



Eurozone

Ernst & Young Eurozone Forecast

Winter edition - December 2011



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Welcome



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

In our Autumn forecast in September, we outlined our concerns about prospects for the Eurozone economy and predicted a slowdown in growth. While recognizing that there were significant downside risks, I don't think any of us thought that our Winter 2011

report would be anticipating negative growth in the fourth quarter, a mild recession in the first half of 2012 and a fundamental debate about the future of both the Euro and the European Union.

The agreement on 9 December, on a pact to tighten fiscal policy and monitoring, is a significant further step towards the integration of the European Union. In moving to strengthen the authority framework to manage the single currency, the leaders of Europe have sought to address one of the major criticisms of how the Euro was originally set-up and subsequently operated. In doing so, the political leadership of many countries have recognised the increasingly theoretical nature of national sovereignty in a global economy. Sovereignty is not about being free to agree your own policies but about having power to control the consequences for your citizens. By pooling authority, a large majority of national political leaders in Europe believe they can have a greater collective control of events than acting alone. In this case, they believe that

giving up powers to tax and spend freely will deliver the benefits of greater economic growth potential.

The fiscal compact is a bold step and much work is required before it comes into operation, most importantly ratification at the local level by national parliaments. Not all countries may be able to meet the new criteria or gain local political consensus but a direction has been set. We have clarity even if we still have significant uncertainty.

And one of the major issues is that while the fiscal compact will prevent the building up of sovereign debt in the future, its impact on dealing with the current debt crisis is less clear and possibly more indirect than direct. The uncertainties associated with the current level of sovereign debt remain, as do liquidity challenges and high levels of unemployment in many of the Eurozone countries. As we highlight in this report, the economic growth prospects for some of the most challenge Eurozone countries remain bleak with, in the worst affected, recession conditions continuing for several years. This will hamper efforts being made to address the level of debt in their economies.

We will continue to see a debate among the political leadership of Europe, but this also needs to happen within the boardrooms of companies that operate across Europe. Ernst & Young's quarterly *Eurozone Forecasts* this year have repeatedly drawn attention to the damage that major uncertainties about the future of the Eurozone are inflicting on actual growth rates and prospects. Lack of confidence is leading to delay in business investment, which in turn delays a return to growth.

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But business also has a role as an active participant in this debate. Businesses, after all, have been among the loudest voices arguing for the single market and the single currency to enable them to compete successfully in the global economy. Business should also recall that even when the single currency was launched, it was recognized that one of its benefits would be that, through increasing transparency and competition, countries would be forced to address some of the structural reforms that businesses argue are needed by the new economy. One of the major drivers behind the current crisis is that some countries have been too slow to address these challenges.

The fiscal compact reconfirms the logic of a single European market as the primary device to provide European companies with a “domestic market” similar in scale to China, India or the US. It is the success of those companies – both in the single market and beyond – that will determine the future prosperity of Europe and its citizens.

In our interconnected world, no country is immune from the impact of troubles in one of the major markets. The Eurozone has stalled and risks a double-dip recession – albeit probably less severe than in 2008-09 – but so too have other developed markets. The prospects for the UK and the US, for example, remain difficult. Nor are the emerging markets immune – while their growing domestic demand bodes well for the future, exports still feature as a major factor in their economic performance. Our recent *Rapid-Growth Markets Forecast* indicated that their growth was falling back as a consequence of the problems in advanced economies, albeit that this

slows rather than stops their ascent to global leadership.

The “borrow to buy” decade has come to an end and the consequent debt has major implications for individuals, companies and countries. However, while focusing on the debt carcass may be necessary, it will not feed the future. Fundamentally, the real challenge for Europe and the “advanced economies” is growth and whether mature economies can find ways to grow above their historical trend to pay off their debt and learn to live within their means going forward. This is a huge and multifaceted challenge, but I think there are at least three areas for immediate focus by governments and business.

Firstly, there are opportunities for individual management teams to improve their performance and the performance of their business. Difficult economic conditions may be around for some time – and not just in the Eurozone – the challenge is whether a business can master them. And in our recent study, *Growing Beyond*, we found the number of companies reporting that they are now looking to take advantage of the new economy had increased from 19% to 29% since 2008. These companies are ahead in optimizing their customer reach, their operational agility, their cost competitiveness and their stakeholder confidence. Confidence is a key factor – it marks the moment when a person or an organization stops looking for barriers to excuse inaction and starts looking for opportunities to improve.

Secondly, there are growing markets where companies from Europe need to win. In our recent report, *Trading places*, we model the emergence of new

patterns of international trade over the next 10 years. World trade in goods has recovered strongly and we forecast will total around US\$35 trillion by 2020 – two and a half times its level in 2010. World trade in services will double in the same period to US\$6 trillion. Patterns of trade will change dramatically, but Europe is well placed to gain not least because Europe, led by the European Union (EU), has been at the forefront of driving free-trade agreements with countries around the world. We forecast that Europe is the developed region that is expected to gain most, for example, from the expansion of demand in China, with exports rising by around US\$370 billion over the next 10 years.

Finally, as well as government making essential structural reforms to support the creation of new business and new jobs, we need to encourage change in the culture of Europe toward business, innovation and entrepreneurship. In our 2011 *Entrepreneurship Barometer* produced for the G20 Young Entrepreneur Summit in October, we explored what governments in the G20 were doing to provide the right platforms for growth through effective policies, regulations and incentives. The EU and a number of European governments are engaged in addressing this area. All of us need to be actively involved.

I encourage you to visit our dedicated Eurozone website – www.ey.com/eef – for additional information on the Ernst & Young *Eurozone Forecast* and the 17 individual country forecasts it comprises.

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A test of nerve and confidence



Economics and politics are inseparable. Economic crises are a test, not only of political nerve, but also of business confidence. With the agreement on a tax and budget pact on December 9, known as the “fiscal compact”, European leaders have taken a step towards closer fiscal integration in the belief that providing a stronger authority framework will give greater credibility to the shared currency. Closer integration with greater authority and fiscal discipline is intended to generate greater certainty and hence confidence in the euro. There is much work still to do and even the leaders themselves do not believe that the accord will be finalized before March – a full 4 months away.

If a week is a long time in politics, it can seem an eternity to the financial markets who have an inherent and seemingly insatiable appetite for data and drama. Our forecast says that the Eurozone economy has probably already fallen back into a recession. Growth will only resume toward the end of next year, rising to 1.5%-2% in 2013-15, after just 0.1% for 2012. Unemployment will not fall below 10% until 2015. Even though December 9 brought an agreement on binding rules over tax and spending, and sanctions against countries that overspend, the recession will still be a reality to tackle for business leaders in the near future. As Governments, corporates, financial institutions and the European Union work to transform themselves, there is a real risk of severe disruptions to normal patterns of economic activity. Markets are extremely volatile and even seemingly minor events can cause significant reactions in this environment

The near future will therefore continue to be volatile and business leaders in the Eurozone need to take precautionary steps to minimize risks as well as see the opportunities when and where they are offered.

The Eurozone solution: austerity and growth

The elixir of economic growth is needed to find a lasting solution to the debt crisis. Certainly, the extreme weakness of European growth prospects will do nothing to encourage investment in the Eurozone economy – quite the opposite, in fact. The paradox is that the fiscal compact will impose increased austerity on national governments and reduce their ability to stimulate growth in their countries. Having a balanced lifestyle may be essential to a long and healthy life, but no one would argue that dieting is the happiest of experiences.

Our Winter 2011 forecast expects business investment to be on hold in 2012. This is severely disappointing given that large companies are holding very large cash balances. It would seem that many boards will again succumb to the temptations of buying back shares or holding cash reserves rather than investing in growth – either through investing locally in Europe or in Rapid growth markets elsewhere. Aversion to risk is now very strong in corporate boardrooms.

But as the Eurozone (and the UK) slides into a recession, the really vulnerable companies are in the small and medium-sized enterprise (SME) sector. Large businesses are better placed to see a recession through, thanks to their cash reserves; few SMEs have such luxury. They are very much more dependent on their banks for working capital and credit lifelines. In normal times, banks will lend to well-managed SMEs with good products and a strong client base, even when they run into temporary difficulties. But the near-term anxiety in the Eurozone means a credit tightening by banks, out of caution and risk aversion in some cases, and out of the necessity to strengthen their capital in others. The European Council agreed on 26 October that bank capital should be strengthened up to 9% of risk weighted assets. This is not a tough target for all banks, but it is for some. These are probably the ones that featured in the European Central Bank's Q4 2011 lending survey as tightening their lending standards.



It is likely that banks will restrict their lending and their business, leading companies to secure financing for every possible situation. Therefore, both the availability of financing and the cost of capital will be a challenge. To respond to the decreased possibilities of accessing capital, companies need to replace some of their former credit lines with other sources of credit. This will create new markets and new market parties, through joint ventures, for example. Challenging times also create opportunities, so the strongest companies need to be active in taking advantage of cases that may appear. At the same time, when companies are looking for growth opportunities, they need to be ready for sustained cost reduction.

Rapid-growth markets can be a real help

If SMEs are badly hit by a credit crunch, there will be virtually no prospect of achieving a serious reduction in unemployment rates, nor of returning consumption to a rising trend. Our Winter 2011 forecast sees private consumption grinding to a halt. It concludes that the best hope of a growth stimulus lies in exports, above all to the emerging economies. The Ernst & Young *Rapid-Growth Markets Forecast* (issued in November 2011) expects an average 6% growth in 2012, with slightly more than 7% in Asia. India will lead the way with 8.7% growth a year for 2012-15, closely followed by China with 8.5%. These numbers are a softening on this year's performance for these countries and regions but highly valuable for the global economy and European businesses if they hold.

According to our *Rapid-Growth Markets Forecast*, advanced economies will be exporting 33% of all their exports to rapid-growth markets by 2020, equivalent to US\$17.6 trillion, compared with US\$9.3 trillion today. This should deliver some kind of boost to the Eurozone economy in the coming years and is why we expect Eurozone growth to recover to 2% by 2014-15. Rapid-growth markets are already becoming vital for some consumer products manufacturers, such as the beer, spirits and wine sector, whose products are in great demand from the rapidly growing middle classes in

these countries. The IMF estimates indicate that 70% of world growth over the next few years will come from emerging markets, with China and India accounting for 40% of this growth.

In drawing attention to the opportunities in rapid-growth markets, we are not only thinking in terms of private sector markets. The public sector's procurement needs should also be investigated and addressed by many companies beginning to feel the effects of the squeeze on spending in European countries.

The business wish list

One key growth factor is innovation and, although the EU has been very ambitious in this field, initiating many important projects to stimulate innovation, the question is: how can the EU innovation policy be more effective? It is interesting to note that the public sector investment in innovation in Europe is higher than anywhere else in the world, the shortfall is caused by a lack of private sector investment. In our latest report on EU innovation policy, *Next generation innovation policy*¹, a number of the business specialists interviewed state that they want to see more effective university-industry partnerships and technology transfer. They also think that the EU and national governments should do more to create demand for innovation. Another key issue they point out is the fact that the innovation policy is too fragmented at a national level and they want to see a stronger coordination of innovation policy at the EU level.

Respondents in our latest *Entrepreneurship Barometer*² are content with parts of the markets conditions in the EU; for example, the sophisticated financial sector, the high-quality education and access to several well-established SME stock markets. However, respondents are negative about funding as well as regulatory channels, and they point out the remaining barriers to a single EU labor market as an obstacle for growth.

¹ Next generation, innovation policy. The future of EU innovation policy to support market growth. www.ey.com/government-innovation
² Entrepreneur Barometer. www.ey.com



The demand for a European “growth-enhancing” policy is also reflected in Business Europe’s priorities:

- ▶ Full implementation of the services directive in the single market, together with developing e-commerce and the deployment of broadband networks
- ▶ Concluding the World Trade Organization’s Doha Round and strengthening transatlantic economic cooperation
- ▶ Closing the skills gap in science, technology, engineering and mathematics
- ▶ Employment policies that will reintegrate the 10 million long-term unemployed into the labor market and address the growing problem of youth unemployment.
- ▶ Leveraging the €200 billion investment needed in European energy infrastructure by 2020

Clearly there is a strong engagement and willingness among business to be part of the discussion on how to create real growth and build a future for Europe as a strong player in the global market.

In the meantime, boards have to review and implement their strategies for coping with low or zero growth in the Eurozone. European and US difficulties have enhanced the rise of Asia, and will continue to do so. Companies need to ensure that they have an eligible Asia strategy. We think that businesses with a strong Asia strategy and foothold will outperform their Europe- or US-focused competitors. Another opportunity for growth is technology that will drive productivity to public services, especially to care of the elderly.

The economic doldrums are a time for companies to seek to raise efficiencies, because it is often the case that quality companies take market share from weaker competitors during a downturn. Outsourcing inevitably comes up for review, although the argument is far from cut-and-dried between bringing certain functions and processes back into a company and maintaining outsourcing. The issue needs to be looked at on its merits and the advantages of existing arrangements either confirmed or questioned.

Investing for growth can be a winning strategy during a recession, and merger and acquisitions markets currently make very good propositions. There are bargains to be had: shares in Europe are trading on low price/earnings ratios – even on a 10-year average. Some analysts are predicting an M&A boom before long.

However, the near-term evolution of the financial markets very much depends on how the sovereign debt crisis unfolds. There are already some positives: The agreement reached on 9 December offers a platform for a strengthened integration and tightened fiscal policy. Greece and Italy have Governments of limited duration with mandates to reform public finances and administration, restructure labor and product markets, privatize state assets and adopt growth-enhancing structural policies. These Governments draw their political strength, as do those in Portugal and Ireland, from a general, if reluctant, acceptance by their political classes that there are no viable alternative strategies consistent with remaining in the Eurozone. The next 12 months will be crucial for the future of the European single currency area. If the crisis eases, Europe will tread a route to recovery, and emerging markets and the global economy as a whole can look forward to stability and growth.

Questions for businesses active in the Eurozone

Shareholders, analysts and banks are starting to ask increasingly detailed questions of companies about the size of any potential impact under plausible scenarios, whether contingency plans are in place, and the longer-term consequences for their business model.

Typical questions include.

- ▶ The banks have been subject to stress tests, how would your business perform under similar tests?
- ▶ Are you capable of withstanding the fall-out of a major shock to the financial system?
- ▶ Have you analysed the impact of likely changes to the financial sector on your financial strategy?
- ▶ Is your business model fit for purpose for a significant period of below-trend economic growth?
- ▶ Could your operations cope with an emergency denomination of a currency?
- ▶ Is there a plan in place to manage additional economic and financial risk?
- ▶ Have you identified the opportunities that may emerge in this volatile environment?
- ▶ Does your company have a stakeholder communications plan to address these questions?



Sizing the impact

Shareholders, lenders and analysts are now asking management teams what all this means for their company and what plans are in place to develop with changes in markets. Management must have a view, supporting analysis and a plan to share with external stakeholders. There are a range of scenarios for the future development of the Eurozone economy which will, in turn, drive the performance of linked markets such as the UK. These scenarios will be characterized by different rates of economic growth, differing levels of intervention by fiscal and monetary

bodies and assumptions on possible exit (s) from the currency zone, and different levels of liquidity in the capital markets.

Individual companies need to determine the scenarios of relevance to them which, as a minimum, we recommend should involve a base case, and a downside and a significant downside; and to analyse the impact of these scenarios on their key activities in terms of a risk and opportunity matrix. This is effectively a "stress" test for business, tailored to individual circumstances.

The risk and opportunity matrix

Our risk and opportunity matrix provides a framework for analyzing the key issues and assessing whether they pose a risk (e.g. funding is not in place), are stable (e.g. funding is secure), or present an opportunity (e.g. funding availability is sufficient to

support the acquisition of a currently undervalued business). By working through the issues in this way, the short-term contingency activities can be identified alongside the potential opportunities to position the business for the medium- and longer-term.

The priority issues to consider include:

Financing/Treasury

- ▶ Cash-flow projections
- ▶ Access to future funding
- ▶ Safety of cash deposits
- ▶ Debt maturity profile
- ▶ Hedging strategy
- ▶ Ability to incorporate new currency effects

Accounting

- ▶ Asset valuations/impairment
- ▶ Quantification of liabilities and contingencies
- ▶ Disclosure and sensitivity analysis
- ▶ Regulatory reporting
- ▶ Systems to cope with redenomination

Tax

- ▶ Tax operating model
- ▶ Obtain value for trading losses
- ▶ Transfer pricing approach
- ▶ Tax audits
- ▶ Opportunity to restructure/move assets
- ▶ Indirect tax

Suppliers/Customers

- ▶ Supplier financial status
- ▶ Exposure to capital/ trade controls
- ▶ Contractual flexibility
- ▶ Supply chain resilience
- ▶ Assess customer credit ratings
- ▶ Review outstanding balances
- ▶ Analyse impact of currency move relative to the Euro
- ▶ Redenomination pricing

Opportunities

- ▶ Update previous analysis of acquisition targets
- ▶ Assess competitor positioning
- ▶ Identify assets potentially coming to market and seller status
- ▶ Scope to acquire to grow, consolidate or take out competitors

Stakeholders

- ▶ Identify current status of stakeholder contact on issues
- ▶ Prepare briefing on impact assessment
- ▶ Prepare briefing on contingency plans
- ▶ Identify potential ethics risks
- ▶ Develop future lobbying plans



0001.15



Index
70%

EUROS

12345

Billion

Increase

100

5967

47

91,162,15
+ 1,001,32
+ 623,92
46,891,781

Highlights

- ▶ The Eurozone reforms agreed on 9 December 2011 that institute tighter fiscal rules and provide additional funding are a step in the right direction. It is essential that these reforms are implemented swiftly and in a credible manner.
- ▶ At the time of writing, details on how the agreement will be enforced remained unknown. Uncertainty and volatility are likely to remain high in the near future, dampening near-term growth prospects. Our baseline forecast shows that the Eurozone economy will probably fall back into recession in Q4 2011 and Q1 2012. However, assuming that the restructuring of Greek debt occurs in an orderly fashion, and that the 9 December agreement is implemented, moderate growth should resume toward the end of 2012, rising to 1.5%-2% in 2013-15 after near zero growth in 2012. Given this outlook, the jobless total will remain high for a lengthy period - we do not expect the unemployment rate to fall below 10% until 2015.
- ▶ The European Central Bank (ECB) has started to reverse its interest rate rises of earlier in 2011. Further easing may be required accompanied by more measures to supply liquidity to banks. In addition, ongoing doubts about the ability of some countries to implement necessary reforms may mean that the ECB will need to keep buying government bonds, now widely seen as one of its essential roles in this crisis. However, with bond markets very volatile, weak growth prospects and high borrowing needs in 2012, the ECB may have to consider acting as lender of last resort if even deeper problems – perhaps even a split in the Eurozone – are to be avoided.
- ▶ While there are now hopes of progress in Greece, Italy and Spain, it is imperative that all Eurozone countries implement structural reforms rapidly to reduce public debt and to enable them to tap into strong growth in nascent consumer markets in emerging economies. Changes to the Eurozone labor markets to enhance their flexibility and reduce labor costs would help ensure that the Eurozone comes out of this crisis on a stronger basis. IMF estimates show that the emerging markets will account for 70% of world growth in the next few years, led by China and India, and will overtake the developed world in terms of share of world GDP as soon as 2014. And Ernst & Young's Rapid-Growth Markets (RGM) Forecasts shows that, by 2020, advanced economies will export almost US\$18 trillion of goods to RGMs, up from US\$9.3 trillion today, accounting for some 33% of all exports from advanced economies.
- ▶ The changing composition of growth in the RGM economies as they mature over the medium term will offer major opportunities for Eurozone companies. In particular, the growth of their middle classes will offer a rapidly expanding new market for consumer-based manufactured goods and food – as well as in distribution, tourism, hotels and restaurants – sectors that are all suffering in European countries. Other sectors that will also grow strongly in the major emerging markets include financial and business services, areas in which Western businesses have a strong advantage.

Time for Eurozone reforms to tap into emerging market growth



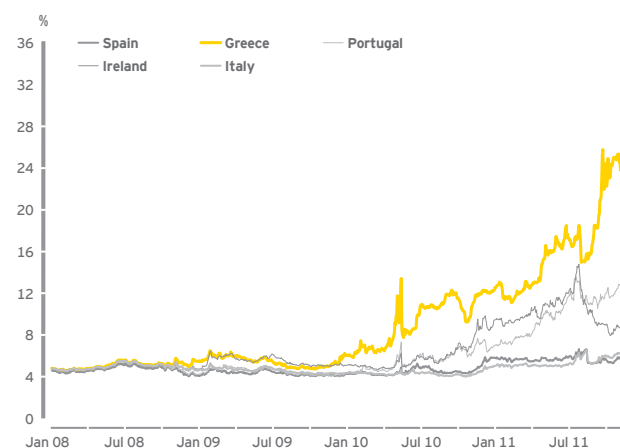
Crises in Italy and Greece force significant reforms ...

The package of measures agreed by Eurozone leaders at the 26 October 2011 summit to tackle the worsening debt crisis brought only short-lived respite to financial markets.

It was hoped that the new program for Greece could be agreed by end 2011, with the exchange of bonds under the proposed debt restructuring taking place in January 2012. But although the shock move to call a referendum was quickly jettisoned and a unity Government has now been formed, the political turmoil leaves it unclear when the measures can be implemented. These concerns have been exacerbated by mounting problems in Italy and Spain, leading to even greater financial market volatility, falling stock markets and rising bond yields in most Eurozone countries.

As a result, the October agreement was quickly followed by another deal, signed on 9 December 2011, that institutes stricter fiscal rules. Additional funding, via the European Stabilisation Mechanism whose start has been brought forward to June 2012 and via loans to the IMF, have also been agreed upon and will help prevent an escalation of tensions similar to what we saw in November 2011.

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	1.8	1.6	0.1	1.4	1.9	2.0
Private consumption	0.9	0.4	-0.1	0.9	1.4	1.6
Fixed investment	-0.9	2.2	-0.4	2.4	3.6	3.5
Stockbuilding (% of GDP)	0.4	0.5	0.1	0.1	0.0	-0.1
Government consumption	0.4	0.0	-0.5	0.1	0.8	1.0
Exports of goods and services	10.9	6.5	3.2	5.7	6.0	5.5
Imports of goods and services	9.1	4.6	1.9	5.1	5.8	5.4
Consumer prices	1.6	2.7	1.7	1.5	1.8	1.8
Unemployment rate (level)	10.1	10.1	10.8	10.7	10.3	9.8
Current balance (% of GDP)	-0.5	-0.8	-0.3	-0.1	-0.1	-0.1
Government budget (% of GDP)	-6.3	-4.1	-3.1	-2.4	-1.9	-1.6
Government debt (% of GDP)	85.4	87.1	87.9	88.4	88.5	88.5
ECB main refinancing rate (%)	1.0	1.3	1.1	2.1	3.5	3.9
Euro effective exchange rate (1995 = 100)	120.7	121.0	119.2	121.1	117.0	114.8
Euro/US dollar exchange rate (\$ per €)	1.33	1.39	1.33	1.33	1.27	1.24

... as financial markets fall further

The response to the 9 December deal was mildly positive. Investors remain very concerned about the commitment and ability of governments to implement reforms quickly. In particular, it will be very hard for Greece to implement the latest deep spending cuts and proposed increase in privatization revenues – from an already ambitious €50 billion to €65 billion – at a time when the economy is still contracting sharply and consumer spending is very weak. And in Italy, there remain major obstacles to the scale of economic reforms required to win back investor confidence. Meanwhile, the new centre-right government in Spain has promised more austerity, but will face challenges when the economy is barely growing.

In addition, the bank recapitalization proposed at the end of October 2011 will weigh on growth in the Eurozone overall, with lending coming under further pressure if banks try to meet the targets set by shrinking their balance sheets. In particular, it is difficult to see how some banks will be able to comply with the new capital requirements, given the current depressed economic conditions and difficulties in raising new capital from financial markets at a reasonable cost.

The ECB may need to act ...

A number of countries face a much slower period of growth in the years ahead, plus much higher interest payments, than previously expected. If debt interest payment rates remain significantly higher than GDP growth, as now seems possible, the debt and deficit problems facing Italy, Spain and other peripheral countries are likely to worsen steadily. For example, Italian 10-year bond yields were 6.5-7% in early November and, although they have fallen since, bond markets remain volatile. With Italian debt at around 120% of GDP and borrowing needs of €300 billion in 2012 (around €500 billion including short-term debt), interest rates at this level (5 percentage points above German rates) would add massively to debt service costs and are probably unsustainable for any length of time. There is a risk that Italy's problem turns from one of liquidity into one of solvency.

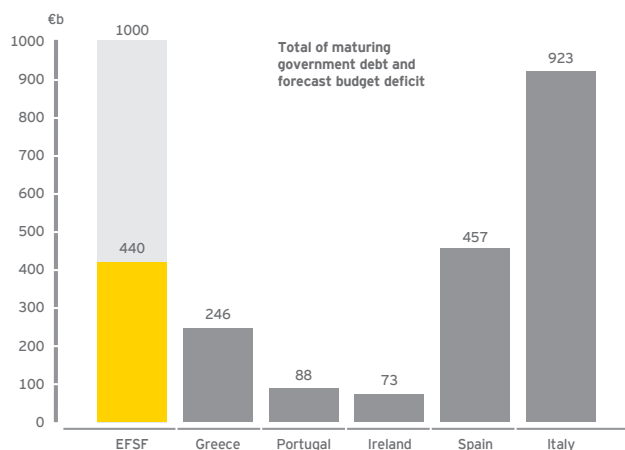
Since reforms to the fiscal and economic structures take time, the European Central Bank (ECB) may play a key role in ensuring over the near term that bond yields do not reach or stay at unsustainable levels. Calls for the ECB to act as a lender of last resort to solvent but illiquid governments have multiplied, to buy enough time for members' structural reforms to take effect and for Eurozone institutional changes to be implemented.

... as reforms and a move towards a fiscal union are put in place

In addition to the probable need for short-term underpinning from the ECB, the deep problems facing the Eurozone and the prospect of several more years of sluggish growth, underline the need for faster reforms in many countries, if monetary union is to survive in its current form.

The key problem facing the peripheral countries – Greece in particular, but also Italy, Spain and Portugal – has been a loss of competitiveness over the years since adopting the euro. With their narrow industrial bases and labor costs relatively high compared with non-EU countries, these countries have seen their share of world trade fall steadily, in turn increasing reliance upon financial market inflows. As the latter have dried up in recent years, so the underlying weakness of these economies has become increasingly exposed. A key reform that these countries need to embrace is greater labor market flexibility and changes to restrictive working practices, which, over time, would encourage greater industrial diversification and labor mobility. The impressive turnaround in competitiveness seen in Ireland is an example of what can be achieved. From mid-2008 to mid-2011, labor costs per unit of output have been reduced by more than 10%. Taking into account, increases in labor costs in other countries during that time, this means that Ireland's competitiveness has been improved by around 35%, more than offsetting the worsening in competitiveness in the years leading to the crisis. This improvement has required sharp cuts in wages and living standards, something that has proved more difficult in southern Eurozone countries as the reforms have met with social resistance.

Figure 2
Eurozone: Financing needs 2011-15 and EFSF



Source: Oxford Economics

Time for Eurozone reforms to tap into emerging market growth

Beside changes to the labor market structures, reform of public finances is needed in the southern peripherals. Public sector cutbacks, improved efficiency of tax systems and changes to retirement ages and pension entitlements are key areas that need to be addressed to bring down deficits and to put public finances in these countries on a sustainable long-term footing.

Alongside these country-specific reforms, some moves towards fiscal union are necessary to prevent future crises. The Eurozone reforms discussed at the 9 December 2011 meeting that would institute tighter fiscal rules are a step in the right direction. Countries are to define their own fiscal rule that will be enshrined in their national constitution and will be monitored by the European Court of Justice. It is essential that these reforms are implemented swiftly and in a credible manner. In particular, the rules should be clearly defined, leaving no room for interpretation and discretion. Many countries have resisted a loss of control over their fiscal policies – with the core countries fearing higher funding costs for the weaker members, and the peripherals facing a loss of control over spending and revenue-raising decisions. But without the ability to control state spending across the Eurozone, fiscal stability will still be in doubt even if the current problems can be resolved. Without major changes to the fiscal rules, a split in the Eurozone would still be only a matter of time, given the long period of retrenchment and sluggish growth that the current economic position demands.

Possible break-up scenarios

The latest European agreement lowers the risk of a breakup of the Eurozone. This risk remains however, especially since in 2012 very large amounts of sovereign debt need to be refinanced which may cause tensions. The costs of a break-up of the Eurozone would undoubtedly be very high and have a long-lasting impact on the whole

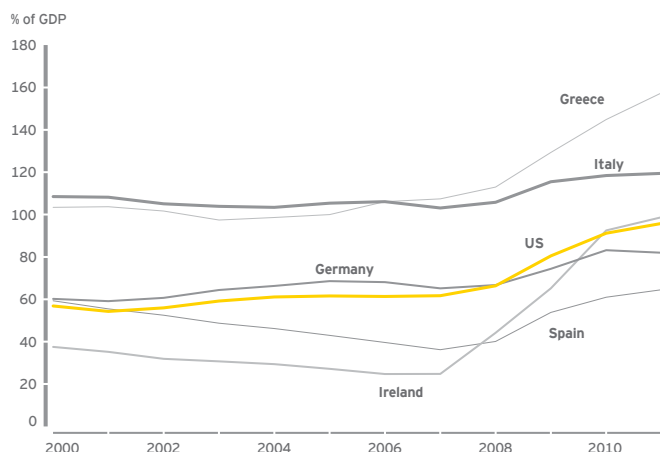
of Europe and the world economy. As a result, we think that the authorities in the leading countries will strive to hold the single currency zone together. It seems likely that the cost of the ECB acting as lender of last resort would be less than the medium-term costs of a break-up. For instance, if the ECB were to intervene in bond markets of solvent but illiquid governments for the next two years, by buying perhaps around €1 trillion of bonds, this would still be equal to only about 10% of Eurozone GDP, proportionately less than the quantitative easing seen in the UK and the US, which have amounted to 14% and 17% of GDP respectively since 2009 so far.

With around €1 trillion of government debt from Italy, Spain, Greece, Ireland and Portugal needing to be refinanced over the next three years, such purchases would go a long way to ease tensions in sovereign markets.

And although some remain opposed to this type of action, fearing moral hazard and possible inflationary consequences, the main threat at present comes from deflation, if the Eurozone slides back into deep recession – especially as governments are now not able to try to spend their way out of recession as they did in 2009.

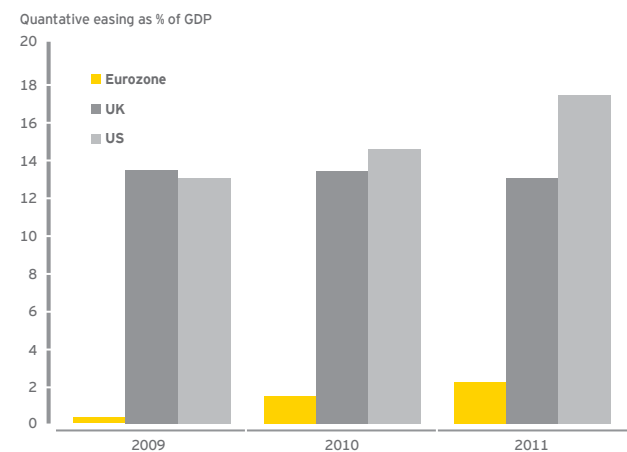
A split could take place in a number of ways. First, and most likely, is that some peripheral countries, such as Greece, could decide to opt out of the single currency, as the burden of fiscal austerity could become politically unbearable. This would have heavy costs for Europe. If only a few countries exit, with, in particular Italy and Spain still inside the single currency, the impact would be manageable. The costs would obviously be heavy for Greece, which would face hefty devaluation, of perhaps some 50% in its re-introduced drachma, sharply higher inflation and several years of deep recession, corporate defaults and exclusion from international capital markets. History provides some examples of successful management of

Figure 3
General government debt



Source: Oxford Economics

Figure 4
Eurozone: Quantitative easing



Source: Oxford Economics, Haver Analytics



debt defaults and devaluation. This was demonstrated, for example, by Argentina following its US\$ currency peg crisis of 2001 – after a steep 11% GDP drop in 2002, it has been growing strongly since 2003 and regained pre-crisis levels within two years. Similarly, after the UK withdrew from the European Exchange Rate Mechanism in September 1992, its more competitive exchange rate boosted exports, investment flowed in and growth accelerated very strongly in the mid-1990s. These positive examples, however, were only made possible by flexible economies that allowed the countries to preserve their competitive gains for several years. This involved some short-term pain in the form of weak or low growth in real incomes and profit margins.

A second possibility is a move to a “core” Eurozone, which would center around the Franco-German axis and include the northern countries such as the Netherlands, Belgium, Finland, Austria, Slovakia and a number of others. This scenario would exclude the larger southern European economies of Italy and Spain, meaning that the split would trigger massive upheaval in financial markets, with deep falls in asset prices. The sharp depreciations of the new currencies would trigger large losses to companies operating in these countries. Overall, in this scenario the Eurozone and probably the world economy would be plunged back into a deep recession, probably more severe than what was experienced in 2008-09.

A third possibility is that Germany decides to withdraw from the euro, unhappy with the increasing fiscal burden that it may have to shoulder in the coming years in bailing out profligate southern partners. This is a highly unlikely scenario, given that it would imply a sharp appreciation of the new German currency which would threaten the country’s large export sector.

One major unknown risk in these scenarios is the impact on electorates in both member countries and prospective members. If the Eurozone does split in some form, leading to even greater costs in the near term, will

politicians have a strong enough mandate to try to rebuild the currency union with the closer fiscal union that this will entail? There is already a disconnect in many countries between politicians driving the move for closer ties within the Eurozone and electorates who are rarely consulted on such matters. Failure to win electoral support for moves towards deeper European integration could have serious political implications.

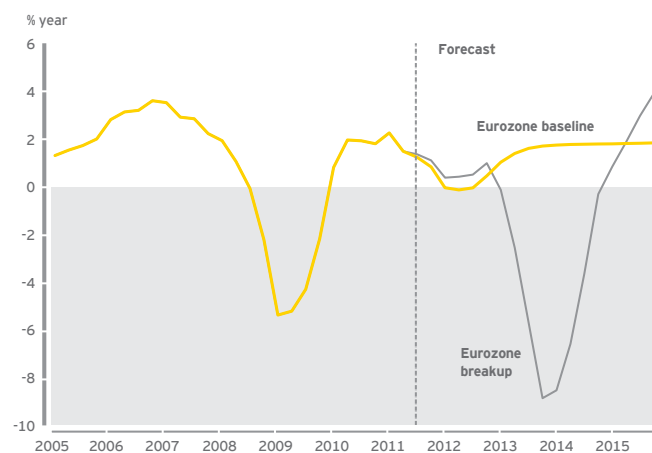
GDP growth forecasts cut sharply ...

Although we assume that the Eurozone remains intact, the debt crisis, volatile financial markets and a weaker than previously expected US economy (see Box 1) mean that our growth forecasts for the Eurozone have been lowered sharply. Having slowed to just 0.2% in Q2 2011, Eurozone growth remained in positive territory in Q3, also at 0.2%, but is now expected to post declines in Q4 2011 and Q1 2012.

This would deliver overall 2011 growth of about 1.6%, with a slowdown to just 0.1% predicted for 2012. The latter figure is sharply down from our forecast of 1.3%, three months ago. And with the uncertainty over the Greek debt situation now likely to drag on for some months, the risks for 2012 are probably on the downside, although monetary easing by the ECB – via lower interest rates and continued additions of liquidity – and the continued buoyancy of emerging markets should offer some respite to this gloomy picture.

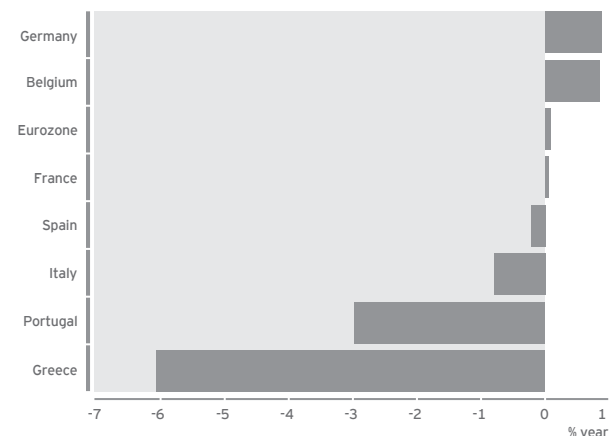
The latest data reinforces expectations of a return to mild recession after the very weak growth in Q2 and Q3 2011. The Eurozone manufacturing Purchasing Managers’ Index (PMI) fell throughout Q3 and in November was down to 46.4, its lowest since mid-2009. The service sector PMI is also pointing to contraction moving into Q4. On an individual country basis, survey data from Germany continue to weaken and the jobless total rose in October for the first time in nearly two

Figure 5
Eurozone GDP



Source: Oxford Economics

Figure 6
GDP: 2012 growth



Source: Oxford Economics

Time for Eurozone reforms to tap into emerging market growth

years. And amid mounting concerns about its banking sector exposure to Greece and a possible credit rating downgrade, the news from France is equally gloomy, with October unemployment at its highest level in nearly 11 years and the PMI surveys below the 50 level.

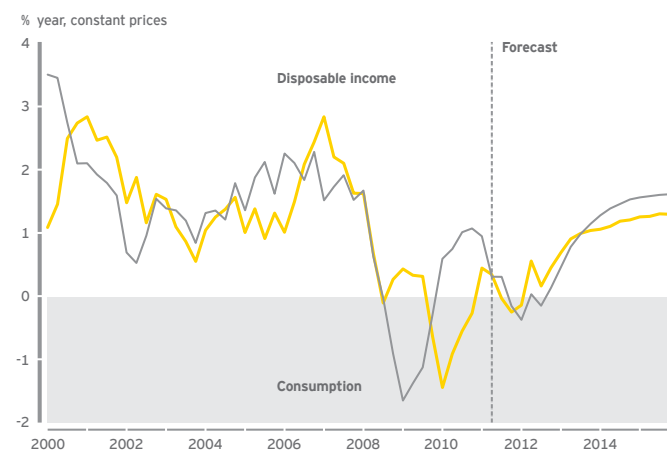
Despite the generalized slowdown throughout the Eurozone, divergence in member countries' growth rates is set to remain as the core continues to outperform the peripherals. Germany is forecast to grow by just under 1.0% in 2012, down from 3.1% in 2011. But Italian GDP is now forecast to fall 0.8% in 2012 and Greek GDP is seen plunging to 6%.

In contrast, however, Ireland has implemented significant budget deficit reduction measures to tackle its problems and is now expected to grow 1.2% in 2011 and 0.5% in 2012. As mentioned, the sharp improvement in competitiveness has been a significant factor behind Ireland's relatively better performance. The economy remains highly dependent on exports however. With the outlook for the Eurozone, by far its main market, so uncertain, the economy is not yet on a safely secured expansionary path.

... as domestic demand weakens ...

The composition of growth in both 2011 and 2012 highlights the vulnerability of the Eurozone economy. With private and public sector retrenchment continuing in the attempt to reduce levels of indebtedness, our forecast sees domestic demand in the Eurozone contracting by 0.5% in 2012, after growing 1.2% in 2011. With inflation still running above wage increases in most countries and overall taxes rising, private consumption is forecast to grind to a halt, while the worsening global outlook will also stop investment. And with public consumption declining in an attempt to cut budget deficits, the main hope for growth is from the export sector. We expect exports to contribute around 1.3 percentage points to overall GDP growth in 2012, although this impetus will be lower than in 2010 and 2011.

Figure 7
Households' income and consumption



Source: Oxford Economics

Bleak and uncertain economic prospects will force businesses to revise recruitment plans. The headline jobless rate for the Eurozone rose to 10.3% in October, this covers a wide range of rates across member countries, from about 4% in Austria and 5.5% in Germany to 22.8% in Spain. And with companies increasingly concerned about the outlook, there is little prospect of any meaningful reduction in jobless rates. Indeed, if the Eurozone does return to recession as we expect, then unemployment is likely to start rising again in early 2012 and is not expected to drop below 10% until 2015.

... and firms are wary of investing ...

As expected, there is growing concern that the prospect of very slow growth in the Eurozone will deter firms from investing. Despite having built up solid financial surpluses, firms are likely to focus on deleveraging to protect themselves from further deterioration in the business cycle in the near-term and to position themselves for the upturn when it finally emerges. Debt of Eurozone non-financial companies amounts to around 100% of GDP (about the same levels as in 2009); moreover, the uncertain climate for corporate financing will deter companies from over-extending themselves, given current financial market concerns.

... as lending conditions tighten further

Adding to the problems facing business are credit constraints. Bank lending in the Eurozone remains tight, as banks restructure their balance sheets and reduce exposure to riskier sectors and countries. The ECB lending survey for Q4 2011 showed that lending standards tightened again, with surveys for individual countries suggesting tighter conditions throughout the Eurozone. Among the key factors accounting for this are reduced access to capital markets and banks' worsening perceptions of the general economic outlook. These lending figures suggest an increasingly adverse impact on business investment and companies' capacity to raise production heading into 2012. So, despite strong corporate cash reserves, business sector investment is still expected to grow by only 2% this year and next.



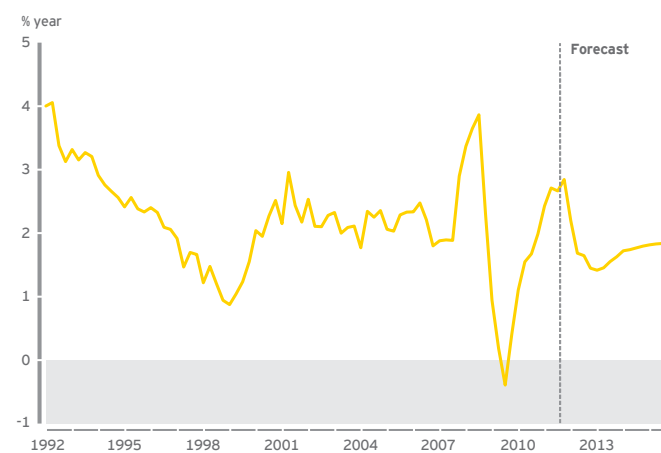
ECB now reversing earlier rate rises

Sentiment may be helped by the ECB's decision to start reversing its interest rate rises implemented earlier in 2011. A 25 basis points (bp) rate cut was announced in November, despite consumer price inflation remaining at 3%, above the ECB target of close to but below 2%.

But several factors should ensure that inflation slows in 2012. Firstly, oil prices are off their peak and are now forecast to fall by about 10% in 2012. Secondly, base effects will become favorable. And thirdly, there will be a step down in the headline inflation rate in the opening months of 2012 as the effects of VAT increases at the start of 2011 (equal to around 0.5 percentage point on inflation) drop out. We expect inflation to average 1.8% in 2012, down from 2.6% in 2011, with similar rates seen in 2013-14.

The ECB cut interest rates to 1% in December and we expect it to keep them at this level through 2012. It has also extended its loans to banks to loans for up to three years and widened the range of collateral that banks can use to obtain liquidity from the ECB. All these measures are aimed at easing the current very difficult funding situation for banks, enabling them to play their essential role as provider of loans to the economy.

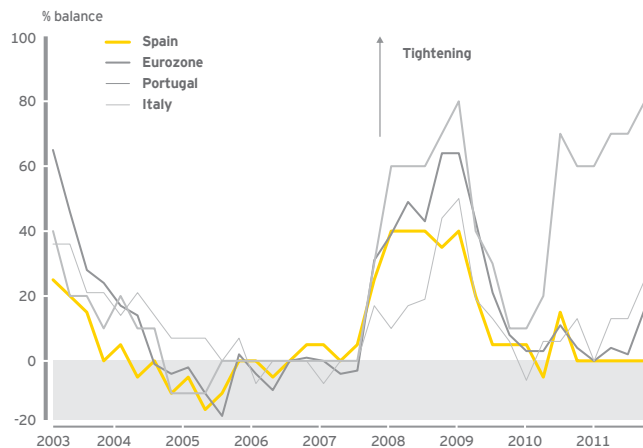
Figure 9
Inflation



Source: Oxford Economics

Figure 8

Credit conditions for loans to businesses



Source: Oxford Economics

Box 1

Forecast assumptions – international environment and commodity prices

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

Here, we explain these assumptions.

The outlook for global growth is less favorable than it was at the time of our previous forecast. The US economy slowed more than expected in H1, and previous data was revised down; the problems in the Middle East and North Africa (MENA) continue to weigh on confidence and the disaster in Japan has caused more severe disruption than earlier envisaged. 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 2.9% this year at market exchange rates, or 3.8% in purchasing power parity (PPP) terms, and by 3.7% (4.5% in PPP terms) p.a. in 2012-15.

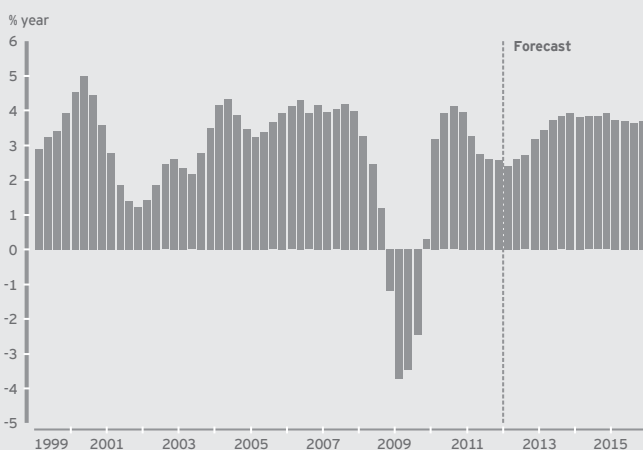
The lower H1 GDP data has led us to lower our growth forecast for the US economy this year to 1.7%, significantly weaker than the 2010 outturn, revised to 2.4% from 2.9%. However, we think that the weakness in Q1 2011 was at least partly explained by temporary factors and we expect a pickup in the pace of growth in the remainder of 2011. In 2012-15, we forecast 3.2% GDP growth on average. This will reflect moderate growth in consumer spending, some recovery in construction and continued strength of equipment investment. Real net trade is expected to exert a mild drag on growth as the dollar strengthens in the medium term as growth prospects for the US are higher than for Europe.

Global growth will continue to be sustained to a great extent by emerging markets. We expect these countries to grow by around 6% p.a. over the next five years, with their share in the global economy rising from 24% in 2005 to 28% in 2010 and 32% in 2015 (at market exchange rates). China is expected

to lead this group, with growth at 9% in 2011 and 8.4% in 2012. This is slightly slower than last year's 10.3% growth, as monetary policy tightening dampens domestic demand, but still implies rapid increases in demand for goods and services from the rest of the world, including the Eurozone.

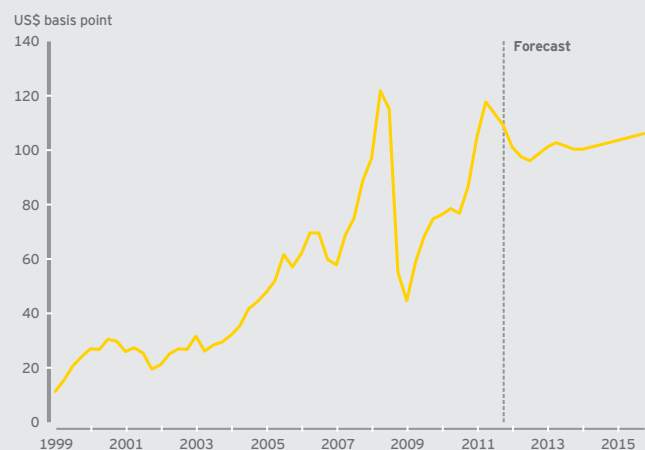
With regard to commodities, after a seemingly relentless rise, commodity prices fell back somewhat at the beginning of May 2011. The correction happened at the time of some disappointing data release on the US economy, but it seems that it reflected a broader-based reassessment by investors of the fundamentals underpinning commodity prices. Nevertheless, we expect commodity prices to remain elevated for some time as demand from emerging markets, which are large consumers of commodities, remains strong. An additional factor keeping oil prices high is concern that the crises in the MENA region could spread and further disrupt oil supplies.

Figure 10
World: GDP growth



Source: Oxford Economics

Figure 11
Oil price, nominal



Source: Oxford Economics



Medium-term prospects brighter ...

Despite the gloom about economic prospects in the short term, there are positives for the medium-term. The situation in Italy, Spain and Greece remains extremely worrying, but there is a focus on the seriousness of the situation. And early progress on reforms in Italy and Greece could give the authorities in other countries the mandate needed to proceed with similar tough reforms. In turn this would give a psychological boost to the markets, which have been awaiting some positive news on the reform front from the peripherals, and could thus see long-term borrowing rates starting to fall decisively.

At the same time, the easing of the Eurozone crisis would give a lift to world markets and the prospect of a gradual pick-up in European growth would encourage greater investment in productive capacity in the major emerging markets that export to Europe. Despite the gloom surrounding the Eurozone currently, our forecasts for the emerging markets remain upbeat, with emerging Asian countries still expected to grow by over 7% in both 2012 and 2013, albeit down a little from just above 9% in 2010. This strong performance will continue to be led by China, forecast to grow by about 8.5% pa over the period 2012-15, and India, where growth is expected to average 8.7% p.a. over the same period.

As well as the rapidly growing Asia-Pacific region, other emerging market regions should also perform relatively strongly. Oil-producers will continue to benefit from high oil prices, albeit easing from 2011 levels. Much of Latin America remains resilient to the global problems due to its large domestic market and relatively low dependence upon foreign trade, with Brazil set to lead the way as it steps up investment in infrastructure ahead of major international sporting events that it will host in the years ahead.

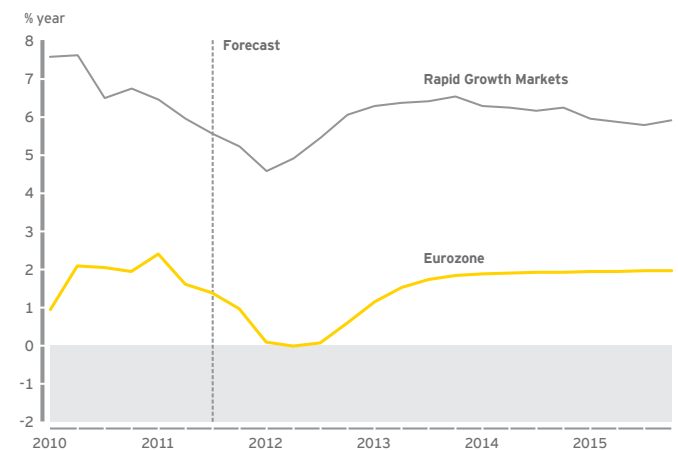
Although smaller in a global context, commodity producers in Africa will also grow strongly, acting as a magnet for inflows of investment as the world's major economies seek to meet the rising demand for minerals and food that is being driven up inexorably by the rising world population and higher living standards. The emerging markets overall now attract almost 50% of global foreign direct investment (FDI) inflows and account for 25% of FDI outflows, shares that will inevitably rise further in the years ahead.

As a result, world growth and trade will be underpinned by emerging markets. IMF estimates show that 70% of world growth over the next few years will come from the emerging markets, with China and India accounting for 40% of this growth. As a consequence, the emerging markets are now expected to overtake the developed economies as a share of GDP as early as 2014. And Ernst & Young's *Rapid-Growth Markets Forecasts* show that by 2020 advanced economies will export around US\$17.6 trillion of goods to RGMs, up from US\$9.3 trillion

today, accounting for an estimated 33% of all exports from advanced economies. In turn, this impressive performance should give an increasing boost to the Eurozone in the years ahead. Partly as a result of this strong external demand, we expect Eurozone growth to recover to 2% by 2014-15, although this would still be a lackluster recovery from the deep recession.

Figure 12

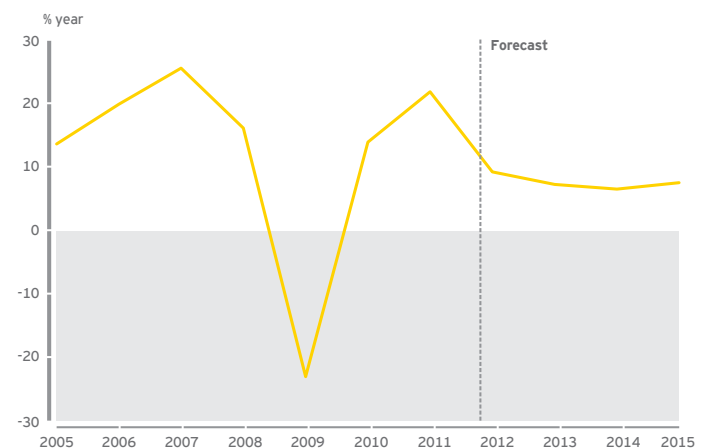
GDP: Eurozone and rapid growth markets



Source: Oxford Economics

Figure 13

Eurozone: Exports to rapid growth markets



Source: Oxford Economics

Time for Eurozone reforms to tap into emerging market growth

... as links with RGMs offer opportunities

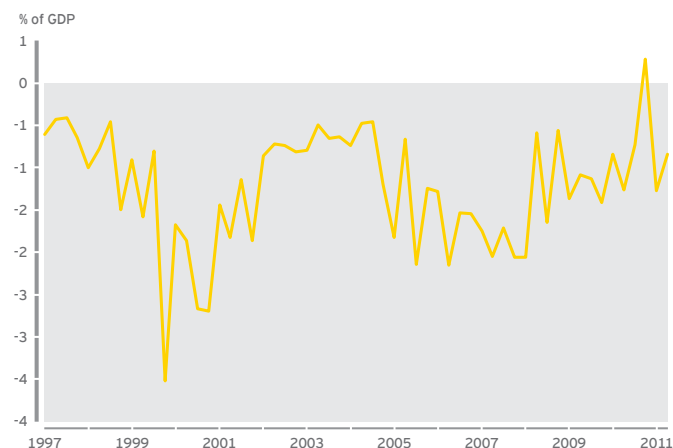
Although near-term prospects for the Eurozone remain gloomy, the manufacturing and business services are the two sectors that still appear to offer the best prospects. The manufacturing sector has benefited from rising demand for exports, in particular from emerging markets, but with the leading emerging markets now slowing, the pace of Eurozone export growth looks set to moderate.

However, the changing composition of growth in the RGM economies as they mature over the medium-term will present major opportunities for Eurozone companies. In particular, the growth of their middle classes will offer a huge new market for consumer-based manufactured goods and food, as well as in distribution, tourism, hotels and restaurants – sectors that are all suffering in European countries where household spending is under intense pressure. And companies that, in the past, have relied heavily on public sector demand in main European countries should seek to supply high-spending governments in many of the RGMs that will not face the same public spending constraints.

Construction companies facing stagnant or falling house prices and cutbacks on public sector investment in most Eurozone countries, especially in the peripherals, should experience far stronger demand in the main emerging markets. Major housing programs are likely in many countries while the upcoming global sporting events in Brazil over the coming years are already leading to massive construction and infrastructure projects.

Figure 14

Eurozone: FDI inflows into the Eurozone



Source: Oxford Economics

Conclusions

Hopes that the October package would bring an end to the Eurozone debt crisis were always ambitious. This deal was quickly followed by a further agreement on 9 December that institutes stricter fiscal rules. In addition, the new political leaderships in Greece, Italy and Spain may have a clearer mandate to press ahead with tough reform measures. As a result, we expect the situation in these countries to stabilize, in turn encouraging other countries to proceed more rapidly with reforms needed to improve competitiveness, diversify and reduce their deficits and debt.

But it remains clear that merely imposing further rounds of austerity on stagnant economies in order to reduce deficits is self-defeating – the focus needs to be on much deeper reforms, including labor market liberalization and faster privatization, together with other measures aimed at boosting growth such as tapping into the rapid growth still being experienced in the emerging markets.

Finally, overcoming the problems currently facing the Eurozone and ensuring that there is no repeat will inevitably involve a loss of fiscal sovereignty. In the past, this has met with enormous political opposition – but there is a growing realization that monetary union (even among the so-called core countries) may be unworkable over the longer term without enforceable and transparent fiscal rules. It is essential that the 9 December agreement is implemented swiftly and in a credible manner. Failure to recognize and act on this may merely store up more problems for the future, perhaps leading to some sort of split in the Eurozone, with high associated costs. We still expect the Eurozone to remain intact, in part because the economic cost of any break-up would probably be significantly higher than cost of the ECB acting as a lender of last resort.

The prospect of continued subdued growth in the core Eurozone countries and near-zero growth or contraction in the peripheral countries means that the ECB has started to reverse its policy tightening seen earlier in 2011. With inflation expected to slow to the target of below 2% early in 2012, failure to cut rates further in the coming months would merely exacerbate the problems facing the troubled peripheral countries.

Despite the short-term gloom, we still expect the Eurozone to stabilize in 2012, with an end to the crises in Italy and Greece enhancing medium-term growth prospects and a return to greater financial stability. Moreover, the ongoing stimulus from the emerging markets, which are expected to drive world growth in the coming years and overtake the developed countries as a share of world GDP as early as 2014, will help lift Eurozone growth back to around 2% in 2014-15, with improving prospects thereafter. And the shift in the growth stimulus in the RGMs from investment and primary industries towards consumer goods as their middle classes expand rapidly, will offer major new opportunities for European companies, which face several years of subdued demand in their main domestic markets.

Forecast for Eurozone countries

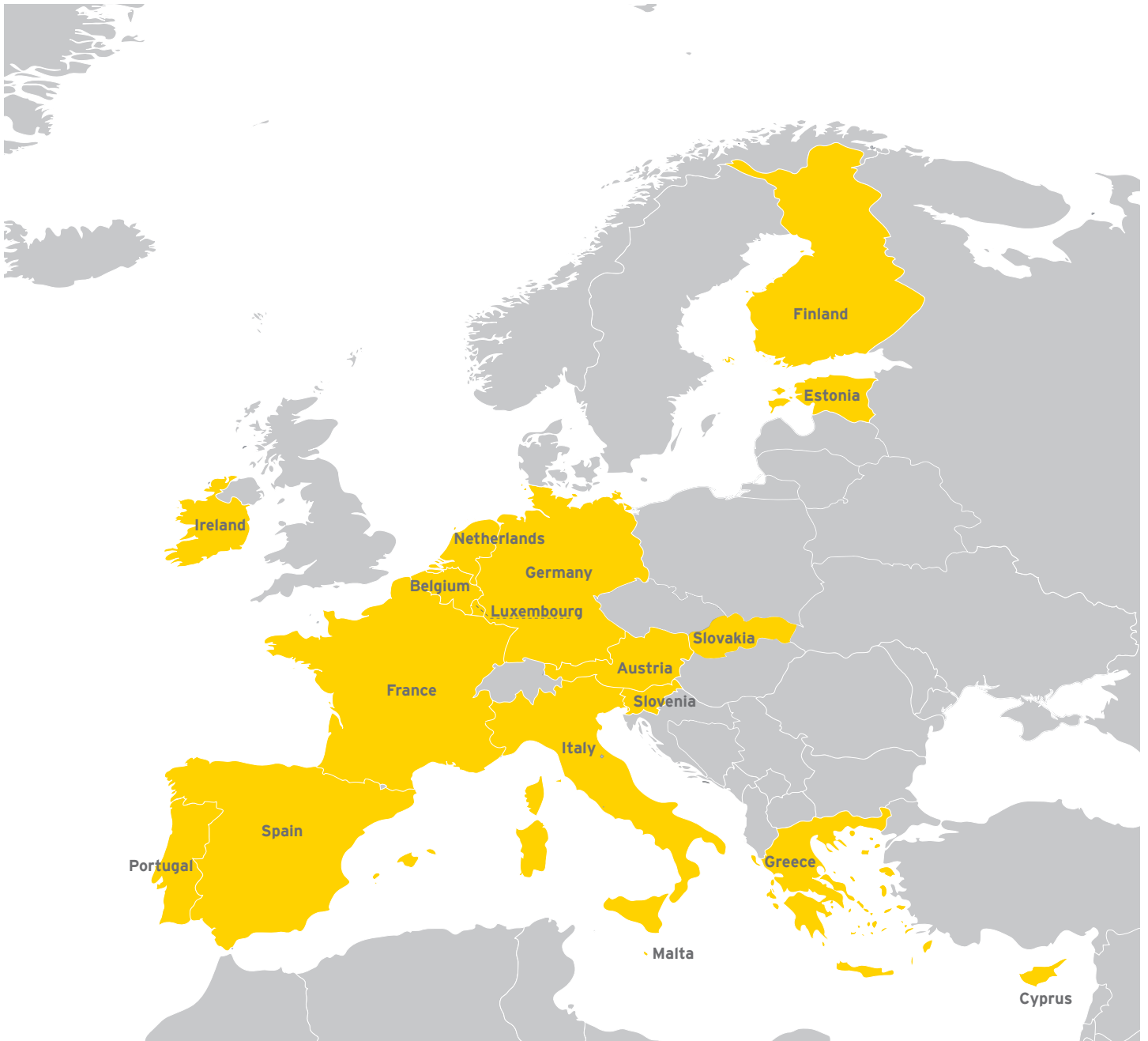
- Austria
- Belgium
- Cyprus
- Estonia
- Finland
- France
- Germany
- Greece
- Ireland
- Italy
- Luxembourg
- Malta
- Netherlands
- Portugal
- Slovakia
- Slovenia
- Spain



17 Eurozone countries

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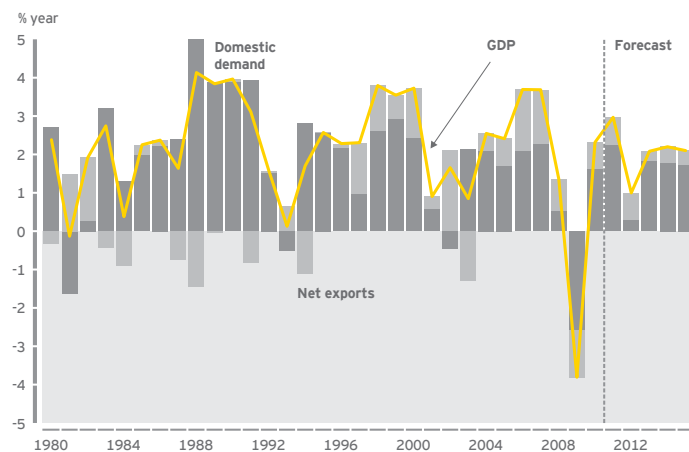
Austria

- ▶ Leading indicators have suggested that the economy probably ground to a halt in Q4 2011. In view of the deteriorated economic environment, in particular for exports, we have lowered our 2012 GDP growth forecast to only 1% (from 1.7%).
- ▶ The downside risks to the forecast have increased, due to heightened uncertainty surrounding the resolution of the Eurozone debt crisis. Should the Greek default happen in a disorderly fashion, this could throw the Eurozone and, with it, Austria back into a steep recession.

- ▶ Output in the highly export-dependent industrial sector will slow in the short-term, but the medium-term outlook is optimistic. Businesses in the sector are flexible and have embraced globalization. We expect the industry sector to outpace the economy as a whole with its share of GDP, already now one of the largest in the Eurozone, increasing to 22% in 2015.

Figure 15

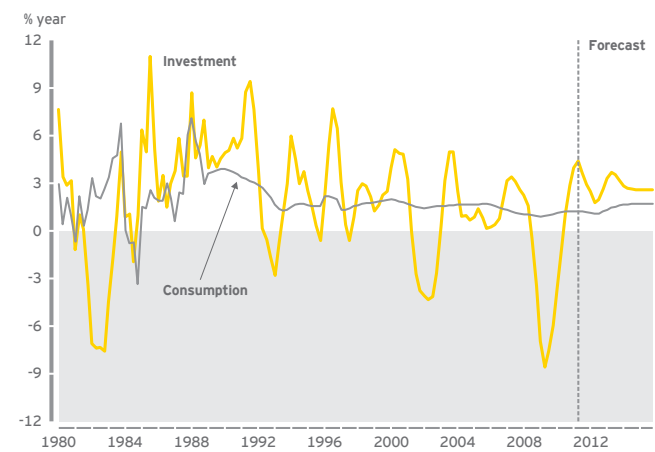
Contributions to GDP



Source: Oxford Economics

Figure 16

Consumption and investment



Source: Oxford Economics

Table 2

Austria (annual percentage changes unless specified)

Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	2.4	3.2	1.0	2.1	2.2	2.1
Private consumption	1.2	1.2	1.1	1.5	1.7	1.7
Fixed investment	-0.3	3.7	2.2	3.4	2.7	2.6
Stockbuilding (% of GDP)	1.3	2.3	1.5	1.1	1.1	1.1
Government consumption	-0.1	1.3	1.1	1.3	1.8	2.0
Exports of goods and services	8.3	7.0	2.8	5.8	5.3	5.4
Imports of goods and services	7.4	6.9	2.2	5.3	5.2	5.5
Consumer prices	1.7	3.4	2.2	2.1	2.0	2.0
Unemployment rate (level)	4.4	4.1	4.2	4.1	4.1	4.1
Current account balance (% of GDP)	3.0	2.8	2.6	2.4	2.2	2.1
Government budget (% of GDP)	-4.4	-3.4	-3.1	-3.1	-2.6	-2.4
Government debt (% of GDP)	71.7	71.8	72.9	73.4	73.2	72.8

Belgium

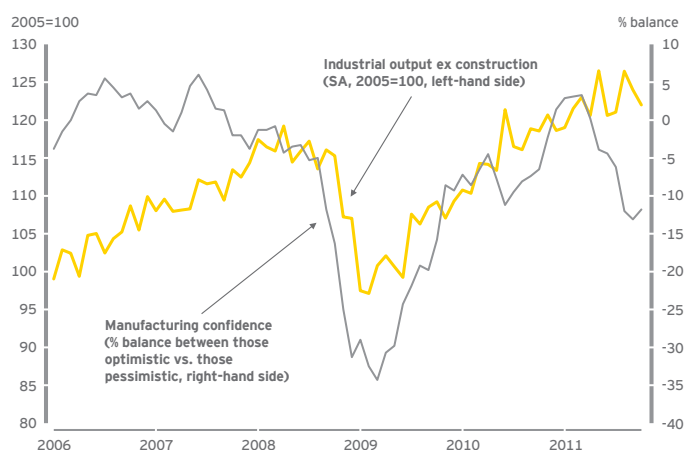
- ▶ Belgium's recovery has lost pace at an alarming rate through 2011, thanks to both domestic and external factors, Households are becoming increasingly concerned about the prospect of further job losses, driving a period of cautiousness about spending, while export growth looks likely to slow further in 2012.
- ▶ We expect Belgium's economy to grow by less than 1% in 2012. In 2013, prospects seem brighter. Exports should rebound, albeit less forcefully than in 2010. We think that the labor market will start to

recover, and business investment will pick up, helping to drive GDP growth of 2.9%.

- ▶ But the road to recovery is fraught with risks. The Government's annual financing needs as a proportion of GDP are on a par with other crisis countries, and banks' exposure to sovereign debt elsewhere in Europe is an additional threat to both fiscal sustainability and the sector's ability to support recovery.

Figure 17

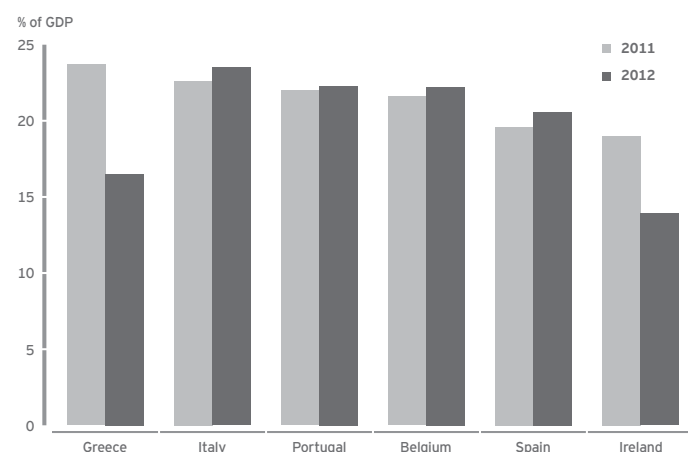
Industrial output and manufacturing confidence indicator



Oxford Economics, Haver Analytics

Figure 18

Eurozone: Financing needs 2011-12



Source: Oxford Economics, Haver Analytics

Table 3

Belgium (annual percentage changes unless specified)

Source: Oxford Economics

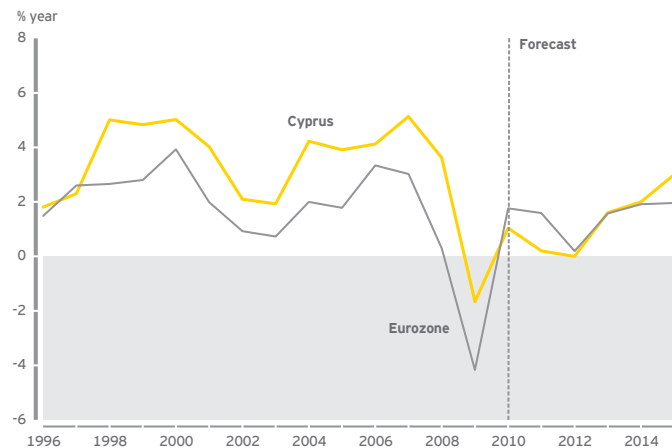
	2010	2011	2012	2013	2014	2015
GDP	2.3	2.0	0.9	2.9	2.5	2.1
Private consumption	2.3	0.9	0.4	1.6	2.0	2.0
Fixed investment	-0.9	4.7	-0.3	5.4	4.4	3.1
Stockbuilding (% of GDP)	-1.0	-0.4	-0.2	0.5	1.2	1.0
Government consumption	0.2	0.5	1.3	1.5	1.6	1.4
Exports of goods and services	9.9	5.0	1.1	7.6	5.7	4.4
Imports of goods and services	8.7	5.5	1.0	8.1	6.5	4.3
Consumer prices	2.4	3.5	2.4	2.0	2.0	1.9
Unemployment rate (level)	8.3	7.0	7.5	7.6	6.9	6.4
Current account balance (% of GDP)	1.5	0.1	0.5	0.3	-0.4	-0.2
Government budget (% of GDP)	-4.1	-3.4	-3.8	-2.9	-1.7	-0.7
Government debt (% of GDP)	96.2	95.2	97.0	97.2	97.2	96.8

Cyprus

- ▶ Cyprus's domestic economy continues to be weak and an escalation of the Greek debt crisis has darkened growth prospects further. We expect the economy to expand by 0.2% in 2011 and to stagnate in 2012.
- ▶ Cyprus's banks have heavy exposure to Greek sovereign debt and the proposed 50% reduction in the face value of private sector holdings of Greek debt is likely to inflict a severe loss. This has led to a tightening of credit conditions and will dampen domestic demand.
- ▶ Furthermore with the growth outlook remaining weak, we expect the Government to miss its fiscal targets (despite the announcement of further austerity) and the budget deficit is forecast to remain elevated at 7.1% in 2011 and 5.3% in 2012.

Figure 19

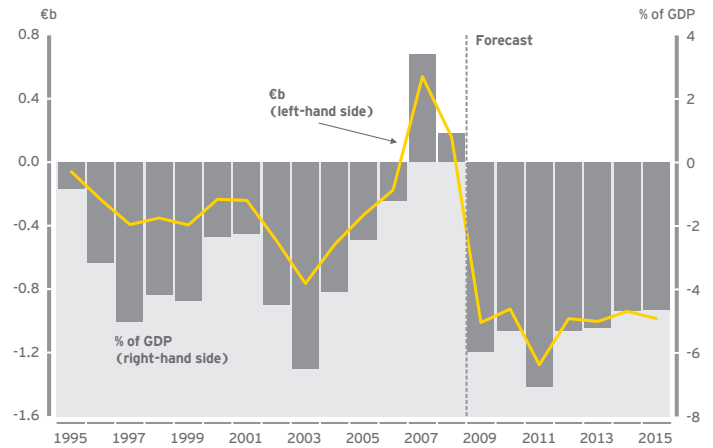
Real GDP growth



Source: Oxford Economics

Figure 20

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	0.2	0.0	1.6	2.0	3.0
Private consumption	0.8	1.1	-0.3	0.8	1.5	2.0
Fixed investment	-7.9	-7.5	3.0	4.0	5.5	4.8
Stockbuilding (% of GDP)	0.8	0.4	0.5	0.1	-0.7	0.0
Government consumption	0.5	-2.1	-3.0	1.2	2.0	2.5
Exports of goods and services	0.6	4.1	3.0	4.0	5.3	5.3
Imports of goods and services	3.1	0.5	2.5	2.6	4.0	5.6
Consumer prices	2.6	3.3	2.7	2.3	2.3	2.3
Unemployment rate (level)	6.4	7.3	7.5	7.0	6.0	4.5
Current account balance (% of GDP)	-7.8	-7.6	-7.2	-6.6	-6.1	-5.9
Government budget (% of GDP)	-5.3	-7.1	-5.3	-5.2	-4.7	-4.7
Government debt (% of GDP)	60.8	65.8	69.4	72.0	73.7	74.7

Estonia

▶ Although GDP growth remains on course to reach 8% in 2011, the rate will slow sharply next year, and risks have moved to the downside since mid-2011. This is mainly because growth has been heavily reliant on net exports, whose rise is likely to be restrained by the slowdown in main Eurozone markets. We now expect the economy to grow by just 2.5% in 2012, down from our autumn forecast of 3.8%. Growth should pick up beyond next year, as the global economy recovers, with GDP growth expected to average 4.4% a year from 2013-15.

▶ Low public debt and Q3 credit-rating upgrades ensure that the Government can respond to the export slowdown by running a fiscal deficit in 2012-13, boosting domestic demand and avoiding risk of recession. The tax-cutting agenda could prolong this deficit into 2014, without eroding creditor confidence or impeding the recovery of private investment.

Figure 21

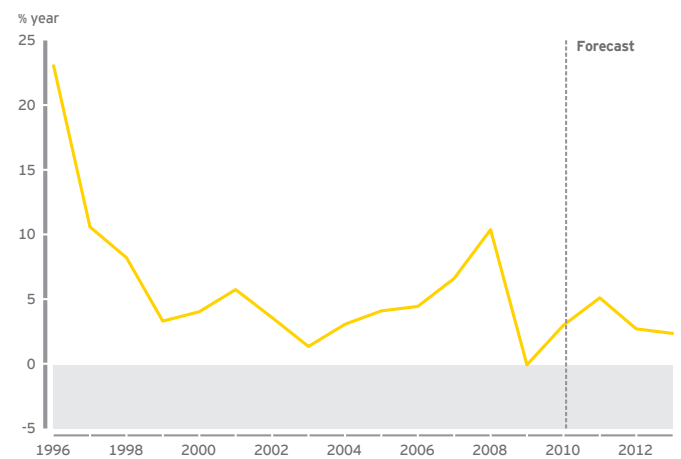
Real GDP growth



Source: Oxford Economics

Figure 22

Inflation



Source: Oxford Economics

Table 5

Estonia (annual percentage changes unless specified)

Source: Oxford Economics

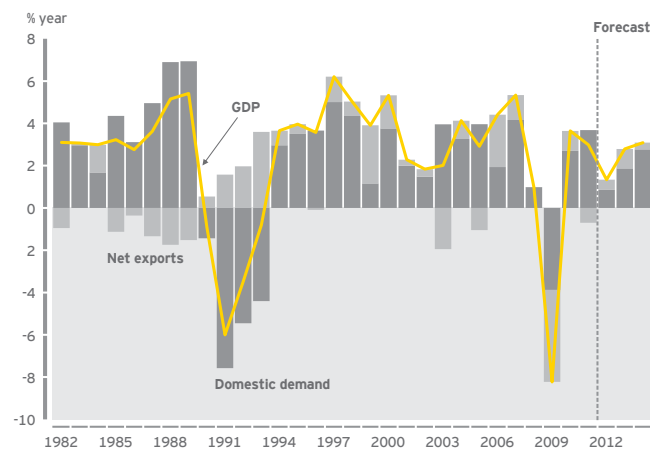
	2010	2011	2012	2013	2014	2015
GDP	2,3	8,0	2,5	3,8	4,8	4,7
Private consumption	-1,7	3,3	2,6	4,5	4,7	4,7
Fixed investment	-9,1	16,5	7,0	10,5	8,5	5,8
Stockbuilding (% of GDP)	1,0	3,7	3,0	0,5	0,3	0,3
Government consumption	-1,1	1,5	1,0	2,0	2,5	2,7
Exports of goods and services	22,5	25,0	3,9	7,6	5,7	5,4
Imports of goods and services	20,6	26,0	4,1	6,9	6,0	5,4
Consumer prices	3,0	5,1	2,7	2,3	2,1	2,2
Unemployment rate (level)	16,8	13,0	11,0	9,2	7,4	6,1
Current account balance (% of GDP)	3,6	0,7	-0,6	-0,5	-0,7	-0,7
Government budget (% of GDP)	0,3	-0,9	-2,5	-0,1	0,1	0,0
Government debt (% of GDP)	6,7	6,8	9,0	8,6	7,9	7,4

Finland

- ▶ Finland's economy has begun to show signs of fatigue. We expect weak growth to continue and anticipate that GDP will rise by 1.6% in 2012 after having increased by 2.8% in 2011.
- ▶ However, Finland's economy is structurally sound, which will help it avoid a deep recession. Strong fundamentals will also help Finland rebound once uncertainty about the Eurozone sovereign debt crisis begins to clear. In 2013, we expect the economy to recover, expanding by 2.0%.
- ▶ Over the short term, the external sector in Finland is likely to perform better than in most other Eurozone countries, thanks to geographic diversification toward countries outside the Eurozone. Demand for Finnish products should start to pick up allowing exports to grow by 4.2% in 2013.

Figure 23

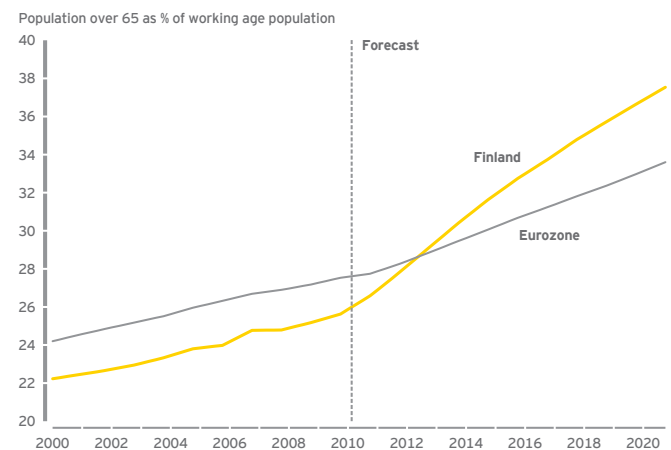
Contributions to GDP growth



Source: Oxford Economics

Figure 24

Population aging



Source: Oxford Economics

Table 6

Finland (annual percentage changes unless specified)

Source: Oxford Economics

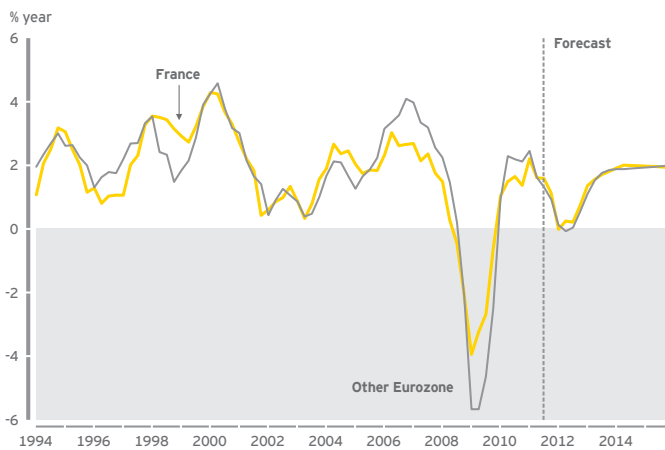
	2010	2011	2012	2013	2014	2015
GDP	3.6	2.8	1.6	2.0	3.9	3.4
Private consumption	2.7	3.3	1.7	2.9	4.6	3.4
Fixed investment	2.8	4.6	2.8	3.1	4.3	3.9
Stockbuilding (% of GDP)	2.9	2.8	2.4	1.5	0.9	0.9
Government consumption	0.6	0.6	0.4	1.1	1.3	1.2
Exports of goods and services	8.6	-1.3	0.5	4.2	6.8	5.9
Imports of goods and services	7.4	-1.5	-0.7	3.7	5.5	5.6
Consumer prices	1.7	3.4	2.2	1.7	1.7	1.6
Unemployment rate (level)	8.4	7.9	7.8	7.5	7.1	6.9
Current account balance (% of GDP)	1.8	0.0	2.1	2.5	2.5	2.5
Government budget (% of GDP)	-2.5	-1.4	-1.1	-0.8	-0.6	-0.3
Government debt (% of GDP)	48.3	46.5	46.4	45.8	44.1	42.3

France

- ▶ The sharp turn in investor sentiment, which reflects nervousness about the outlook for French public finances and the banking sector, combined with a further significant downgrade of the outlook for the Eurozone as a whole, have led us to lower our forecast for French GDP growth sharply.
- ▶ We now expect no growth in French GDP in 2012, after 1.6% in 2011. There is a large risk that the French economy will fall back into recession at the beginning of 2012 as, in particular, credit conditions will probably tighten.
- ▶ As long as a strong commitment to reduce the deficit is shown, missing the fiscal targets should not trigger a sharp increase in bond yields. But a more adverse response from financial markets is one source of downside risk to our forecast.

Figure 25

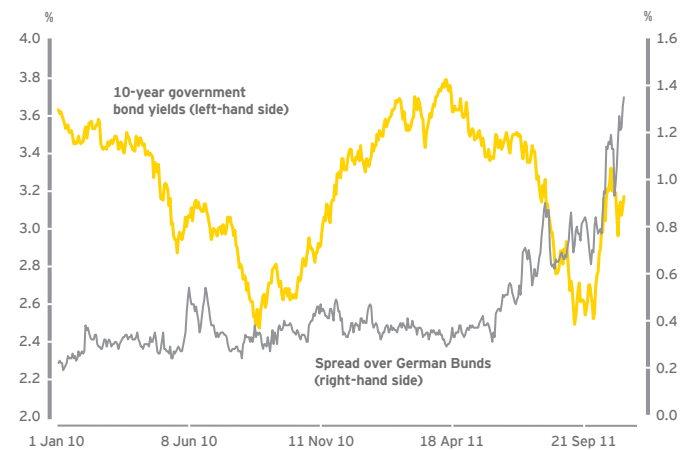
GDP: France vs. rest of Eurozone



Source: Oxford Economics, Haver Analytics

Figure 26

Government bond yields and spreads



Source: Oxford Economics

Table 7

France (annual percentage changes unless specified)

Source: Oxford Economics

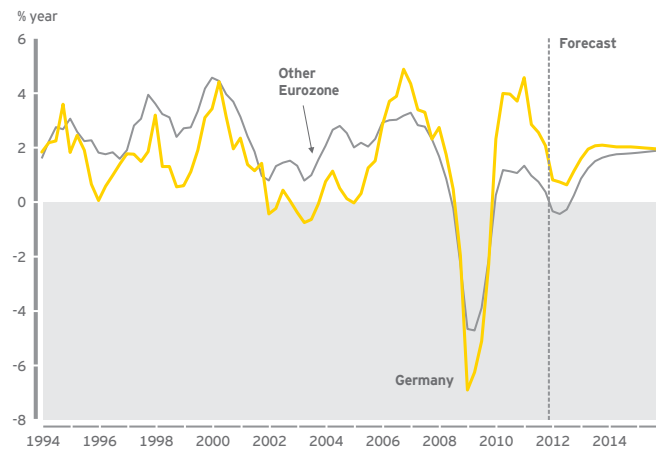
	2010	2011	2012	2013	2014	2015
GDP	1.4	1.6	0.0	1.6	2.0	2.0
Private consumption	1.4	0.6	0.6	1.4	1.7	1.8
Fixed investment	-1.4	2.8	0.5	2.6	3.0	2.9
Stockbuilding (% of GDP)	-0.1	0.7	0.2	0.1	0.2	0.3
Government consumption	1.2	0.8	-0.1	0.7	1.2	1.2
Exports of goods and services	9.3	4.2	2.1	5.6	5.9	5.5
Imports of goods and services	8.3	5.1	1.4	4.6	5.5	5.2
Consumer prices	1.7	2.2	1.6	1.7	1.9	1.9
Unemployment rate (level)	9.8	9.8	10.2	9.9	9.5	9.2
Current account balance (% of GDP)	-1.7	-2.3	-2.8	-2.8	-2.8	-2.8
Government budget (% of GDP)	-7.1	-5.9	-4.7	-3.6	-2.8	-2.4
Government debt (% of GDP)	82.3	85.7	89.2	90.9	91.9	93.6

Germany

- ▶ Concerns about the impact of the Eurozone debt crisis on growth prospects have taken their toll on business confidence in Germany. The less favorable international environment will also dampen investment and halt improvement in the labor market.
- ▶ We now expect GDP growth at only 0.9% in 2012, after 3.1% in 2011. Despite sound balance sheets in the private and public sectors, German growth remains highly dependent on developments in the rest of the world and, in particular, in the Eurozone.
- ▶ Assuming that the Eurozone debt crisis is contained, growth should resume to around 2% in 2013-15.

Figure 27

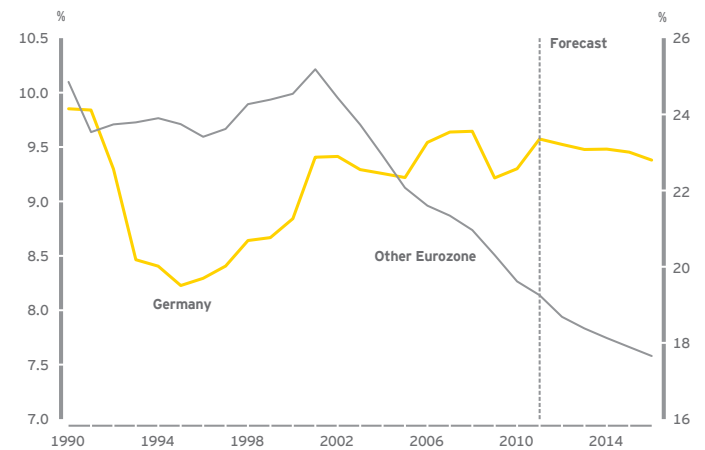
GDP: Germany vs. rest of Eurozone



Source: Oxford Economics

Figure 28

Share of world export volumes



Source: Oxford Economics

Table 8

Germany (annual percentage changes unless specified)

Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	3.6	3.1	0.9	1.8	2.1	2.0
Private consumption	0.6	1.3	0.9	1.4	1.4	1.5
Fixed investment	5.2	7.0	1.9	3.8	5.0	4.4
Stockbuilding (% of GDP)	0.6	0.5	0.2	-0.1	-0.4	-0.6
Government consumption	1.7	1.3	1.0	0.6	0.7	0.7
Exports of goods and services	13.4	8.8	4.4	6.6	6.9	6.2
Imports of goods and services	11.5	7.8	4.7	6.5	6.8	6.1
Consumer prices	1.2	2.5	1.6	1.8	1.8	1.8
Unemployment rate (level)	7.1	6.0	5.8	5.6	5.4	5.2
Current account balance (% of GDP)	5.6	4.9	5.1	5.1	4.8	4.6
Government budget (% of GDP)	-4.3	-1.4	-1.2	-1.0	-0.9	-0.6
Government debt (% of GDP)	83.2	81.5	81.0	80.4	80.4	80.8

Greece

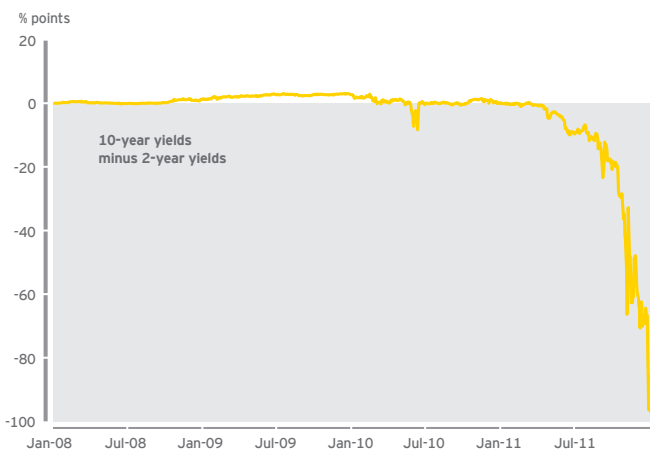
- ▶ Just days after the new rescue package was announced, the political situation in Greece grew more uncertain with the announcement of a referendum on the new rescue package. The political situation has since stabilized with the appointment of a new Prime Minister, but yields on Greek government bonds remain close to record highs.
- ▶ The new deal for Greece includes a 50% write-down on Greek debt for private bondholders. EU authorities calculate that this will reduce Greece's debt stock to around 120% of GDP by the end of the

decade. As a significant portion of Greece's debt is currently owned by the official sector, private-sector creditors may be forced to take a larger write-down on their holdings of Greek debt.

- ▶ The measures have already come at a large cost to output and employment. GDP is forecast to continue shrinking at a rate of over 6% in 2011 and 2012, with sharp declines in all components in domestic demand.

Figure 29

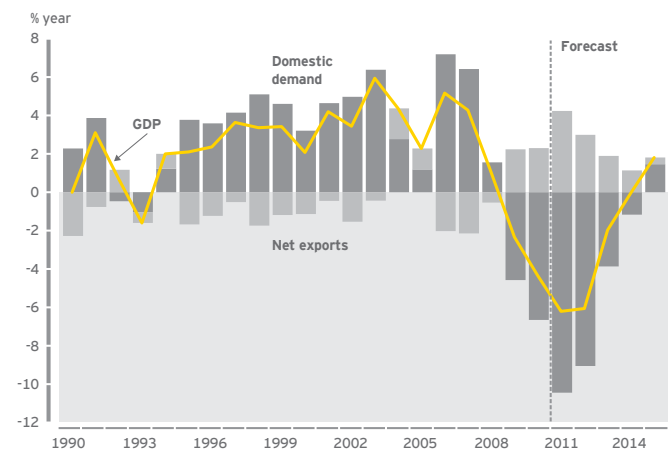
Yield curve



Source: Oxford Economics, Haver Analytics

Figure 30

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	-6.2	-6.1	-2.0	0.0	1.8
Private consumption	-4.6	-5.5	-7.3	-3.8	-0.9	1.4
Fixed investment	-16.5	-15.5	-12.0	-6.4	-0.9	4.1
Stockbuilding (% of GDP)	0.5	-0.7	0.0	0.9	0.9	0.7
Government consumption	-8.3	-13.7	-14.4	-6.4	-2.7	0.6
Exports of goods and services	3.8	0.1	2.2	2.7	4.3	6.1
Imports of goods and services	-4.8	-13.3	-8.5	-4.3	-0.1	4.7
Consumer prices	4.7	2.7	0.0	-0.3	0.6	1.6
Unemployment rate (level)	12.6	17.3	20.4	21.8	22.3	22.0
Current account balance (% of GDP)	-10.0	-10.0	-7.7	-5.9	-4.5	-3.8
Government budget (% of GDP)	-10.6	-9.0	-6.3	-6.7	-6.3	-5.7
Government debt (% of GDP)	144.9	165.8	129.0	135.6	140.1	141.2

Ireland

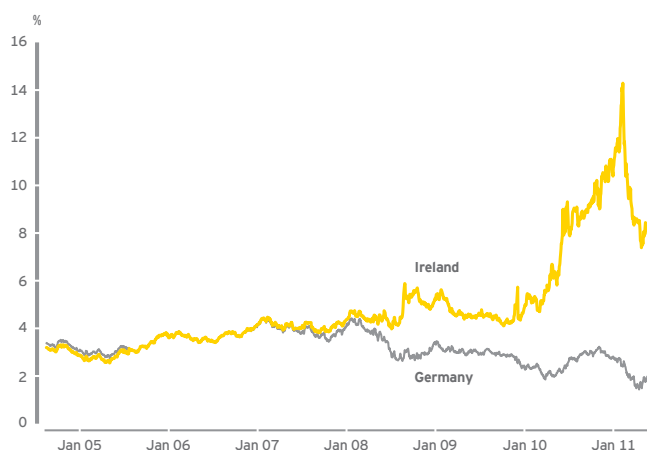
- ▶ The deal finalized in July 2011 substantially lowered Ireland's debt burden and helped to increase investor confidence. As a result, borrowing costs have declined sharply and the IMF believes that Ireland may be able to return to financial markets by early 2013. These signs are very encouraging and will help to set the Irish economy apart from other countries on the Eurozone's periphery.
- ▶ The Government has made significant progress in restoring the health of the financial system under the Financial Measures Program, and their goals of deleveraging, reorganizing and

recapitalizing the banking sector seem to be on track. As a result, Irish banks' borrowing from the ECB and Central Bank of Ireland has started to decline.

- ▶ Despite these encouraging developments, the growth prospects, on the back of reduced domestic demand and adverse developments in the global economy, remain weak in the short-term. Meanwhile, risks to our forecast, stemming from the Eurozone debt crisis, are skewed on the downside.

Figure 31

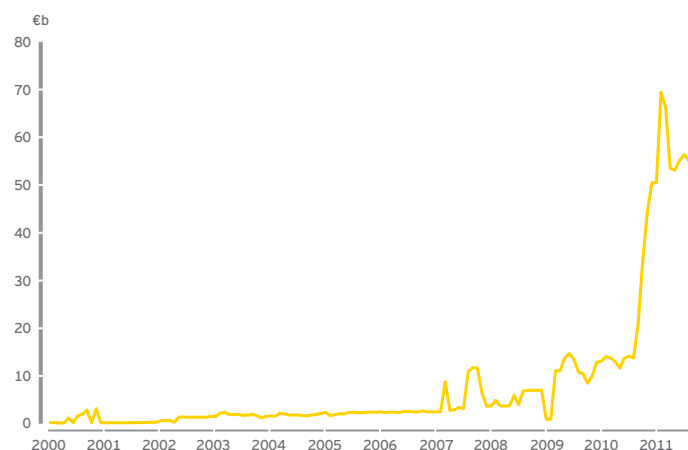
Long-term government borrowing interest rate



Source: Oxford Economics

Figure 32

Banks' borrowing from the Central Bank of Ireland



Source: Oxford Economics

Table 11

Ireland (annual percentage changes unless specified)

Source: Oxford Economics

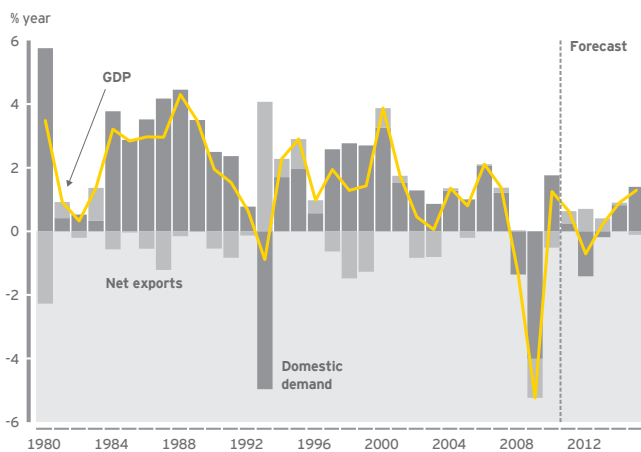
	2010	2011	2012	2013	2014	2015
GDP	-0.4	1.2	0.5	3.1	3.4	3.8
Private consumption	-0.7	-3.4	-1.9	-0.1	1.4	2.5
Fixed investment	-24.9	-7.8	-2.4	3.4	6.5	8.8
Stockbuilding (% of GDP)	-0.6	0.6	0.2	0.1	0.4	0.4
Government consumption	-3.9	-3.6	-2.4	-2.1	-2.1	-1.8
Exports of goods and services	6.3	4.1	3.0	5.7	5.0	5.0
Imports of goods and services	2.7	0.8	1.5	3.3	4.1	4.3
Consumer prices	-1.6	1.1	0.7	0.6	1.0	1.7
Unemployment rate (level)	13.7	14.4	13.9	13.2	12.7	12.0
Current account balance (% of GDP)	0.5	-0.8	2.1	2.5	2.4	2.3
Government budget (% of GDP)	-32.0	-9.2	-7.7	-5.6	-3.4	-2.0
Government debt (% of GDP)	92.5	101.5	108.4	108.9	107.2	103.8

Italy

- ▶ Given the urgent need to implement bold structural reforms and the very high uncertainty about the political and economic outlook, we now expect the economy to shrink by 0.7% in 2012, after low growth in 2011, at 0.6%.
- ▶ Growth would then return gradually, but it will take years before the reforms come to fruition. As a result, we are now expecting lower growth throughout 2013-15, at 0.7% per year on average.
- ▶ Under the current measures, the budget deficit is expected to narrow to around 2.0% of GDP in 2012 and 0.8% of GDP in 2013, from 4.0% of GDP in 2011. However, interest rates on government 10-year bond yields rose above 7% in November 2011 and the risk of insolvency increases.
- ▶ Prime Minister Berlusconi resigned on 12 November. Mario Monti, a former European Union commissioner, was appointed Prime Minister and formed a technocratic government that should remain in power until the next elections in 2013.

Figure 33

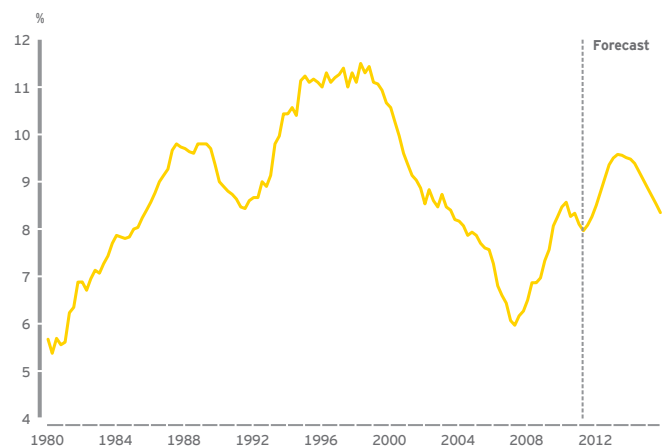
Contributions to GDP growth



Source: Oxford Economics

Figure 34

Unemployment rate



Source: Oxford Economics

Table 10

Italy (annual percentage changes unless specified)

Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	1.2	0.6	-0.8	0.0	0.8	1.4
Private consumption	1.0	0.6	-0.9	-0.5	0.7	1.2
Fixed investment	2.3	0.6	-2.4	0.2	2.0	2.7
Stockbuilding (% of GDP)	0.6	0.3	0.1	0.2	0.0	0.1
Government consumption	-0.6	0.2	-1.1	-1.0	0.1	0.9
Exports of goods and services	8.9	4.4	0.7	1.8	3.6	4.7
Imports of goods and services	10.3	2.7	-1.8	0.3	3.1	4.8
Consumer prices	1.6	2.9	1.9	0.7	1.8	2.0
Unemployment rate (level)	8.4	8.2	9.3	9.9	9.6	8.7
Current account balance (% of GDP)	-3.5	-3.5	-2.5	-2.0	-1.8	-1.9
Government budget (% of GDP)	-4.6	-4.0	-2.0	-0.8	-0.6	-0.6
Government debt (% of GDP)	118.4	120.1	120.7	119.5	117.1	114.1

Luxembourg

► The outlook for GDP growth in 2011 and 2012 has weakened further, as a result of the ongoing deterioration of Eurozone growth prospects and the impact that the lingering and worsening Eurozone debt crisis is likely to have on Luxembourg's important financial sector. We now forecast growth of only 0.9% in 2012 (1.7% earlier).

► Luxembourg's low public debt and relatively stable economy have become further advantages in attracting additional investment fund inflows, which have become more important to industry growth as market volatility holds back the growth of fund assets. The size of the mainstream UCITS (Undertakings for Collective Investment in Transferable Securities) sector, second in size only to New York's, is now a major attractor for hedge funds, especially those adapted to operate within the UCITS framework.

Figure 35

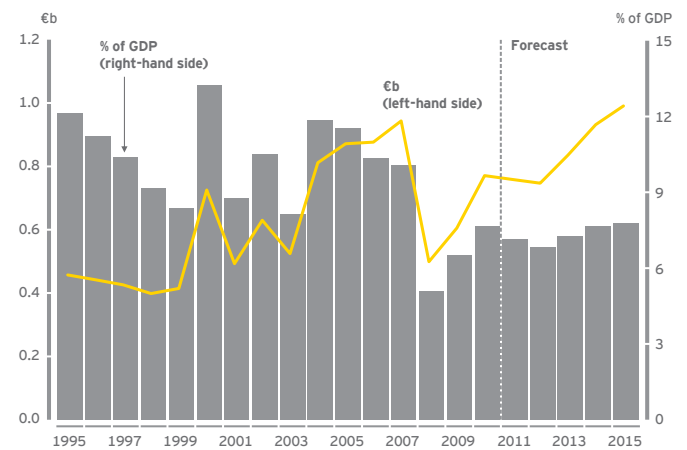
Real GDP and employment



Source: Oxford Economics

Figure 36

Current account balance



Source: Oxford Economics

Table 12

Luxembourg (annual percentage changes unless specified)

Source: Oxford Economics

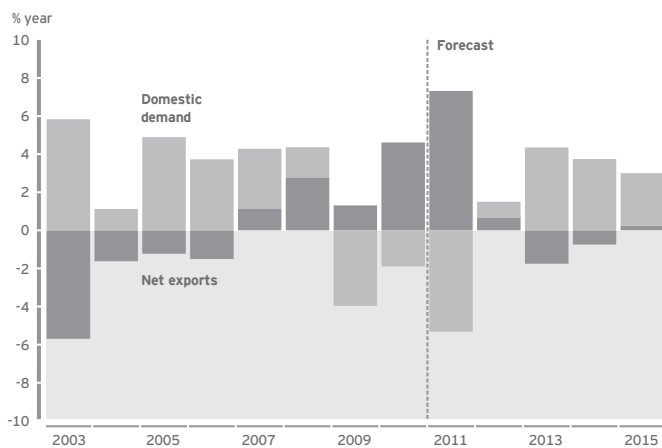
	2010	2011	2012	2013	2014	2015
GDP	2,7	1,9	0,9	3,4	3,5	3,0
Private consumption	2,1	2,4	1,9	3,0	2,9	2,5
Fixed investment	3,0	5,1	5,0	5,4	4,3	3,6
Stockbuilding (% of GDP)	0,0	1,4	0,2	0,4	0,5	0,4
Government consumption	3,0	-1,1	3,0	2,0	2,0	1,9
Exports of goods and services	2,8	5,2	3,4	5,8	5,1	4,2
Imports of goods and services	4,6	7,0	4,1	6,3	5,2	4,2
Consumer prices	2,8	3,6	2,3	2,1	2,1	2,0
Unemployment rate (level)	4,6	4,7	5,2	5,2	4,7	4,0
Current account balance (% of GDP)	7,8	7,2	6,8	7,3	7,7	7,8
Government budget (% of GDP)	-1,1	-0,8	-1,4	-1,1	0,1	0,5
Government debt (% of GDP)	19,1	18,9	19,8	19,8	18,6	17,3

Malta

- ▶ We expect GDP growth to average 2.0% in 2011, down from 2.7% in 2010, and to drop to 1.5% in 2012. The forecast implies a slowdown of the economy in H2 2011, due to the weaker external outlook.
- ▶ We expect inflation to continue to decline in the coming months and stabilize at 2.3% in the next few years, after averaging 2.5% in 2011. Lower inflation will support purchasing power and, hence, consumption.
- ▶ The scale of public debt has prompted one credit-rating downgrade in Q3 2011. Under the current policies, we expect public debt to peak at 70% of GDP in 2012 and to decline gradually below 68% of GDP in 2015.
- ▶ The end of the conflict in Libya opens up opportunities to renew and extend the projects that were previously in progress there.

Figure 37

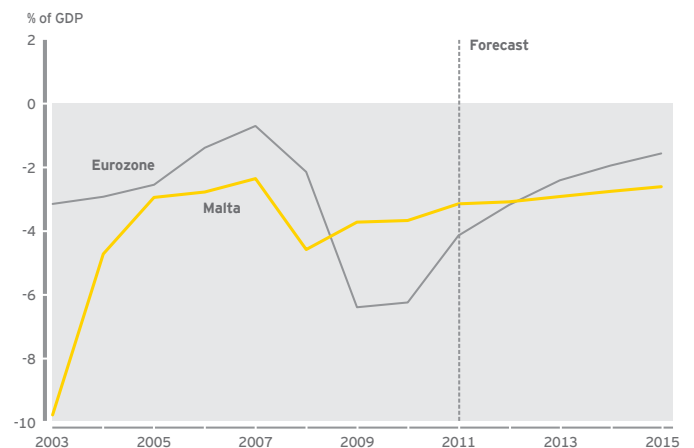
Contributions to GDP



Source: Oxford Economics

Figure 38

Fiscal balance versus Eurozone



Source: Oxford Economics

Table 13

Malta (annual percentage changes unless specified)

Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	2.7	2.0	1.5	2.6	3.0	3.0
Private consumption	-1.4	0.5	1.3	2.0	3.0	2.9
Fixed investment	-8.7	-16.3	6.0	7.2	8.0	6.0
Stockbuilding (% of GDP)	0.0	-4.2	-4.9	-3.1	-2.6	-2.8
Government consumption	0.9	2.6	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	3.5	4.2	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	6.7	6.5	6.1	5.6	5.1
Current account balance (% of GDP)	-5.1	-4.4	-4.2	-4.0	-3.9	-3.9
Government budget (% of GDP)	-3.7	-3.1	-3.1	-2.9	-2.8	-2.6
Government debt (% of GDP)	68.9	69.4	69.9	69.5	68.7	67.8

Netherlands

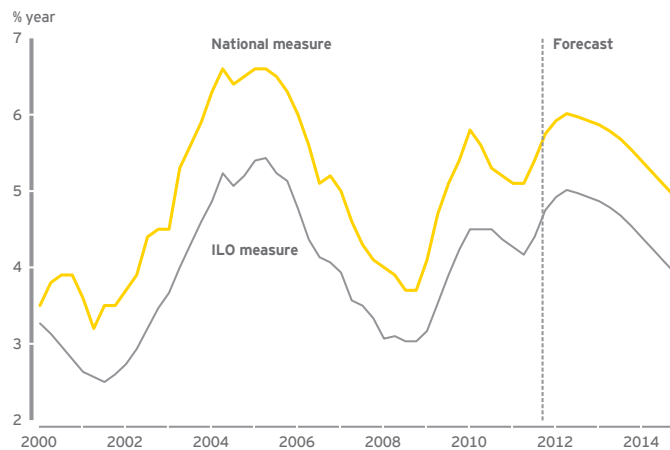
- ▶ The escalation of the sovereign debt crisis has raised financial stress levels and damaged confidence across the Eurozone, seriously hampering export prospects. With Dutch households also under pressure from falling real wages and rising unemployment, the outlook has deteriorated significantly since our autumn forecast and the economy is forecast to endure a mild recession.
- ▶ As a result, we have lowered our forecasts for GDP growth for 2012 to 0.2%. Assuming that confidence improves, momentum should

build through 2012 and we expect GDP growth to average 2.0% a year from 2013 to 2015, similar to our autumn forecast, but the risks remain heavily skewed to the downside.

- ▶ Despite the weaker outlook, the September budget reaffirmed the commitment to austerity and suggested further measures could be implemented if weaker growth causes borrowing targets to be missed. We are not convinced that this is the right approach as it could exacerbate the downturn.

Figure 39

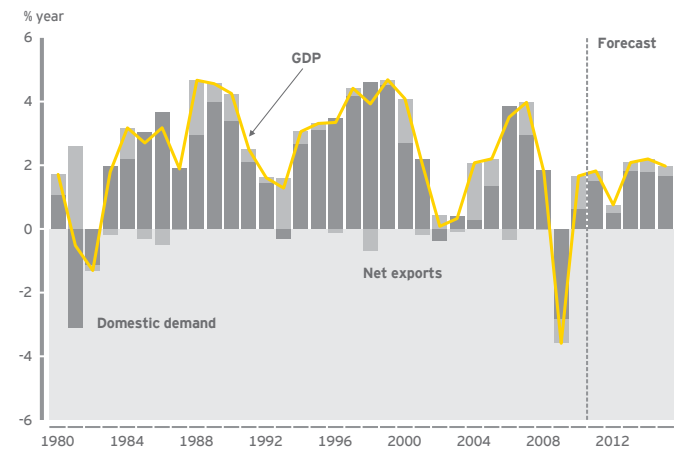
Unemployment



Source: Oxford Economics

Figure 40

Contributions to GDP growth



Source: Oxford Economics

Table 14

Netherlands (annual percentage changes unless specified)

Source: Oxford Economics

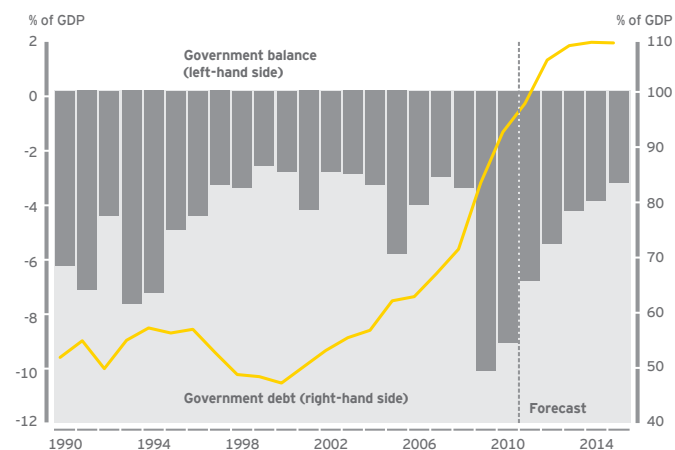
	2010	2011	2012	2013	2014	2015
GDP	1.6	1.5	0.2	1.7	2.3	2.1
Private consumption	0.4	-0.7	-0.3	1.2	2.0	1.8
Fixed investment	-4.4	6.0	-0.6	3.2	3.3	2.9
Stockbuilding (% of GDP)	0.5	0.7	0.3	0.3	0.3	0.3
Government consumption	1.0	0.4	-0.6	0.1	1.0	1.2
Exports of goods and services	10.8	4.6	2.3	5.1	5.2	4.1
Imports of goods and services	10.6	4.5	1.6	5.0	5.2	4.2
Consumer prices	0.9	2.5	1.9	1.8	1.7	1.9
Unemployment rate (level)	4.5	4.4	5.1	4.9	4.2	3.7
Current account balance (% of GDP)	6.6	7.9	6.8	7.2	7.2	7.2
Government budget (% of GDP)	-5.1	-4.3	-3.9	-3.0	-2.2	-1.3
Government debt (% of GDP)	62.9	65.5	68.3	68.8	68.1	66.7

Portugal

- ▶ Although our forecast assumes that the Greek sovereign debt default will remain orderly, it greatly increases the risk of financial contagion to other Eurozone countries, especially Portugal.
- ▶ Portugal's public finances have shown little improvement, and the fiscal targets are likely to be missed. The Government has therefore unveiled one of the harshest austerity budgets for 2012 and 2013, which is likely to dampen domestic demand via various transmission channels. GDP is forecast to fall by 1.3% in 2011 and 2.3% in 2012.
- ▶ Portugal is in dire need of structural reforms such as increasing flexibility in the labor market and making key sectors such as energy and communications more open to competition. The Government has made some progress so far, and, assuming that these reforms go through, we expect the economy to start recovering by 2013.

Figure 41

Government balance and debt



Source: Oxford Economics

Figure 42

Bond spread over German Bunds



Source: Oxford Economics

Table 15

Portugal (annual percentage changes unless specified)

Source: Oxford Economics

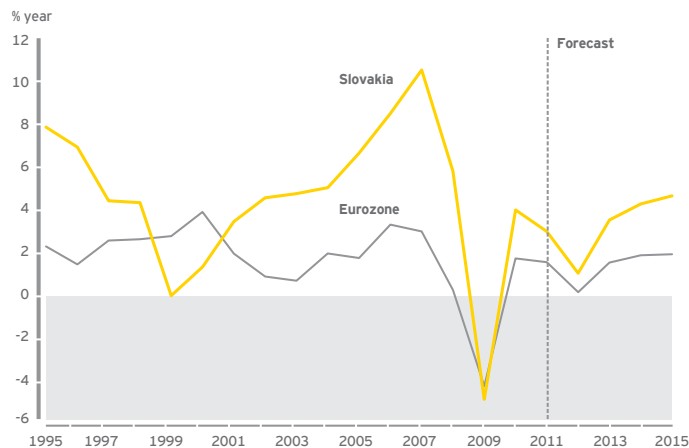
	2010	2011	2012	2013	2014	2015
GDP	1.3	-1.3	-3.0	0.9	1.7	1.6
Private consumption	2.3	-3.8	-5.5	-0.4	1.2	1.2
Fixed investment	-4.9	-10.3	-9.3	1.1	4.7	4.8
Stockbuilding (% of GDP)	0.0	-0.3	0.4	0.7	0.3	-0.2
Government consumption	1.2	-3.7	-5.3	-3.1	0.3	0.9
Exports of goods and services	8.8	6.4	3.3	4.9	4.8	4.6
Imports of goods and services	5.1	-5.7	-4.4	1.2	3.8	3.6
Consumer prices	1.4	3.7	1.4	1.7	1.9	2.0
Unemployment rate (level)	12.1	12.6	14.0	14.8	14.3	13.1
Current account balance (% of GDP)	-10.0	-7.7	-6.0	-4.3	-3.7	-3.4
Government budget (% of GDP)	-9.8	-6.9	-5.5	-4.3	-4.0	-3.3
Government debt (% of GDP)	93.3	100.2	107.7	109.9	110.4	110.0

Slovakia

- ▶ Slovakia's economy is expected to slow significantly as the sovereign debt crisis undermines key European export markets and business confidence. The disappointing GDP performance observed in Q3 2011 was mainly caused by a sharp decline in export growth.
- ▶ We expect GDP growth to fall to only 1.1% in 2012 after 2.3% in 2011. Further ahead, much depends on how the Eurozone crisis evolves but, assuming that the Eurozone avoids a disorderly default, the Slovak economy is forecast to grow by 3.6% in 2013.
- ▶ However, Slovakia's competitive position and sound balance sheet mean that it is still expected to remain one of the strongest performers in the Eurozone over the medium term. We expect the economy to grow, on average, 4.1% per year between 2013 and 2015.

Figure 43

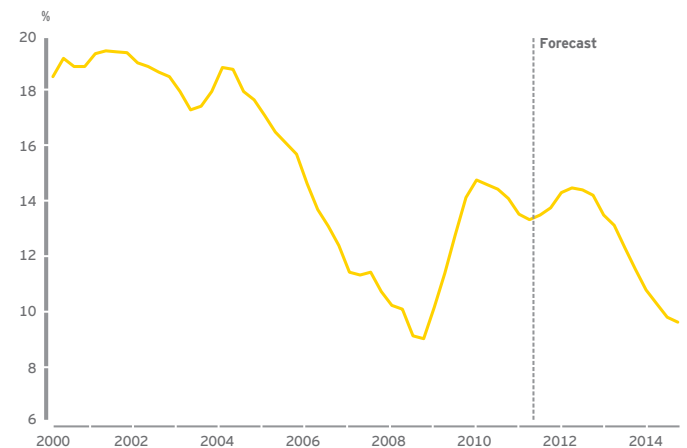
Real GDP growth



Source: Oxford Economics

Figure 44

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	3.0	1.1	3.6	4.3	4.7
Private consumption	-0.3	-0.1	0.3	3.0	5.3	5.9
Fixed investment	3.6	2.4	1.0	4.2	7.5	7.6
Stockbuilding (% of GDP)	-0.2	-1.3	-0.7	0.5	1.1	1.1
Government consumption	0.1	-2.1	1.7	3.2	2.6	2.5
Exports of goods and services	16.4	10.1	2.9	7.0	8.3	6.9
Imports of goods and services	14.9	6.3	3.4	8.5	10.4	8.1
Consumer prices	1.0	3.8	2.5	2.6	2.5	2.4
Unemployment rate (level)	14.4	13.4	14.6	13.1	10.6	9.7
Current account balance (% of GDP)	-3.4	-0.1	-1.8	-2.0	-2.0	-2.5
Government budget (% of GDP)	-7.7	-5.4	-4.1	-3.3	-2.9	-2.6
Government debt (% of GDP)	41.0	43.0	44.6	44.2	42.9	41.3

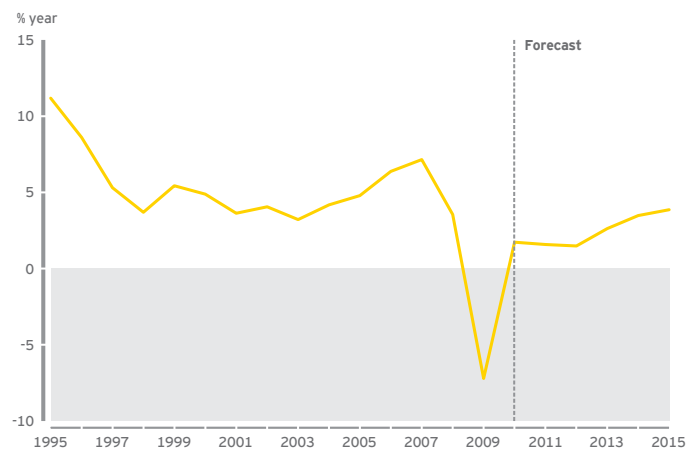
Slovenia

- ▶ Activity in the Slovenian economy has decelerated sharply since the beginning of 2011 due to weakening demand from the Eurozone, and subdued domestic investment. We estimate that GDP growth averaged just 1.1% in 2011 as a whole, with similar growth forecast for 2012.
- ▶ Slower growth, combined with the rejection of key pension and labor-market reforms, has resulted in another fiscal deficit overshoot. The new Government is likely to introduce additional

fiscal austerity measures, which we expect will bring the budget deficit back down to 5% in 2012 from an estimated 5.8% in 2011.

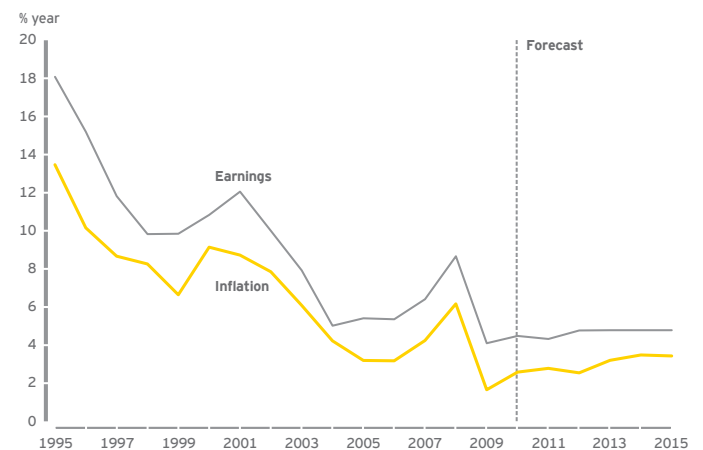
- ▶ The banking sector is a source of downside risk to our forecast. Banks need to raise capital which is likely to be difficult in current financial market conditions. This raises the risk that banks will shrink their balance sheets, slowing the supply of loans to the economy, which will undermine domestic demand.

Figure 45
Real GDP



Source: Oxford Economics

Figure 46
Inflation and earnings



Source: Oxford Economics

Table 17
Slovenia (annual percentage changes unless specified)

Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	1.3	1.1	1.0	2.2	3.1	3.5
Private consumption	-0.6	0.7	1.2	1.8	2.4	2.5
Fixed investment	-8.3	-13.0	3.4	5.1	4.6	4.2
Stockbuilding (% of GDP)	1.3	2.6	2.6	2.5	2.6	3.0
Government consumption	1.5	-0.5	1.0	1.7	2.0	2.2
Exports of goods and services	9.2	8.0	4.5	5.5	5.6	5.3
Imports of goods and services	6.8	4.6	5.5	5.8	5.4	5.1
Consumer prices	1.8	2.0	1.8	2.5	2.8	2.8
Unemployment rate (level)	7.3	8.0	7.3	6.0	5.1	5.1
Current account balance (% of GDP)	-0.8	-1.1	-1.0	-0.6	0.1	0.3
Government budget (% of GDP)	-5.6	-5.8	-5.0	-4.3	-3.7	-3.5
Government debt (% of GDP)	39.0	43.6	47.4	49.5	50.4	50.9

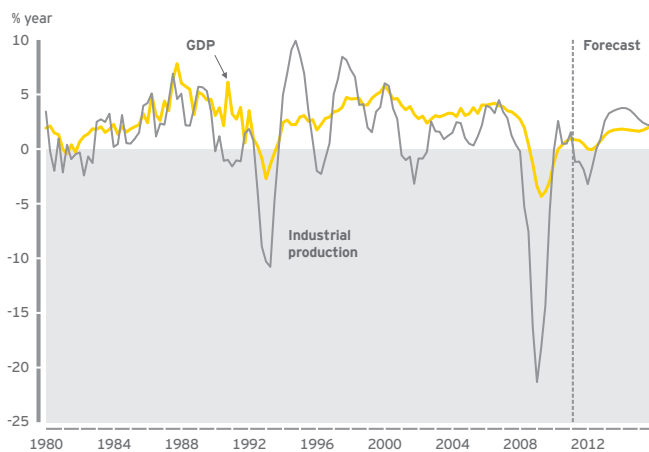
Spain

► With sovereign and financial stress likely to remain an acute issue in the coming months, we now believe that Spain will fall back into recession during Q4 2011 and Q1 2012. The Spanish Government is also expected to step up its fiscal austerity program in its next budget, which has contributed to a downward revision to our forecast for GDP growth in 2012 to 0.2%. Austerity measures will continue to weigh on growth in 2013, for which our forecast has been downgraded to 0.8%.

► The risks to these economic forecasts remain skewed to the downside. The latest rescue plan agreed by EU leaders has done nothing to dampen borrowing costs for Spain as it did not deliver a clear and credible firebreak to prevent financial contagion from engulfing the country. Moreover, the bank recapitalization plan may induce Spanish banks to shrink their balance sheets, which could further constrain the supply of credit and undermine the already weak economy.

Figure 47

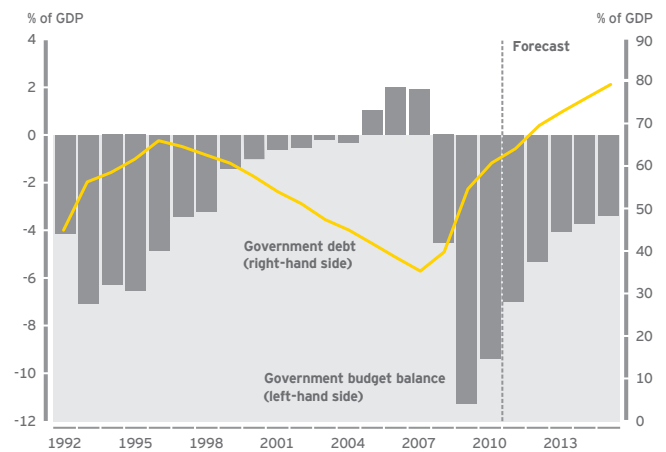
GDP and industrial production



Source: Oxford Economics

Figure 48

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	0.7	-0.2	0.8	1.5	1.9
Private consumption	0.8	0.0	-0.4	0.8	1.5	1.7
Fixed investment	-6.3	-4.7	-4.2	0.9	3.0	3.0
Stockbuilding (% of GDP)	0.6	0.5	0.5	0.7	0.6	0.4
Government consumption	0.2	-1.5	-2.8	0.1	1.3	1.6
Exports of goods and services	13.5	9.3	6.2	6.8	6.8	7.0
Imports of goods and services	8.9	1.6	1.2	7.3	7.5	7.0
Consumer prices	2.0	3.1	2.0	1.4	1.4	1.5
Unemployment rate (level)	20.1	21.6	23.6	23.1	22.1	21.1
Current account balance (% of GDP)	-4.6	-4.4	-3.1	-2.9	-2.6	-2.2
Government budget (% of GDP)	-9.3	-7.0	-5.3	-4.1	-3.8	-3.4
Government debt (% of GDP)	61.0	66.7	72.1	75.9	79.4	82.4



Detailed tables and charts





Forecast assumptions

	2010	2011	2012	2013	2014	2015
Short-term interest rates (%)	0.8	1.4	1.2	2.2	3.6	4.0
Long-term interest rates (%)	3.6	4.4	4.4	4.8	5.3	5.2
Euro effective exchange rate (1995=100)	120.7	121.0	119.2	121.1	117.0	114.8
Oil prices (€/barrel)	59.9	79.9	73.7	76.3	80.1	84.5
Share prices (% year)	7.1	-9.2	-19.3	14.7	16.3	13.7

	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	1.4
Long-term interest rates (%)	3.7	3.6	3.4	3.7	4.3	4.5	4.3	4.4
Euro effective exchange rate (1995=100)	125.6	118.6	118.0	120.4	119.8	123.0	121.7	119.6
Oil prices (€/barrel)	76.2	78.4	76.7	86.6	104.8	117.6	113.3	109.0
Share prices (% year)	41.5	7.1	-4.3	-5.8	-0.7	10.7	-20.7	-25.2

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	0.2	-0.1
Private consumption	0.2	0.2	0.3	0.4	0.1	-0.5	0.3	-0.1
Fixed investment	-0.6	2.1	0.1	-0.4	1.9	0.0	0.1	-0.3
Government consumption	-0.5	0.2	0.1	0.0	0.0	-0.1	0.0	-0.1
Exports of goods and services	3.3	4.5	2.2	1.2	1.6	1.1	1.5	0.4
Imports of goods and services	3.5	3.9	1.8	1.0	1.1	0.3	1.1	0.1

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	0.2	-0.1
Private consumption	0.1	0.1	0.2	0.2	0.1	-0.3	0.2	-0.1
Fixed investment	-0.1	0.4	0.0	-0.1	0.4	0.0	0.0	-0.1
Government consumption	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Stockbuilding	0.5	0.1	0.0	0.1	0.1	0.1	-0.2	-0.2
Exports of goods and services	1.4	1.9	1.0	0.5	0.8	0.5	0.7	0.2
Imports of goods and services	-1.4	-1.7	-0.8	-0.5	-0.5	-0.1	-0.5	0.0

Annual levels – real terms

(€ billion, 2000 prices)

	2010	2011	2012	2013	2014	2015
GDP	7,602	7,723	7,729	7,835	7,983	8,143
Private consumption	4,358	4,374	4,371	4,409	4,471	4,543
Fixed investment	1,465	1,496	1,490	1,526	1,581	1,636
Government consumption	1,613	1,614	1,605	1,608	1,620	1,637
Stockbuilding	34	37	11	5	-1	-8
Exports of goods and services	3,441	3,665	3,782	3,999	4,238	4,473
Imports of goods and services	3,310	3,464	3,530	3,711	3,927	4,139

Annual levels – nominal terms

(€ billion)

	9154	9429	9581	9870	10227	10611
GDP	9,154	9,429	9,581	9,870	10,227	10,611
Private consumption	5,262	5,415	5,499	5,624	5,804	6,004
Fixed investment	1,746	1,813	1,827	1,902	2,002	2,107
Government consumption	2,014	2,036	2,053	2,094	2,152	2,219
Stockbuilding	18	43	-11	3	17	23
Exports of goods and services	3,740	4,157	4,420	4,759	5,133	5,516
Imports of goods and services	3,626	4,035	4,208	4,512	4,882	5,258

Prices and costs indicators

(annual percentage changes unless specified)

	2010	2011	2012	2013	2014	2015
HICP headline inflation	1.6	2.7	1.7	1.5	1.8	1.8
Inflation ex-energy	1.0	1.6	1.5	1.3	1.6	1.7
GDP deflator	0.7	1.4	1.5	1.6	1.7	1.7
Import deflator	4.7	5.2	2.6	1.8	1.8	1.8
Export deflator	10.8	9.6	0.1	1.3	1.7	1.9
Terms of trade	6.1	4.4	-2.5	-0.6	0.0	0.1
Earnings	1.7	2.4	1.5	2.3	2.9	3.0
Unit labor costs	-0.6	1.0	0.6	1.0	1.4	1.6
Output gap (% of GDP)	-3.8	-2.7	-3.1	-2.7	-2.1	-1.6
Oil prices (€ per barrel)	59.9	79.9	73.7	76.3	80.1	84.5
Euro effective exchange rate (1995=100)	120.7	121.0	119.2	121.1	117.0	114.8

	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	2.8
Inflation ex-energy	0.9	0.9	1.0	1.1	1.3	1.7	1.7	1.7
GDP deflator	0.3	0.7	1.0	0.9	1.2	1.2	1.4	1.7
Import deflator	1.2	5.2	6.1	6.3	7.2	4.4	3.7	5.6
Export deflator	4.5	11.6	12.9	14.2	15.3	10.0	6.8	6.7
Terms of trade	3.3	6.4	6.9	7.9	8.1	5.6	3.1	1.1
Earnings	1.5	1.9	1.6	1.7	2.5	2.6	2.4	2.4
Unit labor costs	-0.8	-0.8	-0.7	-0.1	0.2	1.3	1.3	1.2
Output gap (% of GDP)	-4.6	-3.8	-3.5	-3.3	-2.7	-2.7	-2.6	-2.9
Oil prices (€ per barrel)	76.2	78.4	76.7	86.6	104.8	117.6	113.3	109.0
Euro effective exchange rate (1995=100)	125.6	118.6	118.0	120.4	119.8	123.0	121.7	119.6

Labor market

(annual percentage changes unless specified)

	2010	2011	2012	2013	2014	2015
Employment	-0.5	0.3	-0.8	0.0	0.5	0.5
Unemployment rate (%)	10.1	10.1	10.8	10.7	10.3	9.8
NAIRU (%)	8.6	8.9	8.9	8.8	8.6	8.3
Participation rate (%)	73.9	74.2	74.4	74.6	74.8	75.0
Earnings	1.7	2.4	1.5	2.3	2.9	3.0
Unit labor costs	-0.6	1.0	0.6	1.0	1.4	1.6

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Employment	-1.3	-0.6	-0.1	0.2	0.3	0.5	0.4	-0.1
Unemployment rate (%)	10.1	10.2	10.1	10.1	10.0	10.0	10.1	10.4
NAIRU (%)	8.4	8.5	8.6	8.8	8.9	8.9	8.9	9.0
Participation rate (%)	73.8	73.9	73.8	73.9	73.9	74.2	74.3	74.3
Earnings	1.5	1.9	1.6	1.7	2.5	2.6	2.4	2.4
Unit labor costs	-0.8	-0.8	-0.7	-0.1	0.2	1.3	1.3	1.2

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

Current account and fiscal balance

	2010	2011	2012	2013	2014	2015
Trade balance (€b)	-14.2	-26.6	39.2	69.5	71.0	73.1
Trade balance (% of GDP)	-0.2	-0.3	0.5	0.9	0.9	0.9
Current account balance (€b)	-45.6	-73.7	-30.5	-10.9	-7.3	-6.0
Current account balance (% of GDP)	-0.5	-0.8	-0.3	-0.1	-0.1	-0.1
Government budget balance (€b)	-572	-391	-300	-234	-197	-165
Government budget balance (% of GDP)	-6.3	-4.1	-3.1	-2.4	-1.9	-1.6
Cyclically adjusted surplus (+) /deficit (-) (% of GDP)	-5.5	-3.5	-2.4	-1.5	-1.0	-0.6
Government debt (€b)	7819	8211	8421	8723	9052	9395
Government debt (% of GDP)	102.9	106.3	108.9	111.3	113.4	115.4

Measures of convergence and divergence within the Eurozone

	2001-2005	2006-2010	2011-2015
Growth and incomes			
Standard deviation of GDP growth rates	1.8	2.2	1.6
Growth rate gap (max-min)	6.4	8.6	6.5
Highest GDP per capita (Eurozone = 100)	234.1	243.7	241.9
Lowest GDP per capita (Eurozone = 100)	51.1	64.8	67.0
Inflation and prices			
Standard deviation of inflation rates	1.5	1.0	0.6
Inflation rate gap (max-min)	6.1	4.0	2.4
Highest price level (Eurozone = 100)	116.4	116.5	116.2
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	2.3	8.0	2.5	3.8	4.8	4.7	4.7
2	Slovakia	4.0	3.0	1.1	3.6	4.3	4.7	3.3
3	Finland	3.6	2.8	1.6	2.0	3.9	3.4	2.7
4	Luxembourg	2.7	1.9	0.9	3.4	3.5	3.0	2.5
5	Malta	2.7	2.0	1.5	2.6	3.0	3.0	2.4
6	Ireland	-0.4	1.2	0.5	3.1	3.4	3.8	2.4
7	Slovenia	1.3	1.1	1.0	2.2	3.1	3.5	2.2
8	Austria	2.4	3.2	1.0	2.1	2.2	2.1	2.1
9	Belgium	2.3	2.0	0.9	2.9	2.5	2.1	2.1
10	Germany	3.6	3.1	0.9	1.8	2.1	2.0	2.0
11	Netherlands	1.6	1.5	0.2	1.7	2.3	2.1	1.6
12	France	1.4	1.6	0.0	1.6	2.0	2.0	1.4
13	Eurozone	1.8	1.6	0.1	1.4	1.9	2.0	1.4
14	Cyprus	1.0	0.2	0.0	1.6	2.0	3.0	1.4
15	Spain	-0.1	0.7	-0.2	0.8	1.5	1.9	0.9
16	Italy	1.2	0.6	-0.8	0.0	0.8	1.4	0.4
17	Portugal	1.3	-1.3	-3.0	0.9	1.7	1.6	0.0
18	Greece	-4.4	-6.2	-6.1	-2.0	0.0	1.8	-2.5

Inflation rates (% year)								
Rank		2010	2011	2012	2013	2014	2015	Average 2011-2015
1	Greece	4.7	2.7	0.0	-0.3	0.6	1.6	0.9
2	Ireland	-1.6	1.1	0.7	0.6	1.0	1.7	1.0
3	France	1.7	2.2	1.6	1.7	1.9	1.9	1.8
4	Spain	2.0	3.1	2.0	1.4	1.4	1.5	1.9
5	Italy	1.6	2.9	1.9	0.7	1.8	2.0	1.9
6	Eurozone	1.6	2.7	1.7	1.5	1.8	1.8	1.9
7	Germany	1.2	2.5	1.6	1.8	1.8	1.8	1.9
8	Netherlands	0.9	2.5	1.9	1.8	1.7	1.9	2.0
9	Finland	1.7	3.4	2.2	1.7	1.7	1.6	2.1
10	Portugal	1.4	3.7	1.4	1.7	1.9	2.0	2.1
11	Austria	1.7	3.4	2.2	2.1	2.0	2.0	2.3
12	Belgium	2.4	3.5	2.4	2.0	2.0	1.9	2.4
13	Malta	2.0	2.5	2.3	2.3	2.3	2.3	2.4
14	Slovenia	1.8	2.0	1.8	2.5	2.8	2.8	2.4
15	Luxembourg	2.8	3.6	2.3	2.1	2.1	2.0	2.4
16	Cyprus	2.6	3.3	2.7	2.3	2.3	2.3	2.5
17	Slovakia	1.0	3.8	2.5	2.6	2.5	2.4	2.7
18	Estonia	3.0	5.1	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	4.1	4.2	4.1	4.1	4.1	4.1
2	Netherlands	4.5	4.4	5.1	4.9	4.2	3.7	4.5
3	Luxembourg	4.6	4.7	5.2	5.2	4.7	4.0	4.8
4	Germany	7.1	6.0	5.8	5.6	5.4	5.2	5.6
5	Malta	6.9	6.7	6.5	6.1	5.6	5.1	6.0
6	Slovenia	7.3	8.0	7.3	6.0	5.1	5.1	6.3
5	Cyprus	6.4	7.3	7.5	7.0	6.0	4.5	6.5
8	Belgium	8.3	7.0	7.5	7.6	6.9	6.4	7.1
9	Finland	8.4	7.9	7.8	7.5	7.1	6.9	7.4
10	Italy	8.4	8.2	9.3	9.9	9.6	8.7	9.1
11	Estonia	16.8	13.0	11.0	9.2	7.4	6.1	9.4
12	France	9.8	9.8	10.2	9.9	9.5	9.2	9.7
13	Eurozone	10.1	10.1	10.8	10.7	10.3	9.8	10.4
14	Slovakia	14.4	13.4	14.6	13.1	10.6	9.7	12.3
15	Ireland	13.7	14.4	13.9	13.2	12.7	12.0	13.2
16	Portugal	12.1	12.6	14.0	14.8	14.3	13.1	13.8
17	Greece	12.6	17.3	20.4	21.8	22.3	22.0	20.8
18	Spain	20.1	21.6	23.6	23.1	22.1	21.1	22.3

Government budget (% of GDP)								
Rank		2010	2011	2012	2013	2014	2015	Difference 2011-2015
1	Estonia	0.3	-0.9	-2.5	-0.1	0.1	0.0	-0.3
2	Cyprus	-5.3	-7.1	-5.3	-5.2	-4.7	-4.7	0.7
3	Malta	-3.7	-3.1	-3.1	-2.9	-2.8	-2.6	1.1
4	Luxembourg	-1.1	-0.8	-1.4	-1.1	0.1	0.5	1.5
5	Austria	-4.4	-3.4	-3.1	-3.1	-2.6	-2.4	2.0
6	Slovenia	-5.6	-5.8	-5.0	-4.3	-3.7	-3.5	2.1
7	Finland	-2.5	-1.4	-1.1	-0.8	-0.6	-0.3	2.2
8	Belgium	-4.1	-3.4	-3.8	-2.9	-1.7	-0.7	3.4
9	Germany	-4.3	-1.4	-1.2	-1.0	-0.9	-0.6	3.7
10	Netherlands	-5.1	-4.3	-3.9	-3.0	-2.2	-1.3	3.8
11	Italy	-4.6	-4.0	-2.0	-0.8	-0.6	-0.6	4.0
12	France	-7.1	-5.9	-4.7	-3.6	-2.8	-2.4	4.7
13	Eurozone	-6.3	-4.1	-3.1	-2.4	-1.9	-1.6	4.7
14	Greece	-10.6	-9.0	-6.3	-6.7	-6.3	-5.7	4.9
15	Slovakia	-7.7	-5.4	-4.1	-3.3	-2.9	-2.6	5.1
16	Spain	-9.3	-7.0	-5.3	-4.1	-3.8	-3.4	5.9
17	Portugal	-9.8	-6.9	-5.5	-4.3	-4.0	-3.3	6.5
18	Ireland	-32.0	-9.2	-7.7	-5.6	-3.4	-2.0	30.0



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