Eurozone

Ernst & Young Eurozone Forecast

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Since our latest forecast, Eurozone growth has been more vigorous than was expected in the spring of 2011, prompting a rise in forecast growth for this year from 1.7% to 2%. But the downside risks are also larger and more apparent. Interest rates are now heading upward and energy prices, already high, are vulnerable to more political turmoil in the Middle East. The US economy is handicapped by political deadlock in Washington over fiscal policy and doubts about funding prospects for the budget deficit. The Eurozone is balanced precariously on an economic and political tightrope without much in the way of a safety net below. It is living through very tense times. And so are we.

Peering through the cloud of uncertainty in Europe, it seems that economic growth and job creation in northern Europe may be stronger than in recent years but the weakness of the Eurozone economy remains the struggle to keep the peripheral countries solvent. We believe that Greece — and possibly Ireland and Portugal — will be unable to fend off debt restructuring without new bailout packages, which may in any case just buy a couple of years before the specter of default returns to spook the markets. Without a rapid improvement in their competitiveness, all three economies, as well as Spain and Italy, will be challenged by low levels of economic growth.

One of the most disturbing problems in this context is the unemployment among young people and how it affects the society and the younger generation's ability to become established in the labor market. The latest available statistics are alarming: in Spain, nearly 45% of citizens under 25 are unemployed. The figure for Greece is 36%. This is far too many young people who are not using their insights, energy and ideas to build and develop future businesses and public services.

At the time of writing, it appears that Greece will not be able to pay its debts based on the current terms, and the lack of consensus on alternatives is increasing uncertainty about the prospects for the Eurozone. The question is now how it, and the rest of the Eurozone, can handle the situation. The discussion about the best way of solving the Eurozone sovereign debt problem between the EU and the ECB has been hard and reveals a strong disagreement over what measures need to be taken. At the same time, there appears a lack of political consensus among the Eurozone countries about the different rescue packages. In Greece, there is strong opposition to the austerity packages initiated by the Government and in Germany there is widely expressed opposition to any further aid to Greece.

Both the finance markets and the political leadership in Europe fear that if Greece, Portugal and Ireland fail, then Italy and Spain might fail too and the deepening crisis would strike hard against European banks, especially in Germany and France. The publication of the bank stress tests in July will reveal how robust the banking sector is. At the same time, the regulators' demands on the financial sector are high and, according to the latest lending survey, Eurozone banks are trying to repair their balance sheets, which in turn mean less credit to help recovery in business investment and household consumption.

My advice to business is to closely follow developments in the markets and keep organizations ready for quick response to rapidly changing developments, and to be aware of both risks and opportunities. Seeking new markets, seeking new business partners and seeking new ideas by creating an innovative environment within companies is key but there will be opportunities for agile and cost-competitive companies in even the most depressed economies.

As the banking sector is facing more pressure, it needs to have a more strategic approach to balance – sheet management and a consolidated approach to managing the enormous volume of regulatory changes. At the same time, it is important for business to closely follow the development within the banking sector and explore what alternative forms of funding may be available. Given the uncertainties on the financial market, it is essential that business also carry out detailed stress testing using a range of scenarios that could affect their financial situation.

The Eurozone crisis is a great challenge for its governments and central banks, but this is not only about creating consensus at the EU level. All governments in the Eurozone and their political opponents have a great responsibility when it comes to finding common strategies to lift their countries out of the crisis and to secure Europe's future as a strong single market.

I also believe that the business community must take an active part in this ongoing discussion. We believe that strong solutions can only be created if governments are aware of the implications that policy-making have on the ability of business to create jobs and growth. Therefore, it is important that they share knowledge and exchange ideas as a base for their respective strategies.

I encourage you to visit our dedicated Eurozone website – www.ey.com/eurozone – for additional information on the Ernst & Young *Eurozone Forecast* and the 17 individual country forecasts it comprises. Learn more about our thoughts for a stronger EU innovation policy at www.ey.com/government-innovation

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Growing risk of disorder but current growth is a comfort

As far as growth rates are concerned, countries at the core of the Eurozone are certainly faring better than in the recent past. But at mid-year 2011, the business landscape is fraught with uncertainties and is not without real perils.

As our summer 2011 economic forecasts indicate, risk analyses must grapple with unusually difficult scenarios. Our report attaches a high probability to a worsening of the EU sovereign debt crisis. It argues that a restructuring of Greece's national debt is virtually unavoidable in combination with another bailout. But neither a restructuring nor a bailout are in themselves likely to provide lasting solutions and restructuring would almost certainly carry in its wake the necessity of similar exercises for Ireland and Portugal. An additional uncertainty is whether debt restructuring comes via an orderly or disorderly process. If it is the latter, the risk of contagion to other countries increases and the Eurozone's reasonably healthy growth prospects for 2011 and 2012 are likely to be extinguished. In fact, the economy would go backward.

This creates an obscure and potentially dangerous economic and political context for business over the next 12 months, and one that is not geographically limited to Europe either. Even an orderly debt restructuring could rock global financial markets. Economic recovery in Europe would falter as confidence in the euro and the solidity of the Eurozone weakens. Consumer confidence, by no means robust in the Eurozone at present, would be weakened further and the interest rate horizon, already clouded by the prospect of more ECB tightening in the second half of the year, would look even darker. Into this bleak outlook, we should also factor in growing uncertainty over the direction of US economic policy, some doubts over the safety of US debt obligations, the maintenance of oil prices at current high levels and the possibility of even higher, and fluctuating, commodity prices.

What do leading business representatives think about Europe's possibilities of attracting investments? Ernst & Young is following up the developments in the Eurozone with a survey on Europe as a market for locating, investing and growing, and how Europe compares with other regions. In connection with the World Investment Conference, 25-27 May in La Baule, France, we will publish the 2011 edition of the European attractiveness survey.

Learn more on www.ey.com/attractiveness

What is there in this sea of difficulties to give rise to even moderate optimism in the corporate sector? Markets outside the US and Europe are strong and account for much of our forecast of 3.3% growth in the global economy this year and 3.7% next year (compared to 3.9% in 2010). Even in the Eurozone, where the overall forecast is 2% this year and 1.6% for 2012, the northern, central and eastern countries have much stronger growth prospects than the southern peripheral countries that are burdened by debt and deficits. The report's expectation of 3.5% growth in Germany this year, and 1.9% in 2012, contrasts with 0.9% and 1.3% for Italy, 0.7% and 1.2% for Spain and declines in Greece and Portugal.

Overall, diverging growth prospects between Eurozone countries, and between the Eurozone and emerging economies, is an invitation to business to focus new investments in the high-growth countries and regions and to limit spending in the low-growth countries to the minimum necessary. The numbers are clear enough: in the five years 2007–12, emerging economies will have grown by nearly 30% and the advanced world by just 4%.

The attraction of higher growth elsewhere risks condemning the Eurozone's periphery to an indefinite cycle of virtual stagnation and high unemployment. This in any case, say the pessimists, is the future decreed for them by the austerity policies imposed by the EU/International Monetary Fund (IMF) bailout packages. Even if they are politically feasible — and there is a serious question mark against both the will and the ability of the Greek Government to persevere — the austerity packages will not allow enough economic growth for Greece, Ireland and Portugal to repay their debts in full and to return to borrowing in world financial markets. This line of argument is often taken to the conclusion that some or all of these countries will be forced to adopt the nuclear option of leaving the Eurozone and reintroducing national currencies.

With some justification, others claim that leaving the Eurozone would be the worst possible option for these countries, leading to massive debt defaults since these countries' debts would be inflated by weak and devaluing national currencies. Moreover, the financial markets would remain closed to these countries for many years. The impact on the credibility of the Eurozone would be devastating, prompting frightened investors to insist on astronomical premia for Spanish and Italian debt or to withhold financing entirely. Finally, we would have to fear for the political cohesion of the EU. Extreme pessimists say its continued existence would be severely threatened — a worst case scenario in every sense.

The future of the European market

Anxious to counter loose and gloomy talk, European officials draw attention to the potentially significant changes that have been made in the governance of the Eurozone. The Stability and Growth Pact, which failed for more than 10 years to bring discipline to the management of member states' fiscal deficits and national debts, has been revamped. The new Pact, together with other legislative measures, aims for much closer coordination of a wider range of national economic policies, allows for stronger political pressures on member states that do not honor their policy commitments, and provides for penalties, including fines, on governments that flout policy recommendations from the EU.

On paper, the revised Stability and Growth Pact should encourage greater fiscal discipline and prevent the buildup of large deficits funded by heavy state borrowing. Much, however, depends on the behaviors of the large member states. In 2003–05, France and Germany effectively neutered the Pact by ignoring its 3% of GDP limit on budget deficits. If they were to repeat this behavior, it is difficult to believe the Mark II version will be any more effective. However, the immediate future (say three to five years) will be colored by the memory of the current sovereign debt crisis and a sharp desire to avoid repetition. In addition, it is possible that the markets will exercise a discipline that was totally absent for much of the first decade of Economic and Monetary Union. Then, debt was priced without any real concern about the underlying strength of a member state's economy and its ability to pay back its debts. Yield differentials between 10-year German Bunds and comparable Greek or Portuguese bonds were only a fraction of the 10–15 percentage points (ppt) that have been seen in recent times.

As there is little chance of the austerity packages restoring growth and financial health to Greece, Ireland and Portugal, an orderly restructuring, as outlined by our report, is not the worst outcome. This could involve some lengthening of maturities on the debts and inflicting losses (referred to as "haircuts" by market players) on private investors.

However, there is one huge obstacle to this option — the unremitting and uncompromising opposition of the ECB. The ECB's biggest fears appear to be of a severe collapse of confidence in the euro, huge losses to banking systems and a closure of the debt markets to Spain, and possibly Italy and Belgium as well. In these circumstances, the EU could be facing the breakup of the Eurozone and the loss of the single currency.

Business dependence on bank finance

Given business's apparent preference for bank finance for current spending and investment, any risk of a banking crisis would send waves of fear sweeping through boardrooms. For now, prudent management should be taking a quiet interest in the amount of capital their banks are holding as well as in their risk-weighted assets. There remains the possibility of spreading risk through a wider variety of banking relationships than normal.

It would not be prudent for any company to assume that governments will stand behind the "too big to fail" banks as they did in the 2007–08 crisis. In both Europe and the US, regulators are anxious to separate retail from investment banking, not by breaking up banks but by resolution arrangements that would protect the retail side of the business from any imminent bank collapse while requiring an orderly winding up of investment banking. Even if this approach is successful and shelters the taxpayer from the burden of bailouts, the shock to the system of another pan-European banking crisis so soon after the last one would be immense. Business investment is starting to rise again, as confirmed by our report, but analysts say a significant proportion is replacement capital rather than new investment. Both could well be choked off by another banking crisis shutting off credit flows.

Strategies for profitability and productivity

Caution is, and will continue to be, the approach for many businesses, although manufacturers and suppliers of business services will be anxious to make the most of the relative strength of demand for their sectors highlighted in our forecast. This should not prevent them, however, focusing on a strategy for exploiting the opportunities provided by countries and regions enjoying better growth prospects than most of Europe. And — as we found in our earlier *Opportunities in adversity* study — there are opportunities for some players within even the most depressed of markets.

Public sector perspectives

Economic and political risks are challenging the public sector

When looking at the most significant challenges facing the public sector within the Eurozone, two trends are ascendant: austerity and accountability. On the one hand, many Eurozone governments have little choice but to reduce spending, following their extensive bailouts and stimulus packages. On the other hand, citizens are increasingly demanding to know whether they are getting good value for money, and want oversight on how their tax dollars are spent.

The aging of the Eurozone population could restrict potential growth for many years to come. Such demographic changes will also create ever greater demand for government assistance. Many governments face a dilemma: a need to reduce spending in order to address large-scale deficits, but also a growing need for government services.

Necessary investment in infrastructure has become more difficult for many countries in the Eurozone as borrowing limits are imposed and access to financing is constrained. Security, management of migration flows and border control also remain key challenges across the Eurozone. A growing area of concern is cyber-terrorism. As the public sector increasingly utilizes technology to provide services, attacks on technological systems by independent or state-sponsored cyber-terrorists are more likely and more potentially damaging.

Eurozone divergence challenges the public sector

The divergence in the Eurozone is also mirrored in the conditions for the public sector. Clearly, governments on the periphery of the Eurozone face more acute pressures to reduce public sector spending. They are faced with making deeper cuts to the public sector wage bill, more consumer tax increases and even the difficult proposition of dismissing public servants. Of course, this can lead to political unpopularity and social unrest, as we are seeing on the streets of Madrid.

The absence of a common integrated fiscal policy is also exacerbating the risks of a double-dip recession in the peripheral countries of the area. The productivity gap these countries are facing will imply a strong adjustment on the side of prices and salaries in order to ensure the restoring of adequate growth in the economy.

New tools and strategies for the public sector

Innovations in information technology (IT) have the potential to change the way governments interact with citizens, including new service delivery models. The widespread availability of electronic banking, for example, propels expectations that the public sector offers similar standards of service. Social media platforms will also increasingly influence how governments communicate with citizens. Governments must do more to ensure the success of IT projects through the application of tailored project management, continued implementation of forward-looking technology policy and sound hardware and software choices.

There is great potential to use the legacy of the financial crisis as an opportunity to make public services more efficient by radically transforming the structure of government and how governments deliver services. Whether this happens will depend on the ability of national, regional and local governments to create the cultural and management conditions to facilitate transformation. Unfortunately, few governments are really embracing this big challenge radically or sufficiently. So far, most of them have focused on short-term efforts to "do more with less" as a way of coping with the fiscal crunch. However, governments will face an increasing need to revolutionize their role and the systems they use to deliver services, especially in developed countries that are facing deep fiscal problems.

This should be part of a broader-based approach that also concentrates on strengthening profitability. Operating in Europe, this means a vigilant approach to controlling inventory and labor costs. According to our forecast, general inflation and wage pressures are unlikely to bear heavily on costs in the coming months. However, scope for passing on cost increases, in transport or raw materials, for example, may be limited.

Attention must also be paid to raising productivity. One alternative worthy of study, however, is to save on transport costs and protect market share by relocating some manufacturing closer to markets and/or the sources of raw materials. Profitability will also be improved if businesses successfully concentrate on increasing their efficiency. Large companies are sitting on very generous reserves of cash, some of which can be allocated to technology and systems capable of delivering reasonably speedy bottom line benefits. This may well persuade some boards to loosen the budget restrictions — possibly against the wishes of corporate treasurers who want to keep their large cash balances at the prospect of rising interest rates.

Mergers and acquisition activity has been gaining pace around the world and may be further encouraged in Europe by relatively low growth. Companies can acquire markets and growth through well-judged mergers and should be looking for opportunities to create synergies via concentration. If the sovereign debt crisis in Europe does worsen in the coming months, asset prices, including equities, are bound to drop and bring mergers and acquisitions that may once have seemed too costly into affordable range.

The turbulence in the world's markets is also creating a new set of requirements and shareholder demands, resulting in many business and financial reporting risk considerations. Many businesses are concerned about the risks and opportunities associated with mandatory conversion from local accounting standards to

International Financial Reporting Standards (IFRS). For those that have already converted to IFRS, however, the challenge may be a different one — keeping up with the gradual maturation of IFRS as the concepts and rules are refined to respond to market conditions.

Evaluating effects on business of a future EU tax legislation

There is now an ongoing discussion about the European Commission's proposal of harmonized corporate taxation within the EU. The proposal aims to provide for a fully harmonized European tax base for EU-based groups of companies via pooling cross-border losses with profits by consolidating income from members of the group. It also aims to reduce transfer pricing issues by disregarding intragroup transactions, limit double tax issues by disregarding intragroup restructurings and lower cost of compliance by introducing a one-stop shop for administrative matters.

The discussion on common EU tax legislation started more than 10 years ago; however, the current proposal now provides the basis for companies to fully consider the effects of the proposed legislation. Companies should use this opportunity to assess and calculate the impact of such a change in determining the corporate tax base on its European tax rate compared to potential savings in tax compliance costs.

Although this would not necessarily lead to full harmonization, the underlying change to national corporate tax systems to more closely mirror the basic principles of the CCCTB (Common Consolidated Corporate Tax Base) would start the process of aligning tax systems in many member states. We think it is unlikely that the proposal will reach unanimous consent among the 27 member states necessary to achieve adoption. However, there will probably be a mechanism of enhanced cooperation where a number of member states agree as a first step to adopt the Directive. This scenario was what occurred when Europe adopted the single currency.

Banking sector perspectives

In this issue of the *Ernst & Young Eurozone Forecast*, we have discussed how a restructuring process will affect the banking sector; there are risks to the economic outlook which need to be considered.

In April 2011, the European Banking Authority (EBA) agreed to adopt a benchmark of Core Tier 1 (CT1) against which to assess banks in the 2011 EU-wide stress test. The 90 banks that will undergo this stress test represent more than 65% of banking assets in the EU and more than half of the banking assets in all individual EU countries. The result of the test will be reported in mid-June 2011. The CT1 benchmark will be set at 5% of risk-weighted assets, which is not a legal minimum requirement. However, the EBA expects any bank failing to meet the benchmark, or showing specific weaknesses in the stress test, to agree the appropriate remedial measures with the relevant supervisory authority and execute them in due time. The EBA expects these measures to be disclosed separately.

Testing different stress levels

There are obviously political constraints on the stress scenarios chosen by EBA. However, we believe that the EBA stress test output would be more useful if it enabled the market to change the dimension of the risk tested, particularly with regard to Eurozone issues, but also inflation. The 2011 stress test would be much more useful if the market was given the results in a way that they could look at alternative, more severe, stresses, i.e., multiplying up the stress levels. It is also important to test the likely profitability of business under alternative economic outturns over a three- to five-year horizon.

Given the uncertainties in this summer edition of the *Ernst & Young Eurozone Forecast*, in particular regarding the possible widespread impact that would be experienced from a sovereign debt crisis, as well as the possibility of other adverse outcomes, it is essential that banks carry out detailed stress testing using a range of scenarios.

The Basel III changes radically affect the banks' costs of doing business. Equity capital will increase by 40%–100% for some banks, but the increases are greater for some activities than others. The cost of the new liquidity buffers will also have to be absorbed. This requires the adoption of a new approach to strategic planning and optimization of strategy across capital, liquidity and leverage. We are already seeing banks take decisions to exit some markets, and this will intensify. To get the strategy right, banks will need new, more sophisticated, planning tools.

Reassessing business strategy

Although we see signs of recovery in the sector, banks will also need to find new sources of revenue growth, as well as focusing on costs, in order to respond to the profitability challenges. One way of increasing customer trust and getting more loyal clients is to develop new offers and proposals, and also consider whether location outside Europe, in emerging markets, would give access to growth opportunities.

Banks therefore need to reassess their strategies and carefully stress test for different possible economic outcomes. If inflation accelerates in some countries and interest rates have to increase, that will put borrowers under more pressure and default rates will rise. An intensification of sovereign debt problems in the Eurozone would also have repercussions. As we can expect a huge amount of regulatory changes, it is important for banks to have a consolidated approach and prepare in time for these changes. They also need to create a robust internal and external assurance mechanism for corporate accountability.

One year into the Eurozone sovereign debt crisis, tensions show no sign of abating. Instead, we have reached a significant new stage in this crisis, with a new bailout for Greece nearly certain and some kind of restructuring of Greek sovereign debt now looking unavoidable. An orderly sovereign debt restructuring, involving a "reprofiling" or a "rollover" of debt payments, can provide some short-term relief. However, to be orderly, debt restructuring probably needs to involve only limited measures that bring little relief to the debt burden and thereby to the fiscal and economic restructuring effort.

Highlights

- Our baseline forecast assumes that a combination of measures that include an orderly restructuring and an additional bailout will prevent a financial crisis engulfing the Eurozone. This will allow the Eurozone economy to continue to grow, albeit at only a moderate rate. We forecast Eurozone GDP growth at 2% this year, 1.6% in 2012 and 2% on average in 2012–15. The 2011 forecast has been revised up based on positive surprises in Q1. The longer-term forecast is broadly unchanged from our earlier forecasts. The number of unemployed is expected to stay above 13 million until 2015, compared with a trough at 11.5 million in 2008.

- However, once the restructuring process gets under way, there is a risk of an adverse reaction by financial markets that leads to a more comprehensive and disorderly restructuring cannot be avoided. Such a disorderly process increases the risk of contagion to other countries. In such a scenario, Eurozone GDP would probably fall as sharply as in 2008–09, inevitably raising questions about the durability of monetary union in its current form.

- Debt restructuring would hit the banking sector across the Eurozone particularly hard, as it owns significant amounts of sovereign debt. The stress tests to be published in July are likely to shed further light on the health of the banking sector. Lending surveys indicate that Eurozone banks are still repairing their own balance sheets and continue to keep a tight lid on credit, hampering the recovery in household consumption and business investment.

- While Eurozone growth overall will be weak and faces significant downside risks, some countries are expected to grow robustly. In the "core" Eurozone countries, GDP is forecast to rise by 2.2% per year on average in 2011–15, a growth rate slightly higher than in the decade before the crisis. By contrast, in the "periphery," GDP is forecast to rise by only 1.2% per year in the next five years, not even half the pace of the decade before the crisis.

- These contrasts create opportunities for companies that want to tap rising purchasing power in the core countries. Companies with strong balance sheets could also see opportunities in the periphery where production costs are likely to fall. This is particularly the case for Ireland, where labor costs have already adjusted significantly downward.

- Eurozone prospects are also mixed at the sectoral level. Business services is among the sectors with the brightest outlook, with the Eurozone benefiting from a skilled workforce and expertise established in this area. The manufacturing sector is also expected to recover more quickly than the economy as a whole, benefiting from robust external demand for the Eurozone's goods, in particular from emerging markets. However, much of this growth will merely recoup the losses experienced during the crisis.

- The ECB continues to face difficult choices as it struggles to deal with relatively high inflation, significant downside risks to growth and the contrasts between a robust core and a shrinking periphery. So far, it has put more emphasis on high inflation and the robust core, and has signaled that further increases in interest rates are likely in the second half of 2011.

- We think this tightening is premature, adding to the challenges for the peripheral economies, especially as further monetary tightening will exert upward pressure on the euro. The downside risks to the Eurozone outlook are such that the ECB risks having to reverse its tightening, which would have a damaging impact on its credibility. Finally, we think it is unlikely that the current elevated inflation rate will feed into wages or prices more generally. Instead, we forecast Eurozone inflation to fall back below 2% at the beginning of next year.

What could debt restructuring imply for the Eurozone?

A new stage in the Eurozone crisis

One year into the Eurozone sovereign debt crisis, tensions show no sign of abating. Instead, we have reached a significant new stage in this crisis, with a new bailout for Greece almost certain and some kind of restructuring of Greek sovereign debt now looking unavoidable. This is a remarkable development since the financial package put in place in May 2010 by the EU and IMF the release of the funds from the first bailout package was supposed to be conditional on Greece meeting strict targets, thereby excluding, in principle, a new package. Moreover, the bailout was meant to avoid a restructuring of Greek sovereign debt, something that EU officials and the ECB saws as unthinkable.

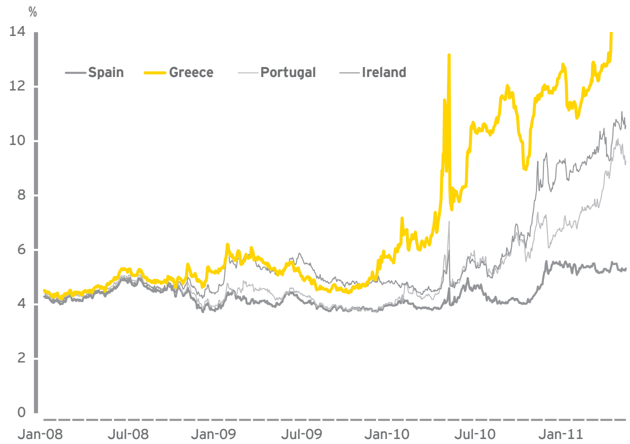
The strong opposition to debt restructuring was twofold: first, it was perceived as too risky a process that could threaten the survival of the monetary union; second, large exposure of European banks to Greek sovereign debt meant that the risk of contagion was high.

All these considerations are still valid. But it seems that EU officials have come to understand what financial markets have been pointing out for a long time — namely, that Greece will not be able to honor its debt repayments under current terms. *Box 1* looks in detail at the fiscal accounts of Greece and other peripheral countries to show why debt restructuring and a new international loan can no longer be avoided.

Assessing these facts and developments, investors have signaled that they place a high probability on a restructuring of debt in the near future by pushing two-year Greek government bond yields up to around 25%.

Figure 1

Bond yields



Source: Oxford Economics, Haver Analytics

Table 1

Forecast of the Eurozone economy (annual percentage changes unless specified) *Source: Oxford Economics*

	2010	2011	2012	2013	2014	2015
GDP	1.7	2.0	1.6	1.9	2.0	2.0
Private consumption	0.8	0.9	0.9	1.3	1.4	1.6
Fixed investment	-1.0	2.7	2.6	3.7	3.8	3.5
Stockbuilding (% of GDP)	0.2	0.5	0.7	0.8	0.9	1.0
Government consumption	0.3	0.5	0.0	0.6	1.0	1.2
Exports of goods and services	11.1	7.0	5.8	6.1	5.8	5.3
Imports of goods and services	9.3	6.0	5.2	6.1	5.9	5.4
Consumer prices	1.6	2.5	1.9	1.8	1.8	1.9
Unemployment rate (level)	10.1	9.8	9.5	9.2	8.8	8.5
Current balance (% of GDP)	-0.4	-0.6	-0.3	-0.1	0.0	0.0
Government budget (% of GDP)	-6.0	-4.3	-3.2	-2.4	-1.9	-1.5
Government debt (% of GDP)	85.4	87.0	87.6	86.9	85.7	84.1
ECB main refinancing rate (%)	1.0	1.3	2.3	3.1	3.5	3.9
Euro effective exchange rate (1995 = 100)	120.7	122.4	121.8	119.5	115.2	113.3
Euro/US dollar exchange rate ($ per €)	1.33	1.42	1.38	1.33	1.27	1.24

Box 1

Government debt challenges

This box sets out the scale of the debt challenge facing the most troubled Eurozone economies. The debt position looks especially challenging for Greece which, on the basis of IMF projections and our forecast, will see its gross debt-to-GDP ratio rise to close to 170% by 2013. The debt ratio is then projected to edge down slowly, but this is based on relatively optimistic assumptions of Greece fully implementing a fiscal adjustment of over 11% of GDP (on a cyclically adjusted basis) from 2010–15, returning to growth and regaining access to market financing at reasonable rates. Any slippage on these issues risks putting the debt stock back on a rising path again.

Moreover, Greece also faces an acute liquidity problem, as much of the debt will come due over the next few years. Debt redemptions from 2011–15 exceed €200 billion. The first bailout package from the IMF and EU covers most of this year's financing needs (both the budget deficit and maturing debt), but a substantial financing gap will exist next year, and even larger ones in 2013–15, unless market access can be restored. With current market yields on Greek debt at extremely high levels of 15% to 25%, accessing private markets next year looks prohibitively expensive.

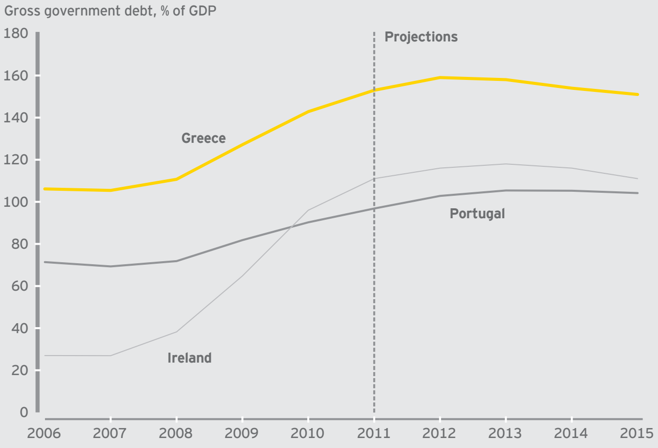
Another issue for Greece is the political aspect of the current debt dynamics. From 2012–15, interest payments are projected to total around 8% of GDP per annum, or 20% of government revenue. The bulk of these payments — 70% to 80% — will go to foreign creditors, implying that, to fulfill its obligations to the IMF and EU, Greece will have to undertake a very large annual transfer of tax revenue and GDP abroad. This inevitably raises questions as to whether such an undertaking is politically sustainable.

For Ireland and Portugal, debt dynamics look less unfavorable than for Greece, while still being very challenging — both countries will have debt-to-GDP ratios above 100% by 2012. The debt stocks are then projected to continue to hover around these levels until 2015, despite fiscal adjustments planned at 8% to 10% of GDP — both countries are faced with having to work very hard just to stand still. As with Greece, there is also the issue that debt projections are based on relatively optimistic assumptions for growth and future interest rates.

Overall, however, Ireland looks in the most difficult position of the two countries. Its initial budget position is weaker, and projected interest payments as a share of government revenue are higher. Ireland also has the problem that its Government issued guarantees for a large volume of bank liabilities during the global financial crisis, estimated at as much as 100% of GDP.

Figure 2

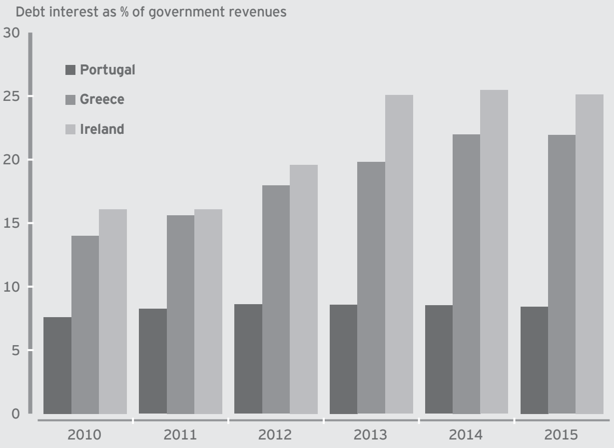
Peripherals debt



Source: Oxford Economics, IMF, Irish Dept. of Finance

Figure 3

Peripherals interest burden



Source: Oxford Economics, IMF, Irish Dept. of Finance

Additional package would only be a short-term solution …

An additional bailout package from the EU and IMF will only offer short-term relief. It will deal with the liquidity issue facing Greece, providing funds for the country's debt repayments in 2012 and 2013. But, while it will buy more time for the Greek Government to improve its fiscal accounts and make progress in structural reforms, it will not in itself provide a long-term solution.

Indeed, we expect Greek government debt to rise to close to 170% of GDP by 2013, with interest payments amounting to more than 20% of government revenues. Moreover, the difficulties in implementing the conditions of the first package that have emerged in 2010 and at the beginning of this year — with, for instance, strong opposition from unions to privatization — and long negotiations to get the latest fiscal austerity measures approved on 8 June bode ill for the Government's ability to implement these plans.

Furthermore, once bailout renegotiations are reopened for Greece, the EU and IMF would also need further discussion with Ireland and Portugal, thereby undermining any remaining credibility in the conditions attached to their packages.

… orderly restructuring would bring little relief …

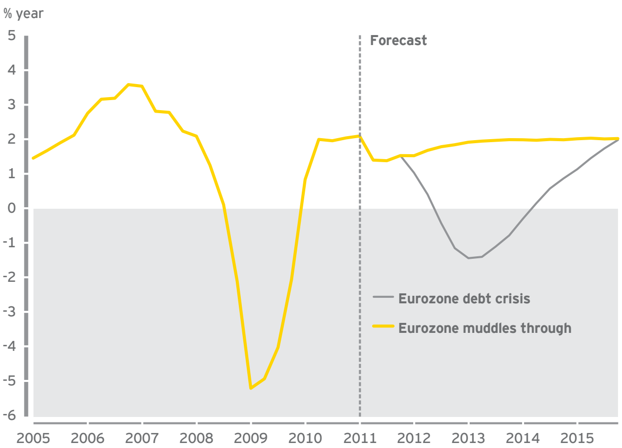
In addition, political opposition across the Eurozone to these new bailouts has intensified. This is why a number of EU governments are pushing for a "soft restructuring" or "reprofiling" of Greek government debt, as a way to share the burden between taxpayers and private investors. The argument is that these measures, that would extend the maturity of government debt held by the private sector, would keep restructuring orderly. But to be orderly, restructuring needs to meet a number of requirements.

First, it needs to involve support from the EU and IMF, since Greece will continue to require financing to repay what debt remains and is unlikely to see its access to financial markets improve for some time. Second, restructuring needs to be small, minimizing the losses to private investors. Extensions of debt maturities are a way to reduce debt repayments in the short term in a generally relatively less painful way for bondholders than outright "haircuts" (i.e., cuts in the principal being repaid). Interest payment moratoriums may also be sought. Third, a clear and credible plan needs to be presented to show that Greece will be able to meet its redefined debt repayments. Fourth, support needs to be given (probably from the ECB) to Greek banks and other financial institutions that would be severely affected by the restructuring.

… and entails significant downside risks

A limited restructuring is clearly the preferred route, in that it offers some relief to the Greek Government, buying it some time to improve its fiscal accounts, while trying to avoid chaos on the Eurozone financial and banking sectors. However, a limited restructuring also implies little relief to the debt burden and thereby to the fiscal and economic restructuring effort that are still needed. As a result, it risks failing to restore investors' confidence, thereby requiring a wider restructuring.

Figure 4
Eurozone GDP



Source: Oxford Economics

More generally, the conditions for the restructuring to be orderly that have been outlined are demanding. For instance, in the current environment of mistrust of the various packages put together by peripheral countries and the EU and IMF, it is doubtful that Greece could come up with a revised plan that would look like a credible solution to its debt problems. It also seems ambitious for the Government to raise €50 billion from privatization of public assets. Finally, the ECB remains strongly opposed to this reprofiling. It fears that this will constitute a credit event that will imply significant damage to banks' balance sheets. It will also prevent banks from using Greek bonds as a collateral in the ECB's refinancing operations, thereby in effect cutting Greek banks off these operations and pushing the whole Greek banking sector in turmoil.

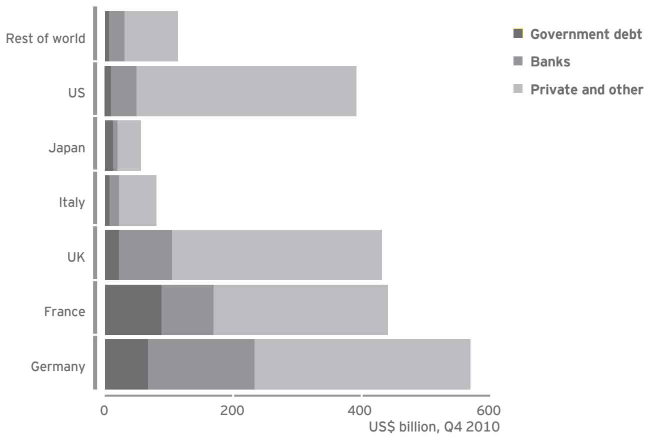
So far neither the ECB nor EU governments appear ready to make any concession. A compromise will need to be found however since Greece needs a solution urgently.

Whatever restructuring package is decided, it is likely that investors' confidence would remain low and bond yields high. As a result, once the restructuring process starts, there is a risk that it gets out of hand and a more comprehensive and disorderly restructuring cannot be avoided. Such a disorderly process increases the risk of contagion to other countries.

Contagion would spread first to other peripheral countries, and in particular Ireland and Portugal, that face similar — albeit somewhat less severe — debt challenges (*see Box 1*). Contagion could also spread to core countries via the banking sector. Indeed, according to data from the Bank of International Settlements (BIS), as of Q4 2010, German and French banks owned US$156 billion (around 2.7% of the two countries' GDP) of government debt from peripheral countries, of which US$46.1 billion was Greek government debt.

A disorderly restructuring that would involve significant haircuts (probably at least 50%) would have a large negative impact on banks' balance sheets across the Eurozone. The hit on the banking sector would in turn imply that the Eurozone economy as a whole is affected, via more restricted credit and negative confidence effects on businesses and households.

Figure 5
World: Bank exposures to peripherals



Source: Oxford Economics, BIS

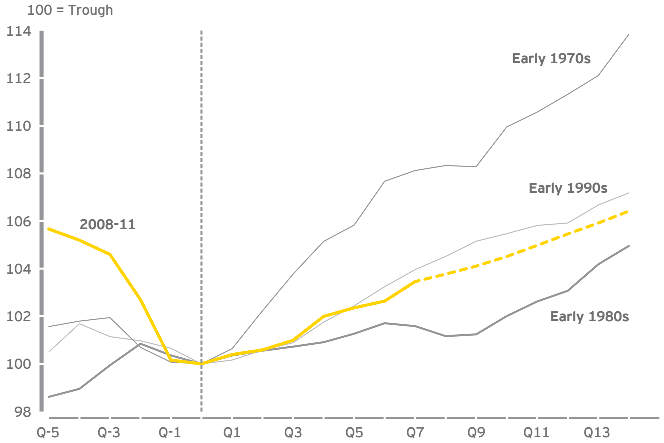
Baseline forecast of low, albeit positive, Eurozone growth ...

Given the very negative implications, we think that policy-makers, aware of these risks, will take the necessary measures to avoid a disorderly restructuring. Our baseline forecast therefore assumes that a combination of measures is used to defuse the current crisis, involving a new austerity package and some extension of debt maturities.

Based on this assumption, we forecast Eurozone GDP growth at 2% this year, 1.6% next year and 2% on average in 2013–15. Stronger-than-expected growth in the core Eurozone in Q1 2011, at 0.8% quarter on quarter, has led us to raise our forecast for this year. Nonetheless, the overall shape of the forecast has remained broadly unchanged and we continue to expect a relatively slow recovery. In the seven quarters since the start of the upturn, the Eurozone has recouped around two-thirds of the losses in activity of the 2008–09 downturn. We think that it will take another five or six quarters before it returns to pre-crisis activity levels.

The challenges facing the Eurozone that we highlighted in our previous forecasts remain. Beyond this year, our central growth forecast therefore remains unchanged. In addition, there is a large degree of uncertainty around this forecast. A number of factors could push the Eurozone economy away from this central forecast path, either on the downside or, less likely, on the upside. *Box 2* explains the main risks surrounding our central scenario.

Figure 6
Recoveries compared

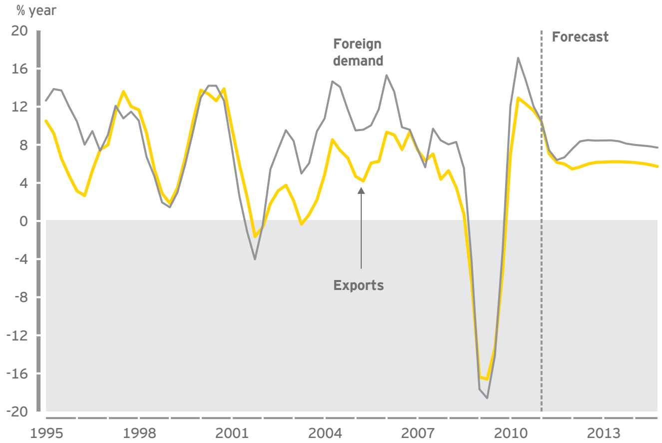


Source: Oxford Economics

... pulled by robust global demand ...

The outlook for the composition of growth between external and domestic activity has also changed little over the past year. Exports will probably return to pre-crisis levels by the end of 2011. The strength of the euro, which appreciated by around 5% in the first four months of this year against multiple currencies and remains above its value in early January despite some weakening in May, will dent the Eurozone's price competitiveness somewhat but should be more than offset by strong global demand. We continue to expect robust growth in the world economy, albeit less rapid than during 2010. We forecast world GDP to rise by 3.2% this year and 3.7% in 2012, compared with 3.9% in 2010 (at market exchange rates — see *Box 3* for further details on the external assumption to this forecast). This will underpin growth in Eurozone exports, which we forecast at 7% this year and 5.8% in 2012.

Figure 7
Exports



Source: Oxford Economics

What could debt restructuring imply for the Eurozone?

Box 2

Alternative scenarios for the Eurozone

This section focuses on our central scenario — i.e., what we see as the most likely outcome for the Eurozone economy. There is, however, a large degree of uncertainty about various key economic developments. In this context, we believe that there is about a 45% probability that economic developments follow the central scenario. Other possible outcomes include both upside and downside risks although, currently, we believe that the risks are skewed to the downside. This box describes what we see as the most likely alternative scenarios to the baseline forecast.

A number of factors point to the possibility of lower growth than we currently forecast. As discussed in this report, the possibility of a disorderly restructuring of sovereign debt entails significant downside risks to Eurozone growth. We attach a 10% probability to that scenario and estimate that, in that case, Eurozone GDP would fall both this year and next.

But there are other possible sources of downside risk. One relates to inflation developments in emerging markets. Inflation may increase more than currently envisaged in these countries due to strong demand and tight capacity. This would force central banks to raise interest rates significantly, which would slow activity and dampen Eurozone exports. To some extent, this process is embedded in our baseline forecast. But we could be underestimating the underlying price pressures in emerging markets and thereby the degree of both necessary monetary policy tightening and the resulting slowdown in economic activity. We think that there is a 20% probability associated with such a scenario.

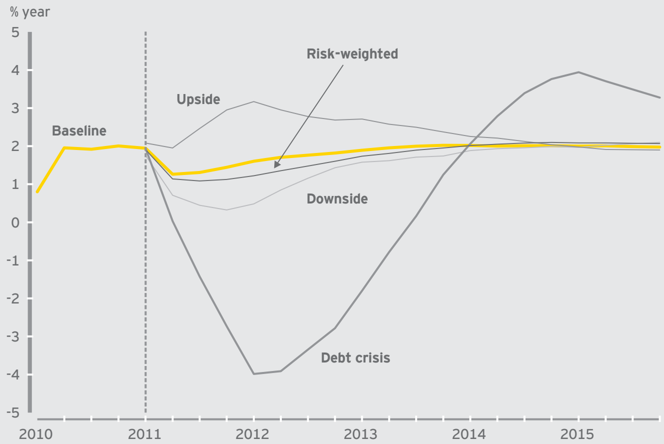
Another source of downside risk would be the intensification of tensions in the Middle East and Africa involving large oil suppliers and economies such as Saudi Arabia and the United Arab Emirates. Oil prices could rise to around US$200 per barrel. Risk premiums would increase for a broad range of assets and share prices would tumble. Balance sheets of Eurozone banks would deteriorate, thereby restricting credit availability. Business and consumer confidence would be hit, hindering investment and consumer spending. In this case, Eurozone GDP growth would be around 0.5%–0.7% lower than in the baseline, at around 1% in 2011 and 2012. We attribute a 10% probability to this scenario.

There are also some upside risks. In the US, the UK and the Eurozone, companies have large amounts of cash that they could spend more quickly than we currently envisage. Higher investment would lead to higher employment levels, allowing households to lower debt while increasing consumption. Governments would also benefit from higher tax revenues, making fiscal restructuring less difficult to achieve. We attribute a 15% probability to that scenario.

The chart below shows the path of Eurozone GDP growth in each of these scenarios. The risk-weighted GDP represents the average GDP growth rates of the different scenarios, weighted by the probability attached to each scenario.

Figure 8

GDP growth



Source: Oxford Economics

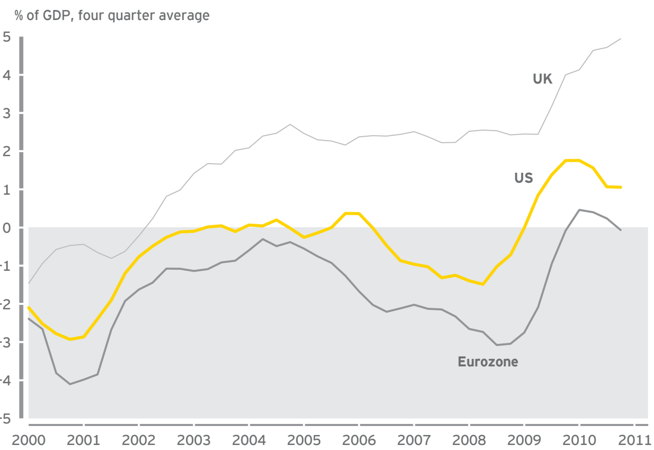
... while businesses prefer to reduce debt ...

Meanwhile, the recovery in domestic activity is forecast to continue at a slow pace. Strong export performance has not yet been sufficient to make companies in the Eurozone as a whole confident enough to raise investment at a robust pace yet. Given ample amounts of cash available to the business sector on aggregate, we forecast business investment to start rising again this year. However, we think that the corporate balance sheet restructuring that has been a main focus of companies over the past year will continue to weigh on investment for some time.

We forecast Eurozone business investment to rise by 2.7% this year and 2.6% in 2012. This would leave the level of investment at the end of next year still around 10% below pre-crisis levels. Business investment is not expected to return to pre-crisis levels before 2014.

Figure 9

World: Private non-financial corporations financial balances



Source: Oxford Economics, Haver Analytics

... and banks keep credit tight

Moreover, Eurozone banks are keeping a tight lid on loans as they restructure their own balance sheets and reduce their exposure to the riskier sectors and countries. The Q2 results of the ECB's Bank Lending Survey show that only banks in core countries have started to unwind the tightening of credit standards imposed during the crisis and, even in these countries, this unwinding is slow.

Box 3

Forecast assumptions — international environment and commodity prices

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

The outlook for global growth is less favorable than it was at the time of our previous forecast. The US economy slowed somewhat more than expected in Q1, the crises in the Middle East and North Africa (MENA) now seem unlikely to be resolved quickly, while the tsunami in Japan looks likely to cause more severe disruptions than earlier envisaged. However, these factors are not enough to derail the global recovery and the overall picture of a robust world trade remains broadly unchanged. We forecast world GDP to rise by 3.2% this year (at market exchange rates; 4% in purchasing power parity (PPP) terms) and 3.7% (4.5% in PPP terms) per year in 2012–15.

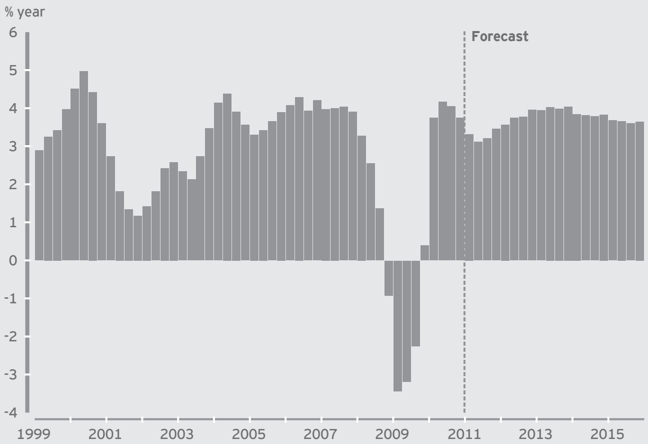
The lower Q1 GDP data have has led us to revise down our forecast for the US economy this year to 2.5%, somewhat lower than in 2010 (2.9%). However, we think that the weakness in Q1 was at least partly explained by temporary factors and we expect a pickup in the pace of growth in the remainder of this year. In 2012–15, we forecast 3.2% GDP growth on average. This will reflect moderate growth in consumer spending, some recovery in construction and continued strength of equipment investment. Real net trade is expected to exert a mild drag on growth as the dollar strengthens in the medium term.

Global growth will continue to be sustained to a great extent by emerging markets. We expect these countries to grow by around 6% per year over the next five years, with their share in the global economy rising from 24% in 2005 to 28% in 2010 and 32% in 2015 (at market exchange rates). China is expected to lead this group, with growth at 9% this year and 8.4% next year. This is slightly slower than last year's 10.3% growth, as monetary policy tightening dampens domestic demand, but still implies very fast increases in demand for goods and services from the rest of the world, including the Eurozone.

As regards commodities, after a seemingly relentless rise, commodity prices fell back somewhat at the beginning of May. The correction happened at the time of some disappointing data release on the US economy, but it seems that it reflected a broader-based reassessment by investors of the fundamentals underpinning commodity prices. Nevertheless, we expect commodity prices to remain elevated for some time as demand from emerging markets, which are large consumers of commodities, remains strong. An additional factor keeping oil prices high is concern that the crises in the MENA region could spread and further disrupt oil supplies.

Figure 10

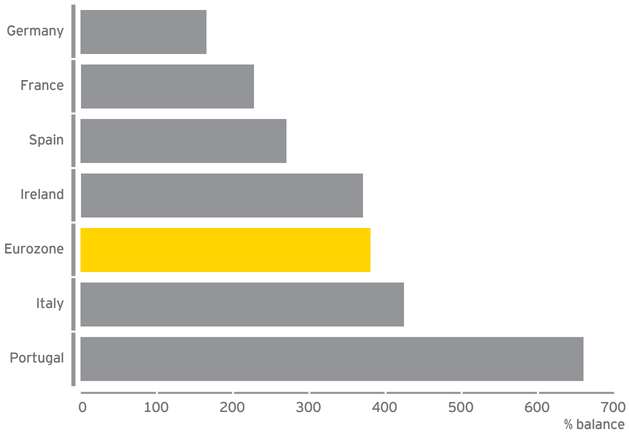
World: GDP growth



Source: Oxford Economics

Figure 11

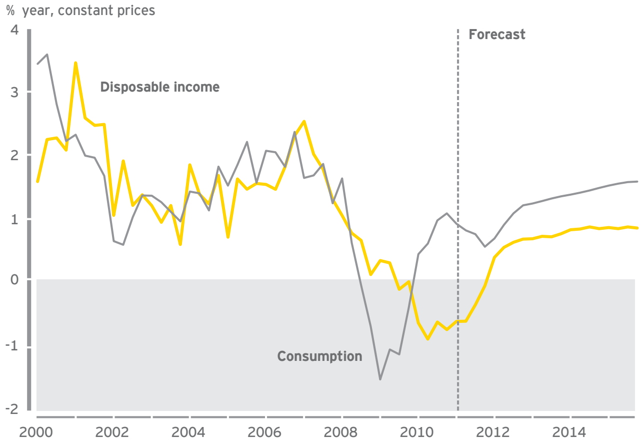
Cumulated tightening from mid-2007 to Q1 2012



Source: Oxford Economics, Haver Analytics

Figure 12

Households' income and consumption



Source: Oxford Economics

The stress tests to be published in July are likely to shed further light on the health of the banking sector. We think that the current situation of tight credit will continue for some time, acting as an additional brake on capital expenditure.

Households purchasing power to fall

The economic environment will also constrain private consumption, which accounts for around 58% of Eurozone GDP. We forecast private consumption to rise by only 0.9% this year, no faster than in 2010.

We expect a continuation in the downward trend in the household saving ratio observed in 2010. However, this will not be enough to offset very weak income growth. Indeed, in real terms, we are expecting household disposable incomes to fall again this year, before leveling off in 2012. Four main factors combine to weigh on household income.

First, we expect inflation to remain elevated throughout this year. Headline consumer price inflation reached 2.8% in April on the back of double-digit increases in energy prices. Despite a slight dip to 2.7% in May, headline inflation is likely to rise further through the summer, before starting to fall in the second half of the year.

We forecast consumer price index (CPI) inflation to average 2.5% this year. From next year, however, inflation should come back down below 2%, as our crude oil price forecast implies that energy price inflation falls sharply and the effect of the VAT increases in a number of countries at the beginning of this year (worth around 0.5 percentage points (ppt) on headline inflation) will fall out of the inflation rate calculation.

Second, wage inflation is likely to remain moderate. At the end of last year, compensation per employee was up only 1.6% compared with a year earlier. Continued high levels of unemployment will limit workers' bargaining positions and we forecast average wages per person to rise by 1.9% this year. As the recovery gathers pace, wage growth should rise modestly, to 2.5% in 2012.

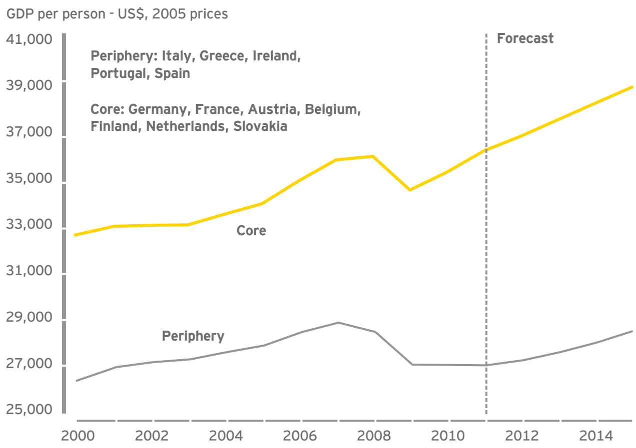
Third, Eurozone companies are still trying to recoup the losses in profitability incurred during the crisis when productivity dropped sharply. This process will continue through this year and businesses' efforts to restore profitability will dampen employment growth. Moreover, in a number of countries, governments are cutting public sector wages, typically by not replacing all employees who are leaving.

We forecast an increase in employment of only 120,000 this year, compared with 3.8 million jobs lost during the crisis. We think that the recovery in employment will be very slow as companies remain hesitant about recruiting as long as the outlook for the Eurozone remains uncertain. As a result, the number of unemployed is expected to stay above 13 million until 2015, compared with a trough at 11.5 million in 2008.

A final factor weighing on household income will be fiscal tightening. This applies mainly to peripheral countries (and includes wage cuts or freezes and employment cuts in the public sector) but fiscal restraint will also have a negative impact on growth in household incomes in core countries as, for example, some benefits are cut.

Figure 13

Divergence



Source: Oxford Economics

Robust growth in core Eurozone ...

While Eurozone growth overall will be weak and faces significant downside risks, some countries are expected to grow robustly. In the "core" Eurozone countries (here defined as Germany, France, Austria, Belgium, Finland, the Netherlands and Slovakia), GDP is forecast to rise by 2.2% per year on average in 2011–15, a growth rate slightly higher than in the decade before the crisis. By contrast, in the periphery, GDP is forecast to rise by only 1.2% per year in the next five years, not even half the pace of the decade before the crisis.

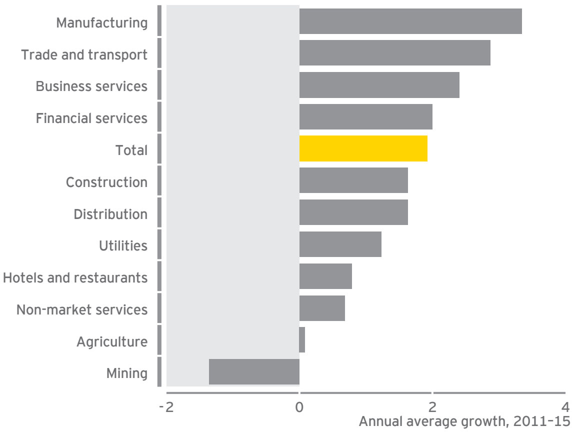
... and in manufacturing and business services

Eurozone prospects are also mixed at the sectoral level. Manufacturing and business services are the two sectors presenting the brightest outlook. The manufacturing sector benefits from strong demand for exports, in particular from emerging markets. However, much of this growth will merely recoup the losses experienced during the crisis. Value added in manufacturing is forecast to be back to pre-crisis levels only in the first half of 2012, just one or two quarters earlier than the economy as a whole.

Added value in business services is forecast to grow more rapidly than the economy as a whole, as the Eurozone benefits from a skilled workforce and expertise established in this area.

Meanwhile, consumer-facing sectors such as distribution and hotels and restaurants are expected to suffer as household spending power is constrained by fiscal tightening and relatively high unemployment. Companies that rely in large part on government procurement for their sales will also be significantly affected by the cuts in general and local government spending.

Figure 14
Value added by sector



Source: Oxford Economics

More difficult choices for the ECB

The ECB continues to face difficult choices between relatively high inflation and significant downside risks to growth, as well as between a robust core and a shrinking periphery. So far, it has chosen to put more emphasis on high inflation and the robust core. The ECB raised interest rates by 25 basis points (bp) in April and has indicated that further increases in rates are likely in the second half of 2011. We expect the ECB to increase rates by another 25bp in July.

We think that this tightening is premature. The downside risks to the Eurozone outlook are such that the ECB could have to reverse its tightening, which would have a damaging impact on its credibility. In addition, the tightening of monetary policy has already contributed to a strengthening of the euro that risks threatening Eurozone exports, still one main source of growth in the region. Finally, we think it is very unlikely that the current elevated inflation rate will feed into wages or prices more generally. Instead, we forecast Eurozone inflation to fall back below 2% at the beginning of next year.

Conclusions

The Eurozone debt crisis has reached a significant new stage, a new bailout for Greece nearly certain and some kind of restructuring of Greek sovereign debt now looking unavoidable. These measures are no comprehensive solution and entail risks. In particular, once a debt restructuring process is started, there is a significant risk that it becomes disorderly and that contagion spreads to other peripheral countries and to the Eurozone banking sector as a whole. In the event of a disorderly restructuring of sovereign debt, Eurozone GDP would probably fall nearly as sharply as in 2008–09, inevitably raising questions about the durability of monetary union in its current form.

Given the very negative implications, policy-makers must urgently take the necessary measures to avoid a disorderly restructuring. But the most likely approach — probably involving some extension of debt maturities alongside a further round of austerity measures and privatizations — is likely to fall short of a comprehensive and long-lasting solution. That will leave the peripheral economies struggling still under a burden of unsustainable debts and distrust by financial markets.

In contrast, the core Eurozone countries are forecast to experience robust growth, riding the boom in emerging markets. This in turn is likely to be reflected in outperformance by the manufacturing and business services sectors.

Heterogeneity across countries and sectors, and tensions between relatively elevated inflation and fragile growth, imply that the ECB continues to face difficult choices when setting monetary policy. So far, it has chosen to put more emphasis on high inflation and the robust core. We expect the ECB to increase rates by another 25bp in July. But we think that this tightening is premature as inflation is likely to come down next year and very large downside risks to growth.

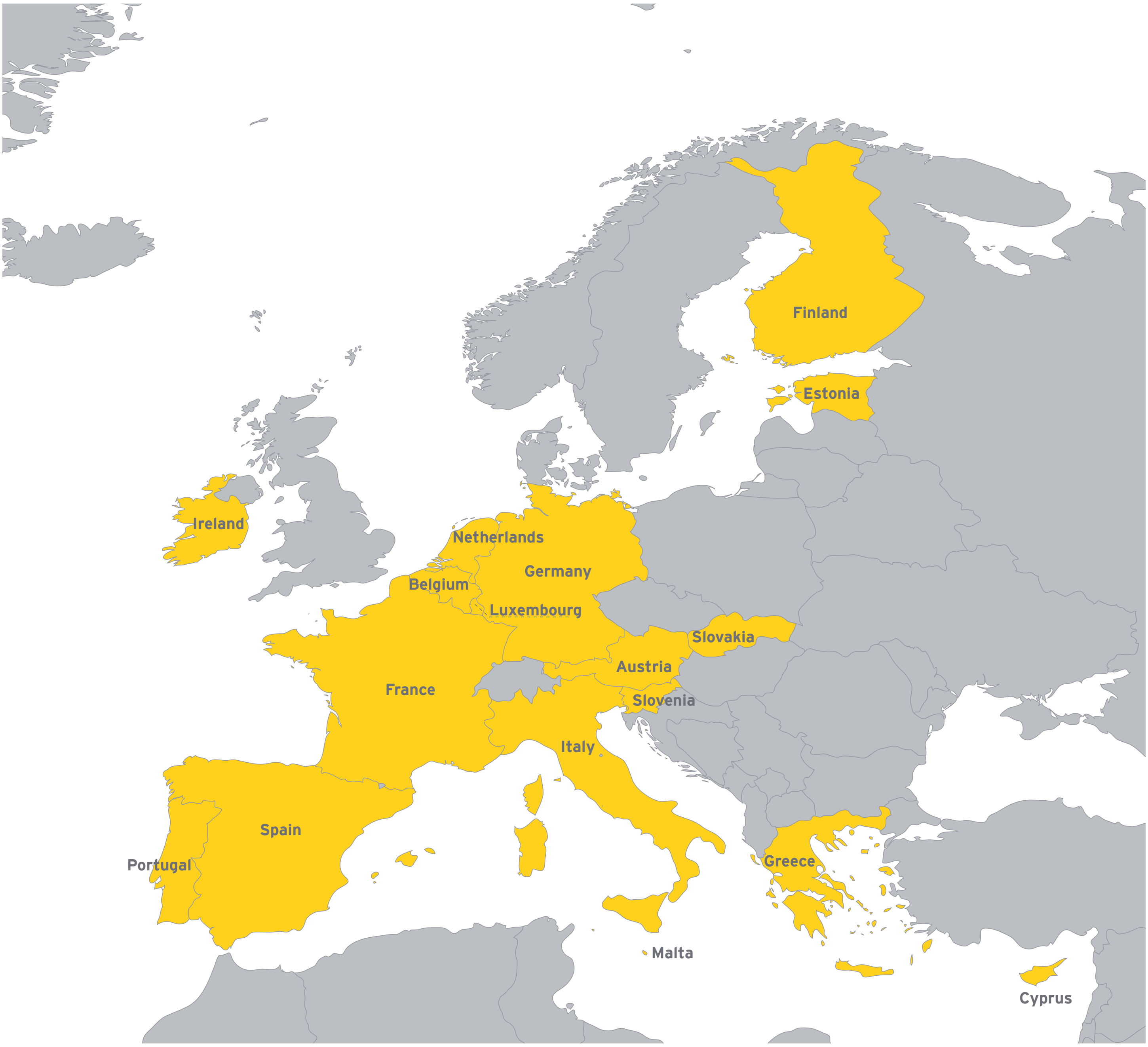
Forecast for Eurozone countries

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

17 Eurozone countries

Please visit our dedicated 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

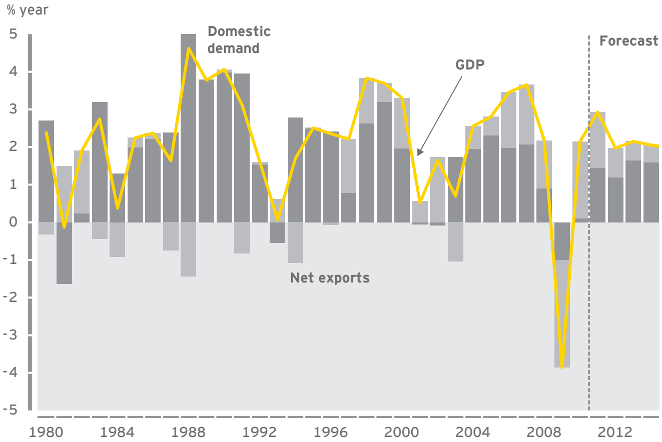


Austria

- After a solid export-driven recovery last year, growth is starting to broaden to investment this year, but consumption is set to remain muted. We forecast growth of 2.9% this year and 2% in 2012.
- Austrian exporters continue to benefit from ongoing strong growth in Germany, particularly in the industrial sector to which they provide inputs. We forecast exports to grow 8.9% this year, and 6% next. Strong activity in the export-oriented industrial sector will boost capacity utilization and stimulate investment.
- Risks to the forecast remain skewed to the downside, stemming predominantly from external developments — in particular, the increased turbulence on the European sovereign debt markets.
- Inflation rose to 3.7% in April. While inflationary pressures are likely to be close to their peak, inflation will remain rather high during the year and negatively affect consumer spending, which we forecast to grow only 1% this year.

Figure 15

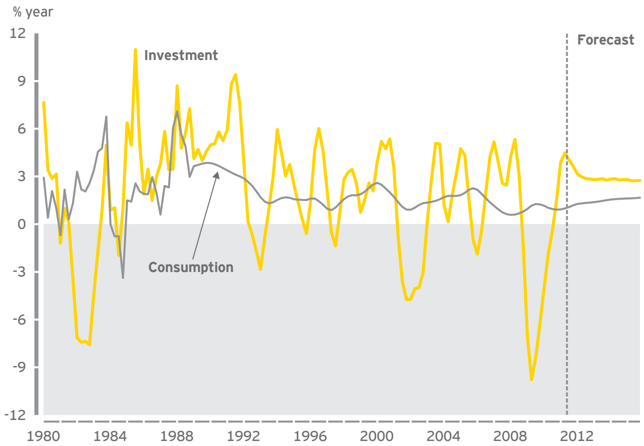
Contributions to GDP growth



Source: Oxford Economics

Figure 16

Consumption and investment



Source: Oxford Economics

Table 6

Austria (annual percentage changes unless specified)

Source: Oxford Economics

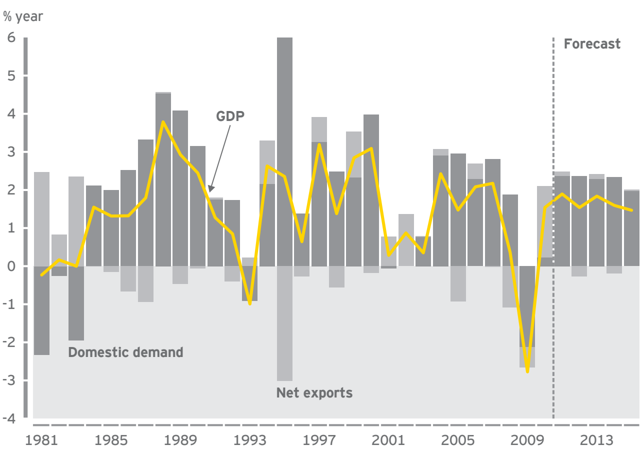
	2010	2011	2012	2013	2014	2015
GDP	2.2	2.9	2.0	2.2	2.1	2.0
Private consumption	1.1	1.0	1.3	1.4	1.6	1.6
Fixed investment	-1.1	3.8	3.0	2.8	2.7	2.6
Stockbuilding (% of GDP)	0.9	1.2	0.9	1.2	1.1	1.0
Government consumption	-0.1	0.0	0.9	1.3	1.8	2.0
Exports of goods and services	10.4	8.9	6.3	5.5	5.3	5.4
Imports of goods and services	8.3	7.5	5.8	5.8	5.3	5.5
Consumer prices	1.7	3.2	2.2	2.1	2.0	2.0
Unemployment rate (level)	4.4	4.4	4.4	4.4	4.4	4.4
Current account balance (% of GDP)	2.7	3.0	2.6	2.4	2.2	2.2
Government budget (% of GDP)	-4.1	-3.6	-3.0	-2.6	-2.3	-2.1
Government debt (% of GDP)	69.1	69.5	69.8	69.7	69.3	68.8

Belgium

- Following a surprisingly robust performance in 2010, the Belgian economy has continued to defy expectations with a surge of growth in the first months of 2011. The strong start to the year means that we have increased our forecast for overall GDP growth in 2011 to 2.4%.
- Progress on fiscal consolidation has been even better than expected, with the budget deficit falling to 4.1% of GDP in 2010, down from 5.9% in 2009. Our forecast is for the budget deficit to shrink further to 3.0% of GDP this year. Although the fiscal consolidation process appears to be making good headway, Belgium will require a full government to decide on the longer-term direction of economic policy.
- The country remains at risk of contagion from renewed financial market turmoil, which could lead to a widening of spreads on Belgium's sovereign debt. This would undermine confidence, increase financing costs and depress demand.

Figure 17

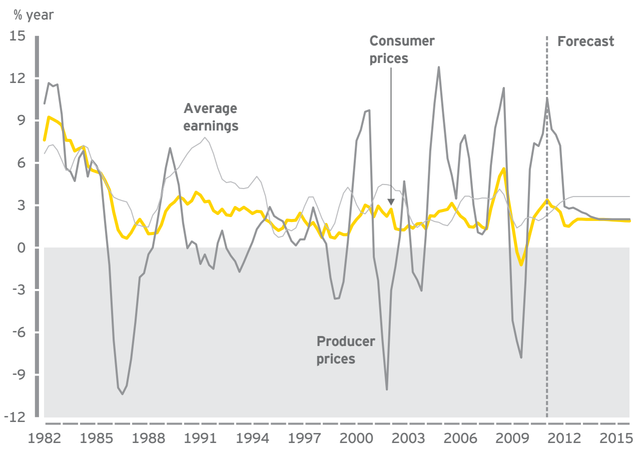
Contributions to GDP growth



Source: Oxford Economics

Figure 18

Prices and earnings



Source: Oxford Economics

Table 5

Belgium (annual percentage changes unless specified)

Source: Oxford Economics

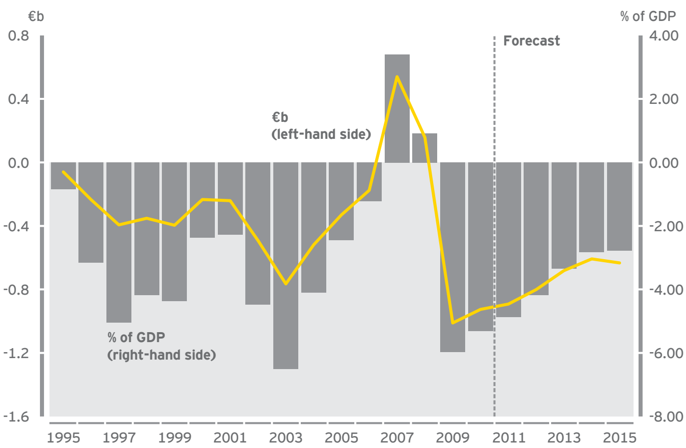
	2010	2011	2012	2013	2014	2015
GDP	2.1	2.4	2.0	2.4	2.2	2.0
Private consumption	1.6	1.8	2.3	2.3	2.4	2.2
Fixed investment	-1.5	3.4	3.4	3.6	3.3	3.0
Stockbuilding (% of GDP)	0.2	0.7	0.4	0.3	0.3	0.2
Government consumption	1.1	1.2	1.3	1.5	1.6	1.4
Exports of goods and services	10.6	7.0	4.9	5.1	4.2	3.9
Imports of goods and services	8.4	7.2	4.9	5.1	4.5	3.9
Consumer prices	2.4	3.3	1.9	2.0	2.0	1.9
Unemployment rate (level)	8.3	7.5	7.0	6.6	6.4	6.4
Current account balance (% of GDP)	1.4	0.7	1.1	1.2	1.0	1.0
Government budget (% of GDP)	-4.1	-3.0	-2.5	-1.8	-0.7	0.0
Government debt (% of GDP)	96.8	97.5	98.4	97.9	96.5	94.6

Cyprus

- GDP growth came to a halt in Q1 as private sector output and the generation of employment failed to offset budget reduction despite an upturn in tourism and exports. The economy is still set to grow by 1.3% in 2011 and 2.5% in 2012, but this is unlikely to be enough to fulfil the Government's deficit projections.
- Indeed, the fiscal deficit in Q1 2011 widened considerably compared with Q1 2010. And a series of downgrades in the sovereign credit ratings (due to the Government's exposure to Greek sovereign debt), coupled with an increase in interest rates by the ECB, is adding to the challenge of restoring the public finances to health.
- Debt restructuring in Greece also threatens to undermine the banking sector. With banks' holdings of Greek government bonds estimated to be 68% of their core capital, a Greek refusal to repay the bonds in full could impact banks' solvency and add to economic instability.

Figure 19

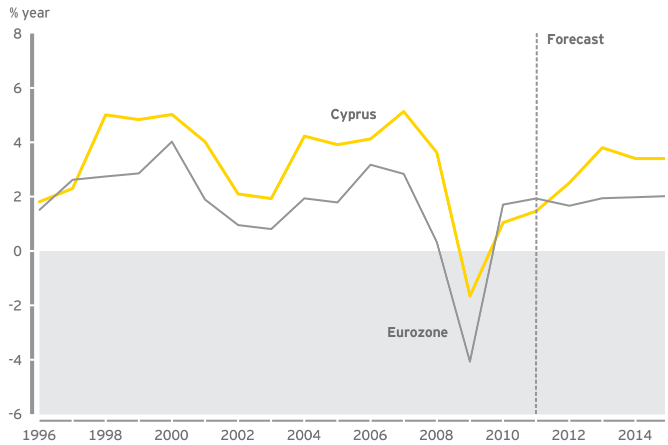
Government budget balance



Source: Oxford Economics

Figure 20

Real GDP growth



Source: Oxford Economics

Table 14

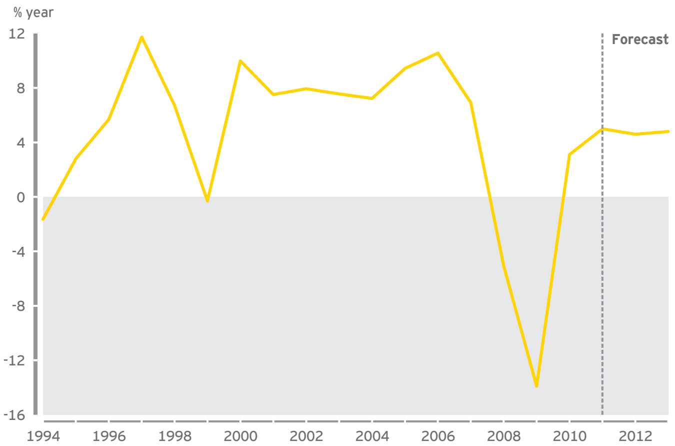
Cyprus (annual percentage changes unless specified) *Source: Oxford Economics*

	2010	2011	2012	2013	2014	2015
GDP	1.0	1.3	2.5	3.8	3.4	3.4
Private consumption	0.8	1.5	2.5	4.0	3.5	3.5
Fixed investment	-7.9	-1.4	-0.2	4.0	5.5	4.8
Stockbuilding (% of GDP)	0.8	0.3	0.1	-0.4	-0.5	-0.5
Government consumption	0.5	2.1	2.1	2.7	3.0	3.3
Exports of goods and services	0.6	4.1	5.2	5.7	5.3	5.3
Imports of goods and services	3.1	2.4	3.4	4.5	5.6	5.6
Consumer prices	2.6	3.7	2.2	2.3	2.3	2.3
Unemployment rate (level)	6.6	7.7	6.8	6.0	5.0	4.5
Current account balance (% of GDP)	-8.3	-7.0	-6.3	-5.6	-5.4	-5.2
Government budget (% of GDP)	-5.3	-4.9	-4.2	-3.3	-2.8	-2.8
Government debt (% of GDP)	60.8	62.7	64.0	63.7	63.0	62.4

Estonia

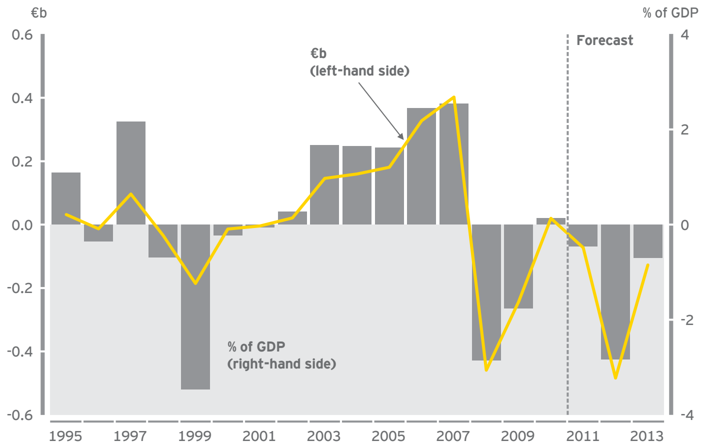
- Annual GDP growth reached 8.5% in Q1 2011, the Eurozone's fastest rate. Though growth is likely to slow as the global recovery cools, reducing the very strong recent contributions from net trade, we expect Estonia to maintain its position as the fastest-growing economy in the Eurozone, with growth at 5.0% this year and 4.8% in 2012–15.
- Inflation moved above 5% in Q1 and will be kept close to this rate for most of 2011 by further food, energy, utility and administratively regulated price rises. The inflation differential over the Eurozone will not blunt the export improvement in the short term, but the growth differential will gradually erode the current account surplus that opened up in 2009.
- The Government uniquely returned to budgetary surplus in 2010. Though the budget will briefly move into deficit over the next couple of years, public finances remain strong and will allow further tax cuts to promote growth.

Figure 21
Real GDP growth



Source: Oxford Economics

Figure 22
Government budget balance



Source: Oxford Economics

Table 15
Estonia (annual percentage changes unless specified) *Source: Oxford Economics*

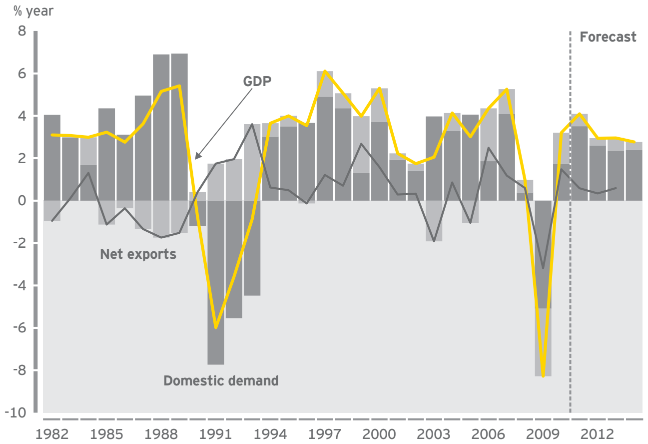
	2010	2011	2012	2013	2014	2015
GDP	3.1	5.0	4.6	4.8	4.8	4.7
Private consumption	-1.9	3.3	4.1	5.5	4.7	4.7
Fixed investment	-9.2	8.1	9.5	9.5	6.5	5.8
Stockbuilding (% of GDP)	6.4	4.5	2.5	0.4	0.4	0.3
Government consumption	-2.1	0.5	1.0	2.0	2.5	2.7
Exports of goods and services	21.7	8.7	7.9	7.4	5.9	5.4
Imports of goods and services	21.0	5.5	6.1	6.4	6.0	5.4
Consumer prices	3.0	4.5	2.6	2.3	2.1	2.2
Unemployment rate (level)	16.7	13.7	11.1	9.0	7.3	6.0
Current account balance (% of GDP)	3.5	2.7	2.0	1.7	0.9	0.3
Government budget (% of GDP)	0.1	-0.5	-2.8	-0.7	-0.2	0.0
Government debt (% of GDP)	6.6	6.5	8.9	9.0	8.5	8.0

Finland

- Growth slowed in Q1 to 0.3%, on the back of a 3% decline in industrial output. But output in the industrial sector is volatile and we think the underlying momentum remains healthy. Moreover, Finland's export outlook has improved. We forecast growth of 4.1% this year and 2.9% in 2012.
- A downside risk to this forecast stems from the increased turbulence on the European sovereign debt markets that could lead to a restructuring of Greek sovereign debt. This would result in slower growth in other Eurozone countries and dampen external demand for Finnish exports.
- Finland's current fiscal position is relatively strong. Despite crisis measures, the deficit never exceeded the 3% threshold. But Finland will soon need to tackle the fiscal impact of a population which, over the next 10 years, is projected to age at a faster rate than any other Eurozone country. We expect first steps toward further fiscal adjustment to be taken this year.

Figure 23

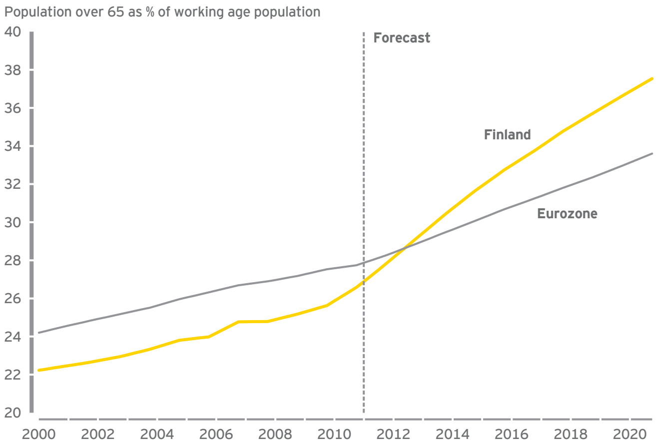
Contributions to GDP growth



Source: Oxford Economics

Figure 24

Population aging



Source: Oxford Economics, Haver Analytics

Table 8

Finland (annual percentage changes unless specified)

Source: Oxford Economics

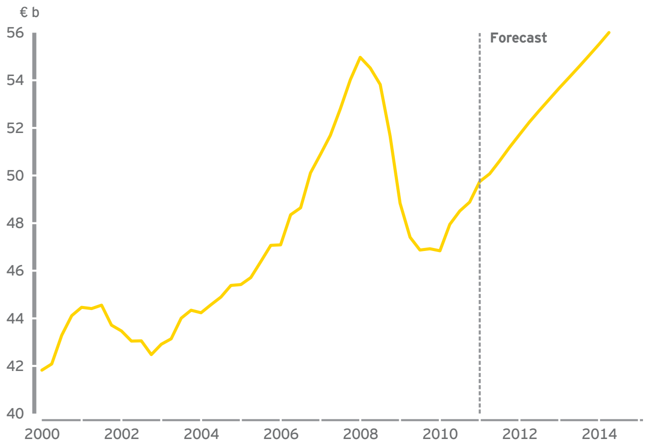
	2010	2011	2012	2013	2014	2015
GDP	3.2	4.1	2.9	3.0	2.8	2.8
Private consumption	2.6	2.0	2.6	2.9	2.9	2.8
Fixed investment	-0.9	7.6	5.0	3.3	3.2	3.3
Stockbuilding (% of GDP)	0.2	0.9	1.1	1.1	1.1	1.2
Government consumption	0.4	1.4	1.0	1.0	1.1	1.2
Exports of goods and services	5.0	8.4	8.5	7.5	6.2	5.6
Imports of goods and services	2.1	8.8	9.5	7.7	6.6	5.9
Consumer prices	1.7	3.2	1.8	1.8	1.7	1.7
Unemployment rate (level)	8.4	8.0	7.5	7.2	7.0	6.9
Current account balance (% of GDP)	3.1	1.6	2.0	2.4	2.5	2.5
Government budget (% of GDP)	-2.5	-1.4	-1.1	-0.8	-0.6	-0.3
Government debt (% of GDP)	48.3	46.4	45.4	44.2	42.8	41.3

France

- We forecast 2.2% GDP growth this year, followed by 2% on average in 2012–15. However, nearly two years into the recovery, economic activity remains dependent on consumer spending.
- With uncertain labor market prospects and relatively high levels of household debt, there are downside risks to the outlook for private consumption that would imply a significant slowdown in growth as a whole.
- For the recovery to be on a firmer footing, France needs a marked increase in investment. Our forecast sees investment rising by 3.2% this year and next, and 3.0% on average in 2012–15. Investment will be supported by low interest rates. But the high levels of debt in non-financial businesses is likely to prevent a stronger recovery.
- Our international forecast implies robust growth in demand for French exports. We forecast exports to rise by around 6% per year in the next five years.

Figure 25

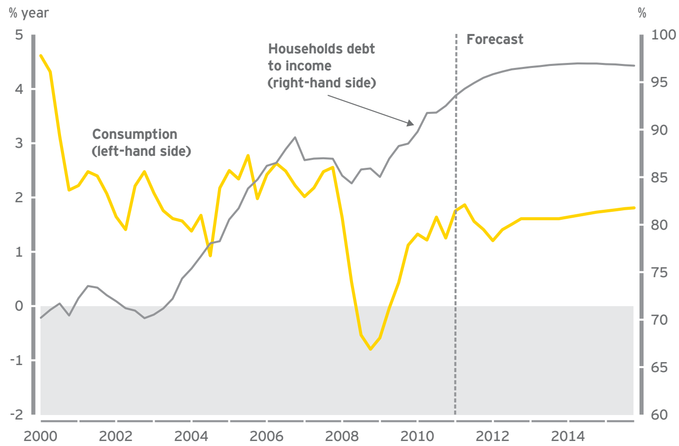
Business investment



Source: Oxford Economics

Figure 26

Households' consumption and leverage



Source: Oxford Economics

Table 3

France (annual percentage changes unless specified) *Source: Oxford Economics*

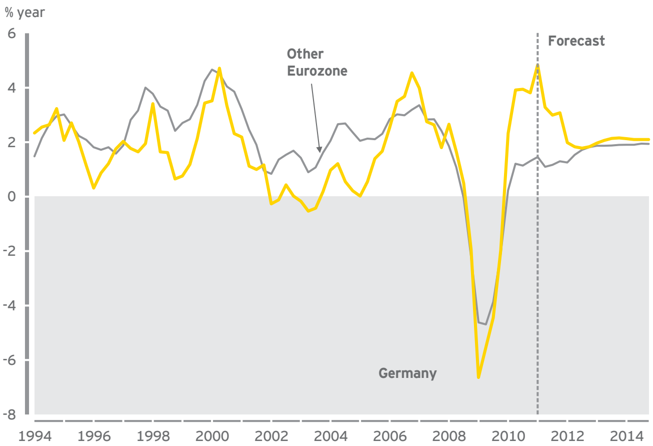
	2010	2011	2012	2013	2014	2015
GDP	1.4	2.2	1.9	2.0	2.0	2.0
Private consumption	1.4	1.6	1.4	1.6	1.7	1.8
Fixed investment	-1.4	3.2	3.2	3.2	3.0	2.9
Stockbuilding (% of GDP)	-0.1	0.7	0.9	1.0	1.1	1.2
Government consumption	1.2	0.8	0.7	1.1	1.2	1.2
Exports of goods and services	9.4	5.5	6.2	6.6	5.9	5.5
Imports of goods and services	8.3	6.8	5.3	5.7	5.5	5.2
Consumer prices	1.7	2.2	1.9	1.8	1.9	1.9
Unemployment rate (level)	9.8	9.3	8.7	8.2	7.8	7.5
Current account balance (% of GDP)	-1.8	-2.7	-2.7	-2.6	-2.7	-2.7
Government budget (% of GDP)	-7.0	-6.0	-4.9	-3.8	-3.0	-2.7
Government debt (% of GDP)	81.7	84.8	86.5	87.0	86.7	86.2

Germany

- The German economy is on course to record another year of exceptional growth at 3.5%. Germany is reaping the benefits of the structural reforms implemented during the previous decade, which have greatly improved the competitiveness of its business sector.
- But the turnaround in the German economy remains surprisingly imbalanced between a buoyant business sector and a muted consumer sector. Sustainable, strong growth in Germany requires that some of the benefits of the strong recovery are passed on to households.
- The opening up of the labor market to Eastern immigrants may relieve many of the economic tensions that could otherwise emerge in the German labor market.

Figure 27

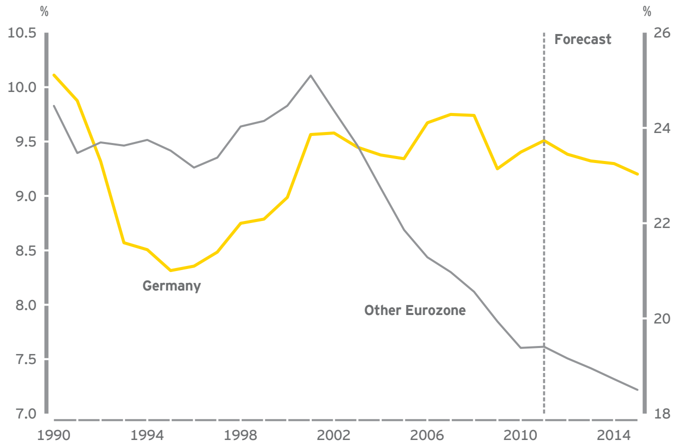
GDP: Germany vs. rest of Eurozone



Source: Oxford Economics

Figure 28

Share of world export volumes



Source: Oxford Economics, Haver Analytics

Table 2

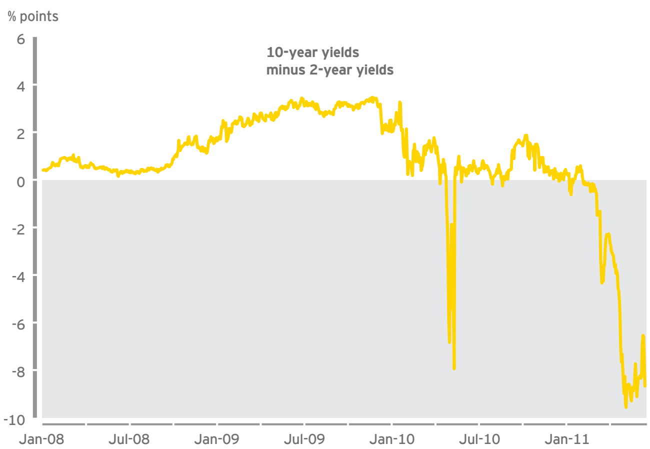
Germany (annual percentage changes unless specified) *Source: Oxford Economics*

	2010	2011	2012	2013	2014	2015
GDP	3.5	3.5	1.9	2.1	2.1	2.0
Private consumption	0.4	1.7	1.2	1.3	1.4	1.5
Fixed investment	5.7	7.2	2.9	4.5	4.9	4.3
Stockbuilding (% of GDP)	-0.7	-1.0	-0.5	-0.2	-0.2	-0.1
Government consumption	1.9	1.2	0.2	0.4	0.6	0.7
Exports of goods and services	14.4	8.1	5.8	6.5	6.4	5.7
Imports of goods and services	12.8	6.2	6.4	7.1	6.8	6.1
Consumer prices	1.2	2.3	1.8	1.8	1.8	1.8
Unemployment rate (level)	7.1	6.0	5.8	5.6	5.3	5.2
Current account balance (% of GDP)	5.6	5.2	5.2	5.2	5.0	4.7
Government budget (% of GDP)	-3.3	-2.3	-1.5	-1.1	-0.7	-0.4
Government debt (% of GDP)	83.2	81.9	80.5	78.7	76.5	74.1

Greece

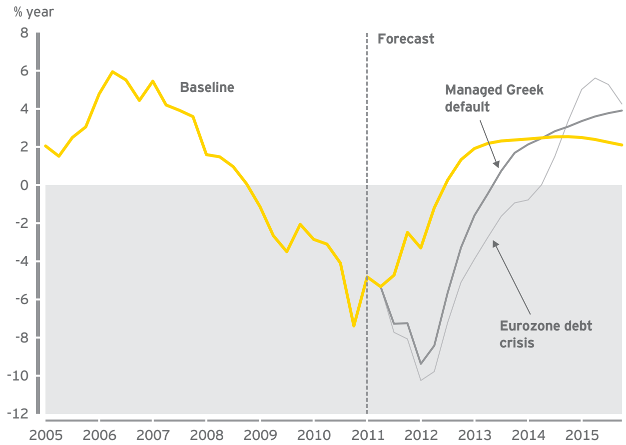
- The last few months have seen an escalation in the fiscal crisis facing Greece. While Greece has funds in place from the EU and IMF to cover its needs in 2011, it faces a financing gap in 2012.
- With access to financial markets prohibitively expensive, a new loan from the EU and IMF is now nearly certain. Another possibility is a "soft restructuring" or "reprofiling" in which the maturity of government debt is extended. However, both of these options leave the Government with a very high stock of debt, which means that it will have to run large primary budget surpluses for many years if it is to bring debt down.
- Greece's high debt stock has raised the possiblity of an eventual write-down on the principal of its debt. This would inevitably have damaging consequences for the Greek economy, with heavy losses in the banking sector and the Government losing access to capital markets for some time.

Figure 29
Yield curve



Source: Oxford Economics, Haver Analytics

Figure 30
GDP



Source: Oxford Economics

Table 7
Greece (annual percentage changes unless specified) *Source: Oxford Economics*

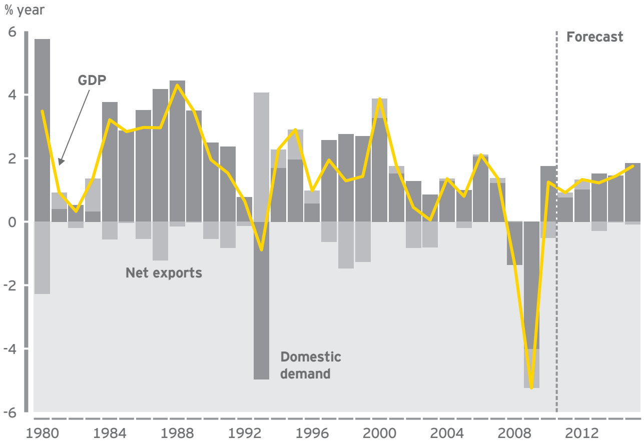
	2010	2011	2012	2013	2014	2015
GDP	-4.4	-4.8	-1.2	1.7	1.9	1.9
Private consumption	-4.6	-4.5	-2.8	0.3	0.9	1.4
Fixed investment	-16.5	-12.9	-4.4	3.4	6.0	5.3
Stockbuilding (% of GDP)	0.5	-0.8	0.2	0.7	0.7	0.7
Government consumption	-8.3	-15.4	-11.1	-2.5	-0.1	0.5
Exports of goods and services	3.8	-1.1	3.4	5.8	6.0	5.5
Imports of goods and services	-4.8	-16.5	-5.8	1.9	4.0	5.3
Consumer prices	4.7	2.8	0.7	1.0	1.2	1.7
Unemployment rate (level)	12.6	15.4	15.9	15.9	15.5	14.9
Current account balance (% of GDP)	-10.4	-9.1	-8.1	-6.2	-5.1	-4.7
Government budget (% of GDP)	-10.5	-8.0	-7.1	-5.1	-3.8	-3.6
Government debt (% of GDP)	142.8	159.2	168.3	168.6	166.4	164.0

Italy

- The Italian economy was still very weak at the beginning of 2011, as GDP increased by just 0.1% on the quarter for the second consecutive quarter.
- Growth in the short term is heavily dependent on external demand, as consumption is dampened by fiscal austerity measures, low nominal wage growth and high inflation. In the medium term, structural low competitiveness will maintain growth well below the Eurozone average. We expect GDP growth to average just 0.9% in 2011 and 1.3% in 2012.
- Low growth implies that unemployment will decline only gradually in 2011 and 2012.
- Although recent data for the public finances showed an improvement in the budget deficit compared with a year earlier, we expect the target of a deficit below 3% of GDP in 2012 to remain challenging.

Figure 31

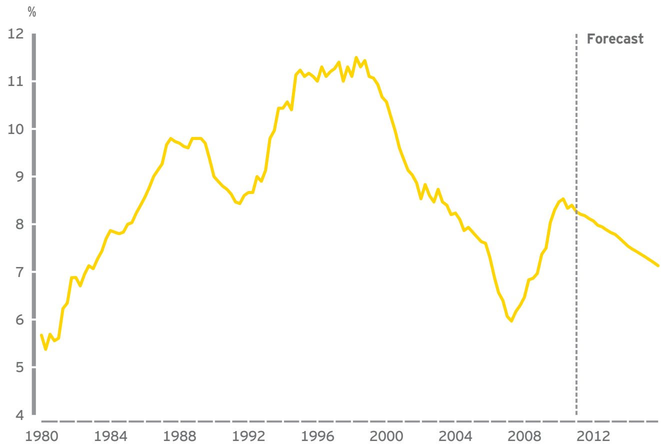
Contributions to GDP growth



Source: Oxford Economics

Figure 32

Unemployement rate



Source: Oxford Economics

Table 4

Italy (annual percentage changes unless specified) *Source: Oxford Economics*

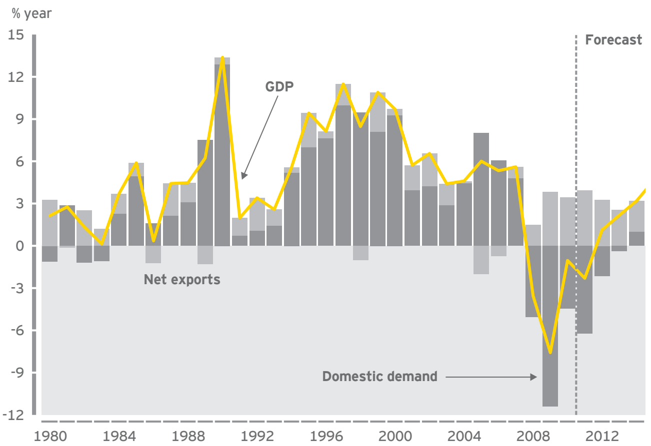
	2010	2011	2012	2013	2014	2015
GDP	1.2	0.9	1.3	1.2	1.4	1.8
Private consumption	1.0	0.9	1.0	1.2	1.4	1.5
Fixed investment	2.3	1.4	3.4	3.3	2.4	2.5
Stockbuilding (% of GDP)	0.6	0.8	0.4	0.5	0.4	0.5
Government consumption	-0.6	-0.2	0.0	0.2	0.9	1.3
Exports of goods and services	8.9	6.0	5.7	4.7	5.9	5.3
Imports of goods and services	10.3	5.7	3.5	5.4	5.6	5.3
Consumer prices	1.6	2.5	2.2	2.1	2.1	2.0
Unemployment rate (level)	8.5	8.1	8.0	7.7	7.5	7.2
Current account balance (% of GDP)	-3.5	-3.5	-3.0	-2.4	-2.1	-2.1
Government budget (% of GDP)	-4.6	-4.1	-3.3	-2.7	-2.1	-1.5
Government debt (% of GDP)	119.0	119.8	119.1	118.1	116.3	113.6

Ireland

- The Irish economy is still very weak, though encouraging steps have been taken to restore economic health. However, we expect the recession to continue into 2011, with GDP forecast to decline by 2.3%.
- While rising international demand and improving price competitiveness will allow exports to grow strongly, domestic demand continues to remain downbeat. The outlook for investment is particularly weak due to ongoing troubles in the banking sector and housing market, while high levels of debt, a weak labor market and strict fiscal consolidation will weigh down on consumer spending.
- Results of the stress tests revealed that Ireland's banking sector needs an additional €24 billion to remain solvent. This has prompted the Government to unveil the Financial Measures Program, which outlines a process of recapitalization, deleveraging and reorganization of the banking system. This is a positive step toward restoring the health of the financial sector — the key to reviving Ireland's economic fortunes.

Figure 33

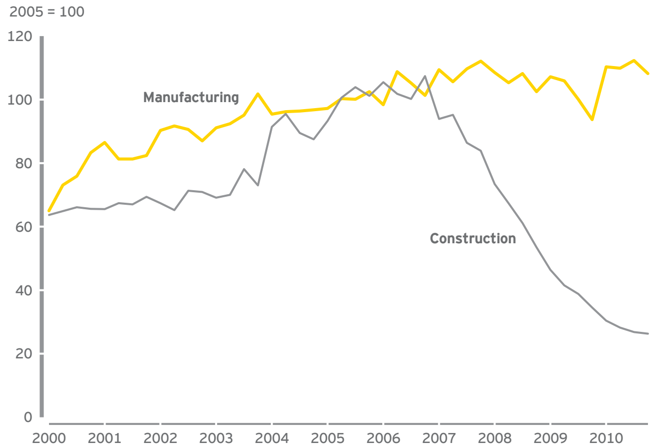
Contributions to GDP



Source: Oxford Economics

Figure 34

Indices of production



Source: Oxford Economics

Table 9

Ireland (annual percentage changes unless specified) *Source: Oxford Economics*

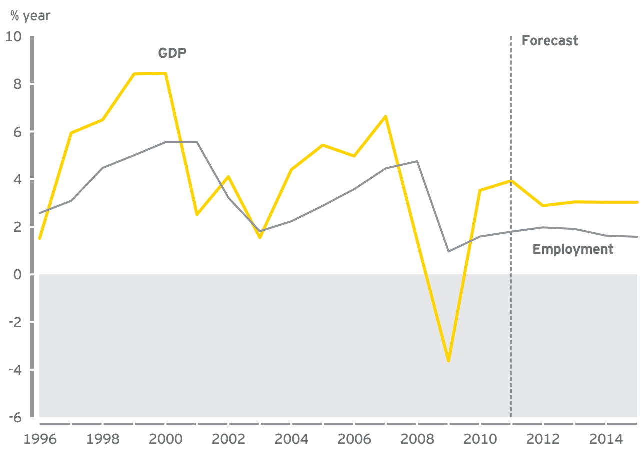
	2010	2011	2012	2013	2014	2015
GDP	-1.0	-2.3	1.1	2.6	3.4	4.7
Private consumption	-1.2	-4.1	-3.3	0.1	1.4	3.7
Fixed investment	-27.7	-15.7	-1.9	4.0	6.5	9.6
Stockbuilding (% of GDP)	-0.5	-0.6	-0.4	-0.5	-0.2	0.4
Government consumption	-2.2	-3.8	-2.6	-2.4	-2.4	-0.8
Exports of goods and services	9.4	5.2	5.3	5.4	5.1	4.5
Imports of goods and services	6.5	1.3	2.7	3.9	4.1	4.3
Consumer prices	-1.6	1.3	0.8	0.6	1.0	1.7
Unemployment rate (level)	13.7	15.7	15.1	14.3	13.8	13.1
Current account balance (% of GDP)	-0.7	1.6	2.4	2.6	2.6	2.5
Government budget (% of GDP)	-32.4	-9.6	-8.0	-5.7	-3.5	-2.0
Government debt (% of GDP)	96.2	108.0	115.3	116.9	115.3	110.6

Luxembourg

- Growth is forecast at 3.9% this year. Business services, manufacturing and fund management are set to maintain their momentum this year, but the banking sector's activity is taking longer to regain pre-recession growth rates.
- The recovery so far has been driven mainly by exports; we expect this pattern to continue this year, with net exports contributing 1.8ppt to growth. The current account is forecast to be around 6% of GDP in 2011.
- Inflation stood at 4% in April (on the EU harmonized measure) – well above the Eurozone average of 2.8%. We expect inflation to slow from Q2 this year, but high average inflation of 3.6% in 2011 will put pressure on consumer spending.
- A renewed escalation of the sovereign debt crisis in the Eurozone, in particular a disorderly restructuring of Greek debt, would pose a significant downside risk to Luxembourg, given the economy's dependence on the banking sector.

Figure 35

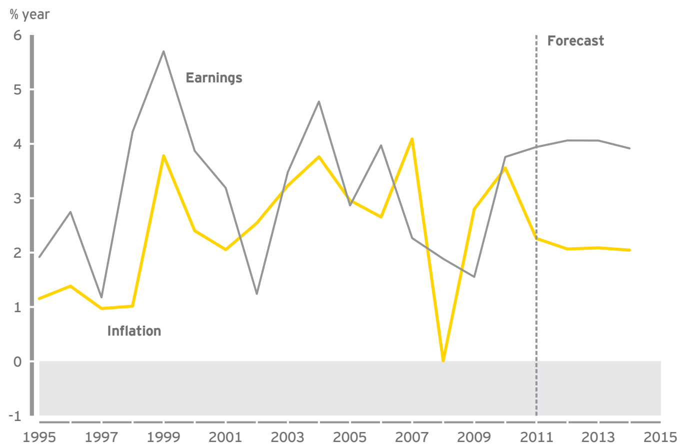
Real GDP and employment



Source: Oxford Economics

Figure 36

Inflation and earnings



Source: Oxford Economics

Table 12

Luxembourg (annual percentage changes unless specified) *Source: Oxford Economics*

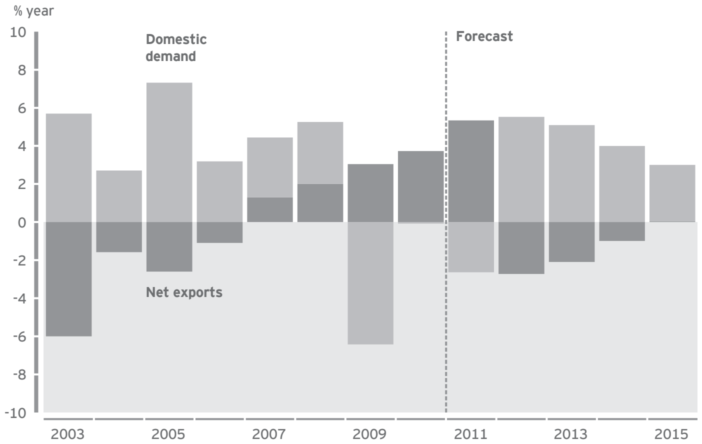
	2010	2011	2012	2013	2014	2015
GDP	3.5	3.9	2.9	3.0	3.0	3.0
Private consumption	2.0	2.4	2.8	3.0	2.8	2.5
Fixed investment	2.6	11.6	6.1	4.4	4.3	3.3
Stockbuilding (% of GDP)	1.6	0.9	0.8	0.5	0.5	0.4
Government consumption	2.9	1.3	2.1	2.0	2.0	1.9
Exports of goods and services	6.3	6.2	5.9	5.7	5.0	4.2
Imports of goods and services	6.7	6.9	6.7	5.9	5.3	4.2
Consumer prices	2.8	3.6	2.3	2.1	2.1	2.0
Unemployment rate (level)	4.5	4.5	4.6	4.5	4.4	4.4
Current account balance (% of GDP)	7.8	6.3	6.4	6.8	7.2	7.3
Government budget (% of GDP)	-1.7	-1.3	-0.5	0.0	0.2	0.2
Government debt (% of GDP)	18.4	18.3	18.0	17.1	16.1	15.0

Malta

- GDP growth reached 3.6%, as financial services returned to growth rates attained before the Eurozone recession, tourism bounced back to record numbers and high added value manufacturing maintained its expansion.
- The growth rate will slow in 2011–12 but remain above the Eurozone average, with the economic base continuing to broaden. Overall, we expect GDP to grow 2.7% in 2011 and 2.8% in 2012.
- Faster revenue growth and a strengthened tax base are reining in the fiscal deficit faster than previously forecast, averting the risk of the Government being forced to cut its pro-growth expenditure on infrastructure and human resources.
- Protracted conflicts in North Africa have severely disrupted trade and investment relationships previously forged there, and accelerated a refugee inflow which could pose inflationary risks.

Figure 37

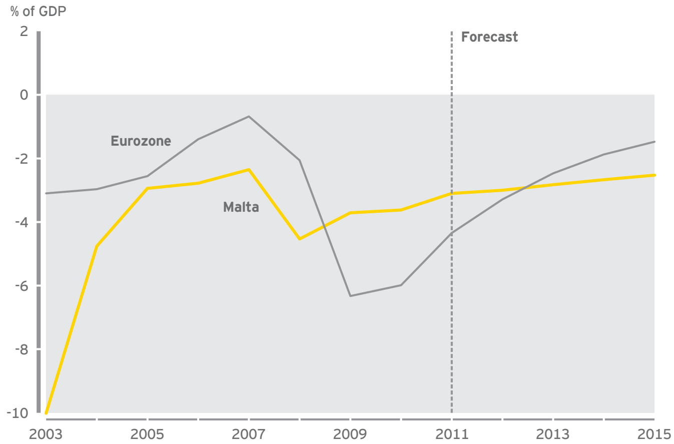
Contributions to GDP



Source: Oxford Economics

Figure 38

Fiscal balance vs. Eurozone



Source: Oxford Economics

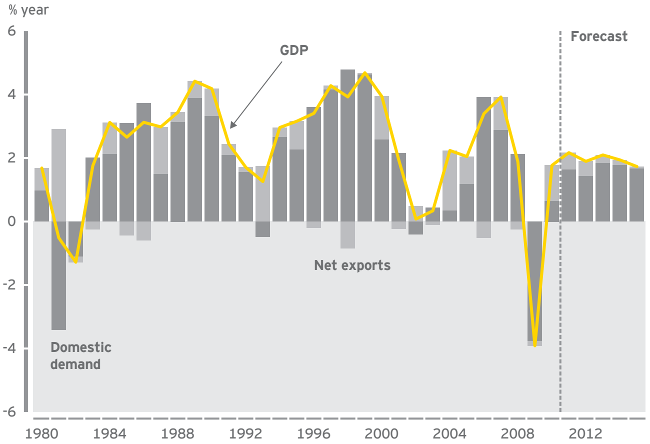
Table 16
Malta (annual percentage changes unless specified)
Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	3.6	2.7	2.8	3.0	3.0	3.0
Private consumption	-0.7	1.5	2.7	3.0	3.0	2.9
Fixed investment	1.8	-12.9	9.0	16.0	8.0	6.0
Stockbuilding (% of GDP)	0.0	-2.0	0.5	1.0	1.4	1.0
Government consumption	0.6	1.5	1.1	3.0	3.0	3.0
Exports of goods and services	17.2	11.0	4.4	3.8	3.0	3.0
Imports of goods and services	12.6	5.6	7.5	6.0	4.0	3.0
Consumer prices	2.0	2.8	2.3	2.3	2.3	2.3
Unemployment rate (level)	6.8	6.3	5.6	5.2	4.4	4.3
Current account balance (% of GDP)	-4.3	-4.2	-3.9	-3.9	-3.8	-3.8
Government budget (% of GDP)	-3.6	-3.1	-3.0	-2.8	-2.7	-2.5
Government debt (% of GDP)	68.0	68.1	67.8	67.1	66.4	65.5

Netherlands

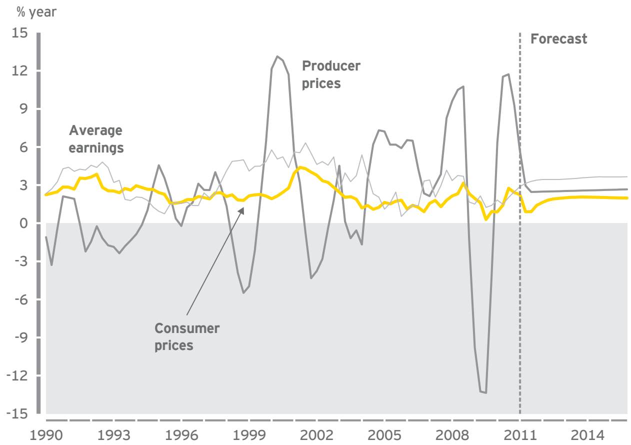
- GDP grew by a surprisingly strong 0.9% in Q1 2011, though this was solely due to exceptional growth in investment, which looks likely to be a one-off. As the global recovery cools, the contribution of net trade is waning and we could see a period of softer growth while the economy rebalances from external- to domestic-led growth. But momentum should build behind the domestic recovery as we move into 2012, and GDP is forecast to grow by 2.2% in 2011 and 1.9% in 2012.
- Though inflation edged up to 2.2% on the EU harmonized measure in April — a two-and-a-half year high — price pressures remain much more muted than in many other Eurozone countries. With recent rises in commodity prices yet to fully feed their way along the supply chain, it seems likely that inflation will hold above 2% for the rest of the year and it could remain high next year if the mooted increase in VAT occurs. But we stay sanguine about underlying inflation, given the amount of slack in the economy and the very low levels of wage growth.

Figure 39
Contributions to GDP growth



Source: Oxford Economics

Figure 40
Prices and earnings



Source: Oxford Economics

Table 6
Netherlands (annual percentage changes unless specified) *Source: Oxford Economics*

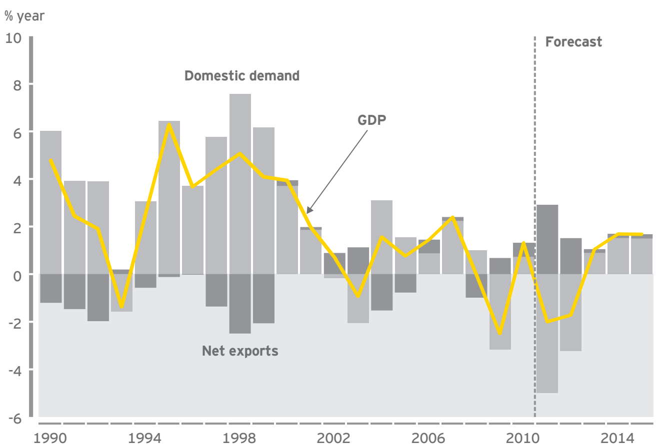
	2010	2011	2012	2013	2014	2015
GDP	1.8	2.2	1.9	2.1	1.9	1.7
Private consumption	0.4	0.7	1.7	1.9	1.9	1.8
Fixed investment	-4.8	5.9	1.9	3.6	3.1	2.8
Stockbuilding (% of GDP)	0.5	0.5	0.6	0.5	0.5	0.4
Government consumption	1.5	0.7	1.1	1.2	1.2	1.2
Exports of goods and services	10.9	4.9	5.9	5.8	5.2	4.1
Imports of goods and services	10.5	4.8	6.0	6.2	5.5	4.4
Consumer prices	0.9	2.2	2.0	2.0	2.0	2.0
Unemployment rate (level)	4.5	4.3	4.3	4.0	3.7	3.7
Current account balance (% of GDP)	7.7	7.1	7.1	7.2	7.1	7.1
Government budget (% of GDP)	-4.5	-4.1	-2.1	-1.0	-0.5	-0.2
Government debt (% of GDP)	63.3	64.8	64.5	62.9	61.0	58.9

Portugal

- Portugal's €78 billion loan from the IMF and EU was finalized on 3 May 2011, with the main goals being to tackle the country's structural problems, strengthen fiscal policy and ensure the stability of the banking sector. Financial assistance is conditional on strict fiscal, structural and financial reforms that are likely to prolong Portugal's economic recession in 2012.
- Indeed, GDP posted a quarterly fall of 0.7% in Q1 2011 and the pace of decline is expected to accelerate over the next few quarters. We have therefore lowered our growth forecast and now expect GDP to fall by 2% in 2011 and 1.7% in 2012 — underpinned by weak domestic demand.
- Significant reforms have been outlined in the bailout package to address Portugal's structural problems and boost competitiveness. This is the key to resolving Portugal's economic troubles, failing which the country faces, at best, low growth for many years to come.

Figure 41

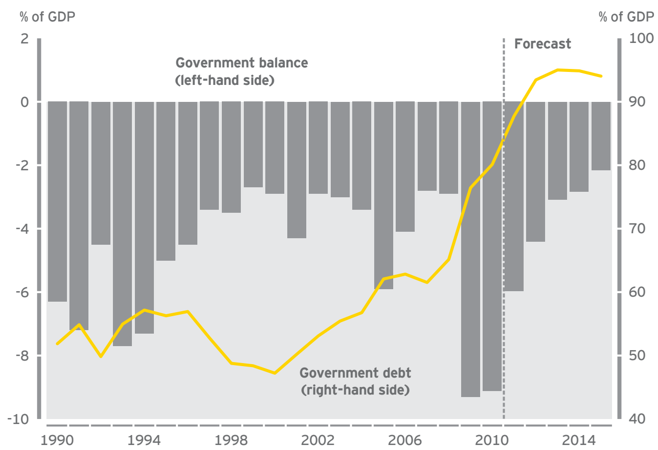
Contributions to GDP growth



Source: Oxford Economics

Figure 42

Government balance and debt



Source: Oxford Economics

Table 10

Portugal (annual percentage changes unless specified)

Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	1.3	-2.0	-1.7	1.0	1.7	1.7
Private consumption	2.3	-4.1	-3.1	0.5	1.3	1.1
Fixed investment	-4.9	-7.1	-5.0	1.3	4.5	4.3
Stockbuilding (% of GDP)	0.0	0.1	0.5	0.8	0.3	0.0
Government consumption	1.2	-6.1	-2.6	-0.6	0.4	1.2
Exports of goods and services	8.8	4.3	3.5	4.8	5.3	4.6
Imports of goods and services	5.1	-5.0	-0.5	3.6	3.8	3.6
Consumer prices	1.4	3.8	1.0	1.5	1.9	2.0
Unemployment rate (level)	11.0	12.9	13.4	13.5	13.2	12.8
Current account balance (% of GDP)	-9.9	-7.0	-6.9	-6.1	-5.5	-5.0
Government budget (% of GDP)	-9.1	-6.0	-4.4	-3.1	-2.8	-2.2
Government debt (% of GDP)	83.4	89.7	95.0	96.1	95.9	94.8

Slovakia

- Growth remained robust at the beginning of 2011, with the economy expanding by 1% in Q1 2011, accelerating slightly compared with the previous quarter.
- However, some signs of a slowdown appeared in recent months, particularly in the key manufacturing sector. As a result, we expect GDP growth to slow to 3.2% this year. Growth should gain momentum in 2012, when it is forecast to be above 4%.
- CPI inflation rose sharply in early 2011, reaching 3.8% in March. Inflation is forecast to average 3.6% for the whole year. However, as the effects of January's VAT hike fade in 2012, we expect inflation to drop to 2.6% in 2012.
- Austerity measures and strong growth are contributing to a reduction of the public deficit. However, we expect the budget balance to fall below 3% of GDP only in 2014.

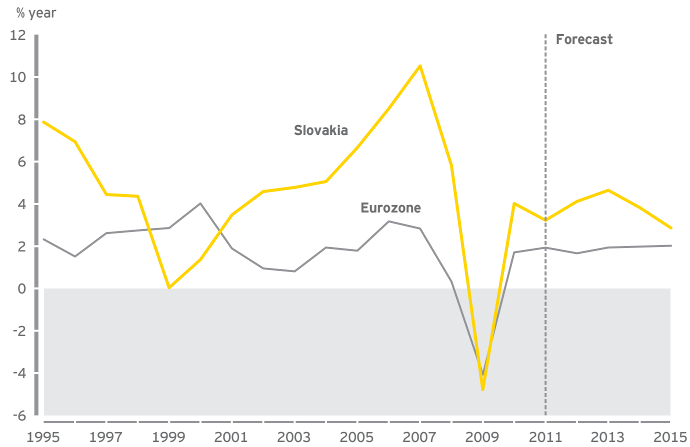
Figure 43

Exports and imports

Source: Haver Analytics

Figure 44

Real GDP growth



Source: Oxford Economics

Table 11

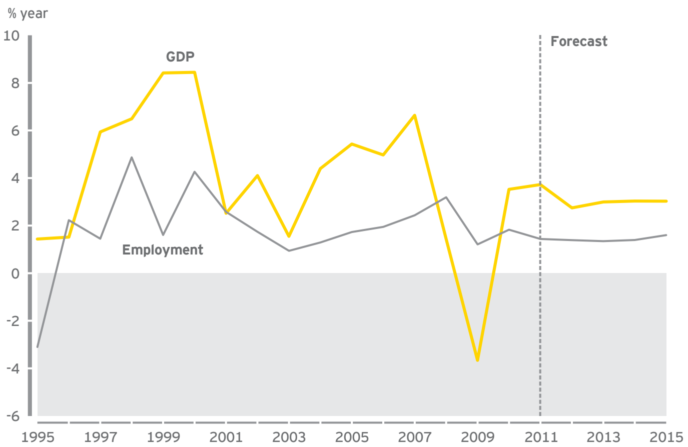
Slovakia (annual percentage changes unless specified) *Source: Oxford Economics*

	2010	2011	2012	2013	2014	2015
GDP	4.0	3.4	4.1	4.4	3.8	2.9
Private consumption	-0.3	0.5	3.3	4.3	4.1	3.8
Fixed investment	3.6	3.8	7.5	6.2	5.9	5.3
Stockbuilding (% of GDP)	-0.2	-0.8	0.1	0.0	0.4	0.5
Government consumption	0.1	-1.8	1.2	3.2	2.6	2.5
Exports of goods and services	16.4	12.9	7.5	8.7	8.3	6.8
Imports of goods and services	14.9	10.2	8.7	9.1	9.5	8.0
Consumer prices	1.0	3.5	2.6	2.5	2.4	2.3
Unemployment rate (level)	14.4	13.7	12.4	11.1	10.3	9.6
Current account balance (% of GDP)	-3.4	-3.0	-3.1	-3.1	-3.1	-2.9
Government budget (% of GDP)	-7.9	-5.3	-4.2	-3.4	-3.0	-2.7
Government debt (% of GDP)	41.0	42.9	43.2	42.6	41.7	41.0

Slovenia

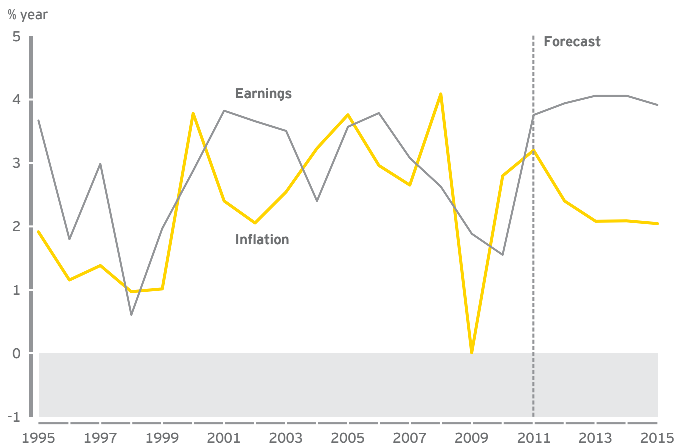
- GDP growth is on track to move above 2% this year, but remains disappointing given the depth of downturn in 2008–09. Initially held back by subdued export markets, expansion has recently been constrained by domestic factors, especially a slow revival in investment.
- Growth remains insufficient to rein in the fiscal deficit, which was estimated at 5.6% of GDP last year and is expected to change little this year. On current projections, there is likely to be a rapid escalation of public debt although, at around 40% of GDP, debt levels remain well below the Eurozone average.
- Inflation has remained below the Eurozone average despite rises in import costs and increasing labor costs. We expect inflation to average 2.2% in 2011 as a whole, as the impact of commodity prices fades later in the year.

Figure 45
Real GDP



Source: Oxford Economics

Figure 46
Inflation and earnings



Source: Oxford Economics

Table 13
Slovenia (annual percentage changes unless specified)
Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	1.1	2.2	2.3	2.4	3.1	3.5
Private consumption	0.5	0.7	1.5	1.8	2.4	2.5
Fixed investment	-6.3	1.2	3.5	5.1	4.6	4.3
Stockbuilding (% of GDP)	0.9	2.3	2.9	3.0	3.1	3.5
Government consumption	0.8	1.0	1.2	1.7	2.0	2.3
Exports of goods and services	7.4	6.1	5.1	5.5	5.6	5.3
Imports of goods and services	6.3	6.2	5.5	5.8	5.4	5.1
Consumer prices	1.8	2.2	1.8	2.5	2.8	2.8
Unemployment rate (level)	7.3	8.0	7.0	6.0	5.1	5.1
Current account balance (% of GDP)	-1.1	-1.1	-0.9	-0.6	0.1	0.3
Government budget (% of GDP)	-5.6	-5.6	-4.7	-3.9	-3.4	-3.2
Government debt (% of GDP)	38.3	42.3	45.3	47.1	47.8	48.2

Spain

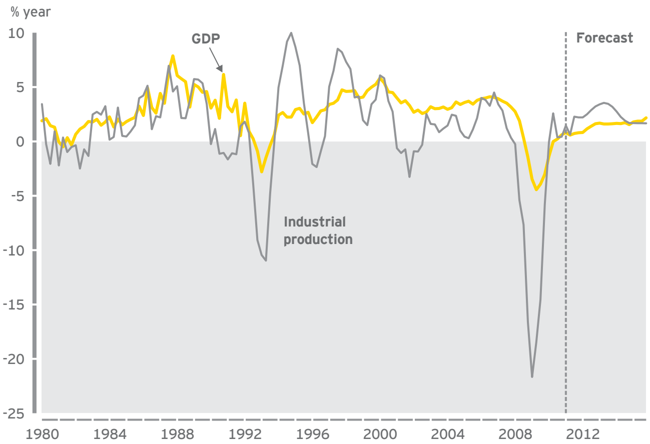
- The economic landscape remains fragile, with a rapid turnaround unlikely amid ongoing fiscal tightening, together with deleveraging in the private sector. We forecast GDP growth of just 0.7% in 2011 as a whole, picking up only modestly to 1.2% in 2012.

- Spain made good progress with its fiscal consolidation last year, cutting the budget deficit by 1.9ppt to 9.2% of GDP. Even more aggressive tightening is planned for 2011. Nevertheless, such achievements are threatened by political uncertainty, the surfacing of more deficits from local governments and slow progress with reforms. We remain cautiously optimistic about the outlook, forecasting a deficit of 6.6% of GDP this year.

- Much of the market's worries about Spain relate to the state of the banking sector and the potential for spillover into public finances. There is a risk that the cost of recapitalizing the regional savings banks (cajas) could prove much higher than the Government expects, which could derail the fiscal consolidation effort.

Figure 47

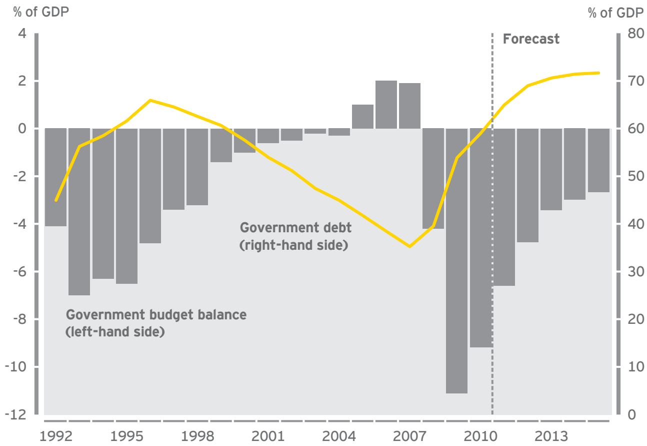
GDP and industrial production



Source: Oxford Economics

Figure 48

Government balance and debt



Source: Oxford Economics

Table 5

Spain (annual percentage changes unless specified) *Source: Oxford Economics*

	2010	2011	2012	2013	2014	2015
GDP	-0.1	0.7	1.2	1.6	1.6	1.9
Private consumption	1.2	0.1	0.6	0.8	0.8	1.1
Fixed investment	-7.6	-4.5	1.6	3.7	4.3	3.9
Stockbuilding (% of GDP)	0.4	0.6	1.0	1.0	1.0	1.1
Government consumption	-0.7	-0.7	-1.4	0.1	1.4	2.3
Exports of goods and services	10.3	10.2	6.0	7.4	6.5	6.6
Imports of goods and services	5.4	4.2	4.4	6.2	6.4	7.0
Consumer prices	2.0	3.3	2.0	1.4	1.5	1.5
Unemployment rate (level)	20.1	20.5	19.9	19.1	18.5	17.6
Current account balance (% of GDP)	-4.5	-4.4	-3.0	-2.8	-2.6	-2.1
Government budget (% of GDP)	-9.2	-6.6	-4.7	-3.4	-3.1	-2.7
Government debt (% of GDP)	62.0	67.4	70.6	71.8	72.6	72.8

Detailed tables and charts

Forecast assumptions

	2010	2011	2012	2013	2014	2015
Short-term interest rates (%)	0.8	1.4	2.4	3.2	3.6	4.0
Long-term interest rates (%)	3.6	4.5	4.8	5.0	5.0	5.0
Euro effective exchange rate (1995 = 100)	120.7	122.4	121.8	119.5	115.2	113.3
Oil prices (€/barrel)	59.9	79.6	79.0	77.3	80.1	84.5
Share prices (% year)	7.1	7.9	7.4	6.2	5.6	5.6

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Short-term interest rates (%)	0.7	0.7	0.9	1.0	1.1	1.4	1.6	1.6
Long-term interest rates (%)	3.7	3.6	3.5	3.8	4.3	4.5	4.6	4.7
Euro effective exchange rate (1995 = 100)	125.6	118.6	118.0	120.4	119.8	123.2	123.4	123.0
Oil prices (€/barrel)	76.2	78.4	76.7	86.6	104.8	118.0	115.0	113.3
Share prices (% year)	41.5	7.1	-4.3	-5.8	-0.7	14.6	9.2	9.6

Eurozone GDP and components

Quarterly forecast
(quarterly percentage changes)

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	0.3	1.0	0.4	0.3	0.8	0.3	0.3	0.4
Private consumption	0.4	0.2	0.2	0.3	0.3	0.1	0.1	0.2
Fixed investment	-0.6	2.2	-0.2	0.0	2.1	-0.5	0.6	0.6
Government consumption	-0.2	0.2	0.2	-0.1	0.8	-0.4	-0.2	0.0
Exports of goods and services	3.5	4.2	1.7	1.7	1.8	1.2	1.2	1.4
Imports of goods and services	3.9	4.0	1.2	1.3	1.9	0.9	1.0	1.2

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

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	0.3	1.0	0.4	0.3	0.8	0.3	0.3	0.4
Private consumption	0.2	0.1	0.1	0.2	0.2	0.0	0.1	0.1
Fixed investment	-0.1	0.4	0.0	0.0	0.4	-0.1	0.1	0.1
Government consumption	0.0	0.0	0.0	0.0	0.2	-0.1	0.0	0.0
Stockbuilding	0.4	0.2	0.1	-0.1	0.0	0.3	0.0	0.0
Exports of goods and services	1.5	1.8	0.8	0.8	0.9	0.6	0.6	0.7
Imports of goods and services	-1.6	-1.7	-0.5	-0.6	-0.8	-0.4	-0.4	-0.5

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

	2010	2011	2012	2013	2014	2015
GDP	7,580	7,728	7,855	8,007	8,165	8,329
Private consumption	4,361	4,400	4,442	4,499	4,564	4,637
Fixed investment	1,465	1,504	1,544	1,601	1,661	1,719
Government consumption	1,614	1,621	1,621	1,630	1,646	1,665
Stockbuilding	14	35	52	67	73	80
Exports of goods and services	3,403	3,642	3,853	4,088	4,327	4,556
Imports of goods and services	3,277	3,474	3,655	3,878	4,106	4,329

Annual levels – nominal terms
(€ billion)

	2010	2011	2012	2013	2014	2015
GDP	9,182	9,481	9,793	10,154	10,536	10,940
Private consumption	5,288	5,481	5,632	5,810	6,002	6,211
Fixed investment	1,745	1,828	1,909	2,014	2,127	2,240
Government consumption	2,012	2,049	2,085	2,137	2,200	2,273
Stockbuilding	14	8	9	13	23	35
Exports of goods and services	3,741	4,181	4,505	4,862	5,236	5,610
Imports of goods and services	3,618	4,066	4,348	4,681	5,052	5,429

Prices and costs indicators

(annual percentage changes unless specified)

	2010	2011	2012	2013	2014	2015
HICP headline inflation	1.6	2.5	1.9	1.8	1.8	1.9
Inflation ex-energy	1.0	1.4	1.8	1.7	1.7	1.7
GDP deflator	0.9	1.3	1.6	1.7	1.8	1.8
Import deflator	6.3	6.1	1.7	1.7	1.7	1.7
Export deflator	10.7	5.1	0.3	0.7	1.3	1.6
Terms of trade	4.4	-1.0	-1.5	-1.0	-0.4	-0.2
Earnings	1.7	1.9	2.4	2.7	2.9	3.1
Unit labor costs	-0.5	-0.9	1.1	1.2	1.3	1.4
Output gap (% of GDP)	-4.1	-2.8	-2.4	-1.8	-1.3	-0.9
Oil prices (€ per barrel)	59.9	79.6	79.0	77.3	80.1	84.5
Euro effective exchange rate (1995=100)	120.7	122.4	121.8	119.5	115.2	113.3

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
HICP headline inflation	1.1	1.5	1.7	2.0	2.4	2.7	2.6	2.4
Inflation ex-energy	0.9	0.9	1.0	1.1	1.3	1.5	1.4	1.5
GDP deflator	0.5	0.9	1.1	1.0	1.2	1.2	1.2	1.6
Import deflator	3.1	5.9	8.2	8.1	8.9	6.4	3.8	5.4
Export deflator	5.3	11.6	13.6	12.5	12.7	5.2	1.1	2.0
Terms of trade	2.2	5.7	5.4	4.4	3.8	-1.3	-2.7	-3.4
Earnings	1.8	2.2	1.6	1.5	2.0	1.5	2.1	1.9
Unit labor costs	-0.5	-0.6	-0.6	-0.2	-2.0	-0.7	-0.9	0.1
Output gap (% of GDP)	-4.9	-4.0	-3.8	-3.7	-3.0	-2.9	-2.8	-2.7
Oil prices (€ per barrel)	76.2	78.4	76.7	86.6	104.8	118.0	115.0	113.3
Euro effective exchange rate (1995=100)	125.6	118.6	118.0	120.4	119.8	123.2	123.4	123.0

Labor market

(annual percentage changes unless specified)

	2010	2011	2012	2013	2014	2015
Employment	-0.4	0.1	0.3	0.4	0.4	0.3
Unemployment rate (%)	10.1	9.8	9.5	9.2	8.8	8.5
NAIRU (%)	8.6	8.9	8.8	8.6	8.4	8.2
Participation rate (%)	73.1	73.0	73.2	73.4	73.6	73.8
Earnings	1.7	1.9	2.4	2.7	2.9	3.1
Unit labor costs	-0.5	-0.9	1.1	1.2	1.3	1.4

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Employment	-1.3	-0.6	-0.1	0.2	0.1	0.0	0.2	0.0
Unemployment rate (%)	10.1	10.2	10.1	10.1	10.0	9.8	9.8	9.7
NAIRU (%)	8.4	8.5	8.6	8.8	8.9	8.9	8.8	8.9
Participation rate (%)	73.0	73.1	73.1	73.1	73.0	73.0	73.1	73.1
Earnings	1.8	2.2	1.6	1.5	2.0	1.5	2.1	1.9
Unit labor costs	-0.5	-0.6	-0.6	-0.2	-2.0	-0.7	-0.9	0.1

Current account and fiscal balance

	2010	2011	2012	2013	2014	2015
Trade balance (€b)	-8.5	-22.2	14.4	39.1	44.1	41.2
Trade balance (% of GDP)	-0.1	-0.3	0.2	0.5	0.5	0.5
Current account balance (€b)	-36.4	-60.6	-30.4	-7.7	-0.8	-1.0
Current account balance (% of GDP)	-0.4	-0.6	-0.3	-0.1	0.0	0.0
Government budget balance (€b)	-550	-406	-316	-247	-196	-161
Government budget balance (% of GDP)	-6.0	-4.3	-3.2	-2.4	-1.9	-1.5
Cyclically adjusted surplus (+)/deficit (-) (% of GDP)	-5.5	-4.0	-2.8	-1.8	-1.2	-0.7
Government debt (€b)	7,837	8,251	8,574	8,828	9,032	9,200
Government debt (% of GDP)	103.4	106.8	109.2	110.3	110.6	110.4

Measures of convergence and divergence within the Eurozone

	2001–2005	2006–2010	2011–2015
Growth and incomes			
Standard deviation of GDP growth rates	1.9	2.3	1.2
Growth rate gap (max–min)	6.6	8.9	4.7
Highest GDP per capita (Eurozone = 100)	234.0	247.6	251.9
Lowest GDP per capita (Eurozone = 100)	51.0	64.9	66.4
Inflation and prices			
Standard deviation of inflation rates	1.5	1.0	0.5
Inflation rate gap (max–min)	6.1	4.0	2.0
Highest price level (Eurozone = 100)	116.3	116.2	116.2
Lowest price level (Eurozone = 100)	46.6	61.6	65.9

Cross-country tables

Real GDP
(% year)

Rank		2010	2011	2012	2013	2014	2015	Average 2011-2015
1	Estonia	3.1	5.0	4.6	4.8	4.8	4.7	**4.8**
2	Slovakia	4.0	3.4	4.1	4.4	3.8	2.9	**3.7**
3	Luxembourg	3.5	3.9	2.9	3.0	3.0	3.0	**3.2**
4	Finland	3.2	4.1	2.9	3.0	2.8	2.8	**3.1**
5	Malta	3.6	2.7	2.8	3.0	3.0	3.0	**2.9**
6	Cyprus	1.0	1.3	2.5	3.8	3.4	3.4	**2.9**
7	Slovenia	1.1	2.2	2.3	2.4	3.1	3.5	**2.7**
8	Germany	3.5	3.5	1.9	2.1	2.1	2.0	**2.3**
9	Austria	2.2	2.9	2.0	2.2	2.1	2.0	**2.2**
10	Belgium	2.1	2.4	2.0	2.4	2.2	2.0	**2.2**
11	France	1.4	2.2	1.9	2.0	2.0	2.0	**2.0**
12	Netherlands	1.8	2.2	1.9	2.1	1.9	1.7	**2.0**
13	Eurozone	1.7	2.0	1.6	1.9	2.0	2.0	**1.9**
14	Ireland	-1.0	-2.3	1.1	2.6	3.4	4.7	**1.9**
15	Spain	-0.1	0.7	1.2	1.6	1.6	1.9	**1.4**
16	Italy	1.2	0.9	1.3	1.2	1.4	1.8	**1.3**
17	Portugal	1.3	-2.0	-1.7	1.0	1.7	1.7	**0.1**
18	Greece	-4.4	-4.8	-1.2	1.7	1.9	1.9	**-0.1**

Inflation rates
(% year)

Rank		2010	2011	2012	2013	2014	2015	Average 2011-2015
1	Ireland	-1.6	1.3	0.8	0.6	1.0	1.7	**1.1**
2	Greece	4.7	2.8	0.7	1.0	1.2	1.7	**1.5**
3	Germany	1.2	2.3	1.8	1.8	1.8	1.8	**1.9**
4	France	1.7	2.2	1.9	1.8	1.9	1.9	**1.9**
5	Spain	2.0	3.3	2.0	1.4	1.5	1.5	**1.9**
6	Eurozone	1.6	2.5	1.9	1.8	1.8	1.9	**2.0**
7	Finland	1.7	3.2	1.8	1.8	1.7	1.7	**2.0**
8	Netherlands	0.9	2.2	2.0	2.0	2.0	2.0	**2.0**
9	Portugal	1.4	3.8	1.0	1.5	1.9	2.0	**2.0**
10	Italy	1.6	2.5	2.2	2.1	2.1	2.0	**2.2**
11	Belgium	2.4	3.3	1.9	2.0	2.0	1.9	**2.2**
12	Austria	1.7	3.2	2.2	2.1	2.0	2.0	**2.3**
13	Luxembourg	2.8	3.6	2.3	2.1	2.1	2.0	**2.4**
14	Malta	2.0	2.8	2.3	2.3	2.3	2.3	**2.4**
15	Slovenia	1.8	2.2	1.8	2.5	2.8	2.8	**2.4**
16	Cyprus	2.6	3.7	2.2	2.3	2.3	2.3	**2.5**
17	Slovakia	1.0	3.5	2.6	2.5	2.4	2.3	**2.7**
18	Estonia	3.0	4.5	2.6	2.3	2.1	2.2	**2.7**

Cross-country tables

Unemployment rate
(% of labor force)

Rank		2010	2011	2012	2013	2014	2015	Average 2011-2015
1	Netherlands	4.5	4.3	4.3	4.0	3.7	3.7	**4.0**
2	Austria	4.4	4.4	4.4	4.4	4.4	4.4	**4.4**
3	Luxembourg	4.5	4.5	4.6	4.5	4.4	4.4	**4.5**
4	Malta	6.8	6.3	5.6	5.2	4.4	4.3	**5.2**
5	Germany	7.1	6.0	5.8	5.6	5.3	5.2	**5.6**
6	Cyprus	6.6	7.7	6.8	6.0	5.0	4.5	**6.0**
5	Slovenia	7.3	8.0	7.0	6.0	5.1	5.1	**6.2**
8	Belgium	8.3	7.5	7.0	6.6	6.4	6.4	**6.8**
9	Finland	8.4	8.0	7.5	7.2	7.0	6.9	**7.3**
10	Italy	8.5	8.1	8.0	7.7	7.5	7.2	**7.7**
11	France	9.8	9.3	8.7	8.2	7.8	7.5	**8.3**
12	Eurozone	10.1	9.8	9.5	9.2	8.8	8.5	**9.2**
13	Estonia	16.7	13.7	11.1	9.0	7.3	6.0	**9.4**
14	Slovakia	14.4	13.7	12.4	11.1	10.3	9.6	**11.4**
15	Portugal	11.0	12.9	13.4	13.5	13.2	12.8	**13.2**
16	Ireland	13.7	15.7	15.1	14.3	13.8	13.1	**14.4**
17	Greece	12.6	15.4	15.9	15.9	15.5	14.9	**15.6**
18	Spain	20.1	20.5	19.9	19.1	18.5	17.6	**19.1**

Government budget
(% of GDP)

Rank		2010	2011	2012	2013	2014	2015	Average 2011-2015
1	Estonia	0.1	-0.5	-2.8	-0.7	-0.2	0.0	**-0.1**
2	Malta	-3.6	-3.1	-3.0	-2.8	-2.7	-2.5	**1.1**
3	Austria	-4.1	-3.6	-3.0	-2.6	-2.3	-2.1	**1.9**
4	Luxembourg	-1.7	-1.3	-0.5	0.0	0.2	0.2	**1.9**
5	Finland	-2.5	-1.4	-1.1	-0.8	-0.6	-0.3	**2.2**
6	Slovenia	-5.6	-5.6	-4.7	-3.9	-3.4	-3.2	**2.4**
7	Cyprus	-5.3	-4.9	-4.2	-3.3	-2.8	-2.8	**2.5**
8	Germany	-3.3	-2.3	-1.5	-1.1	-0.7	-0.4	**2.9**
9	Italy	-4.6	-4.1	-3.3	-2.7	-2.1	-1.5	**3.1**
10	Belgium	-4.1	-3.0	-2.5	-1.8	-0.7	0.0	**4.1**
11	Netherlands	-4.5	-4.1	-2.1	-1.0	-0.5	-0.2	**4.3**
12	France	-7.0	-6.0	-4.9	-3.8	-3.0	-2.7	**4.3**
13	Eurozone	-6.0	-4.3	-3.2	-2.4	-1.9	-1.5	**4.5**
14	Slovakia	-7.9	-5.3	-4.2	-3.4	-3.0	-2.7	**5.2**
15	Spain	-9.2	-6.6	-4.7	-3.4	-3.1	-2.7	**6.5**
16	Greece	-10.5	-8.0	-7.1	-5.1	-3.8	-3.6	**6.9**
17	Portugal	-9.1	-6.0	-4.4	-3.1	-2.8	-2.2	**7.0**
18	Ireland	-32.4	-9.6	-8.0	-5.7	-3.5	-2.0	**30.4**

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