three months have brought a marked change in tone. Political uncertainty in France has been resolved with the election of a socialist government determined to complement reduction in government borrowing with Europe-wide measures to promote economic growth.

These could include lending by the European Investment Bank (EIB) to fund infrastructure projects, especially in southern Europe. There are indications now that Germany may be willing to tolerate higher inflation and pay increases that could help gradually restore the competitiveness of other Eurozone economies. In the meantime Spain is pressing for an accelerated drive to complete the single market. Measures like these, if they transpire, could increase opportunities for business, and add to the need for companies to focus on sector-specific opportunities in particular areas.

Proceeding with caution

However, developing a strategy to maximize opportunities is currently very difficult for corporate executives. In the near term, risk has clearly increased. Predicting the future has rarely been more difficult. There are doubts about which countries will use which currency in the future, and how any transition might happen. There are fears of a liquidity crisis in the European banking system. And there are uncertainties over the prospects for individual economies.

Many companies have responded by slowing to a crawl, deferring big decisions where possible, and ensuring they have plenty of cash to tide them through any new liquidity crisis.

Planning for the worst

We continue to believe the odds are against a break-up of the Eurozone and that Spain, Italy and other peripheral economies will avoid restructuring. Yet the risk of a messy default is real. In our March report we detailed two scenarios, for which we believe companies should develop contingency plans.

First is the risk of a credit crunch. Any strong signs that an exit from the euro by Greece or another country was looming could result in a liquidity crisis that could affect the entire Eurozone. Fears of a bank run in a country unable to recapitalize its banks, or that might soon leave the euro, have also grown. Though the European Central Bank (ECB) would almost certainly seek to prevent a liquidity crisis by offering cheap loans through its long-term refinancing operation (LTRO), this might not work, or banks might use the funds to shore up their balance sheets rather than lending to customers.

Even more catastrophic would be a complete break-up of the Eurozone. Serial national defaults accompanied by a banking crisis would trigger the return of national capital controls and, in effect, a break-up of the single market. Yet relatively few companies seem to have drawn up contingency plans for such outcomes.

What effect would a Eurozone crisis have on companies?

To find out how a Eurozone break-up might affect business, we surveyed over 100 chief financial officers and finance directors of Eurozone companies with revenues ranging from under US$100m to over US$20b. The findings are shown in Figures 1 and 2 on page 6.

Overall, 16.8% said a Eurozone break-up would be a "disaster" for their company. Another 59.4% said that in the short term it would put their company under "severe stress." In sum, three in every four companies expected to suffer severe stress or worse in the event of a Eurozone break-up. Only one in five said a break-up would have no significant impact or be beneficial.

Those predicting "disastrous" effects were drawn from a broad range of sectors, including aerospace and defense, automotive, consumer, financial services, manufacturing and real estate. Severe short-term pressure was expected by companies in more than 18 sectors, ranging from chemicals through luxury and apparel to professional services. Few sectors would escape unscathed.

Companies located in both the core and the periphery of the Eurozone expected to be hard-hit by any break-up. In Spain 80% of companies said a Eurozone break-up would be a disaster or would put them under severe pressure, while in Italy the proportion was 78.2%. In Germany 81.8% expected a severe impact and in France 69.3% predicted disastrous or severe effects.

How have companies responded to the Eurozone crisis?

Only 8.9% of companies assert they have conducted stress tests on profit and revenue forecasts to take into account a "worst case" scenario in the Eurozone, though overall 31.7% appear to have done some assessments. In Germany that proportion rises to 45.5%, but in Italy and Spain it falls to 34.7% and 20% respectively.

Companies clearly find it hard to plan amid the uncertainty. More than a quarter of companies have reduced investment in Europe as a result of the Eurozone crisis. However, 27.7% are emphatic that they haven't cut investment and overall 47.5% insist the crisis has made little difference to their investment programs.

Maintained investment is more common in aerospace and chemicals, and in food production. Companies that are more vulnerable to short-term demand fluctuations — in automotive, financial services, hospitality and leisure and logistics — are more inclined to pare investment. Companies in Germany, where capacity is tight and growth stronger, are more likely to maintain investment (54.6%), as are those in Spain, where structural reform is under way (55%). Companies with sales exceeding US$500m are more likely to maintain investment (53.5%) than smaller ones (40%).

Companies are focused on cash. Overall, 71.3% say they have increased focus on optimizing capital and cash management. That seems especially true in industries with longer lead times that involve manufacturing.

Long-term strategic thinking has taken a back seat. Overall, 40.6% say they are less inclined toward growth through acquisition or through clear insights into their competitive position in the market. Another 35.6% see no change: less than a quarter of companies are more inclined toward strategic moves because of the Eurozone crisis. Financial companies find it especially hard to take a long-term or acquisitive view, and German companies are also disinclined toward deal-making.

But in the short term, if things go wrong, Italian and Spanish companies in the Eurozone's more vulnerable periphery are most likely to have a strategy to hedge the currency and foreign exchange risks related to the Eurozone crisis. Overall, 14.9% of finance chiefs say they have a strategy in place, and 23.8% indicate they have some protection. In Germany, fewer than 1 company in 10 has a strategy in place, and only 18.2% say they have limited protection.

Are companies complacent, confounded or convinced the Eurozone will survive? We believe companies that have yet to draw up contingency plans should do so as a matter of urgency — just in case.

Weathering the storm

During 2012, many companies have been in survival mode. They have focused on cash flow, which also helps to ensure liquidity and minimize the risk of damage through default by creditors. Many continue to achieve creditable profitability. But there will probably still be increased impairments in the year-end accounts, as the value of some assets is written down. Some companies will find sales and profits squeezed more than others. Some companies are more exposed to southern Europe or vulnerable to belt-tightening by consumers. Profit warnings are, as a consequence, likely to be more common. Companies supplying capital equipment to industry may find new contracts deferred, while government suppliers suffer reduced sales because of austerity programs.

Worrying about a funding gap

While many large companies have ample cash piles, others fret about a future funding problem. This is because much corporate debt arranged at low rates before 2008 falls due for repayment in 2013 and 2014. Because banks need to rebuild their balance sheets and hold more capital to meet Basel III regulations, they may be reluctant to renew funding, or will demand substantially higher rates. Many mid-cap companies are therefore likely to turn to bond markets to raise funds. Pending successful refinancing, many companies may remain reluctant to sanction substantial investment.

A return to growth: the fundamentals

Companies operating in Europe can expect relatively soft growth in demand across the Eurozone as a whole over the next five years. Our forecast foresees a slow recovery in Europe where GDP growth will not reach 2% until 2015, increasing at a similar pace in 2016. Growth in private consumption is likely to stay weak, but we expect a marked pick-up in fixed investment in 2014, with growth of 3.3% and staying high in the following two years.

With ongoing growth in the US and emerging markets, however, exporters are likely to fare markedly better than those targeting the Eurozone market alone. We predict export growth of 1.4% this year, even as the Eurozone GDP contracts, with exports rising 3.1% in 2013 and 5.3% in 2014.

Opportunities for companies will therefore vary considerably according to hat they supply and where. Broadly, mass market suppliers to Eurozone consumers are likely to have a tough time, though exporters of luxury goods to the burgeoning middle class in emerging economies could prosper.

Companies supplying capital goods in the meantime, could benefit both from strong growth in emerging markets, which typically have high investment ratios, and from a recovery in Eurozone investment. Much of the European civil aerospace industry is in this "sweet spot," benefiting from a big order backlog arising from renewal of western airline fleets with more fuel-efficient planes, and the growth of air travel in Asia and Latin America.

At the core: opportunities and problems

Our forecast confirms that a relatively healthy core of Eurozone economies is surrounded by a weaker periphery. German growth this year is expected to reach 0.7%, rising to 1.4% next year and running at around 2% thereafter. The foundations of Germany's outperformance are well rehearsed: a focus on top-end manufactured exports delivered by global leaders and mid-sized companies, underpinned by the Hartz labor market reforms dating from 2003-2004.

With rising wages and spending power, Germany's 82 million people, buoyed up by a jobless rate below 6%, are an attractive consumer market for many companies. Add Austria, Finland and Slovakia, which are also delivering relatively strong economic performances, and the healthy consumer market tops 100 million. In the meantime France, with 62 million people, is forecast to recover to 1% growth next year, reaching 1.7% in 2014, adding to aggregate Eurozone demand.

For companies, the top priority in Germany could soon be investment. Actual output there is expected to be just 0.5% below potential output by 2014. Yet rising labor costs and inflation in Germany may encourage companies to look elsewhere in the Eurozone to expand their capacity.

At the periphery: problems and opportunities

Peripheral Eurozone economies are meanwhile characterized by surplus capacity and, in some cases, falling costs. Spain has implemented structural reforms similar to those required of Greece, Ireland and Portugal under bailout packages from the EU and International Monetary Fund (IMF). Designed to increase labor market flexibility and spur competition in previously protected enclaves of the economy, these measures enhance attractions for both domestic and foreign investors.

Today, peripheral countries are potentially attractive locations for onshoring, as rising costs in emerging economies and increased transport prices enhance the attractions of investment in European production. In less certain times, near-to-market manufacturing makes it easier for supply to respond to sales trends. It also reduces the need for high cost inventory, cuts transport times and reduces the risk of supply chain disruption from unforeseen events, such as Japan's 2011 tsunami or Thailand's floods.

But peripheral countries are unlikely to attract much inward investment unless uncertainty over their future membership of the Eurozone is removed.

A looming policy shift?

The first phase of the Eurozone crisis was marked by an insistence by lenders and policy-makers on the importance of austerity accompanied by structural reforms in troubled states. Countries that pursued structural reform energetically, including Ireland and Spain, saw a resurgence of foreign direct investment (FDI) in 2011.

Since the election of François Hollande to the French presidency in May, many Eurozone political and institutional leaders have joined calls for growth measures to complement austerity. Hollande wants €120b of extra investment Europe-wide in infrastructure, renewable energy and new technologies, funded by the EIB and EU structural funds. Germany now recognizes the need for growth in neighboring countries, putting forward proposals designed to enhance job creation, investment and innovation.

Increased investment could bolster markets for capital goods and construction, particularly in the energy, infrastructure, transport and clean-tech sectors.

Despite austerity, some countries are promoting public-private schemes to develop infrastructure and new technologies. France still has €8b of its *Grand Emprunt* investment for the future to invest[1]. Germany has decided to replace nuclear power, leaving a gap for new renewable and fossil-generating capacity.

Cross-border investors see opportunity in Europe

For all the gloomy talk, Western Europe remains the second most attractive destination in the world for international investment, after China[2]. During 2011, the number of inward investment projects in Europe as a whole increased by 4% to 3,906. The number of jobs created by FDI rose 15% to 157,824. Not only did the average project get bigger, but Europe's share of global FDI inflows increased from 26.9% to 28.2%. Job creation was in line with the 10-year average. At a time when pessimists lament the decline of business in Europe, our data suggests rather that Europe is getting back on track.

Though the UK remained Europe's champion FDI destination, Germany overtook France to seize second place. The biggest economy in the Eurozone is now seen as an attractive location for cross-border investment. In 2011 it attracted 697 projects, an increase of 7%.

Spain and the Netherlands, in fourth and fifth place respectively, each had a big surge in project announcements. US investors still trust Europe to produce good returns and so, increasingly, do those from Brazil, Russia, India and China, who together announced 9,385 new jobs in Europe, 8% of the total.

Investors say market appeal and stability are the two most important criteria in investment decisions; labor costs trail in third place. They are optimistic: more than 80% of those surveyed were confident Europe would overcome its crisis. And they see innovation as the driver of future European attractiveness: 46% come to Europe for its research and innovation capacity and a third believe technology will be the engine of European growth.

1 Source: "Louis Gallois à la tête du grand emprunt," *Les Echos*, 5 June 2012.
2 Source: *Ernst & Young's 2012 European attractiveness survey*, June 2012.

Innovation for expansion

Any new growth agenda adopted by Eurozone states is likely to sharpen the focus on innovation, an essential component of any sustained return to Eurozone growth. Today, Europe is global technology leader in clean transport, automobiles, renewable energy, machine tools and advanced manufacturing.[3] But it lags heavily in some fields and lamentably in information, communication and telecoms (ICT) technologies and the development of new smartphone applications.

In an effort to reinforce innovation-led growth, Europe has launched a plethora of programs, projects and funding streams designed to stimulate innovative activity. But they are ill-known and poorly understood.

Europe needs a more streamlined and simplified system to deliver a market-driven innovation policy to catalyze growth. Governments must promote development of world-class innovation infrastructure. They must also make it easier to turn great ideas into innovative products and services, and they should buy innovation through strategic use of public procurement.

And the private sector must do more too. In Europe, the proportion of state funding within R&D spending has risen: in the US, Japan and Korea it is the private sector share that is rising.

3 Source: *The power of simplicity: toward a smarter and streamlined innovation policy in the EU*, Ernst & Young, 2012.

Invest to thrive

In the meantime, companies that delay investment may miss opportunities afforded by technology progress to enhance quality or efficiency. They thereby risk being overtaken by more nimble rivals, who can gain a competitive edge. The longer companies hesitate, the greater the risk. This is particularly true in sectors subject to disruptive technology change and/or shifts in consumer behavior, such as media, retailing and retail banking, which are all affected by increased use of smartphones and/or social media.

Figure 1

Expected impact of a possible Eurozone break-up on company

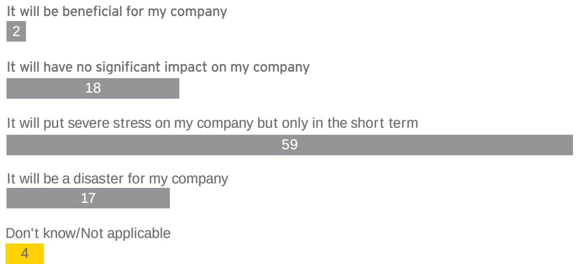
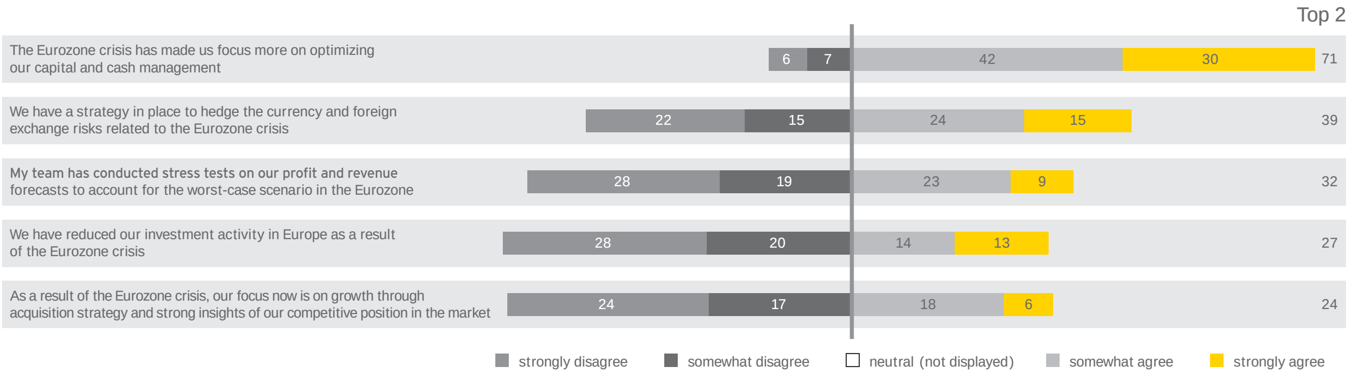


Figure 2

Reactions on the Eurozone crisis



A changing tax landscape

The tax agenda within the Eurozone has been changing rapidly:

- A far greater likelihood that enhanced cooperation (i.e., adoption of policies by a subset of member states) will be used to break the deadlock on tax policy adoption
- A potential shift from austerity to growth measures for some member states
- An increased focus on incentives and the taxation of intellectual property (IP) as a way to stimulate growth and competitiveness

Enhanced cooperation: a new momentum

Despite a clear lack of support from certain member states, the Danish Presidency of the EU's Council of Ministers has been giving priority to the European Commission's three tax initiatives:

- **The common consolidated corporate tax base (CCCTB) proposal**
  The focus of the Presidency has been to obtain ECOFIN (Economic and Financial Affairs) Council conclusions that will allow the continuation of work under the Cypriot Presidency in the second half of the year. While getting the agreement of all 27 countries is highly unlikely, the European Parliament has now suggested that the Directive be adopted in the euro member states through the "enhanced cooperation" procedure, if unanimity on the CCCTB cannot be obtained.
- **Financial transactions tax (FTT)**
  Nine member states expressed the wish that the analysis and negotiation process on the current FTT proposal be accelerated, and France announced that it would introduce an FTT from 1 August 2012. Discussions took place around an intermediate step for those adopting the introduction of an FTT based on the UK stamp duty and the proposed French FTT. The idea would be to introduce such a tax rapidly while negotiations on a comprehensive FTT continued. The issue was raised again at the formal ECOFIN meeting on 22 June.
- **Energy taxation**
  Denmark, along with other Nordic countries, strongly supports the general thrust of the Commission's proposal, particularly a compulsory tax element.

Austerity and enforcement remain strong, while growth is gaining traction

Countries remain in an overall position of austerity, combining existing significant tax increases with spending cuts that they hope will provide markets with the required amount of confidence in their ability to service sovereign debt. However, within this framework, this austerity agenda is now tempered by a shift toward growth, with such impetus coming from France's President François Hollande and Italy's Mario Monti.

Enforcement remains in the forefront, with two different papers released by the EU and the OECD focusing on double non-taxation issues. Tax administrators continue to focus on information sharing and enhanced relationships. We are also witnessing a distinct trend of tax administrations turning to General Anti-Avoidance Rules (GAARs) and other specific anti-abuse measures in an effort to discourage tax avoidance and increase tax revenue.

Two key tools being used to encourage growth continue to be patent boxes, a tax measure where income derived from qualifying IP is typically taxed at a lower rate than the general rate, with focus now on the UK's Patent Box and the Netherlands' Innovation Box; and the use of R&D tax credits. However, beyond the tax relief, we are now seeing a greater use of wider incentives to encourage companies to locate activity within the EU.

Corporate cash piles

Throughout Europe, companies appear to be compounding the economic crisis by piling up cash and deferring investment. Confronted with economic uncertainty, they are taking advantage of high corporate profitability to create massive reserves. The trend is global. In April, Global 1000 companies were estimated to have US$7.8t of cash on their balance sheets.[4]

In the UK, which is within the EU but outside the Eurozone, non-financial companies increased their holdings of currency and bank deposits by £82b last year, taking the total to £754b, a staggering 50% of GDP.[5]

Companies cite lack of demand, volatility and unrealistic vendor expectations as reasons not to invest. Indeed companies' willingness to grow by acquisition has been declining. In April, only 31% of companies surveyed by Ernst & Young[6] expected to pursue an acquisition in the next 12 months, a 24% fall compared with October 2011, despite increased confidence in US and UK economic prospects.

The survey found companies based in the Eurozone were more negative to local economies than counterparts around the globe. European respondents continued to focus on cost-cutting, supply chain rationalization and divestment of non-core assets.

Yet European assets are affordable by historic standards. European equities are trading on a cyclically adjusted price-earnings ratio of 11, compared with 18.1 for the US.[7]

How can Eurozone policy-makers encourage foreign and domestic companies alike to open their wallets and invest to create wealth and jobs?

4 Source: *S&P Capital IQ*, 11 April 2012.
5 Source: *ITEM Club Spring 2012 UK Forecast*.
6 Source: *Ernst & Young's 6th Global Capital Confidence Barometer*, April 2012.
7 Source: "Buttonwood/A contrarian moment." *The Economist*, 2 June 2012.

A growth opportunity – when uncertainty lifts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Highlights

Focus on growth is positive – but only alongside fiscal stability

- Uncertainty over the Eurozone's future has continued to mount since our last forecast, with the Greek elections in May leaving Athens without a government for six weeks, Spain formally requesting financial aid to recapitalize its banks and Cyprus becoming the fifth member country to seek an EU bailout package. With the second round of Greek elections giving a mandate to pro-bailout parties, albeit with a sizable vote for the opposition, our forecast continues to assume Greece will remain in the Eurozone, and that Spain's Government will avoid a formal IMF/EU support package.

- Away from the flash points in Greece and Spain, the key question for policy-makers has shifted from how to enforce austerity to how to improve a gloomy economic outlook. We forecast a mild contraction in the Eurozone this year, with GDP falling by 0.6%. The 2012 average is raised by a better than expected outcome for Q1 in a number of countries. But since then the outlook has deteriorated with a high degree of uncertainty about the future shape of the Eurozone likely to dampen business and consumer spending.

- Rising unemployment continues to weigh on economic activity in much of the region. The jobless rate has risen to almost 25% in Spain, 22% in Greece, and 15% in Portugal (all up 3–4 percentage points in the last six months or so), further undermining domestic demand and investment, and the ability of governments to deliver fiscal deficit reduction plans.

- The second long-term refinancing operation (LTRO) by the European Central Bank (ECB) has reduced the risk of an imminent credit crunch. But the Eurozone banking sector still needs to go through a deep and prolonged restructuring that will curtail availability of credit for some time. This will dampen business investment and consumer spending.

- We believe that growth may be returning in some parts of the Eurozone, but in many economies the contraction seems set to continue into 2013. Assuming the Eurozone remains in its current shape, with Spain, Italy and Portugal averting debt restructuring, 2013 can see a gradual recovery with Eurozone GDP rising 0.4%. But given the ongoing need for consolidation and the damage done to banks, the recovery is likely to be weak into the medium term, with overall Eurozone growth staying below 2% in the next few years.

- As has been the case for some time, the risks remain skewed towards the downside. One key focus remains whether Greece's new Government is able to deliver on its promises to implement the IMF/EU program, or whether the measures become too difficult to implement, especially in the face of a newly energized opposition. Greek exit would place even greater strains on the Eurozone and push up borrowing costs for Portugal, Spain and Italy – at best this would impair the economic recovery further, and at worst it could drive other peripherals toward default.

- With this outlook in mind, we very much welcome policy-makers' efforts to foster growth. But there is no agreement on what this would entail. Moreover, a growth agenda is sometimes presented as incompatible with fiscal adjustment. We think this is a mistake – confidence in fiscal sustainability is a cornerstone for financial stability and a banking sector that can finance growth. Credibility over public finances also enables firms and households to drive spending and investment.

- That said, there are elements of fiscal policy that can be adjusted in a growth-friendly manner. The composition of government spending can be changed at the national level to spur growth, shifting from current to capital expenditure. Those parts of the Eurozone that are more fiscally sound could relax their consolidation plans in order to boost domestic demand, helping spur activity elsewhere in the Eurozone.

- A second key component of a growth strategy has to be broadening trade with rapid-growth markets – Germany is already enjoying substantial growth in its capital goods exports to China and elsewhere, but other countries have fared less well. The challenge is for Italy, Spain and others to follow suit. In order to secure ongoing improvement in competitiveness in the periphery, Germany in particular may need to accept higher wage and price inflation. As a short-term solution, this stance is finding some traction among German policy-makers, but how durable this tolerance will be is far from certain.

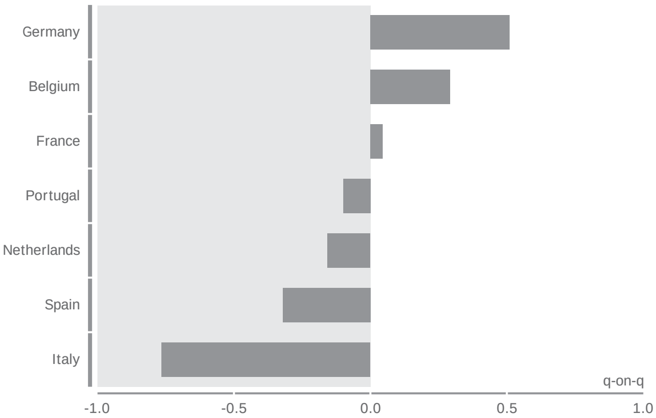
Crisis can be averted, but opportunity for reform must be grasped

New focus on growth?

Much has changed over the past year in the Eurozone economy, mostly for the worse. Economies that 12 months ago were rebounding from the financial crisis through strengthening exports and recovering investment spending are now seeing orders drying up, unemployment rising and concerns about debt sustainability spreading from the "peripheral" countries to an increasing number of "core" countries. Bailout efforts for Greece have failed to deliver a credible solution, fears of contagion to Spain and Italy are returning, and Spain has been forced to acknowledge that its banking sector cannot be stabilized without external assistance. In addition, Cyprus has become the fifth member state to require a bailout from the EU.

The policy debate is also starting to turn, with a demand for more focus on growth measures. There is a risk that this debate will obscure the need to prioritize fiscal and financial stability in the immediate future but, as long as policy-makers understand this, we believe that there is plenty that they can do to boost growth. This is the key theme of this report.

Figure 3
GDP Q1 2012 growth



Source: Oxford Economics

Eurozone stagnates as Germany pulls further ahead ...

Estimates for Q1 2012 show that the Eurozone as a whole saw economic activity unchanged from Q4 2011, but — as before — member countries posted markedly divergent performances in Q1. Germany saw one of the strongest performances along with Estonia and Finland, with GDP expanding by an impressive 0.5%. Belgium grew by a somewhat surprising 0.3%, while France's economy virtually stagnated and many others contracted. Spanish output fell by 0.3% and the Italian economy shrank by 0.8%.

The ongoing divergence in economic performance around the Eurozone has continued to widen differentials in labor markets. Unemployment is well over 20% in Spain and Greece, 15% or so in Ireland and Portugal, and 10% in France and Italy. Meanwhile in Germany, Austria and the Netherlands, it remains below 6%.

Table 1
Forecast of the Eurozone economy (annual percentage changes unless specified)

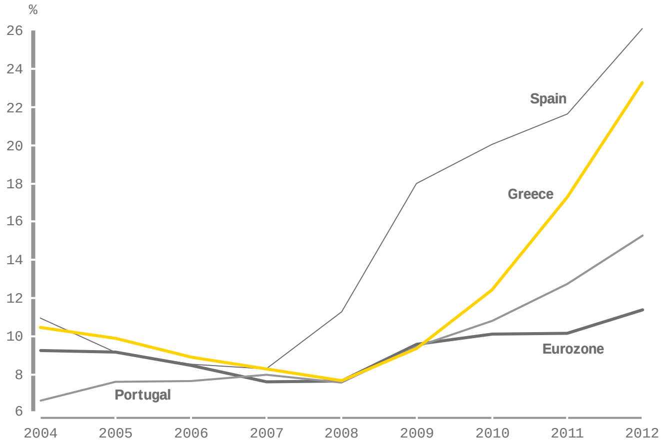
Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	1.5	-0.6	0.4	1.7	2.0	2.1
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	0.2
Government consumption	-0.3	-0.5	-0.6	0.4	0.9	1.2
Exports of goods and services	6.3	1.4	3.1	5.3	5.5	5.1
Imports of goods and services	4.1	-1.2	2.4	5.8	5.7	5.3
Consumer prices	2.7	2.4	1.9	1.8	1.8	1.9
Unemployment rate (level)	10.2	11.4	11.9	11.5	10.9	10.2
Current account balance (% of GDP)	0.0	0.4	1.0	1.0	1.0	1.0
Government budget (% of GDP)	-4.1	-3.5	-2.6	-2.0	-1.5	-1.2
Government debt (% of GDP)	88.0	90.6	92.1	92.3	92.1	91.4
ECB main refinancing rate (%)	1.2	0.8	0.5	0.8	1.9	2.9
Euro effective exchange rate (1995 = 100)*	120.8	114.4	116.6	116.6	115.0	115.1
Exchange rate ($ per €)	1.39	1.27	1.28	1.27	1.24	1.24

* A rise in the effective exchange rate index corresponds to an appreciation of the euro

Figure 4

Unemployment rate



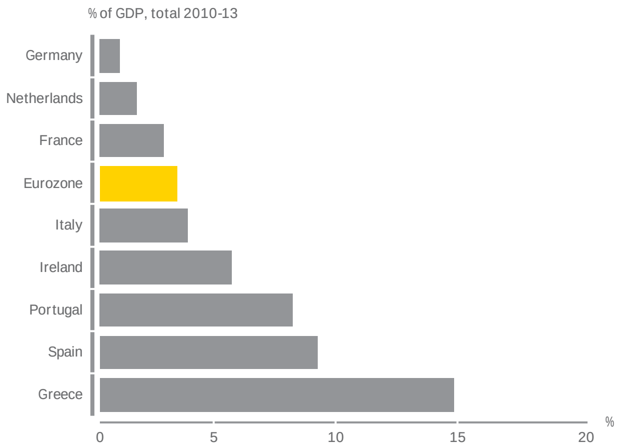
Source: Oxford Economics

... and further contraction expected in many countries

It is likely that, in much of the Eurozone, economic activity will deteriorate further before recovering. A major reason for this is the scale of fiscal consolidation yet to come in a number of countries. Putting Greece to one side, Spain, Portugal and Ireland are likely to be the worst hit, but even in France we expect that fiscal tightening will reduce GDP by around 1% per year over the next two years. At the Eurozone level, we estimate that fiscal correction will reduce growth by about 1% both this year and in 2013.

Figure 5

Discretionary fiscal tightening, 2010–13



Source: Oxford Economics, *Haver Analytics*

The likelihood of further public sector job losses and uncertainty over future entitlements from the state are just two of the many factors currently undermining consumer confidence. Households also face a number of other challenges, including the deteriorating job market and the resulting low wage growth, the legacy of strong inflation in 2011 on real incomes, and the wider impact on confidence of ongoing uncertainty about the future of the single currency. With the notable exception of Germany, where households are reasonably upbeat according to the latest surveys, consumer confidence across the Eurozone has continued to weaken in recent months.

As a result, we expect real consumer spending to grow by around 0.9% in Germany in 2012 and by just 0.2% in France, and to stagnate or fall in much of the rest of the Eurozone. As uncertainty around the Eurozone's structure dissipates, moving into 2013 we should see consumer spending regain a little momentum in northern European countries, growing by 1% or so. The headwinds facing consumers in peripheral economies are much stronger — household spending is likely to fall further in 2013, and to bottom out only in 2014.

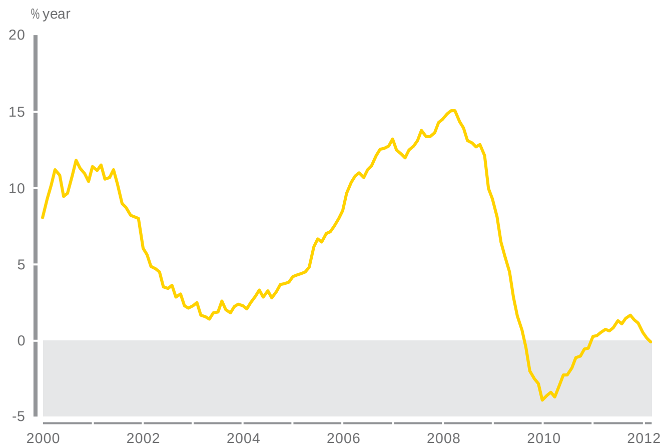
Businesses still wary of investing

There was at least one piece of good news during the past few months, with the ECB's Q2 2012 bank lending survey indicating that the crisis in the banking sector had eased following the implementation of its LTROs. Banks reported that the credit standards they demanded of potential borrowers had steadied (albeit at higher levels than in Q1), while the banks' own liquidity positions and access to finance seemed to have stabilized after a sharp decline during 2011.

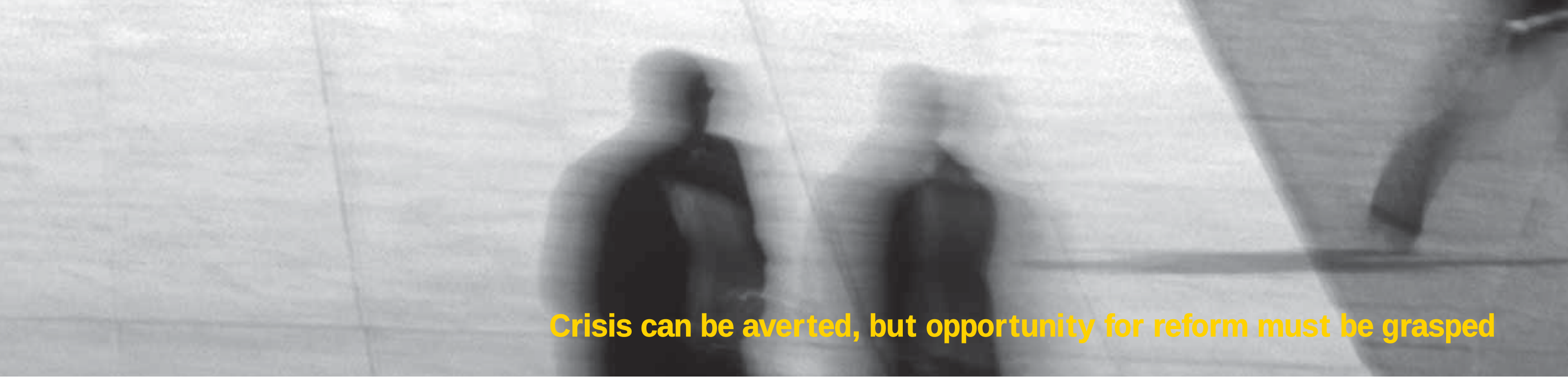
That said, the survey also found that demand for loans was markedly weaker at the start of Q2. The ratio of banks seeing fewer loan applications to those seeing more was greater than at any point since the middle of 2009. As a result, although the prospect of an outright credit crunch seems to have been averted for now, this has done little to spur corporate (or consumer) appetite for more borrrowing.

Figure 6

Lending to non-financial companies



Source: Oxford Economics, *Haver Analytics*



Combined with the fiscal squeeze, consumer caution and uncertainty over the future structure of the Eurozone, weak demand means that firms are likely to put capital spending on hold for the rest of 2012. Within this context, Germany will see modest growth in investment spending, although most of the rest of the Eurozone will see stagnation (France, Belgium and the Netherlands) or steep falls (Italy, Spain and Portugal). Investment will continue to fall in Spain, Portugal and Ireland well into 2013, while we expect capital spending to pick up more substantially, by 3%–5%, in Germany, Austria and the Netherlands.

Competitiveness will hamper exporters

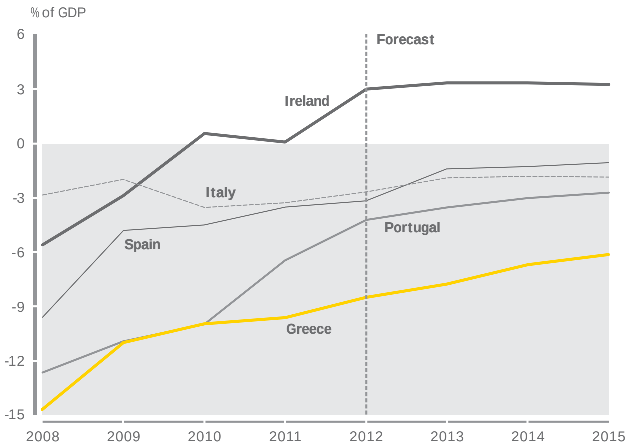
At the root of many of the Eurozone's problems though, which have led to stubbornly high rates of unemployment in many countries, weak export growth and falling investment, are fundamental differences in competitiveness. Since the euro's inception, unit labor costs have risen far more rapidly in the periphery of the Eurozone than in Germany, Austria and the other economies that have fared better over the past year. Between 2000 and 2008, unit labor costs actually fell by 5% in Germany, but rose by 15% in France and by 25% or more in Italy, Spain, Portugal and Greece.

Prior to the euro, countries often dealt with higher costs of production and the impact on their current accounts by allowing their currencies to devalue. Although helping to boost competitiveness in the short run, this often led to wage-price spirals and further depreciation. Such volatility inhibited the formation of trade and investment links, one of the motivations for the formation of the euro.

Inside the euro, disparities have to be tackled by falling nominal unit labor costs, sometimes referred to as internal devaluation. This can happen in one of two ways: producing more output per unit of labor (increased productivity), or reducing the amount paid to each unit of labor (falling wages).

Figure 7

Current account balance

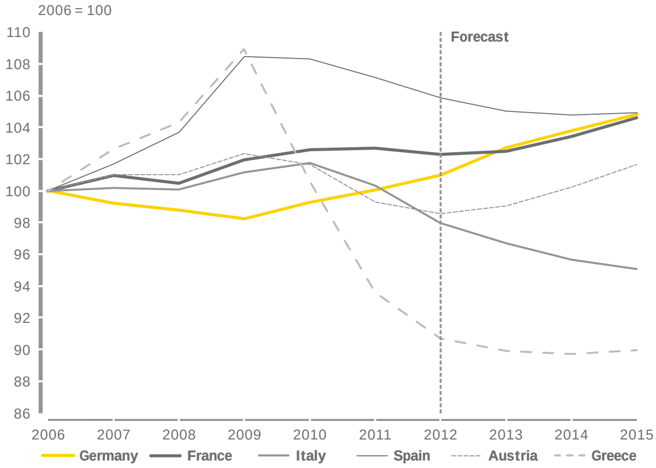


Source: Oxford Economics

Until recently, those countries with the weakest competitiveness levels have largely allowed a weaker labor market to do the work. Real wages fell by 1%–1.5% in Spain and Italy in 2011 and are expected to continue to fall this year. However, even though we expect real wages to fall yet further in 2013 and 2014, there remains some way to go before such a process will, of itself, restore competitiveness.

Figure 8

Real wages



Source: Oxford Economics

As a result, export prospects for these countries remain weak. Exports from Italy and Spain will grow by 0%–1.5% in 2012–13. Ireland and Portugal, which have seen steeper falls in unit labor costs, should do a little better, with export growth of 3%–4% in 2013. By contrast, we expect German exports to expand by about 3% in 2012 and 4% in 2013, and by up to 6% in the following two years.

2012 weak, 2013 somewhat better ...

Assuming that the Greek austerity program proceeds according to plan, and that other Eurozone members such as Spain and Italy avoid further financial turbulence, we see some of the current risk aversion among financial markets, businesses and households starting to lift toward the end of 2012. Nevertheless, output in the Eurozone as a whole is forecast to contract by 0.6% this year even in this "base-case" scenario.

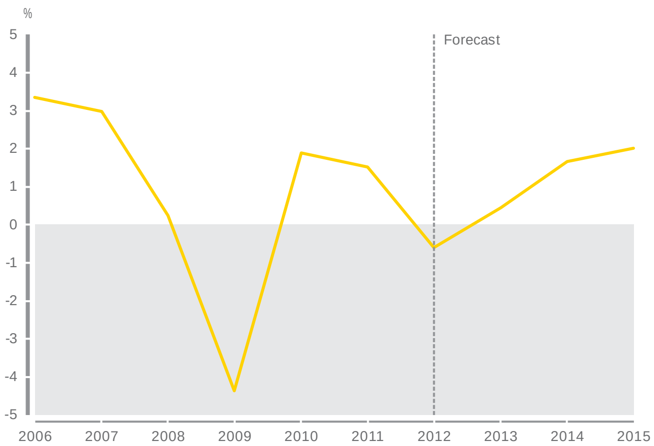
Moving into 2013, the recovery will be modest given the multiple headwinds facing the Eurozone. As we have noted, fiscal policy will exert a drag on many economies for a couple of years or more. With painfully high unemployment bearing down on household budgets, consumers will remain cautious in most of the Eurozone. And some countries are less well-placed than others to tap into still strongly growing demand in the RGMs (rapid-growth markets).

Overall, we expect the Eurozone to grow by 0.4% in 2013. As the pace of fiscal tightening starts to ease in 2014, and the world economy gathers pace, we anticipate the Eurozone will post growth of 1.7% in 2014 and of about 2% in the following couple of years.

Within this context we expect Germany to lead the way, growing by 1.4% in 2013 and 2% in 2014. France will lag behind by around 0.5%, before settling at around 2% in the medium term. It is likely to be 2014 before output starts to recover in Italy, Spain and Portugal, however. In the medium term, most countries' potential growth rates will settle at well below 2%.

Figure 9

GDP



Source: Oxford Economics

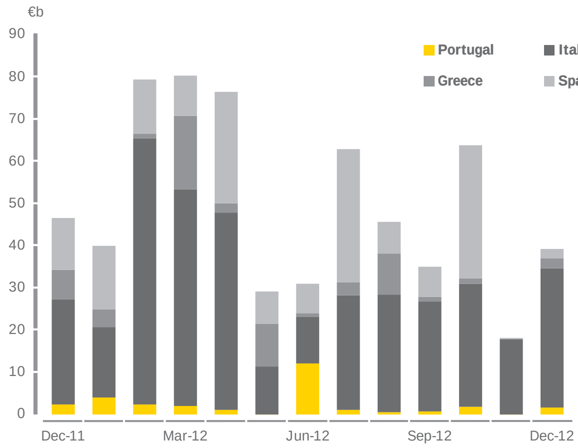
... and risks still firmly to downside

Our central economic forecast continues to be based on the assumption that Greece stays in the Eurozone, with Spain, Italy and other peripheral economies avoiding debt restructuring. The Greek elections on 17 June delivered a working coalition of parties in favor of the IMF/EU program, but also gave parties opposing the bailout a sizable vote. There remains a significant risk that the challenges to implementing the fiscal and reform measures in Greece become too great, resulting in an eventual exit from the Eurozone. More generally, deteriorating living standards in other peripherals are likely to inhibit governments' ability to press ahead with spending cuts, meaning the risk to sovereign solvency and liquidity will remain for some time.

Eurozone economies will have a heavy burden of debt refinancing throughout 2012. Spain in particular has spikes of debt falling due in July and October, while Italy's requirements are set to rise to €20–30b a month for the rest of the year (substantially greater than in recent months). Signs of slippage against fiscal commitments would risk triggering further increases in borrowing costs, possibly to unsustainable levels.

Figure 10

Maturing government debt



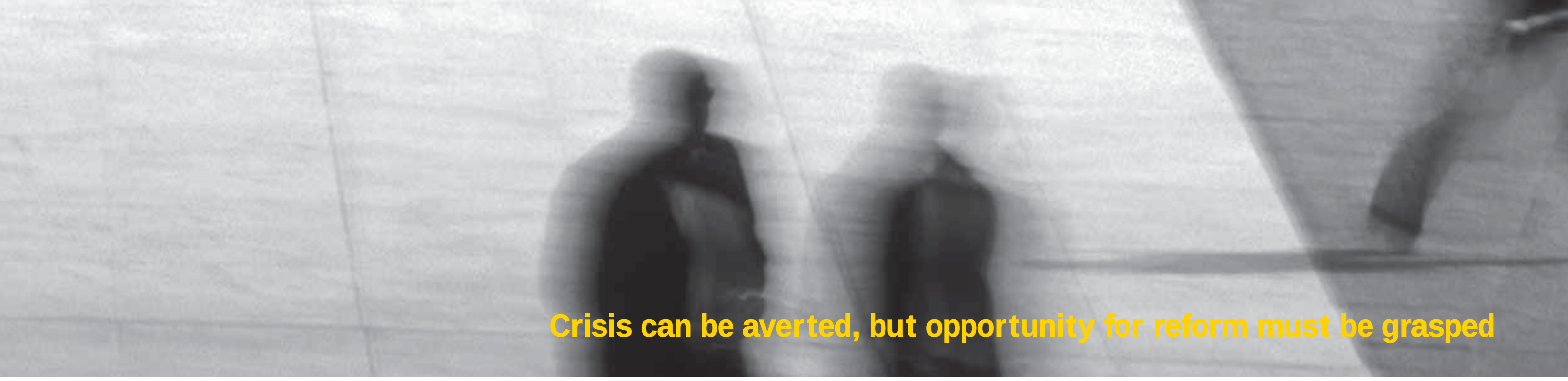
Source: *Bloomberg*

We also remain concerned about the health of the banking system. Recent weeks have seen further trouble in Spain in particular. Shortly after the €19b recapitalization (and effective nationalization) of Bankia, the Spanish Government acknowledged that it could no longer guarantee the stability of the banking sector without external assistance. This was followed by the agreement of €100b in support from the EU, with the details to be finalized following an assessment of financing needs at each institution. Whether this is enough to sustain confidence more widely remains to be seen.

There is a risk that the deposit flight seen in recent months in Greece will spread in earnest to other at-risk economies, again potentially demanding intervention that governments can ill afford. For now, wider confidence in the interbank market remains reasonably stable, but this clearly cannot be taken for granted, and the ECB may have to provide yet more emergency support. In Box 1 on page 19, we discuss in more detail the policy package that we believe is necessary to prevent the Eurozone from breaking up.

In addition, there are risks from the wider world economy, including the threat of further oil price spikes arising from tensions in the Middle East. This would not only reduce growth, but by boosting inflation could lead to calls for a premature tightening of monetary policy. Other potential downside risks include a more restrictive fiscal stance in the US over the next couple of years, and a hard landing in China.
We discuss in more detail our outlook for the world economy in Box 2 on page 20.

Upside risks are much harder to identify. Having said that, were we to see a confluence of positive factors, including aggressive reform measures and credible fiscal consolidation in the periphery, a willingness on the part of Germany and other "core" countries to boost domestic demand, and a positive external environment, we could see a faster recovery. Such a positive outcome remains, though, far less probable than a damaging downside scenario.



Growth versus austerity

Against this gloomy and risk-laden background, the policy debate has begun to focus on how to deliver faster growth, without which the austerity programs may ultimately prove self-defeating. For some participants this is framed as a straight choice between austerity and growth, but this is a dangerous simplification. Given the exposure of banks around the Eurozone to sovereign debt, fiscal sustainability and the stability of the financial system are more deeply interconnected than ever. Therefore, fiscal sustainability is a key part of a return to health in the banking sector, as is the provision of finance for investment and growth.

In addition, in order to plan for the medium term, households and businesses need clarity over their future entitlements from, and obligations to, the state. Uncertainty over fiscal sustainability is likely to deter firms from investing and encourage households to increase their precautionary savings, thereby depressing demand.

That said, there are changes that governments can implement to make fiscal consolidation as growth-friendly as possible. In countries where taxation on labor income is relatively high, reorienting the burden of taxation away from income towards consumption should improve incentives to participate in the labor market. Ultimately this should improve household incomes (boosting demand) as well as broadening the labor pool (boosting potential supply).

Governments should also seek to make savings on future obligations that are unfunded by current taxation. In the short term, savings that can be achieved in this area should be used to protect capital spending, especially in areas critical to future innovation and productivity.

One final policy measure that could trigger an improvement in confidence and activity around the Eurozone would be for the European Investment Bank (EIB) to use its banking license to borrow from the ECB on the same terms as commercial banks. It could then use the proceeds to expand substantially its lending to infrastructure projects, especially in the peripheral economies.

Expanding the EIB's balance sheet would potentially expose it to greater financial risk. However, if the projects it financed were scrutinized to ensure they delivered real benefit to the economy and repayment to the EIB, this could provide a valuable short-term boost to activity — and improve countries' long-term growth potential.

Germany leading the way in RGMs ...

Europe could also do more to ensure that countries other than Germany and its supply chain benefited from demand in the RGMs in Asia, Africa and Latin America. As we noted earlier, export prospects within the Eurozone are fairly bleak for the coming few years, so firms need to look further afield.

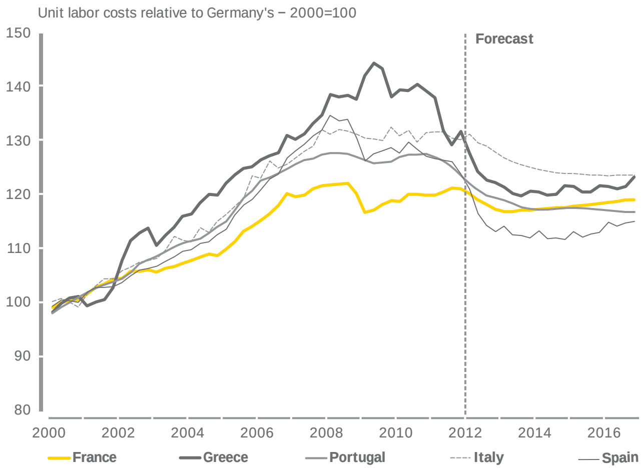
The growth of the middle classes in emerging markets provides a major opportunity here. We examine progress so far in more detail in Box 3 on page 21, but we simply note at this point that between 2005 and 2011 Germany's exports to China rose from $30b to $92b. France, Italy and Spain's shipments have seen similar rates of growth over this period, but together these three countries export just half of Germany's total.

More needs to be done in just about every Eurozone country to exploit these opportunities. This does not simply mean more effective marketing of goods and services, but greater efficiency in the production process in order to compete with producers elsewhere in the Eurozone, and in the target markets themselves.

... and rebalancing has a role to play ...

We noted earlier that substantial disparities in competitiveness remain between northern and southern Europe, and that one way to narrow these gaps is for wages to fall further. A less painful way would be to boost the productivity of existing workers. Such a goal could be achieved via a range of measures, including reforming wage indexation mechanisms that link wages to prices rather than productivity, making it easier for younger workers to compete for jobs against labor market "insiders," and reducing the incentives for early retirement that can deprive firms of experienced workers.

Figure 11
Competitiveness



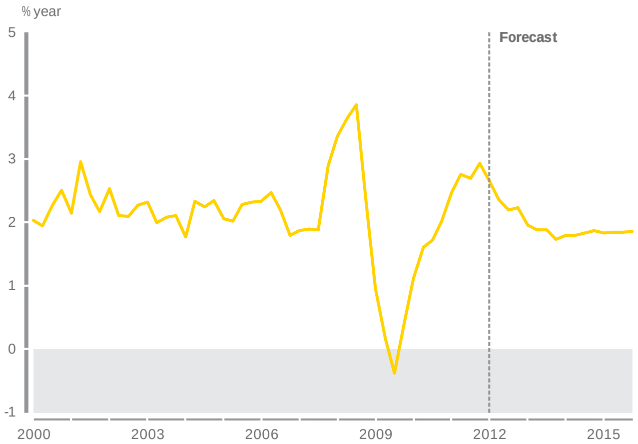
Source: Oxford Economics

Such reforms take time to bear fruit, however. As a short-term help it may be necessary for Germany to accept slightly higher wage inflation. This would boost consumer incomes in Germany, providing demand for the rest of the Eurozone, and improve competitiveness on the periphery.

Given that Germany is growing faster than most other Eurozone countries, its level of spare capacity is falling much more quickly — we expect actual output to be just 0.5% below potential output by the end of 2014, while there will still be an output gap of 2% or more in most other Eurozone economies. Given these conditions, wages in Germany are already starting to rise faster and sooner than elsewhere on the Continent, helping to narrow the cost gap automatically.

Early indications are that the German Government and the ECB would be content with such a development if this helped the outlook in countries that are struggling to boost growth. But in order to sustain this tolerance for higher inflation, it is likely that Germany policy-makers would demand real measures to improve competitiveness in the periphery, and not just a "free ride" on German inflation.

Figure 12
Inflation



Source: Oxford Economics

This strikes us as a good compromise between the near-term need to boost growth, and the longer-term need for uncompetitive economies to become more dynamic and innovative.

Our forecast includes some of that rebalancing within the Eurozone, with stronger German consumption compared to the previous decade helped by more robust real wage increases. There remains a risk, though, that such a change may not last or may not be large enough to have a significant impact on competitiveness in peripheral countries.

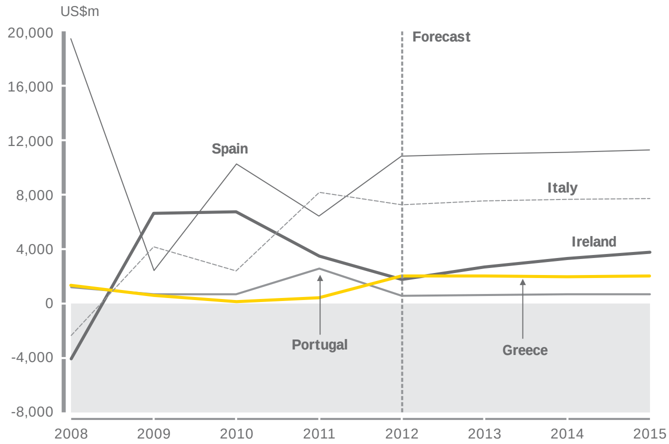
Germany could also help to promote a rebalancing in the Eurozone through other means, for example by using some of its fiscal space to support domestic demand in its own economy (and imports from around the Eurozone), or through liberalizing its service sector in order to give other countries the opportunity to sell into the German market.

... while onshoring also provides opportunities

For countries that are successful in getting labor costs down, there are also opportunities to pick up those parts of the global manufacturing chain that have become too expensive to locate at a distance from European markets. Rising wage costs in Asian economies, as well as the likelihood of structurally higher transport costs over the medium term than in the decade running up to the crisis, both mitigate in favor of locating production for EU markets closer to Europe.

In recent years, central and eastern European countries have been key investment destinations for firms looking to produce low-cost goods close to European markets. However, some argue that firms are still willing to look at Eurozone destinations if productivity levels were to improve sufficiently.

Figure 13
Inward FDI to peripheral economies, 2008–2015



Source: Oxford Economics

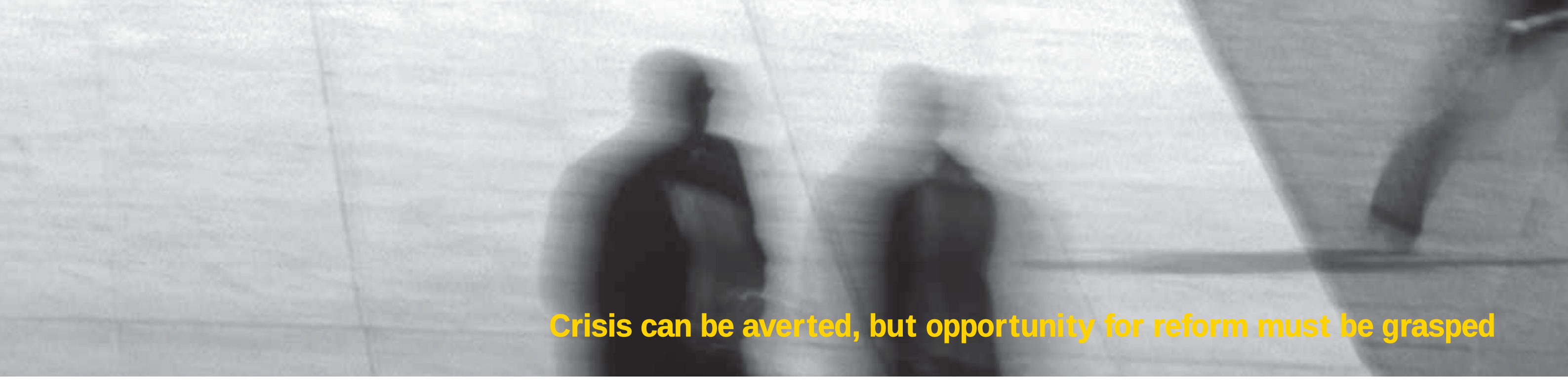
Conclusions

Our forecast assumes that no Eurozone member will leave the single currency, although events in Greece have further increased the possibility that one or more may do so. Concerted action in the weeks ahead to recommit to the IMF/EU deal will be necessary to keep Greece in the Eurozone and avert the damaging economic impacts of a fracturing of the single currency.

Assuming that this is achieved, we expect a difficult year for the Eurozone economy, with a mild contraction in output this year. Multiple headwinds facing consumers and businesses will limit the pace of recovery from 2013 onwards.

However, the paths of the Eurozone's member economies have continued to diverge from that of Germany, which is apparently rising above the turmoil. Even Germany, though, cannot expect to escape unscathed from a fracturing of the single currency, given the impact on the European banking system and the economies that take two-thirds of its exports.

Although we still expect the Eurozone to remain intact, the risk of a break-up has intensified over the past quarter. As a result there is a shared interest not only in keeping financial crisis at bay, but also in generating a sustainable return to growth throughout the Eurozone. We welcome this shift in focus, but it has to be underpinned by an ongoing commitment to fiscal discipline. It will also require difficult decisions to be taken in all economies, not just in those where the crisis is at its worst.



Crisis can be averted, but opportunity for reform must be grasped

Box 1

A plan to save the euro

Our forecast continues to assume that the current structure of the Eurozone remains intact, although the risk of a break-up has certainly intensified since our last forecast. Although the fiscal effort Greece will need to make to remain in line with the package agreed with the IMF is unprecedented, and there are multiple reforms to be made that will arouse the opposition of powerful interest groups, the damage to Greece of an exit is, in our opinion, even greater. For the Eurozone, a failure to save Greece would undermine market confidence in its ability to save others, and lead to further capital flight from countries such as Spain, Italy and Portugal. In itself this could lead to further departures and a collapse of the single currency, with devastating economic and social impact. It is therefore in everyone's interest to save the euro, and there is plenty that can be done. But action needs to start now.

The loss of confidence in Spain's banking sector has resulted in a €100b package of support for the country's banks from the EU bailout funds. This separation of official sector support for sovereigns and the banking sector is welcome, as it helps reduce the probability a banking crisis will lead directly to a fiscal one.

But more needs to be done. Europe needs to move toward a **Eurozone-wide guarantee of bank deposits**. In addition, **the ECB needs to be given powers to enable it to recapitalize banks directly**, in the same way as the Federal Reserve in the US. This would ease the fiscal risks of a Eurozone-wide banking deposit scheme, by making it less likely that banks would require sovereign support from the national governments that do have fiscal space remaining. Together, these measures would protect at-risk sovereigns, as well as giving households and firms the confidence to keep deposits in local banks where they have a greater chance of supporting growth, rather than shifting deposits around Europe in search of safety.

Provided that Greece's new government can stick to the broad fiscal path agreed with the IMF and EU, as well as making early progress on structural reform, we think there should be some *quid pro quo* from official creditors. Although clearly presenting the risk of moral hazard to Ireland and Portugal, **Greece should be allowed some relief on the burden of debt interest on official borrowing** given the scale of its fiscal effort. This should be supplemented by further official sector support for Portugal as necessary. In order to finance this, and substantially boost the prospect of financing support for Italy and Spain (should this prove necessary), the **European Stability Mechanism** should be increased from €500b to €2t or more. This should be supported by moves toward a fiscal union, in which there is greater institutional control over national fiscal policies, in return for a **degree of mutuality** in debt obligations.

On the growth side, as we have noted in the report, all parties in the Eurozone have obligations. For the peripheral economies, the need to **reform labor markets and improve the efficiency of domestic service sectors** in particular is familiar. The German Government could support this process by **opening up its own service sector** to overseas firms and generating faster domestic demand and wage growth to support activity and competitiveness elsewhere in the Eurozone. The government could help generate such a development by raising the wages paid to public sector workers (even if it does so in a fiscally neutral way, for example by making savings in future public sector pensions), driving the private sector to respond to attract workers in a tight labor market.

To smooth market tensions that seem inevitable along the path to an agreement on these issues (which should nevertheless be an urgent priority), the ECB could **revitalize the Securities Markets Program (SMP)**. The facility remains on hand for the ECB to smooth short-term market tensions, but the scale of interventions has not been great enough to generate genuine falls in borrowing costs for governments. Radically raising the self-imposed weekly limit, from €20b to €100b for example, could help give solvent governments much more breathing space in times of crisis. This should also be complemented by **further LTROs** to provide more lubrication to the banking sector.

Box 2

Forecast assumptions — international environment and commodity prices

Our forecast for the Eurozone is predicated on a number of assumptions about the international environment, world GDP and trade and commodity prices. Here, we explain these assumptions.

Since our last forecast there has been mixed news from the US, with some slightly weaker than expected indicators and some unanticipated strength. On the plus side, consumers are enjoying a boost from easing gasoline prices, with the cost of fuel down by around 7% since the end of March. In addition, construction activity has continued to edge upward and industry surveys remain positive. These positive signals have not driven as much improvement in the labor market as expected, however. Looking ahead, the weakness of the labor market (unemployment remains above 8%), and likelihood of further falls in house prices will temper the pace of consumer spending. The Federal Reserve's latest credit survey showed that banks are generally keeping steady the terms upon which they offer credit, but there has been a pickup in business demand for credit. We expect firms to increase capital spending by around 5% this year, rising to 7% in 2013. Meanwhile, we expect the US to experience only a modest slowdown in its export markets, given its modest exposure to the Eurozone. Overall we expect US growth of 2.4% in 2012, slightly stronger than in our Spring forecast. As global financial uncertainty eases, we believe this should increase to 2.7% in 2013 and 3.2% in 2014.

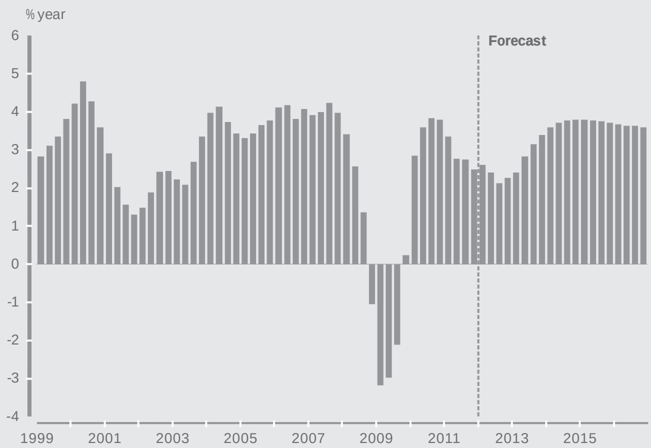
In Japan, we now expect GDP growth of almost 2% after the major setbacks that saw GDP fall by 0.7% in 2011, but there will be a gradual slowdown in parts of emerging Asia. Growth in China is now slowing to 7.5% this year, down from about 8.5% at the time of our last forecast, while India is growing by only about 6%, slowing in response to earlier interest rate rises that were needed to curb high inflation. Elsewhere in the RGMs, most other countries are expected to see growth at broadly the same pace as 2011. Emerging European markets, however, will be badly affected by the Eurozone recession of 2012, with exports and financing flows slowing, placing the onus on consumers and constrained governments to drive growth.

Overall, world GDP growth is now seen slowing to 3.2% in 2012 (on a purchasing power parity basis) from 3.8% in 2011. World trade growth is forecast at just 3.2%, down from 6.2% in 2011 (and 14.5% in 2010). In 2013, assuming that the Eurozone crisis is resolved satisfactorily, world GDP growth is forecast to pick up to 3.7%, although the risks are clearly on the downside.

In addition to the risks to the world economy, there remains considerable uncertainty about oil prices amid ongoing political tensions in the Middle East. Despite these tensions, oil prices have recently fallen back to under US$100 per barrel (pb), but strong emerging market demand is likely to temper the easing in prices. We believe oil prices will average US$105pb in 2012, down from US$111pb in 2011.

Figure 14

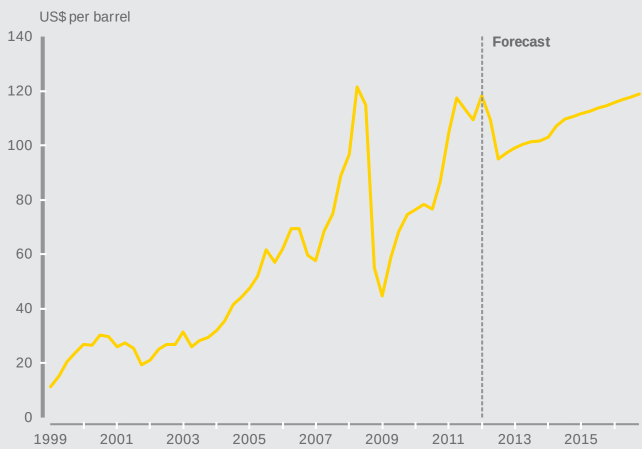
World GDP growth



Source: Oxford Economics

Figure 15

Oil price, nominal



Source: Oxford Economics

Box 3

Opportunities in RGMs

Consumers in the G7 countries have been the primary source of demand in the global economy for the last 25 years, but in the coming decades it will be the RGMs of Asia, Latin America and Africa that will drive global consumer demand. Our forecasts show that the number of households in emerging markets with an income of over US$30,000 will double to 149 million by 2020, overtaking the US and the Eurozone. The demand that these households generate provides a thriving new market for European economies.

Asia has the largest potential – by 2020 a quarter of global consumer spending will come from this region, up from 14% last year. By 2030, this proportion will rise to 40%, with China alone accounting for 20% of the world total. By 2020 Chinese households with an income of over US$30,000 will have a total of US$1.2t to spend, up from less than US$100b in 2010. India's share of world consumer spending will double by 2030, and the proportion of households with an income over US$5,000 will surge from just 47% in 2010 to more than 80% by 2020.

Latin America and EMEA will also see some growth in the middle classes, but these regions start from much higher average income levels and their progress will thus be less eye-catching. Nevertheless, the number of households in the higher income bands is expected to grow rapidly in the next 10 years, especially in Eastern Europe. By 2020, almost 40% of households in Poland will have an income of above US$30,000, up from less than 25% in 2010. In Africa progress will be a little slower, but nevertheless there will be a noticeable improvement in some countries such as Ghana and Nigeria, shifting around 10% of households above the US$5,000 a year threshold.

Underpinning this movement into the higher income bands are two principal drivers:

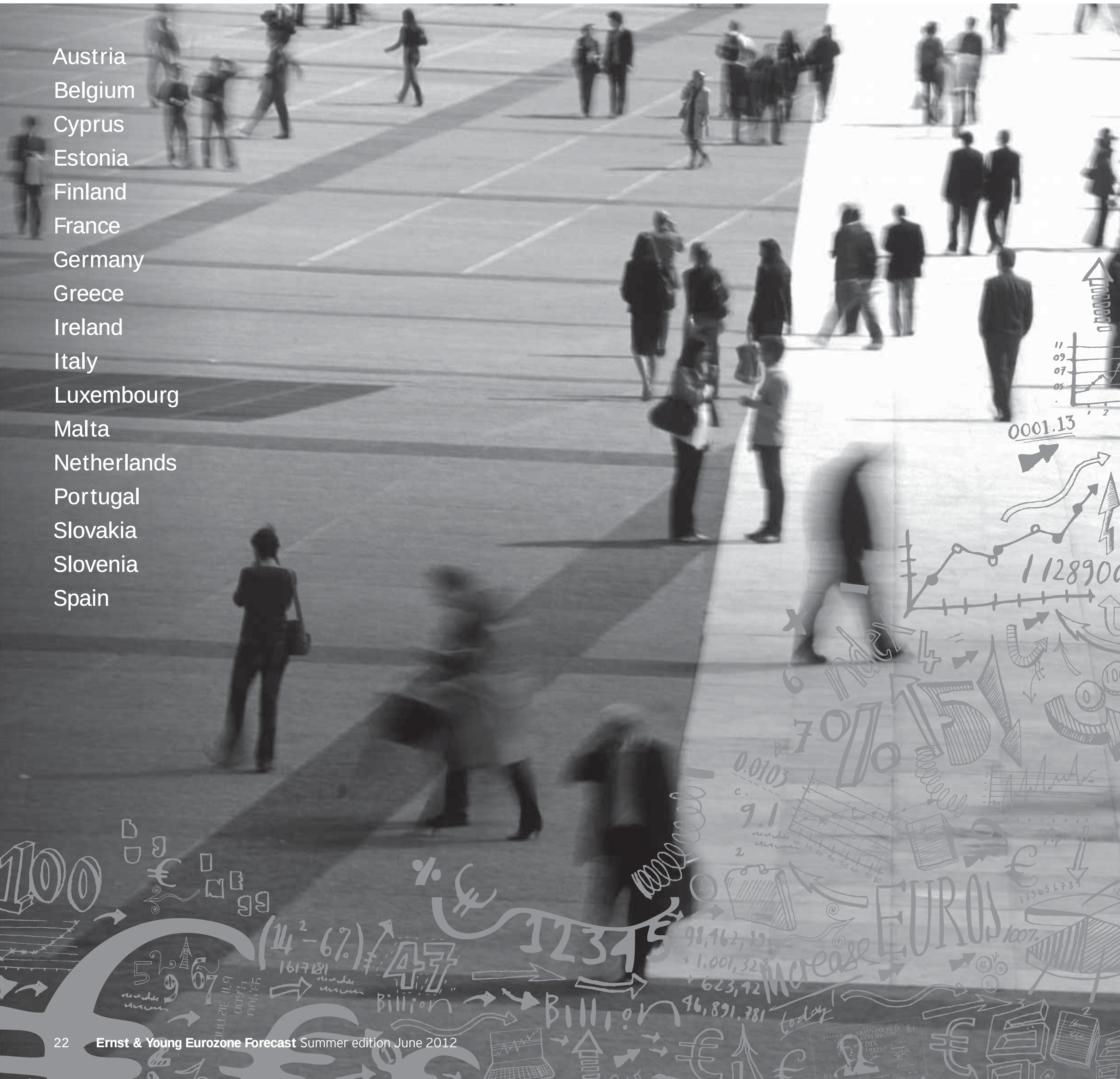
- The emerging markets enjoy **a demographic advantage** over the advanced economies. The ratio of people of retirement age to those of working age is expected to remain under a quarter into the 2020s in China, Brazil, Russia and India, whereas in the EU and Japan it already exceeds a third.
- With the **shift from rural to urban** populations, human capital will also increase across the RGMs, enabling these countries to compete in more sophisticated sectors.

In addition, households in the RGMs tend to be less indebted than their counterparts in the advanced economies, which should give consumers a greater freedom to spend. As such, we expect that in 25 years' time almost two-thirds of global consumer spending will come from RGMs, with emerging Asia responsible for almost 40%. This represents valuable potential custom for the Eurozone.

Of course, domestic suppliers will aim to exploit these opportunities, and are likely to enjoy cost advantages in doing so. But some European economies have already tapped into this demand. German exports to China have grown from around US$30b in 2005 to over US$90b in 2011, and the value of shipments to India has risen from US$5b to US$15b over the same period. This might partly reflect Germany's expertise in capital goods, which are of course in demand in industrializing economies, but also consumer exports.

The challenge will be for firms in other Eurozone economies to do likewise, competing in areas where they enjoy a reputation for excellence in Western economies. Higher end consumers in RGMs are becoming just as brand-aware as those in the US or Europe, so quality consumer goods, vehicles, fashion and tourism should all be areas in which opportunities can be found. In order to make the most of this, many economies will need to become more innovative and responsive to changing consumer demand. This underpins the need to reform labor markets, ease other regulatory burdens and restore health to the financial sector.

Forecast for Eurozone countries

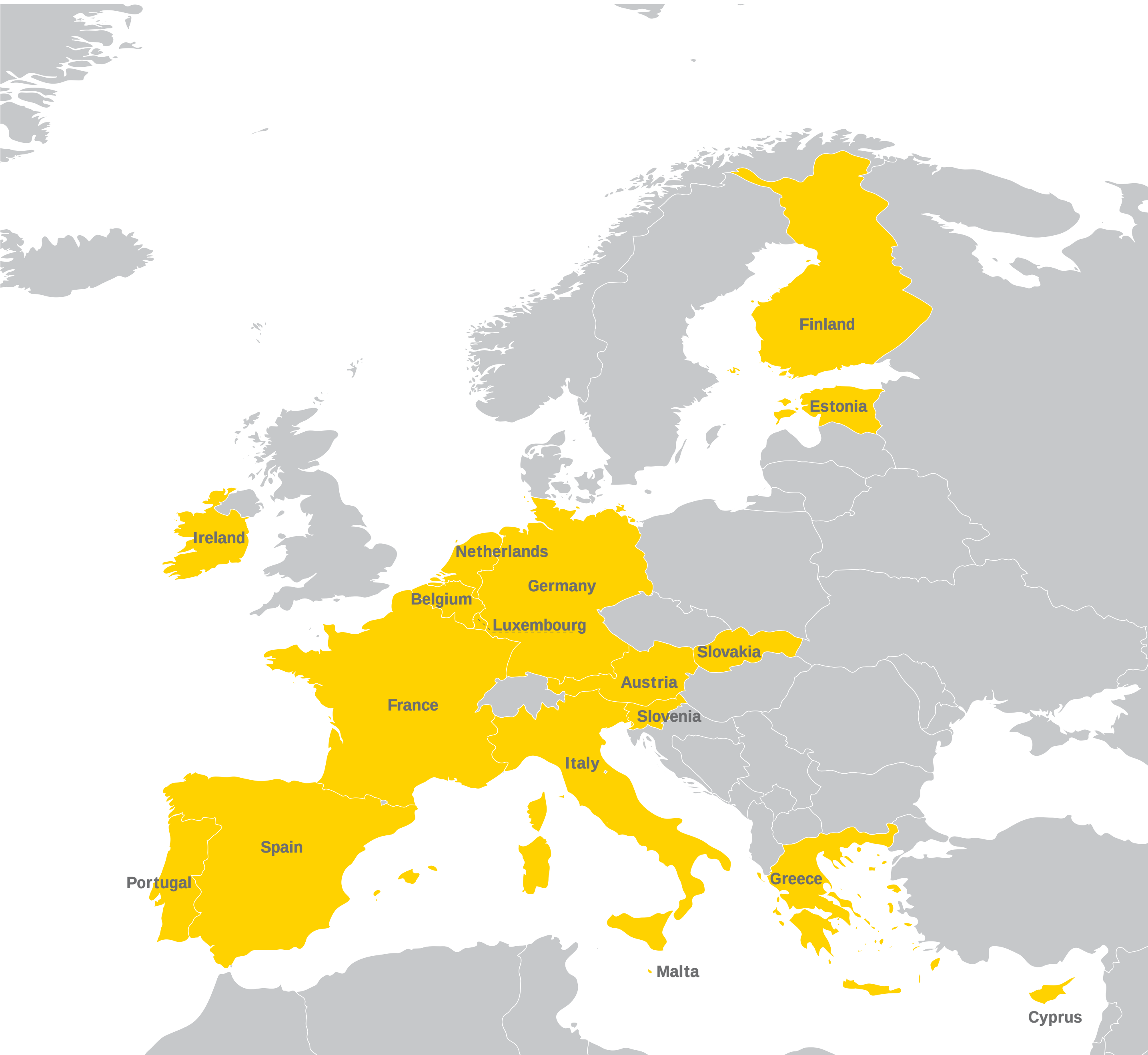


Austria
Belgium
Cyprus
Estonia
Finland
France
Germany
Greece
Ireland
Italy
Luxembourg
Malta
Netherlands
Portugal
Slovakia
Slovenia
Spain

17 Eurozone countries

Please visit our Eurozone website for access to additional information on the *Ernst & Young Eurozone Forecast*, the 17 individual country forecasts and additional perspectives and interview content. The site contains the latest version of our reports as well as an archive of previous releases.

To find out more, please visit www.ey.com/eurozone

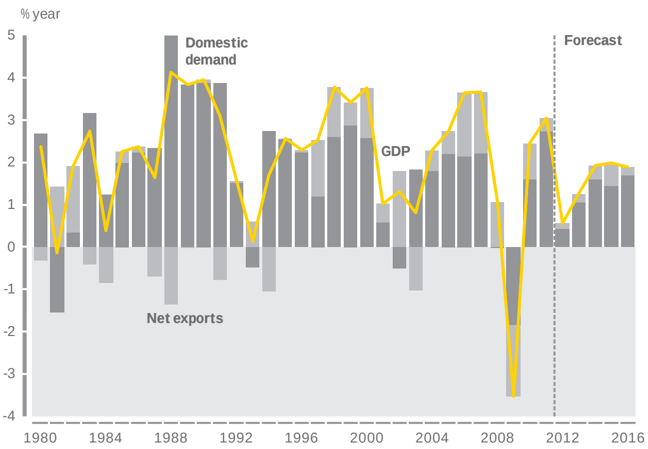


Austria

- GDP rose 0.2% in Q1 2012 after two quarters of effective stagnation, but recent partial data suggests that growth may have weakened since then. The outlook for the rest of this year remains one of subdued growth overshadowed by external risks, and we forecast GDP growth of 0.6% in 2012 as a whole.
- Growth should pick up next year but, at 1.3%, our forecast remains quite low. Economic activity will be dampened by weak external demand and the impact of domestic austerity measures. For 2014–16 we expect average growth of around 2% a year, underpinned by the resilient export sector and Austria's strong competitiveness.
- The substantial austerity package (aimed at saving 9.3% of 2011 GDP until 2016) came into effect in May. But lack of clarity on some of the measures means that our current forecast sees the budget deficit staying above the official forecast, at 1.5% of GDP in 2016.

Figure 16

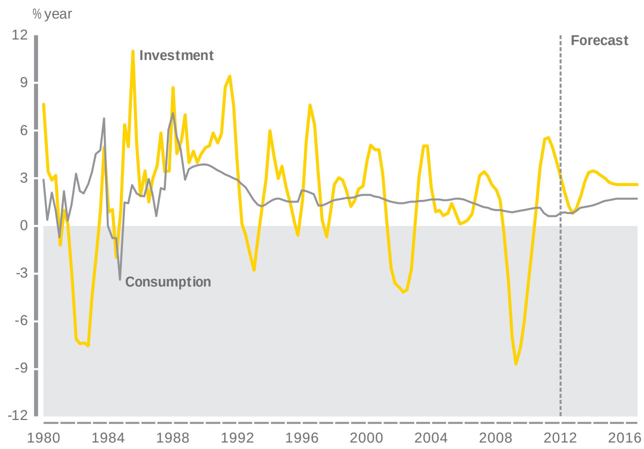
Contributions to GDP



Source: Oxford Economics

Figure 17

Consumption and investment



Source: Oxford Economics

Table 2

Austria (annual percentage changes unless specified)

Source: Oxford Economics

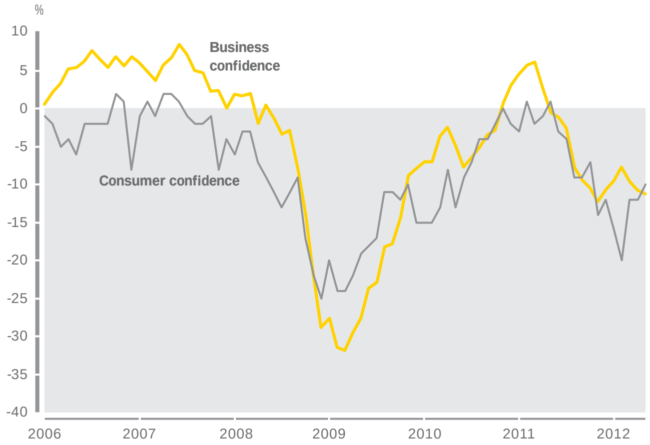
	2011	2012	2013	2014	2015	2016
GDP	3.0	0.6	1.3	1.9	2.0	1.9
Private consumption	0.7	0.8	1.1	1.4	1.7	1.7
Fixed investment	5.0	1.8	2.3	3.2	2.7	2.6
Stockbuilding (% of GDP)	2.2	1.7	1.4	1.3	1.0	0.9
Government consumption	0.4	0.7	1.1	1.4	1.7	1.8
Exports of goods and services	7.1	2.1	3.9	6.6	5.5	5.3
Imports of goods and services	7.5	2.1	4.0	6.9	5.2	5.7
Consumer prices	3.6	2.5	2.2	2.0	2.0	1.9
Unemployment rate (level)	4.2	4.0	4.1	3.9	3.8	3.7
Current account balance (% of GDP)	2.0	1.8	1.9	2.5	3.1	3.3
Government budget (% of GDP)	-2.6	-3.3	-2.9	-2.0	-1.6	-1.5
Government debt (% of GDP)	72.2	74.1	74.8	74.1	72.9	71.6

Belgium

- Belgium's economy posted stronger than expected expansion of 0.1% in Q1 2012, thanks to unexpected strength in exports. But fundamentals point to ongoing weakness among firms and consumers.
- With the Eurozone outlook worsening, export markets will weaken in the second half of 2012, causing labor demand to ease. With unemployment rising to around 8% by mid 2013, consumer spending will see minimal growth.
- As the EU recovers, we expect GDP growth to rise from 0.1% in 2012 to just below 1% in 2013. But Belgium's long-term growth prospects remain weak — reforms are needed to lift potential growth above .5%.
- In addition, Belgium's high debt stock leaves it exposed to a rise in investor risk aversion. More fiscal measures may be needed to keep the deficit on track and protect Belgium from rising borrowing costs.

Figure 18

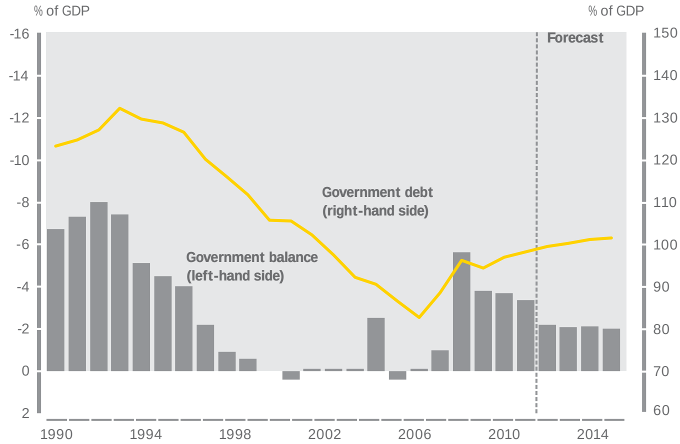
Consumer and business confidence



Source: Oxford Economics

Figure 19

Government balance and debt



Source: Oxford Economics

Table 3

Belgium (annual percentage changes unless specified)

Source: Oxford Economics

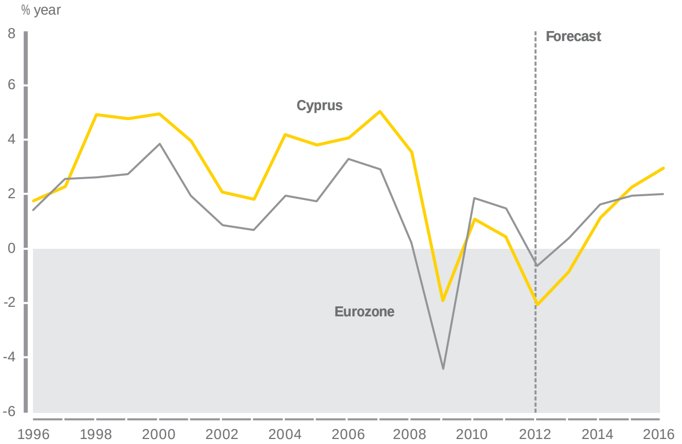
	2011	2012	2013	2014	2015	2016
GDP	2.0	0.1	0.8	1.7	2.3	2.4
Private consumption	0.9	0.1	1.1	1.6	1.6	1.6
Fixed investment	5.2	0.0	2.5	4.8	4.0	2.9
Stockbuilding (% of GDP)	-0.2	0.0	-0.5	-0.8	-0.7	-0.3
Government consumption	0.6	-0.6	-0.6	1.2	1.8	2.5
Exports of goods and services	4.4	-0.9	2.9	4.8	4.4	4.0
Imports of goods and services	5.1	-0.9	2.6	5.2	4.5	4.1
Consumer prices	3.4	2.9	1.6	1.9	1.9	1.8
Unemployment rate (level)	7.2	7.5	7.8	7.4	6.7	6.4
Current account balance (% of GDP)	-0.3	-0.1	0.6	0.3	0.3	0.3
Government budget (% of GDP)	-3.7	-3.4	-2.2	-2.1	-2.1	-2.0
Government debt (% of GDP)	98.0	99.7	100.9	102.0	102.8	103.2

Cyprus

- Having moved into recession in H2 2011, GDP continued to fall in Q1 2012 as weak Eurozone demand weighed on exports, and the spreading of the region's financial problems (primarily from Greece) curbed investment. With the Government having to cut spending and raise taxes, we now forecast a 2% decline in GDP this year and a further decline of 0.8% in 2013.
- The Greek debt write-down has left Cypriot banks needing to raise more capital, which will restrain new lending and require asset disposals. Assuming Greece remains in the Eurozone, its bailout will help to stabilize the banks, but €1b must still be raised internally.
- Despite the fiscal measures, the budget deficit is forecast at 4.7% of GDP, well above the official target of 2.6%, and still casts doubt over the sustainability of public finances. As a result, the Government has formally requested an EU bailout to help shore up its banks.

Figure 20

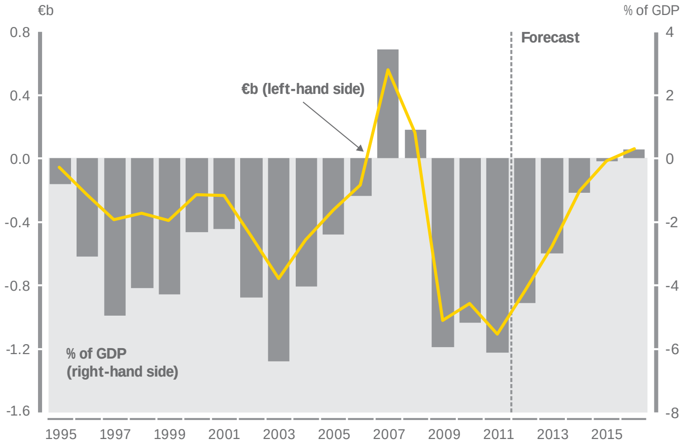
Real GDP growth



Source: Oxford Economics

Figure 21

Government budget balance



Source: Oxford Economics

Table 4

Cyprus (annual percentage changes unless specified)

Source: Oxford Economics

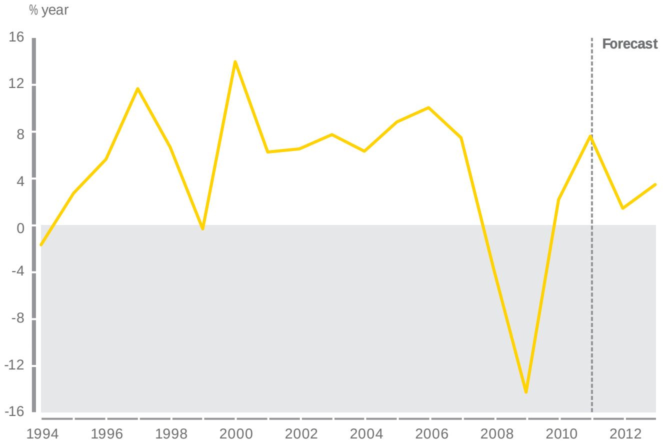
	2011	2012	2013	2014	2015	2016
GDP	0.5	-2.0	-0.8	1.2	2.3	3.0
Private consumption	0.2	-0.5	-0.3	1.2	2.0	3.0
Fixed investment	-13.8	-6.0	-2.0	2.0	3.0	4.8
Stockbuilding (% of GDP)	0.1	0.1	-0.2	0.2	0.5	0.5
Government consumption	-4.7	-3.8	-1.2	1.0	1.5	2.3
Exports of goods and services	3.6	-3.0	-1.0	2.0	4.0	5.3
Imports of goods and services	-5.0	-3.0	-1.5	3.0	4.0	5.6
Consumer prices	3.5	2.8	2.2	2.3	2.3	2.3
Unemployment rate (level)	7.8	9.9	9.7	8.3	7.0	5.5
Current account balance (% of GDP)	-7.7	-7.9	-7.2	-6.5	-6.4	-6.1
Government budget (% of GDP)	-6.3	-4.7	-3.1	-1.1	-0.1	0.3
Government debt (% of GDP)	66.3	70.5	72.6	71.2	68.2	64.5

Estonia

- A sharp trade-led slowdown is under way after last year's 7.6% GDP growth. However, domestic demand is holding up, which should keep Estonia clear of recession this year. Further support should come from the Government's plan to use its strong fiscal position to implement a modest stimulus program to support demand, alongside allowing the automatic stabilizers — including a rise in social spending — to operate. GDP growth is forecast at 1.5% in 2012, among the fastest growth rates in the Eurozone.
- Assuming that the Eurozone pulls out of recession in late 2012, external demand should strengthen, enabling the recovery to gain greater momentum. An improvement in the external outlook should also bolster business confidence and strengthen investment growth. We expect GDP growth to accelerate to 3.5% in 2013 and to just below 5% in 2014–15.

Figure 22

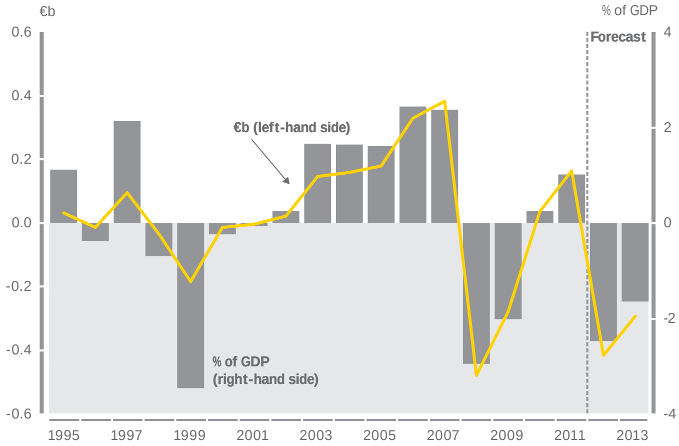
Real GDP growth



Source: Oxford Economics

Figure 23

Government budget balance



Source: Oxford Economics

Table 5

Estonia (annual percentage changes unless specified)

Source: Oxford Economics

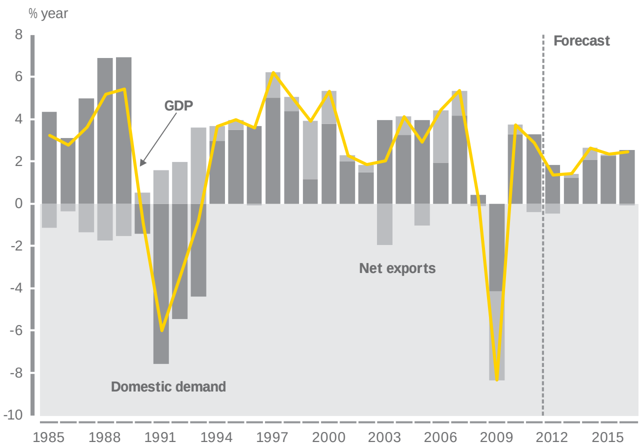
	2011	2012	2013	2014	2015	2016
GDP	7.6	1.5	3.5	4.8	4.7	4.5
Private consumption	4.2	2.0	3.3	4.3	4.7	4.6
Fixed investment	26.8	5.0	6.5	8.0	5.8	5.0
Stockbuilding (% of GDP)	-2.1	-1.3	0.1	0.3	0.3	0.3
Government consumption	1.6	1.0	1.0	1.8	2.7	3.0
Exports of goods and services	24.9	2.0	5.1	5.7	5.4	5.2
Imports of goods and services	27.0	4.1	6.9	6.0	5.4	5.1
Consumer prices	5.0	3.8	2.6	2.2	2.2	2.1
Unemployment rate (level)	12.5	11.4	10.1	8.6	7.3	6.3
Current account balance (% of GDP)	3.2	-0.2	-1.6	-1.6	-1.5	-1.4
Government budget (% of GDP)	1.0	-2.5	-1.6	-0.5	0.3	0.3
Government debt (% of GDP)	5.0	7.2	8.4	8.3	7.4	6.6

Finland

- The performance of the Finnish economy at the start of the year was better than expected. GDP grew by a strong 0.8% on the quarter in Q1 2012, although we anticipate a correction in Q2. More importantly, Finland will avoid recession in 2012 on the back of its stable financial system and healthy fiscal accounts, which should enable the authorities to provide additional support if needed.
- Tight credit conditions across the region, coupled with low business confidence, mean that European firms are likely to continue to delay investment, hitting demand for the capital goods in which Finland specializes.
- Despite the country's sound fiscal accounts, additional austerity measures, aimed at bringing the deficit below 1% by 2015, will be introduced. Although these steps are in the right direction, they need to be complemented by reforms to the legal framework aimed at stimulating competition and enhancing productivity.

Figure 24

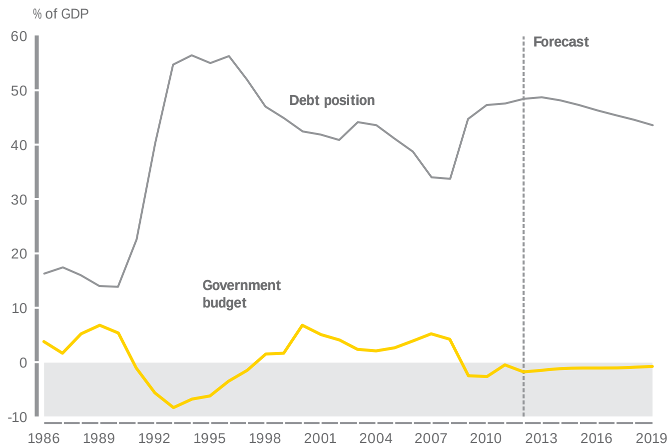
Contributions to GDP growth



Source: Oxford Economics

Figure 25

Government balance and debt



Source: Oxford Economics

Table 6

Finland (annual percentage changes unless specified)

Source: Oxford Economics

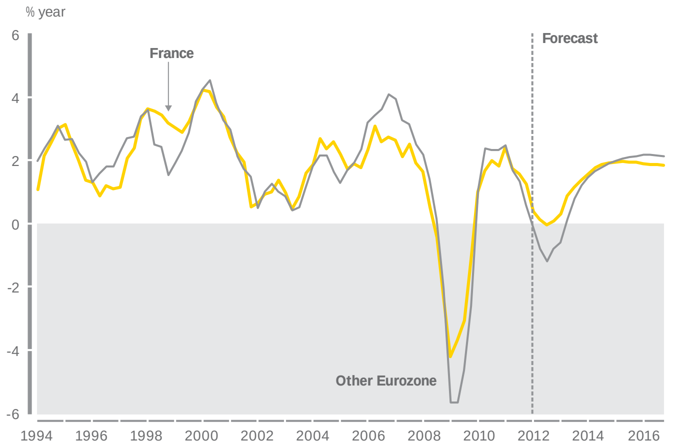
	2011	2012	2013	2014	2015	2016
GDP	2.9	1.3	1.4	2.6	2.3	2.4
Private consumption	3.3	0.9	1.2	2.7	2.5	3.0
Fixed investment	4.6	-1.3	1.4	5.1	5.1	4.4
Stockbuilding (% of GDP)	2.6	4.0	4.1	3.5	3.1	2.9
Government consumption	0.8	0.4	0.9	1.2	1.2	1.4
Exports of goods and services	-0.8	-0.2	2.9	6.7	5.9	5.2
Imports of goods and services	0.1	1.0	2.8	6.1	6.4	6.0
Consumer prices	3.3	2.9	2.8	2.0	1.9	1.8
Unemployment rate (level)	7.8	7.8	7.5	7.0	6.5	6.0
Current account balance (% of GDP)	-0.7	1.1	3.2	4.3	4.4	3.9
Government budget (% of GDP)	-0.5	-1.6	-1.5	-1.1	-1.0	-1.0
Government debt (% of GDP)	48.6	49.2	49.4	48.6	47.7	46.7

France

- The new Government faces a challenging economic environment, as growth is likely to remain weak throughout this year, both in France and in its main trading partners.
- We forecast GDP growth at 0.1% in 2012, with possibly some quarters of negative growth. Growth is expected to pick up to 0.9% in 2013 and to average 1.8% a year in 2014-16.
- It is essential that France pursues its efforts to reduce its public deficit and debt in order to secure a low cost of debt finance.
- France already ranks among the top economies in some key aspects that influence hiring and investment decisions, such as tax treatment on research and high productivity per hour. Efforts to make it easier to create businesses and to reduce employment-related red tape would help to raise investment and job creation.

Figure 26

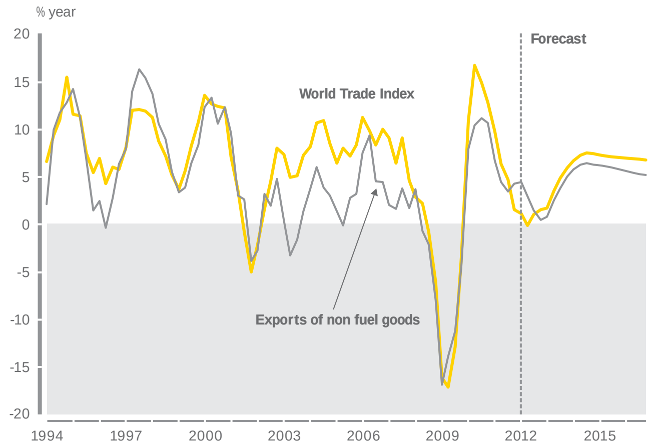
GDP growth: France versus rest of Eurozone



Source: Oxford Economics

Figure 27

Exports – potential and actual



Source: Oxford Economics

Table 7

France (annual percentage changes unless specified)

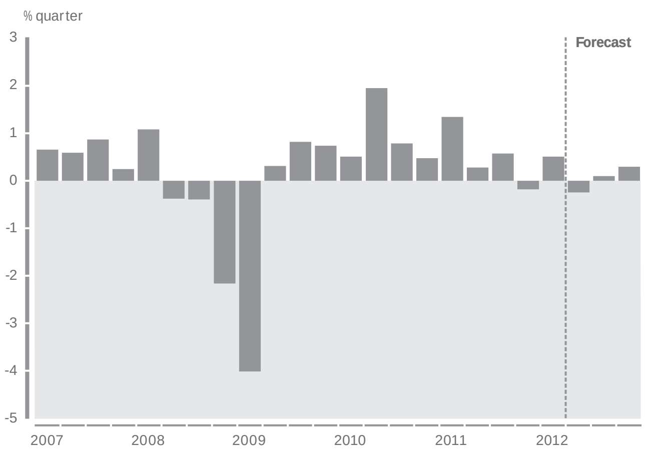
Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	1.7	0.1	0.9	1.7	1.9	1.8
Private consumption	0.3	0.2	1.1	1.6	1.7	1.7
Fixed investment	3.5	0.0	1.0	2.8	2.9	2.8
Stockbuilding (% of GDP)	0.4	-0.4	-0.4	-0.3	-0.3	-0.2
Government consumption	0.2	0.6	0.3	1.2	1.2	1.2
Exports of goods and services	5.5	1.9	3.0	5.6	5.5	5.1
Imports of goods and services	5.2	-0.4	2.9	5.5	5.3	5.1
Consumer prices	2.3	2.3	2.0	1.9	1.9	1.9
Unemployment rate (level)	9.7	10.2	10.1	9.6	9.2	8.9
Current account balance (% of GDP)	-2.2	-2.4	-2.3	-2.3	-2.3	-2.3
Government budget (% of GDP)	-5.2	-4.8	-3.9	-3.1	-2.7	-2.3
Government debt (% of GDP)	85.8	89.3	91.9	93.4	95.2	96.7

Germany

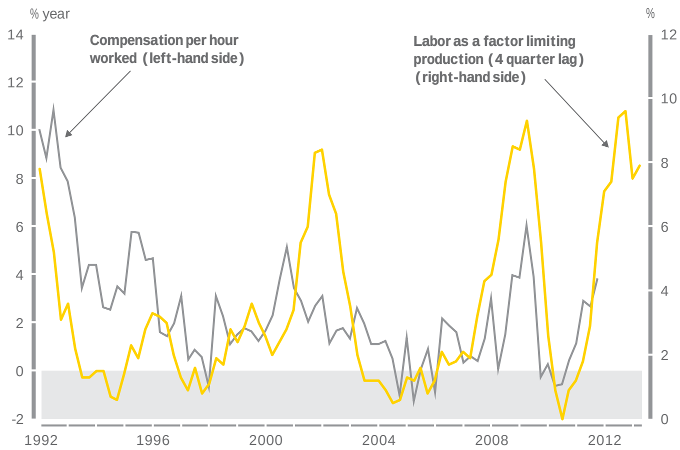
- After contracting by 0.2% in Q4 2011, the German economy has accelerated again, with quarterly growth of 0.5% in Q1 2012. But if the economy is to continue growing, financial stability in the Eurozone must be secured and Germany must help address the growth challenges facing the region. One way in which Germany could assist in this process would be by tolerating faster wage growth and hence higher inflation.
- Assuming that policies are implemented at the Eurozone level to help the region emerge from the sovereign debt crisis, the German economy should grow by 0.7% in 2012 and by 1.4% in 2013.
- The main risk facing the German economy is an intensification of the Eurozone crisis, which would have an impact directly through trade and financial channels, and indirectly by snuffing out the recovery in business and consumer confidence. If these downside risks materialize, then Germany will be in the enviable position of being able to afford to ease fiscal policy in response.

Figure 28
GDP



Source: Oxford Economics

Figure 29
Wage inflation



Source: Oxford Economics, *Haver Analytics*

Table 8
Germany (annual percentage changes unless specified)
Source: Oxford Economics

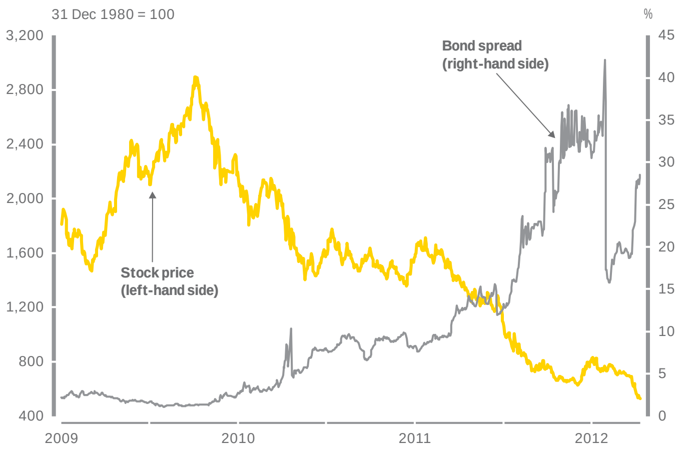
	2011	2012	2013	2014	2015	2016
GDP	3.1	0.7	1.4	2.1	2.0	2.0
Private consumption	1.4	0.9	1.3	1.4	1.5	1.5
Fixed investment	6.6	-0.4	2.2	4.7	4.4	3.7
Stockbuilding (% of GDP)	0.8	0.1	-0.1	0.1	0.1	0.1
Government consumption	1.1	1.0	0.5	0.7	0.7	0.7
Exports of goods and services	8.4	3.0	3.8	5.8	6.0	5.3
Imports of goods and services	7.9	1.7	3.4	6.5	6.3	5.5
Consumer prices	2.5	2.1	1.8	1.9	2.0	2.0
Unemployment rate (level)	5.9	5.7	5.6	5.4	5.2	5.1
Current account balance (% of GDP)	5.7	6.4	6.7	6.2	6.0	5.9
Government budget (% of GDP)	-1.0	-1.2	-1.0	-0.9	-0.6	-0.1
Government debt (% of GDP)	81.2	81.0	80.7	80.7	81.0	80.8

Greece

- After a period of political uncertainty, the center-right New Democracy (ND) party won a narrow victory over the anti-bailout Syriza party at elections held on 17 June. The political situation in Greece has now stabilized in the near term, but the new Government faces huge challenges ahead.
- Although the new Government nominally supports the terms of the bailout program, the austerity measures are extremely unpopular in Greece, and even ND has promised to renegotiate some of the terms of the program. Its unpopularity is not surprising, as the measures have plunged the economy into a recession. Moreover, Greece faces several more years of austerity in order to bring its debt/GDP ratio down, but this will further weaken the domestic economy.
- The immediate threat of a Greek Eurozone exit has eased, but the prolonged period of political uncertainty has raised speculation that it could eventually reject the terms of its bailout and be forced out of the Eurozone.

Figure 30

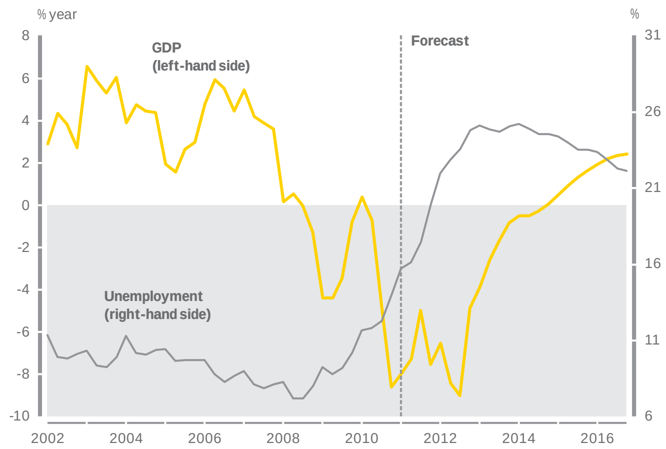
Bond spread and stock market



Source: *Haver Analytics*

Figure 31

Real GDP and unemployment



Source: Oxford Economics

Table 9

Greece (annual percentage changes unless specified)

Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	-6.9	-7.2	-2.3	-0.3	1.1	2.2
Private consumption	-7.1	-8.3	-3.0	-1.1	0.2	1.3
Fixed investment	-20.6	-24.8	-3.3	0.4	4.8	6.9
Stockbuilding (% of GDP)	-1.1	0.3	1.1	1.2	1.0	1.1
Government consumption	-9.1	-10.3	-9.0	-3.7	0.8	1.4
Exports of goods and services	-0.9	-6.5	1.7	3.5	3.7	4.0
Imports of goods and services	-8.0	-15.2	-2.4	-0.3	1.7	3.4
Consumer prices	3.1	1.2	0.3	0.5	1.0	1.5
Unemployment rate (level)	17.7	23.7	25.4	25.2	24.3	23.1
Current account balance (% of GDP)	-9.6	-7.1	-7.0	-5.8	-5.1	-4.9
Government budget (% of GDP)	-9.0	-8.0	-7.2	-6.1	-5.8	-5.7
Government debt (% of GDP)	164.1	162.4	172.3	176.3	176.1	173.5

Ireland

- In the past few years, Ireland has steadily implemented fiscal and structural reforms, thus managing to raise competitiveness and get a grip on public finances. However, the latest escalation of the Eurozone crisis reinforces the view that, despite these positive trends, the Government will not be able to return to financial markets by the end of 2013 when the international money runs out.
- The recovery in Ireland in 2013 will be modest at best. After a decline of 0.1% in 2012, GDP is forecast to increase by just 0.6% in 2013.
- Irish exports continue to outperform and, with domestic demand likely to keep falling in 2013, the recovery is expected to be driven entirely by net trade. We expect exports to increase by 1.6% in 2012 and 3.7% in 2013. However, with over 40% of total exports going to the Eurozone, where demand is weak, risks to this forecast are skewed to the downside.

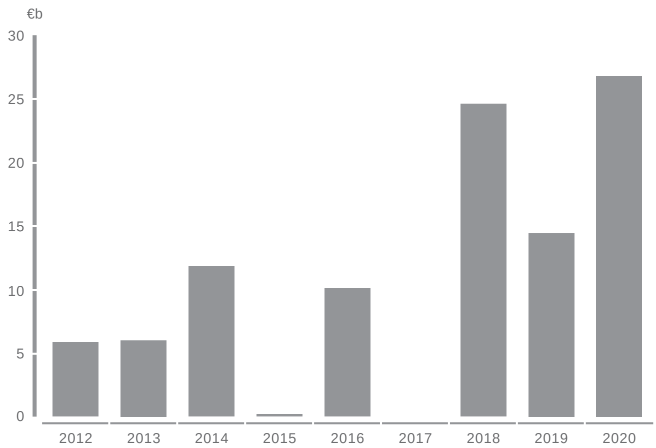
Figure 32

Long-term government borrowing interest rate

Source: Oxford Economics, *Haver Analytics*

Figure 33

Government financing needs



Source: *Bloomberg*

Table 10

Ireland (annual percentage changes unless specified)

Source: Oxford Economics

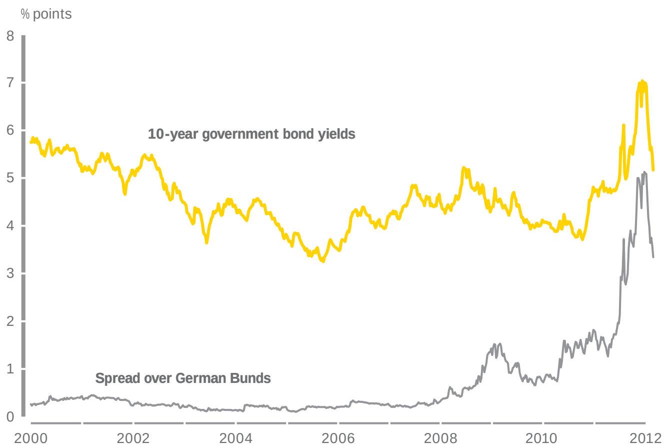
	2011	2012	2013	2014	2015	2016
GDP	0.7	-0.1	0.6	1.4	3.0	3.8
Private consumption	-2.7	-2.6	-1.3	0.4	1.5	2.9
Fixed investment	-10.6	-9.4	-1.9	3.3	10.6	11.1
Stockbuilding (% of GDP)	0.3	-0.6	-0.3	0.0	0.6	0.3
Government consumption	-3.7	-5.8	-1.9	-1.3	-0.1	0.7
Exports of goods and services	4.1	1.6	3.7	4.1	4.0	4.3
Imports of goods and services	-0.6	-0.9	3.1	4.5	4.5	4.0
Consumer prices	1.2	1.4	0.4	0.4	0.9	1.4
Unemployment rate (level)	14.4	14.9	15.2	15.1	14.4	13.4
Current account balance (% of GDP)	0.1	3.0	3.4	3.4	3.3	3.0
Government budget (% of GDP)	-13.0	-8.6	-7.0	-4.8	-3.2	-2.1
Government debt (% of GDP)	108.2	117.1	121.4	122.7	120.7	116.4

Italy

- The recession that started in Q3 2011 is expected to last into 2013, as domestic demand is hit by fiscal austerity and tight credit conditions, while external demand remains subdued. We now expect Italian GDP to shrink by 2.3% in 2012, weaker than the forecast of a 1.6% decline in our Spring report, and by a further 0.2% in 2013. But we now anticipate that GDP growth will average 1.5% in 2014–16, a little above the pre-crisis average of 1.2%–1.3%, as the effects of structural reforms gradually feed through into the economy.
- The domestic political outlook has worsened following the local elections in May, increasing the risk that reforms will be postponed. This, coupled with the worsening debt crisis in the Eurozone, resulted in a significant rise in government bond yields, as well as a sharp drop in consumer and business confidence, which will contribute to the contraction of domestic demand in 2012–13.

Figure 34

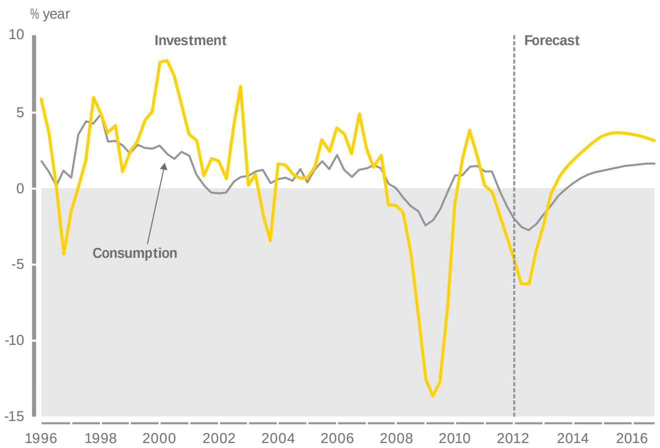
Government bond yields and spreads



Source: Oxford Economics, *Haver Analytics*

Figure 35

Consumption and investment



Source: Oxford Economics

Table 11

Italy (annual percentage changes unless specified)

Source: Oxford Economics

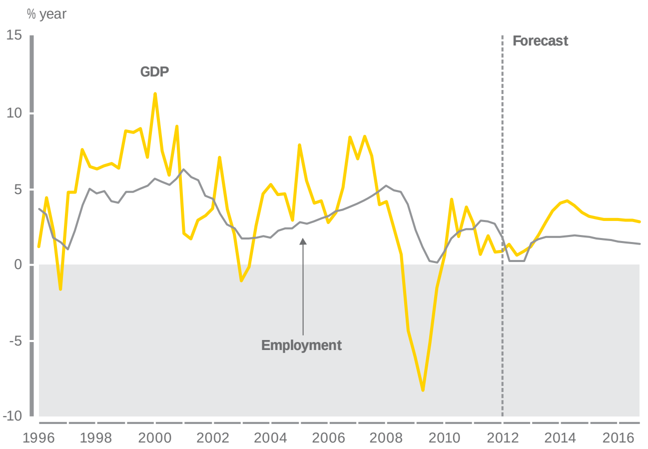
	2011	2012	2013	2014	2015	2016
GDP	0.5	-2.3	-0.2	1.2	1.6	1.8
Private consumption	0.2	-2.4	-0.8	0.7	1.3	1.6
Fixed investment	-1.2	-5.3	-0.2	2.5	3.6	3.4
Stockbuilding (% of GDP)	0.0	-1.1	-0.6	0.1	0.5	0.5
Government consumption	-0.9	-2.0	-1.1	-0.1	0.8	1.2
Exports of goods and services	6.3	0.6	1.3	3.6	4.7	5.1
Imports of goods and services	1.0	-5.3	1.3	5.3	6.1	5.7
Consumer prices	2.9	3.2	2.4	2.3	2.0	2.0
Unemployment rate (level)	8.5	10.5	11.2	10.9	10.0	9.1
Current account balance (% of GDP)	-3.3	-2.7	-1.9	-1.8	-1.9	-1.9
Government budget (% of GDP)	-3.9	-2.5	-1.3	-0.9	-0.7	-0.6
Government debt (% of GDP)	120.1	123.6	123.1	120.5	117.2	113.6

Luxembourg

- We maintain our forecast of GDP growth of about 1% in 2012, although this will be stronger than for many Eurozone countries. In the absence of an external stimulus, domestic demand will be the main driver of growth until well into 2013, when faster growth of exports of services will help to lift GDP growth to about 2.5%.
- For 2014–16, we expect GDP growth of over 3% a year as the gradual restoration of confidence and stability within the Eurozone further boosts the orientation of Luxembourg's economy toward business services, which will become an important growth driver in the medium term.
- But Luxembourg could be hit hard by further financial contagion from the Greek crisis. And there are also regulatory risks arising from US and EU policy-makers' reactions to the crisis. These could lead to restrictions on the high-yield strategies that have been a particular focus of Luxembourg's recent fund growth.

Figure 36

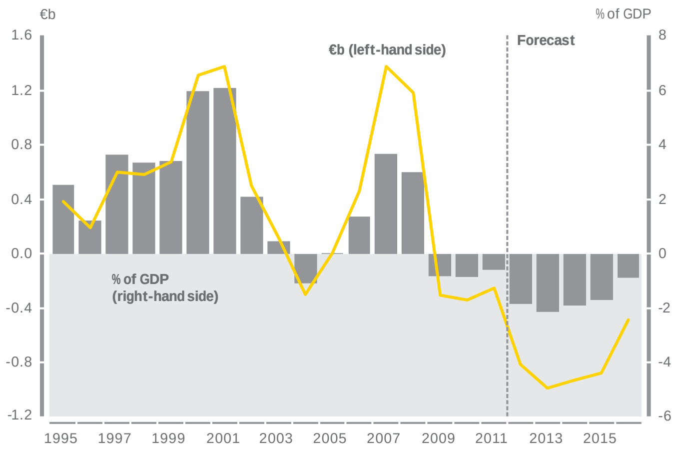
Real GDP and employment



Source: Oxford Economics

Figure 37

Government budget balance



Source: Oxford Economics

Table 12

Luxembourg (annual percentage changes unless specified)

Source: Oxford Economics

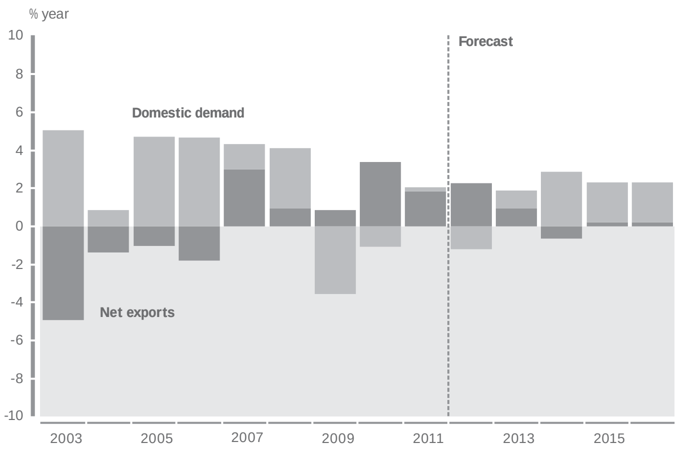
	2011	2012	2013	2014	2015	2016
GDP	1.6	1.0	2.4	3.9	3.1	2.9
Private consumption	1.8	1.1	3.1	3.5	2.6	2.4
Fixed investment	8.3	9.7	6.0	3.9	1.6	1.2
Stockbuilding (% of GDP)	0.4	0.8	0.8	0.9	0.6	0.5
Government consumption	2.5	2.5	1.8	2.0	1.9	1.8
Exports of goods and services	1.7	0.1	5.1	6.6	4.8	3.9
Imports of goods and services	3.2	1.8	6.1	6.6	4.4	3.4
Consumer prices	3.7	2.7	2.2	2.1	2.0	2.0
Unemployment rate (level)	4.8	5.3	5.3	4.6	4.1	3.6
Current account balance (% of GDP)	7.1	4.8	4.2	5.3	6.3	6.7
Government budget (% of GDP)	-0.6	-1.8	-2.1	-1.9	-1.7	-0.9
Government debt (% of GDP)	18.2	19.4	20.7	21.5	22.1	21.9

Malta

- The outlook for 2012 has improved slightly, but GDP growth will be limited to around 1% as the main Eurozone markets remain subdued. In particular, tourism might struggle to match last year's record arrivals, and industrial output will continue to decline in the first half of 2012.
- The Government kept the fiscal deficit below 3% of GDP in 2011, while maintaining growth in the financial services industry. However, weak growth implies that the deficit will rise to 2.9% of GDP in 2012, from 2.7% in 2011, before declining from 2013.
- A significant risk to the forecasts is represented by the relatively large size of the financial sector, which will raise concerns about the state's ability to support it if conditions in the Eurozone deteriorate further.

Figure 38

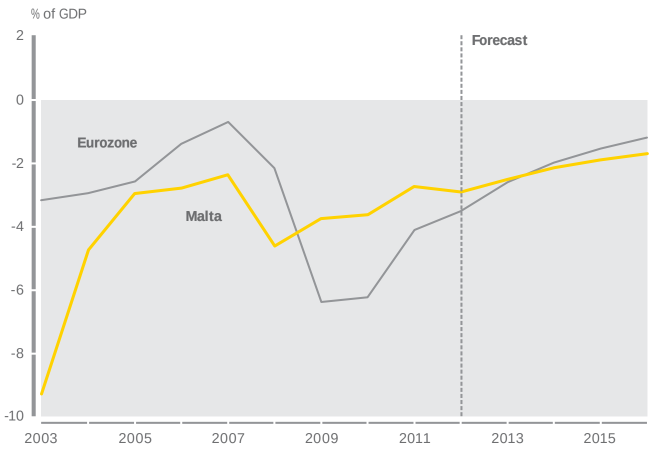
Contributions to GDP



Source: Oxford Economics

Figure 39

Fiscal balance versus Eurozone



Source: Oxford Economics

Table 13

Malta (annual percentage changes unless specified)

Source: Oxford Economics

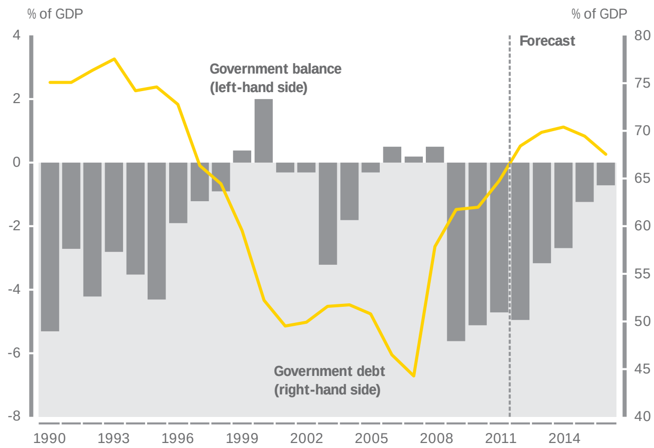
	2011	2012	2013	2014	2015	2016
GDP	2.1	1.1	1.9	2.2	2.3	2.3
Private consumption	3.2	0.6	1.0	2.1	2.5	3.2
Fixed investment	-21.9	-3.0	1.0	3.1	4.3	4.0
Stockbuilding (% of GDP)	0.7	-0.7	-0.7	0.1	-0.3	-1.2
Government consumption	3.5	0.5	1.0	2.2	2.8	3.0
Exports of goods and services	1.0	1.0	2.4	3.0	3.0	3.0
Imports of goods and services	-1.0	-1.5	1.5	4.0	3.0	3.0
Consumer prices	2.4	2.0	1.9	2.2	2.3	2.3
Unemployment rate (level)	6.5	6.3	6.2	5.7	5.2	4.6
Current account balance (% of GDP)	-3.1	-2.9	-2.6	-2.4	-2.2	-2.1
Government budget (% of GDP)	-2.7	-2.9	-2.5	-2.1	-1.9	-1.7
Government debt (% of GDP)	69.2	69.6	69.2	68.3	67.2	65.8

Netherlands

- The outlook for the Dutch economy has worsened significantly over the past three months, with additional austerity measures denting our growth forecast and the collapse of the Government providing an extra layer of uncertainty over the future direction of policy.
- The economy is forecast to remain in recession until the latter part of 2012, by which time external demand should have begun to recover. The domestic recovery will take longer to materialize, particularly on the consumer side, with the decision to increase VAT set to keep inflation high and maintain the squeeze on household finances.
- We now expect GDP to contract by 1% in 2012, before a weak recovery sees expansion of just 1% in 2013. The risks remain skewed to the downside, with external vulnerability to the sovereign debt crisis and domestic concerns over capital levels in the banking sector and the degree of consumer indebtedness.

Figure 40

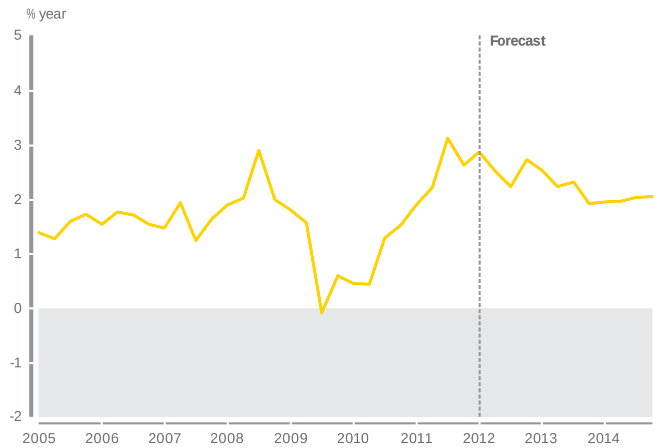
Government balance and debt



Source: Oxford Economics

Figure 41

Consumer prices



Source: Oxford Economics

Table 14

Netherlands (annual percentage changes unless specified)

Source: Oxford Economics

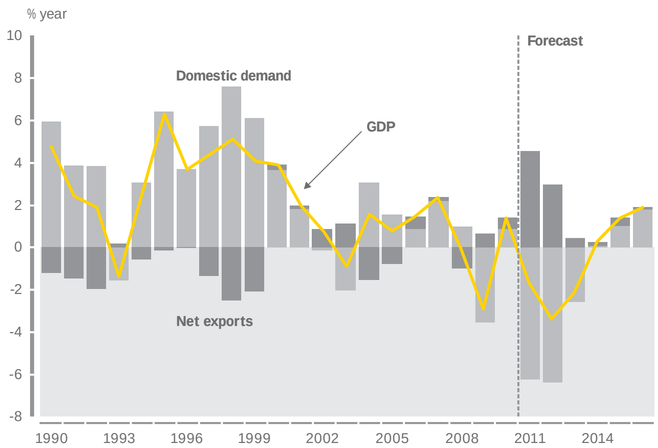
	2011	2012	2013	2014	2015	2016
GDP	1.3	-1.0	1.0	2.0	2.1	2.0
Private consumption	-1.1	-0.8	0.3	1.9	2.3	2.0
Fixed investment	5.8	-1.7	3.2	3.2	3.0	2.9
Stockbuilding (% of GDP)	0.5	0.2	0.2	0.2	0.2	0.2
Government consumption	0.2	-0.6	-0.5	-0.2	0.0	0.7
Exports of goods and services	3.8	1.0	2.6	5.3	4.3	3.4
Imports of goods and services	3.5	0.7	2.6	5.2	4.2	3.4
Consumer prices	2.5	2.6	2.3	2.0	1.9	1.8
Unemployment rate (level)	4.4	5.3	5.5	5.1	4.4	3.9
Current account balance (% of GDP)	9.1	7.4	7.5	7.7	7.9	8.1
Government budget (% of GDP)	-4.7	-5.0	-3.1	-2.7	-1.2	-0.7
Government debt (% of GDP)	65.2	70.1	71.2	71.4	69.8	67.8

Portugal

- The better than expected outturn for Q1 has led us to raise our 2012 forecast slightly, to a GDP decline of 3.4%. However, the broader picture is little changed and the outlook for domestic demand remains exceptionally weak.
- Draconian austerity measures are taking a severe toll on the labor market. The unemployment rate has risen by almost 3% over the past year and real incomes are declining sharply. These factors will have a negative impact on consumer spending, forecast to fall by over 6% in 2012 and about 2% in 2013.
- The Government has made good headway in implementing economic reforms, thus earning praise from the EU and IMF in their latest review. However, the weak growth outlook, recent escalation of the Eurozone crisis and government bond yields trading at over 12% make the chances of Portugal returning to financial markets on schedule in 2013 very small.

Figure 42

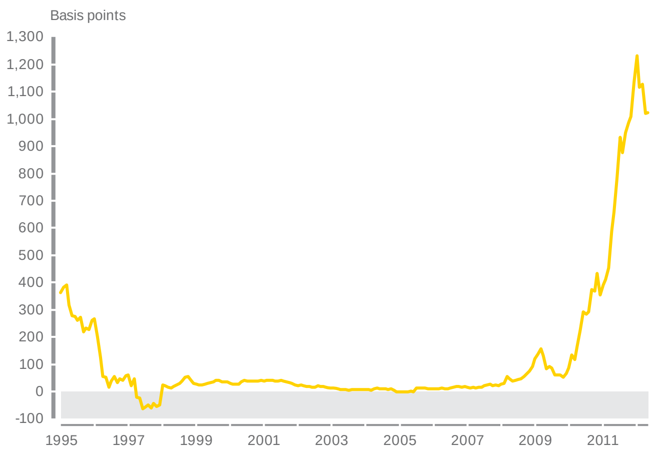
Contributions to GDP growth



Source: Oxford Economics

Figure 43

Bond spread over German Bunds



Source: *Haver Analytics*

Table 15

Portugal (annual percentage changes unless specified)

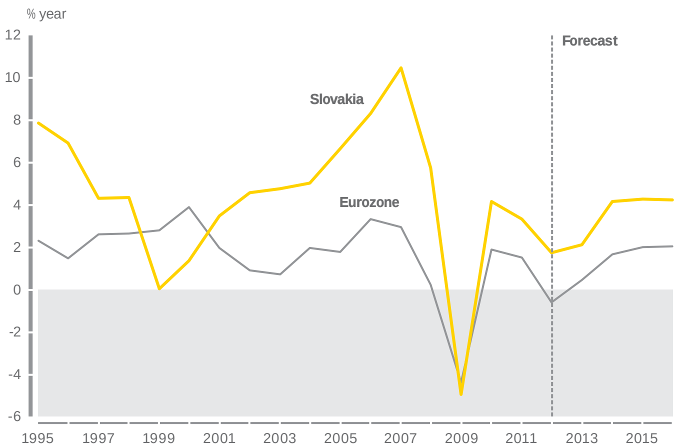
Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	-1.6	-3.4	-2.1	0.3	1.4	1.9
Private consumption	-4.0	-6.1	-2.1	0.3	0.9	1.2
Fixed investment	-11.3	-10.9	-7.0	-1.7	2.5	3.8
Stockbuilding (% of GDP)	-0.7	-0.4	0.1	0.4	0.3	0.4
Government consumption	-3.8	-3.3	-3.0	-0.4	0.9	1.7
Exports of goods and services	7.6	2.9	2.7	4.3	4.5	3.5
Imports of goods and services	-5.3	-5.1	1.5	3.8	3.6	3.3
Consumer prices	3.6	2.8	0.9	1.1	1.2	1.2
Unemployment rate (level)	13.0	15.3	16.1	15.9	15.0	14.0
Current account balance (% of GDP)	-6.4	-4.2	-3.5	-3.0	-2.7	-2.5
Government budget (% of GDP)	-4.2	-5.0	-4.6	-3.3	-2.5	-1.9
Government debt (% of GDP)	107.8	114.8	120.6	121.6	120.2	117.8

Slovakia

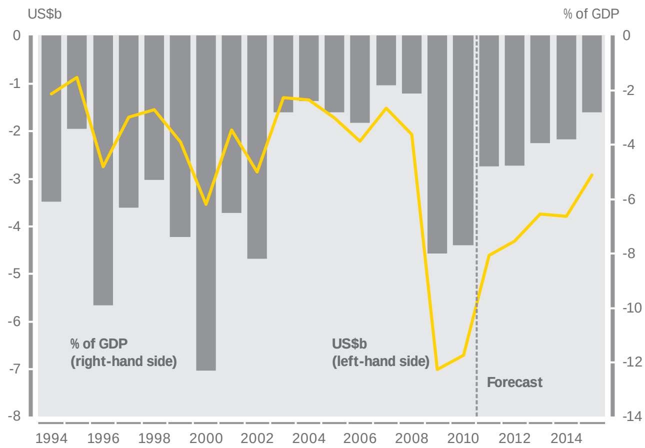
- Slovakia's export-oriented economy is expected to lose momentum in 2012 as the sovereign debt crisis in the Eurozone undermines regional demand for durable goods such as vehicles and electronic equipment. In turn, this will have knock-on effects on investment and employment, undermining consumer demand.
- Overall, we forecast GDP growth at 1.7% in 2012, before accelerating to about 2% in 2013. However, growth will remain below potential as sluggish Eurozone growth weighs on exports and output.
- The new Government will need to bring down the budget deficit from 4.8% of GDP in 2011 to below 3% in 2013 in order to meet the targets agreed by European leaders. We remain skeptical that the authorities will be able to achieve this objective. Given the weak economy, and the relatively stable fiscal position, the Government may need to reconsider the pace of the fiscal consolidation.

Figure 44
Real GDP growth



Source: Oxford Economics

Figure 45
Government budget balance



Source: Oxford Economics

Table 16
Slovakia (annual percentage changes unless specified)
Source: Oxford Economics

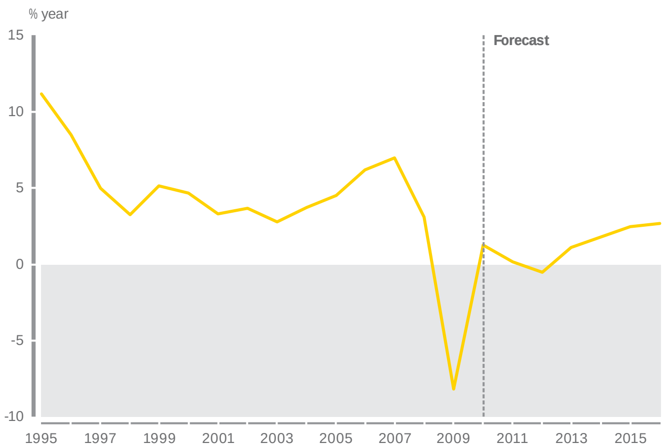
	2011	2012	2013	2014	2015	2016
GDP	3.3	1.7	2.1	4.2	4.3	4.3
Private consumption	-0.4	0.2	2.4	3.4	3.6	3.5
Fixed investment	5.7	1.8	1.6	5.2	5.1	4.7
Stockbuilding (% of GDP)	-1.8	-3.7	-3.7	-2.2	-2.0	-2.3
Government consumption	-3.5	0.4	1.9	2.3	2.5	2.5
Exports of goods and services	10.8	1.6	2.7	5.6	7.6	7.9
Imports of goods and services	4.5	-2.1	2.7	7.2	7.8	7.3
Consumer prices	3.9	3.2	2.3	2.4	2.4	2.3
Unemployment rate (level)	13.6	14.7	13.5	11.4	10.5	9.8
Current account balance (% of GDP)	0.1	2.0	1.7	1.3	2.5	4.5
Government budget (% of GDP)	-4.8	-4.8	-3.9	-3.8	-2.8	-2.5
Government debt (% of GDP)	43.3	46.6	48.9	49.8	49.5	48.9

Slovenia

- After minimal growth in 2011, GDP is forecast to decline 0.5% this year as the new Government tries to rein in the large budget deficit and persistent external deficit. Subdued growth is forecast to resume in 2013, mainly reliant on exports, with an investment revival contributing to stronger expansion from 2014.
- Despite planned austerity measures, the fiscal deficit will fall more slowly than officially hoped in 2012 due to the expected GDP decline, and deficit financing remains difficult after the past year's credit rating downgrades. Extensive fund-raising in 2011 meant the authorities could delay a €1.5b bond issue in April, hoping for better pricing in Q3; its reception will be an early test of market confidence in the new Government.
- Worsening bad debts have increased the major banks' need to raise additional capital by an amount exceeding 1% of GDP for the sector as a whole. Constraints on bank lending will put a brake on both investment and GDP growth in 2013–15.

Figure 46

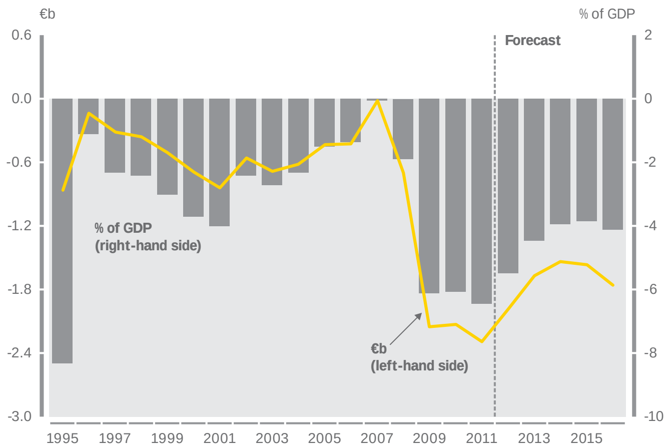
Real GDP growth



Source: Oxford Economics

Figure 47

Government budget balance



Source: Oxford Economics

Table 17

Slovenia (annual percentage changes unless specified)

Source: Oxford Economics

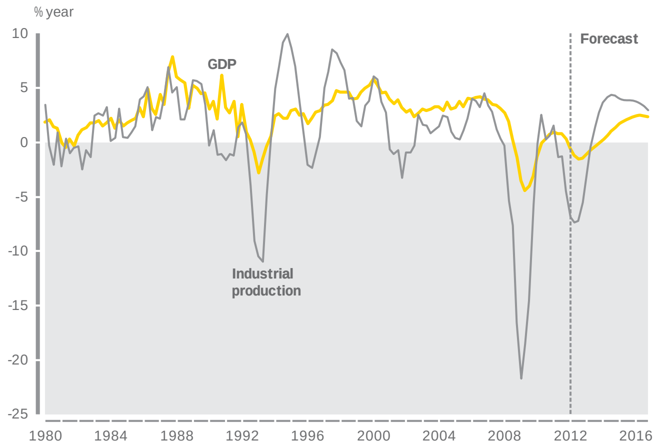
	2011	2012	2013	2014	2015	2016
GDP	0.2	-0.5	1.1	1.8	2.5	2.7
Private consumption	-0.2	-0.5	0.5	1.3	2.0	2.5
Fixed investment	-10.2	-5.0	-0.8	2.5	4.2	4.0
Stockbuilding (% of GDP)	2.0	1.8	1.8	1.6	1.3	1.0
Government consumption	-0.9	0.0	0.3	1.0	2.0	2.5
Exports of goods and services	7.8	3.5	4.0	5.1	5.3	5.0
Imports of goods and services	5.6	2.2	3.0	4.5	5.1	4.8
Consumer prices	1.8	2.3	2.1	2.0	2.1	2.2
Unemployment rate (level)	8.2	8.8	8.6	7.9	6.8	6.0
Current account balance (% of GDP)	-1.1	-0.5	-0.3	0.0	0.1	0.1
Government budget (% of GDP)	-6.4	-5.5	-4.4	-3.9	-3.8	-4.1
Government debt (% of GDP)	43.0	47.7	50.6	52.7	54.2	55.7

Spain

- Growing problems in the Spanish banking sector have become the focal point of investor concerns. The Government has requested a loan of up to €100b from the EU bailout funds to recapitalize the sector, but investors still fear the need for an even larger rescue package.
- Spain is facing a deep fiscal retrenchment that will depress domestic demand in the near term. We now forecast that GDP will shrink by 1.8% this year, with a further 2% decline expected in 2013.
- Assuming that the situation in the banking sector is stabilized, the economy could emerge from recession in H2 2013. We forecast GDP growth at 1.1% in 2014, accelerating to 2.3% in 2015. In particular, structural reforms will begin to pay dividends over this period in terms of increased competitiveness, which will help to boost exports and business investment.

Figure 48

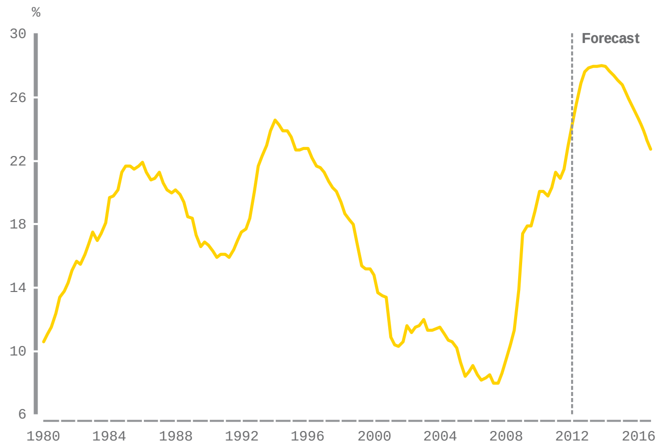
GDP growth and industrial production



Source: Oxford Economics

Figure 49

Unemployment rate



Source: Oxford Economics

Table 18

Spain (annual percentage changes unless specified)

Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	0.7	-1.8	-2.0	1.1	2.3	2.5
Private consumption	-0.1	-2.0	-2.7	0.5	2.2	2.2
Fixed investment	-5.1	-9.9	-3.8	2.0	3.5	2.8
Stockbuilding (% of GDP)	0.4	0.4	0.0	0.3	0.1	0.4
Government consumption	-2.2	-4.5	-3.5	-0.7	1.0	1.5
Exports of goods and services	9.0	0.5	2.8	5.9	8.2	7.4
Imports of goods and services	-0.1	-8.1	-1.9	6.3	8.2	8.0
Consumer prices	3.1	1.8	1.4	1.4	1.4	1.5
Unemployment rate (level)	21.7	25.5	27.4	26.9	25.4	23.1
Current account balance (% of GDP)	-3.5	-3.2	-1.4	-1.3	-1.1	-0.9
Government budget (% of GDP)	-8.9	-6.9	-4.5	-3.0	-2.1	-1.6
Government debt (% of GDP)	68.5	76.6	82.7	85.7	86.9	87.3

Detailed tables and charts

Forecast assumptions

	2011	2012	2013	2014	2015	2016
Short-term interest rates (%)	1.4	0.7	0.5	0.9	2.0	3.0
Long-term interest rates (%)	4.4	4.2	4.1	4.2	4.5	4.9
Euro effective exchange rate (1995=100)	120.8	114.4	116.6	116.6	115.0	115.1
Oil prices (€/barrel)	80.0	82.9	78.6	84.9	91.4	94.7
Share prices (% year)	-7.1	-9.7	9.4	14.4	11.8	9.0

	2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Short-term interest rates (%)	1.1	1.4	1.6	1.5	1.0	0.7	0.5	0.5
Long-term interest rates (%)	4.3	4.5	4.3	4.5	4.4	3.9	4.1	4.2
Euro effective exchange rate (1995=100)	119.4	122.4	121.2	120.4	116.8	114.8	112.2	113.7
Oil prices (€/barrel)	76.6	81.7	80.2	81.2	90.3	85.6	77.3	78.0
Share prices (% year)	-0.7	10.7	-20.7	-17.1	-14.9	-20.7	1.8	-0.6

Eurozone GDP and components

Quarterly forecast
(quarterly percentage changes)

	2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	0.7	0.1	0.1	-0.3	0.0	-0.5	-0.2	0.0
Private consumption	-0.1	-0.4	0.3	-0.5	0.0	-0.4	-0.2	0.0
Fixed investment	1.8	-0.1	-0.3	-0.4	-1.4	-1.2	-0.5	0.1
Government consumption	-0.1	0.0	-0.3	-0.1	0.2	-0.3	-0.4	-0.2
Exports of goods and services	1.4	1.1	1.5	-0.7	1.0	-0.5	0.4	0.6
Imports of goods and services	0.8	0.6	0.7	-1.7	0.1	-0.9	0.0	0.4

Contributions to GDP growth
(percentage point contribution to quarter-on-quarter GDP growth)

	2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	0.7	0.1	0.1	-0.3	0.0	-0.5	-0.2	0.0
Private consumption	-0.1	-0.2	0.2	-0.3	0.0	-0.2	-0.1	0.0
Fixed investment	0.3	0.0	-0.1	-0.1	-0.3	-0.2	-0.1	0.0
Government consumption	0.0	0.0	-0.1	0.0	0.0	-0.1	-0.1	0.0
Stockbuilding	0.2	0.2	-0.3	-0.3	-0.2	-0.1	-0.1	0.0
Exports of goods and services	0.6	0.5	0.7	-0.3	0.4	-0.2	0.2	0.3
Imports of goods and services	-0.3	-0.2	-0.3	0.7	-0.1	0.3	0.0	-0.2

Annual levels – real terms
(€ billion. 2000 prices)

	2011	2012	2013	2014	2015	2016
GDP	8,593	8,543	8,581	8,725	8,900	9,083
Private consumption	4,845	4,813	4,820	4,877	4,956	5,042
Fixed investment	1,633	1,584	1,594	1,647	1,707	1,765
Government consumption	1,832	1,822	1,811	1,818	1,835	1,856
Stockbuilding	37	-19	-20	2	7	14
Exports of goods and services	3,752	3,806	3,923	4,133	4,361	4,581
Imports of goods and services	3,506	3,463	3,547	3,752	3,967	4,175

Annual levels – nominal terms
(€ billion)

	2011	2012	2013	2014	2015	2016
GDP	9,411	9,473	9,674	10,008	10,394	10,804
Private consumption	5,400	5,480	5,588	5,756	5,958	6,175
Fixed investment	1,812	1,780	1,819	1,909	2,012	2,116
Government consumption	2,030	2,043	2,069	2,116	2,178	2,247
Stockbuilding	39	-67	-82	-35	-12	4
Exports of goods and services	4,122	4,234	4,425	4,747	5,103	5,459
Imports of goods and services	3,992	3,998	4,144	4,485	4,845	5,196

Prices and cost indicators

(annual percentage changes unless specified)

	2011	2012	2013	2014	2015	2016
HICP headline inflation	2.7	2.4	1.9	1.8	1.8	1.9
Inflation ex-energy	1.7	1.7	1.9	1.7	1.7	1.8
GDP deflator	1.2	1.3	1.7	1.7	1.8	1.8
Import deflator	5.1	5.0	0.6	1.8	1.9	1.8
Export deflator	10.2	1.2	-0.3	1.9	1.9	1.5
Terms of trade	5.1	-3.9	-0.9	0.1	0.0	-0.3
Earnings	2.5	1.7	2.1	2.3	2.6	2.7
Unit labor costs	0.9	1.2	1.0	0.9	1.2	1.4
Output gap (% of GDP)	-2.1	-3.3	-3.6	-2.9	-2.2	-1.5
Oil prices (€ per barrel)	80.0	82.9	78.6	84.9	91.4	94.7
Euro effective exchange rate (1995=100)	120.8	114.4	116.6	116.6	115.0	115.1

	2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
HICP headline inflation	2.5	2.8	2.7	2.9	2.7	2.4	2.2	2.2
Inflation ex-energy	1.3	1.7	1.7	2.0	1.9	1.5	1.5	1.8
GDP deflator	1.1	1.3	1.3	1.3	1.1	1.2	1.2	1.5
Import deflator	7.3	4.4	3.9	4.9	7.7	4.9	4.0	3.6
Export deflator	15.4	10.1	7.4	8.3	6.6	0.5	-1.0	-1.3
Terms of trade	8.1	5.7	3.5	3.4	-1.0	-4.3	-5.0	-4.9
Earnings	2.3	2.5	2.6	2.4	1.7	1.6	1.7	2.0
Unit labor costs	0.0	1.0	1.2	1.3	1.0	1.1	1.4	1.3
Output gap (% of GDP)	-1.9	-2.0	-2.0	-2.6	-2.7	-3.3	-3.6	-3.7
Oil prices (€ per barrel)	76.6	81.7	80.2	81.2	90.3	85.6	77.3	78.0
Euro effective exchange rate (1995=100)	119.4	122.4	121.2	120.4	116.8	114.8	112.2	113.7

Note: HICP is the European Harmonized Index of Consumer Prices.

Labor market indicators

(annual percentage changes unless specified)

	2011	2012	2013	2014	2015	2016
Employment	0.1	-1.0	-0.6	0.3	0.7	0.8
Unemployment rate (%)	10.2	11.4	11.9	11.5	10.9	10.2
NAIRU (%)	8.1	8.1	8.0	7.8	7.6	7.4
Participation rate (%)	74.1	74.4	74.6	74.7	74.9	75.1
Earnings	2.5	1.7	2.1	2.3	2.6	2.7
Unit labor costs	0.9	1.2	1.0	0.9	1.2	1.4

	2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Employment	0.2	0.4	0.2	-0.2	-0.5	-1.0	-1.3	-1.3
Unemployment rate (%)	9.9	10.0	10.2	10.6	10.9	11.2	11.6	11.8
NAIRU (%)	8.1	8.1	8.1	8.1	8.1	8.1	8.1	8.1
Participation rate (%)	73.9	74.1	74.2	74.3	74.4	74.4	74.4	74.5
Earnings	2.3	2.5	2.6	2.4	1.7	1.6	1.7	2.0
Unit labor costs	0.0	1.0	1.2	1.3	1.0	1.1	1.4	1.3

Note: NAIRU is the Non-Accelerating Inflation Rate of Unemployment i.e., the rate of unemployment below which inflationary pressures would start to appear due to labor market tightness.

Current account and fiscal balance

	2011	2012	2013	2014	2015	2016
Trade balance (€b)	-7.6	86.2	122.1	103.5	97.8	99.2
Trade balance (% of GDP)	-0.1	1.0	1.4	1.2	1.1	1.1
Current account balance (€b)	-4.3	35.8	91.8	96.5	102.6	107.0
Current account balance (% of GDP)	0.0	0.4	1.0	1.0	1.0	1.0
Government budget balance (€b)	-387	-332	-250	-197	-158	-129
Government budget balance (% of GDP)	-4.1	-3.5	-2.6	-2.0	-1.5	-1.2
Cyclically adjusted surplus (+) /deficit (-) (% of GDP)	-3.6	-3.0	-2.1	-1.4	-1.0	-0.6
Government debt (€b)	8,285	8,587	8,908	9,235	9,569	9,874
Government debt (% of GDP)	96.4	100.5	103.8	105.8	107.5	108.7

Measures of convergence and divergence within the Eurozone

	2002–2006	2007–2011	2012–2016
Growth and incomes			
Standard deviation of GDP growth rates	1.9	2.3	1.3
Growth rate gap (max–min)	6.7	9.2	5.0
Highest GDP per capita (Eurozone = 100)	238.7	244.2	245.2
Lowest GDP per capita (Eurozone = 100)	53.4	66.5	64.7
Inflation and prices			
Standard deviation of inflation rates	1.3	1.0	0.6
Inflation rate gap (max–min)	5.4	4.0	1.8
Highest price level (Eurozone = 100)	116.8	116.1	117.3
Lowest price level (Eurozone = 100)	64.6	65.9	67.2

Cross–country tables

Real GDP
(% year)

Rank		2011	2012	2013	2014	2015	2016	Difference 2011–2016
1	Estonia	7.6	1.5	3.5	4.8	4.7	4.5	**3.8**
2	Slovakia	3.3	1.7	2.1	4.2	4.3	4.3	**3.3**
3	Luxembourg	1.6	1.0	2.4	3.9	3.1	2.9	**2.7**
4	Finland	2.9	1.3	1.4	2.6	2.3	2.4	**2.0**
5	Malta	2.1	1.1	1.9	2.2	2.3	2.3	**2.0**
6	Ireland	0.7	-0.1	0.6	1.4	3.0	3.8	**1.7**
7	Germany	3.1	0.7	1.4	2.1	2.0	2.0	**1.6**
8	Austria	3.0	0.6	1.3	1.9	2.0	1.9	**1.5**
9	Slovenia	0.2	-0.5	1.1	1.8	2.5	2.7	**1.5**
10	Belgium	2.0	0.1	0.8	1.7	2.3	2.4	**1.5**
11	France	1.7	0.1	0.9	1.7	1.9	1.8	**1.3**
12	Netherlands	1.3	-1.0	1.0	2.0	2.1	2.0	**1.2**
13	Eurozone	1.5	-0.6	0.4	1.7	2.0	2.1	**1.1**
14	Cyprus	0.5	-2.0	-0.8	1.2	2.3	3.0	**0.7**
15	Spain	0.7	-1.8	-2.0	1.1	2.3	2.5	**0.4**
16	Italy	0.5	-2.3	-0.2	1.2	1.6	1.8	**0.4**
17	Portugal	-1.6	-3.4	-2.1	0.3	1.4	1.9	**-0.4**
18	Greece	-6.9	-7.2	-2.3	-0.3	1.1	2.2	**-1.4**

Inflation rates
(% year)

Rank		2011	2012	2013	2014	2015	2016	Difference 2011–2016
1	Greece	3.1	1.2	0.3	0.5	1.0	1.5	**0.9**
2	Ireland	1.2	1.4	0.4	0.4	0.9	1.4	**0.9**
3	Portugal	3.6	2.8	0.9	1.1	1.2	1.2	**1.4**
4	Spain	3.1	1.8	1.4	1.4	1.4	1.5	**1.5**
5	Germany	2.5	2.1	1.8	1.9	2.0	2.0	**1.9**
6	Eurozone	2.7	2.4	1.9	1.8	1.8	1.9	**2.0**
7	France	2.3	2.3	2.0	1.9	1.9	1.9	**2.0**
8	Belgium	3.4	2.9	1.6	1.9	1.9	1.8	**2.0**
9	Austria	3.6	2.5	2.2	2.0	2.0	1.9	**2.1**
10	Netherlands	2.5	2.6	2.3	2.0	1.9	1.8	**2.1**
11	Slovenia	1.8	2.3	2.1	2.0	2.1	2.2	**2.1**
12	Malta	2.4	2.0	1.9	2.2	2.3	2.3	**2.1**
13	Luxembourg	3.7	2.7	2.2	2.1	2.0	2.0	**2.2**
14	Finland	3.3	2.9	2.8	2.0	1.9	1.8	**2.3**
15	Cyprus	3.5	2.8	2.2	2.3	2.3	2.3	**2.4**
16	Italy	2.9	3.2	2.4	2.3	2.0	2.0	**2.4**
17	Slovakia	3.9	3.2	2.3	2.4	2.4	2.3	**2.5**
18	Estonia	5.0	3.8	2.6	2.2	2.2	2.1	**2.6**

Cross-country tables

Unemployment rate
(% of labor force)

Rank		2011	2012	2013	2014	2015	2016	Difference 2011–2016
1	Austria	4.2	4.0	4.1	3.9	3.8	3.7	**3.9**
2	Luxembourg	4.8	5.3	5.3	4.6	4.1	3.6	**4.6**
3	Netherlands	4.4	5.3	5.5	5.1	4.4	3.9	**4.9**
4	Germany	5.9	5.7	5.6	5.4	5.2	5.1	**5.4**
5	Malta	6.5	6.3	6.2	5.7	5.2	4.6	**5.6**
6	Finland	7.8	7.8	7.5	7.0	6.5	6.0	**6.9**
7	Belgium	7.2	7.5	7.8	7.4	6.7	6.4	**7.1**
8	Slovenia	8.2	8.8	8.6	7.9	6.8	6.0	**7.6**
9	Cyprus	7.8	9.9	9.7	8.3	7.0	5.5	**8.1**
10	Estonia	12.5	11.4	10.1	8.6	7.3	6.3	**8.8**
11	France	9.7	10.2	10.1	9.6	9.2	8.9	**9.6**
12	Italy	8.5	10.5	11.2	10.9	10.0	9.1	**10.4**
13	Eurozone	10.2	11.4	11.9	11.5	10.9	10.2	**11.2**
14	Slovakia	13.6	14.7	13.5	11.4	10.5	9.8	**12.0**
15	Ireland	14.4	14.9	15.2	15.1	14.4	13.4	**14.6**
16	Portugal	13.0	15.3	16.1	15.9	15.0	14.0	**15.3**
17	Greece	17.7	23.7	25.4	25.2	24.3	23.1	**24.4**
18	Spain	21.7	25.5	27.4	26.9	25.4	23.1	**25.7**

Government budget
(% of GDP)

Rank		2011	2012	2013	2014	2015	2016	Difference 2011–2016
1	Estonia	1.0	-2.5	-1.6	-0.5	0.3	0.3	**-0.7**
2	Finland	-0.5	-1.6	-1.5	-1.1	-1.0	-1.0	**-0.5**
3	Luxembourg	-0.6	-1.8	-2.1	-1.9	-1.7	-0.9	**-0.3**
4	Germany	-1.0	-1.2	-1.0	-0.9	-0.6	-0.1	**0.9**
5	Malta	-2.7	-2.9	-2.5	-2.1	-1.9	-1.7	**1.0**
6	Austria	-2.6	-3.3	-2.9	-2.0	-1.6	-1.5	**1.1**
7	Belgium	-3.7	-3.4	-2.2	-2.1	-2.1	-2.0	**1.7**
8	Slovakia	-4.8	-4.8	-3.9	-3.8	-2.8	-2.5	**2.3**
9	Slovenia	-6.4	-5.5	-4.4	-3.9	-3.8	-4.1	**2.3**
10	Portugal	-4.2	-5.0	-4.6	-3.3	-2.5	-1.9	**2.3**
11	France	-5.2	-4.8	-3.9	-3.1	-2.7	-2.3	**2.9**
12	Eurozone	-4.1	-3.5	-2.6	-2.0	-1.5	-1.2	**2.9**
13	Italy	-3.9	-2.5	-1.3	-0.9	-0.7	-0.6	**3.3**
14	Greece	-9.0	-8.0	-7.2	-6.1	-5.8	-5.7	**3.4**
15	Netherlands	-4.7	-5.0	-3.1	-2.7	-1.2	-0.7	**4.0**
16	Cyprus	-6.3	-4.7	-3.1	-1.1	-0.1	0.3	**6.6**
17	Spain	-8.9	-6.9	-4.5	-3.0	-2.1	-1.6	**7.3**
18	Ireland	-13.0	-8.6	-7.0	-4.8	-3.2	-2.1	**10.9**

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