Eurozone

Ernst & Young Eurozone Forecast

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Another difficult year draws to a close. A year of economic contraction, rising unemployment, government austerity and chronic business uncertainty. Predictions of disaster may have proved false, but it seems certain that few in the Eurozone will mourn the passing of 2012.

Today, a new realism is spreading throughout the Eurozone. Confirmation that the 17-country bloc fell back into recession in the third quarter has ended any illusion that the crisis was waning, or confined to peripheral southern states. The going is tough — for many businesses, in many places — and getting tougher overall. Our recent *Growing Beyond* study found over 90% of the highest performing companies expect the market to be more challenging in the next two years than the last.

The recent EU summit in Brussels laid bare many of the problems affecting the region. Against the backdrop of a contracting Eurozone economy, country leaders sought to balance their competing domestic agendas with securing Europe's spending priorities for the period between 2014 and 2020. Finding a way to reduce costs and increase investment to catalyze growth proved, for now at least, beyond them — although in focusing on how to make Europe more supportive of entrepreneurs and business, they are looking in the right direction.

But, of course, it's not only about events within Europe's borders. In our interconnected world, the Eurozone is competing against a US economy that faces its own "fiscal cliff" and against rapid-growth economies that continue to grow. And nor is the competition confined to the BRICs — countries such as Vietnam, Turkey and Indonesia have been singled out by the *Ernst & Young Rapid-Growth Markets Forecast* as ones to watch over the next decade. The next 10 years in Europe, by contrast, are likely to be far bleaker. Rather than preparing for a quick return to a "normal" situation with continuous growth, five years into the crisis, companies should prepare for a "lost decade," one marked by continued struggles over growth and lingering high levels of unemployment.

We continue to expect that, after contracting by about 0.5% in 2012, the Eurozone economy will stagnate in 2013 before growing by just 1.3% a year in 2014–16 and at similar ratesby about 1.6% a year in the remainder of the decade — well below rates in the pre-crisis period. In this environment, unemployment will continue to rise throughout 2013, peaking at close to 20 million. It could, however, have been worse and some real progress has been made. The risk of a Greek exit has diminished, and actions taken by the European Central Bank have reduced the risk of a Eurozone breakup. There have also been significant advances made by peripheral economies. Ireland and Spain, for example, have achieved large increases in productivity, which have helped reverse negative competitiveness trends. But these results aside, peripheral economies continue to be challenged. The adjustment in competiveness, itself far from complete, will in the short term lead to a further squeeze on household incomes, which will, in turn, deepen the domestic recessions and increase political tension in those countries.

The solutions to these systemic challenges partly lie with the Growth Pact, which was approved at September's European Council meeting. But while the supply-side reforms agreed are likely to lead to some long-term benefits, the Pact is unlikely to shift the immediate dynamics of the Eurozone. Re-establishing a political consensus on Europe may require a new form of engagement with its members and their citizens.

While policy-makers continue to work to deliver sustainable solutions, business leaders — some sitting on record piles of cash — also need to step up. They need to ask themselves the right questions. Do I fully understand the implications for my market of further instability among clients, suppliers and the financial sector? Can my organization respond quickly to possible changes in tax policy and regulations? Is now the time to invest to shape the new market opportunity?

What Europe requires now is confidence. Confidence that there is enough shared will across Europe to imagine a new economic framework and sufficient political courage and skill to create it. The biggest boost to growth in the short term would be to remove uncertainty about the future of the euro — this would help persuade companies to dip into their reserves and unlock investment. But looking further ahead, the answers we need won't be found by operating within our national borders, but instead by sharing our experiences, sharing Europe's abundant resources and strengths, and by sharing opportunities for growth.

In a world both competitive and shrinking, it is all too easy for people and organizations to turn inward. Working together represents the best opportunity to secure the growth and prosperity so urgently required — in both 2013 and beyond.

Contents

Realism and recovery

As companies weigh their achievements in 2012 and their prospects for 2013 and beyond, they need to reflect upon the broad economic outlook. They need now to plan for a European "lost decade," like that experienced in Japan from 1991 after the bursting of its asset price bubble.

The current recession is likely to prove relatively shallow for the Eurozone as a whole, we believe. Our economic forecast remains broadly unchanged from September, reflecting our continuing expectation that after contracting by 0.4% this year, the Eurozone economy will mark time in 2013, and show only anemic growth thereafter through 2016. And there's the nub of the challenge for business: recovery will prove long and laborious, and growth patterns will be very different from those that preceded the 2008 financial crisis.

The first Eurozone-wide protests against austerity, which swept through Europe on 14 November, reflect an awareness that economists now share: austerity measures to contain burgeoning national deficits are undermining economic recovery. Cuts in government spending are compounding weakness of consumer demand, creating a negative economic feedback loop. Shrinking sales and margins are the top concerns of businesses arising from the Eurozone crisis — especially in peripheral countries.

Weak demand is overshadowed by wrangles over EU policy and uncertainties over the future shape of the Eurozone — including the survival of the currency. These are real, but should be kept in perspective. Since Mario Draghi, President of the European Central Bank, promised in July to do whatever it takes to ensure the survival of the euro, equity markets have stabilized, peripheral bond yields have fallen, and markets seem more convinced that the Eurozone will survive.

The blueprint for a deep and genuine economic and monetary union — unveiled by José Manuel Barroso, the President of the European Commission, on 28 November — sets out a medium-term plan to underpin the currency. It aims to centralize more budgetary powers within the Eurozone, widen reforms and move toward a banking union, though it lacks details of a deposit guarantee scheme, which we deem essential.

In many ways, the future of the Eurozone looks more secure than it did at the beginning of the year. On balance, we think the likelihood of a Greek exit from the single currency area has markedly diminished, though much remains to be done.

Yes, the contraction of the Greek economy suggests its budget deficit is likely to require government "haircuts" on loans agreed under the earlier €174 billion bailout, and signing off a deal on that will not be easy.

Yes, EU states will wrangle over the 4.8% budget increase sought by the European Commission for 2014. But an inflation-plus version of the 2013 budget would automatically be imposed and cap spending, if Herman van Rompuy, the European Council President, fails to secure the €973 billion he seeks.

And yes, Catalans may yet win a referendum on independence, and Spain may sooner or later be obliged to seek an official bailout from the European Union.

Many profound changes could reformat the Eurozone as it strives to regain economic momentum and craft new policies to underpin recovery. The absence of a clear and shared vision of the zone's future among leaders of the currency bloc is perhaps the biggest uncertainty of all.

Wise corporate leaders will draw up contingency plans for possible outcomes to these multiple risks, which could be disruptive to varying degrees. Business continuity planning requires no less. But then businesses need to get on with developing strategies appropriate to the new era. Every region of the world has its uncertainties — those in Europe, though region-specific, have merely risen toward levels common place elsewhere.

So today, directors and executives of enterprises in Europe need to focus on business, not politics. There are glimmers that some are doing so. The Markit purchasing managers' index for the Eurozone rose slightly in November, though it is still below the 50 level that would signal recovery. Economic contraction remains the order of the day. But vanguard businesses need to be thinking beyond recession, to how best they should prepare recovery.

A future unlike the past

The overriding message of the Winter 2012 Ernst & Young *Eurozone Forecast* is that the Eurozone economy is not going to bounce back to resemble that of the carefree years before the financial crisis. Rather, profound and long-term shifts are under way across the region. At best, the zone is likely to average growth of around 1.3% in the next few years, significantly below pre-crisis trends.

The implications for business are serious, and need to be recognized now. Recovery is likely to take longer than it has from past recessions. Both business and consumer confidence have been falling, according to surveys by the European Commission. Companies are in "wait-and-see" mode, holding off on investment, recruitment, and mergers and acquisitions.

The ability of governments to stimulate demand is largely exhausted: many are striving to contain or reduce their spending and borrowing.

The €120 billion European Growth Pact, unveiled by EU leaders in June, envisaged three key measures to promote public investment. Of the money, €55 billion is unused aid for EU regions that will be put to work. The capital of the European Investment Bank is to be increased by €10 billion, so that it can lend an extra €60 billion to underpin a total additional €180 billion of infrastructure investment. And a €4.5 billion top-up should come from the issue of project bonds backed by the EU. But such measures take time to implement, and often prove complex for companies involved. If and when it materializes, additional infrastructure spending will be welcome, but will provide only modest relief to belt-tightening in public sector markets.

Consumer spending, meanwhile, remains firmly under pressure, limiting demand for goods and services from companies. We estimate that Eurozone consumption will fall by 1% this year, and forecast a further decline in 2013, under pressure from rising unemployment. This we expect to peak at almost 20 million people, or 12.5% of the workforce, in the first quarter of 2014.

At a time when it is extremely difficult to pass on cost increases to customers — whether governments, consumers or businesses — companies operating within the Eurozone will also find their margins coming under pressure from suppliers. As costs rise in emerging markets, the price of many components, goods or services sourced by Eurozone companies from these low-cost markets will burgeon too. Meanwhile, capital and credit will remain less plentiful than before the financial crisis. Thriving in the "lost decade" will require careful forethought and preparation.

Grasping export opportunities

Against this difficult backdrop, exports and business investment will be more important drivers of future growth.

Our forecast is that Eurozone goods exports will rise by 3.2% this year and by 5.3% in 2013, accelerating to a growth rate of 6%–7% a year in 2014–16. This expansion will be underpinned by a weaker euro and by faster growth outside the Eurozone, notably in the US and in emerging markets.

The re-election of President Barack Obama in the United States has lifted one source of uncertainty, and shifted attention to the next and most critical US challenge: dealing with the so-called "fiscal cliff" that hangs over the US economy. If that can be successfully addressed, the US, where economic growth was 2.7% year-on-year in the third quarter, is potentially an increasing source of demand for Eurozone companies.

So is China, where two key uncertainties have been removed. The once-in-a-decade transition of power to a new leadership under Xi Jinping has gone smoothly. President Xi inherits an economy where growth already appears to be accelerating once more. Chinese industrial production, investment and retail sales all picked up in October, putting the world's second-largest economy on track for a strong finish to 2012, with annual growth in GDP approaching 8%. Retail sales in China were up 14.5% year-on-year in October, reflecting surging consumer demand.

Many of the Eurozone's traditional exporters — in sectors ranging from machinery, aircraft, and oil and gas equipment to luxury goods — are already benefiting from strong demand in overseas markets. But as emerging markets develop, Eurozone companies catering to consumers will see increased export opportunities.

We foresee a €1 trillion increase in Eurozone export of goods and services from €4.3 trillion in 2012 to almost €5.4 trillion in 2016. By 2030, the share of Eurozone exports going to these markets could exceed intra-Eurozone trade.

Germany's export strength, founded on manufacturing, has long been admired by its Eurozone partners. Now many are seeking to emulate its success and some are making progress in doing so. Ireland, Spain and Portugal are already increasing their market share in exports, as structural reforms, falling wages and rising productivity help to make them more competitive in overseas markets, and to renew their appeal for investors.

Waiting for investment to spur recovery

Business investment hinges upon both demand and confidence. Success in export markets could become one driver for investment. Yet our forecast predicts that fixed investment will fall 1.4% next year, following a 3.5% drop in 2012. We think an uptick will come in 2014 with growth of a little over 2%. This should help create a virtuous upward economic spiral underpinned by greater business-to-business demand within the Eurozone. This should be reinforced by investment in research and development and in intangible assets, including intellectual property and human capital, via training that enhances productivity.

Companies that can access affordable capital today can invest in efficiency, capacity or growth by acquisition. Market consolidation through mergers and acquisition activity may be timely for some.

Inward investment continues to flow. The number of foreign direct investment (FDI) projects in Europe as a whole reached 1,586 in the first half of 2012, up 6.3% year-on-year, according to Ernst & Young's latest *European attractiveness survey*.[1] Though the UK remained Europe's leading FDI destination, within the Eurozone France was in the lead, and Spain leapfrogged Germany, pulling big investments in automotive and chemicals.

Europe-wide investment inflows increased into business services; automotive components and assembly; machinery and equipment; transport services; and chemicals, plastics and rubber. They remained significant, though lower, in software; finance; electronics; and food, the study found. US companies provided 32.5% of inflows, with German corporates the second-biggest group of investors into Europe.

Funding growth

Many companies are fretting about what might go wrong in the Eurozone. That is holding back investment. In addition to pressure on sales and margins, they worry about counterparty default risk; credit availability; supply chain risk; increased regulation; the price of M&A assets; treasury management and banking; and taxation.

Back in April, Ernst & Young's *Capital Confidence Barometer* found just over half of the panel of global companies surveyed were focused on growth. The October 2012–April 2013 survey showed only 41% of companies worldwide looking to grow.

In Germany, the proportion of companies focused on growth trails at just 26%, though the proportion of growth-seeking French companies, at 40%, is in line with the global average, according to the Ernst & Young survey.[2]

Yet companies in the Eurozone's two biggest economies are relatively well-placed to fund investment. The same study found that 42% of French companies and 38% of German companies planned to fund their next acquisition with cash, compared with a global average of 42%.

1 *Opportunities in a downturn FDI in Europe: 2012 performance and prospects 2013*, Ernst & Young, 2012.
2 *Ernst & Young Capital Confidence Barometer*: October 2012–April 2013, Ernst & Young, 2012.

Realism and recovery

Many multinationals, in the Eurozone as elsewhere, are sitting on cash mountains and can easily fund investment in organic growth, acquisitions or restructuring.

But the proportion of French and German companies planning to use debt for their next big deal, at 31% and 33% respectively, is substantially below the global average of 38%, and their inclination to fund a deal with equity markedly higher.

In general, credit conditions remain tight within the Eurozone. Availability of capital is also being constrained by the radical reshaping of banking and elements of European financial services. Under pressure to shrink their balance sheets, some banks have been shedding assets both within and outside the Eurozone to refocus on their core markets. Some global banks are also paring back their investment banking activities, or ring-fencing them under pressure from regulators.

Rates charged to companies are often substantially above those at which banks borrow. Small and medium-sized enterprises are most vulnerable to the squeeze on bank lending.

Anecdotal evidence suggests some international companies have been able to refinance country operations in southern Europe with local borrowing guaranteed by the parent group, enabling them to hedge against the risk that a particular country leaves the Eurozone.

Larger companies with strong cash flows are able to access bank lending. They also have more financing options. Some have been taking advantage of low rates and investor appetite to refinance by issuing bonds on capital markets, shifting to a pattern of financing more typical in the US. Others continue to look to equity markets to help them expand — when they are ready to do so.

Adapting to a multispeed Eurozone economy

Already, Eurozone economies are proceeding at varying speeds. Overall, Eurozone GDP fell by 0.1% in the quarter to the end of September, after a 0.2% fall in the quarter to the end of June. Seasonally adjusted, the fall was 0.6% year-on-year.

The Greek economy remains in freefall, shrinking about 7% year-on-year. The pace of contraction in Italy and Spain slowed, though they were still down 2.4% and 1.6% respectively.

More striking was the slowdown in northern economies, which have hitherto proved relatively robust. The German economy, the motor of the Eurozone, grew by just 0.2% in the third quarter, though still showed expansion of 0.9% year-on-year. The French economy escaped recession, but was up only 0.1% at an annual rate. The Dutch economy contracted sharply, though, and even Austria's also fell. But the Baltic economies continued to post significant growth.

Structural reforms are beginning to deliver competitiveness benefits in peripheral countries. We foresee a modest return to growth in Ireland next year, with Italy, Spain and Portugal following in 2014 and Greece in 2015.

Business can no longer treat the Eurozone as a bloc: each market needs to be weighed on its merits, both geographically and in terms of customers.

Understanding changing markets

Rising unemployment contributes to the emergence of a multispeed society, and the differences are becoming starker. According to Eurostat, almost 18.5 million people are without work in the Eurozone, a jobless rate of 11.6%. Worst hit is Spain, where 25.8% of workers are jobless, followed by Greece. But in Austria, the jobless rate has fallen to 4.4%.

Young people are hit especially hard. Across the Eurozone as a whole, just over 23% of under-25s are without work, but the rate tops 54% in Spain and exceeds 35% in Italy and Portugal. Overall, perhaps two-thirds of Eurozone consumers do their shopping on a tight budget.

The spread of smartphones, tablets and online retailing has also helped make price more central to purchasing decisions. Technology facilitates price and product comparisons, intensifying competition in many sectors.

Retailers and consumer-focused companies are being obliged to tailor their product or service offering to increasingly diverse market niches and changing consumer behaviors.

Product cycles are not only changing, but may vary from country to country. Rapid change driven by technological evolution is now the norm in almost every sector. Hardware and content vie for supremacy in electronics and entertainment. Energy and telecoms utilities battle in liberalized markets. Pharmaceutical companies strive to absorb advances in biotechnology, and adapt to competition from generic drugs encouraged by states seeking to contain health care budgets.

Despite the challenges that businesses are facing, Ernst & Young's annual global survey of 1,500 business leaders for our report *Growing Beyond: how high performers are accelerating ahead* (www.ey.com/growingbeyond) suggests that there has been a change of attitude and strategies from a reactive to a proactive approach, since the start of the crisis. The respondents have a very realistic view of what key features characterize the new economy: market variation, increased volatility, growing cost pressure and deep uncertainty. Five years after the start of the global downturn, many companies continue to struggle — certainly more than we would have expected at this stage in previous recessions. But a growing number are demonstrating that they have learnt to master the new economy and have changed their strategy from securing the survival of the existing business to taking advantage of the situation to pursue new market opportunities.

Preparing the launchpad

Amid these shifting sands, corporate leaders must simultaneously analyze how to protect their business and how to improve it. They need to take a fresh look at what they do, where, and how. Restructuring may mean downsizing, but it can also mean investing in business efficiency, and gaining a first-mover advantage by doing so.

Corporate restructuring activity is already substantial within the Eurozone. In the first six months of 2012, there were 677 restructuring cases within the Eurozone, according to Ernst & Young's latest *European attractiveness survey*, *Opportunities in a downturn.* Of these, 263 cases created jobs and 406 cost jobs, leading to a net loss of 48,474 jobs within the Eurozone.

The report identified manufacturing as the hardest-hit sector, which has shed 31,917 jobs as companies sought to become more cost-competitive. Transport, storage and communications and financial intermediation also suffered.

Changes in business models can have a big impact and are evolving fast in many sectors. In air travel, for example, former national champions unleash successive rounds of cost-cutting, reshaping repeatedly in an effort to stem the advance of low-cost carriers. Technological change underlines efforts by bricks and mortar retailers to integrate online shopping with their store networks.

Business leaders must review their operations and identify all their opportunities — including those within their business, as well as those outside.

Planning for agility in response to the unpredictable

Business leaders need to plan for a future that is unlike the past. But they also need to ensure companies have flexibility to meet the requirements of a future that may differ from expectations. In the past couple of years, unexpected events, from the Arab Spring to Hurricane Sandy, have demonstrated their capacity both to surprise and to deliver wide-ranging impacts.

In our interconnected world, faraway events can have unexpected effects, especially in markets for specialized components and materials. In October 2011, floods in Thailand disrupted the personal computer industry, when factories with a large share of world hard disk supply were inundated.

Global supply chains are especially vulnerable to disruption of this kind. Japan's earthquake and tsunami in the same year hit international supplies of motor components and even pharmaceutical ingredients. Relatively minor events can also have sizeable knock-on effects for companies: in April this year a fire at a European factory triggered widespread concerns over supplies of specialist nylon.

The nature of risk is changing. Instant mass communication can now disrupt markets, whether for Japanese cars in China, or foods manufactured by European companies in the Middle East.

While companies worry about obvious risks to the Eurozone and its currency, what are they missing?

Weighing wider options

Today, even small and medium-sized businesses have global options. The attractions of investing within Eurozone markets have to be weighed alongside alternative or complementary opportunities elsewhere. Some branded goods companies seek to be present everywhere. Resource constraints or strategic objectives oblige others to be more selective.

Even as the Eurozone flags, rapid-growth markets (RGMs) are accelerating. The Autumn 2012 edition of the *Ernst & Young Rapid-Growth Markets Forecast* predicts growth of 4.6% for 2012 across its selection of 25 countries, picking up to 5.6% next year and 6.5% in 2014. Those are mouth-watering figures compared with our expectations for the Eurozone. As many investors have learned, however, rapid growth does not guarantee rapid returns. And where high returns are possible, they may be synonymous with high risks. RGMs, like markets in the Eurozone, need to be evaluated individually, and the scale of opportunity they offer will vary substantially from one sector to another.

The Eurozone is characterized by feeble growth prospects, an ageing population and unprecedented uncertainty over its currency and policy outlook. But it nonetheless offers a massive market, excellent infrastructure, sophisticated institutions and a highly skilled workforce. RGMs offer a very different mix of risks and rewards.

Getting into shape for the new era

As companies limber up for a new era, what action should executives take — and why?

Now is undoubtedly the moment for company directors to face up to the new realities. They must reassess the uncertainties, both economic and political, and anticipate the possible consequences.

Being prepared is vital, and gives a head start if scenarios that seem improbable should nonetheless arise. For example, contingency measures in case a country leaves the euro should include refinancing locally, where appropriate, thereby reducing exposure to that uncertainty.

Prudent planning should include stress testing against events ranging from a credit freeze to the inability of a key supplier to deliver. And backup plans must be monitored and kept up-to-date.

Businesses need to define a clear agenda and begin implementing it. If there are opportunities to invest, restructure and seek economies of scale, including through consolidation, acting early offers competitive advantage.

Companies have no time to spare. A "lost decade" has begun in the Eurozone. Now is the time to get in shape for a decade that will be unlike any previously seen.

Seeking opportunities in rapid-growth markets

For companies seeking to widen their investment options, five rapid-growth markets stand out. In addition to China and India, whose merits are widely appreciated, Indonesia, Turkey and Vietnam are particularly attractive, according to the Autumn edition of the *Ernst & Young Rapid-Growth Markets Forecast* (RGMF).

Like China and India, these three rising stars are expected to grow by at least 5% a year over the next 25 years. They also have large domestic markets, favorable demographic trends and rising household consumption.

Indonesia is kindling interest, as economic transformation gathers pace. It has a population of 237 million and rapidly improving education levels, with 80% of children now receiving secondary schooling. By 2020, the country is expected to have more households earning over US$30,000 than China does today.

GDP growth of 6% is expected this year, delivering nominal GDP of US$884 billion, or US$3,720 per person. The authorities are targeting average annual growth of 7% by 2014, underpinned by gradual implementation of reforms to ease the cost of doing business, though the pace of reform is variable. Infrastructure is a big challenge in an archipelago of five major islands and more than 17,000 smaller ones, but the World Bank says it is improving.

With government debt of only 25% of GDP in 2011, and high levels of investment, the RGMF predicts that in 25 years' time Indonesia will have the world's ninth-largest economy and five workers for every person over 65 — an exceptionally favorable ratio.

Turkey is another country with exceptionally bright prospects, according to our forecast. GDP growth is expected to be relatively subdued this year at 2.7%, as the authorities try to curb inflation. But a rate of 5% a year is predicted over the coming quarter century.

Turkey's 74.6 million population is less than a third that of Indonesia, but GDP per head is expected to reach US$10,706 in 2012. In 10 years' time, more than 11 million households are expected to have income exceeding US$30,000 a year, matching the number in Canada today.

Turkey's population is also relatively young, yet nearly half of school-leavers now go on to education beyond the age of 18, up from just 12% in 1990. A strong domestic market combines with an exceptional geographical location. Today, almost half of Turkey's exports go to Europe, but the proportion going to the Middle East, North Africa and Asia is rising. Turkey is developing stronger economic links with the Middle East, where it plays a wider role.

Vietnam's population, at 89.7 million, exceeds Turkey's and its forecast growth rate for the next quarter century, at nearly 6%, is a shade faster. The proportion of children educated to secondary level is now almost 80%, but Vietnam is a very different investment proposition.

Vietnam's GDP in 2012 is expected to be US$139.5 billion, giving GDP per head of US$1,555. Today, the scale of the domestic market is relatively modest compared with India and Turkey, although GDP per capita is expected to grow sixfold over the coming 25 years.

However, manufacturing wages are estimated at only half those of China and Thailand, making it an attractive location for labor-intensive manufacturing. Vietnam has attracted more than US$6.5 billion of FDI in each of the past five years. The country is a big exporter of clothing and footwear, and its electronics sector is developing fast. The transition to a market economy has some way to go, although inflation has slowed and the currency has stabilized after stresses in 2010.

These markets offer very different growth prospects to those of the Eurozone. But, as the RGMF also shows, each has its own challenges.

Are you prepared for a lower-growth environment?

Contingency planning is the key when preparing for sudden or expected changes. To be ready, you should try to identify and understand the issues that might affect your business. What are the possible scenarios and what would be the main consequences that might affect your market or operations? The next step is to analyze exposures to a "shock event" that may occur under the various scenarios. Map out the critical effects of:

- Currency redenomination
- Instability among suppliers, clients, banks, commodity markets, etc.
- Market, credit, currency, cash and earning risks
- Legal, regulatory and reporting changes
- Tax policy and regulation changes

Questions to ask yourself

Is my portfolio optimized?
Analyze across Europe, segments and business sectors. Have you considered the opportunities to acquire and divest?

Has your company worked through the economic implications?
Ask yourself if your business model will work in a lower-growth environment and if you understand the potential impact, looking, for example, at market segments. How will your product portfolio, supply chain and cost-reduction plans be challenged? Also, should you assess the scope for re-shoring?

Are you comfortable with your approach to forecasting, decision-making and valuation?
It is important to understand that drivers of value are changing, including growth, multiples and risk-free rates. Are your assumptions appropriate and reflective of likely future developments? Are you using the appropriate decision criteria?

Have you reviewed your financing?
Review your scope to refinance now, so that you can avoid any future squeeze. Match assets and liabilities across geographies, financing locally to reduce exposures. Also consider the role of inward investments.

Are you comfortable with your tax strategy?
You may need to look into your transfer pricing arrangements, given the changes in financial markets. You should also review the implications of greater tax harmonization.

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Highlights

Progress toward a more secure Eurozone

- In recent months there has been significant progress toward a more secure Eurozone. At the end of November, the European Commission (EC) set out a clear blueprint of future measures that will go a long way toward restoring confidence in the Eurozone's longer-term prospects if they are fully implemented. Policies adopted by the European Central Bank (ECB) have greatly diminished the short-term risk of a breakup. Meanwhile, progress has been made toward a banking union and the policy mix is shifting from a focus on austerity toward measures designed to foster growth. The risk of a Greek exit has also receded, especially following the deal at the end of November that will see the release of the next tranche of bailout funding. Overall, at the close of 2012, the near-term future of the Eurozone seems safer than when the year started.

- However, a lot remains to be done to ensure that the Eurozone can stay in its current shape and start growing again. The framework for a banking union is incomplete, as is the framework for closer fiscal union. Some form of eurobond seems a distant prospect and we have yet to see how the Growth Pact will be implemented. As a result, business confidence remains low. Moreover, the necessary restructuring of the Eurozone economy will continue to dampen growth for some time.

- Our forecast remains broadly unchanged from September 2012. We expect that, after contracting by 0.4% in 2012, the Eurozone economy will stagnate in 2013 before growing by just 1.3% a year in 2014–16 and by about 1.6% a year for the remainder of the decade. In this environment, unemployment will continue to rise throughout 2013, peaking at close to 20 million in Q1 2014.

- Businesses thus need to plan for a European "lost decade." This will be a tough operating environment for both business and political leaders. Companies cannot assume that growth will be driven by their domestic markets. Growth will also have to come from cost cutting, winning market share and exporting to more rapidly growing economies.

- In general, we expect that the Eurozone peripheral economies will continue to undershoot official forecasts, leading to further overshoots in fiscal deficits and public debts in coming years. This will, in turn, lead to a prolonged period of fiscal restraint.

- There has been significant progress in the restructuring of peripheral economies. In particular, countries like Ireland and Spain have achieved large increases in productivity. This has helped to reverse negative competitiveness trends and has been reflected in strong export growth. However, the adjustment in competitiveness is far from complete. Moreover, in the short term, these changes lead to a significant squeeze on household incomes, which in turn will deepen and prolong the domestic recessions in these countries.

- We assume that the revival of the Growth Pact at the September EU Council meeting will have a positive impact, as it contains supply-side reforms that could yield large longer-term benefits. The pact is also a welcome broadening of policy beyond austerity. The idea that deficit-cutting can boost growth has been largely contradicted by evidence so far, which has seen a fiscal multiplier of greater than one.[3] Even institutions that previously focused on fiscal corrections, such as the IMF, are now recommending a more balanced approach that, while abiding by the general direction of reducing public deficits, allows it to proceed at a slower pace and stresses the need for broader economic reforms.

- But amid continuing uncertainty over the EU budget for the coming years, the measures contained in the pact are unlikely to alter prospects for demand and growth in the short term. The biggest short-term boost to growth would come from removing uncertainty about the survival of the euro. This would have the potential to unlock investment and recruitment plans that are currently on hold, as companies wait and see what happens to the Eurozone.

3 The fiscal multiplier is the ratio of change in GDP to the change in government spending that causes it.

Progress toward a more secure Eurozone

The Eurozone's future looks more secure now than it did at the beginning of 2012. ECB policy has greatly diminished the risk of a Eurozone breakup in the short term, and the EC blueprint of future measures announced at the end of November will help to bolster confidence in longer-term prospects. Meanwhile, progress has also been made toward a banking union and there are encouraging signs that the policy mix is shifting from a sole focus on austerity toward measures designed to foster growth.

In addition to lending to banks for up to three years, the ECB stands ready to cap the yields on Eurozone peripheral debt. Since Mario Draghi, the ECB president, made it clear in a speech in London in July that the ECB was committed to doing whatever it takes to ensure the survival of the euro, equity markets have rallied, market volatility has fallen, the euro has strengthened, peripheral bond yields have dropped and the yield on German bunds, often seen as a safe haven, has risen. In short, markets now seem much more convinced than they did in the early summer that the Eurozone will survive.

But despite these developments, our growth forecast for the Eurozone remains broadly unchanged from our September report. High frequency indicators, such as business surveys, suggest that the Eurozone will contract again in both Q4 2012 and Q1 2013. After that, we expect growth to return, albeit only gradually, during the remainder of 2013, as further policy action helps confidence to improve slowly and risk premiums to fall.

Figure 1

10-year bond yields

Source: Haver Analytics

As a result, the Eurozone economy is now seen contracting by 0.4% in 2012 overall, and then broadly stagnating in 2013, before growing by just 1.3% a year in 2014–16. The protracted process of deleveraging the banking system, and in some countries both households and the public sector, will weigh on growth for many years to come.

Table 1

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

Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	1.5	-0.4	-0.2	1.0	1.4	1.5
Private consumption	0.1	-1.0	-0.3	0.7	1.1	1.3
Fixed investment	1.6	-3.5	-1.4	2.2	2.9	2.8
Stockbuilding (% of GDP)	0.5	-0.1	-0.2	-0.2	-0.2	-0.2
Government consumption	-0.1	-0.1	-0.9	-0.3	0.4	0.6
Exports of goods and services	6.4	3.0	2.7	4.0	4.4	4.1
Imports of goods and services	4.2	-0.3	1.6	3.7	4.5	4.2
Consumer prices	2.7	2.5	1.9	1.5	1.3	1.3
Unemployment rate (level)	10.2	11.4	12.3	12.3	12.0	11.7
Current account balance (% of GDP)	0.0	0.9	1.2	1.1	1.0	1.0
Government budget (% of GDP)	-4.1	-3.3	-2.6	-2.1	-1.7	-1.3
Government debt (% of GDP)	88.1	92.9	95.3	96.5	97.2	97.4
ECB main refinancing rate (%)	1.2	0.9	0.8	0.8	0.8	0.8
Euro effective exchange rate (1995 = 100)*	120.8	115.4	115.3	112.9	110.2	110.3
Exchange rate ($ per €)	1.39	1.28	1.27	1.21	1.17	1.17

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

Growth performance within the Eurozone is set to remain divided, with the core countries expected to continue to outperform the troubled peripherals, with the latter struggling to grow over the next few years. Germany will remain the main driver for the core countries; it is forecast to grow by about 1% in both 2012 and 2013, before picking up to some 1.7% a year in 2014–16.

The risk of a Greek exit has receded ...

The market rally makes sense, given the ECB's firm commitment to ensuring the survival of the euro. Indeed, the near-term risk of Greece exiting the Eurozone has fallen. This reflects both ECB policy action and a shift in attitude among Eurozone creditor nations (particularly Germany), which have decided that the likely economic and electoral costs of a Greek exit exceed the likely cost of allowing it sufficient access to finance to struggle on inside the Eurozone. In late November, the European Union (EU) and the International Monetary Fund (IMF) reached an urgently needed deal on the Greek bailout terms. As a result, official creditors agreed to cut Greece's debt by €40 billion and have paved the way for the release of the next tranche of bailout loans, totaling €44 billion. Consequently, we have cut our estimate of the probability of Greece leaving the Eurozone in the next six months to 5% from some 10%–15% in June.

... although Greece's medium-term prospects have not improved

However, the fact that a near-term Greek exit from the Eurozone is less likely does not reflect greater optimism over Greece's medium-term economic and fiscal prospects. Indeed, the outlook for Greece has deteriorated since our Autumn 2012 forecast and we now predict even steeper falls in Greek GDP. This is because exports have come in below expectations and unemployment has surprised on the upside.

Despite the deal at the end of November, the terms of Greece's second rescue package from the IMF and the EU are still unlikely to be achieved. This program, agreed in early 2012, projected that Greece's government debt-to-GDP ratio would peak at 167% in 2013 and fall to 145% in 2016, the supposed end of the program. But due to the recession being deeper than expected, we now forecast that the debt-to-GDP ratio will be as high as 185% of GDP in 2016. Consequently, it seems likely that, if Greece is to remain in the Eurozone, its creditors may have to ease the terms of its loans yet again in the coming years.

Momentum of policy progress must be maintained

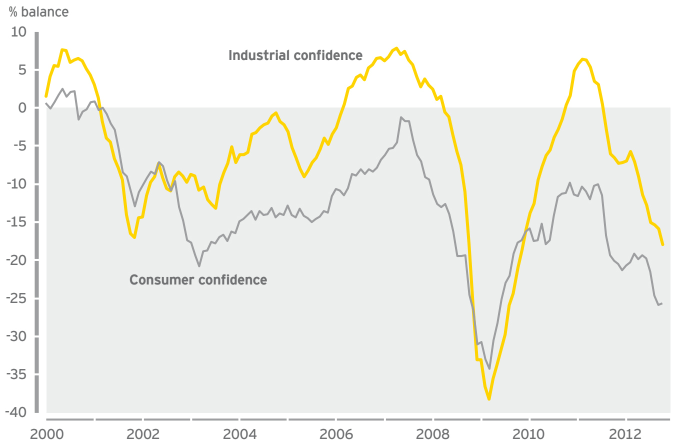
A lot remains to be done to ensure that the Eurozone can stay in its current shape and start growing again. The framework for a banking union discussed earlier in the year remains incomplete and we have yet to see how the Growth Pact will be implemented. Consequently, it is very encouraging that the EC has set out a clear blueprint of future measures that will go a long way toward restoring confidence in the Eurozone's longer-term prospects if fully implemented.

The growth package is expected to comprise several measures to boost spending on infrastructure and other investments, backed by European taxpayer money. These measures include: increasing the capital of the European Investment Bank by €10 billion, which would enable the EU government-backed institution to increase its lending capacity by several times that amount; fully deploying unused money in the European Commission's regional funds; creating pan-European "project bonds" — common debts used to finance specific investment projects, such as the construction of pan-European transport networks.

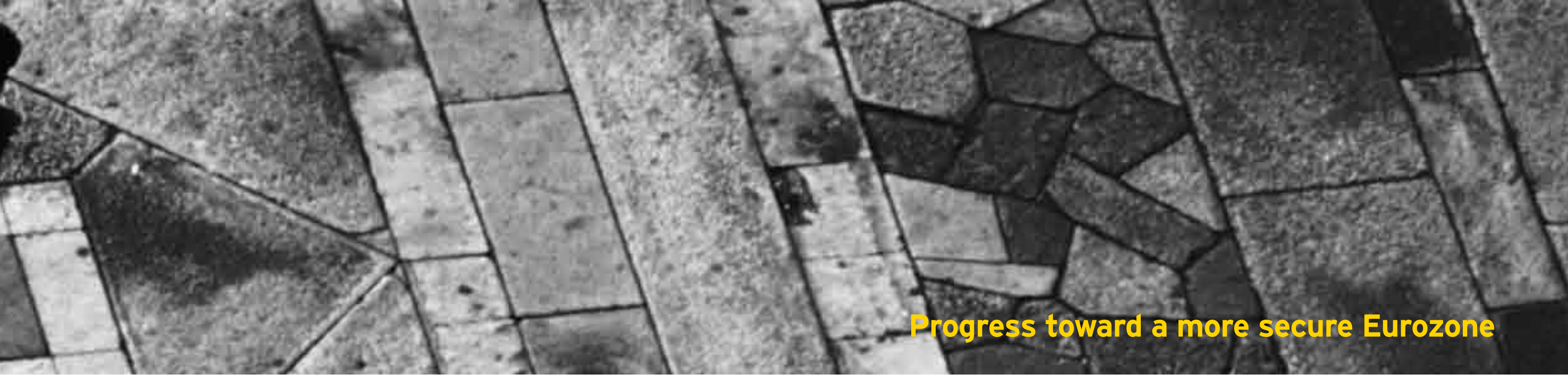
At the country level, fiscal consolidation should be pursued in a growth-friendly way that takes into account country-specific circumstances. Further steps need to be taken to promote growth and competitiveness by addressing deep-rooted imbalances. Structural reforms are needed to unlock domestic growth potential. These should include: opening up to competition in utility networks, promoting the digital economy, exploiting the potential of green industries, removing unnecessary restrictions on service providers and making it easier to start a business. All these steps would help to boost the potential growth rates of European countries.

Figure 2

Industrial and consumer confidence



Source: Haver Analytics



Steps also need to be taken to tackle high unemployment, a major social consequence of the current crisis. Reforms need to be pursued to improve employment levels, in particular to reduce youth unemployment by providing quality traineeships and apprenticeships, as well as improving the mobility of young people. In addition, public administration needs to be modernized, in particular by reducing delays in the judicial system, easing administrative burdens and developing e-government services.

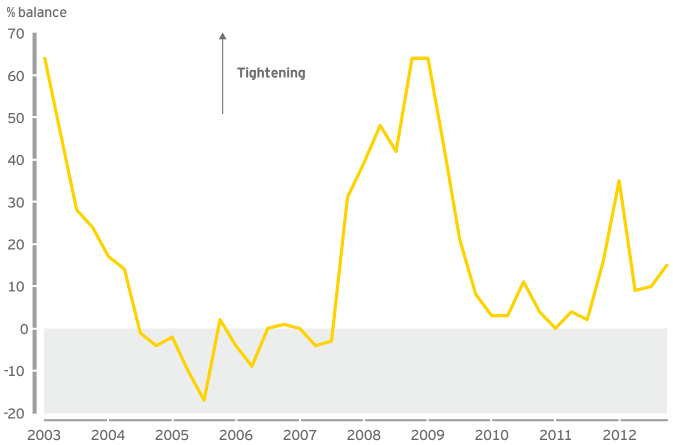
Because a policy framework to ensure the Eurozone's survival remains a work in progress, business and consumer confidence have not improved in the way that financial markets did in the initial weeks following Mario Draghi's speech in July. Over the last three months, both the European Commission's survey measure of industrial confidence and its measure of consumer confidence have fallen further. Despite the efforts of policy-makers to bring the Eurozone crisis to an end, both measures of confidence have fallen fairly consistently for the past 12–18 months. Until confidence improves, companies will remain in "wait-and-see" mode and hold back on capital spending, recruitment and M&A activity. As a result, our Eurozone forecast includes a decline of 1.4% in fixed investment in 2013 following an expected 3.5% drop in 2012. As further policy steps are taken during 2013 to ensure the Eurozone's survival, business confidence should gradually improve and we expect investment growth of just over 2% in 2014.

Credit conditions continue to tighten

Another reason we expect business investment to fall further is that credit conditions are likely to remain tight for the foreseeable future. The ECB's latest bank lending survey showed a further net tightening of credit standards on corporate loans in Q3 2012. The overall tightening of credit standards appears to have been applied more to small and medium-sized enterprises (SMEs) than to large firms. This is worrying because SMEs have less access to alternative sources of non-bank finance, such as bond markets, than large companies. Consequently, they tend to be hit particularly hard when banks tighten credit conditions.

Figure 3

Credit conditions for enterprises



Source: Haver Analytics

The further tightening in credit standards was driven by an increasing concern about the general economic outlook among loan officers. This was sufficient to offset improvements in banks' capital bases, liquidity positions and access to market financing. As we do not expect the Eurozone economy to start growing again until Q2 2013, an easing of credit conditions seems unlikely in the near term.

Progress on recapitalizing the banking system, and the successful steps taken by the ECB to provide banks with liquidity and improve their access to wholesale funding markets, is not feeding through to easier credit conditions on loans to companies, because the deteriorating economic environment is making banks less willing to lend. The gloomy assessment of the outlook by banks is consistent with the picture currently being painted by business surveys. Only when banks' confidence about the economic outlook improves will credit conditions improve. For this to happen, as with business confidence, further steps need to be taken to ensure the Eurozone's survival.

Financial markets could easily lose patience with Spain

The three months of financial market calm from the start of August to the end of October may prove to be merely the latest in the series of fluctuations between episodes of extreme turbulence, driven by worries over economic and fiscal prospects in periphery countries, and liquidity-induced rallies that have occurred since the Eurozone debt crisis started over two years ago.

A joint EU and IMF rescue program for Cyprus still seems likely, perhaps introducing sizeable cuts to the face value of loans for bank creditors, prior to access to European Stability Mechanism (ESM) funding and loans from the Eurozone governments within a bailout plan. More importantly, Spain may soon enter a program and Italy could follow by the middle of 2013. These steps would imply external oversight of fiscal policy, but need not lead to additional fiscal austerity in these countries. They would also enable the ECB to attempt to limit any rise in the government bond yields of these countries, thereby contributing to stabilizing the cost of debt and allowing governments to focus on further reforms.

At present, financial markets appear reconciled to Spain delaying its entry into a rescue program. However, the country's peace with financial markets is fragile. Spanish bond yields have only fallen because markets are assuming that Spain will soon enter a program in order to allow the ECB to purchase its government bonds. An ugly standoff with the bond market seems inevitable if Spain does not eventually agree on the terms for an ECB intervention.

Further progress toward banking union is needed to ensure the euro's survival

The initial plans for a banking union sought to place Eurozone banks under the overarching supervision of the ECB, followed by the creation of a bank resolution scheme for the Eurozone and eventually a Eurozone-wide deposit guarantee scheme.

However, the plan for the scheme has met with political and industrial resistance. This has been particularly strong in Germany, where banks oppose a single deposit "pot" that would pool resources in a banking union. Understandably, German institutions fear that this would use their savers' money to bail out banks in other countries. Disappointingly, recent comments from ECB officials suggest that plans for a Eurozone-wide deposit guarantee scheme have been shelved in response to this resistance.

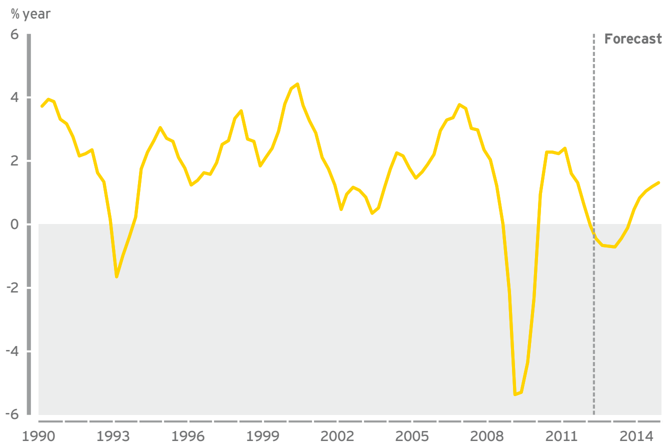
We continue to believe that a common deposit guarantee scheme is a necessary component of an effective Eurozone banking union. Without a guarantee scheme there will always be a risk that retail and corporate deposits will leak away from countries that have weak banks and poor fiscal positions toward those with healthy banks and public finances. Taken to its extreme, this process would cause a run on the banks in the weaker countries. A Eurozone-wide guarantee scheme would give depositors comfort that funds, up to the limit of the scheme, are equally safe, regardless of which Eurozone country they are held in. Although a guarantee scheme, unless industry funded, would create a contingent liability for all member states, if it is credible it is unlikely to be triggered in reality. Moreover, the cost to all governments of trying to stem bank runs in parts of the Eurozone would more than outweigh the guarantees necessary for a common deposit guarantee scheme.

Rising unemployment will keep the pressure on policy-makers

As indicated by our forecasts, the domestic economy in the Eurozone will remain muted for some time. Exports are expected to fare better thanks to growth in both the emerging markets and in the US (see Box 1 on page 23), which is showing increasing signs that growth will accelerate as long as the so-called "fiscal cliff" is successfully negotiated. We forecast demand for Eurozone goods exports will rise by 5.3% in 2013, after 3.2% in 2012, and accelerate toward 6%–7% a year in 2014–16. Combined with the assumption that the euro exchange rate will weaken and thereby boost competitiveness, Eurozone exports of goods and services should rise by 2.7% in 2013 and accelerate to growth of 4% in 2014–16.

Figure 4

GDP growth

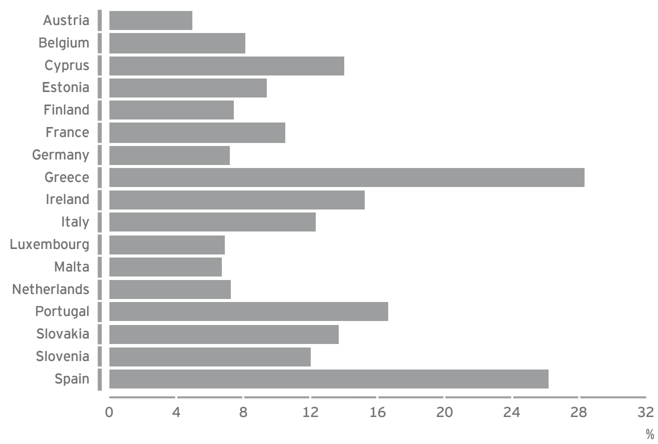


Source: Oxford Economics

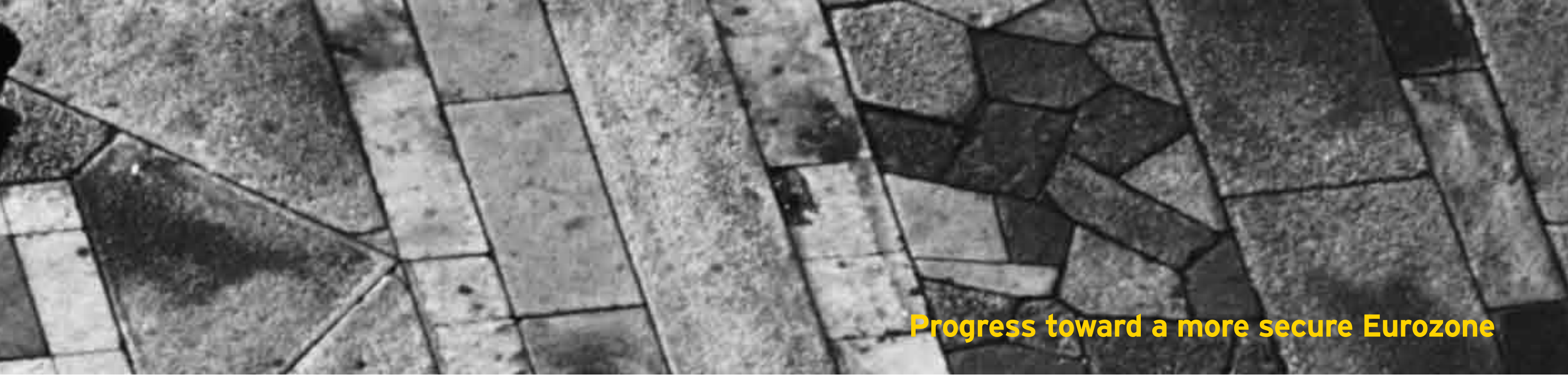
The weak GDP growth outlook, combined with companies' attempts to raise productivity, means that unemployment will continue to rise throughout 2013, peaking at 12.5% in Q1 2014, with almost 20 million people unemployed across the Eurozone. The peak in unemployment is expected to be both higher and slower to unwind in the peripheral economies, with the unemployment rate expected to peak at over 28% in Greece, 26% in Spain and almost 17% in Portugal. This labor market weakness will, along with financial markets, keep politicians and policy-makers under pressure to continue to progress toward a more sustainable structure for the Eurozone.

Figure 5

Unemployment rates



Source: Oxford Economics



High unemployment, together with the impact on households' budgets of fiscal austerity, will dampen the ability and willingness of consumers to spend. We estimate that consumption fell by 1% in 2012, as sharp a fall as in 2009, and forecast a further decline in 2013. As the pace of austerity lessens and unemployment starts to fall, consumption should start rising from 2014, although it is not expected to reach pre-crisis highs until mid-2015.

Deflation more of a risk than inflation

The combination of the weak growth outlook for 2013 and 2014 and excess capacity means that we expect Eurozone inflation to continue moderating throughout 2013–15. Inflation should almost halve from 2.5% in 2012 to 1.3% in 2015. And in a number of the peripheral countries, pressures to reduce costs and increase competitiveness add to the poor demand environment to result in very low or sometimes negative inflation.

With risks to our growth forecast skewed to the downside, deflation is more of a risk than inflation. This means that the ECB is likely to keep interest rates on hold at 0.75% until 2017. We have in the past advocated a further cut in interest rates, alongside quantitative easing, as a means to loosen monetary policy even further. But the latest announcements by the ECB suggest that neither policy action is under consideration at the moment. It would probably take a further worsening in the economic outlook to convince the ECB that more policy easing is warranted.

Businesses should plan for a European "lost decade"

In the four years running up to the 2008–09 global financial crisis, economic growth in the Eurozone averaged 2.5%, with the pace close to 3.5% in 2006. Although we expect the Eurozone to return to growth in 2014, we do not expect it to recover to its pre-crisis pace. Europe will experience its own "lost decade."

We expect that progress toward a fuller fiscal and banking union will be fitful. Policy-makers will do enough to hold the Eurozone together, but are unlikely to be able to do enough to boost growth prospects materially. Such an environment will be one in which risk premiums will fall slowly and fears about the Eurozone's survival will continue to weigh on business confidence, and thus deter business investment and recruitment.

It seems likely that, in coming years, none of the peripheral economies will be able to achieve solid economic growth, and that most of them will need some form of external support or backstop for government financing for many years to come.

Over time, we expect economic weakness and fiscal trends in periphery countries will be reflected in a return of fears that Greece could leave the Eurozone, with a slow move to fiscal burden sharing, probably including some kind of Eurozone fiscal body, which would be allowed to issue debt. But this process is likely to be spread over several years, locking the Eurozone into a long period of economic weakness.

Consequently, we do not expect the level of Eurozone GDP growth to exceed its pre-financial crisis peak until 2015. Moreover, there is a wide divergence between countries. While Germany's output has already surpassed its pre-crisis peak, the periphery will still be smaller at the end of the decade than it was before the financial crisis started. For example, Italy is not expected to be larger than it was before the financial crisis until late 2020.

A prolonged period of subdued growth will result in a tough environment for both business leaders and political leaders. Even in stable, conservative and socially cohesive Japan, changes of prime minister have been twice as frequent in the two decades since its property bubble burst in 1989 than in the two previous decades.

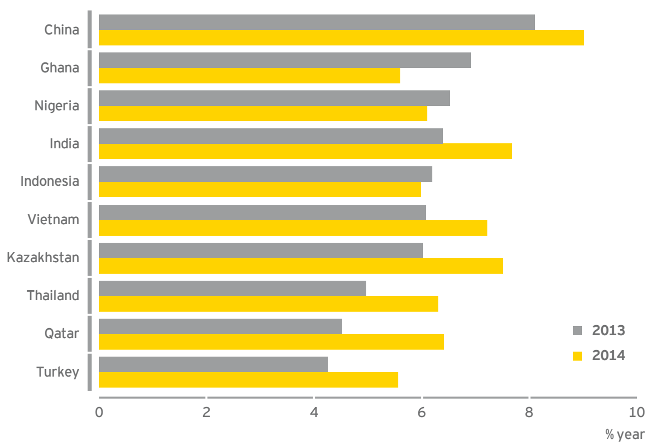
In such a business environment, European companies will not be able to assume that growth will be driven by their domestic markets. Growth will also have to come from cost cutting, winning market share and exporting to more rapidly growing economies.

Encouragingly, the example of Japan shows that individual companies and sectors can prosper even when their domestic economies are struggling. Although the Japanese stock market has been falling since 1989, particular companies and sectors have performed well. For example, Japanese export champions and stocks that pay high dividends have outperformed the broader equity market.

In an environment in which we do not expect the ECB policy rate to rise until 2017, yield is also likely to be highly prized by European investors in the years ahead. Eurozone companies will increasingly need to look beyond the region's borders to the rapid-growth markets of South America, Asia, Africa and the Middle East if they are to thrive (see Box 2 on page 24).

Figure 6

10 fastest growing rapid-growth markets



Source: Oxford Economics

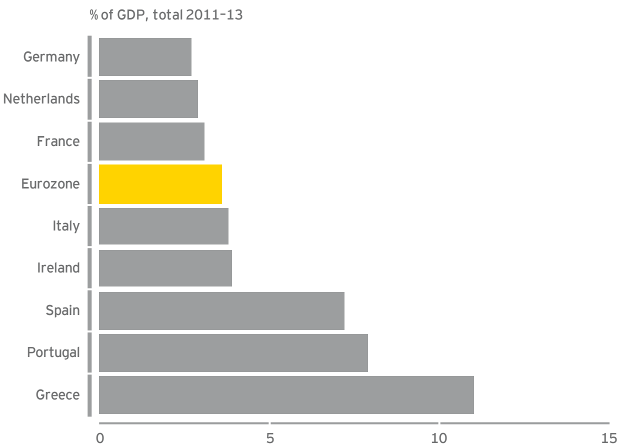
The periphery is likely to undershoot official forecasts in the near term …

Since 2008 the peripheral Eurozone economies have been trapped in a downward spiral of fiscal austerity, poor external competitiveness, private sector deleveraging, poor credit availability and tightening monetary conditions.

In the near term, we expect the peripheral economies to continue undershooting official forecasts, leading to further overshoots in fiscal deficits and public debts in coming years. We forecast continued recessions in 2013 in Greece, Portugal, Italy and Spain, and falling domestic demand, but positive GDP growth, in Ireland.

Figure 7

Discretionary fiscal tightening, 2011–13



Source: Oxford Economics; Haver Analytics

… but there has been significant progress on restructuring

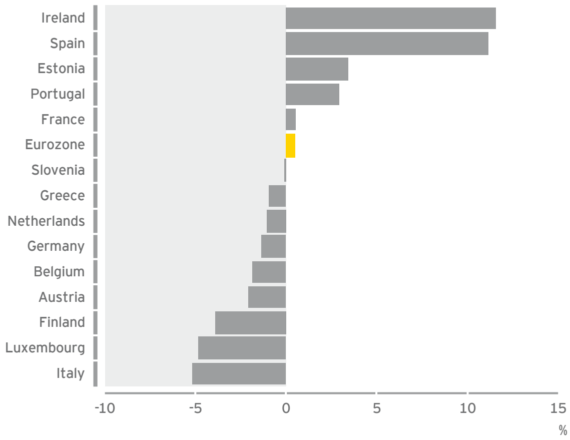
Although the short-term outlook for the peripheral economies remains challenging, there are glimmers of hope in the medium term. In particular, there has been significant progress in the restructuring of peripheral economies. For example, countries like Ireland and Spain have achieved large increases in productivity. This has helped reverse negative competitiveness trends and has been reflected in strong export growth. However, the adjustment in competitiveness is far from complete. Moreover, in the short term, these changes will lead to a significant squeeze on household incomes, which in turn will deepen and prolong the domestic recessions in these countries.

Greece, Ireland, Portugal, Spain and Italy are often lumped together as a group. These five countries do share common features, but also have stark differences. Looking at developments since 2008, Greece stands out for the depth of its recession. Investment has collapsed, as prospects of returns were drastically revised and financing dried up. We expect the Greek economy to contract by over 4% in 2013 and then by 1.1% in 2014. By the time the economy bottoms out in mid-2014, it will have contracted by 25% and have been in recession for six years.

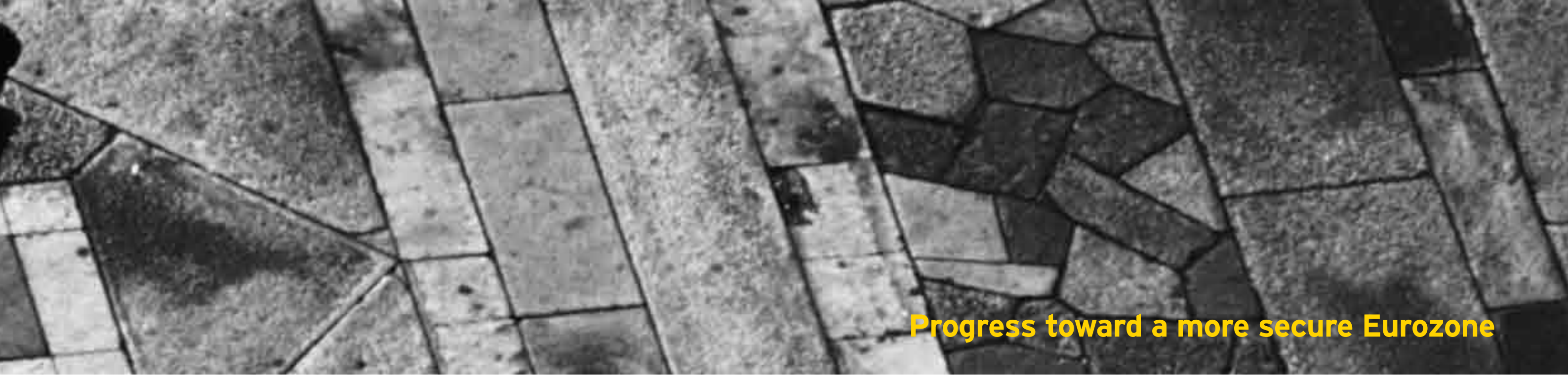
Ireland has experienced a similar slump in investment, but export performance has been much stronger than in Greece. This is largely thanks to established export companies offering products and services made more attractive by the improvement in competitiveness. In the first half of 2012, Greek exports fell by over 20%, whereas Irish exports grew by 3%. This export performance differential reflects Ireland's superior productivity performance. Since Q1 2008, productivity has risen by 10.7% in Ireland but fallen by 3% in Greece. Consequently, we expect the Irish economy to grow by 1% in 2013 and then by 1.9% in 2014. Other notable gains in productivity have occurred in Spain, where it has risen 11.3% since Q1 2008, and Portugal, where it has risen by 5.4%. As a result, although these economies are both expected to contract in 2013, we forecast them to return to growth in 2014.

Figure 8

Change in productivity, Q1 2008–Q1 2012



Source: Oxford Economics



More surprising has been the performance of Portuguese and Spanish exports. Both countries have managed to increase market share, notably in goods. Strong exports have contributed to the reduction of current account deficits that were very large at the start of this crisis and a symptom of the imbalances within these economies. This has in turn eased financing issues as foreign capital inflows dried up.

Over the forecast period, the outlook for the five peripheral economies is subdued at best. But there are large differences in our individual forecasts for these countries. While Ireland is expected to grow by 2.3% a year on average in 2013–17, Greece is forecast to contract further (by 0.2% a year). Greece and Ireland are the two extremes in this group of five.

Uncertainty about future developments for the "middle countries" — Portugal, Spain and Italy — is in some way higher. On the one hand, the recent strength in exports suggests that we could be underestimating momentum ahead. On the other hand, the fact that these countries have performed better than Greece so far could be partly because the adjustment process started later — we might also be underestimating the size of the adjustment still ahead of them. On balance, although these three economies are expected to contract in 2013, we expect them to return to growth in 2014.

Growth Pact will only improve growth prospects in the long run

We assume that the revival of the Growth Pact at the September EU Council meeting will have a positive impact. The pact contains supply-side reforms that could yield large longer-term benefits, particularly for the smaller and hence potentially more open economies. However, the measures contained in the pact, though worth implementing, are unlikely to alter prospects for demand and growth in the short term. Nevertheless, European leaders need to maintain a sense that they will move in this direction given the right conditions. For this to happen, Germany and other creditors need to be convinced that further integration is not an open-ended invitation to profligacy at their expense.

Uncertainty about the euro's future needs to be reduced further

The biggest boost to growth in the short term would come from removing uncertainty about the survival of the euro. This would require risk- and burden-sharing across the whole Eurozone. The euro's future would be strengthened by a European system to recapitalize banks and guarantee deposits to break the vicious cycle of weak banks and weak sovereigns pulling each other down. Some form of joint eurobond could stop countries being pushed into insolvency.

Broadening of the policy debate beyond austerity is welcome

The Growth Pact is also a welcome broadening of policy beyond austerity. The idea that deficit-cutting can boost growth has been largely contradicted by evidence so far. Even institutions, such as the IMF, that previously focused on fiscal corrections are now recommending a more balanced approach, which, while abiding by the general direction of reducing public deficits, allows adjustment to proceed at a slower pace and stresses the need for broader economic reforms.

The latest evidence is that, in a downturn, the multiplier effect of fiscal tightening can lead to deeper recession, making it even harder to cut the deficit. In the Eurozone, moreover, individual countries cannot mitigate the impact of tight fiscal policy with looser monetary policy or currency devaluation.

History suggests that the levels of debt reached in the peripheral economies will stifle long-term growth. Sooner or later, they will have to work off their debt. So the choice is not really between austerity and growth, but over the timing and speed of deficit-cutting and the right mix of structural reforms.

Ideally, the peripheral countries should be allowed to carry out more gradual fiscal adjustment in the short term, coupled with credible medium-term debt-reduction plans. European officials are now debating whether they can make fiscal targets more flexible without losing credibility, and without giving governments a licence to break the rules. At present, it appears that any easing of short-term austerity will be limited.

The adjustment would be faster if countries like Germany were to boost domestic demand through higher spending or lower taxes. The Germans would also have to accept higher inflation to allow others to regain competitiveness without being pushed into deflation. However, given Germany's fear of inflation, this seems unlikely to happen.

Conclusions

At the end of 2012, the near-term future of the Eurozone seems safer than it did at the start of the year. The EC and the ECB have clearly stated their commitment to securing the survival of the Eurozone, the EU Growth Pact signaled a welcome broadening of policy beyond austerity, and there has been significant progress in the restructuring of peripheral economies. In particular, countries like Ireland and Spain have achieved large increases in productivity. This has helped reverse negative competitiveness trends and has been reflected in strong export growth.

However, these developments are unlikely to alter prospects for demand and growth in the short term. The biggest short-term boost to growth would come from removing uncertainty about the survival of the euro. This would have the potential to boost business confidence and unlock investment and recruitment plans that are currently on hold as companies wait to see what happens to the Eurozone. Consequently, even more needs to be done to convince businesses that the Eurozone can stay in its current shape and start growing again. In particular, the framework for a banking union needs completing and the shift away from austerity toward growth contained in the Growth Pact needs to be reflected in its implementation.

Even if these measures are taken, the necessary restructuring of the Eurozone economy will continue to dampen growth for some time. Consequently, businesses need to plan for a European "lost decade." This will be a tough operating environment in which companies cannot assume that growth will driven by their domestic markets. Growth will also have to come from cost cutting, winning market share and exporting to more rapidly growing economies.

EC blueprint for long-term European economic and monetary union

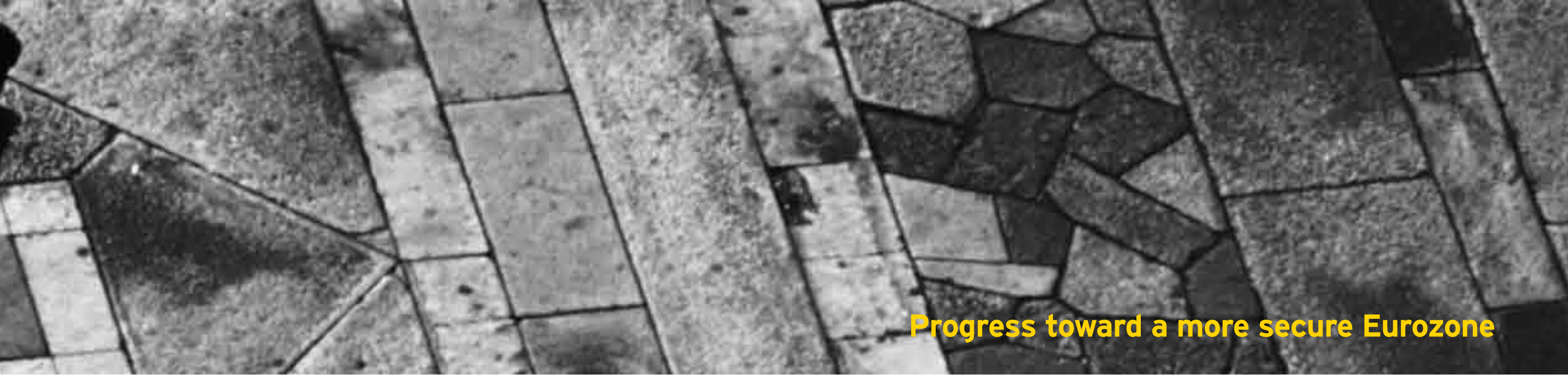
In its blueprint for a deep and genuine economic and monetary union announced at the end of November, the EC has presented a far-reaching agenda for the future of the Eurozone. The EC's proposal is structured in three time frames: measures that can be tackled in the next 6–18 months; those that will take 18 months to 5 years; and those that will only be achieved from 2018 onwards, which in the view of the EC will be the final stage of monetary union.

The short-term measures include an agreement on the single supervisory mechanism and the creation of a single resolution mechanism. The latter is a major change — previously the EC proposed introducing harmonized national resolution regimes by 2018. The EC also wants to create a new "convergence and competitiveness instrument" to strengthen the enforcement of structural measures in countries with excessive macroeconomic imbalances.

In the medium term, the EC wants to give European institutions more control over national budgets and wants to introduce a debt redemption fund in order to reduce the sovereign debt of member countries, as well as the introduction of common issuance of euro-bills with maturity of up to one to two years. In addition there should be a Eurozone "fiscal capacity," with the power to borrow, and the aim of supporting structural reforms.

In the long term, the EC wants to have a full banking union, including a deposit guarantee scheme. Furthermore, there should be a Eurozone treasury and a political union, with an increased role for the European Parliament. Overall, the EC proposals would create a two-speed EU, with more far-reaching integration in the Eurozone than in the rest of the EU.

The implementation of the near-term targets, including the resolution scheme, is ambitious, but is perhaps achievable. In contrast, the proposals for debt mutualization in the medium and long term will have to overcome considerable political and legal hurdles on the road to implementation. These proposals contain the right measures to restore market faith in the Eurozone's survival, but the long time frame and the implementation challenges mean that uncertainty about the Eurozone's future will be slow to dissipate.



Box 1

Forecast assumptions — international environment and commodity prices

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

Indicators from the US have remained mixed, but overall the picture has improved since our last report in September. In particular, there are signs that the consumer sector is stirring: real consumption rose 0.4% in September — the best since the start of the year — and this should be supported in the coming months by rising house prices and the stronger pace of job gains seen in recent months. In addition, the banking system continues to recover and activity is supported by loose monetary policy. But the outlook for investment remains uncertain and government spending continues to contract. Our forecast for GDP growth in 2012 remains unchanged at 2.2%, but we now expect a pickup to 2.5% in 2013 followed by about 3% in 2014. The balance of risk has shifted to the upside, and will do so further if the so-called "fiscal cliff" can be averted.

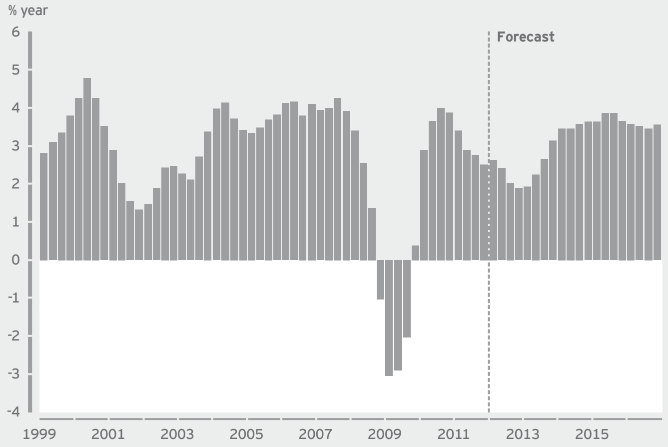
In Japan, the activity indicators have worsened and growth is now forecast to be just 1.6% in 2012 and less than 1% in 2013, a sizeable downgrade from our September forecast. But much depends on developments in China, as Japanese exports to China have accounted for almost half of total export growth over the past decade. The Chinese economy has slowed more than expected, but the authorities are taking action to support growth and, with the leadership transition now over, it is likely that more policy support will be forthcoming if required. We now expect Chinese GDP to grow by 7.5% this year and by a little over 8% in 2013. Elsewhere in the emerging markets, India is also slowing, but the authorities have no room to cut interest rates in the face of persistent inflation and a weak exchange rate. Mexico has struggled to pick up pace as the US recovery has stuttered, but its prospects for 2013–14 are now improving. Meanwhile, the steep interest rate cuts in Brazil could see a significant pickup in growth in the coming years. Emerging European markets, including Russia, are struggling with the effects of the Eurozone recession this year, but the pace is forecast to pick up as exports, and then consumer and public sector demand, start to improve.

This pattern of subdued growth is reflected in our forecast for a notable slowdown in the pace of expansion of world trade to just 2% in 2012, down from around 7% in 2011. But the pace of world trade is forecast to pick up to about 4.5% in 2013 and then to 6%–7% a year in 2014–16. Overall, our forecasts for world GDP in 2012 and 2013 remain broadly unchanged, at around 3% and 3.5% respectively (on a purchasing power parity basis), before a further pickup to 4%–4.5% a year in 2014–16.

Although oil prices have remained steady at around US$110 per barrel in recent months, there remains considerable uncertainty about the future given political developments in the Middle East. Our forecast is for oil prices to average US$110 per barrel in 2012, down slightly from 2011, with a further decline to US$101 per barrel expected in 2013. Demand conditions may improve slightly and geopolitical risks in the Middle East will persist, but higher output in a number of major and medium-sized producers is likely to see prices weaken during 2013.

Figure 9

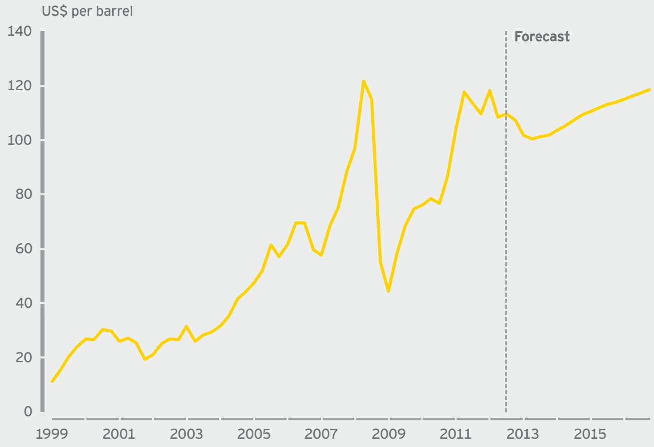
World: GDP growth



Source: Oxford Economics

Figure 10

Oil price, nominal



Source: Oxford Economics

Box 2

Rapid-growth markets — an increasingly important growth engine for Europe

Last year, almost two-thirds of the world's population lived in the 25 rapid-growth markets, but only a third of world GDP was produced by these economies. Fast-forward 25 years to 2036 and, as the chart below shows, the RGMs will enjoy a bigger share of global GDP than of population, illustrative of the rapid-growth concept. Rapid-growth markets will become an even more dominant force in global trade over the coming decade. Trade will be increasingly focused around Asia, the Middle East and Africa.

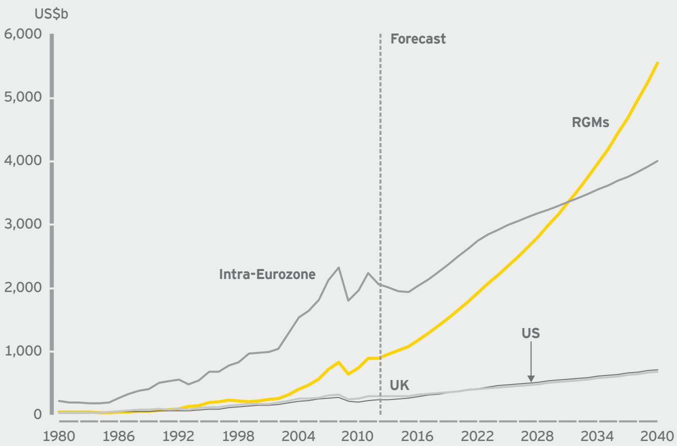
Indeed, Oxford Economics forecasts for bilateral trade show Europe's exports to Africa and the Middle East by 2020 are forecast to be around 50% larger than its exports to the US. Companies will need to gain footholds in rapid-growth markets at an early stage, while they still have the opportunity to establish a significant market presence. Exports from the Eurozone to the RGMs were valued at US$895 billion in 2011, up from US$230 billion in 2000. The charts below illustrate our bilateral trade forecasts, showing that in 20 years' time exports from the Eurozone to the RGMs will have overtaken intra-Eurozone trade.

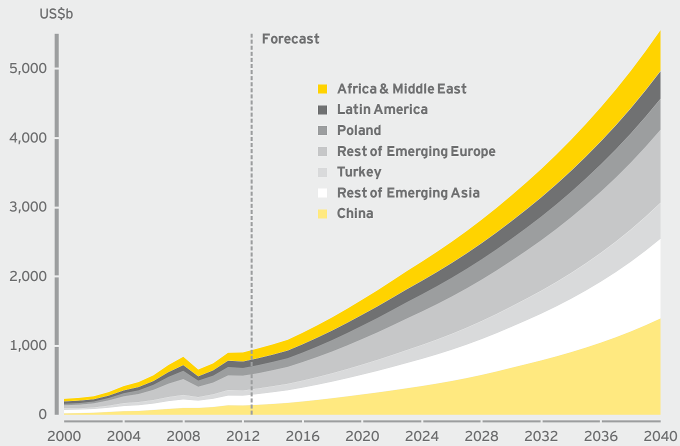
Indonesia, Turkey and Vietnam stand out alongside China and India. These countries are expected to grow by at least 5% per annum (p.a.) over the next 25 years, all have favorable demographic trends and rising household incomes and are expected to contribute a much greater share of global GDP over the next 25 years.

In 25 years' time, not only will Indonesia have the fourth largest population in the world, it will also be the ninth largest economy, having grown by more than 5% p.a. over the next 25 years. Many of the emerging Asian economies are export-led and exports account for less than a third of GDP in just three countries: China, India and Indonesia. And the demographic trends are very favorable: in 25 years, Indonesia will still have at least five workers for every person over 65. In 1990, under half of secondary school-age children were in education, now 80% are. By 2020, Indonesia will have more households earning over US$30,000 than China does today.

Turkey is the 18th largest country in the world, both in terms of population and GDP. Although we expect quite subdued growth this year, over the next 25 years we expect GDP growth of 5% p.a. It has a large domestic market and in 10 years' time there will be more than 11 million households earning more than US$30,000, the same number as Canada has now. Like Indonesia, demographic trends are very favorable. In 25 years' time there will still be five workers for every elderly person in Turkey, while in Japan and Germany there will be less than two. The population is well-educated, with almost half of school leavers going on to education beyond the age of 18, up from just 12% in 1990.

Vietnam is expected to grow by almost 6% p.a. over the next 25 years, making it the third fastest growing country among the RGMs behind China and India. The authorities are targeting growth of at least 5.5% in 2013 and we expect growth in excess of 7% in 2014, provided banks are successfully stabilized and planned FDI rule changes enacted. And by population, Vietnam is the 13th largest country in the world and the population is young and increasingly well-educated. The number of children educated to secondary-school level is almost 80%, having more than doubled in the last 20 years. Per capita income is expected to grow by more than sixfold over the next 25 years, while the number of households earning over US$30,000 will rise from less than 6,000 to more than 60,000 in 10 years' time.





Progress toward a more secure Eurozone

Forecast for Eurozone countries

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

17 Eurozone countries

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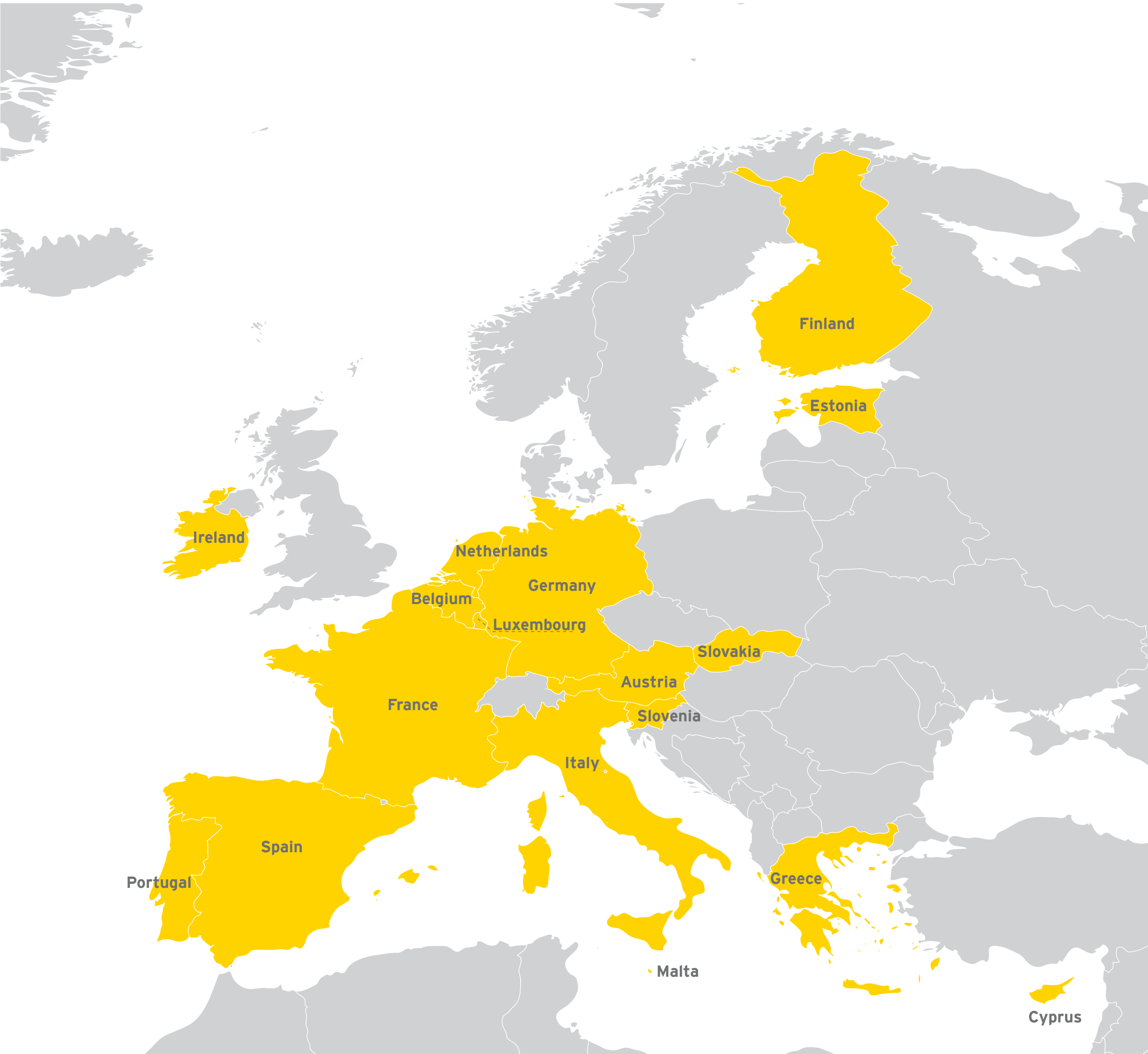
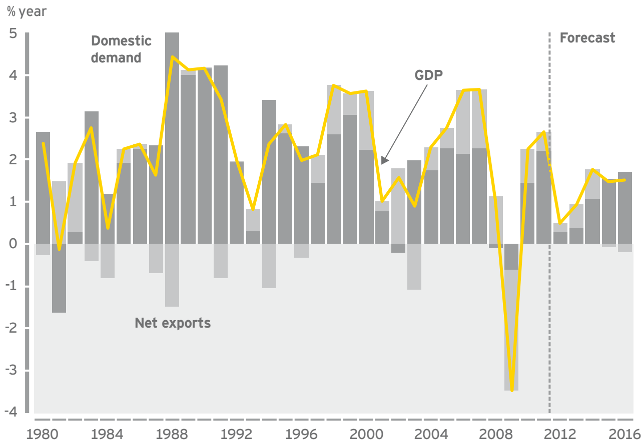


Austria

- Conditions for an export-driven recovery remain difficult against the background of the depressing effect of the Eurozone crisis on demand for Austrian exports. Growth prospects, in particular in 2013, will largely rest on the resilience of domestic demand to an only gradually improving environment.
- Private consumption stagnated in the first nine months of 2012, but real incomes have increased for the first time in four years. This should stimulate spending in 2013-14, despite rising unemployment and low confidence.
- Despite recent progress, our forecast remains subject to considerable downside risks stemming from the Eurozone crisis. Should these materialize, Austria should still have leeway to ease fiscal policy, as the fiscal position remains relatively benign, despite likely deficit overshooting in 2012-13.

Figure 13

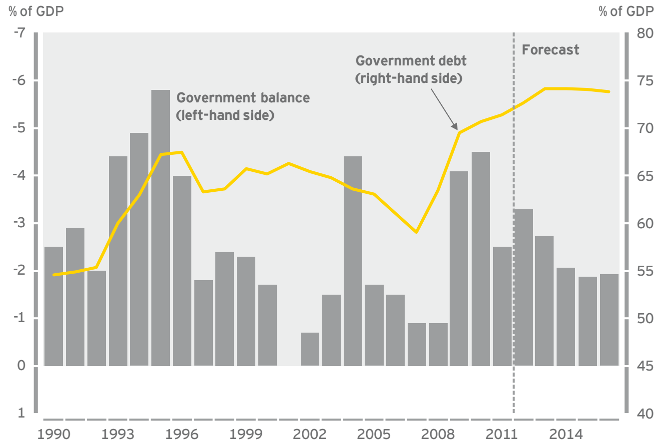
Contributions to GDP



Source: Oxford Economics

Figure 14

Government balance and debt



Source: Oxford Economics

Table 2

Austria (annual percentage changes unless specified)

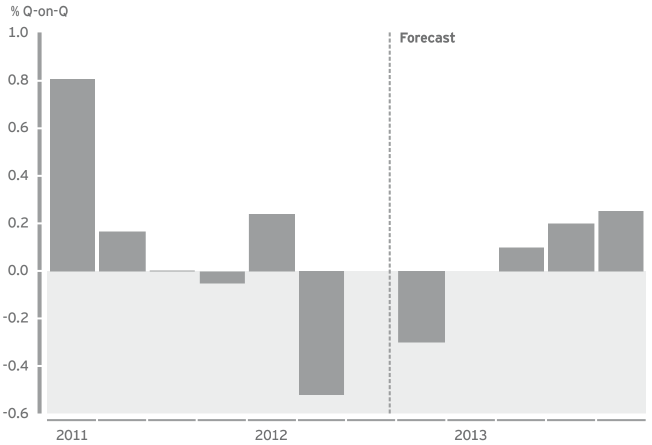
Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	2.7	0.5	0.9	1.8	1.5	1.5
Private consumption	0.9	0.3	0.8	1.3	1.5	1.6
Fixed investment	6.3	1.0	1.0	2.8	2.4	2.1
Stockbuilding (% of GDP)	1.9	1.6	1.0	0.5	0.4	0.6
Government consumption	0.5	1.2	1.6	1.4	1.6	1.6
Exports of goods and services	7.1	1.9	3.6	5.8	4.7	4.5
Imports of goods and services	7.0	1.7	2.8	5.2	5.4	5.3
Consumer prices	3.6	2.5	2.2	1.8	1.8	1.8
Unemployment rate (level)	4.2	4.4	4.9	4.6	4.3	4.2
Current account balance (% of GDP)	0.6	1.4	1.7	2.6	2.6	2.4
Government budget (% of GDP)	-2.5	-3.3	-2.7	-2.1	-1.9	-2.0
Government debt (% of GDP)	72.4	74.1	75.5	75.4	75.1	74.9

Belgium

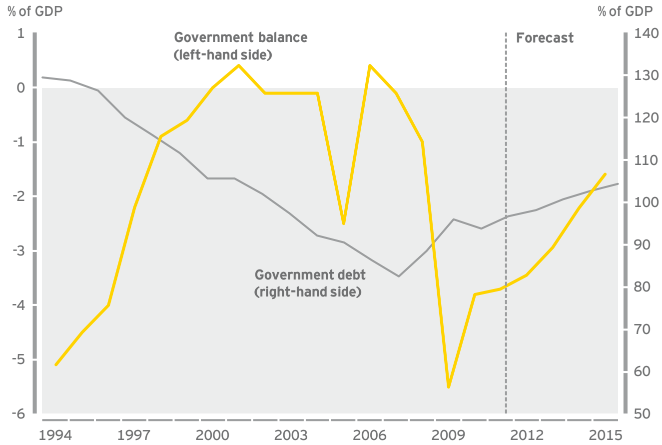
- The Belgian economy has slowed as the Eurozone crisis has undermined export activity as well as domestic demand. GDP was flat in Q3 but, with a fall expected in Q4, an overall 2012 GDP contraction of 0.2% is expected. We forecast a further small decline in 2013 as concerns about the Eurozone persist.
- While business confidence remains well above the low seen in 2009, it has been edging down through most of 2012, driven by the slowdown in Eurozone trade and investment, and a persistent risk of Eurozone breakup.
- Although the sluggish recovery should allow inflation to ease, there remains a lack of progress on reforms to tackle declining competitiveness, low employment and a heavy tax burden on labor and capital income. The 2013 budget includes some measures, but falls short of what is required to address Belgium's underlying problems.

Figure 15
GDP growth



Source: Oxford Economics

Figure 16
Government balance and debt



Source: Oxford Economics

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

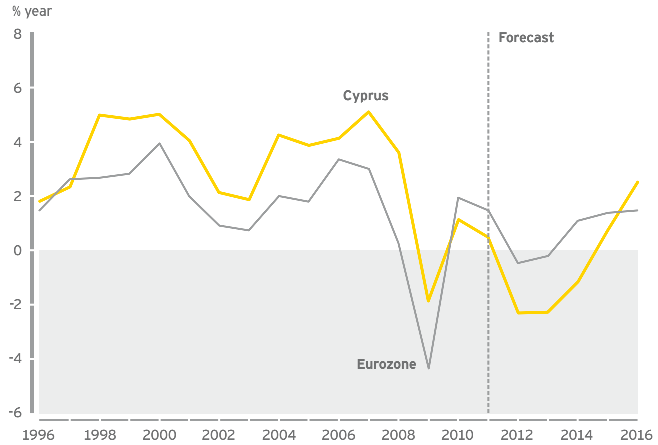
	2011	2012	2013	2014	2015	2016
GDP	1.8	-0.2	-0.1	1.0	1.2	1.4
Private consumption	0.2	-0.7	0.3	1.3	1.5	1.7
Fixed investment	4.1	-0.4	-0.8	0.9	1.7	2.2
Stockbuilding (% of GDP)	1.3	1.3	1.4	1.3	0.7	0.0
Government consumption	0.8	-0.2	-1.1	-0.8	-0.3	0.5
Exports of goods and services	5.5	0.3	1.4	3.5	4.0	3.8
Imports of goods and services	5.7	-0.1	1.4	3.2	3.2	3.4
Consumer prices	3.4	2.7	2.1	1.9	2.0	1.9
Unemployment rate (level)	7.2	7.3	7.9	8.1	7.9	7.7
Current account balance (% of GDP)	-0.9	0.2	1.4	1.8	1.9	2.0
Government budget (% of GDP)	-3.7	-3.5	-2.9	-2.2	-1.6	-1.0
Government debt (% of GDP)	97.8	99.8	102.5	104.6	106.0	106.4

Cyprus

- The Cypriot Government is in negotiations with the EC, ECB and IMF over a bailout package totaling up to €16 billion, with up to €10 billion of the package likely to be allocated to the banking sector.
- The financial crisis is having profound economic impacts, with GDP expected to drop 2.3% in 2013. Financial crises take a long time to resolve and growth will also be hit by fiscal austerity measures under the bailout package. We also expect GDP to fall by around 2.3% in 2013 with a further 1.2% drop in 2014.
- The outlook for investment is bleak: public investment will be hit by austerity measures, construction activity is sliding and, despite some projects such as a new oil-storage facility, private investment will also shrink sharply this year and next. Conditions are just as tough for consumers, as public sector wages are frozen and unemployment is surging, while purchasing power is squeezed by the VAT rise implemented in March.

Figure 17

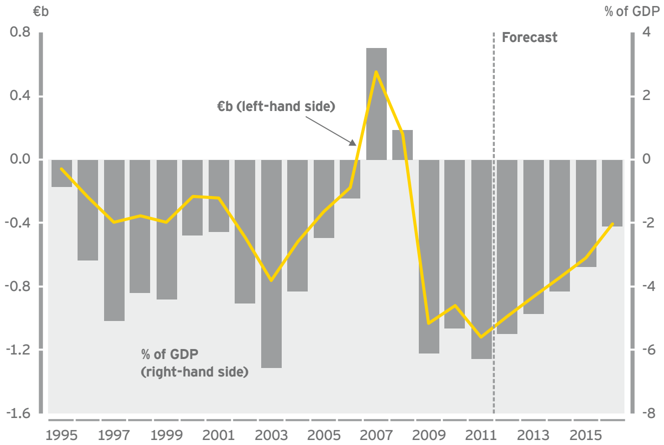
Real GDP growth



Source: Oxford Economics

Figure 18

Government budget balance



Source: Oxford Economics

Table 4

Cyprus (annual percentage changes unless specified)

Source: Oxford Economics

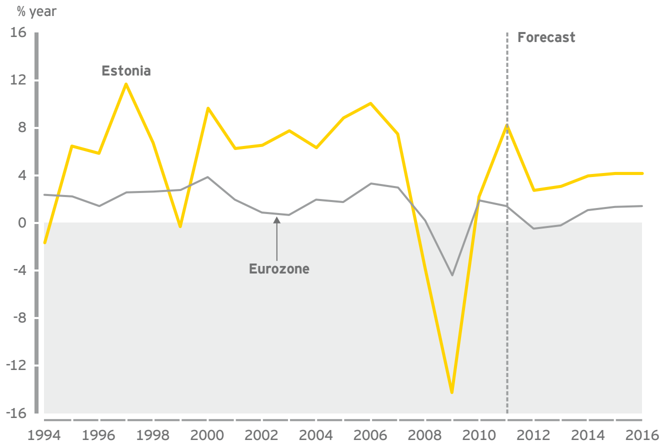
	2011	2012	2013	2014	2015	2016
GDP	0.5	-2.3	-2.3	-1.2	0.7	2.5
Private consumption	0.2	-3.5	-3.0	-2.0	-0.2	1.9
Fixed investment	-13.8	-25.2	-17.3	-10.9	-5.6	-1.5
Stockbuilding (% of GDP)	0.1	0.1	0.1	0.3	0.2	0.2
Government consumption	-4.7	-1.9	-2.9	-2.4	-0.5	1.0
Exports of goods and services	3.6	-2.9	0.5	2.0	3.5	5.3
Imports of goods and services	-5.0	-12.6	-5.5	-1.7	0.3	3.2
Consumer prices	3.5	3.3	2.0	1.5	1.8	2.3
Unemployment rate (level)	7.9	11.9	14.0	14.5	14.8	14.5
Current account balance (% of GDP)	-10.3	-7.7	-4.4	-3.5	-3.5	-3.4
Government budget (% of GDP)	-6.3	-5.5	-4.8	-4.1	-3.4	-2.1
Government debt (% of GDP)	71.6	90.4	98.3	102.2	103.0	100.4

Estonia

- After slowing in Q2, year-on-year GDP growth accelerated to 3.4% in Q3. The threat of recession has been averted due to stronger domestic demand and, with the pace expected to be maintained in Q4, we have raised our full-year 2012 growth forecast to 2.8%, before a pickup to over 3% in 2013.
- The outlook is for substantially stronger growth, of a little over 4% a year in 2014–16, as larger export markets recover and stronger domestic investment offsets the expected reduction in fiscal deficit spending. Export growth will strengthen despite rising relative costs, caused by persistent wage and price inflation differentials over Eurozone partners.
- A rising state wage bill and infrastructure projects prioritized to avert the risk of recession will raise the fiscal deficit to 1%–2% of GDP in 2012–13 and may keep it open longer than the government intends. However, minimal public debt (still below 7% of GDP) makes a two to three year deficit easily financeable.

Figure 19

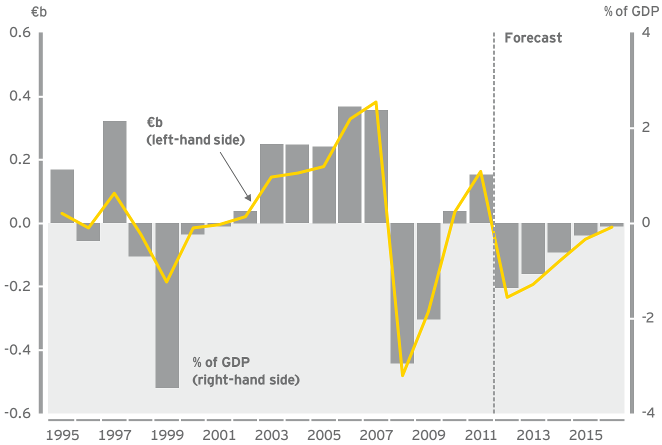
Real GDP growth



Source: Oxford Economics

Figure 20

Government budget balance



Source: Oxford Economics

Table 5

Estonia (annual percentage changes unless specified)

Source: Oxford Economics

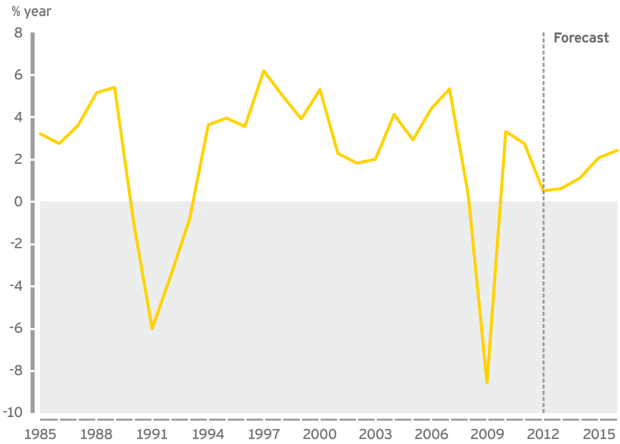
	2011	2012	2013	2014	2015	2016
GDP	8.3	2.8	3.1	4.0	4.2	4.2
Private consumption	4.2	2.0	3.0	3.5	4.2	4.6
Fixed investment	26.8	7.0	5.0	7.0	7.0	5.5
Stockbuilding (% of GDP)	-1.5	-1.1	0.3	1.3	1.4	1.5
Government consumption	1.6	1.0	1.0	1.8	2.7	3.0
Exports of goods and services	24.9	2.5	3.3	4.0	4.3	4.3
Imports of goods and services	27.0	3.2	5.0	5.2	5.0	4.7
Consumer prices	5.0	4.0	3.0	2.2	2.2	2.1
Unemployment rate (level)	12.4	10.2	9.3	8.4	7.7	6.9
Current account balance (% of GDP)	2.1	0.0	-0.3	-1.3	-2.1	-2.3
Government budget (% of GDP)	1.0	-1.3	-1.1	-0.6	-0.2	-0.1
Government debt (% of GDP)	6.0	9.6	10.5	10.6	10.2	9.6

Finland

- We still expect Finland to avoid recession thanks to its strong fiscal position and well-capitalized banking system that is outperforming most of its Eurozone peers. We forecast that the economy will grow a modest 0.4% in 2012 and 0.5% in 2013.
- The risks to growth remain skewed to the downside, as domestic demand will offer only limited support to the economy. That said, the performance of the economy will also depend significantly on a very fragile external environment, and Finland could slip back into recession if a scenario of persistent global slowdown materializes.
- With a budget deficit as low as 0.7% of GDP in 2012, Finland continues to display a healthier fiscal position than most Eurozone countries. This has enabled it to retain its AAA credit rating. We forecast the fiscal deficit will remain below 1% of GDP throughout the next decade, with public debt falling to around 45% of GDP by 2016.

Figure 21

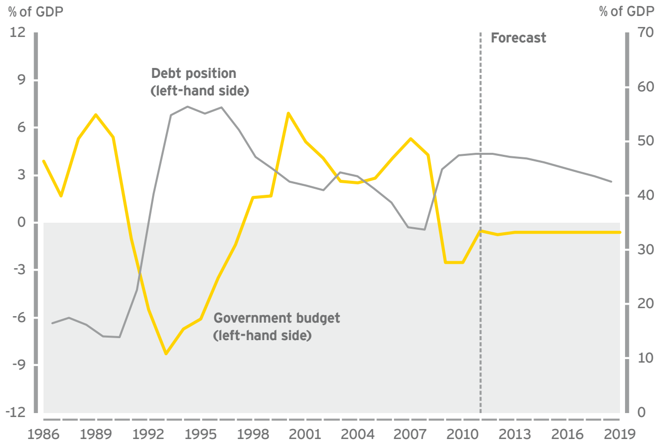
GDP growth



Source: Oxford Economics

Figure 22

Government balance and debt



Source: Oxford Economics

Table 6

Finland (annual percentage changes unless specified)

Source: Oxford Economics

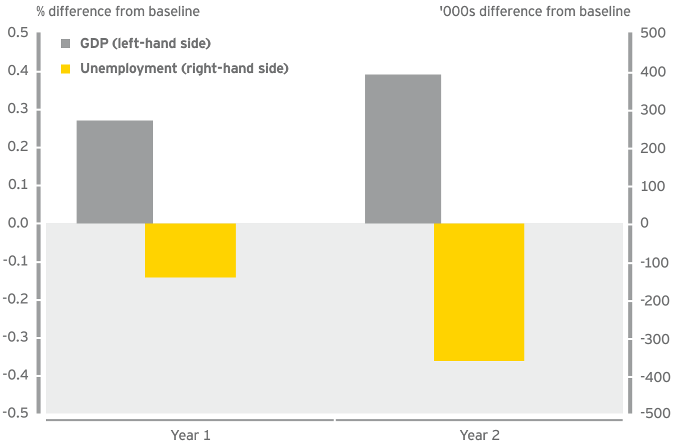
	2011	2012	2013	2014	2015	2016
GDP	2.7	0.4	0.5	1.2	2.1	2.4
Private consumption	2.4	0.7	0.6	1.9	2.4	2.6
Fixed investment	6.8	-0.5	-1.2	0.5	2.1	3.5
Stockbuilding (% of GDP)	2.2	2.8	2.6	1.6	1.0	0.6
Government consumption	0.4	-0.2	0.7	1.2	1.2	1.4
Exports of goods and services	2.0	-2.4	1.8	3.9	4.0	3.9
Imports of goods and services	5.0	-1.5	1.0	2.3	2.9	3.4
Consumer prices	3.3	3.0	2.6	1.3	1.2	1.2
Unemployment rate (level)	7.8	7.7	8.1	7.8	7.3	7.1
Current account balance (% of GDP)	-1.6	-1.8	-0.4	0.7	1.6	1.9
Government budget (% of GDP)	-0.6	-0.7	-0.6	-0.6	-0.6	-0.6
Government debt (% of GDP)	49.0	48.4	47.9	47.6	46.8	45.9

France

- France is rightly focusing on enhancing competitiveness over the next few years. Making the country's products, services and production locations more attractive is essential to achieve sustained and robust growth.
- The challenge is significant and the positive impact of enhanced competitiveness is likely to materialize only slowly. We forecast GDP growth of just over zero in both 2012 and 2013, followed by 1.2% a year on average in 2014-16.
- The Government's competitiveness policies could provide a boost to investment, especially if they are followed by similar measures. This comes on the heels of a setback in the 2013 budget, which raised the tax burden on companies. So it will probably be some time before businesses can be confident that the policy environment is indeed turning more favorably to investment and recruitment in France.

Figure 23

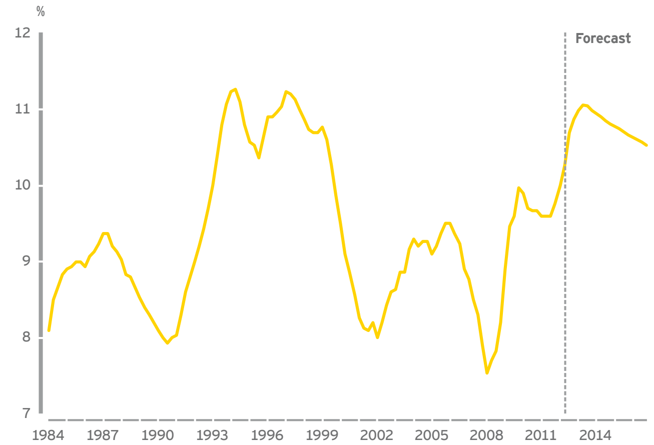
Impact of a €20b reduction in labor costs



Source: Oxford Economics

Figure 24

Unemployment



Source: Oxford Economics

Table 7

France (annual percentage changes unless specified)

Source: Oxford Economics

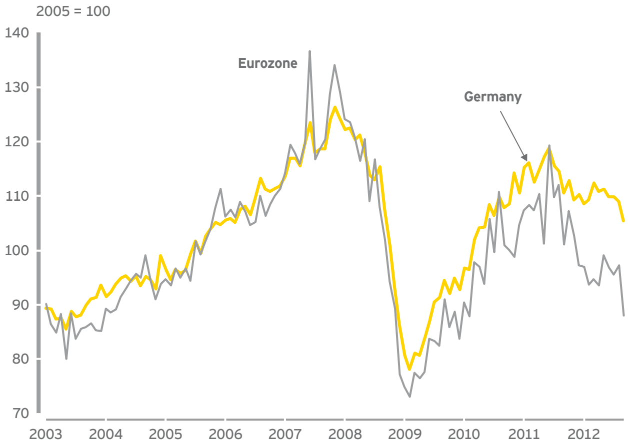
	2011	2012	2013	2014	2015	2016
GDP	1.7	0.1	0.2	1.1	1.2	1.3
Private consumption	0.3	0.0	0.4	1.0	1.1	1.2
Fixed investment	3.5	0.5	-0.2	1.7	2.0	2.0
Stockbuilding (% of GDP)	0.4	-0.6	-0.6	-0.4	-0.4	-0.4
Government consumption	0.2	1.3	0.3	0.5	0.8	0.9
Exports of goods and services	5.5	2.5	1.6	4.3	4.8	4.8
Imports of goods and services	5.2	0.2	1.8	4.0	4.7	4.4
Consumer prices	2.3	2.3	1.6	1.6	1.4	1.3
Unemployment rate (level)	9.6	10.5	11.0	10.9	10.7	10.6
Current account balance (% of GDP)	-2.0	-2.1	-2.1	-2.2	-2.2	-2.3
Government budget (% of GDP)	-5.2	-4.7	-3.2	-2.5	-2.0	-1.7
Government debt (% of GDP)	86.0	92.6	95.5	97.3	99.3	100.4

Germany

- Although German GDP growth has slowed in response to the Eurozone crisis, it has not actually contracted yet — unlike most other countries in the region. But this looks set to change. Weakness in business confidence, industrial orders and tightening credit conditions point to a 0.2% quarterly GDP contraction in Q4.
- But Q4 is unlikely to mark the start of a sustained period of falling output. We expect quarterly growth to pick up during 2013 as recovery in world trade boosts export growth and a gradual improvement in business confidence lifts investment. Consequently, we forecast GDP growth of 0.8% in 2013, a little below the expected outturn for 2012, and then 1.7% in 2014.
- The slowdown in the economy has hit the labor market, but any further rise in unemployment should be modest. We expect the unemployment rate to rise from 5.4% in Q3 2012 to 5.8% by Q4 2013, before starting to fall back in 2014.

Figure 25

Manufacturing orders



Source: Haver Analytics

Figure 26

Job vacancies and Ifo employment barometer

Source: Haver Analytics

Table 8

Germany (annual percentage changes unless specified)

Source: Oxford Economics

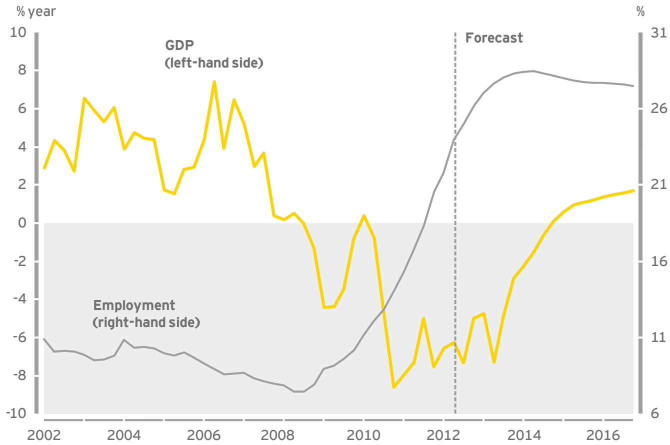
	2011	2012	2013	2014	2015	2016
GDP	3.1	1.0	0.8	1.7	1.7	1.6
Private consumption	1.7	0.6	0.9	1.2	1.2	1.2
Fixed investment	6.4	-1.6	0.3	4.0	3.9	3.2
Stockbuilding (% of GDP)	0.7	0.2	0.0	0.1	0.0	-0.1
Government consumption	1.0	1.0	0.6	0.7	0.7	0.7
Exports of goods and services	7.9	4.9	3.8	4.7	5.0	4.9
Imports of goods and services	7.5	2.7	3.9	5.1	5.3	5.1
Consumer prices	2.5	2.1	1.8	1.7	1.5	1.5
Unemployment rate (level)	6.0	5.6	5.7	5.6	5.4	5.2
Current account balance (% of GDP)	5.7	6.6	6.5	5.9	5.4	5.2
Government budget (% of GDP)	-0.8	-0.2	-0.3	-0.4	-0.3	-0.1
Government debt (% of GDP)	80.5	79.1	78.7	78.8	79.4	79.8

Greece

- Fresh austerity measures will continue to weaken an already battered economy. We expect output to decline by over 4% in 2013, after an estimated 6% contraction in 2012. This will lead to a deterioration in the debt ratio in the medium term. On Greece's current path, we forecast this will remain far above the 124% target by 2020.
- As a result, official creditors have agreed to changes in Greece's bailout program, enabling release of the delayed tranche of funding. But there is still disagreement over how much debt relief is needed. It seems likely that a credible and decisive resolution to Greece's debt-sustainability problem will continue to be postponed, prolonging the uncertainty surrounding its future in the Eurozone and hence delaying the economy's recovery.
- Given the weakness of domestic demand, the export sector is Greece's avenue for growth. Recent export performance has been disappointing, but developments on this front will be crucial in the future.

Figure 27

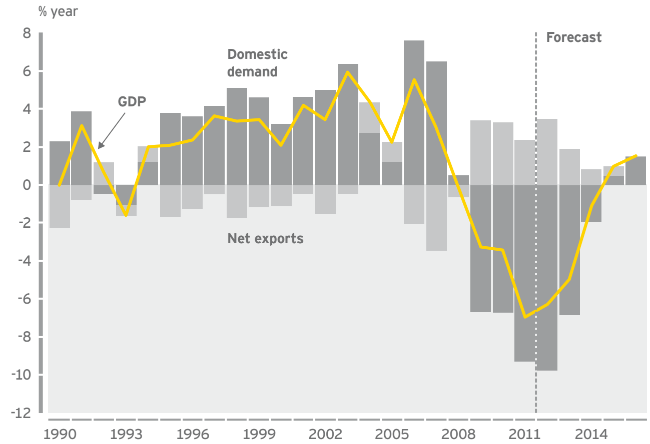
Real GDP and employment



Source: Oxford Economics

Figure 28

Contributions to GDP growth



Source: Oxford Economics

Table 9

Greece (annual percentage changes unless specified)

Source: Oxford Economics

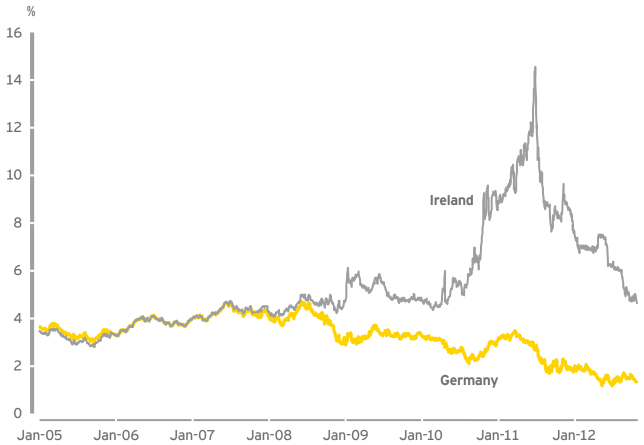
	2011	2012	2013	2014	2015	2016
GDP	-7.2	-5.9	-4.3	-1.1	1.0	1.5
Private consumption	-7.1	-8.8	-4.4	-2.1	0.1	0.7
Fixed investment	-20.8	-20.2	-17.6	0.8	4.8	6.2
Stockbuilding (% of GDP)	-2.2	-0.5	0.2	0.5	0.5	0.5
Government consumption	-9.1	-6.7	-7.7	-4.1	-0.7	1.2
Exports of goods and services	-0.9	-6.2	1.0	3.9	4.6	3.6
Imports of goods and services	-8.0	-15.8	-5.9	0.5	2.6	3.2
Consumer prices	3.1	1.0	0.3	0.1	0.4	0.8
Unemployment rate (level)	17.7	24.2	27.8	28.4	27.8	27.6
Current account balance (% of GDP)	-9.9	-4.8	-4.6	-4.0	-3.7	-3.5
Government budget (% of GDP)	-9.4	-8.3	-6.2	-5.4	-5.6	-5.7
Government debt (% of GDP)	170.6	166.0	177.7	183.3	184.8	185.0

Ireland

- According to the latest review by the EU and IMF, economic reforms in Ireland remain on track, with the Government expected to regain full market access by the beginning of 2014, when the bailout money runs out. Indeed, 10-year government bond yields have fallen drastically in recent months and are trading at less than 5% — well below their peak of over 14% in July last year and lower than their Spanish equivalents.
- But economic reforms, though necessary to put Ireland on a stable long-term growth path, are contributing to tough operating conditions in the near term and the outlook for domestic demand is weak. Indeed, the economy is still in recession and GDP growth is expected to remain flat in 2012 overall before picking up to grow 1% in 2013 and 1.9% in 2014, driven almost entirely by exports. Therefore, severe challenges for economic policy remain.

Figure 29

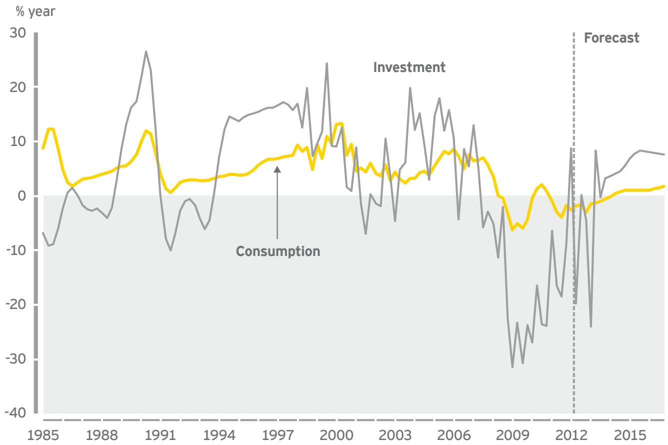
Long-term government bond yields



Source: Oxford Economics; Haver Analytics

Figure 30

Consumption and investment



Source: Oxford Economics

Table 10

Ireland (annual percentage changes unless specified)

Source: Oxford Economics

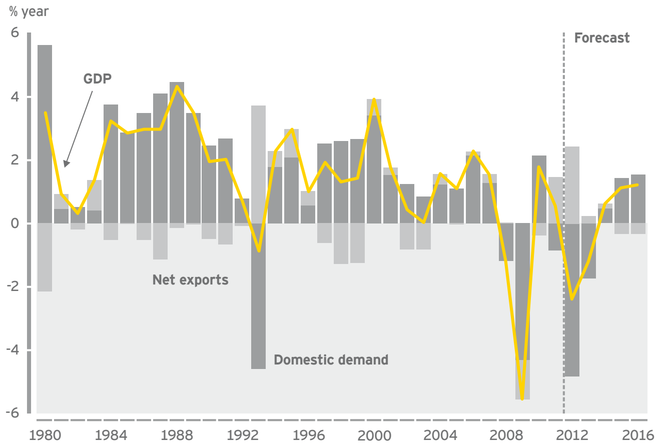
	2011	2012	2013	2014	2015	2016
GDP	1.4	0.0	1.0	1.9	2.2	2.8
Private consumption	-2.4	-2.3	-1.1	0.5	1.0	1.4
Fixed investment	-12.7	-3.8	-4.9	4.5	7.8	7.8
Stockbuilding (% of GDP)	0.1	-0.1	0.0	0.0	0.0	0.0
Government consumption	-4.3	-4.4	-2.2	-1.3	-0.9	-0.8
Exports of goods and services	5.0	3.2	2.9	4.4	3.9	3.8
Imports of goods and services	-0.3	1.1	1.7	4.2	3.9	3.3
Consumer prices	1.2	2.0	1.3	1.2	1.4	1.5
Unemployment rate (level)	14.5	14.9	15.3	15.2	14.9	14.5
Current account balance (% of GDP)	1.1	3.5	3.9	3.9	3.8	3.7
Government budget (% of GDP)	-13.3	-8.6	-6.8	-4.6	-3.1	-2.0
Government debt (% of GDP)	106.4	113.2	117.2	118.2	117.2	114.3

Italy

- Italy's GDP contracted for the fifth successive quarter in Q3 2012, and was down 2.4% on the year, as companies struggle in the wake of tighter credit conditions and plunging demand. The recession is expected to last into 2013, with GDP now forecast to fall 2.1% in 2012 and 1.1% in 2013.
- The Government revised its austerity plan for 2013 in an attempt to boost growth. But rising public debt — seen peaking at 127% of GDP in 2013 — will raise pressure from the EU to implement further consolidation, which in turn would risk keeping the economy in a vicious circle of austerity and recession and make intervention by the ECB more likely.
- The banking sector will remain under strain, as banks piled up troubled Italian government bonds and face a surge of bad debts. This will restrain credit to companies and households and weigh on the recovery. We now forecast GDP growth will average just 1% in 2014–16.

Figure 31

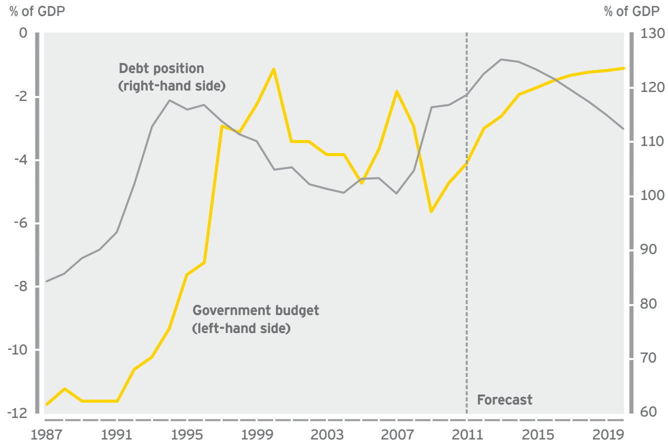
Contributions to GDP growth



Source: Oxford Economics

Figure 32

Government balance and debt



Source: Oxford Economics

Table 11

Italy (annual percentage changes unless specified)

Source: Oxford Economics

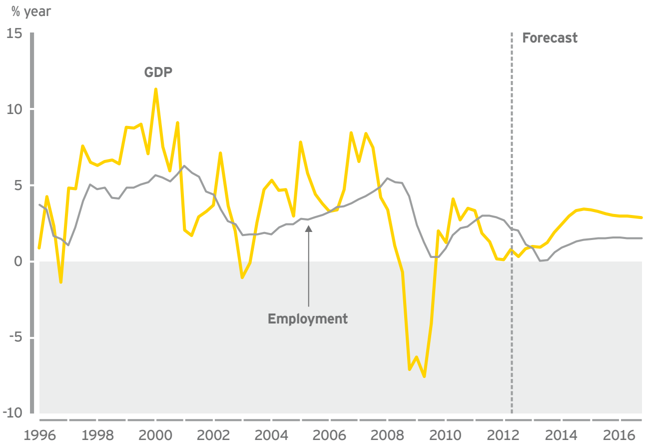
	2011	2012	2013	2014	2015	2016
GDP	0.6	-2.1	-1.1	0.3	1.1	1.2
Private consumption	0.1	-3.4	-1.4	0.0	0.9	1.4
Fixed investment	-1.3	-8.4	-2.9	1.8	3.1	3.1
Stockbuilding (% of GDP)	0.0	-0.8	-0.7	-0.5	-0.2	-0.1
Government consumption	-0.8	-0.9	-2.2	-1.0	0.1	0.4
Exports of goods and services	6.7	1.0	1.0	2.1	3.0	2.3
Imports of goods and services	1.2	-7.8	-1.0	2.2	4.8	3.7
Consumer prices	2.9	3.3	2.4	1.8	1.1	1.2
Unemployment rate (level)	8.4	10.7	12.1	12.3	11.8	11.3
Current account balance (% of GDP)	-3.1	-1.4	-0.6	-0.8	-1.1	-1.4
Government budget (% of GDP)	-3.9	-2.7	-2.2	-1.9	-1.7	-1.5
Government debt (% of GDP)	120.7	124.6	126.6	126.7	125.5	124.0

Luxembourg

- Net trade has remained a drag on growth in 2012 and will not contribute more noticeably until 2014. Until then, domestic demand will continue to drive rather weak growth — albeit still outperforming the Eurozone — despite a weak performance by the banking sector.
- With the gradual stabilization of the Eurozone, growth in the banking sector should add impetus to growth from 2014. This will be generated by non-banking financial services, which have been more resilient, and a boost in services exports.
- The draft budget for 2013 contains savings measures able to consolidate the fiscal position in the medium term, despite very benign debt levels at below 20% of GDP. In order to consolidate long-term finances, Luxembourg will also need to move ahead with adjustments in the health and pension systems.

Figure 33

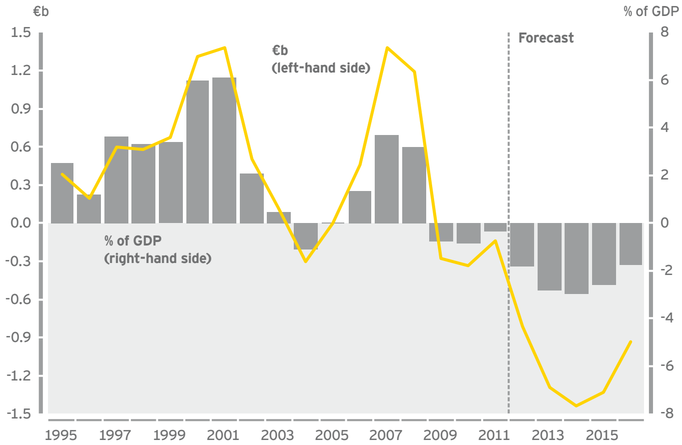
Real GDP and employment



Source: Oxford Economics

Figure 34

Government budget balance



Source: Oxford Economics

Table 12

Luxembourg (annual percentage changes unless specified)

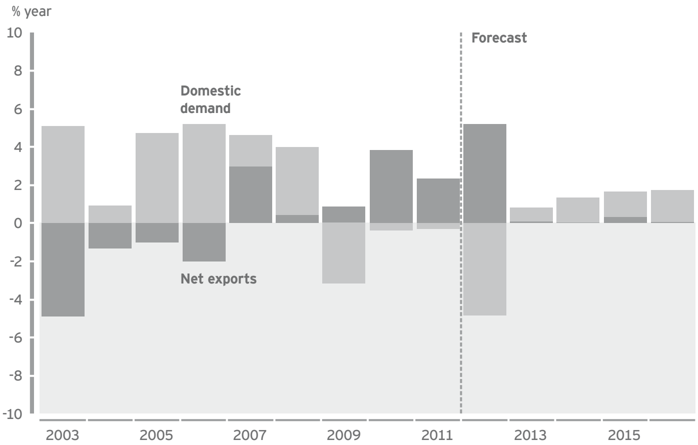
Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	1.7	0.5	1.3	3.1	3.2	3.0
Private consumption	2.4	2.0	1.5	3.0	2.7	2.4
Fixed investment	10.2	6.9	7.0	3.0	1.7	1.2
Stockbuilding (% of GDP)	3.7	1.6	0.0	0.2	-0.9	-0.9
Government consumption	1.5	3.4	2.0	2.0	1.9	1.8
Exports of goods and services	6.0	-3.8	2.9	6.2	5.7	4.2
Imports of goods and services	8.6	-4.1	3.2	6.6	4.9	3.8
Consumer prices	3.7	2.8	2.1	2.0	2.0	2.0
Unemployment rate (level)	4.8	5.2	6.1	6.1	5.9	5.3
Current account balance (% of GDP)	7.1	5.6	5.3	5.8	7.1	7.5
Government budget (% of GDP)	-0.3	-1.8	-2.8	-3.0	-2.6	-1.7
Government debt (% of GDP)	18.3	19.3	21.5	23.4	24.9	25.4

Malta

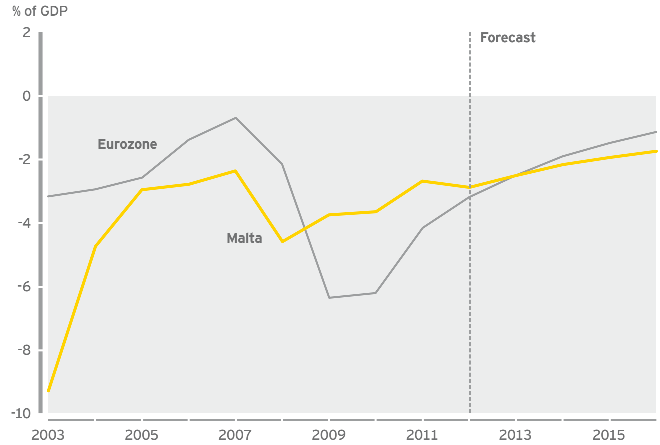
- The contrast between weakness in the domestic economies and robust export growth seen across the Eurozone is also apparent in Malta. But while export oriented sectors like tourism and financial services are major contributors to economic activity, growth will need to be more broadly based to be sustained.
- Growth will also remain constrained by the need to tighten fiscal policy and subdued activity in the Eurozone, and to a lesser extent the UK. After a year of near-stagnation in 2012, we expect GDP growth of 0.8% in 2013 and 1.5% a year on average in 2014-16.
- But growth in some parts of the economy is minimal. We estimate that investment has shrunk by 9% in 2012, to well below pre-crisis peaks. Given the weak external prospects, we expect only a slow recovery, with investment still below its pre-crisis peak by 2016. This will constrain employment in sectors other than tourism, which has performed well so far in 2012 despite weak Eurozone demand.

Figure 35
Contributions to GDP



Source: Oxford Economics

Figure 36
Fiscal balance vs. Eurozone



Source: Oxford Economics

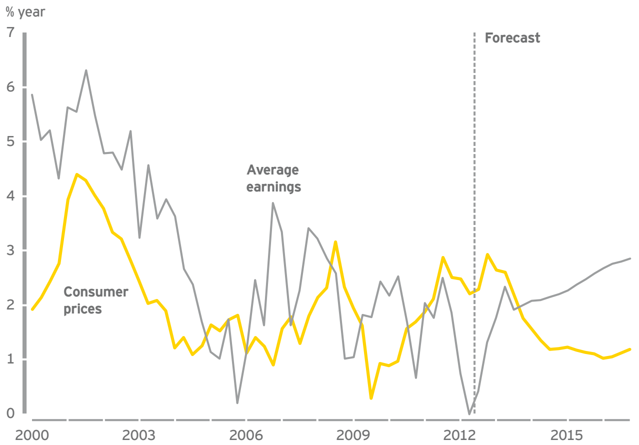
Table 13
Malta (annual percentage changes unless specified)
Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	1.9	0.3	0.8	1.3	1.6	1.7
Private consumption	4.0	-4.8	0.0	1.3	1.4	1.5
Fixed investment	-14.6	-9.0	2.0	4.0	2.8	2.5
Stockbuilding (% of GDP)	-1.7	-2.3	-1.8	-1.8	-1.8	-1.6
Government consumption	3.2	-0.9	0.1	0.7	0.8	1.3
Exports of goods and services	2.5	4.3	2.5	2.7	3.0	2.7
Imports of goods and services	0.1	-1.2	2.7	3.0	3.0	3.0
Consumer prices	2.5	3.1	2.3	2.0	1.8	2.0
Unemployment rate (level)	6.5	6.5	6.7	6.2	5.5	4.7
Current account balance (% of GDP)	-3.1	1.4	0.2	0.0	-0.1	-0.1
Government budget (% of GDP)	-2.7	-2.9	-2.5	-2.2	-1.9	-1.7
Government debt (% of GDP)	70.8	71.3	71.7	71.5	71.1	70.3

Netherlands

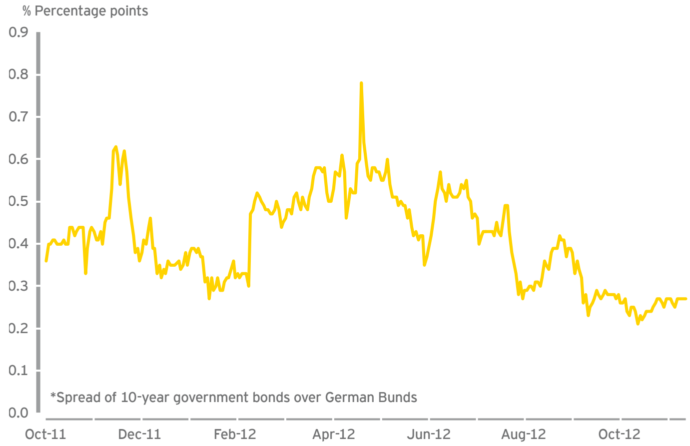
- The short-term outlook remains very challenging, with the economy on the verge of sinking back into recession. GDP fell by just over 1% in Q3 2012 as export demand declined and added to the drag from the domestic economy. Recovery from next year is likely to be slow. Though the squeeze on consumers should steadily ease, the pickup in external demand will be slow. The Eurozone is set for a very weak and protracted recovery, while the domestic austerity program will be a further drag. Our forecast shows GDP falling by 0.9% in 2012 and 0.4% in 2013, before a weak recovery sees expansion of just 1% a year in 2014–16.
- The rapid formation of a two-party coalition promises greater political stability. However, its plan for further austerity is a retrograde step. There is room to pursue a slower pace of deficit reduction without compromising market sentiment or the AAA rating. The current plan will weigh heavily on growth and may ultimately compromise the ability of the Government to balance the budget.

Figure 37
Prices and earnings



Source: Oxford Economics

Figure 38
Government bond spread*



Source: Haver Analytics

Table 14
Netherlands (annual percentage changes unless specified)
Source: Oxford Economics

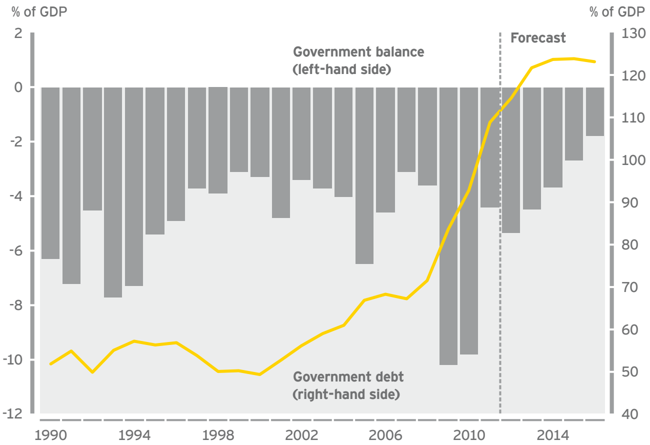
	2011	2012	2013	2014	2015	2016
GDP	1.1	-0.9	-0.4	0.9	1.0	1.1
Private consumption	-1.0	-1.5	-0.9	0.0	0.5	0.9
Fixed investment	5.7	-4.5	-0.1	1.5	2.1	2.1
Stockbuilding (% of GDP)	0.7	0.8	0.4	0.3	0.3	0.3
Government consumption	0.1	0.5	-0.4	-0.3	-0.3	-0.1
Exports of goods and services	3.9	2.6	1.7	3.3	3.5	3.1
Imports of goods and services	3.6	2.4	1.2	2.7	3.4	3.1
Consumer prices	2.5	2.8	2.3	1.3	1.2	1.1
Unemployment rate (level)	4.4	5.2	6.1	6.3	6.3	6.1
Current account balance (% of GDP)	9.7	8.2	7.1	7.4	7.6	7.9
Government budget (% of GDP)	-4.5	-3.7	-3.2	-3.0	-2.7	-2.4
Government debt (% of GDP)	65.5	69.3	71.7	73.3	74.5	75.1

Portugal

- In its 2013 budget, the Portuguese Government unveiled some of the harshest austerity measures seen in the past few years in an attempt to meet the fiscal deficit target of 4.5% of GDP set by the EU and the IMF. Although the IMF has expressed strong support for the latest package of measures, we feel that these pose the risk of plunging the economy into a vicious downward spiral. We have downgraded our growth forecast in 2013 and now expect GDP to decline by 2.6%, compared with a fall of 2% projected in our Autumn 2012 report.
- Additional austerity is likely to dent domestic demand. Higher taxes and job cuts in the public sector will damage individuals' disposable incomes and lead to higher unemployment, while lower consumer demand will dampen companies' propensity to invest. As such, both consumer spending and investment are likely to fall over the coming year.

Figure 39

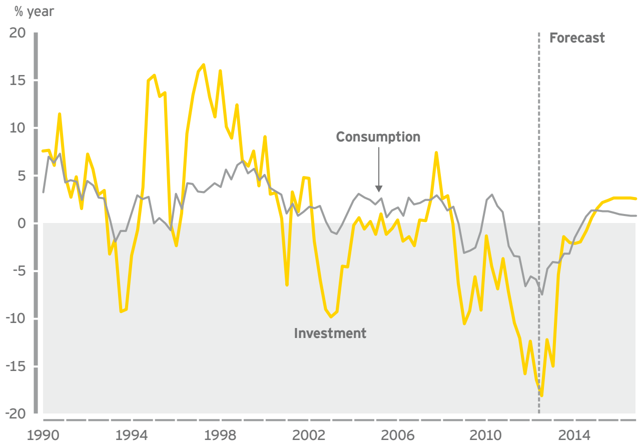
Government balance and debt



Source: Oxford Economics

Figure 40

Consumption and investment



Source: Oxford Economics

Table 15

Portugal (annual percentage changes unless specified)

Source: Oxford Economics

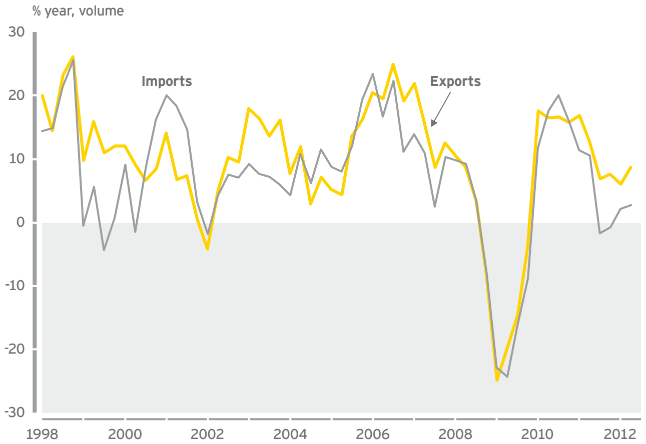
	2011	2012	2013	2014	2015	2016
GDP	-1.6	-3.2	-2.6	0.7	1.4	1.3
Private consumption	-4.0	-6.0	-3.5	0.1	1.2	0.8
Fixed investment	-11.3	-15.1	-6.9	0.0	2.2	2.6
Stockbuilding (% of GDP)	-0.7	-0.5	-0.2	0.3	0.0	0.0
Government consumption	-3.8	-3.5	-3.5	-0.3	1.6	1.2
Exports of goods and services	7.5	5.3	2.5	2.8	3.9	3.4
Imports of goods and services	-5.3	-5.8	-0.5	2.1	3.3	3.3
Consumer prices	3.6	2.8	1.1	0.8	0.8	0.8
Unemployment rate (level)	12.9	15.6	17.1	17.5	17.2	16.8
Current account balance (% of GDP)	-6.5	-1.8	-1.0	-0.8	-0.7	-0.7
Government budget (% of GDP)	-4.4	-5.4	-5.3	-3.7	-2.7	-1.8
Government debt (% of GDP)	108.1	117.2	124.9	126.4	126.0	124.9

Slovakia

- Slovakia's recent model of export-led growth will be tested in 2013 by a number of challenges. Weak Eurozone demand means the external environment will remain difficult, and capacity constraints will begin to bind in key export sectors. So export growth is expected to slow from an estimated 7.6% in 2012 to 4.2% in 2013.
- There is likely to be a mild rebalancing of demand toward domestic sources in 2013 as consumption and fixed investment recover from their estimated contraction in 2012. However, the economy will remain fundamentally reliant on foreign demand, meaning Slovakia will struggle to improve on its 2012 performance. GDP growth is forecast to remain at 2.3% in 2013, the same as in 2012.
- Persistent structural problems in the labor market are unlikely to alleviate much in 2013. Inflation is forecast to come down only slowly, from 3.7% in 2012 to 3% in 2013. In addition, growth will not be fast enough to bring unemployment down much below 14%.

Figure 41

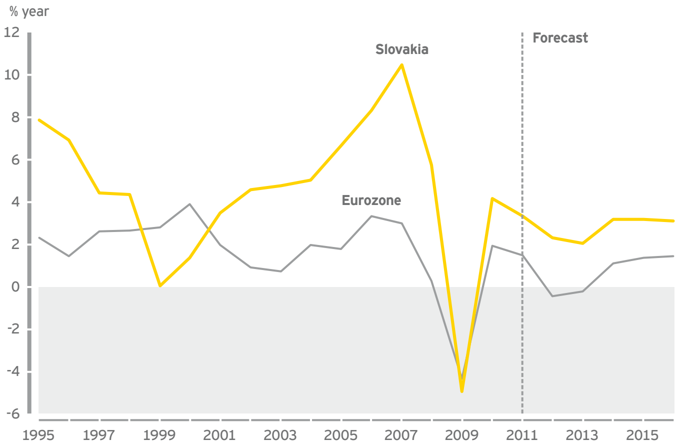
Exports and imports



Source: Haver Analytics

Figure 42

Real GDP growth



Source: Oxford Economics

Table 16

Slovakia (annual percentage changes unless specified)

Source: Oxford Economics

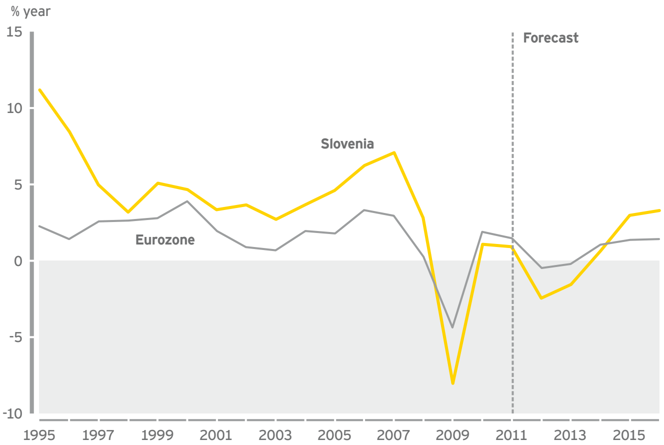
	2011	2012	2013	2014	2015	2016
GDP	3.2	2.3	2.3	3.2	3.2	3.1
Private consumption	-0.4	-0.2	1.0	2.3	2.6	2.5
Fixed investment	5.7	-1.0	1.6	4.1	4.3	4.6
Stockbuilding (% of GDP)	-1.7	-1.2	-0.6	-0.5	0.1	0.6
Government consumption	-3.5	-0.2	1.6	2.5	2.3	2.5
Exports of goods and services	10.8	7.6	4.2	4.7	4.3	4.3
Imports of goods and services	4.5	5.5	4.1	4.7	4.9	5.0
Consumer prices	3.9	3.7	3.0	2.3	2.1	2.1
Unemployment rate (level)	13.6	13.9	13.8	12.8	11.6	10.8
Current account balance (% of GDP)	0.1	1.2	0.7	0.4	-0.3	-0.8
Government budget (% of GDP)	-4.9	-4.8	-3.9	-3.5	-3.1	-2.8
Government debt (% of GDP)	43.3	46.6	48.7	49.8	50.4	50.6

Slovenia

- The outlook for Slovenia continues to deteriorate. With the Eurozone mired in recession, economic activity has weakened further as demand for Slovenian exports is faltering. In addition, domestic demand is not expected to support growth. There are historically low levels of confidence among consumers and businesses, as pressures from investors for more austerity measures depress consumption and investment.
- In view of this, we forecast a more severe recession than envisaged earlier, with GDP expected to fall 2.4% this year followed by a further 1.5% drop in 2013.
- As most of the austerity measures will not be effective before next year, the Government is almost certain to miss its deficit target of 3.5% of GDP for this year. We expect a deficit of 5.2% this year and 4.7% of GDP in 2013. As a result, public debt should peak at 60% of GDP in 2015 before it starts to fall gradually as economic activity finally gains momentum.

Figure 43

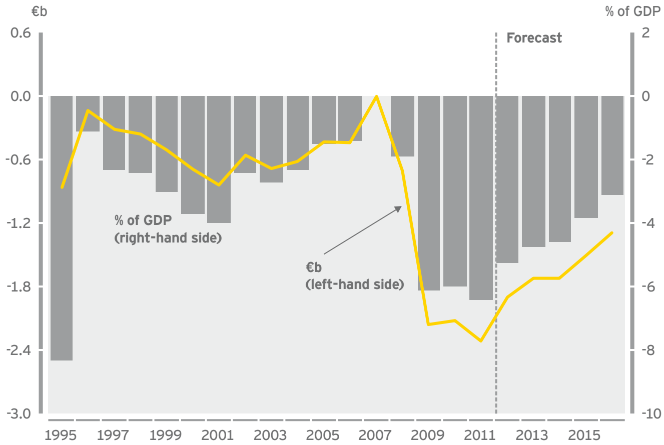
Real GDP growth



Source: Oxford Economics

Figure 44

Government budget balance



Source: Oxford Economics

Table 17

Slovenia (annual percentage changes unless specified)

Source: Oxford Economics

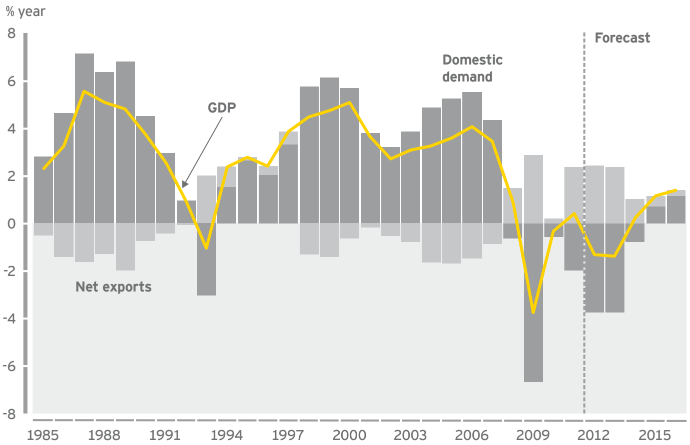
	2011	2012	2013	2014	2015	2016
GDP	1.0	-2.4	-1.5	0.7	3.0	3.3
Private consumption	1.0	-2.0	-1.8	0.5	1.5	1.8
Fixed investment	-8.3	-7.5	-2.1	1.9	4.5	4.0
Stockbuilding (% of GDP)	1.6	0.5	-0.3	-0.5	0.3	0.9
Government consumption	-1.2	-2.7	-2.4	0.3	1.0	1.4
Exports of goods and services	8.0	0.1	1.4	2.6	3.0	3.5
Imports of goods and services	6.1	-2.4	-0.1	2.5	2.8	2.9
Consumer prices	1.8	2.7	2.2	2.0	2.1	2.2
Unemployment rate (level)	8.2	8.5	9.0	9.5	8.5	7.7
Current account balance (% of GDP)	0.0	0.8	1.6	1.8	2.0	2.4
Government budget (% of GDP)	-6.4	-5.2	-4.7	-4.6	-3.8	-3.1
Government debt (% of GDP)	46.9	52.1	56.4	59.5	60.4	60.3

Spain

- The continuing improvement in Spain's competitiveness has made us more optimistic about export prospects, resulting in a modest upward revision to our near-term GDP forecasts. Following an expected decline of 1.3% in 2012, we now expect GDP to decline by 1.4% in 2013, with positive, albeit sluggish, growth of 0.3% forecast for 2014.
- But at the same time, we have raised our forecasts for the budget deficit to 8.2% of GDP in 2012 and 6.5% in 2013. We believe that attempting to correct these overshoots with even more austerity measures will likely prove self-defeating, as they would merely deepen and prolong the recession.
- The upward revisions to our headline GDP growth forecasts belie the deep uncertainty that continues to shroud the outlook. Although the immediate threat to Spain of a forced exit from the Eurozone has been reduced, more still needs to be done to address the interplay between sovereign and banking-sector risks.

Figure 45

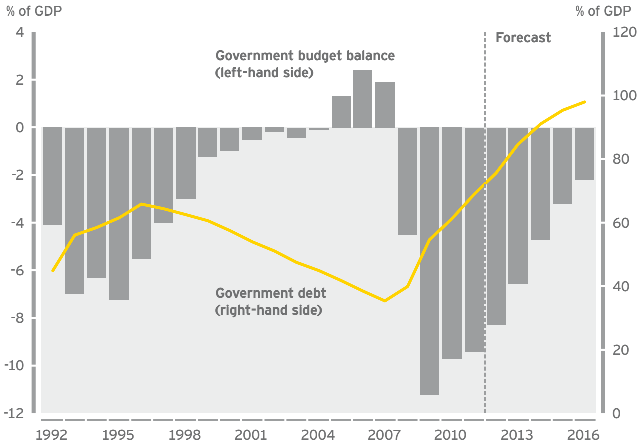
Contributions to GDP growth



Source: Oxford Economics

Figure 46

Government balance and debt



Source: Oxford Economics

Table 18

Spain (annual percentage changes unless specified)

Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	0.4	-1.3	-1.4	0.3	1.2	1.4
Private consumption	-1.0	-1.8	-2.0	-0.1	1.0	1.4
Fixed investment	-5.3	-8.8	-5.5	-0.2	2.0	2.1
Stockbuilding (% of GDP)	0.6	0.6	0.3	0.3	0.3	0.3
Government consumption	-0.5	-4.1	-5.7	-3.4	-1.0	-0.3
Exports of goods and services	7.6	3.7	5.5	4.1	4.4	3.4
Imports of goods and services	-0.9	-4.5	-2.3	1.1	3.8	3.3
Consumer prices	3.1	2.4	1.8	1.0	0.9	1.0
Unemployment rate (level)	21.7	25.0	26.5	26.6	25.9	25.3
Current account balance (% of GDP)	-3.5	-2.3	-1.4	-1.3	-1.1	-1.0
Government budget (% of GDP)	-9.4	-8.2	-6.5	-4.7	-3.2	-2.2
Government debt (% of GDP)	69.3	79.0	87.8	93.7	97.4	99.7

Detailed tables and charts

Forecast assumptions

	2011	2012	2013	2014	2015	2016
Short-term interest rates (%)	1.4	0.6	0.3	0.3	0.4	0.5
Long-term interest rates (%)	4.4	4.0	3.5	3.6	3.8	4.1
Euro effective exchange rate (1995 = 100)	120.8	115.4	115.3	112.9	110.2	110.3
Oil prices (€/barrel)	80.0	86.5	80.2	87.9	96.1	100.0
Share prices (% year)	-7.1	-5.3	6.0	9.2	9.5	8.6

	2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Short-term interest rates (%)	1.1	1.4	1.6	1.5	1.0	0.7	0.4	0.3
Long-term interest rates (%)	4.3	4.5	4.3	4.5	4.4	4.3	4.0	3.4
Euro effective exchange rate (1995 = 100)	119.4	122.4	121.2	120.4	116.8	115.8	113.3	115.8
Oil prices (€/barrel)	76.6	81.7	80.2	81.2	90.3	84.7	87.7	83.2
Share prices (% year)	-0.7	10.7	-20.7	-17.1	-14.9	-20.5	12.6	8.7

Eurozone GDP and components

Quarterly forecast
(quarterly percentage changes)

	2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	0.6	0.2	0.1	-0.3	0.0	-0.2	-0.1	-0.3
Private consumption	0.0	-0.4	0.2	-0.5	-0.2	-0.4	-0.1	-0.3
Fixed investment	2.0	-0.2	-0.4	-0.5	-1.2	-1.5	-0.8	-0.7
Government consumption	-0.2	0.1	-0.2	0.0	0.1	0.0	-0.2	-0.3
Exports of goods and services	1.6	0.6	1.5	-0.1	0.7	1.3	0.9	0.3
Imports of goods and services	1.2	0.2	0.4	-1.4	-0.2	0.6	0.3	0.0

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

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

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

	2011	2012	2013	2014	2015	2016
GDP	8,598	8,563	8,547	8,636	8,755	8,883
Private consumption	4,855	4,807	4,790	4,822	4,875	4,937
Fixed investment	1,626	1,568	1,546	1,579	1,624	1,669
Government consumption	1,837	1,835	1,818	1,813	1,820	1,831
Stockbuilding	42	-10	-18	-17	-18	-22
Exports of goods and services	3,769	3,881	3,986	4,148	4,330	4,507
Imports of goods and services	3,530	3,518	3,576	3,708	3,875	4,039

Annual levels — nominal terms
(€ billion)

	2011	2012	2013	2014	2015	2016
GDP	9,417	9,501	9,606	9,833	10,105	10,395
Private consumption	5,405	5,466	5,551	5,667	5,802	5,953
Fixed investment	1,803	1,760	1,752	1,813	1,890	1,969
Government consumption	2,031	2,048	2,057	2,079	2,118	2,163
Stockbuilding	42	-25	-74	-44	-11	-1
Exports of goods and services	4,144	4,342	4,529	4,793	5,090	5,385
Imports of goods and services	4,008	4,090	4,209	4,474	4,783	5,075

Prices and cost indicators

(annual percentage changes unless specified)

	2011	2012	2013	2014	2015	2016
HICP headline inflation	2.7	2.5	1.9	1.5	1.3	1.3
Inflation ex-energy	1.7	1.8	1.8	1.4	1.2	1.2
GDP deflator	1.2	1.3	1.3	1.3	1.4	1.4
Import deflator	5.1	4.0	1.7	1.8	1.8	1.6
Export deflator	10.3	3.3	-0.3	2.2	2.1	1.5
Terms of trade	5.1	-0.7	-2.0	0.4	0.3	-0.2
Earnings	2.3	1.6	1.2	1.9	2.2	2.4
Unit labor costs	0.9	1.3	0.5	0.7	1.1	1.2
Output gap (% of GDP)	-2.2	-2.9	-3.8	-3.7	-3.4	-3.1
Oil prices (€ per barrel)	80.0	86.5	80.2	87.9	96.1	100.0
Euro effective exchange rate (1995 = 100)	120.8	115.4	115.3	112.9	110.2	110.3

	2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
HICP headline inflation	2.5	2.8	2.7	2.9	2.7	2.5	2.5	2.3
Inflation ex-energy	1.3	1.7	1.7	2.0	1.9	1.8	1.8	1.7
GDP deflator	1.1	1.2	1.2	1.3	1.2	1.2	1.4	1.4
Import deflator	7.3	4.4	3.9	5.0	3.9	4.4	4.0	3.7
Export deflator	15.5	10.0	7.6	8.4	6.2	5.1	1.3	0.7
Terms of trade	8.2	5.6	3.7	3.4	2.3	0.7	-2.8	-3.0
Earnings	2.2	2.3	2.4	2.4	2.1	1.6	1.5	1.2
Unit labor costs	0.0	1.0	1.1	1.5	1.5	1.4	1.4	0.9
Output gap (% of GDP)	-2.3	-2.0	-2.0	-2.4	-2.5	-2.8	-3.0	-3.5
Oil prices (€ per barrel)	76.6	81.7	80.2	81.2	90.3	84.7	87.7	83.2
Euro effective exchange rate (1995 = 100)	119.4	122.4	121.2	120.4	116.8	115.8	113.3	115.8

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

Labor market indicators

(annual percentage changes unless specified)

	2011	2012	2013	2014	2015	2016
Employment	0.3	-0.7	-0.8	-0.1	0.2	0.2
Unemployment rate (%)	10.2	11.4	12.3	12.3	12.0	11.7
NAIRU (%)	8.1	8.2	8.5	8.5	8.4	8.3
Participation rate (%)	74.3	75.0	75.3	75.5	75.6	75.7
Earnings	2.3	1.6	1.2	1.9	2.2	2.4
Unit labor costs	0.9	1.3	0.5	0.7	1.1	1.2

	2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Employment	0.4	0.5	0.3	-0.1	-0.5	-0.6	-0.7	-0.8
Unemployment rate (%)	9.9	9.9	10.2	10.6	10.9	11.3	11.5	11.9
NAIRU (%)	8.1	8.1	8.1	8.1	8.1	8.2	8.2	8.3
Participation rate (%)	74.0	74.2	74.4	74.5	74.6	75.0	75.1	75.2
Earnings	2.2	2.3	2.4	2.4	2.1	1.6	1.5	1.2
Unit labor costs	0.0	1.0	1.1	1.5	1.5	1.4	1.4	0.9

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

Current account and fiscal balance

	2011	2012	2013	2014	2015	2016
Trade balance (€b)	-7.7	94.9	149.3	151.4	142.3	147.3
Trade balance (% of GDP)	-0.1	1.1	1.7	1.8	1.6	1.7
Current account balance (€b)	-3.1	87.0	112.7	109.9	101.9	99.3
Current account balance (% of GDP)	0.0	0.9	1.2	1.1	1.0	1.0
Government budget balance (€b)	-389	-314	-251	-204	-168	-136
Government budget balance (% of GDP)	-4.1	-3.3	-2.6	-2.1	-1.7	-1.3
Cyclically adjusted surplus (+)/deficit (-) (% of GDP)	-3.7	-2.8	-2.1	-1.5	-1.1	-0.7
Government debt (€b)	8,297	8,830	9,151	9,484	9,826	10,126
Government debt (% of GDP)	96.5	103.1	107.1	109.8	112.2	114.0

Measures of convergence and divergence within the Eurozone

	2002-2006	2007-2011	2012-2016
Growth and incomes			
Standard deviation of GDP growth rates	1.9	2.3	1.3
Growth rate gap (max-min)	6.6	9.1	5.1
Highest GDP per capita (Eurozone = 100)	238.6	242.8	243.2
Lowest GDP per capita (Eurozone = 100)	53.4	66.5	65.8
Inflation and prices			
Standard deviation of inflation rates	1.3	1.0	0.6
Inflation rate gap (max-min)	5.4	4.0	2.2
Highest price level (Eurozone = 100)	122.5	121.7	119.8
Lowest price level (Eurozone = 100)	52.1	67.7	71.5

Cross-country tables

Real GDP
(% year)

Rank		2011	2012	2013	2014	2015	2016	Average 2012–2016
1	Estonia	8.3	2.8	3.1	4.0	4.2	4.2	**3.7**
2	Slovakia	3.2	2.3	2.3	3.2	3.2	3.1	**2.8**
3	Luxembourg	1.7	0.5	1.3	3.1	3.2	3.0	**2.2**
4	Ireland	1.4	0.0	1.0	1.9	2.2	2.8	**1.6**
5	Germany	3.1	1.0	0.8	1.7	1.7	1.6	**1.3**
6	Finland	2.7	0.4	0.5	1.2	2.1	2.4	**1.3**
7	Austria	2.7	0.5	0.9	1.8	1.5	1.5	**1.2**
8	Malta	1.9	0.3	0.8	1.3	1.6	1.7	**1.1**
9	France	1.7	0.1	0.2	1.1	1.2	1.3	**0.8**
10	Eurozone	1.5	-0.4	-0.2	1.0	1.4	1.5	**0.7**
11	Belgium	1.8	-0.2	-0.1	1.0	1.2	1.4	**0.6**
12	Slovenia	1.0	-2.4	-1.5	0.7	3.0	3.3	**0.6**
13	Netherlands	1.1	-0.9	-0.4	0.9	1.0	1.1	**0.3**
14	Spain	0.4	-1.3	-1.4	0.3	1.2	1.4	**0.0**
15	Italy	0.6	-2.1	-1.1	0.3	1.1	1.2	**-0.1**
16	Portugal	-1.6	-3.2	-2.6	0.7	1.4	1.3	**-0.5**
17	Cyprus	0.5	-2.3	-2.3	-1.2	0.7	2.5	**-0.5**
18	Greece	-7.2	-5.9	-4.3	-1.1	1.0	1.5	**-1.8**

Inflation rates
(% year)

Rank		2011	2012	2013	2014	2015	2016	Average 2012–2016
1	Greece	3.1	1.0	0.3	0.1	0.4	0.8	**0.5**
2	Portugal	3.6	2.8	1.1	0.8	0.8	0.8	**1.2**
3	Spain	3.1	2.4	1.8	1.0	0.9	1.0	**1.4**
4	Ireland	1.2	2.0	1.3	1.2	1.4	1.5	**1.5**
5	France	2.3	2.3	1.6	1.6	1.4	1.3	**1.6**
6	Eurozone	2.7	2.5	1.9	1.5	1.3	1.3	**1.7**
7	Germany	2.5	2.1	1.8	1.7	1.5	1.5	**1.7**
8	Netherlands	2.5	2.8	2.3	1.3	1.2	1.1	**1.7**
9	Finland	3.3	3.0	2.6	1.3	1.2	1.2	**1.9**
10	Italy	2.9	3.3	2.4	1.8	1.1	1.2	**2.0**
11	Austria	3.6	2.5	2.2	1.8	1.8	1.8	**2.0**
12	Belgium	3.4	2.7	2.1	1.9	2.0	1.9	**2.1**
13	Cyprus	3.5	3.3	2.0	1.5	1.8	2.3	**2.2**
14	Luxembourg	3.7	2.8	2.1	2.0	2.0	2.0	**2.2**
15	Malta	2.5	3.1	2.3	2.0	1.8	2.0	**2.2**
16	Slovenia	1.8	2.7	2.2	2.0	2.1	2.2	**2.2**
17	Slovakia	3.9	3.7	3.0	2.3	2.1	2.1	**2.6**
18	Estonia	5.0	4.0	3.0	2.2	2.2	2.1	**2.7**

Cross-country tables

Unemployment rate
(% of labor force)

Rank		2011	2012	2013	2014	2015	2016	Average 2012–2016
1	Austria	4.2	4.4	4.9	4.6	4.3	4.2	**4.5**
2	Germany	6.0	5.6	5.7	5.6	5.4	5.2	**5.5**
3	Luxembourg	4.8	5.2	6.1	6.1	5.9	5.3	**5.7**
4	Malta	6.5	6.5	6.7	6.2	5.5	4.7	**5.9**
5	Netherlands	4.4	5.2	6.1	6.3	6.3	6.1	**6.0**
6	Finland	7.8	7.7	8.1	7.8	7.3	7.1	**7.6**
7	Belgium	7.2	7.3	7.9	8.1	7.9	7.7	**7.8**
8	Estonia	12.4	10.2	9.3	8.4	7.7	6.9	**8.5**
9	Slovenia	8.2	8.5	9.0	9.5	8.5	7.7	**8.6**
10	France	9.6	10.5	11.0	10.9	10.7	10.6	**10.7**
11	Italy	8.4	10.7	12.1	12.3	11.8	11.3	**11.6**
12	Eurozone	10.2	11.4	12.3	12.3	12.0	11.7	**11.9**
13	Slovakia	13.6	13.9	13.8	12.8	11.6	10.8	**12.6**
14	Cyprus	7.9	11.9	14.0	14.5	14.8	14.5	**13.9**
15	Ireland	14.5	14.9	15.3	15.2	14.9	14.5	**14.9**
16	Portugal	12.9	15.6	17.1	17.5	17.2	16.8	**16.8**
17	Spain	21.7	25.0	26.5	26.6	25.9	25.3	**25.9**
18	Greece	17.7	24.2	27.8	28.4	27.8	27.6	**27.2**

Government budget
(% of GDP)

Rank		2011	2012	2013	2014	2015	2016	Difference 2012–2016
1	Finland	-0.6	-0.7	-0.6	-0.6	-0.6	-0.6	**0.1**
2	Germany	-0.8	-0.2	-0.3	-0.4	-0.3	-0.1	**0.1**
3	Luxembourg	-0.3	-1.8	-2.8	-3.0	-2.6	-1.7	**0.1**
4	Italy	-3.9	-2.7	-2.2	-1.9	-1.7	-1.5	**1.2**
5	Malta	-2.7	-2.9	-2.5	-2.2	-1.9	-1.7	**1.2**
6	Estonia	1.0	-1.3	-1.1	-0.6	-0.2	-0.1	**1.2**
7	Austria	-2.5	-3.3	-2.7	-2.1	-1.9	-2.0	**1.3**
8	Netherlands	-4.5	-3.7	-3.2	-3.0	-2.7	-2.4	**1.3**
9	Eurozone	-4.1	-3.3	-2.6	-2.1	-1.7	-1.3	**2.0**
10	Slovakia	-4.9	-4.8	-3.9	-3.5	-3.1	-2.8	**2.0**
11	Slovenia	-6.4	-5.2	-4.7	-4.6	-3.8	-3.1	**2.1**
12	Belgium	-3.7	-3.5	-2.9	-2.2	-1.6	-1.0	**2.5**
13	Greece	-9.4	-8.3	-6.2	-5.4	-5.6	-5.7	**2.6**
14	France	-5.2	-4.7	-3.2	-2.5	-2.0	-1.7	**3.0**
15	Cyprus	-6.3	-5.5	-4.8	-4.1	-3.4	-2.1	**3.4**
16	Portugal	-4.4	-5.4	-5.3	-3.7	-2.7	-1.8	**3.6**
17	Spain	-9.4	-8.2	-6.5	-4.7	-3.2	-2.2	**6.0**
18	Ireland	-13.3	-8.6	-6.8	-4.6	-3.1	-2.0	**6.6**

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