Eurozone

Ernst & Young Eurozone Forecast

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Welcome

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We launched the *Ernst & Young Eurozone Forecast* last year as a tool to help business manage their operations across the world's largest single market as well as consider the implications of the Eurozone on the broader global economy. Looking back to my comments in the winter of 2010, I open with, "Our last forecast was gloomy and this winter forecast confirms our sceptical outlook." I am afraid that as we report now, our view remains one of concern for the prospects of the Eurozone. While the sovereign debt challenges have been with us for a considerable time, what has become more apparent is the deterioration in some of the most challenged countries. This "deterioration" is as much a reference to the economic outlook as it is to the reaction of citizens to deficit reduction activities and their views about their own future and their perceptions of fairness. Clearly the two are linked and can feed off each other in a downward destructive fashion. Alongside this we see weakening business and consumer confidence which is negatively impacting investment, employment and ultimately demand. The consequence for most business is a weakening earnings outlook.

European banks have enormous current exposure to sovereign debt of the so-called "peripheral states." This exposure can only curtail their lending activity as they seek to strengthen their balance sheets for what might be ahead. What is often forgotten in considering the consequences thereof, is that in the years leading up to the crisis, capital was plentiful, cheap and readily accessible. So we have moved from copious lending to curtailed lending effectively removing one of the drivers of Economic activity and growth.

The final element I would highlight from the last few months has been the inability of our governments to reach a consensus on appropriate action or to develop a plan which provides a level of comfort to financial markets. This should come as no surprise as the dilemma we face is extremely complex and any solution proposed will have severe short-term consequences for the voting public across the Eurozone.

Once again we find ourselves asking whether the Eurozone is heading back into recession and indeed whether the current Eurozone construct will survive. As growth nearly stalled during the summer and global economic developments, both in the US and in some of the rapid growth markets such as China and India, now look less favorable, we are revising our forecast downward. This year, we expect Eurozone GDP growth to average only 1.6%, and in 2012, we are seeing growth struggling around only 1%. We don't yet forecast a recession but, with risks to this forecast heavily weighted to the downside, we estimate that there is a 35% probability that the Eurozone will plunge back into recession next year with negative consequences for many non-euro markets.

The discussion of the euro, however, has moved beyond economic and business considerations to an increasingly political discussion of its very future. Will Greece or Ireland or Portugal have to leave? What are the prospects for Italy or Spain? Will the richer member states – and more particularly their

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electorates — continue to fund costly support? Are the member states of the Eurozone prepared to take further steps toward economic integration in order to provide the robust governance framework that any currency needs?

We are not privy to all the political discussions and recognize that the situation is very uncertain, but we do not believe that a breakup will result. We estimate that there is only a 5% probability that it will happen, because the consequence for business and the wider economy would be huge.

The structural weaknesses in the governance of the currency area should not distract from the fundamental purpose of the single currency. Faced with intensifying global competition, the leaders of Europe sought to create a "single market" to give European business the scale of local market that their American, Chinese and now Indian competitors take for granted. The single currency sought to reduce the cost of doing business across borders in Europe, to increase the degree of transparency for consumers and to drive the process of structural change across the European economy.

The competitive challenges facing European business continue to increase, and it is hard to see how reintroducing 17 national currencies would help them to win. Would the people of Europe be more prosperous if their local currencies were racing each other to devalue? Would the sovereign debt discussion that challenges even the US economy be better addressed by the drachma, the lire or the punt? From a business perspective, I believe that we must not give up on the idea of a common currency area before the structure required for its future is fully in place.

So far, political will to solve this crisis has been lacking, as governments calculate the implications for their national electorates. Even after a set of measures agreed in late July between Greece and the Eurozone governments, we question the sustainability of Greece's public finances. The possibility of a disorderly default that would cause severe stress in other peripheral countries remains high. With very large exposure of banks in the core of the Eurozone to these peripheral countries, contagion to the Eurozone as a whole could be very rapid and significant. Governments would need to shore up their countries' banks, highlighting once again this tight link between public and banking sector crises. In such a scenario, even our central forecast of modest growth would prove too optimistic. The Eurozone would plunge back into recession, with investment and recruitment plans significantly delayed.

The current development within the banking sector is affecting business by a general tightening of credit to enterprises. But even those many companies with significant cash reserves seem hesitant to commit to increasing staff levels and investment spending, as uncertainty about the economic outlook remains high. Instead, businesses prefer to focus on deleveraging in order to be in a stronger position to benefit from the upturn, as and when it becomes more established, and to weather a possible downturn better.

Trying to formulate an adequate strategy to solve the crisis is an enormous challenge for decision-makers at all levels, in all fields. It is clear that fiscal austerity on its own is not enough; we need structural reforms to stimulate the economy in the medium term. And, given the time lag in such reforms bearing fruit, we need them now. Increased privatization and liberalization of labor markets is necessary in the peripheral Eurozone countries. There is also an urgent need for continued focus on creating a true common market in the EU and a strong innovation policy, including pan-European investments in academic education and research.

My advice to business remains the same as in our last forecast. Focus on internal performance and go where the customers are. Closely follow developments in your market and keep the organization agile to respond quickly to rapidly changing conditions as well as regulatory changes. And, be proactive in seeking new markets and creating an innovative environment internally opening up for new ideas.

The current situation underlines the need for a mutual understanding and knowledge-sharing between the business community and policy-makers. The business community must engage in the public discussion about the future of the Eurozone, and governments must be aware of the implications that policy-making has on economic growth.

The need for a debate between business and policy-makers extends beyond the Eurozone, which is why we will launch our first *Rapid-growth markets forecast* in October 2011. In this new quarterly forecast, we will give a macroeconomic overview of the 25 fastest-growing countries in the world to enable business leaders to keep abreast of the opportunities these markets present.

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.

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Eurozone handicapped by weak growth as its survival is threatened by the sovereign debt crisis

There is little comfort for businesses in the autumn 2011 *Ernst & Young Eurozone Forecast*. However, some positivity remains around expectations that growth in 2011 ought to remain above the line, despite it only reaching 1.6% rather than the 2.0% indicated in our summer forecast.

Prospects for 2012 are, unfortunately, markedly worse (projected growth of 1.1%), but Ernst & Young is currently sticking to its view of a 2% rise in output for both 2013 and 2014. Nevertheless, growth in developed economies globally is increasingly hard to come by, not least in Europe and the United States. The apparent recovery since the 2008–09 financial crises has been more short-lived than many hoped and expected. Output in the Eurozone is still around 30% short of 2007 levels.

Perplexity and risk aversion will be the most powerful reactions in many boardrooms to the economic outlook. Investment allocations are likely to be very cautious, with many companies looking to internal reorganization and cost cutting along the value chain to sustain and improve profitability. Industries with strong order books, notably aerospace, will continue to surf these troubled waters with relative ease, while the continuous process of upgrading to exploit evolving intellectual property and internet-related technologies should keep companies in the internet space operating at high levels. There is likely to be less enthusiasm among executives in the renewables sector, where governments are cutting back on incentives. Other sectors dependent on public support and procurement will also feel the pinch. Pulp and paper companies may struggle against a falling demand for their products across a broad front.

Companies will also have to grapple with the impacts of political change and uncertainty, such as next year's presidential elections in France, the November election in Spain, as well as the turmoil and domestic critism in Italy and Germany.

Falling interest rates as demand weakens

Our report foresees a benign interest rate environment for the next 12 months, with rates on hold well into 2012. With inflation forecast to fall below the European Central Bank's 2% target in 2012, the ECB is expected to reverse the move to higher rates it led in April and July. In early September, Jean-Claude Trichet, the ECB Chairman, confirmed a probable change of direction.

These, however, seem to be the only upsides. Households' disposable incomes are expected to fall this year and to level out in 2012, while consumer demand is expected to be static and unemployment to stay high at around 10%. Overall domestic demand will rise by less than 1% in 2011 and 2012 while growth in business investment will be limited to 2%. The OECD forecasts of early autumn were very much in line with our report.

The Ernst & Young analysis sides with those who believe that, overall, the Eurozone countries' commitment to austerity policies is too severe, and that those countries with more margin of maneuver on budget deficits and national debt (principally the core Eurozone) should put more emphasis on borrowing and spending to create positive spillover benefits across the single currency area.

The evident flattening of German growth in the second quarter of this year is substantially dampening expectations. The US, where growth is also weakening, and the emerging economies, where it remains strong, are, with European Union (EU) markets, important sources of demand for German exports. Exports are expected to contribute three percentage points to Eurozone GDP. Any slackening of export performance will have spillover effects for the Eurozone.

Moreover, the pattern of growth is very uneven because of major divergences in the Eurozone economy. The forecasts for the core Eurozone (Austria, Belgium, France, Finland, Germany, Netherlands and Slovakia) point to growth rates of around 2% a year until 2015, although Germany will fall from 3% to 1.4% next year. But annual GDP growth in the peripheral countries is unlikely to be above 1.2% in the same period. In 2011 and 2012, output will either fall back (Greece -5% in 2011 and -1% in 2012; Portugal -2% in both years) or tread water (Ireland -1% this year and +0.9% next year; Spain +0.6% and +0.9%; Italy +0.7% and +0.4%).

Implications for the financial sector

Real threats to the stability of the banking system

A successful resolution of the Eurozone debt crisis is of paramount importance for global business. A Spanish or Italian default could easily trigger a major European banking crisis, with fearsome implications for the global economy because of the volumes of sovereign debt that leading European banks are currently holding. Doubts are already running high about the solidity of many banks, despite the clean bill of health they were given following the stress tests conducted earlier this year by the European Banking Authority (EBA). Only nine out of the 91 tested failed for lack of sufficient capital, but the EBA tests did not model a stressed scenario that included a sovereign default. Although the public release of data as part of the stress-testing process has enabled the market to conduct its own analysis, the tests did not sufficiently prove that those of the 91 banks who are more exposed to sovereign debt will be able to weather the worst-case scenario.

The ongoing uncertainty over potential defaults within the Eurozone, and the impact that would have on banks within the region — whether through exposure to that country's sovereign debt or its banks — has caused considerable debate over whether banks' capital or liquidity ratios need yet more strengthening. By early autumn 2011, concern over the liquidity of Eurozone banks had intensified and overnight funds deposited with the ECB reached a 12-month high in the first weekend of September. Funding costs for banks are rising and there is evidence that some are starting to tighten credit strings. Meanwhile, spreads on bank credit, the premium over benchmark interest rates, demanded by investors to hold the debt, have widened in recent months, indicating buyer nervousness.

European political uncertainty and the ongoing macroeconomic challenges across the region are both factors that are beyond the control of the banks but affect their revenue pipeline, as well as their outlook. As a consequence, banks have turned their attention to the opportunities within their own business models, focusing on restructuring, cost control and preparing for new regulations, and as a result, many are not able to devote as much resource to growing their revenues as they had previously.

Downside risks are formidable

This adds up to a highly challenging outlook for corporates burdened by an enormous weight of uncertainty. Our report is clear that the risks to these forecasts are all on the downside. Instability in the financial markets and serious weaknesses in the Eurozone banking system allied to, and fed by, the sovereign debt crisis, could severely prejudice the outlook and turn modest growth into recession.

As it is, there are real obstacles to recovery in the peripheral economies now being propped up by EU and International Monetary Fund (IMF) rescue programs (Portugal, Ireland and Greece). They cannot pay off their debts and regain access to financial markets without faster growth, based on much sharper competitiveness. The core recipe for them, and for others in the periphery, is fundamental reform of labor market structures, radical cuts in government spending, privatizations and pension reforms.

The most perilous development in the last few months is the shift in focus of investors' concerns towards Spain and Italy. Both countries' debt issues have to deal with unprecedented yield spreads above benchmark 10-year German Bunds. Continued widening of these differentials would eventually shut them out of the markets. Controversially, the ECB has been purchasing both countries' bonds in an effort to prevent yields going sky high.

Italy and Spain need to refinance €1.5 trillion of debt over the next five years. If the markets are closed to them, the European Financial Stability Facility (EFSF) currently sustaining the three bailout programs would require far more resources than the €440 billion the Eurozone partners are currently committed to allocating. Our forecast estimates that something like seven times that amount would be needed.

At the urgent request of the ECB, both Madrid and Rome have been trying to win back the confidence of financial markets through new structural reforms and austerity budgets aiming at sharply curbing deficits by 2013. Spain has adopted a constitutional amendment to entrench budgetary stability, and Italy says it will do the same. Though unlikely to be very effective in practice, embarking on such changes would respond to an appeal from France and Germany.

Risk aversion is prevailing in corporate boardrooms

The growing fragility of the economic context and awareness that governments will not yet embrace radical solutions to the debt crisis, such as issuing jointly guaranteed eurobonds and greatly expanding EFSF funds, is making corporate boardrooms a great deal more cautious. This is affecting risk assessment and a range of decisions including investment allocations. Our forecast expects no more than a mild 1.5%–2% growth in Eurozone investment next year, which will not provide a real springboard for cutting the 10% unemployment rate and reviving consumer confidence. Business investment is not expected to return to pre-crisis levels until 2014.

Looking at a variety of business sectors, our forecast is reasonably cheerful about the outlook for manufacturing and business services, the former because of buoyant emerging markets and the latter because of Europe's specialization of skills in financial services. Elsewhere, the outlook is grimmer, with consumer-based sectors, such as distribution, hotels and restaurants, held back by falling real wages and disposable incomes. Construction will remain lifeless because of the lack of recovery of the housing sector in many countries.

Yet it appears that companies are sitting on large reserves of cash. If the political, economic and financial outlooks for the next few months were more positive, companies may be more committed to productive investment in the Eurozone. Instead, emerging markets will surely be given more attention. Diversifying investment alone will rarely be an adequate strategy for sustaining profitability, but for some companies, it will be an important bet on the future.

Handing money back to shareholders will be the preferred method of increasing earnings per share for some boardrooms. They will be prepared to live with criticism that they lack strategic vision and should be positioning for the upturn when it arrives. However, if financial turbulence worsens and corporate financing becomes even more difficult, those that have maintained strong cash reserves may enjoy an important advantage. There is a great deal hanging on an early and successful outcome to the sovereign debt crisis.

Key drivers for competitive advantage

Since 2008, we have studied how successful companies respond to a greater variation in market performance, sharper market volatility, ceaseless pressure on margins, and demanding stakeholders and how they prepare themselves for the increasingly interconnected — and interdependent — global economy.

In our latest report, *Competing for growth: how business is growing beyond boundaries*, we examine the key drivers on which high-performing companies are focusing for competitive advantage. For example:

- **Customer reach.** Effective account management has a strong impact on the product development process, and part of the process of maximizing the return on existing accounts is introducing a broader range of products and services to those accounts.
- **Operational agility.** Focusing on existing customers' requirements and speeding up the product development process is the characteristic of high performers. The speed is driven by an inclusive company-wide innovation process that focuses on people, a clear set of criteria for determinating good ideas and a structured process for product development "from thought to finish."
- **Cost competitiveness.** High-performing companies are much more in control of their pricing than low performers. They see price as the starting point for their consideration of cost, rather than the other way around.
- **Stakeholder confidence.** High-performing companies are reporting more extensively than low performers. This is particularly evident in the extent of the information they provide to external stakeholders.

Learn more on www.ey.com/competing-for-growth

Highlights

- The Eurozone sovereign debt crisis shows no sign of abating. A default on Greek government debt now seems unavoidable. The key question is when this default will occur and how it will be managed. Our baseline forecast assumes that Eurozone governments will prepare this default in order to keep it controlled.

- The combination of rising financial tensions, a near stalling of growth over the summer and a less favorable international environment than previously anticipated has led us to revise our forecast again. We now expect GDP growth to fall to just 1.1% in 2012 from 1.6% in 2011. In addition, risks are even more strongly weighted on the downside, with a probability of 35% that the Eurozone returns to recession.

- Our baseline forecast still assumes that the combination of measures aimed at an orderly restructuring for Greece and additional resources for other troubled countries will help growth stay positive, albeit low. But with no political appetite for significant reforms of Eurozone institutions, financial markets are likely to remain volatile for some time. And with tensions having moved to Spain and Italy since July 2011, there is a real danger that events will overtake policy-makers: we now estimate that there is a 5% probability that the Eurozone will not survive in its current form.

- Faced with this worsening scenario, it is increasingly important that policy-makers in all countries display greater urgency and greater commitment toward the kind of reforms needed to ward off the fiscal and debt crises. In the absence of more comprehensive packages for Greece and the other troubled countries, a vastly expanded funding for the European Financial Stability Fund (EFSF), and the introduction of jointly and severally guaranteed Eurobonds, the list of countries at risk already encompasses Italy and Spain, and could spread wider still.

- Reliance upon further rounds of austerity to reduce deficits will be self-defeating — much deeper reforms, including labor market liberalization and faster privatization, are needed if the peripheral economies are to escape their unsustainable debt burdens and regain investor confidence. But the benefits of such reforms will inevitably take time to be realized. To create that time, countries such as Germany will have to accept some loss of fiscal sovereignty, something that continues to meet with great political opposition.

- Funding costs for banks are on the rise and credit conditions surveys suggest this may be spilling over into a general tightening of credit to enterprises. Combined with low and uncertain growth prospects, this means that investment plans are likely to be postponed. Consumers are expected to be equally cautious, as incomes are hit by fiscal measures and high unemployment, which is set to remain close to 10% across the Eurozone as a whole for some time. The Eurozone is therefore more dependent than ever on exports to drive growth, with exports set to contribute around two to three percentage points (ppt) to overall GDP growth both in 2011 and 2012.

- Given the gloomy and still polarized economic prospects, the European Central Bank (ECB) faces an increasingly difficult challenge. Having raised interest rates in April and July 2011 in response to above-target inflation, the ECB had flagged further increases in rates for the second half of 2011. But at its press conference on 8 September, the ECB signaled a significant change of views. We now expect it to cut interest rates later this year and again in early 2012. We welcome this change and believe the ECB should lower interest rates to below 1%, should the Eurozone fall back into recession.

Is the Eurozone heading back into recession?

Financial market volatility deepens the crisis faced by the Eurozone ...

Despite the new rescue deal for Greece agreed by the European authorities at the end of July 2011, and which also extended more favorable terms to Ireland and Portugal, the Eurozone is now caught up in a new wave of sovereign debt fears. With market concerns shifting to Italy and Spain, both of whose economies (and debt levels) are much larger than the combined economies (and debt) of Greece, Ireland and Portugal, the threat from the crisis spreading from the smaller peripheral countries to the larger Eurozone economies has risen sharply.

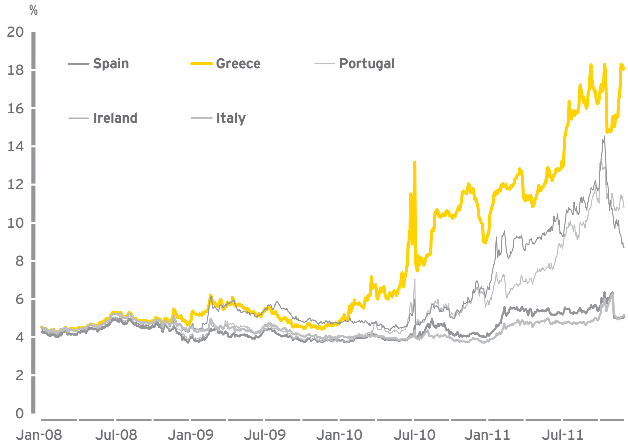
The perceived potential implications of this deepening crisis and sharply slower Eurozone GDP growth in Q2, coupled with mounting concern about the US economy and its rating downgrade, have added significantly to financial market volatility, causing stock markets to slide. This, in turn, has compounded concerns about the health of the banks, notwithstanding the apparently favorable results of the EU-wide stress tests announced in July.

... despite a new package for Greece

The Eurozone authorities have been slow in trying to tackle the problems facing Greece, Ireland and Portugal, with lengthy delays in responding to developments adding to market nervousness. But it was hoped that the rescue package for Greece announced on 21 July 2011 would bring to an end the long period of indecision and uncertainty. Importantly, the new deal for Greece — which also offered concessions for Ireland and Portugal — included private sector participation for the first time.

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	1.6	1.1	1.9	2.0	2.0
Private consumption	0.8	0.5	0.7	1.3	1.5	1.6
Fixed investment	-1.0	2.3	1.8	3.7	4.0	3.6
Stockbuilding (% of GDP)	0.6	0.6	0.5	0.7	0.7	0.8
Government consumption	0.5	0.3	-0.2	0.5	0.9	1.1
Exports of goods and services	10.6	6.4	4.6	6.0	5.9	5.3
Imports of goods and services	8.9	4.8	3.7	6.0	5.9	5.4
Consumer prices	1.6	2.6	1.8	1.8	1.8	1.8
Unemployment rate (level)	10.1	10.0	9.9	9.6	9.2	8.9
Current balance (% of GDP)	-0.5	-0.8	-0.5	-0.3	-0.3	-0.3
Government budget (% of GDP)	-6.0	-4.2	-3.1	-2.3	-1.8	-1.4
Government debt (% of GDP)	85.5	86.9	88.0	87.9	87.8	87.6
ECB main refinancing rate (%)	1.0	1.3	1.2	2.6	3.5	3.9
Euro effective exchange rate (1995 = 100)	120.7	121.1	120.4	119.4	115.4	113.5
Euro/US dollar exchange rate ($ per €)	1.33	1.41	1.38	1.33	1.27	1.24

But while this deal offered some cash flow relief to all three countries, the measures have been criticized for concentrating too much on liquidity and not enough on solvency. The Greek debt swap has put the country into selective default but is modest in scale. Moreover projections for the debt ratio to stabilize at around 155% of GDP, an unsustainably high level unless investor confidence returns, still rely too heavily on optimistic privatization plans. In addition, the Greek economy may well prove to be weaker than officially expected, thus undermining tax revenue assumptions. The Greek Government is also facing strong pressure from public opinion and the trade unions. We can expect the civil unrest to accelerate due to the latest proposals from the Greek Government on increased taxes, decreased pensions and salaries. This will increase the political instability and will cause great difficulties for the Government to collect taxes and stimulate the economy. Overall, the July package now seems insufficient to avoid a second, deeper debt swap, probably involving a reduction in the market value of securities of around 50% or more on Greek government debt. The key question is when this default will occur and how it will be managed. Our baseline forecast assumes that Eurozone governments will prepare this default in order to keep it controlled.

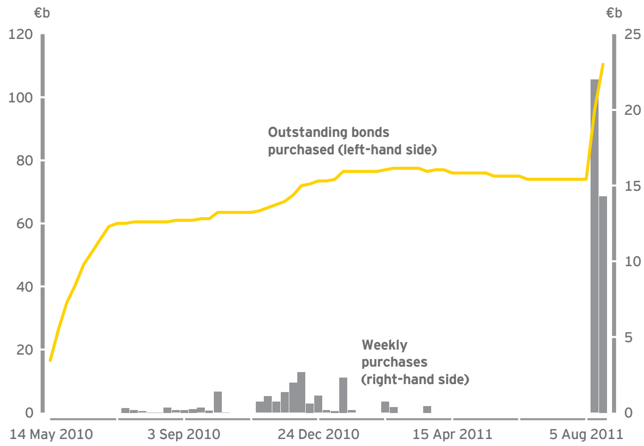
Financial stress to remain high …

Eurozone policy-making remains hesitant and beset by disagreements. The political barriers to introducing jointly and severally guaranteed Eurobonds look formidable, and even a large increase in the size of the EFSF — to give it the firepower to stabilize bond markets in the peripheral countries — has not been agreed. Some countries appear reluctant to go along with the limited deal agreed in July 2011, let alone with what appears to be an increasingly pressing need for vastly expanded EFSF resources to allay concerns about the problems spreading to Italy and Spain.

The ECB has tried to fill the gap created by the failure to increase the size of the EFSF by stepping up its bond purchases. In the week beginning 12 August 2011, it bought €22 billion of Eurozone bonds, compared with a previous maximum weekly amount of €2.7 billion since it started this program in May 2010. In the following two weeks, the ECB bought another €21 billion of Eurozone government bonds. But it is unclear how long this process will continue given questions about the size of the ECB balance sheet, the extent of asset risk being taken and the capacity for and cost of sterilization (i.e., offsetting these bond purchases by selling other kinds of paper in order not to increase money supply). The ECB's move is probably no more than a stopgap measure — Italian and Spanish debt, at around €2.3 trillion, is larger than the ECB's total balance sheet. And in the next five years, the two countries need to refinance around €1.5 trillion of that debt, compared with around €400 billion for Greece, Portugal and Spain.

Figure 2

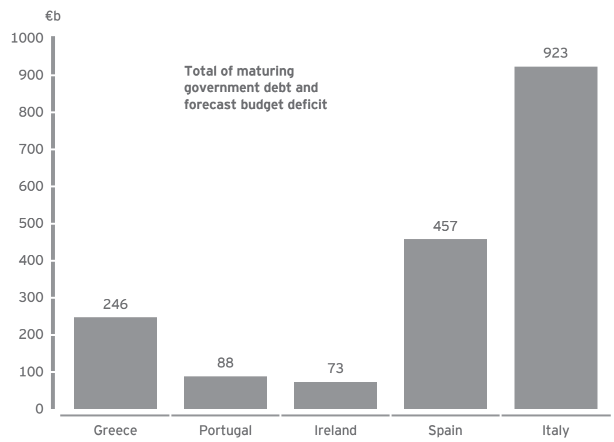
ECB bond purchases



Source: Oxford Economics, Haver Analytics

Figure 3

Financing needs 2011-15



Source: Oxford Economics

… as authorities are slow to react

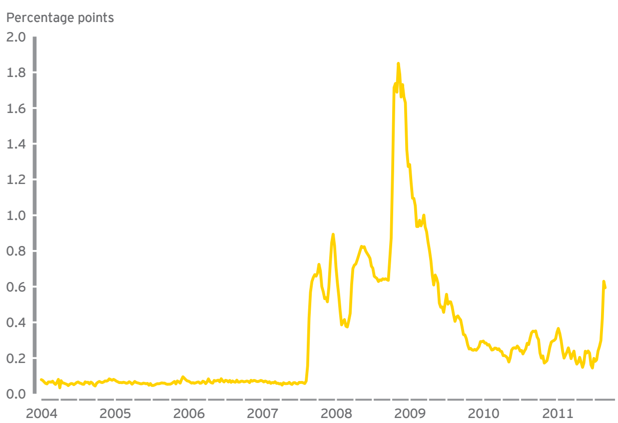
In order to contain the threat of contagion, the resources available to the EFSF should be boosted to cover the financing needs of Spain and Italy — this is likely to require an almost 700% increase on its current €450 billion lending capacity. This would offer a chance for the Eurozone to muddle through the crisis until a firmer long-term framework for a Eurobond is established. But, given the political resistance to the loss of sovereignty that this would entail, it will not be a speedy process.

In the meantime, financial stress remains acute in the Eurozone periphery and serious strains are also visible in Italy and Spain. Funding costs for banks have risen and credit conditions surveys suggest this may be spilling over into a general tightening of credit to business.

Rising interbank and high-yield bond spreads support the idea that the crisis in sovereign bond markets is spreading into other Eurozone financial markets. Mid-September 2011, the spread of the three-month Euribor across overnight interest rate swaps had increased to around 60 basis points (bp), compared with 15bp–20bp in the first half of the year. And internal stresses have now been magnified by the global market sell-off and a retreat from risky assets.

Figure 4

Euro: three-month libor spread over swap rate



Source: Oxford Economics, Haver Analytics

If Spain or Italy were to start to go down the same route as the smaller peripheral countries, even the core countries could no longer be considered immune. Banking and financial sector linkages would inevitably affect all member countries, even the powerful Germany. At this stage, however, the underlying fiscal position in Italy and Spain is very different to the other peripheral countries; the problem is one of liquidity rather than solvency. But if financing costs for these two countries continue to rise as investor caution persists, this soon might be no longer the case and the threat of rapid and widespread contagion that could engulf the entire Eurozone.

More reforms … and closer fiscal union?

The deep and protracted problems facing the Eurozone, coupled with the prospect of several years of divergent growth prospects for member states, underline the need for faster reforms in many Eurozone countries if monetary union is to survive in its current form.

The key problem facing most peripheral countries, Greece in particular, has been the loss of competitiveness over the years since adopting the single currency. With their narrow industrial bases and labor costs relatively high compared with non-EU countries, the periphery has seen its share of world trade falling steadily, in turn increasing its reliance upon financial market inflows. As the latter have dried up in the last two years, so the underlying weakness of these economies has become increasingly exposed. A key reform for these countries is greater labor market flexibility and changes to restrictive working practices, which would encourage greater industrial diversification.

Reform of public finances is another key area, and one that has long been neglected in some of the peripherals. Elimination of excessive bureaucracy and waste, and changes to retirement ages and pension entitlements, are all areas that will need to be addressed to help bring down fiscal deficits and put public finances on a sustainable long-term footing.

How big is the risk of the Eurozone unraveling?

It is nonetheless increasingly difficult to see monetary union surviving in its current form, without an accompanying and unequivocal commitment from the core member countries to greater fiscal union. Many countries will resist this implied loss of sovereignty, but without the ability to monitor, control and finance government spending across the Eurozone, there can be no guarantee that fiscal stability can be maintained after the current severe problems are resolved. The Euro Plus Pact, agreed in March 2011, sets a path for economic and fiscal reforms that are meant to strengthen the cohesion of the Eurozone. While a step in the right direction, such reforms take time and history suggests that they may not be implemented or adhered to. The Pact falls short of Eurobonds that would bind the Eurozone countries together and ensure co-responsibility for government debt. Such reforms will also entail a clear commitment by the core states such as Germany and France to fund struggling states. Without such changes to the fiscal rules, which will undoubtedly meet with significant political opposition, a split in the Eurozone seems only a matter of time, given the long period of retrenchment and sluggish growth that the current economic position has engendered.

Given little political appetite for such reforms, there is a risk that financial markets will dictate governments' agendas. A further escalation of the current financial market turmoil could plunge the Eurozone back into recession. We estimate that there is a 35% probability of this happening.

Box 1

Will the July package rescue Greece?

The package announced on 21 July by the EU was designed to draw a line under the Greek crisis and stop the contagion spreading to other countries. Initial market reaction was positive, but this has been overtaken by gloom as concerns about growth have hit market confidence, leading to sliding stock markets, greater risk aversion, rising bond spreads and, hence, more concern about Eurozone debt problems. But when the latest financial market turmoil eases, will the package be enough to rescue Greece?

The second bailout has been more comprehensive than expected. New support, including IMF funds, amounts to €109 billion, including €20 billion earmarked for recapitalizing the banks. Greece's loans from the EFSF are extended in maturity from 7.5 years to 15–30 years, and the interest rate will be 3.5%, significantly lower than in the original bailout package.

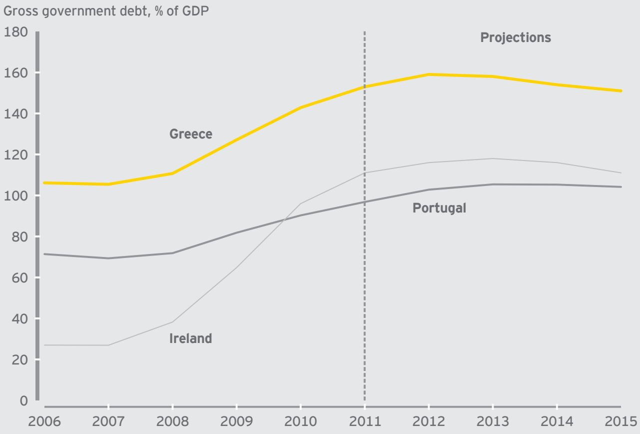
In addition to fresh funding, there is a voluntary loan swap for private sector creditors. Creditors have a menu of options for replacing existing Greek debt holdings maturing by 2020, with an average net present value loss for bondholders of 21%. Four instruments have been designed: a par bond exchange into a 30-year instrument with an interest rate of 4% to 5%; a debt rollover in which investors agree to invest maturing debt in a new 30-year bond with an interest rate of 4% to 5%; a discount bond at 80% of par value with an interest rate of 6% to 7% and a 30-year maturity; and a discount bond at 80% of par value with an interest rate of 5.9% and a 15-year maturity. The first three instruments will be fully collateralized by 30-year AAA bonds from the EFSF. Also included is a buyback facility, which will purchase and retire bonds trading at a discount. The Institute for International Finance (IIF) estimates that, through this program, the private sector will contribute €54 billion of Greece's financing through mid-2014 and €135 billion to end-2020.

Importantly, the new package does not call for more austerity measures — a path that becomes self-defeating if the markets are not convinced by the overall package. But as shown in September, every negotiation round for the release of next tranche of funds from the EU and the IMF involves difficult negotiations and the need for the Greek Government to show commitment to its fiscal objectives by implementing new taxes. This process is not sustainable and a deeper default now seems highly likely. We think that a reduction of the debt principal in the order of 50% at least is needed to hope to bring Greek public finances back on track.

Moreover, further action will be needed to stem the likely contagion to other peripherals and Spain and Italy. The solution lies in a vastly expanded EFSF, the issue of Eurobonds, faster reforms by Greece and other troubled countries and, more controversially, moves toward fiscal union, without which markets will expect problems to re-emerge even after the current crisis is resolved.

Figure 5

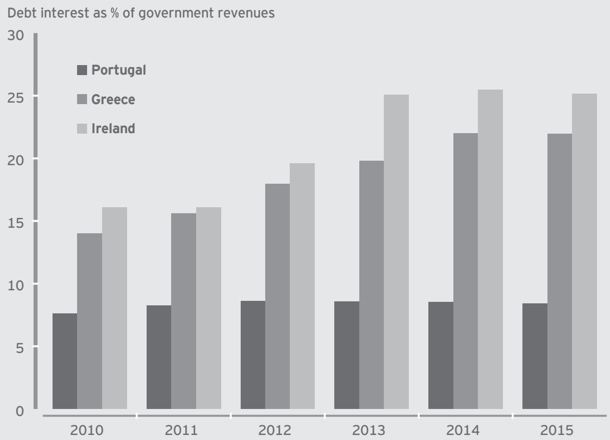
Peripherals debt



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

Figure 6

Peripherals interest burden



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

GDP growth forecasts lowered ...

Given the increasingly gloomy backdrop and the mounting downside risks from the slowing US and global economies, our Eurozone GDP growth forecasts for the next two years have been further lowered. But our baseline forecast still assumes that the current crisis can be defused, with the July Greek deal, increased resources for the EFSF, continued supportive action from the ECB and greater political commitment from the core Eurozone countries combining to stabilize the situation.

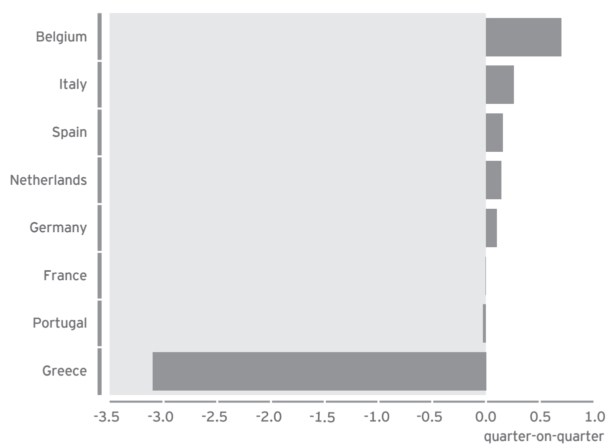
At the same time, as heightened financial market volatility and renewed concern about the debt crisis spreading to Spain and Italy, quarterly GDP growth in the Eurozone slowed to just 0.2% in Q2, with signs of further deterioration in store for Q3. After the strong 0.8% GDP rise in Q1, some slowdown had been predicted, but this result was weaker than expected and, worryingly, was the result of a virtual standstill in the two largest economies, Germany and France. Annual GDP growth in the Eurozone slowed to 1.7% in Q2 from 2.5% in Q1, giving an H1 growth figure of 2.1%.

Thus far, there is little hard data for Q3, but weak output figures in June 2011 suggest a low starting point for the quarter, and the purchasing managers' indices for July and August were far from encouraging. The service sector Purchasing Managers' Index (PMI) in August fell to its lowest since September 2009 and was only a little above the 50 level that marks expansion from contraction, while the manufacturing PMI dipped below the 50 level. Although the PMIs overall were not as weak as had been expected, they point to little or no GDP growth in the Eurozone in Q3, with the core countries looking disappointingly weak. The expected poor Q3 result is compounded by news that the US economy is clearly slowing and some fears that the strong performance in China and the rest of Asia may now be faltering in the face of weak demand from the West.

On this basis, we now forecast Eurozone GDP growth of 1.6% this year, down from 2% three months ago, while our 2012 projection has been cut to 1.1% from 1.6%. Our forecast for 2013–15 remains unchanged at 2% p.a., which implies a long period of sub-par growth after the exceptionally deep recession of 2008–09. Eurozone GDP has still only recouped around two-thirds of the loss in activity seen during 2008–09 and it may take another five or six quarters before it returns to pre-crisis levels.

Figure 7

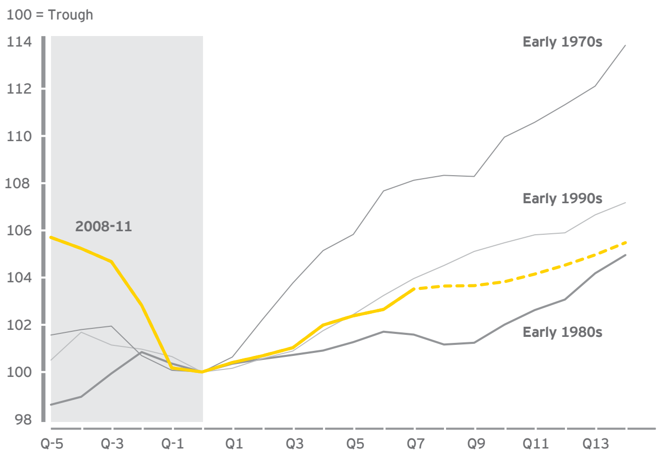
Eurozone GDP Q2 2011 growth



Source: Oxford Economics

Figure 8

Eurozone recoveries compared



Source: Oxford Economics

… as domestic and global demand both weaken …

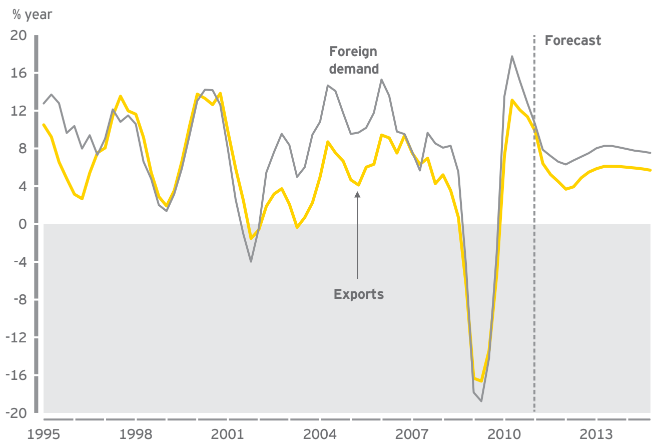
The composition of projected growth in both 2011 and 2012 highlights the vulnerability of the Eurozone economy to slowing activity in the US and the leading emerging market economies (see *Box 2* for more details on the assumptions underpinning our forecast). With ongoing private and public sector retrenchment attempting to reduce levels of debt, our forecast sees domestic demand in the Eurozone growing by less than 1% in both 2011 and 2012, with investment growing by about 2% p.a. Exports are expected to be the main driver of growth, contributing around 2ppt–3ppt to overall GDP growth in both years. In this respect, the apparent weakening in the world economy may mean that the impetus from net exports will be lower than we currently expect.

Growth in private consumption will stay subdued as consumers face numerous headwinds. The record on unemployment remains mixed, but the headline jobless rate for the Eurozone remains close to 10%. However, this covers a wide range of rates across member countries, from about 4% in Austria, 7% in Germany to just over 20% in Spain. And there is little prospect of any meaningful reduction in the overall rate, with economic contraction in the peripheral economies set to keep their jobless rates high, alongside slowing growth in the core economies.

Household income growth will remain weak. Indeed, in real terms, we are expecting household disposable incomes to fall again this year, before leveling out in 2012. The main factor weighing on household income is high inflation, which has been above expectations this year, driven by double-digit energy price rises and continually high food prices. In addition, real wage growth has been very low — we forecast average wages per person to rise by less than 2% this year — while, in most countries, unemployment remains high and fiscal cuts weigh on public sector workers.

Figure 9

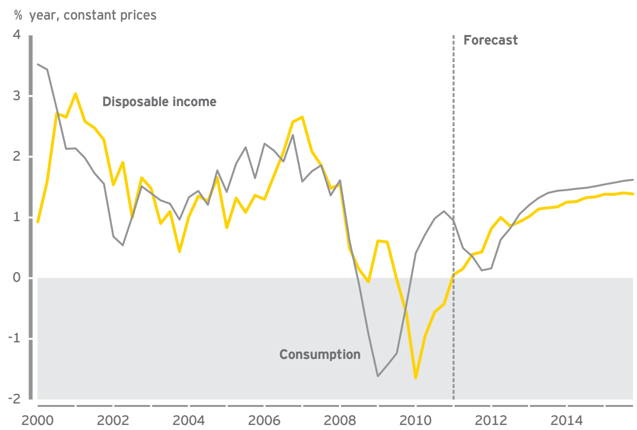
Exports



Source: Oxford Economics

Figure 10

Households' income and consumption



Source: Oxford Economics

Box 2

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 those assumptions.

The outlook for global growth is less favorable than it was at the time of our previous forecast. The US economy slowed more than expected in H1 (and previous data is lowered), the problems in the Middle East and North Africa (MENA) have continued to weigh on confidence, the disaster in Japan has caused more severe disruption than earlier envisaged, and the sovereign debt crisis in the Eurozone has deepened. However, these factors are not enough to derail the global recovery and the overall picture of solid world trade remains broadly unchanged. We forecast world GDP will rise 2.8% this year at market exchange rates, or 3.7% in purchasing power parity (PPP) terms, and by 3.7% (4.5% in PPP terms) p.a. in 2012–15.

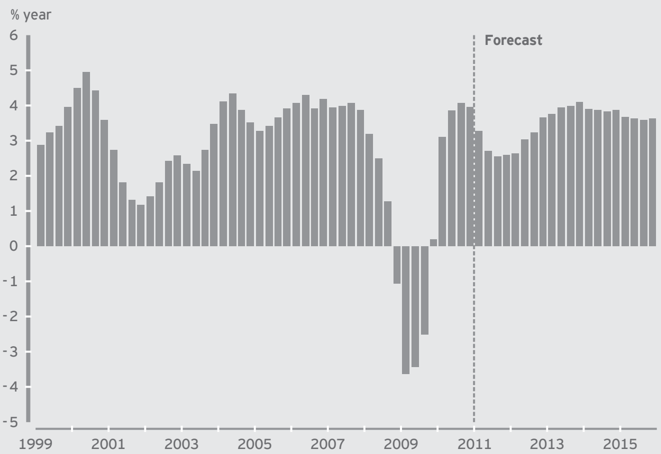
The lower H1 GDP data has led us to revise our growth forecast for the US economy this year to 1.6%, significantly weaker than the 2010 outturn (3%). Although the weakness in H1 was at least partly due to temporary factors, the pickup in the pace of growth in H2 and into 2012 will only be gradual, given the slowdown in demand seen in the rest of the world and the likely impact of the mounting financial problems in the Eurozone. For 2012, we forecast modest GDP growth of 2.2%, before a pickup to just over 3% p.a. in 2013–15. 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 US dollar strengthens in the medium term.

World growth will continue to be sustained by the emerging markets. Although their pace of growth is also slowing as demand in the industrialized world eases, we expect the emerging markets to grow by 6.2% (on a PPP basis) this year and by an average of 6.5% p.a. in 2012–15, with their share of the global economy rising from 28% in 2010 to 32% in 2015 (at market exchange rates). China is expected to lead this group, with growth of 8.8% in 2011 and 8.3% in 2012 (and then 8.7% p.a. in 2013–15). These rates are slower than the 10.3% growth posted in 2010 as tighter monetary policy dampens domestic demand, but still implies strong increases in demand for goods and services from the rest of the world.

After a steep rise in the last two years, oil and non-oil commodity prices have fallen slightly in recent months. This reflects a current slowdown in world demand that is now taking place, as well as a reassessment by investors of the fundamentals underpinning commodity prices. Nevertheless, we expect commodity prices to remain relatively high for some time as demand from emerging markets, which are large consumers of commodities, remains strong. One factor keeping oil prices high is the unrest in the MENA region, which has disrupted oil supply, although this has now been largely offset by higher output by some major producers.

Figure 11

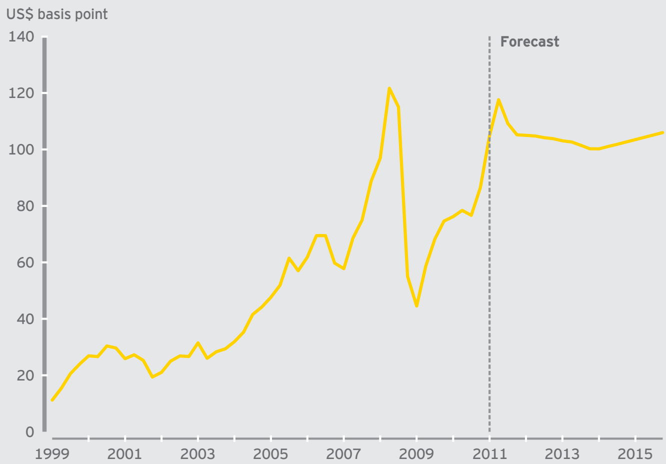
World: GDP growth



Source: Oxford Economics

Figure 12

Oil price, nominal



Source: Oxford Economics

… and firms remain wary of borrowing …

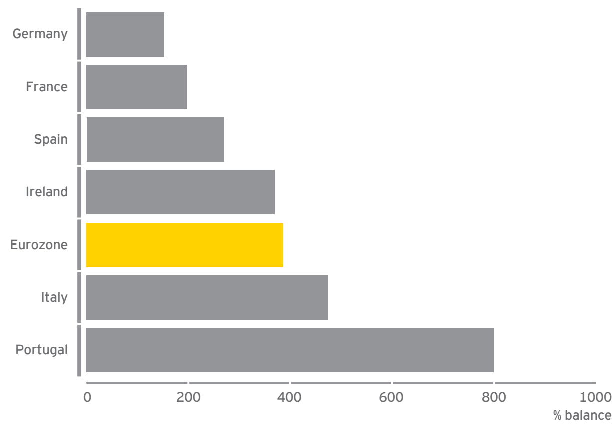
There is also growing concern that the prospect of very subdued growth will deter firms from recruiting and investing, despite having solid financial surpluses, as they focus on deleveraging to protect themselves from further deterioration in the business environment in the near term, and to position themselves for the upturn when it finally emerges. Moreover, the uncertain climate for corporate financing will deter companies from overextending themselves given current financial market concerns. Business failures can sometimes lag behind the business cycle, with banks reluctant to incur write-offs when the economy is still deteriorating. And corporate refinancing needs in the Eurozone are set to rise sharply in 2012 to around €1 trillion from about €750 billion this year; unless financial market conditions improve, this level of refinancing may prove problematic.

… as tight lending conditions persist

In addition, bank lending in the Eurozone remains tight as the banks restructure their own balance sheets and reduce their exposure to riskier sectors and countries. The Q3 ECB lending survey shows that lending standards have again tightened modestly, with more expected in Q4. Bank liquidity and access to finance are both named as factors tending to tighten credit standards, underlining the risk of some spillover of recent financial market volatility and interbank market tightness to lending decisions. It is clear that the unwinding of the tight credit standards imposed during the crisis remains slow.

Figure 13

Cumulated tightening from mid-2007 to Q3 2011



Source: Oxford Economics, Haver Analytics

Tighter credit conditions persist, despite the apparently positive results of the Eurozone-wide bank stress tests published in July. Of 91 banks tested, only nine failed to meet the 5% core Tier 1 capital ratio requirements — two of these were in Greece, five in Spain, one in Austria and one in Germany (although the latter was disputed and hence, excluded from the figures). Overall, the results were positive, with a reported shortfall of only €2.5 billion among the eight named banks. However, as was the case in the July 2010 exercise, the credibility of the stress tests was hampered by too favorable assumptions. In particular, the stress scenario did not include the possibility of a default by a Eurozone government. As a result, financial market analysts have formed their own judgments and even banks that passed the tests comfortably have been under significant pressure through Q3. With no reliable official information available, financial markets are exposed to sharp reversals, sometimes based on rumors, that pose a significant risk of a new deep crisis.

With consumer demand expected to continue to grow weakly, government consumption probably unchanged at best and export performance at risk from weaker world growth, companies in the Eurozone as a whole are unlikely to have sufficient confidence to raise investment rapidly. So, despite strong cash reserves, business sector investment is now expected to grow by only about 2% to 3% both this year and next, which is somewhat weaker than our previous forecast. It is not expected to return to pre-crisis levels before 2014.

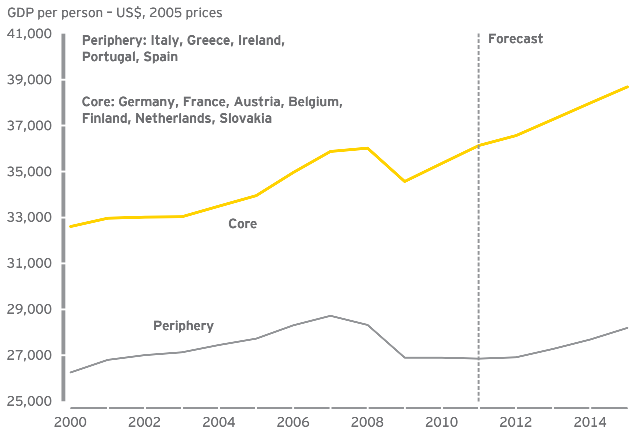
Sluggish growth even in core countries ...

Whereas earlier this year it seemed likely that the core Eurozone countries would continue to grow fairly solidly, there are now mounting fears that the recent bout of financial market instability and slower growth in the US and the main emerging markets will undermine this prospect. As noted above, the German and French economies virtually stagnated in Q2, posting GDP growth of just 0.1% and zero, respectively, and early signals for Q3 show signs of further weakness, with the German Ifo survey for August 2011 showing a particularly sharp decline. Our forecast for German growth in 2011 has been lowered to 3%, with a slowdown to just 1.4% now seen for 2012. This weaker German economy will have knock-on effects for its close trading partners, whose exports have been benefiting from strong German demand.

In the core Eurozone countries (Germany, France, Austria, Belgium, Finland, Netherlands and Slovakia), GDP is now forecast to grow by about 2% p.a. in 2011–15, much the same as in the decade prior to the 2009 recession. In contrast, GDP in the peripheral countries is expected to rise by only 1.2% p.a. in 2011–15, less than half the pace in the pre-crisis decade. As a result, divergence in incomes between the core and the periphery will be at its greatest for 30 years. For peripheral countries, this scenario means that unemployment will be very slow to fall, which, in turn, will make the planned reduction in fiscal deficits even more difficult to attain. There is also the threat of rising social tensions, which have already appeared in some of the countries and could potentially undermine the political will to press ahead with the proposed fiscal consolidation in the future.

Figure 14

Divergence

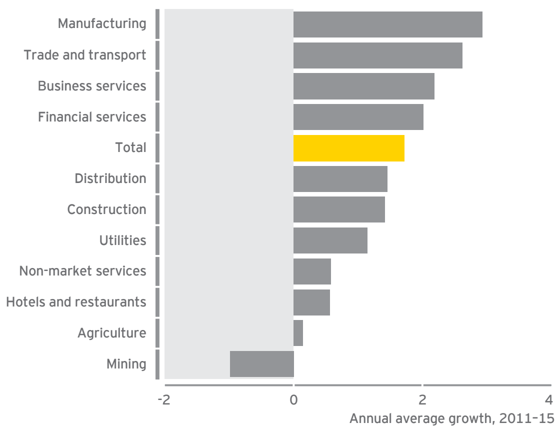


Source: Oxford Economics

… with sectoral prospects mixed

Prospects for the Eurozone are also mixed at the sector level. Manufacturing and business services are the two sectors that appear to offer the brightest outlook. The manufacturing sector is currently benefiting from strong demand for exports, in particular, from emerging markets. But much of this growth is only recovering the losses seen during the recession. And with the leading emerging markets now experiencing slowing growth, albeit still solid, the pace of growth for manufacturing exports looks set to slow. Added value 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 overall economy, as the Eurozone benefits from a skilled workforce and expertise established in this area. The financial services industry may also be helped by regulatory changes, which will draw back some of the business previously lost to some offshore centers that now face tighter controls.

Figure 15
Value added by sector



Source: Oxford Economics

Meanwhile, consumer-based sectors, such as distribution and hotels and restaurants, are suffering as household spending power is constrained by high unemployment, low real wage growth and the need to reduce levels of indebtedness. And companies that, in the past, have relied heavily on the government sector for sales will be increasingly affected by the cuts in general and by local government spending, which are set to deepen further in many countries in the next few years.

Finally, construction will remain subdued in most Eurozone countries, with the housing sector still facing stagnant or falling prices, especially in countries such as Spain and Ireland where prices generally are still significantly overvalued. Public sector construction may continue to support activity in the stronger economies, but this will not be the case in the peripheral countries that face further cuts in government spending in the coming years as they attempt to lower their fiscal deficits.

But lower inflation expected in 2012 …

A combination of factors have combined to lift consumer price inflation above the target set by the ECB of close to, but below, 2%. These include the surge in oil prices, soaring world food prices and the indirect tax increases implemented in many countries in order to tackle their large fiscal deficits. Having risen above 2% in December 2010, inflation then rose to a high of 2.8% in April. But with oil prices now off their peak and base effects turning more favorable, July's inflation fell to 2.5%, and further modest easing is expected in the rest of the year, with little sign of any significant pickup in wage pressures resulting from the higher prices. As a result, we still expect inflation to average 2.6% this year.

From next year, however, inflation should come back down below 2%. Our crude oil price forecast (of a 4% decline to about US$105 a barrel) implies that energy price inflation will be falling steadily, and there will be a step-down in the headline rate in the opening months of 2012, as the effects of the VAT increases in a number of countries at the start of 2011 (equal to around 0.3ppt to 0.5ppt on inflation) fall out of the calculation. We expect inflation to average 1.8% in 2012, with similar rates seen in 2013–14.

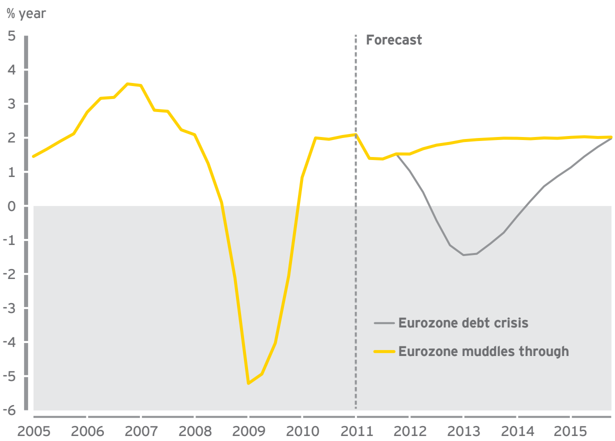
... will add to the dilemma facing the ECB

This inflation outlook would appear to add to the dilemma that has confronted the ECB this year. Faced with above-target inflation, and what had appeared to be quite a strong recovery in the core Eurozone countries in the early part of the year, the ECB has raised its key refinancing rate by 25bp on two occasions, in May and July 2011, taking it to 1.5% currently, while also signaling the likelihood of more rate rises in the latter part of the year. But with inflation widely expected to fall back below the 2% target in 2012 and the downside risks to growth still significant, the bank has faced some criticism for these hikes.

The latest developments reinforce the view that the ECB moved prematurely on rates, with its actions making the growth outlook more difficult for the peripheral Eurozone countries, by adding to their interest rate payments and by pushing up the euro, thereby making life more difficult for exports to countries outside the Eurozone. As noted above, exports are the one clear impetus for growth in most countries within the region.

Figure 16

Eurozone GDP



Source: Oxford Economics

Interest rates now likely to be cut

At its press conference on 8 September, the ECB signaled a significant change of views. It abandoned its tightening bias and indicated that it may cut interest rates, should the economic environment deteriorate. We welcome this change. We now expect the ECB to cut interest rates towards the end of this year and again in the first few months of 2012, taking them back down to 1%.

We believe that the ECB should lower interest rates to below 1%, should the Eurozone fall back into recession. This reversal in interest rates could damage the ECB's credibility. But the ECB is the only institution with some room for maneuver since governments cannot or do not want to relax fiscal policy. If the Eurozone were to re-enter recession, this might bring the risk of deflation. There has even been some speculation that the ECB may have to consider some form of quantitative easing, although we consider this highly unlikely until there has been some more tangible move toward fiscal union.

Conclusions

Despite the second package for Greece, the Eurozone debt crisis has plumbed new depths, with financial markets experiencing a new wave of major volatility. At the same time, there are clear signs that the strong growth in the core countries has come to a halt in Q2 and Q3, while growth is also slowing in the US and leading emerging markets. With our forecasts for Eurozone GDP growth lowered again, and the peripheral countries facing continued contraction, the sovereign debt crisis may worsen, which would undermine growth prospects further.

Unless halted soon, this kind of vicious spiral will hold very serious implications for the future of the Eurozone, raising more questions about the ability of monetary union to survive in its current form.

Faced with this worsening scenario, it is increasingly important that policy-makers in all countries display greater urgency and greater commitment toward the kind of reforms needed to ward off the fiscal and debt crises. In the absence of more comprehensive packages for Greece and the other troubled countries, vastly expanded funding for the EFSF and the introduction of jointly and severally guaranteed Eurobonds, the list of countries at risk may soon encompass Italy and Spain, which would have major implications for the whole of the Eurozone via financial and banking linkages.

Reliance upon further rounds of austerity to reduce deficits will be self-defeating — much deeper reforms, including labor market liberalization, and faster privatization are needed if the peripheral economies are to escape their unsustainable debt burdens and regain investor confidence. Overcoming the problems currently facing the Eurozone, and ensuring that there is no repeat, will inevitably mean a loss of fiscal sovereignty, something that continues to meet with enormous political opposition.

The prospect of more subdued growth in the core Eurozone countries, and continued contraction in the peripheral countries, means that the ECB is likely to halt — and, indeed, reverse — its policy-tightening stance of recent months. With inflation expected to slow to the target of below 2% early next year, rate rises have exacerbated problems facing the troubled peripheral countries and, via a stronger euro, have undermined exports, which are currently supplying the only real impetus to growth in the region. The ECB needs to consider all possible actions and move more boldly in trying to avert the deepening crisis facing the Eurozone.

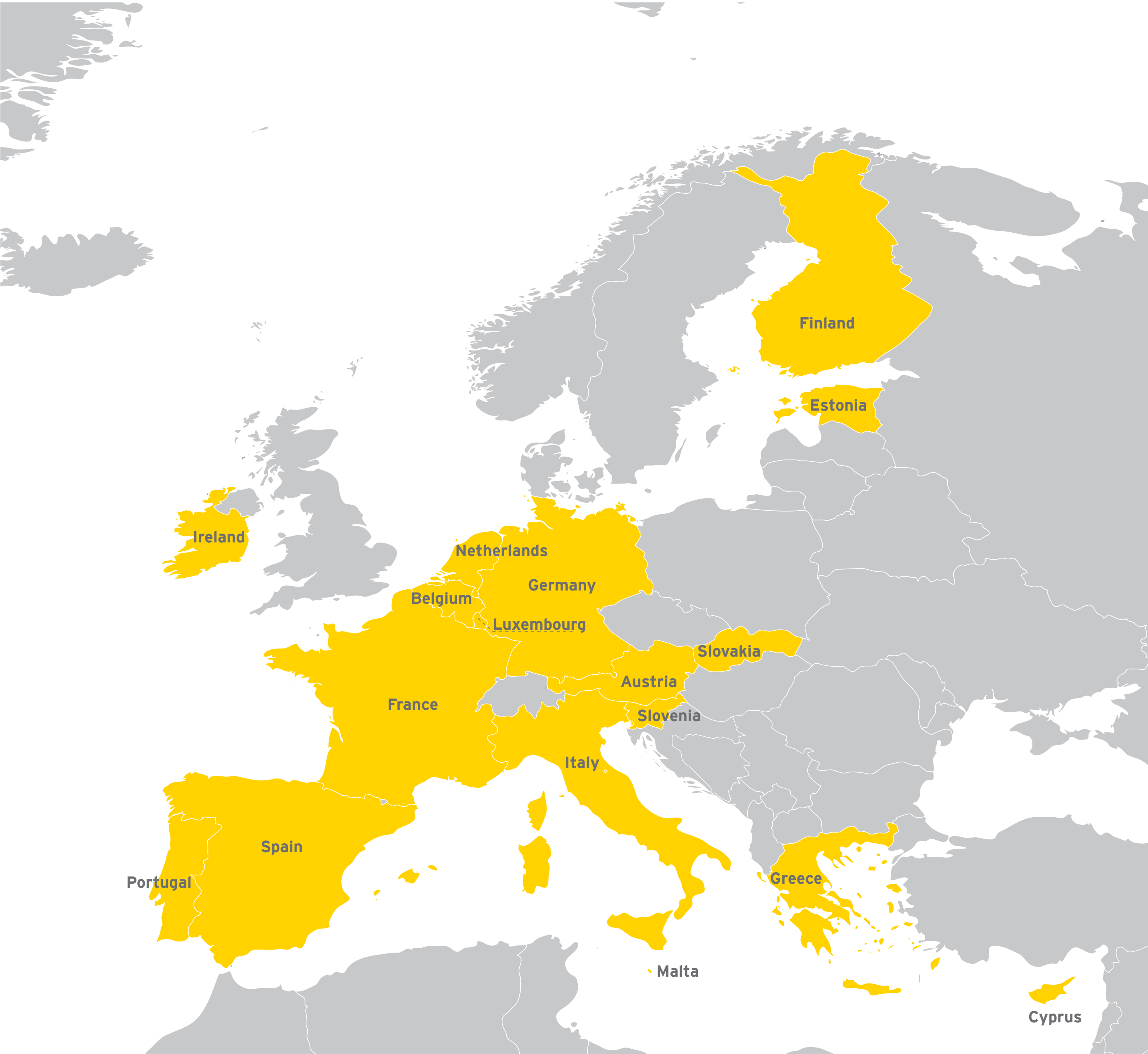
Forecast for Eurozone countries

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

17 Eurozone countries

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

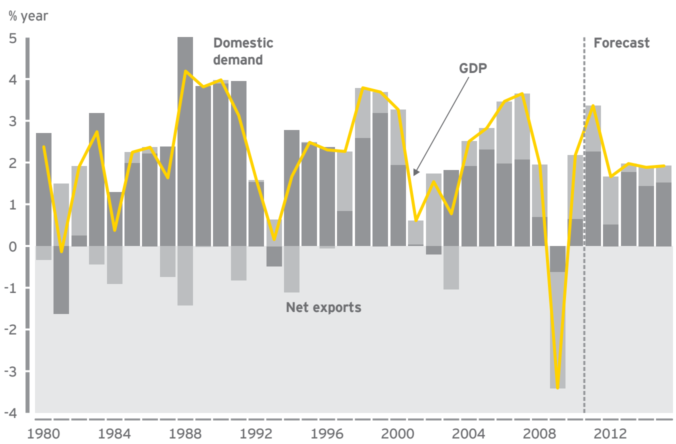
To find out more, please visit www.ey.com/eurozone



Austria

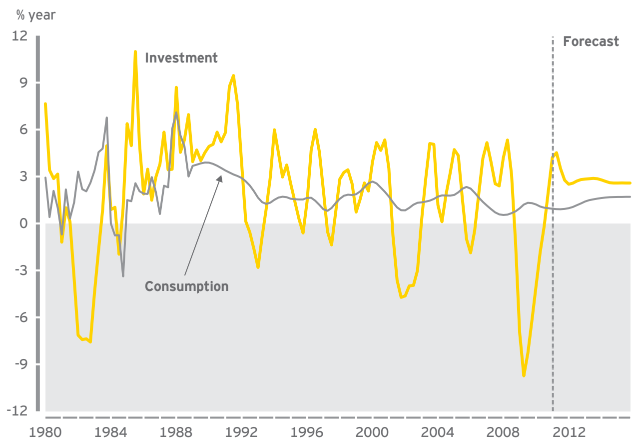
- With average quarterly growth of 0.7% in H1 2011, Austria's economy outpaced most other Eurozone economies.
- However, the reported robust growth rate of 0.7% in Q2 masks a deceleration of underlying performance in line with monthly data, such as weakening industrial output growth and easing manufacturing orders. We expect growth to slow considerably in H2, on the back of slowing external demand. Overall, we forecast GDP growth at 3.4% this year and 1.7% in 2012.
- Inflation, which increased to 3.8% in July 2011, is expected to remain high for the rest of the year, undermining household spending.
- Not only will Austrian investor confidence suffer from the current turbulence in the debt and stock markets, but a further credit event in a Eurozone country would also lead to much tighter credit provision, pulling down investment.

Figure 17
Contributions to GDP growth



Source: Oxford Economics

Figure 18
Consumption and investment



Source: Oxford Economics

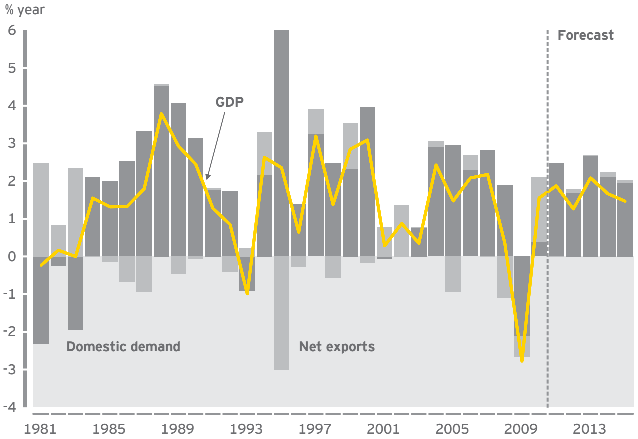
Table 2
Austria (annual percentage changes unless specified) *Source: Oxford Economics*

	2010	2011	2012	2013	2014	2015
GDP	2.2	3.4	1.7	2.0	1.9	1.9
Private consumption	1.1	0.9	1.1	1.5	1.7	1.7
Fixed investment	-1.0	3.7	2.6	2.9	2.7	2.6
Stockbuilding (% of GDP)	1.4	2.2	1.4	1.5	1.2	1.0
Government consumption	-0.5	1.0	1.2	1.3	1.8	2.0
Exports of goods and services	10.2	8.1	5.3	5.3	5.3	5.4
Imports of goods and services	8.1	7.0	3.8	5.8	5.2	5.5
Consumer prices	1.7	3.4	2.2	2.1	2.0	2.0
Unemployment rate (level)	4.4	4.2	4.3	4.1	4.1	4.2
Current account balance (% of GDP)	2.7	2.9	2.6	2.4	2.2	2.2
Government budget (% of GDP)	-4.6	-3.6	-3.0	-2.6	-2.3	-2.1
Government debt (% of GDP)	72.3	72.3	72.8	72.8	72.6	72.0

Belgium

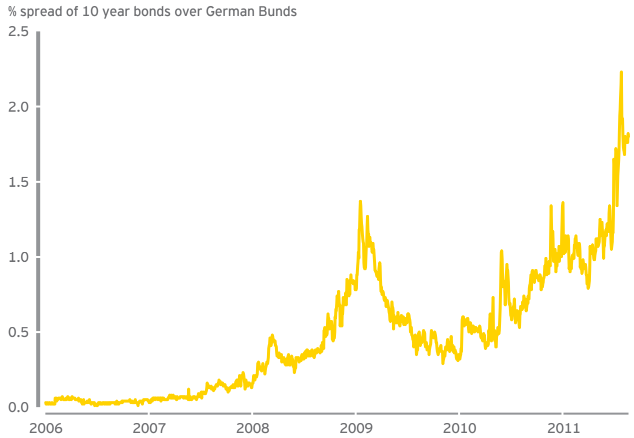
- Belgium posted surprisingly solid economic data in Q2. However, the financial turmoil in July and August 2011, and downward revisions to our forecasts for other Eurozone countries and the rest of the world, point to weaker growth than previously anticipated. We expect GDP growth to cool from 2.5% this year to 1.8% next year.
- Risks to this forecast are on the downside and relate in particular to the possibility that the Eurozone plunges back into recession as policy-makers are overtaken by financial markets and are not fast enough in implementing necessary structural changes.
- Furthermore, Belgium's vulnerabilities are by no means only externally driven. At almost 100% of GDP, debt is high. Even though spreads remain at manageable levels for now, Belgium remains exposed to further market volatility in 2012.

Figure 19
Contributions to GDP growth



Source: Oxford Economics

Figure 20
Spread over Bunds



Source: Oxford Economics, Haver Analytics

Table 3
Belgium (annual percentage changes unless specified) *Source: Oxford Economics*

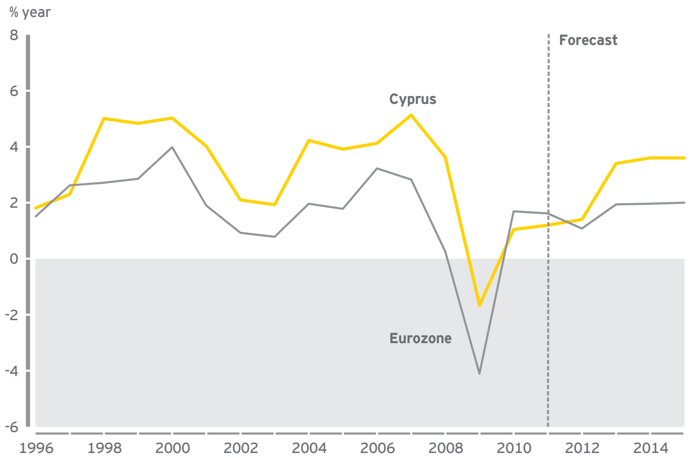
	2010	2011	2012	2013	2014	2015
GDP	2.1	2.5	1.8	2.7	2.2	2.0
Private consumption	1.6	1.8	2.0	2.4	2.7	2.3
Fixed investment	-1.5	3.0	2.8	3.8	4.0	3.3
Stockbuilding (% of GDP)	0.2	0.8	0.6	0.8	0.2	-0.1
Government consumption	1.1	1.2	1.3	1.5	1.6	1.4
Exports of goods and services	10.6	6.4	3.6	5.2	5.8	4.1
Imports of goods and services	8.4	6.6	3.6	5.3	5.7	4.2
Consumer prices	2.4	3.5	1.8	1.9	2.0	1.9
Unemployment rate (level)	8.3	7.4	7.2	6.6	6.4	6.4
Current account balance (% of GDP)	1.1	1.0	1.1	1.1	1.2	1.3
Government budget (% of GDP)	-4.1	-3.0	-2.5	-1.8	-0.7	0.0
Government debt (% of GDP)	96.8	95.6	95.6	94.9	94.4	93.5

Cyprus

- Cyprus' GDP grew by 0.4% on the quarter in Q2 2011, following flat growth in Q1. The economy is expected to slow considerably in H2 on the back of fiscal austerity and a major explosion that destroyed one of the country's biggest power stations. We forecast growth of 1.2% in 2011 and 1.4% in 2012.
- Cyprus needs to consolidate its public finances, and the Government aims to reduce the budget deficit to 4% of GDP in 2011, from 5.3% in 2010. Given weak prospects for growth, this seems too ambitious and we forecast the deficit to narrow to only 4.7% of GDP in 2011.
- All the major credit rating agencies have downgraded Cyprus' sovereign debt, and a need for financial assistance from the EU and IMF cannot be ruled out. Moreover, the debt crisis in the wider Eurozone poses significant risks to the banking sector, due to high exposure of banks to Greek sovereign debt.

Figure 21

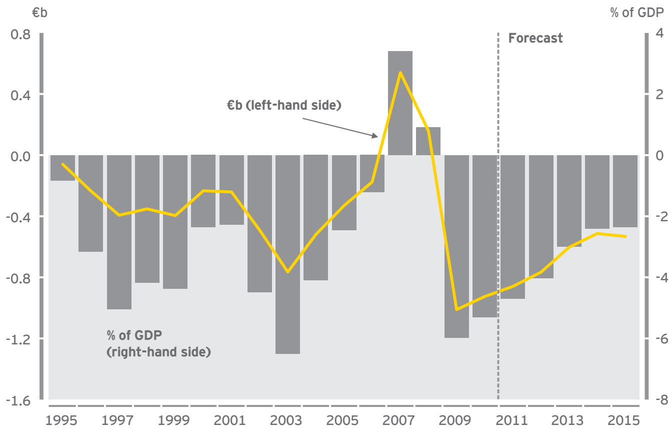
Real GDP growth



Source: Oxford Economics

Figure 22

Government budget balance



Source: Oxford Economics

Table 4

Cyprus (annual percentage changes unless specified)

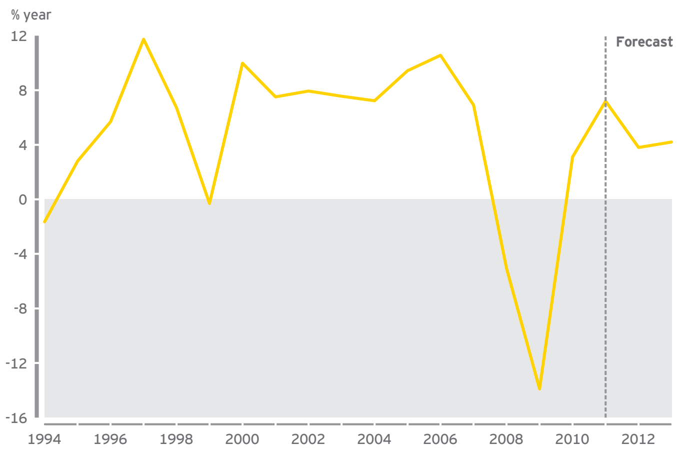
Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	1.0	1.2	1.4	3.4	3.6	3.6
Private consumption	0.8	1.5	2.5	4.0	3.5	3.5
Fixed investment	-7.9	-7.5	-0.2	4.0	5.5	4.8
Stockbuilding (% of GDP)	0.8	1.1	-0.1	-1.0	-0.9	-0.7
Government consumption	0.5	-2.1	1.5	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	0.5	3.4	4.5	5.6	5.6
Consumer prices	2.6	3.6	2.7	2.3	2.3	2.3
Unemployment rate (level)	6.4	7.3	6.8	6.0	5.0	4.5
Current account balance (% of GDP)	-7.8	-8.2	-7.1	-6.3	-5.8	-5.5
Government budget (% of GDP)	-5.3	-4.7	-4.0	-3.0	-2.4	-2.4
Government debt (% of GDP)	60.8	62.7	64.2	63.7	62.6	61.4

Estonia

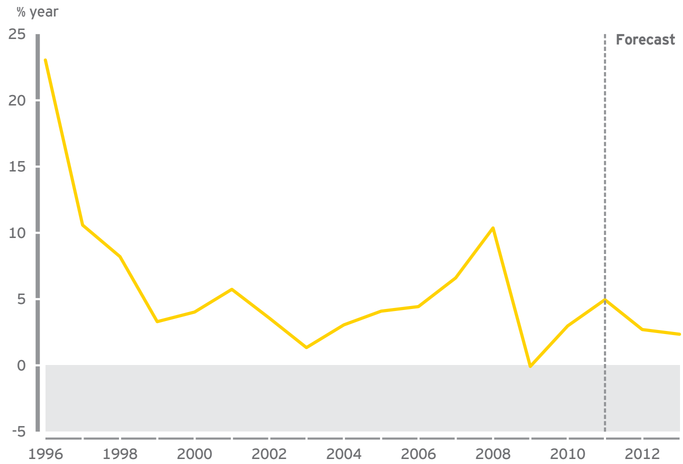
- Estonia's growth rate remained little changed (and substantially the Eurozone's fastest growing economy) in Q2 2011, but will slow in the second half as export growth subsides. Private consumption and investment are not yet strong enough to take up the slack, so public capital spending remains important to sustaining recovery in 2011–12. Our forecast shows GDP growing by 7.2% in 2011 before slowing to 3.8% in 2012.
- Inflation moved back above 5% in July, reflecting rises in commodity import prices as well as stronger domestic demand. Although productivity is also rising, the differential over Eurozone inflation will be prolonged and could damage export competitiveness.
- Return to fiscal balance will remain a priority for the Government. However, low debt levels and improved credit ratings suggest that the Government would be able to sustain growth by running a fiscal deficit for longer if the stimulus from trade and investment weakens unexpectedly.

Figure 23
Real GDP growth



Source: Oxford Economics

Figure 24
Inflation



Source: Oxford Economics

Table 5
Estonia (annual percentage changes unless specified)
Source: Oxford Economics

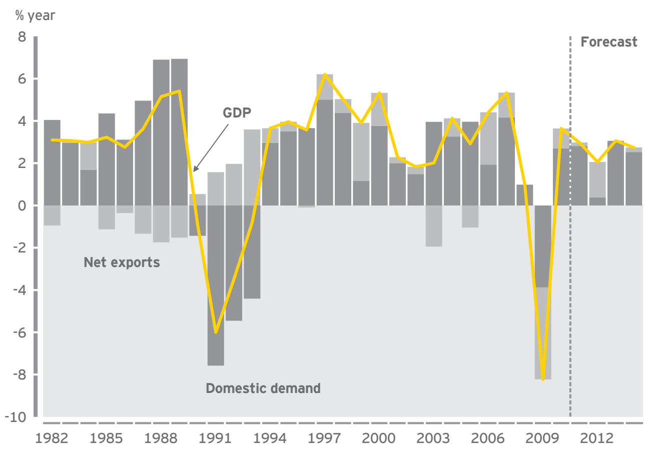
	2010	2011	2012	2013	2014	2015
GDP	3.1	7.2	3.8	4.2	4.8	4.7
Private consumption	-1.9	4.5	3.8	5.5	4.7	4.7
Fixed investment	-9.2	15.5	9.0	9.5	6.5	5.8
Stockbuilding (% of GDP)	6.8	7.8	3.4	0.6	0.6	0.5
Government consumption	-2.1	1.5	1.0	2.0	2.5	2.7
Exports of goods and services	21.7	28.5	9.5	7.4	5.9	5.4
Imports of goods and services	21.5	29.0	6.1	6.4	6.0	5.4
Consumer prices	3.0	4.9	2.7	2.3	2.1	2.2
Unemployment rate (level)	16.8	13.2	10.9	9.1	7.3	6.0
Current account balance (% of GDP)	3.5	0.6	1.0	1.2	0.6	0.2
Government budget (% of GDP)	0.1	-0.8	-2.3	0.1	0.1	0.0
Government debt (% of GDP)	6.6	6.7	8.5	7.8	7.2	6.7

Finland

- Finland's economy outgrew most of its peers in the Eurozone in Q2, with GDP growth at 0.6%. All sectors supported economic activity but in particular exports, which rebounded strongly from their decline earlier in the year despite weak performance in Germany and the US.
- While Finland's direct exposure to the sovereign debt woes of the peripheral countries is limited, indirect exposure is significant, and comes via external demand and credit conditions, both of which would deteriorate and have a negative impact on growth should the situation in the peripheral economies worsen. Our baseline forecast shows GDP growth slowing to 2.1% in 2012, from 3.0% in 2011.
- The budget proposal of the new coalition Government contains a mix of tax increases and spending cuts that, if passed by the parliament, should reduce debt and deficits to the tune of 0.5% of GDP each year from 2012.

Figure 25

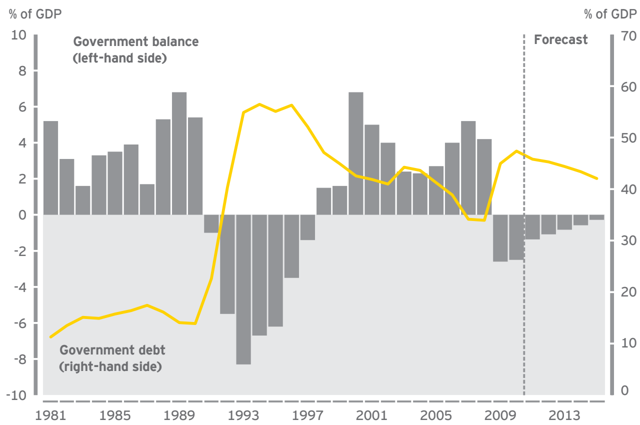
Contributions to GDP growth



Source: Oxford Economics

Figure 26

Government balance and debt



Source: Oxford Economics

Table 6

Finland (annual percentage changes unless specified)

Source: Oxford Economics

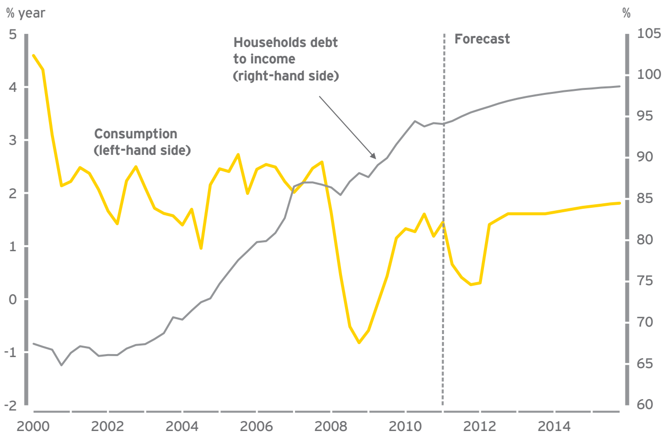
	2010	2011	2012	2013	2014	2015
GDP	3.6	3.0	2.1	3.1	2.7	2.6
Private consumption	2.7	3.7	2.2	3.1	2.9	2.6
Fixed investment	2.8	5.7	3.0	3.3	3.2	2.9
Stockbuilding (% of GDP)	2.9	2.5	0.9	1.5	1.6	1.5
Government consumption	0.6	0.6	1.0	1.0	1.1	1.2
Exports of goods and services	8.6	2.0	8.7	7.1	6.2	5.8
Imports of goods and services	7.4	1.9	5.9	8.4	6.7	5.7
Consumer prices	1.7	3.2	2.1	1.8	1.7	1.7
Unemployment rate (level)	8.4	7.9	7.6	7.2	7.0	6.9
Current account balance (% of GDP)	3.0	0.4	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)	48.4	46.6	46.2	45.1	43.9	42.4

France

- A disappointing Q2 and heightened turbulence on the Eurozone's financial markets has led us to revise our growth forecast to 1.6% in 2011 and 1.2% in 2012.
- Moreover, the risks to this forecast are skewed to the downside. In particular, with a relatively high deficit and a poor record at abiding by objectives of spending restraint, the economy is exposed to a sudden reversal in financial market sentiment that could have a very negative impact on growth.
- In our view, even after the additional measures announced in August 2011, the current fiscal plan does not go far enough to meet the Government's deficit objectives. With no new measures likely to be announced before the elections, it is imperative that the congress ratifies the fiscal rule that will impose a framework to bring public finances back in balance. This would signal a clear commitment to meet fiscal objectives.

Figure 27

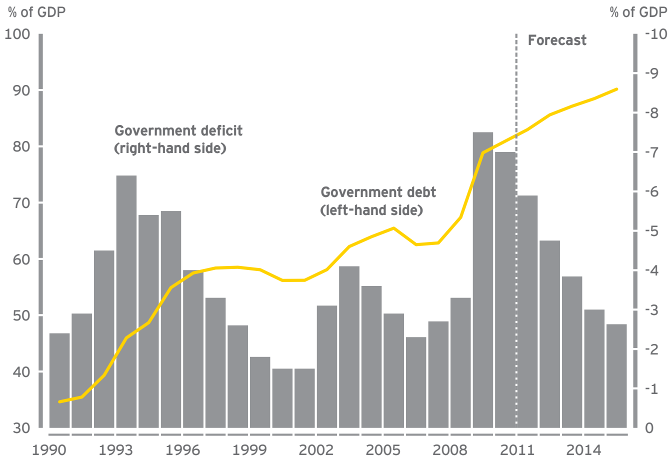
Households' consumption and leverage



Source: Oxford Economicss, Haver Analytics

Figure 28

Government deficit and debt



Source: Oxford Economics

Table 7

France (annual percentage changes unless specified)

Source: Oxford Economics

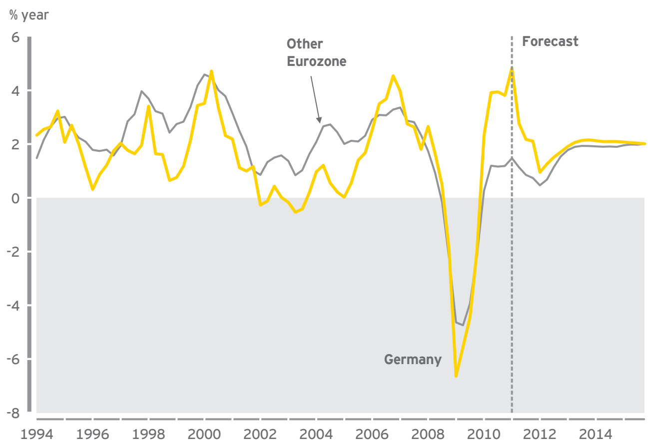
	2010	2011	2012	2013	2014	2015
GDP	1.4	1.6	1.2	2.0	2.0	2.0
Private consumption	1.3	0.7	1.2	1.6	1.7	1.8
Fixed investment	-1.4	3.2	2.2	3.0	3.0	2.9
Stockbuilding (% of GDP)	-0.1	0.7	0.5	0.5	0.7	0.7
Government consumption	1.2	0.8	0.5	1.0	1.2	1.2
Exports of goods and services	9.4	4.4	4.2	6.6	5.9	5.5
Imports of goods and services	8.3	5.7	3.2	5.5	5.5	5.2
Consumer prices	1.7	2.2	1.8	1.8	1.9	1.9
Unemployment rate (level)	9.8	9.6	9.3	8.8	8.4	8.1
Current account balance (% of GDP)	-1.8	-2.7	-2.9	-2.8	-2.8	-2.9
Government budget (% of GDP)	-7.0	-5.9	-4.8	-3.8	-3.0	-2.6
Government debt (% of GDP)	81.7	85.1	87.4	88.9	90.3	92.1

Germany

- After initially appearing to continue to grow strongly as the Eurozone sovereign debt crisis took hold elsewhere, the outlook for the German economy is now less favorable than at the time of our last report.
- The financial turmoil has not spared German markets, with share prices falling as sharply as in other countries. Moreover, as prospects for both the Eurozone and the rest of the world have darkened, we have revised our forecast for German growth to 3.1% in 2011 and 1.5% in 2012. Our medium-term outlook remains broadly unchanged at 2.1% per year on average in 2013–15.
- The main downside risk to this forecast relates to the possibility that the Eurozone debt crisis could escalate and plunge the region back into recession. In that case, and despite the country's sound fiscal position, GDP would likely fall back, possibly as sharply as in 2008–09.

Figure 29

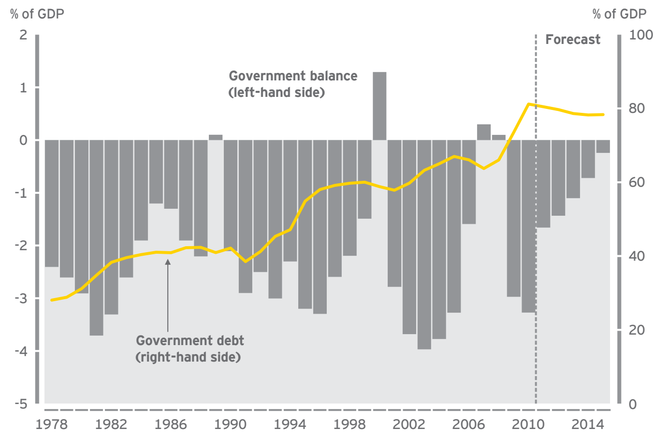
GDP: Germany vs. rest of Eurozone



Source: Oxford Economics

Figure 30

Government balance and debt



Source: Oxford Economics

Table 8

Germany (annual percentage changes unless specified)

Source: Oxford Economics

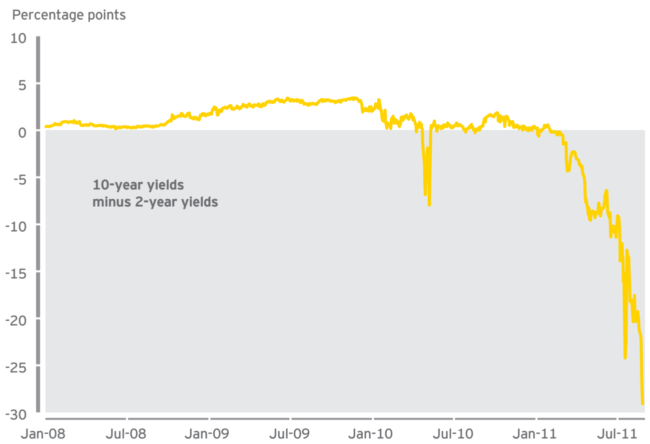
	2010	2011	2012	2013	2014	2015
GDP	3.5	3.1	1.5	2.1	2.1	2.0
Private consumption	0.4	0.9	0.9	1.3	1.4	1.4
Fixed investment	5.8	7.1	2.5	4.7	5.0	4.4
Stockbuilding (% of GDP)	-1.2	-0.8	-0.5	-0.2	0.0	0.1
Government consumption	1.9	0.8	0.6	0.6	0.7	0.7
Exports of goods and services	14.0	8.0	4.7	6.1	6.1	5.7
Imports of goods and services	11.3	7.7	5.1	6.9	6.8	6.1
Consumer prices	1.2	2.4	1.7	1.8	1.8	1.8
Unemployment rate (level)	7.1	6.1	5.9	5.7	5.5	5.3
Current account balance (% of GDP)	5.6	5.0	5.1	4.9	4.5	4.3
Government budget (% of GDP)	-3.3	-1.7	-1.4	-1.1	-0.7	-0.2
Government debt (% of GDP)	83.2	81.8	80.9	80.0	79.9	79.9

Greece

- A default on Greek government debt now seems unavoidable. The key question is when this default will occur and how it will be managed. Our baseline forecast assumes that Eurozone governments will prepare this default in order to keep it controlled.
- The austerity program in place has already come at a large cost to the economy in terms of output and employment. Continued fiscal cutbacks will help keep the economy in recession, with all components of domestic demand falling sharply. We forecast a 6% fall in GDP this year, followed by around -3% next year.
- However, in the near term, the worryingly high government bond yields suggest that investors have essentially priced in a further, deeper private sector debt swap. A deeper write-down would harm, in particular, the Greek banking sector, which would have a knock-on impact on consumer and business confidence, leading to an even deeper near-term recession. Structural reforms to promote growth would become even more important.

Figure 31

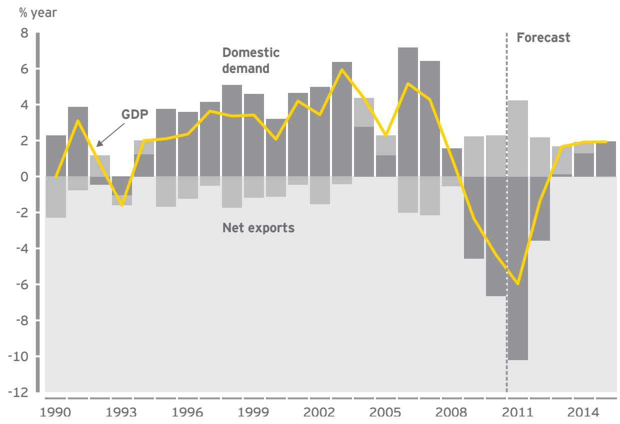
Yield curve



Source: Oxford Economics, Haver Analytics

Figure 32

Contributions to GDP growth



Source: Oxford Economics

Table 9

Greece (annual percentage changes unless specified)

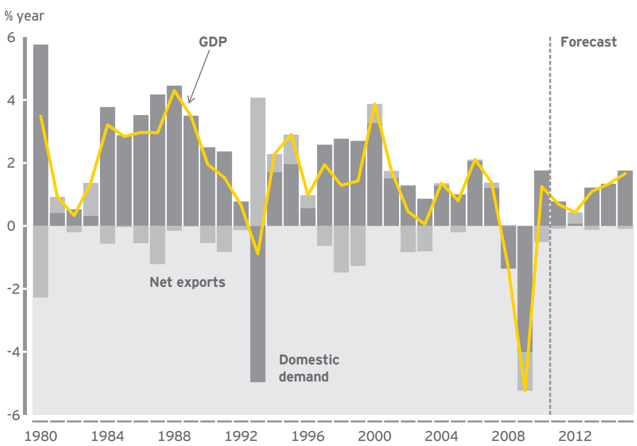
Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	-4.4	-6.0	-1.4	1.7	1.9	1.9
Private consumption	-4.6	-5.3	-3.1	0.3	0.9	1.4
Fixed investment	-16.5	-14.9	-5.2	3.4	6.0	5.3
Stockbuilding (% of GDP)	0.5	-0.7	0.6	0.4	0.3	0.5
Government consumption	-8.3	-13.4	-10.3	-2.5	-0.9	-0.4
Exports of goods and services	3.8	0.2	3.8	5.4	5.5	5.5
Imports of goods and services	-4.8	-13.3	-4.5	-0.8	2.8	5.2
Consumer prices	4.7	2.6	0.9	1.0	1.2	1.7
Unemployment rate (level)	12.6	15.7	15.9	15.7	15.2	14.6
Current account balance (% of GDP)	-10.4	-10.0	-7.6	-5.7	-4.7	-4.4
Government budget (% of GDP)	-10.5	-9.9	-8.6	-6.3	-4.7	-3.8
Government debt (% of GDP)	142.8	150.9	161.6	163.2	162.1	160.0

Italy

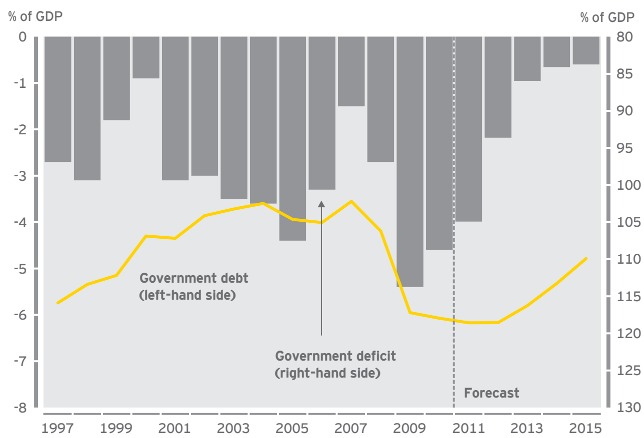
- The short-term outlook for the Italian economy has worsened significantly. We have lowered our forecasts and expect GDP to grow 0.7% in 2011 and 0.4% in 2012. Moreover, the possibility of a return to a recession cannot be excluded.
- The Government approved tough austerity measures worth €54 billion. However, toward the end of August 2011, it created unhelpful confusion over its commitment to implementing these measures. Although the package will help bring down the deficit, it will also weigh on consumer spending.
- Plunging stock markets, higher uncertainty and tighter credit conditions will affect investment, which is expected to grow around 1% in 2011 and 2012. Moreover, unemployment is expected to rise in 2012 and remain above 8% until 2013.
- Risks to the forecasts remain skewed on the downside. In particular, fiscal austerity could drag the country into recession in 2012, if it is not accompanied by reforms to boost growth.

Figure 33
Contributions to GDP growth



Source: Oxford Economics

Figure 34
Government deficit and debt



Source: Oxford Economics

Table 10
Italy (annual percentage changes unless specified)
Source: Oxford Economics

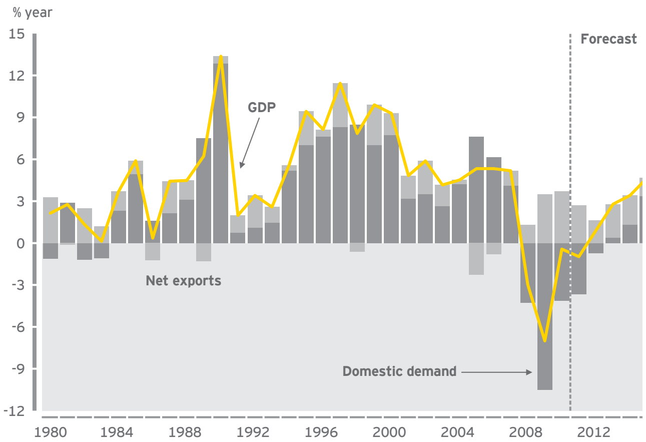
	2010	2011	2012	2013	2014	2015
GDP	1.2	0.7	0.4	1.1	1.3	1.7
Private consumption	1.0	0.7	0.3	1.0	1.2	1.5
Fixed investment	2.3	1.1	1.3	2.9	3.1	2.9
Stockbuilding (% of GDP)	0.6	0.8	0.7	0.7	0.5	0.6
Government consumption	-0.6	-0.3	-1.2	-0.4	0.8	1.1
Exports of goods and services	8.9	5.7	5.1	5.5	6.0	5.3
Imports of goods and services	10.3	5.5	3.5	5.5	5.6	5.3
Consumer prices	1.6	2.7	2.0	2.1	2.1	2.0
Unemployment rate (level)	8.4	8.1	8.2	8.1	7.7	7.4
Current account balance (% of GDP)	-3.5	-3.6	-3.0	-2.4	-2.1	-2.2
Government budget (% of GDP)	-4.6	-4.0	-2.2	-1.0	-0.7	-0.6
Government debt (% of GDP)	119.0	120.1	119.8	117.6	114.9	111.7

Ireland

- The Irish economy remains highly vulnerable to negative developments in the Eurozone. It is a long way from escaping the glare of the financial markets, and the possibility that Ireland will need a new bailout package that contains some element of debt restructuring cannot be ruled out.
- Irish GDP surprised on the upside in Q1 2011, rising 1.3%. However, due to various unresolved issues in its domestic economy, the outlook remains subdued. Meanwhile, increased uncertainty in the global economy means that an export-led recovery will also be difficult to achieve. We forecast GDP to decline by 1% in 2011 and increase by just 0.9% in 2012.
- According to a review conducted by the EU and IMF, the Irish economy remains on track to achieve its fiscal, financial and structural goals. This, however, is fraught with various risks stemming from the possibility of an escalation of the debt crisis in the wider Eurozone.

Figure 35

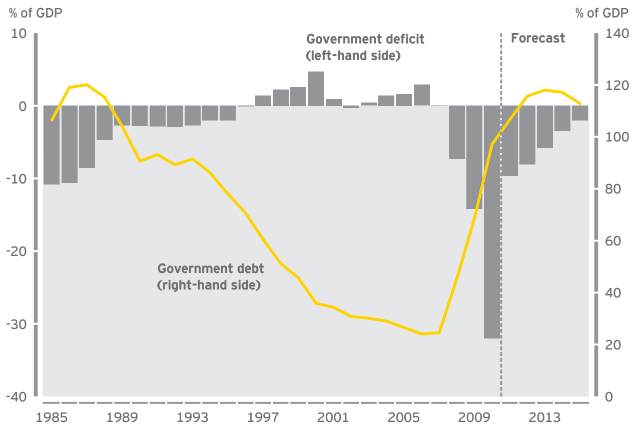
Contributions to GDP growth



Source: Oxford Economics

Figure 36

Government balance and debt



Source: Oxford Economics

Table 11

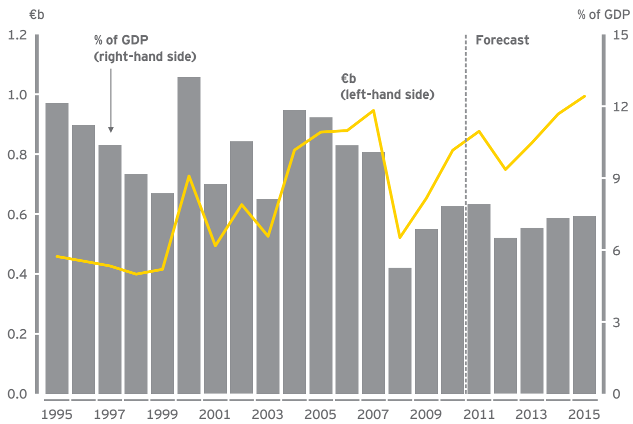
Ireland (annual percentage changes unless specified) *Source: Oxford Economics*

	2010	2011	2012	2013	2014	2015
GDP	-0.4	-1.0	0.9	2.8	3.4	4.7
Private consumption	-0.7	-4.3	-2.1	0.1	1.4	4.1
Fixed investment	-24.8	-12.8	-1.0	3.6	6.5	9.9
Stockbuilding (% of GDP)	-0.6	0.0	0.5	0.8	1.1	1.6
Government consumption	-3.9	-4.1	-2.7	-2.4	-2.4	-0.8
Exports of goods and services	6.3	4.7	4.3	5.3	5.1	4.5
Imports of goods and services	2.7	2.4	3.4	3.9	4.1	4.3
Consumer prices	-1.6	1.1	0.8	0.6	1.0	1.7
Unemployment rate (level)	13.7	14.5	14.3	13.5	13.0	12.3
Current account balance (% of GDP)	0.5	0.6	2.4	2.7	2.6	2.5
Government budget (% of GDP)	-32.0	-9.6	-8.1	-5.8	-3.5	-2.0
Government debt (% of GDP)	96.2	110.1	118.6	120.0	118.3	113.5

Luxembourg

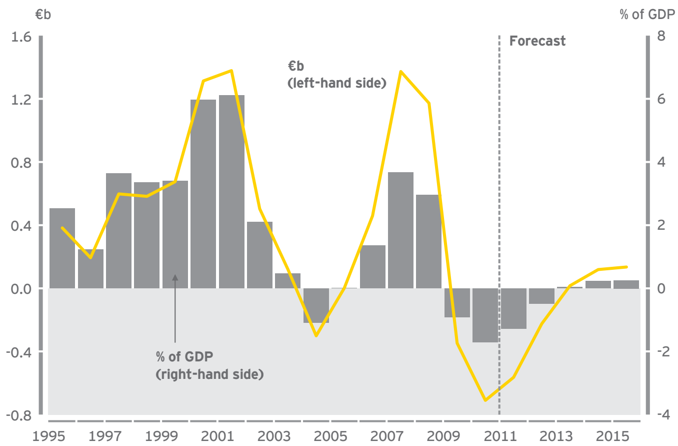
- Growth will remain well above the Eurozone average in 2011. Despite a continued subdued performance of banks, the financial sector as a whole has recovered faster than expected. But the sector is very vulnerable to a further deterioration of the sovereign debt crisis in the Eurozone, as well as to a prolonged weakness of global equity markets.
- The strong recent recovery of asset management revenues and funds under management will continue to be supported by regulatory changes. These include early adaptation of alternative investment fund rules to the EU directive, as well as other rule changes that widen the options for hedge fund registration, which, helped by the tightening of US rules for such funds, could promote their relocation to Luxembourg.
- Strong export growth, underpinned by externally oriented retail activity, has continued to widen the current account surplus, and strong government revenues are narrowing the fiscal deficit without the need for tax increases.

Figure 37
Current account balance



Source: Oxford Economics

Figure 38
Government budget balance



Source: Oxford Economics

Table 12
Luxembourg (annual percentage changes unless specified)
Source: Oxford Economics

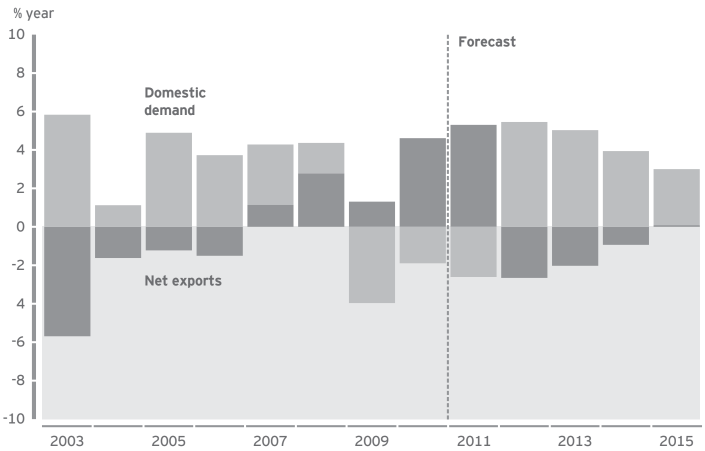
	2010	2011	2012	2013	2014	2015
GDP	3.5	3.5	1.7	3.3	3.3	3.0
Private consumption	2.0	2.0	2.9	2.9	2.8	2.5
Fixed investment	2.6	7.2	7.2	5.6	4.2	3.6
Stockbuilding (% of GDP)	0.8	1.6	0.1	0.6	0.7	0.5
Government consumption	2.9	0.3	3.2	2.0	2.0	1.9
Exports of goods and services	6.3	5.7	4.4	5.6	5.0	4.2
Imports of goods and services	6.7	6.3	5.0	6.3	5.2	4.2
Consumer prices	2.8	3.6	2.0	2.1	2.1	2.0
Unemployment rate (level)	4.5	4.4	4.6	4.5	4.4	4.4
Current account balance (% of GDP)	7.8	7.9	6.5	6.9	7.3	7.4
Government budget (% of GDP)	-1.7	-1.3	-0.5	0.0	0.2	0.3
Government debt (% of GDP)	18.4	18.6	18.4	17.5	16.3	15.3

Malta

- GDP growth declined in line with the forecasts in H1 but is expected to remain in positive territory in 2011 as a whole. We expect growth will average 2.7% in 2011 and 2.8% in 2012.
- A further slowdown of the economy is expected in H2 2011, as the tourist season is affected by the turmoil in the rest of the Eurozone and consumer spending remains very weak. In particular, we expect consumption to grow by 1.5% in 2011 and 2.8% in 2012.
- Strong growth of inward investment has continued to finance the large current account deficit, which is expected at around 4% of GDP in 2011–12. Foreign investments remain concentrated in the financial sector.
- Risks stemming from the Eurozone debt crisis have increased pressure on the Government for fiscal deficit reduction. We forecast the deficit will fall slightly from 3.1% of GDP in 2011 to 2.8% in 2013, less than that in government projections.

Figure 39

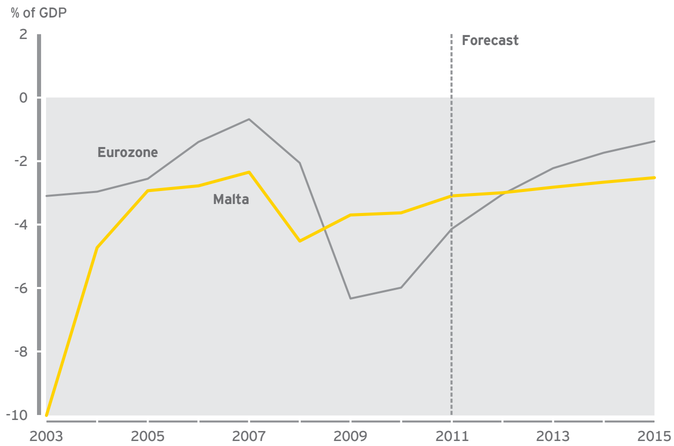
Contributions to GDP growth



Source: Oxford Economics

Figure 40

Fiscal balance vs. Eurozone



Source: Oxford Economics

Table 13

Malta (annual percentage changes unless specified)

Source: Oxford Economics

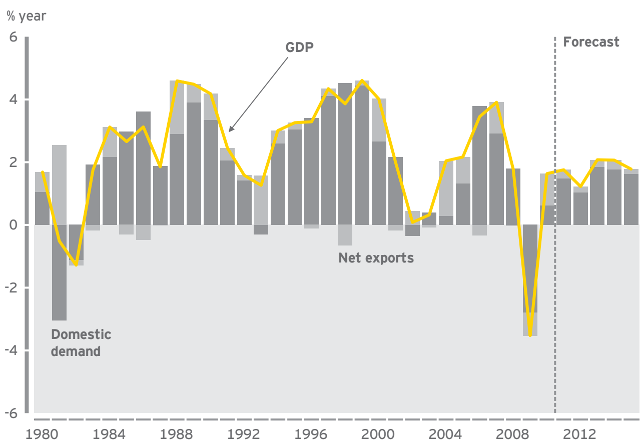
	2010	2011	2012	2013	2014	2015
GDP	2.7	2.7	2.8	3.0	3.0	3.0
Private consumption	-1.4	1.5	2.8	3.0	3.0	2.9
Fixed investment	-8.7	-16.3	9.0	16.0	8.0	6.0
Stockbuilding (% of GDP)	0.0	-2.3	0.3	1.2	1.7	1.4
Government consumption	0.9	3.6	1.1	3.0	3.0	3.0
Exports of goods and services	18.3	10.7	4.4	3.8	3.0	3.0
Imports of goods and services	12.9	5.6	7.5	6.0	4.0	3.0
Consumer prices	2.0	2.5	2.3	2.3	2.3	2.3
Unemployment rate (level)	6.9	6.5	5.8	5.4	4.6	4.5
Current account balance (% of GDP)	-5.1	-4.3	-4.0	-3.9	-3.9	-3.8
Government budget (% of GDP)	-3.7	-3.1	-3.0	-2.8	-2.7	-2.5
Government debt (% of GDP)	68.9	68.9	68.5	67.9	67.1	66.2

Netherlands

- The Dutch recovery has faltered, with previously strong export growth ebbing away and domestic demand remaining subdued. With global economic growth prospects having deteriorated over the past few months, the outlook for the Netherlands has also darkened. We now expect Dutch GDP to grow by 1.8% in 2011 and by just 1.2% in 2012.
- The consumer sector is technically in recession, reflecting the significant squeeze on households' finances from falling real wages. These pressures should ease gradually as the recent declines in commodity prices feed into consumer prices, but even then the consumer recovery will remain slow because of the need to address high levels of indebtedness.
- The risks to the forecast are skewed to the downside. Being such an open economy, the Dutch economy is most vulnerable to a renewed collapse in export demand.

Figure 41

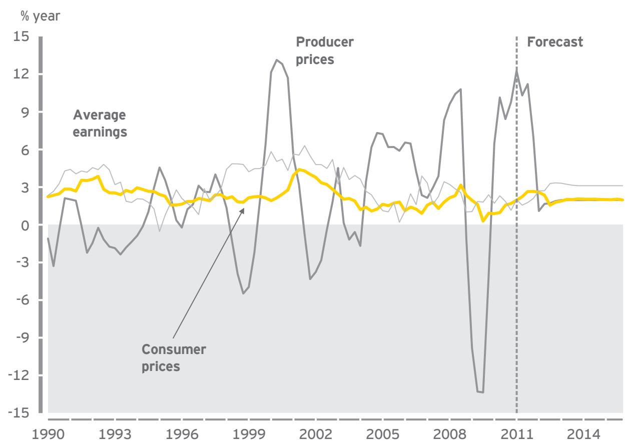
Contributions to GDP growth



Source: Oxford Economics

Figure 42

Prices and earnings



Source: Oxford Economics

Table 14

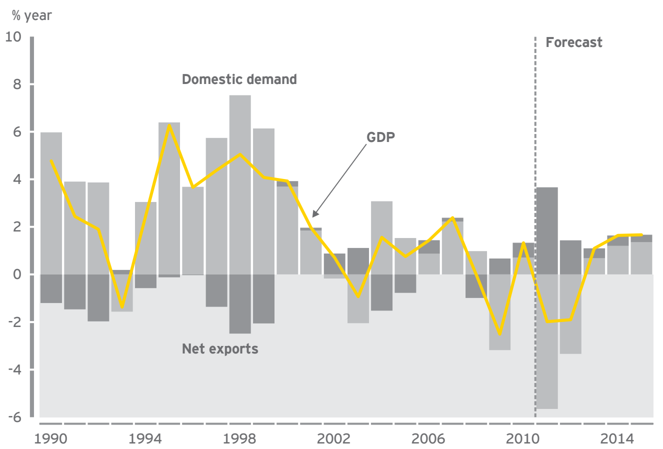
Netherlands (annual percentage changes unless specified) *Source: Oxford Economics*

	2010	2011	2012	2013	2014	2015
GDP	1.6	1.8	1.2	2.1	2.1	1.8
Private consumption	0.4	-0.1	0.7	1.8	1.8	1.7
Fixed investment	-4.4	7.1	2.7	3.5	3.1	2.8
Stockbuilding (% of GDP)	0.5	0.5	0.2	0.3	0.3	0.3
Government consumption	1.0	1.0	1.1	1.2	1.2	1.2
Exports of goods and services	10.8	6.3	5.2	5.5	5.1	4.0
Imports of goods and services	10.6	6.7	5.6	5.9	5.3	4.3
Consumer prices	0.9	2.5	1.9	1.9	1.9	2.0
Unemployment rate (level)	4.5	4.4	4.8	4.6	4.1	3.8
Current account balance (% of GDP)	7.2	8.2	7.4	7.1	6.9	6.8
Government budget (% of GDP)	-5.4	-4.3	-2.8	-2.0	-2.1	-1.2
Government debt (% of GDP)	62.7	65.0	65.9	65.3	64.8	63.6

Portugal

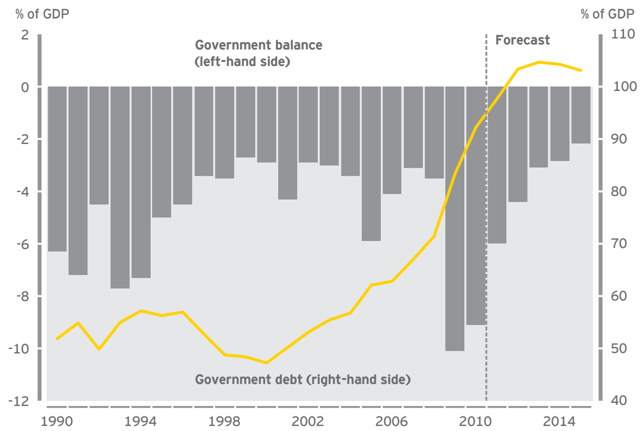
- Portuguese GDP remained flat in Q2 2011. While this was better than expected, fiscal retrenchment and downbeat levels of confidence imply that the outlook remains bleak. We don't expect the economy to recover until 2013, with GDP expected to decline by about 2% in both 2011 and 2012.
- According to the review conducted by the EU and IMF, the economy remains on track to meets its fiscal, structural and financial goals. As a result €11.5 billion has been disbursed to the Portuguese Government for the third quarter.
- However, despite this view, Portugal's sovereign debt was downgraded to junk status by Moody's amid concerns that the economy will be unable to meet the ambitious goals outlined in its bailout package, and that Portugal is likely to need additional financial assistance, possibly with an element of debt restructuring, once the international money runs out.

Figure 43
Contributions to GDP growth



Source: Oxford Economics

Figure 44
Government balance and debt



Source: Oxford Economics

Table 15
Portugal (annual percentage changes unless specified)

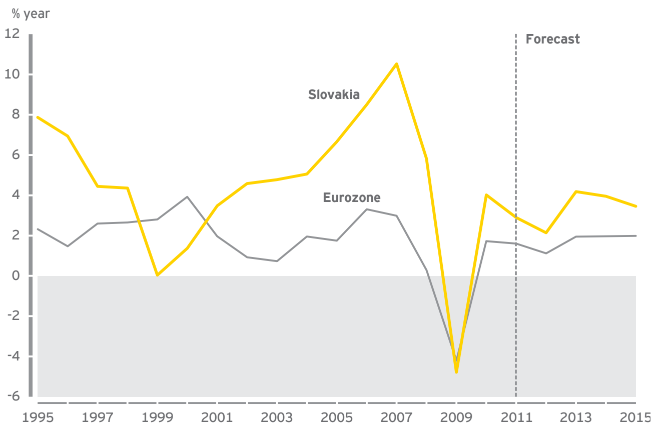
Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	1.3	-2.0	-1.9	1.1	1.6	1.7
Private consumption	2.3	-4.6	-3.5	0.4	1.3	1.1
Fixed investment	-4.9	-8.9	-3.0	1.6	4.4	4.2
Stockbuilding (% of GDP)	0.0	-0.3	0.2	0.4	-0.1	-0.4
Government consumption	1.2	-5.2	-4.9	-0.6	0.1	0.9
Exports of goods and services	8.8	6.3	4.0	4.8	5.3	4.6
Imports of goods and services	5.1	-5.5	-0.2	3.3	3.8	3.6
Consumer prices	1.4	3.4	1.0	1.5	1.9	2.0
Unemployment rate (level)	12.0	12.7	13.5	13.6	13.4	12.9
Current account balance (% of GDP)	-10.0	-8.0	-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)	93.0	99.7	104.9	105.8	105.3	103.9

Slovakia

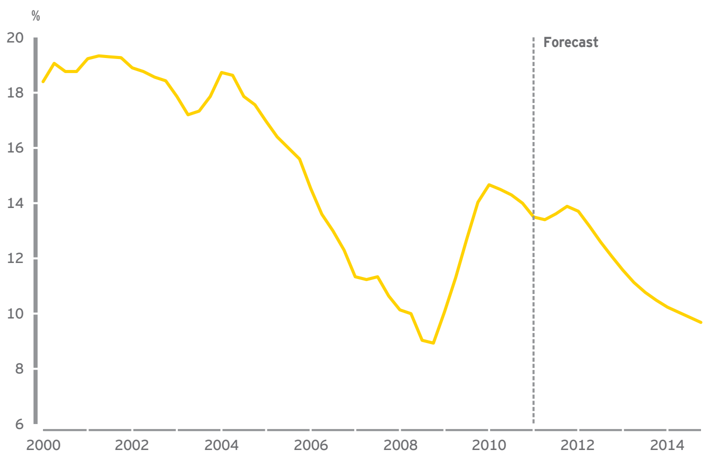
- During Q2 2011, GDP expanded a mere 0.5%, after having grown by 1% in the previous quarter as the impetus from households and the external sector eased. These are trends that are unlikely to be quickly reversed. As a result, the forecast for growth in 2011 has been revised to 2.9% from 3.4% in June 2011. However, Slovakia is still expected to remain one of the strongest performers in the Eurozone over the medium term and we expect the economy to grow, on average, 3.6% per year between 2012 and 2015.
- Growth in Slovakia's European trading partner is likely to remain subdued for some time yet as the repercussions of the sovereign debt crisis continue to be felt and, as a result, export growth will only average 5.6% in 2012, significantly weaker than 2011 and 2010. This highlights the country's exposure to external developments. Should the Eurozone fall back into recession, Slovakia would be particularly badly hit.

Figure 45
Real GDP growth



Source: Oxford Economics

Figure 46
Unemployment rate



Source: Oxford Economics, Haver Analytics

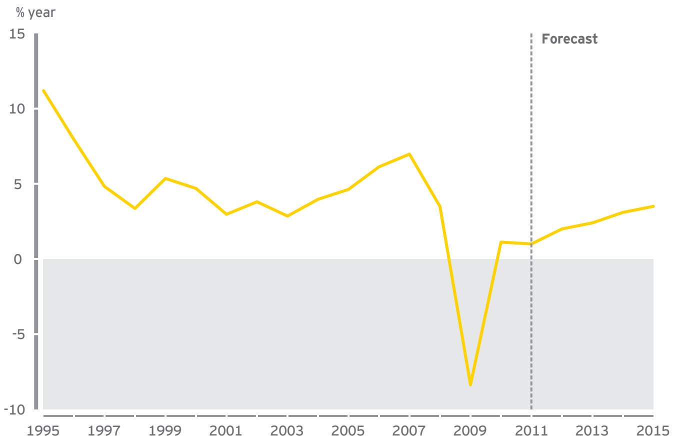
Table 16
Slovakia (annual percentage changes unless specified)
Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	4.0	2.9	2.1	4.2	4.0	3.5
Private consumption	-0.3	-0.1	1.3	4.3	4.9	4.4
Fixed investment	3.6	3.5	4.0	6.4	6.4	5.7
Stockbuilding (% of GDP)	-0.2	-1.0	1.0	1.0	1.2	1.5
Government consumption	0.1	-2.1	1.7	3.2	2.6	2.5
Exports of goods and services	16.4	10.1	5.6	9.0	8.3	6.8
Imports of goods and services	14.9	7.0	8.0	9.9	9.6	8.1
Consumer prices	1.0	3.6	2.8	2.5	2.4	2.3
Unemployment rate (level)	14.4	13.6	13.3	11.7	10.6	10.0
Current account balance (% of GDP)	-3.4	-2.7	-3.3	-3.2	-3.2	-2.9
Government budget (% of GDP)	-7.9	-5.3	-4.3	-3.5	-3.0	-2.7
Government debt (% of GDP)	41.0	43.0	44.3	43.7	42.8	41.8

Slovenia

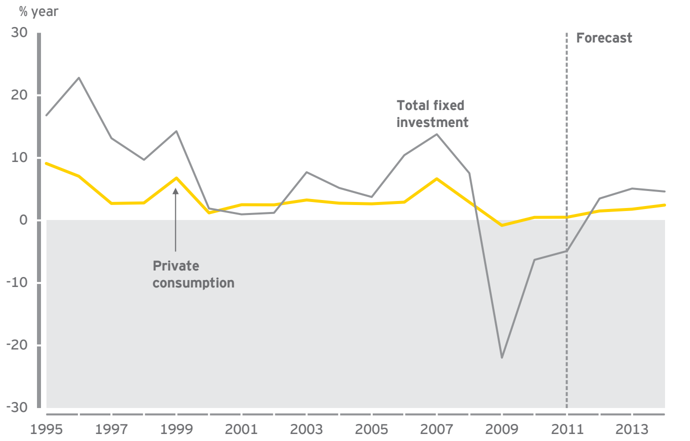
- The growth outlook has deteriorated and it is now unlikely that the economy will grow by the 1.8% assumed in this year's budget. Industrial production and retail sales declined during Q2, and the deep recession in the construction sector is restraining the recovery of the major banks. We now expect growth to be 1.5% in 2011 and 2% in 2012.
- Acceleration of growth in 2012–13 will depend on the continued recovery of tourism and net exports, and so is at risk from an escalation of the Eurozone sovereign debt crisis and a slowdown in Germany, France, Italy and other large export destinations.
- There are domestic constraints on growth. Although now recapitalized, the two biggest banks remain constrained by bad debts due to the ongoing downturn in the construction sector, and their ability to meet additional demand for loans when investment recovers next year will depend on further equity issues.

Figure 47
Real GDP



Source: Oxford Economics

Figure 48
Private consumption and total fixed investment



Source: Oxford Economics

Table 17
Slovenia (annual percentage changes unless specified)
Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	1.1	1.5	2.0	2.4	3.1	3.5
Private consumption	0.5	0.5	1.5	1.8	2.4	2.5
Fixed investment	-6.3	-4.9	3.5	5.1	4.6	4.2
Stockbuilding (% of GDP)	0.9	1.5	1.9	2.0	2.0	2.4
Government consumption	0.8	0.0	1.2	1.7	2.0	2.3
Exports of goods and services	7.4	8.0	5.1	5.5	5.6	5.3
Imports of goods and services	6.3	5.4	5.5	5.8	5.4	5.1
Consumer prices	1.8	1.9	1.8	2.5	2.8	2.8
Unemployment rate (level)	7.3	8.4	7.3	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	-5.3	-4.5	-3.8	-3.2	-3.1
Government debt (% of GDP)	38.3	42.3	45.3	46.9	47.5	47.8

Spain

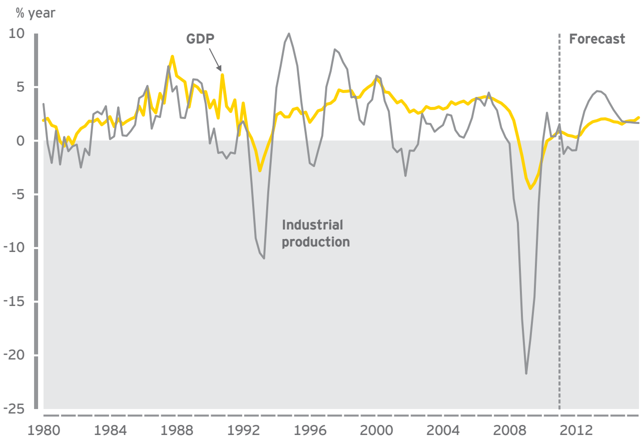
- The turmoil in global financial markets has resulted in heightened uncertainty regarding the economic outlook, both for Spain and the rest of the world. Reflecting these concerns, we have downgraded our forecasts for the second half of this year, such that Spanish GDP for 2011 as a whole is now forecast to rise by just 0.6%. Similarly, our growth forecast for 2012 has been scaled back to 0.9%.

- The risks to these forecasts are skewed to the downside. Despite significant reforms enacted by the Government since the beginning of the crisis, the task of bringing the economy onto a sustainable growth path has only just started. This will weigh on growth for many years and, until significant progress has been achieved, Spain will be exposed to reversals in investors' sentiment.

- Until there is a clear and credible firebreak in place to prevent contagion from engulfing Spain, systemic risks will remain a threat. Unfortunately, it appears that another intensification of the sovereign debt crisis may well be required to force the hand of governments in the core Eurozone.

Figure 49

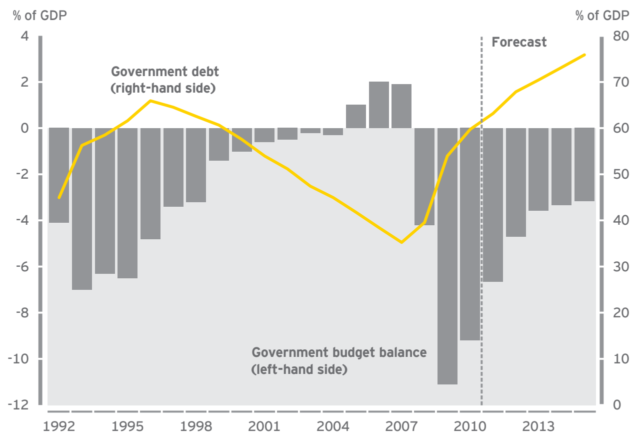
GDP and industrial production



Source: Oxford Economics

Figure 50

Government balance and debt



Source: Oxford Economics

Table 18

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

	2010	2011	2012	2013	2014	2015
GDP	-0.1	0.6	0.9	1.9	1.7	1.8
Private consumption	1.2	0.3	0.4	1.2	1.0	1.1
Fixed investment	-7.6	-6.0	0.0	4.6	4.7	3.9
Stockbuilding (% of GDP)	0.4	0.1	0.1	0.2	0.1	0.1
Government consumption	-0.7	-0.2	-1.9	0.1	1.4	2.2
Exports of goods and services	10.3	6.8	2.8	7.7	6.6	6.6
Imports of goods and services	5.4	-0.2	-0.4	7.2	6.5	7.0
Consumer prices	2.0	3.1	1.8	1.4	1.4	1.5
Unemployment rate (level)	20.1	21.0	21.1	20.2	19.6	18.7
Current account balance (% of GDP)	-4.6	-4.2	-3.1	-2.8	-2.6	-2.2
Government budget (% of GDP)	-9.2	-6.6	-4.6	-3.5	-3.2	-3.1
Government debt (% of GDP)	60.1	65.6	69.8	72.3	75.2	77.9

Detailed tables and charts

Forecast assumptions

	2010	2011	2012	2013	2014	2015
Short-term interest rates (%)	0.8	1.4	1.3	2.7	3.6	4.0
Long-term interest rates (%)	3.6	4.3	4.2	4.8	4.9	4.9
Euro effective exchange rate (1995=100)	120.7	121.1	120.4	119.4	115.4	113.5
Oil prices (€/barrel)	59.9	78.5	75.6	76.7	80.1	84.5
Share prices (% year)	7.1	-1.6	4.1	10.7	7.2	6.3

	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	1.5
Long-term interest rates (%)	3.7	3.6	3.4	3.8	4.3	4.5	4.3	4.1
Euro effective exchange rate (1995=100)	125.6	118.6	118.0	120.4	119.8	123.0	121.0	120.4
Oil prices (€/barrel)	76.2	78.4	76.7	86.6	104.8	117.6	113.4	107.2
Share prices (% year)	41.5	7.1	-4.3	-5.8	-0.7	10.7	-8.8	-6.8

Eurozone GDP and components

Quarterly forecast
(quarterly percentage changes)

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	0.4	0.9	0.4	0.3	0.8	0.2	0.1	0.2
Private consumption	0.3	0.2	0.2	0.3	0.2	-0.2	0.1	0.1
Fixed investment	-0.7	2.1	-0.1	-0.2	1.8	0.2	-0.1	0.3
Government consumption	-0.5	0.3	0.1	0.0	0.4	-0.2	-0.2	-0.1
Exports of goods and services	3.3	4.2	1.8	1.4	2.0	1.0	0.7	0.9
Imports of goods and services	3.7	3.8	1.4	1.2	1.5	0.5	0.3	0.7

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

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	0.4	0.9	0.4	0.3	0.8	0.2	0.1	0.2
Private consumption	0.2	0.1	0.1	0.2	0.1	-0.1	0.1	0.0
Fixed investment	-0.1	0.4	0.0	0.0	0.3	0.0	0.0	0.0
Government consumption	-0.1	0.1	0.0	0.0	0.1	0.0	0.0	0.0
Stockbuilding	0.5	0.1	0.0	0.1	0.0	0.0	-0.1	-0.1
Exports of goods and services	1.4	1.8	0.8	0.6	0.9	0.5	0.3	0.4
Imports of goods and services	-1.5	-1.6	-0.6	-0.5	-0.7	-0.2	-0.1	-0.3

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

	2010	2011	2012	2013	2014	2015
GDP	7,579	7,700	7,786	7,938	8,095	8,255
Private consumption	4,343	4,364	4,393	4,452	4,518	4,590
Fixed investment	1,457	1,490	1,517	1,573	1,636	1,695
Government consumption	1,616	1,621	1,619	1,627	1,642	1,661
Stockbuilding	44	47	42	57	59	63
Exports of goods and services	3,395	3,612	3,777	4,005	4,239	4,463
Imports of goods and services	3,276	3,434	3,562	3,776	4,000	4,217

Annual levels — nominal terms
(€ billion)

	2010	2011	2012	2013	2014	2015
GDP	9,162	9,437	9,688	10,041	10,411	10,802
Private consumption	5,268	5,415	5,539	5,714	5,903	6,106
Fixed investment	1,735	1,805	1,864	1,966	2,078	2,189
Government consumption	2,016	2,045	2,074	2,123	2,185	2,254
Stockbuilding	22	42	15	25	31	38
Exports of goods and services	3,746	4,141	4,402	4,751	5,118	5,484
Imports of goods and services	3,625	4,010	4,206	4,538	4,903	5,269

Prices and costs indicators

(annual percentage changes unless specified)

	2010	2011	2012	2013	2014	2015
HICP headline inflation	1.6	2.6	1.8	1.8	1.8	1.8
Inflation ex-energy	1.0	1.5	1.7	1.7	1.7	1.7
GDP deflator	0.8	1.4	1.5	1.7	1.7	1.7
Import deflator	4.7	4.6	1.7	1.8	1.8	1.7
Export deflator	10.8	6.7	-0.1	1.0	1.4	1.6
Terms of trade	6.1	2.2	-1.8	-0.8	-0.3	-0.1
Earnings	1.7	2.1	2.3	2.7	2.9	3.0
Unit labor costs	-0.5	0.7	1.2	1.1	1.3	1.4
Output gap (% of GDP)	-3.7	-2.7	-2.7	-2.1	-1.6	-1.1
Oil prices (€ per barrel)	59.9	78.5	75.6	76.7	80.1	84.5
Euro effective exchange rate (1995=100)	120.7	121.1	120.4	119.4	115.4	113.5

	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	2.7	2.5
Inflation ex-energy	0.9	0.9	1.0	1.1	1.3	1.7	1.5	1.5
GDP deflator	0.5	0.8	1.1	1.0	1.3	1.4	1.2	1.6
Import deflator	1.2	5.2	6.0	6.3	7.3	4.0	3.3	3.8
Export deflator	4.4	11.5	12.9	14.2	15.4	7.8	2.2	2.4
Terms of trade	3.2	6.3	6.9	7.9	8.1	3.8	-1.1	-1.4
Earnings	1.5	2.0	1.6	1.5	2.0	1.9	2.2	2.2
Unit labor costs	-0.5	-0.7	-0.7	-0.3	-0.2	0.7	1.2	1.2
Output gap (% of GDP)	-4.5	-3.6	-3.3	-3.2	-2.5	-2.6	-2.7	-2.8
Oil prices (€ per barrel)	76.2	78.4	76.7	86.6	104.8	117.6	113.4	107.2
Euro effective exchange rate (1995=100)	125.6	118.6	118.0	120.4	119.8	123.0	121.0	120.4

Labor market

(annual percentage changes unless specified)

	2010	2011	2012	2013	2014	2015
Employment	-0.5	0.3	0.1	0.4	0.4	0.4
Unemployment rate (%)	10.1	10.0	9.9	9.6	9.2	8.9
NAIRU (%)	8.6	8.9	8.8	8.7	8.4	8.2
Participation rate (%)	73.9	74.0	74.2	74.4	74.6	74.8
Earnings	1.7	2.1	2.3	2.7	2.9	3.0
Unit labor costs	-0.5	0.7	1.2	1.1	1.3	1.4

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Employment	-1.3	-0.6	-0.1	0.3	0.3	0.5	0.3	0.1
Unemployment rate (%)	10.1	10.2	10.1	10.1	10.0	10.0	10.0	10.1
NAIRU (%)	8.4	8.5	8.6	8.8	8.9	8.9	8.9	8.9
Participation rate (%)	73.8	73.9	73.8	73.9	73.9	74.1	74.1	74.1
Earnings	1.5	2.0	1.6	1.5	2.0	1.9	2.2	2.2
Unit labor costs	-0.5	-0.7	-0.7	-0.3	-0.2	0.7	1.2	1.2

Current account and fiscal balance

	2010	2011	2012	2013	2014	2015
Trade balance (€b)	-11.4	-34.5	6.1	21.0	20.7	16.2
Trade balance (% of GDP)	-0.2	-0.4	0.1	0.3	0.3	0.2
Current account balance (€b)	-43.1	-75.6	-47.1	-31.9	-28.7	-29.7
Current account balance (% of GDP)	-0.5	-0.8	-0.5	-0.3	-0.3	-0.3
Government budget balance (€b)	-550	-392	-299	-227	-184	-149
Government budget balance (% of GDP)	-6.0	-4.2	-3.1	-2.3	-1.8	-1.4
Cyclically adjusted surplus (+)/deficit (-) (% of GDP)	-5.5	-3.8	-2.6	-1.6	-1.0	-0.6
Government debt (€b)	7,837	8,204	8,522	8,822	9,138	9,465
Government debt (% of GDP)	103.4	106.5	109.5	111.1	112.9	114.7

Measures of convergence and divergence within the Eurozone

	2001–2005	2006–2010	2011–2015
Growth and incomes			
Standard deviation of GDP growth rates	1.8	2.2	1.3
Growth rate gap (max–min)	6.4	8.7	4.7
Highest GDP per capita (Eurozone = 100)	233.4	247.1	251.3
Lowest GDP per capita (Eurozone = 100)	50.9	64.8	66.5
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)	116.4	116.5	115.9
Lowest price level (Eurozone = 100)	63.3	66.0	67.1

Cross-country tables

Real GDP
(% year)

Rank		2010	2011	2012	2013	2014	2015	Average 2011-2015
1	Estonia	3.1	7.2	3.8	4.2	4.8	4.7	**4.9**
2	Slovakia	4.0	2.9	2.1	4.2	4.0	3.5	**3.3**
3	Luxembourg	3.5	3.5	1.7	3.3	3.3	3.0	**3.0**
4	Malta	2.7	2.7	2.8	3.0	3.0	3.0	**2.9**
5	Finland	3.6	3.0	2.1	3.1	2.7	2.6	**2.7**
6	Cyprus	1.0	1.2	1.4	3.4	3.6	3.6	**2.6**
7	Slovenia	1.1	1.5	2.0	2.4	3.1	3.5	**2.5**
8	Belgium	2.1	2.5	1.8	2.7	2.2	2.0	**2.2**
9	Austria	2.2	3.4	1.7	2.0	1.9	1.9	**2.2**
10	Germany	3.5	3.1	1.5	2.1	2.1	2.0	**2.2**
11	Ireland	-0.4	-1.0	0.9	2.8	3.4	4.7	**2.1**
12	Netherlands	1.6	1.8	1.2	2.1	2.1	1.8	**1.8**
13	France	1.4	1.6	1.2	2.0	2.0	2.0	**1.8**
14	Eurozone	1.7	1.6	1.1	1.9	2.0	2.0	**1.7**
15	Spain	-0.1	0.6	0.9	1.9	1.7	1.8	**1.4**
16	Italy	1.2	0.7	0.4	1.1	1.3	1.7	**1.0**
17	Portugal	1.3	-2.0	-1.9	1.1	1.6	1.7	**0.1**
18	Greece	-4.4	-6.0	-1.4	1.7	1.9	1.9	**-0.4**

Inflation rates
(% year)

Rank		2010	2011	2012	2013	2014	2015	Average 2011-2015
1	Ireland	-1.6	1.1	0.8	0.6	1.0	1.7	**1.0**
2	Greece	4.7	2.6	0.9	1.0	1.2	1.7	**1.5**
3	Spain	2.0	3.1	1.8	1.4	1.4	1.5	**1.8**
4	France	1.7	2.2	1.8	1.8	1.9	1.9	**1.9**
5	Germany	1.2	2.4	1.7	1.8	1.8	1.8	**1.9**
6	Eurozone	1.6	2.6	1.8	1.8	1.8	1.8	**2.0**
7	Portugal	1.4	3.4	1.0	1.5	1.9	2.0	**2.0**
8	Netherlands	0.9	2.5	1.9	1.9	1.9	2.0	**2.0**
9	Finland	1.7	3.2	2.1	1.8	1.7	1.7	**2.1**
10	Italy	1.6	2.7	2.0	2.1	2.1	2.0	**2.2**
11	Belgium	2.4	3.5	1.8	1.9	2.0	1.9	**2.2**
12	Austria	1.7	3.4	2.2	2.1	2.0	2.0	**2.3**
13	Slovenia	1.8	1.9	1.8	2.5	2.8	2.8	**2.3**
14	Malta	2.0	2.5	2.3	2.3	2.3	2.3	**2.4**
15	Luxembourg	2.8	3.6	2.0	2.1	2.1	2.0	**2.4**
16	Cyprus	2.6	3.6	2.7	2.3	2.3	2.3	**2.6**
17	Slovakia	1.0	3.6	2.8	2.5	2.4	2.3	**2.7**
18	Estonia	3.0	4.9	2.7	2.3	2.1	2.2	**2.9**

Cross-country tables

Unemployment rate
(% of labor force)

Rank		2010	2011	2012	2013	2014	2015	Average 2011-2015
1	Austria	4.4	4.2	4.3	4.1	4.1	4.2	**4.1**
2	Netherlands	4.5	4.4	4.8	4.6	4.1	3.8	**4.3**
3	Luxembourg	4.5	4.4	4.6	4.5	4.4	4.4	**4.5**
4	Malta	6.9	6.5	5.8	5.4	4.6	4.5	**5.3**
5	Germany	7.1	6.1	5.9	5.7	5.5	5.3	**5.7**
6	Cyprus	6.4	7.3	6.8	6.0	5.0	4.5	**5.9**
5	Slovenia	7.3	8.4	7.3	6.0	5.1	5.1	**6.4**
8	Belgium	8.3	7.4	7.2	6.6	6.4	6.4	**6.8**
9	Finland	8.4	7.9	7.6	7.2	7.0	6.9	**7.3**
10	Italy	8.4	8.1	8.2	8.1	7.7	7.4	**7.9**
11	France	9.8	9.6	9.3	8.8	8.4	8.1	**8.9**
12	Estonia	16.8	13.2	10.9	9.1	7.3	6.0	**9.3**
13	Eurozone	10.1	10.0	9.9	9.6	9.2	8.9	**9.5**
14	Slovakia	14.4	13.6	13.3	11.7	10.6	10.0	**11.8**
15	Portugal	12.0	12.7	13.5	13.6	13.4	12.9	**13.2**
16	Ireland	13.7	14.5	14.3	13.5	13.0	12.3	**13.5**
17	Greece	12.6	15.7	15.9	15.7	15.2	14.6	**15.4**
18	Spain	20.1	21.0	21.1	20.2	19.6	18.7	**20.1**

Government budget
(% of GDP)

Rank		2010	2011	2012	2013	2014	2015	Difference 2011-2015
1	Estonia	0.1	-0.8	-2.3	0.1	0.1	0.0	**-0.1**
2	Malta	-3.7	-3.1	-3.0	-2.8	-2.7	-2.5	**1.1**
3	Luxembourg	-1.7	-1.3	-0.5	0.0	0.2	0.3	**1.9**
4	Finland	-2.5	-1.4	-1.1	-0.8	-0.6	-0.3	**2.2**
5	Austria	-4.6	-3.6	-3.0	-2.6	-2.3	-2.1	**2.5**
6	Slovenia	-5.6	-5.3	-4.5	-3.8	-3.2	-3.1	**2.5**
7	Cyprus	-5.3	-4.7	-4.0	-3.0	-2.4	-2.4	**2.9**
8	Germany	-3.3	-1.7	-1.4	-1.1	-0.7	-0.2	**3.1**
9	Italy	-4.6	-4.0	-2.2	-1.0	-0.7	-0.6	**4.0**
10	Belgium	-4.1	-3.0	-2.5	-1.8	-0.7	0.0	**4.1**
11	Netherlands	-5.4	-4.3	-2.8	-2.0	-2.1	-1.2	**4.2**
12	France	-7.0	-5.9	-4.8	-3.8	-3.0	-2.6	**4.4**
13	Eurozone	-6.0	-4.2	-3.1	-2.3	-1.8	-1.4	**4.6**
14	Slovakia	-7.9	-5.3	-4.3	-3.5	-3.0	-2.7	**5.2**
15	Spain	-9.2	-6.6	-4.6	-3.5	-3.2	-3.1	**6.1**
16	Greece	-10.5	-9.9	-8.6	-6.3	-4.7	-3.8	**6.7**
17	Portugal	-9.1	-6.0	-4.4	-3.1	-2.8	-2.2	**6.9**
18	Ireland	-32.0	-9.6	-8.1	-5.8	-3.5	-2.0	**30.0**

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