Ernst & Young Eurozone Forecast

Winter edition

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Ernst & Young
Quality In Everything We Do

Foreword

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As 2010 draws to a close and we look forward to the coming year, the *Ernst & Young Eurozone Forecast* draws a picture of a very difficult, complex and uncertain state of affairs. As I meet with clients, one of the most common views I hear is that meaningful business planning has never been more difficult. Consequently, I find that our clients are becoming more and more interested in what is actually happening in the European economy and what its likely impact will be for them as a business. That interest and increased engagement is to be welcomed.

Our last forecast was gloomy, and this Winter forecast confirms our skeptical outlook. The Eurozone economy is slowing down after a strong expansion in the first three quarters of 2010. Our forecast growth rate of 1.4% in 2011 remains unchanged, but we now see greater downside risks. In our worst-case scenario, the Eurozone could fall into another period of recession, especially if the present crisis were to lead to a sovereign default. But even if this worst-case scenario does not materialize, the recovery we are entering is far from normal. Business investment and private consumption remain unusually slow. It is the leadership of business, rather than government officials that will play the central role in accelerating private sector investment.

The ongoing financial crisis is affecting another major trend: a growing divergence in economic performance between the north and south. While economic growth remains robust in the northern part of the Eurozone — with the exception of Ireland — the south is suffering from severe fiscal adjustment, falling house prices, a crash in the construction industry, higher market interest rates and increased concerns about solvency. The spread of growth rates ranged from -3.6% in Greece to +3.6% in Germany — and this even before Greece and other peripheral economies have started their fiscal adjustment programs. This divergence is likely to persist for several years.

Variable economic performance of member states across Europe, however, is neither new nor primarily driven by the collective policies of the European institutions. Indeed, there is a strong case for seeing the current "Eurozone crisis" as a collective attempt to deal with the consequences of national economic mismanagement in certain countries.

The divergence is particularly pronounced in the labor market. Our models suggest Eurozone unemployment will not fall below 15 million before 2013. While unemployment in northern member states will fall from 2011, it will not fall in the periphery for another year. But any business that operates across the Eurozone will have experience of variations in national practice that hinder employment in some states.

From a business perspective, what seems particularly striking about the recovery is that it is taking place without significant corporate investment. In our conversations with companies, we find a consistent pattern of cash hoarding. Companies are waiting for a clear signal of a rebound in global activity before they start to invest and this is also reflected in a lower level of M&A activity than we would expect.

One reason for the low rates of investment is the persistence of tight credit. Another is the prevalence of high corporate indebtedness, about 140% of GDP. Overall, we forecast a 1.1% fall in Eurozone investment in 2010 after a drop of 11.3% in 2009. As for the future, our feedback suggests that companies remain cautious, preferring smaller-scale projects they can fund from cash reserves and which produce immediate productivity gains.

Is there any upside amid this gloom? Germany has surprised us this year, and may do so yet again. The Eurozone's relatively good performance during the first three quarters of 2010 was primarily due to strong exports, but these arguably reflected restocking as much as growth in the global economy. The Eurozone's export market share, by way of contrast, did not improve markedly during that period. It is too soon to predict whether domestic demand in Germany will continue to strengthen.

The single overriding message for policy-makers is that economic policy must take into account the formidable risks to the recovery of the Eurozone and, if necessary, counteract them quickly and decisively. The ECB might need to depart from its planned monetary policy exit strategy, and adopt a more accommodating policy, should the negative scenarios in our forecast prevail.

The Eurozone's political leadership is confronted with an existential challenge to the future well-being of the Eurozone economy. It doesn't seem sustainable for the ECB, and wider Eurozone community, to continue to deal with the consequences of national mismanagement without having the power to prevent that mismanagement occurring or being repeated. The political decisions taken in the next few weeks with regard to Ireland, Portugal and Spain will have a much larger influence on the Eurozone economy in 2011 than any other foreseeable global and technological developments. Our forecast is thus subject to an unusually large degree of uncertainty.

According to our latest study, *Competing for growth*, senior executives around the world are expecting increased competition as they seek to return to profitable growth. Expanding their customer reach, enhancing their operational agility and strengthening their stakeholder's confidence are as important as securing ongoing cost competitiveness in determining future success. In this new environment, the Eurozone plays an even more important role — certainly for companies based in Europe. The creation of the single European market — and the role and management of the single currency — have never been more central to European businesses success.

I encourage you to visit www.ey.com/eef for additional information on the *Ernst & Young Eurozone Forecast* and the 16 individual member states.

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Weak economic recovery challenges business

Uncertain market prospects pressure companies towards increasing flexibility and faster changes of business strategy

Forecasts are always subject to some degree of uncertainty, but rarely has the degree of uncertainty been so great as it is right now, which makes this a particularly challenging time for business. As we state in our forecast, a sovereign default would have a severely negative impact on next year's growth. Even a financial crisis short of default could still cause significant damage, through the interest rate channel, as market rates have soared in several parts of the Eurozone, and through the confidence channel.

How can business create growth in such an unstable environment? As the Eurozone is diverging and the crisis strikes differently in different parts of it, you will have to analyze the risks and possibilities in different countries individually. Despite the political and economical turbulence, there are opportunities, depending on the extent to which a business can interpret current developments, and on its level of risk appetite.

Weak and uneven recovery

In their response to the financial crisis, European governments placed an unspoken bet. Governments everywhere placed a protective umbrella over their banks, hoping that future economic growth would take care of the problem. With a return of economic growth, bank profits would increase and balance sheets would improve. Low central bank interest rates would provide additional support to raise the profits of the banking sector.

The European financial crisis is an expression that this strategy has not worked. The financial markets no longer trust the story that growth will automatically take care of the financial sector's debts. Our forecast tells us why. The post-crisis economic recovery is weaker than governments had hoped — and, worse still, much more uneven. It is weakest where the debts are highest, in countries on the Eurozone's periphery.

In Ireland, the problems of the banking sector turned into a sovereign debt crisis when the Irish Government first guaranteed all debts, exempting the bondholders of all responsibility, and then nationalized large parts of the banking systems. As it turned out, Ireland's banks were not only too big to fail, but, more pertinently, too big to save. A bank solvency problem thus turned into a sovereign solvency problem. The Irish Government says it can grow out of its debts, projecting growth rates of 2.5% per year from 2011 onwards. Our forecast for Ireland is more cautious.

Risks and possibilities

The risk of doing business in the Eurozone periphery in general, and in Ireland specifically, currently dominates the opportunities that arise. In the case of Ireland, these opportunities include a continuing low corporate tax rate of 12.5%, despite the recent support package from the EU, and the recent fall in unit labor costs. The time to invest, or to re-enter those markets, is when the financial crisis shows signs of abating.

But once the immediate crisis subsides, Ireland — more so than Portugal and Spain — will be able to reap the benefits from a flexible adjustment to the crisis, because of downward wage flexibility. In Greece, a good time to invest would be when the Government starts — and succeeds politically — with its announced program of microeconomic reforms, which include the liberalization of labor markets and reforms to inject competition into product markets and eliminate the most egregious levels of corruption. Currently, the Government is focusing on fiscal, not structural, adjustment, and it is finding that the deficit reductions are much harder to implement, for the reason outlined above. The growth projections on which the debt reduction programs are based turned out to be too optimistic.

Based on the assumption that the Eurozone will have another three to four years of uncertainty, many companies are focusing on other markets outside the Eurozone. But growth by choosing to be present in emerging markets is not that simple. Going east may be a necessary strategy, but it will not be sufficient on its own. Our feedback from companies is that they remain cautious, unwilling to invest until they see a clearer picture of global economic growth. They are also aware of the fact that it takes up to a year to break even in a new market, and many companies do not have that time.

Two additional factors are weighing on companies. Both are indirect consequences of the credit crisis. The first is the need by the corporate sector to deleverage. European companies have traditionally relied heavily on bank finance, but this source of funding has been drying up during the crisis, forcing companies to deleverage. The second factor is Basel III, which will raise capital requirements for banks. As they will find it hard to raise sufficient capital to sustain current levels of lending, they may, at least partially, try to comply with the rules through more cautious lending policies. This, in combination with the crisis-induced need to deleverage, is likely to have an adverse impact on investment over a longer time horizon. Together, both factors suggest that investment growth rates in the coming decade are likely to be somewhat lower than in the previous one.

Improving performance by flexibility

What is our key message to companies? One important lesson from the crisis is the need for greater flexibility in the supply chain. We have never seen so much investment in outsourcing and new partnerships. This gives a company the possibility of investing in research and development, and product development, with a much lower risk than before. Since it will become more difficult to finance expansion through credit, the outsourcing and partnership trend will continue. You share the risk with several suppliers that are experts in their area and you do not have to burden your balance sheet. Among clients that are high performers, we see evidence of effective account management, focusing on the most profitable segments among their customers and trying to strengthen their position among current customers. Another way of increasing the return from existing customers is, of course, to broaden the range of products and services to meet the needs of the market better. Innovation is a key to growth, as well as opening new distribution channels.

Building trust among stakeholders

The financial crisis has increased the speed of development of new legislation and regulation, and it is important to monitor how changes in this area impact your business model and strategy. We are currently seeing proposals for, and changes in, the regulation of the financial market, including accounting changes impacting on what and how companies report, taxation, environmental controls, pension provisions and corporate governance. The financial crisis resulted in a lack of trust in many areas. Building trust with key stakeholders — i.e., investors and regulators, as well as the workforce and media — will be one of the most important measures for business leaders. Improving transparency, increasing the frequency of risk assessment and risk management, and producing reports that are understood by the stakeholders, are all important. Market conditions will change rapidly, which makes it even more important to conduct proper scenario planning and find out what balance there is in the risk assessment for your company.

The future: three scenarios

We think it is best to look at future developments in terms of three scenarios. In the optimistic scenario, economic growth picks up and the fiscal consolidation efforts by governments boost the confidence of financial markets. The positive impact on private sector investment would compensate for a drop in consumer demand. In this scenario, exports and investments support growth.

This is not our forecast. In our scenario, we will see very slow demand growth, and slow overall economic growth, as the fiscal adjustment programs start to bite. The positive developments in the first three quarters of 2010 were in part the consequences of the various discretionary stimulus programs, many of which only kicked in with some delays, and of a natural bounce-back effect after the steep crisis of 2009. Our average projection for economic growth in 2011 is 1.4%, which is lower than one would expect for this stage in the economic cycle, as private consumption and investment are still growing at relatively low rates.

This average hides a large deviation among member states. The prosperous countries in the north will generally outperform the south — or, more precisely, the Eurozone core will outperform the periphery. Germany will enjoy an economic growth rate of 3.5% in 2010, followed by rates of 2.1% in 2011 and 1.7% in 2012. Italy will grow at rates of close to 1% in each of those years, while in Spain, growth will turn only marginally positive in 2011 before the start of a slow recovery in 2012.

Our forecast is cautious but not alarmist. In our scenario, solvency is assured everywhere in the Eurozone. The risk to the Eurozone does not therefore stem from a scenario in which our forecast becomes true, but from a third, much more negative, scenario, in which growth falls below the level needed to sustain solvency in some parts of the Eurozone.

We conclude that the risks of our forecast are tilted to the downside, and the degree of the tilt will depend predominantly on the future development of the crisis. If the anti-crisis policies work, we will quickly return to our baseline scenario of modest, but unspectacular, growth. If the crisis persists — even without any dramatic events such as a sovereign default — growth will suffer across the Eurozone, albeit unevenly. If the crisis takes a dramatic turn for the worse, all bets are off. We would then move outside of any scenario that a forecast could conceivably capture.

Highlights

European Central Bank still needs a "plan B" as downside risks remain to the fore

- The European Central Bank (ECB) has appeared to close the door on following the US Federal Reserve and engaging in quantitative easing to boost the economy. Instead, the ECB has intimated a desire to start exiting from its accommodative monetary stance. But while growth in the core Eurozone economies has been stronger than expected over the last six months, the risks to the outlook mean the ECB may yet find itself having to look for ways to support demand and avoid a double-dip recession.

- The robust performance of the Eurozone economy in the first three quarters of 2010 hides large and widening differences between countries. In the year to Q3 2010, GDP growth ranged from -3.6% in Greece to +3.6% in Germany. This is even before the peripheral economies will have been hit by the full strength of deficit tightening measures.

- Divergent economic conditions are particularly manifest in the Eurozone labor markets and are expected to persist for several years. Overall, we do not expect the number of unemployed in the Eurozone to fall below 15 million before 2013. But while unemployment in the North of the Eurozone is expected to begin falling from early 2011, in the South this is not forecast to happen until one year later at the earliest.

- Our baseline forecast shows a moderate slowdown in the Eurozone next year. We forecast that GDP growth will fall to 1.4% in 2011 from 1.7% in 2010. In 2012-14, GDP growth should increase somewhat to average 1.9% over that period.

- The risks to the growth outlook are skewed to the downside. Financial tensions in the "peripheral" Eurozone states have risen again recently, culminating in the crisis in Ireland. In a worst-case scenario featuring a chain of sovereign debt defaults, our modeling suggests that the Eurozone could be plunged back into a deep recession.

- In this context, now is not the time to tighten monetary policy. Instead, the ECB should monitor the highly uncertain impact of fiscal tightening and developments in financial markets, and stand ready to provide more support, should current growth expectations prove too optimistic. If the Eurozone is hit by a new crisis, the ECB should be ready to loosen monetary policy further, be it by using similar measures as in 2009 and early 2010 or by resorting to quantitative easing.

- Much of the slowdown in 2011 is accounted for by fiscal tightening, which we estimate will amount to more than 1% of GDP. Across the Eurozone, public sector jobs will be cut by around 150,000.

- It seems unlikely that the private sector will pick up the slack. The Eurozone banking sector has not yet fully recovered and, given the substantial uncertainties about the economic outlook, banks remain cautious in their lending decisions, and availability of credit is still tighter than before the crisis.

- Tight credit adds to other factors discouraging investment. Private companies have accumulated significant cash balances that could be used to purchase new equipment, but they are also still highly indebted. Here again, there are significant differences between the South, where investment is expected to be still well below pre-crisis levels in five years' time, and the North, where investment should be back at its pre-crisis peak by 2012.

- Faced with the prospects of stubbornly high unemployment, cuts in government outlays and, in some cases, tax increases, households will remain reluctant to spend. Private consumption is forecast to grow on average by less than 1% per year this year and next. This implies a slower recovery in consumption than from the recessions of the 1970s and 1990s.

- Compared with the significant uncertainties about the growth outlook, the prospects for inflation pose little concern. We forecast steady inflation at around 1.5%-1.6% in 2010 and 2011. At these levels, inflation poses no threat to growth and should not prevent the ECB from further monetary stimulus if growth falters.

16 Eurozone countries

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

Please visit our dedicated Eurozone website for access to additional information on the Eurozone report, the 16 individual country reports and additional perspectives and interview content. The site contains the latest version of our reports as well as an archive of previous releases.

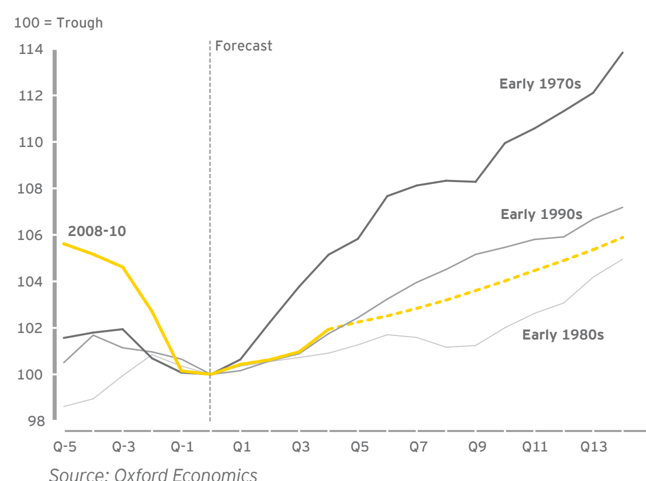
To find out more, please visit www.ey.com/eef

European Central Bank still needs a "plan B" as downside risks remain to the fore

The European Central Bank's (ECB) recent communications have appeared to close the door on the possibility of following the US Federal Reserve and engaging in quantitative easing. But while growth in the core Eurozone economies has been stronger than expected over the last six months of 2010, the risks to the outlook mean the ECB may yet find itself having to look for ways to support demand and avoid a double-dip recession.

Figure 1

Eurozone: recoveries compared



Source: Oxford Economics

Eurozone growth was again robust in Q3 2010 after a strong Q2. But, so far, the recovery has been proceeding at a similar pace to that seen in the early 1990s and much more slowly than in the early 1970s, despite a steeper downturn. In particular, consumption and investment have lagged behind previous recoveries. Exports have rebounded strongly, but risks to the domestic economy remain on the downside. As a result, we believe monetary policy should remain loose and ready to provide extra support if the downside risks materialize.

Robust growth hides widening divergence ...

Our baseline forecast — what we think is the most likely scenario — shows a moderate slowdown in 2011. We forecast that GDP growth will fall to 1.4% in 2011 after 1.7% in 2010. In 2012–14, GDP growth should increase somewhat to average 1.9% over that period.

Growth in the Eurozone in 2010 has so far surprised on the upside, especially given the crisis in the peripheral Eurozone and the strengthening of the euro. However, the gap in growth performance between the so-called "peripheral" or "Southern" Eurozone countries — Greece, Ireland, Italy, Portugal and Spain — and core Eurozone countries is widening. In the year to Q3 2010, based on data available at the time of writing, GDP growth ranged from -3.6% in Greece to +3.6% in Germany. As shown in Box 1, divergence is expected to persist, making policy coordination increasingly difficult.

Table 1

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

	2009	2010	2011	2012	2013	2014
GDP	-4.0	1.7	1.4	1.7	2.0	2.0
Private consumption	-1.1	0.5	0.7	1.2	1.4	1.5
Fixed investment	-11.3	-1.3	1.7	2.7	3.6	3.6
Stockbuilding (% of GDP)	-0.6	0.6	0.8	1.0	1.0	1.2
Government consumption	2.4	1.1	0.2	0.2	0.7	1.0
Exports of goods and services	-13.1	9.6	5.7	6.0	6.6	6.0
Imports of goods and services	-11.8	9.4	4.8	5.7	6.1	6.0
Consumer prices	0.3	1.5	1.6	1.6	1.7	1.8
Unemployment rate (level)	9.4	10.0	10.0	9.8	9.4	9.0
Current balance (% of GDP)	-0.8	-0.3	0.0	-0.1	0.0	0.2
Government budget (% of GDP)	-6.3	-6.5	-4.9	-3.9	-3.0	-2.3
Government debt (% of GDP)	81.8	86.7	89.6	90.9	90.9	90.2
ECB main refinancing rate (%)	1.1	1.0	1.2	2.3	3.1	3.5
Euro effective exchange rate (1995 = 100)	129.7	121.7	117.8	108.5	106.9	110.0
Euro/US dollar exchange rate ($ per €)	1.39	1.34	1.31	1.14	1.11	1.15

Box 1

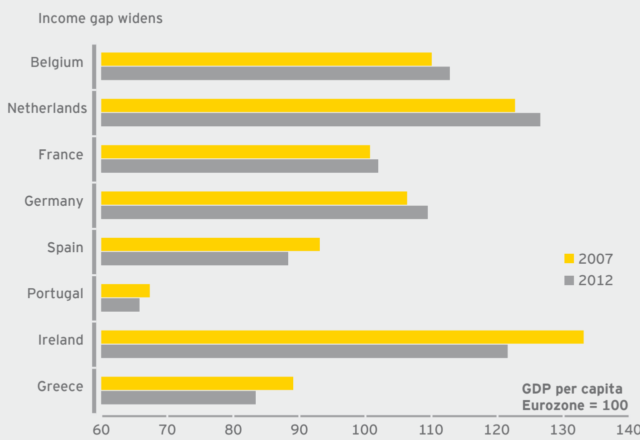
Convergence and divergence within the Eurozone

We have updated our indicator of "convergence" within the Eurozone. The indicator looks at a broad range of measures in order to capture the many aspects of convergence. In particular, we look at convergence in the "level" of both economic performance and in economic cycles. And, within each aspect, we look at several variables, including incomes (GDP per capita), prices, fiscal positions and labor markets. We then measure convergence/divergence by examining the cross-country standard deviations in these variables.

The results are shown in the charts below. Further divergence that had already been expected in the previous reports is now likely to be even more marked. Countries with relatively low income levels are expected to grow more slowly than average, so the income gap across the Eurozone is forecast to widen back to the level of the early 1990s. Cyclical developments are expected to become more similar across countries, largely because former outperformers in the South of the Eurozone are now expected to experience only muted growth, if any.

Figure 2

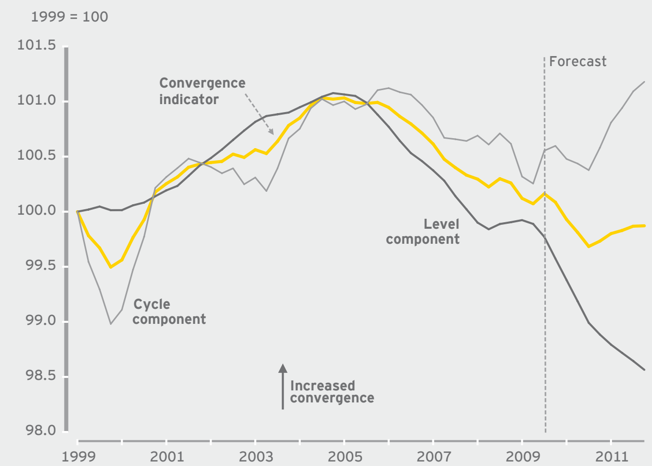
Income gap widens



Source: Oxford Economics

Figure 3

Convergence within the Eurozone



Source: Oxford Economics

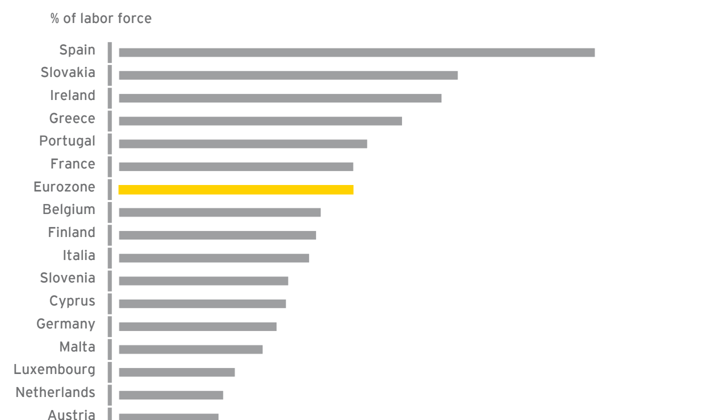
… in particular in labor markets

The divergence in economic conditions is particularly in the Eurozone labor markets. By October 2010, unemployment rates ranged from 4.3% in Austria to 20.5% in Spain. Unemployment rates fell in Austria, Germany, Finland and Malta, by between 0.3 percentage points (ppts) and 0.8ppts. By contrast, unemployment has continued to rise sharply in Ireland and Spain, by more than 1ppt.

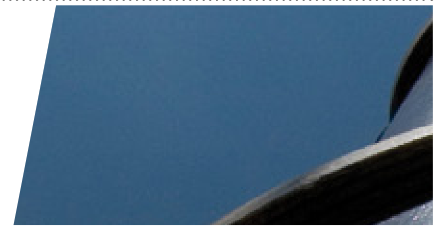
Wide cross-country variations show in other measures of unemployment. There are particularly large differences in unemployment rates among the young, from 8.5% in Austria to a staggering 41.6% in Spain. And the proportion of unemployed who have been without a job for one year or more ranges from 18.3% in Cyprus to 63.5% in Slovakia.

Figure 4

Unemployment rates



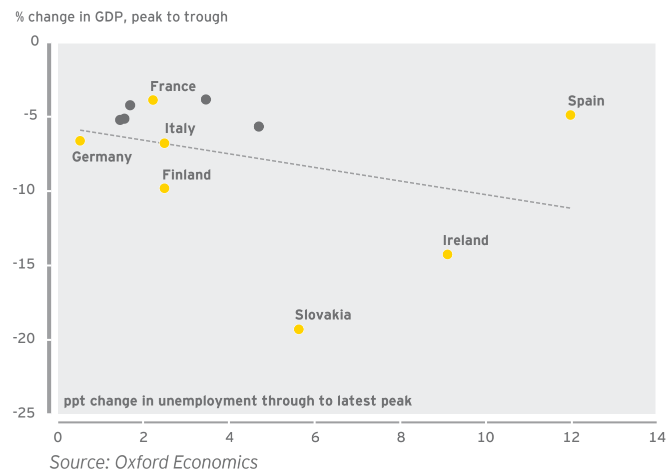
Source: Haver Analytics



Divergent labor market conditions do not simply reflect differences in the depth of the falls in GDP faced by countries. Peak to trough (in the period to November 2010), Spanish GDP has "only" fallen by 4.9%, similar to the Eurozone average of 5.3%. But the 12ppts rise in the unemployment rate has been more than four times the Eurozone average (+2.8ppts). By contrast, Finland's GDP dropped nearly 10% peak to trough, but its unemployment rate rose by only 2.5ppts. And while Slovakia's GDP fell by close to 20%, its unemployment rate "only" increased by 5.6ppts.

Figure 5

GDP vs. unemployment



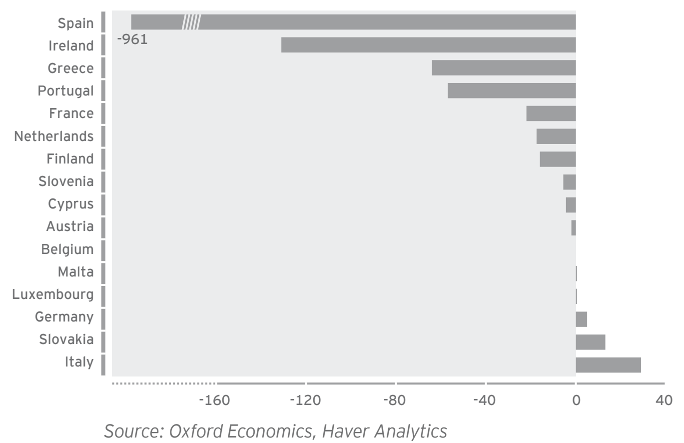
Source: Oxford Economics

In part, divergent labor market developments reflect differences in government policy. Some governments, for example, put in place measures aimed at preserving jobs, such as the short-hour schemes in Germany and the wage supplementation scheme in Italy.

But the different behaviors of labor markets across the Eurozone also reflect differences in the sectoral composition of employment — such as the size of the construction sector — and persistent structural differences, such as the ease with which firms can lay off workers. The largest rises in unemployment rates have happened in Spain and Ireland, which are also the two countries where the labor-intensive construction sector has been hit hardest. These two countries also have, in some ways, the most flexible labor markets. Spain's flexibility is more about duality between a highly flexible segment on temporary contracts that can be hired and fired at short notice and at relatively low cost (about one-third of employment) and a segment that is very inflexible. In Ireland, the labor market is more homogeneous, but still more flexible than in most Eurozone economies.

Figure 6

Change in employment in construction

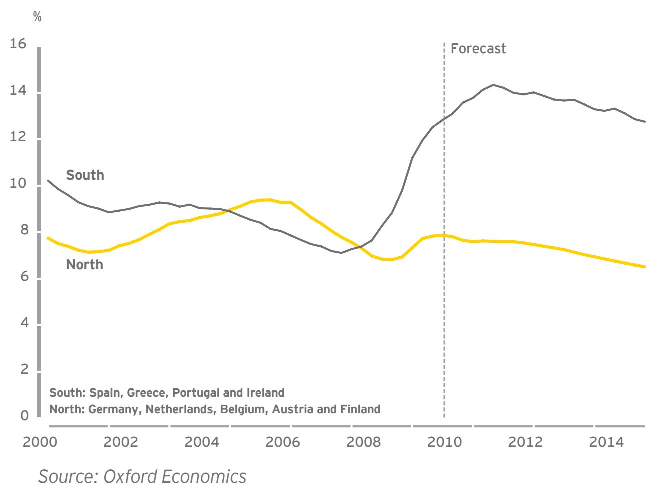


Source: Oxford Economics, Haver Analytics

We expect the divergence in unemployment rates to remain high over the next few years. Employment in peripheral countries is expected to be flat at best, dampened by cuts in public sector jobs and the negative impact of the tighter government budgets on the private sector. Moreover, labor market reforms in Spain and Greece, while positive for growth and the job market in the medium term, are likely to lower employment in the short term. Finally, in countries like Spain and Ireland, the construction sector will take a long time to recover and is unlikely to return to pre-crisis levels for many years. This means that a large proportion of the unemployed needs to be retrained to be able to take other jobs. As this will take time, unemployment will remain high for years to come.

Figure 7

Unemployment rates



Source: Oxford Economics

Meanwhile, in the rest of the Eurozone, employment growth is expected to pick up modestly through the course of 2011, leading to a gradual fall in unemployment. Overall, these divergent conditions imply that the level of unemployment in the Eurozone as a whole is unlikely to fall over the next year or so. We do not expect the number of unemployed to fall below 15 million before 2013.

Irish crisis highlights large downside risks

After a calmer period in July and August, tensions in Eurozone bond markets have risen again in recent weeks. Behind this lie renewed concerns about the fiscal positions of Greece and Portugal, and a steep escalation in banking sector problems in Ireland, with the estimated costs of restructuring Irish banks rising sharply. In addition, investor sentiment was badly hit by suggestions that new rules for the management of state budgets in the Eurozone might include provision for the restructuring of sovereign debt. This proposal was later endorsed by the 28 November announcement that Eurozone Finance Ministers had agreed to create the European Stabilisation Mechanism (ESM) from 2013. Under this mechanism, all bonds issued from 1 July 2013 will carry collective action clauses which means that a specified majority of bond holders can overrule minority bond holders and thereby force losses when arranging debt restructuring with a government.

As a result of these developments, by mid-November, Greek bond spreads had risen close to pre-bailout levels, while Irish spreads had surged to a new record or more than 9%. Spanish and Portuguese bond spreads were also widening fast. Meanwhile, ECB lending to the banking sectors of the troubled countries has remained high, with a surge in lending to Ireland in October.

With financial markets remaining skeptical about the ability of the peripheral country governments to achieve fiscal sustainability with current policies, the governments of these countries face a number of possible choices:

- Implement yet more spending cuts and tax increases
- Appeal for funds from the European Financial Stability Facility (EFSF) — and possibly from the International Monetary Fund — put in place in the aftermath of the Greek crisis last May
- Engage in debt restructuring

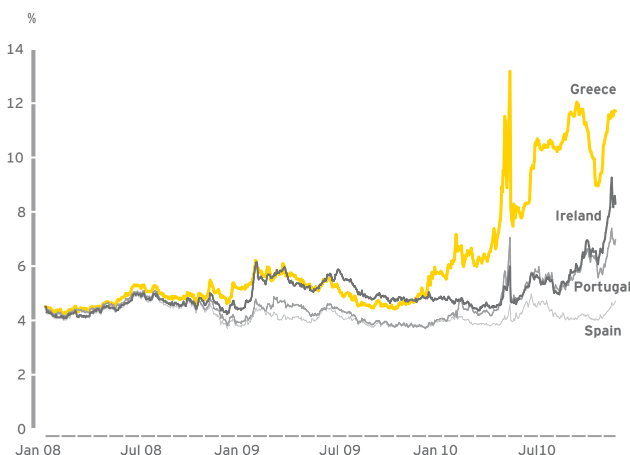
None of these options is appealing. With companies and households already burdened by drastic tightening measures, the scope for governments to implement yet more pain through fiscal tightening is narrowing. And even if they could pass additional measures, their effectiveness in closing deficits and bringing debt down is in doubt, given the large negative impacts on growth.

Similarly, peripheral governments have so far tended to resist the option of bailouts from the EFSF. As well as fearing a certain stigma attached to asking the EFSF for help, they may also be wary of the conditions that would be attached to EU loans that could compromise their fiscal and economic strategies. In the case of Ireland for instance, the national authorities were adamant not to have to raise the corporate tax rate for fear of losing the country's appeal as a location for foreign direct investment.

Furthermore, debt restructuring or default risks cutting off governments (and possibly parts of the private sector) from financial markets for years to come.

Figure 8

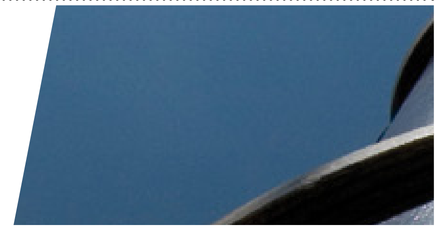
Bond yields



Source: Oxford Economics, Haver Analytics

In November 2010, a crisis that had escalated since September in Ireland reached a climax with the Irish government presenting a four-year austerity plan in advance of its December budget and turning to the EFSF and IMF for financial aid, for an amount of €85 billion. The austerity plan attempted to calm financial market concerns that had pushed bond yields passed 9%, well above the peaks reached at the height of the Greek crisis in May. The package unveiled even more spending cuts and tax increases than envisaged a few weeks earlier. While the bailout funds will be channeled to the Irish Government, a large part will be used to try to rescue and rebuild the banking sector, and prevent a collapse of the financial system that would also drag down the real economy.

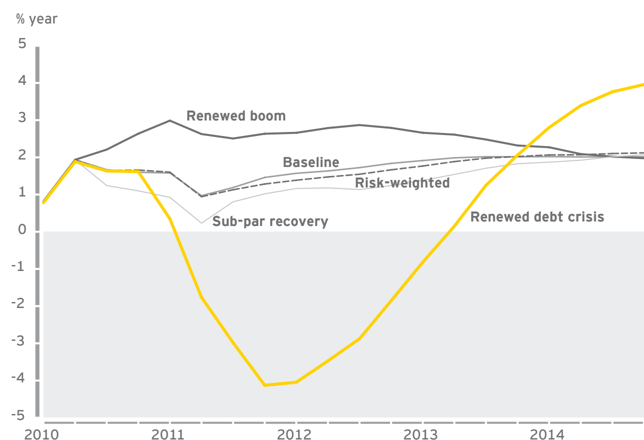
The example of Ireland shows that economic assessment and market sentiment can turn around very quickly. Even if a solution is found for this crisis, the risk of a new crisis erupting in one



peripheral country is significant. As shown by the concomitant rise in bond yields across peripheral countries since September, should a Eurozone government face serious problems, the contagion would spread very quickly to other peripheral countries. Bond yields would rise even higher, forcing a new wave of spending cuts and tax increases, which would, in turn, dampen growth and undermine the ability to achieve the fiscal targets. Access to the EFSF, or from 2013 the ESM, could be granted again, but these facilities have limited resources, carry relatively high interest rates and come with a loss of fiscal sovereignty for the appealing government.

In this context, we have looked at the possible consequences of an escalation of the sovereign debt crisis that would lead to a significant restructuring of peripheral Eurozone government debt and could ultimately lead to a financial crisis similar to that following the collapse of Lehman Brothers' in 2008 (see Box 2). We estimate that Eurozone GDP growth would be significantly negative, probably around -2% to -3% for a couple of years and more than reverse the recovery seen to date. If such a crisis were to occur in 2011, Eurozone GDP would still be around 3.5% below pre-crisis levels at the end of 2014.

Figure 9
GDP growth



Source: Oxford Economics

Note: Risk-weighted GDP represents the average GDP growth rates of the different scenarios weighted by the probability attached to each scenario.

Box 2
Alternative scenarios for the Eurozone

At the current juncture, an unusually high degree of uncertainty affects our forecast. This report presents what we see as the most likely scenario, which we think has a 45% probability of happening. The Eurozone economy could take a number of alternative paths. Here, we describe what we see as the next most likely outcomes.

On the one hand, although we think that risks to our forecast mainly lie on the downside, there are some upside risks to our central view. The restructuring of the financial system and fiscal consolidation may bear fruit more quickly than currently expected, both for the Eurozone and other major economies. This would enhance business and consumer confidence, leading to a quicker recovery in demand. In particular, businesses may be encouraged to spend their significant cash balances more quickly. Stronger economic activity would, in turn, have a positive impact on banks' balance sheets and public finances. In this scenario, Eurozone GDP would expand by 2.6% in 2011 and 2.7% in 2012, compared with 1.5% and 1.6% in our baseline forecast. We attach a 20% probability to this renewed boom scenario.

On the other hand, the recovery may proceed at an even more sluggish pace than we currently forecast. Public and private sector deleveraging in industrialized economies could be more pronounced than in our baseline forecast and depress domestic demand, which would be further hampered by subdued credit growth as banks struggle to mend their balance sheets. Eurozone GDP growth would decelerate to 1% in 2011 and 0.8% in 2012, with several peripheral countries returning in recession. We attach a 25% probability to this sub-par recovery scenario.

Finally, we attach a 10% probability to a renewed crisis. The harsh fiscal measures announced in peripheral Eurozone countries may prove to be insufficient to reduce the deficits. This would fuel tensions on sovereign bond markets and depress share prices. Risk aversion would rise again in interbank markets. As a result, financing conditions would tighten considerably. Business and consumer confidence would be severely affected. In this scenario, the Eurozone would plunge back into recession, with GDP falling by more than 2% in 2011 and by a further 3% in 2012.

ECB should beware of downside risks

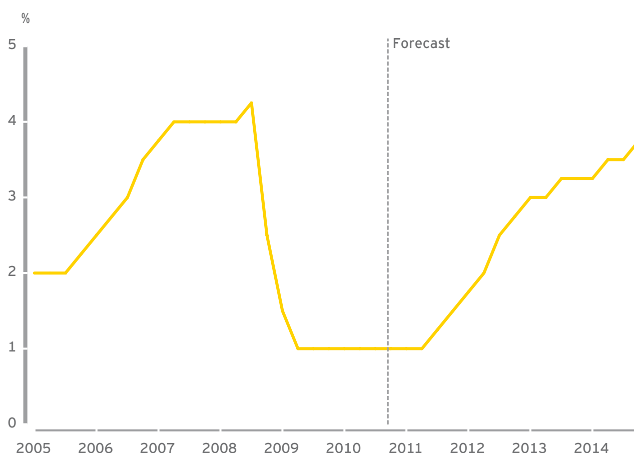
In this context, now is not the time to tighten monetary policy. Instead, the ECB should monitor the highly uncertain impact of fiscal tightening and developments in financial markets and stand ready to provide more support should current growth expectations prove too optimistic.

Nevertheless, monetary conditions have tightened significantly since the first half of 2010 as the ECB has started to wind down its lending to the Eurozone banking sector, pushing interbank rates up. For instance, the three-month EURIBOR has increased from around 0.65% in April to more than 1% now. The trengthening of the euro has added to the tightening of monetary conditions. Given these developments, we think that the ECB should not start raising interest rates until the latter part of 2011 at the earliest.

In addition to setting its refinancing rate, the ECB also needs to decide whether to prolong the "full allotment" set-up of liquidity provision at one-week to three-months maturities, whereby banks can get as much money from the ECB as they ask for. On 2 December the ECB decided to prolong this set-up until at least April 2011.

Figure 10

Refinancing rate



Source: Oxford Economics

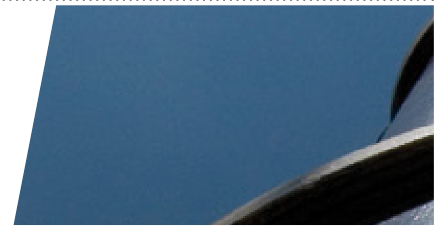
The robust growth results of the first part of 2010 may encourage the ECB to believe that the recovery is well engaged and that the Eurozone economy can support tighter monetary conditions. Moreover, some members of the ECB Governing Council are concerned that the large amounts of liquidity provided during the crisis could fuel inflation in coming years. However, we think that this risk is relatively small at the moment and outweighed by the downside risks to growth outlined earlier.

Should a renewed crisis erupt in the Eurozone, the ECB should be ready to loosen the current monetary policy stance. If liquidity appears tight across the board, this would involve reinstating the longer-term maturity liquidity provisions of 2009 and early 2010. If tensions are particularly acute in the bond markets of the peripheral countries, the ECB may need to expand its bond purchase program to help relieve some pressures. In the case of a broader-based fall in asset prices, the ECB should not rule out quantitative easing, in a similar way as implemented by other central banks such as the US Federal Reserve.

The benefits of quantitative easing come via lower market rates and higher asset prices. A lower overall cost of capital for firms (through both debt and equity) feeds through into higher investment. Higher investment raises employment and, along with higher financial wealth, provides a boost to consumption. Lower long-term interest rates also lead to a depreciation of the currency. This in turn improves competitiveness and boosts exports.

Our analysis of the impact of the Fed's second quantitative easing (QE2) phase shows significant potential positive effects for the US economy, of the order of 1% of GDP by 2012. This is supported by observed changes in US financial markets since the Fed announced the possibility of further quantitative easing at the Jackson Hole meetings of central bankers in August 2010. From 27 August, the date of Fed Chairman Bernanke's speech at the Jackson Hole conference, to early November, the market reaction has been clearly positive: the S&P 500 has climbed 14%, the dollar has fallen over 6% against the euro (and 4.5% down on a trade-weighted basis), and 10-year treasury yields have largely maintained the very low levels reached during August and September 2010, when worries about the state of the US economy were very considerable.

The ECB's New Area-Wide Model suggests that the impact of quantitative easing in the Eurozone could be even more significant than in the US. An 80 basis point fall in Eurozone interest rates, which is our estimate of the impact of QE2 on US long rates, would raise GDP in the Eurozone by about 2% by 2012. Further positive effects would result from higher share prices and a weaker euro.



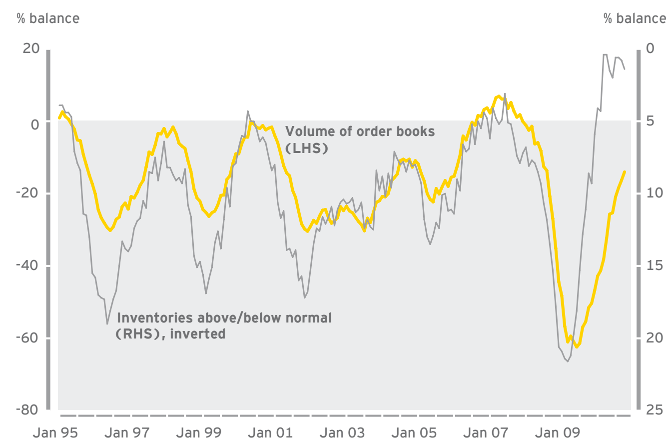
It is a cause for concern that the ECB appears to have rejected outright the option of using quantitative easing. This would mean that the ECB could be left with very little effective ammunition to counter the negative impact of a renewed Eurozone sovereign debt crisis, as it is difficult to see how it would achieve such effects using its current set of tools. The ECB's government bond purchase program has been limited and sterilized (i.e., offset by the sale of other paper, mainly German short-term paper). The ECB has tried to relieve pressure on specific government bond markets in peripheral countries rather than to lower interest rates across the board, but the impact has been limited, at best. While ECB President, Mr Trichet, said on 1 December that the Central Bank's government bond purchase program was still active, he dampened market expectations that the ECB would step up these purchases the following day. In addition, the program has been controversial, with some ECB Governing Council members voicing their opposition to it. Should there be a need for broader action, reaching an agreement within the Governing Council would be very difficult. But a "plan B" for Eurozone monetary policy is needed given the downside risks to growth.

2010 growth rebound temporary

Our baseline forecast shows GDP growth at 1.7% in 2010, somewhat better than we were expecting a few months ago. But a look at the composition of the growth offers little room for complacency. Restocking is expected to account for 80% of growth in 2010. Eurozone firms, like their global counterparts, had reduced the level of their stocks dramatically during the crisis. But as orders returned, companies also quickly rebuilt their stock levels, thereby fuelling growth in the Eurozone in 2010.

Figure 11

Restocking probably close to peak



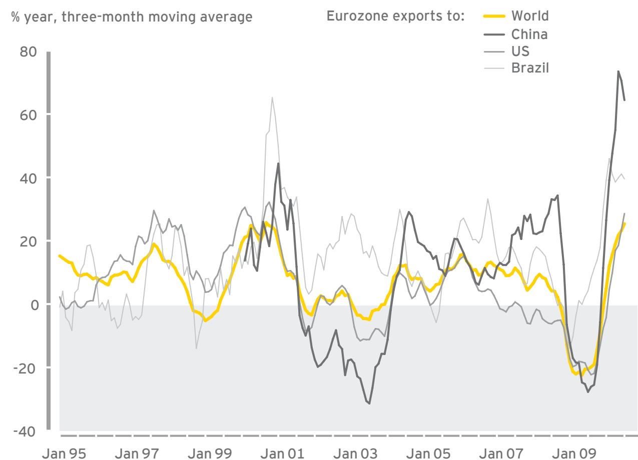
Source: Oxford Economics, Haver Analytics

By nature, restocking is temporary. It is also prone to sharp reversals as soon as companies perceive a weakening in demand. The European Commission survey of the manufacturing sector shows that most companies now estimate that their stocks are at "normal" levels. The change in assessment about stocks has happened much more quickly than that about orders. This suggests that restocking is probably close to its peak and that, going forward, what has been a major source of growth in 2010 will disappear.

International demand has been an additional significant source of growth so far in 2010. Export growth has been fuelled by very strong demand from emerging markets. In the year to August 2010, Eurozone exports of goods to Asia were up by around 30% on a year earlier in nominal terms. Exports to Brazil and Russia increased by around 50% during that period. But exports to developed economies have also bounced back strongly. Shipments to the UK and the US, still by far the largest markets for Eurozone exporters, increased by around 10% and 30%, respectively, in the year to August 2010.

Figure 12

Exports of goods



Source: Oxford Economics, Haver Analytics

These rebound in exports has been driven by higher overseas demand, with no evidence that the Eurozone has been gaining market share worldwide. As a result, the outlook for exports critically depends on the pace of demand growth in the Eurozone's export markets. Manufacturing surveys point to a tentative strengthening in global growth in October/November 2010 compared with the previous three months. But the pace of growth seen at the beginning of 2010 is unlikely to be sustained and, indeed, we estimate that demand for Eurozone exports has already slowed markedly (see Box 3).

Box 3

Forecast assumptions — international environment and commodity prices

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

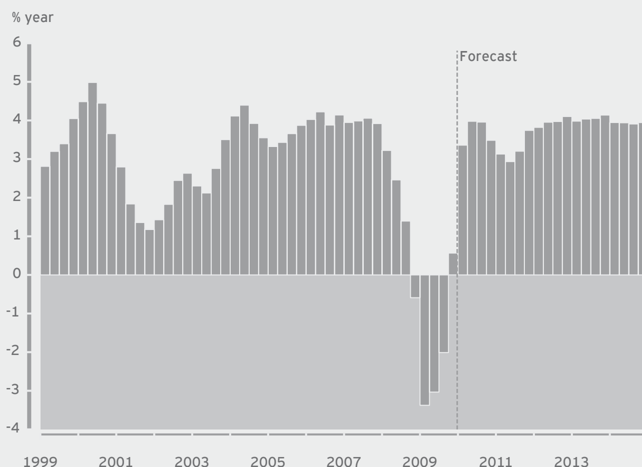
World GDP growth is estimated at 3.7% in 2010 (at market exchange rates). The recovery is expected to moderate slightly during 2011, with world growth at 3.3%, reflecting the ongoing constraints on the major economies from weak banking sectors, private sector deleveraging, the end of the US fiscal stimulus and, in the Eurozone, significant fiscal tightening. Emerging market growth will also moderate as a result of the fading of the stock cycle and tighter monetary policy in many countries, but will remain robust. As deleveraging pressures ease and banking sector health improves, we expect growth in the major economies to pick up in 2012. With continued solid growth in the emerging markets underpinned by robust rises in domestic demand (emerging Asian growth is expected to run at around 7% per annum), world GDP growth is forecast to pick up to 3.5% in 2012. Allowing for the composition of growth in each country/region and the geographical pattern of Eurozone trade, we forecast demand for Eurozone exports to rise by around 7%–8% in 2011 and 2012, after a 13.3% increase in 2010

Risks to our baseline forecast are slightly skewed to the downside. The main downside risk is of a "sub-par" recovery resulting from low business confidence in the major economies, weak growth in employment and investment and a lack of traction for monetary policy as a result of banking weakness. In case of further financial shocks, e.g., from a fiscal collapse of one or more of the troubled Eurozone countries, a double-dip recession could be triggered by sharp falls in asset prices, increased pressures on the banking sector and extra "precautionary" fiscal tightening by countries keen to avoid default. In this case, a contraction in global risk appetite and rapid capital outflows would also seriously damage emerging market growth. The main upside risk is that the strong corporate liquidity position in the major economies feeds into a boom in investment and a rapid pick-up in hiring, in turn boosting consumer and business confidence, and bringing forward the recovery of bank balance sheets and credit growth. This would also feed into stronger tax revenue, easing the pressure for fiscal consolidation.

Our baseline scenario also contains assumptions for the development of key commodity prices. Oil prices have risen strongly since September 2010, reflecting robust growth in demand from Asia and the fall in the dollar (itself connected to expectations of US monetary easing). We expect oil prices to stabilize as world GDP growth slows, averaging around US$84/barrel in 2011 (i.e., close to current levels) and US$85/barrel in 2012. Non-oil commodity prices have also risen strongly recently, often on the back of supply constraints. We expect further increases in the course of 2011, albeit at a much more moderate pace. On average, after a 22.5% rise in 2010, we forecast non-oil commodity prices to increase by 10.7% in 2011 remaining flat in 2012.

Figure 13

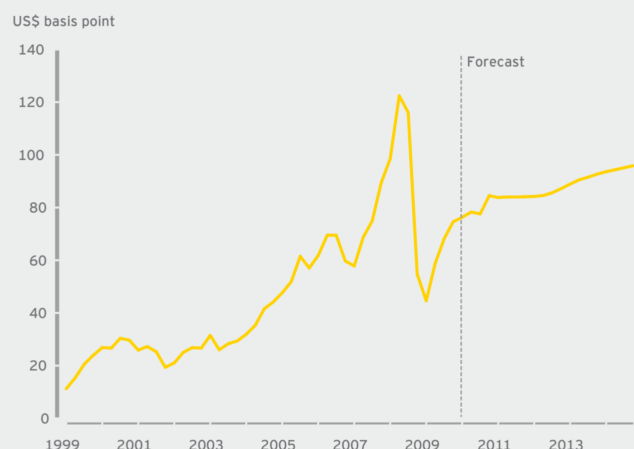
World GDP growth



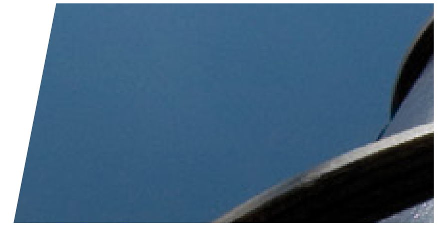
Source: Oxford Economics

Figure 14

Oil price, nominal



Source: Oxford Economics

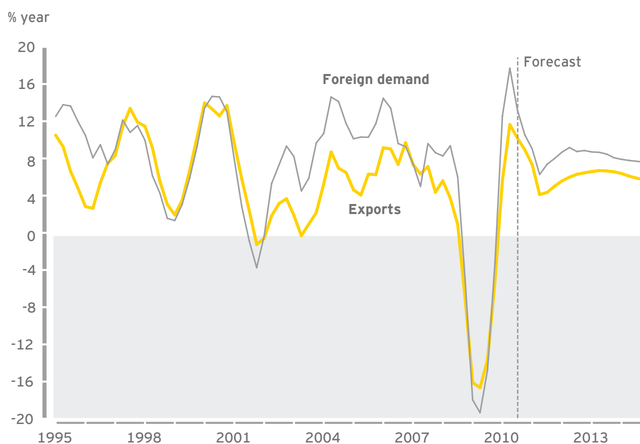


Furthermore, the appreciation of the euro that started in September 2010 has somewhat undermined the competitiveness of Eurozone goods and services. In effective terms — i.e., measured against a basket of currencies that reflects the geographical pattern of Eurozone trade — the euro appreciated by around 7.5% between early September and early November 2010. While this is manageable, and some of this appreciation has been reversed since, it will slightly dampen growth in exports in the quarters ahead.

As a result of slowing demand and somewhat lower competitiveness, we expect Eurozone export growth to slow to 5.7% in 2011 from more than 9% in 2010. The contribution of exports to GDP growth will therefore fall from 3.9ppts in 2010 to 2.5ppts in 2011.

Figure 15

Exports passed their cyclical peak



Source: Oxford Economics

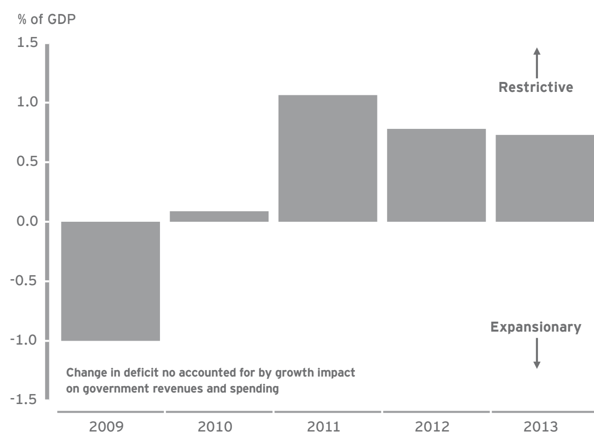
Fiscal cuts starting to bite in 2011 ...

Fiscal policy will also dampen growth in 2011. After a significant loosening of fiscal policy in 2009 to help the Eurozone economy in the global crisis, fiscal measures were broadly neutral in 2010. A number of tightening measures have been announced since May but, given the lags in implementation and transmission to the economy, the negative effects will be mainly felt in 2011. In addition, most governments have now announced their budget plans for 2011. In several cases, these budgets include further spending cuts and tax increases. We estimate that fiscal tightening measures will amount to more than 1% of GDP in 2011 and around 0.75% of GDP for each of 2012 and 2013. This will have a significant negative impact on growth in the Eurozone.

Fiscal tightening is being implemented in every Eurozone country. However, the degree of fiscal tightening varies greatly, from more than 3%–4% of GDP in 2011 in Spain and Portugal to around 0.5% in Germany, Austria and Belgium. The impact of government spending cuts will be felt acutely in labor markets. Across the Eurozone, public sector jobs will be cut by around 150,000 next year, compared with increases of 20,000–40,000 per year before the crisis. These job cuts and other spending restriction measures will affect household incomes, inducing lower spending and thereby spreading and multiplying the negative impact of the fiscal tightening on the economy as a whole.

Figure 16

Fiscal tightening



Source: Oxford Economics

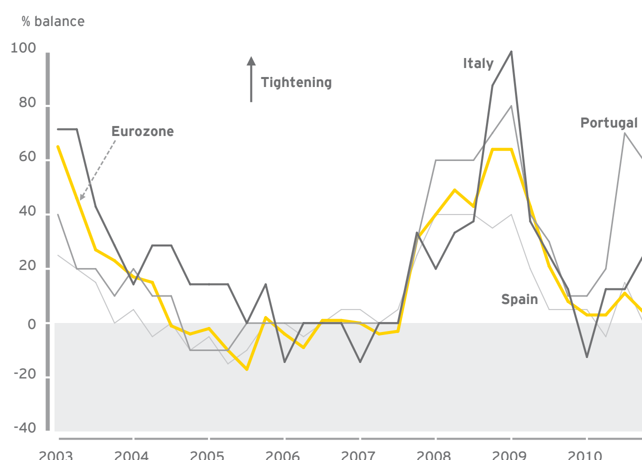
Moreover, growth in peripheral countries is likely to disappoint compared with the assumptions embedded in the government budgets. This implies a risk of lower tax revenues than currently expected. Pressure from financial markets to meet the fiscal targets remains very high, as shown in elevated interest rates on government bonds from the peripheral countries. In this context, governments may have to find more space for spending cuts and tax increases in order to avoid sharp increases in the cost of debt.

Banking sector not fully recovered ...

Budget cuts of 1% of GDP need not imply that GDP growth will be 1% lower. The overall growth outcome depends on the ability of the private sector to offset some of the fiscal tightening by increasing its spending. However, it seems unlikely that the private sector will pick up the slack in the near future. First, while the Eurozone banking sector no longer needs the kind of life-support system that was required at the height of the crisis, it has not fully recovered yet.

Figure 17

Credit conditions for loans to business

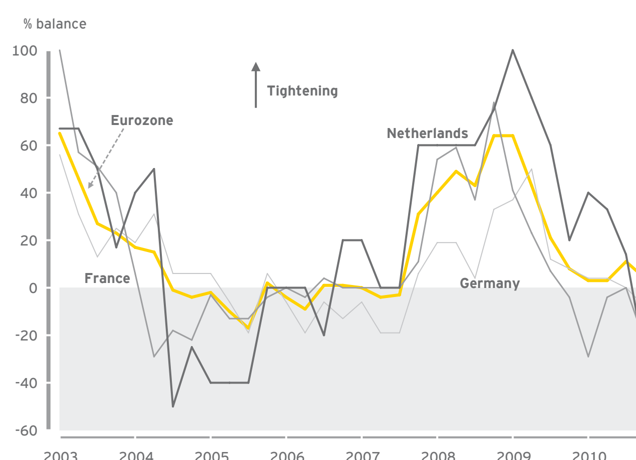


Source: Oxford Economics, Haver Analytics

Note: figures 17 and 18 show the net percentage balance of responses from banks indicating whether they have tightened or loosened their credit standards for loans to businesses.

Figure 18

Credit conditions for loans to business



Source: Oxford Economics, Haver Analytics

Banks in Greece, Ireland, Portugal and Spain are still highly dependent on the ECB for access to funds. In September 2010, ECB lending to these countries stood at €350 billion compared with around €50 billion in the first half of 2007, before the crisis.

In these precarious conditions, the health of the Eurozone banking sector could worsen again should economic and fiscal developments take a turn for the worse. Banks seem to be aware of the downside risks and remain cautious in their lending decisions. As a result, availability of credit is still tighter than before the crisis.

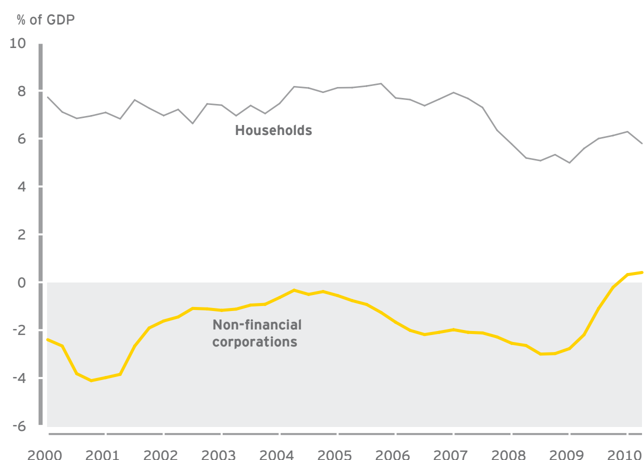
Moreover, the European Bank Lending Surveys (BLS) show diverging credit conditions within the Eurozone. While German, French and Dutch banks have started to apply easier credit standards since Q3 2010, banks in the peripheral countries and Italy are continuing to tighten their lending criteria. Divergent credit conditions will exacerbate the growth differentials that have built up within the Eurozone since the start of the crisis. With limited access to capital markets and tighter credit conditions, companies in peripheral Eurozone countries will face significant difficulties in finding the funds necessary for investment. This will hamper the ability of the private sector in these countries to offset the negative impact of the fiscal cuts, and thereby drive a deeper wedge between peripheral Eurozone economies and the rest of the Eurozone.

... while private businesses hesitate to spend

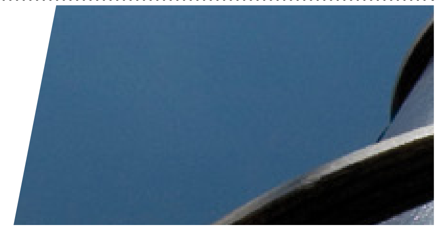
Tight credit adds to other factors discouraging investment by the non-financial private sector. Eurozone companies and households have significant cash balances but, despite this, they remain reluctant to increase spending.

Figure 19

Net lending/borrowing



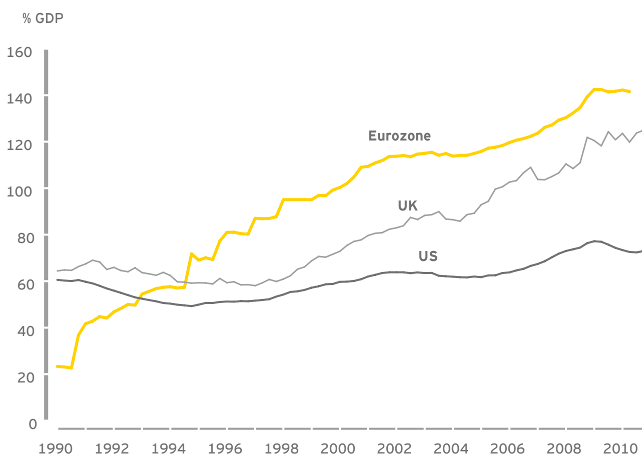
Source: Oxford Economics, Haver Analytics



One of the reasons is that Eurozone companies have high levels of debt, at around 140% of GDP, which has not changed much since the start of the crisis. The BLS shows that debt restructuring still dominates fixed investment as a motive for businesses' demand for loans. And again, peripheral countries tend to fare worse in this regard. Debt of non-financial corporations amounts to around 200% of GDP in Ireland and 140% in Spain and Portugal. Only Greece has relatively low risks related to corporate debt, with debt-to-GDP ratios below 70%.

Figure 20

Liabilities, debt and non-financial corporations



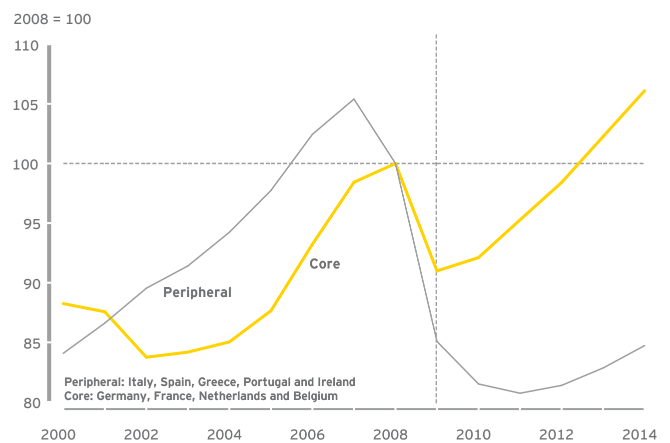
Source: Oxford Economics, Haver Analytics

Overall, we forecast a 1.3% fall in Eurozone investment in 2010, following a fall of 11.3% in 2009. There is a risk that companies may adopt even more cautious behavior than currently envisaged and favor cash flow over investment. This would lead to an even slower recovery than in our baseline forecast. Although, assuming for a moment that financial markets remain resilient, a double-dip would probably be avoided.

The average decline in investment in 2010 consists of a 4.1% fall in investment in peripheral Eurozone economies and a 1.2% rise in core Eurozone economies. Diverging conditions are likely to persist for many years. While investment in peripheral Eurozone economies is expected to remain well below pre-crisis levels for the next five years, it is expected to achieve by 2012 in the core countries.

Figure 21

Divergence in investment



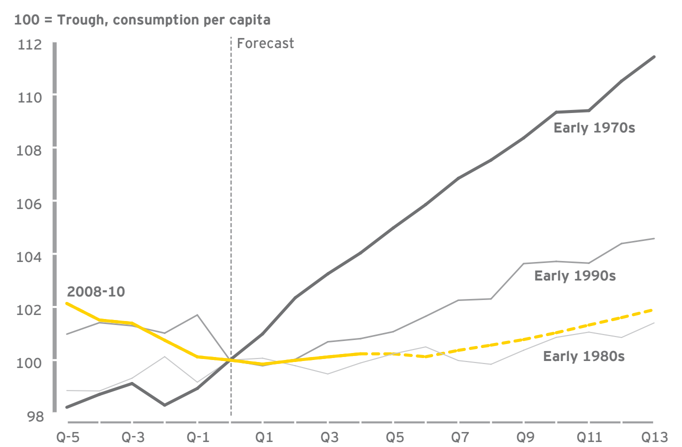
Source: Oxford Economics, Haver Analytics

… and private consumption lags previous recoveries

Faced with the prospects of stubbornly high unemployment, cuts in government transfers and, in some cases, tax increases, households will remain reluctant to spend. Private consumption growth is forecast to average less than 1% per year over 2010–11. The recovery in consumption is set to be much slower than in the 1970s and 1990s, as household income growth is much more muted.

Figure 22

Consumption recoveries compared



Source: Oxford Economics

Deflation a bigger worry than inflation

Compared with the significant uncertainties about the growth outlook, the prospects for inflation give relatively little cause for concern. We forecast steady a inflation rate of around 1.5%–1.6% in 2010–11. This hides the impact of offsetting factors. On the one hand, as explained in Box 3, commodity price increases are expected to be more moderate in 2011 than those seen at the beginning of 2010. In addition, the recent strength of the euro will lower import price inflation somewhat in 2011. On the other hand, the VAT increases implemented in a number of countries have temporarily raised headline inflation rates.

At these levels, inflation poses no threat to growth and does not distort businesses' and households' spending decisions. Moreover, with the risks to growth skewed to the downside, deflation is a bigger threat than inflation. Our forecast shows inflation close to zero in the peripheral countries. Even if strong growth in emerging markets were to push up commodity prices further, this would be deflationary for the Eurozone in the medium term. At a time when weak demand prevents companies from passing on higher costs, increased commodity prices would put pressure on profit margins, with negative consequences for investment and employment.

Summary

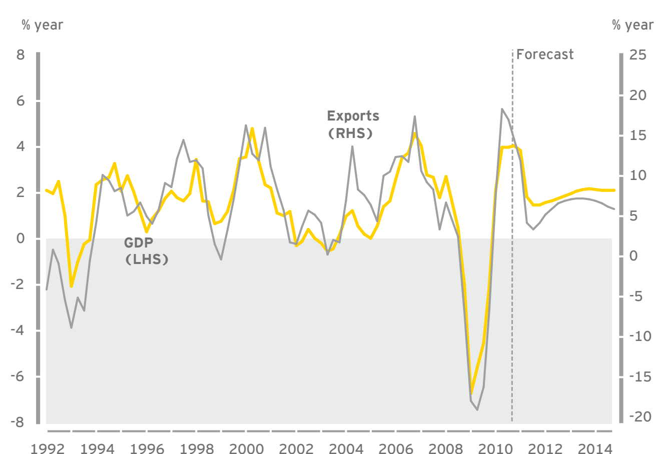
Overall, after robust if unexceptional growth in 2010, we expect a slowdown in the Eurozone economy next year. Moreover, the risks to this baseline forecast are skewed to the downside. We think that a further worsening of the turmoil in Eurozone bond markets is possible, given ongoing concerns about public finances.
In the event this led to sovereign defaults, the Eurozone would likely be plunged back into recession. Against this background, the ECB needs to keep monetary policy accommodative for some time, until the recovery is firmer and the banking sector more secure. And if the situation deteriorates further, the ECB should be ready to loosen monetary policy again, be it by using similar measures to those seen in 2009 and early 2010 or by resorting to quantitative easing.

Forecast for Eurozone countries

Germany

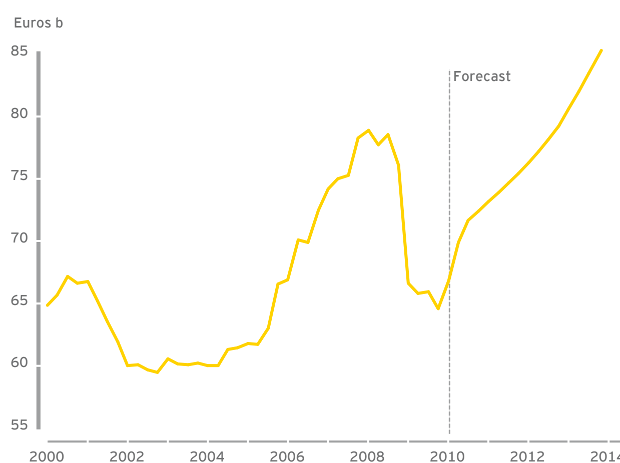
- The German economy has recovered more quickly than anticipated so far. We have revised our forecast for GDP growth this year to 3.5%. Pre-crisis levels of GDP will be reached by the end of 2011, much sooner than we had earlier expected.
- Exports have greatly contributed to this recovery. But, they are set to slow, in line with more moderate demand globally. The domestic business sector has also started to contribute significantly to the recovery. We expect investment to continue to expand steadily, as financing conditions are relatively favorable and business confidence is strong.
- In this generally positive environment, households have not yet significantly benefited from, or contributed to, the recovery. Without a broader-based recovery, the German economy will remain highly exposed to changes in economic conditions abroad.

Figure 23
GDP and exports



Source: Oxford Economics

Figure 24
Business investment



Source: Oxford Economics, Haver Analytics

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

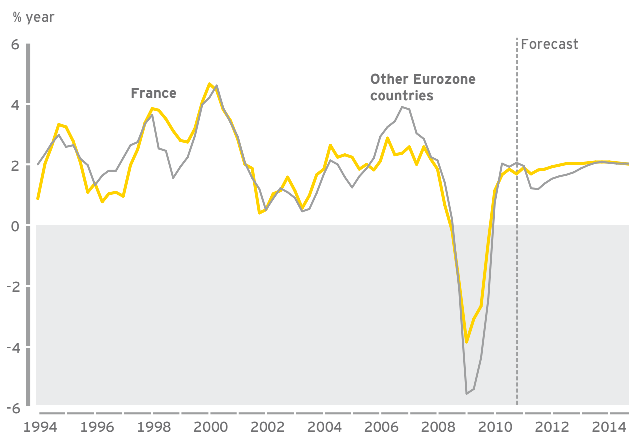
	2009	2010	2011	2012	2013	2014
GDP	-4.7	3.5	2.1	1.7	2.1	2.1
Private consumption	-0.1	0.4	1.1	1.1	1.3	1.4
Fixed investment	-10.0	5.7	4.1	3.2	4.5	4.9
Stockbuilding (% of GDP)	-1.3	-0.5	-0.2	-0.2	-0.1	-0.1
Government consumption	2.9	2.3	1.0	0.3	0.4	0.6
Exports of goods and services	-14.3	14.3	6.3	6.4	7.3	6.6
Imports of goods and services	-9.4	13.7	6.5	6.3	7.4	7.0
Consumer prices	0.2	1.1	1.5	1.5	1.6	1.7
Unemployment rate (level)	7.5	6.9	6.6	6.5	6.2	5.9
Current balance (% of GDP)	5.0	5.0	4.8	4.1	3.9	4.0
Government budget (% of GDP)	-3.0	-4.1	-3.6	-2.8	-2.1	-1.5
Government debt (% of GDP)	74.2	75.3	76.6	76.9	76.1	74.8

France

- We forecast GDP growth of 1.6% in 2010, broadly unchanged from our Eurozone forecast forAutumn 2010 . In 2011–14, we expect GDP growth of around 1.8%–2%. France would thus grow slightly faster than the Eurozone on average; more slowly than Germany, but more strongly than countries in the south of the Eurozone.
- With a smaller presence in fast-growing Asian investment markets, French exporters are missing out on an opportunity for strong growth.
- Part of the underperformance is also accounted for by business investment which has remained sluggish so far, despite favorable financing conditions. This may be related to excess investment in sub-optimal projects before the crisis. If so, investment spending is likely to remain moderate for some time.
- The Government's medium-term assumptions of growth are unlikely to be met. This means that new measures may be needed to meet the fiscal targets.

Figure 25

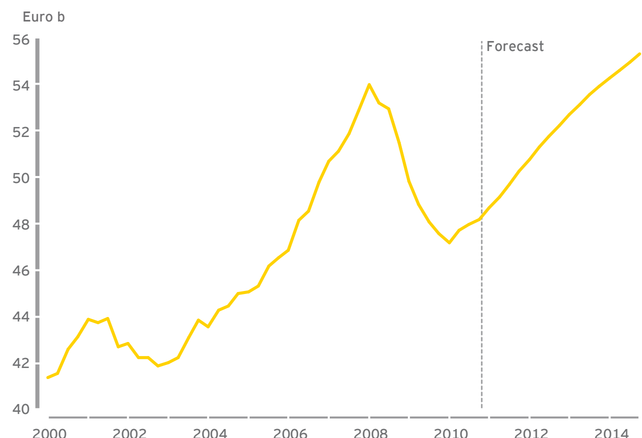
GDP: France vs. rest of Eurozone



Source: Oxford Economics

Figure 26

Business investment



Source: Oxford Economics

Table 3

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

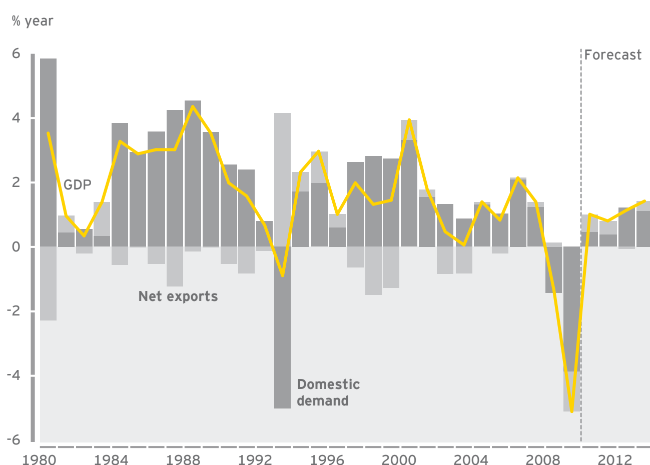
	2009	2010	2011	2012	2013	2014
GDP	-2.5	1.6	1.8	2.0	2.1	2.0
Private consumption	0.6	1.5	1.3	1.5	1.7	1.8
Fixed investment	-7.0	-1.7	2.6	3.3	3.1	2.6
Stockbuilding (% of GDP)	-1.2	-0.5	0.2	0.5	0.7	1.0
Government consumption	2.8	1.5	0.9	0.7	1.1	1.2
Exports of goods and services	-12.2	9.6	5.4	6.2	6.1	5.8
Imports of goods and services	-10.6	8.5	6.3	5.4	5.8	5.5
Consumer prices	0.1	1.7	1.8	1.8	1.9	1.9
Unemployment rate (level)	9.5	9.9	9.8	9.5	9.1	8.6
Current balance (% of GDP)	-2.0	-2.0	-2.3	-2.6	-2.8	-2.7
Government budget (% of GDP)	-7.5	-7.8	-6.1	-4.8	-3.8	-3.0
Government debt (% of GDP)	76.0	82.2	85.5	87.1	87.5	87.1

Italy

- The relatively strong showing of the manufacturing sector during July and August led us to revise our growth forecast slightly up for 2010, from 0.9% to 1%. However, we have cut our forecast for GDP growth in 2011, from 1.1% to 0.8%.
- We expect activity to grow at less than 1.5% per year in 2012–14 as low productivity, which led the Italian economy to underperform the rest of the Eurozone in the decade preceding the crisis, will persist, hindering a sustained recovery.
- Employment continues to fall, and business surveys do not point to a quick turnaround of the situation. We expect the unemployment rate to remain above 8% until at least mid-2011.
- Given the dismal prospects for growth, the planned reduction of the budget deficit to less than 3% of GDP by 2012 seems difficult to attain. We see budget deficit narrowing only to around 4% of GDP by that year.

Figure 27

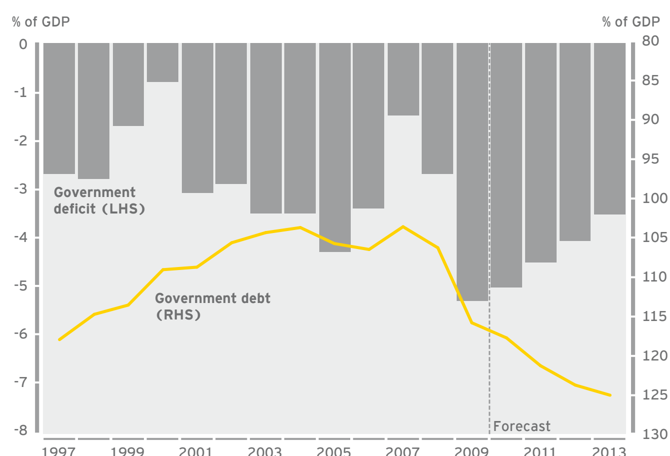
Contributions to GDP growth



Source: Oxford Economics

Figure 28

Government deficit and debt



Source: Oxford Economics

Table 4

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

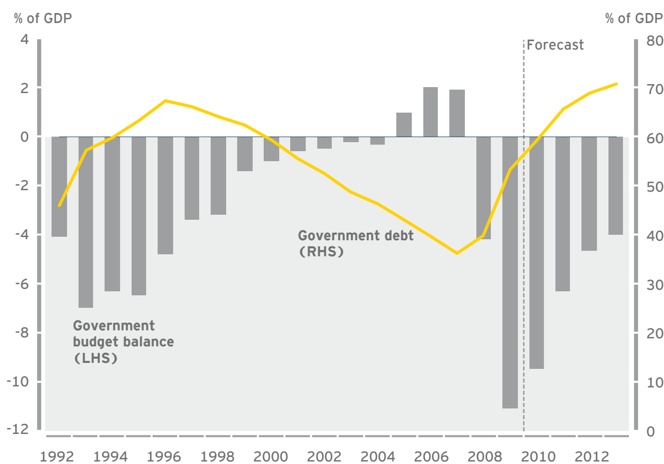
	2009	2010	2011	2012	2013	2014
GDP	-5.1	1.0	0.8	1.1	1.4	1.5
Private consumption	-1.8	0.4	0.5	1.2	1.4	1.4
Fixed investment	-12.2	1.8	0.7	1.6	2.2	2.2
Stockbuilding (% of GDP)	0.0	-0.1	0.1	0.2	-0.1	-0.3
Government consumption	0.6	-0.4	-1.2	0.1	1.0	1.0
Exports of goods and services	-19.1	7.4	4.1	4.7	5.8	6.1
Imports of goods and services	-14.6	4.8	2.5	4.8	4.5	5.3
Consumer prices	0.8	1.6	1.7	2.0	2.1	2.1
Unemployment rate (level)	7.8	8.4	8.0	7.7	7.3	7.0
Current balance (% of GDP)	-3.2	-3.8	-2.3	-2.7	-2.3	-2.1
Government budget (% of GDP)	-5.3	-5.0	-4.5	-4.1	-3.5	-2.9
Government debt (% of GDP)	116.1	120.5	123.8	126.1	127.1	127.2

Spain

- GDP was flat in Q2, in line with our forecast, as the temporary factors that boosted domestic demand in the first half of 2010 disappeared and net trade moderated. Our forecast of a 0.2% contraction in GDP in 2010 remains unchanged. Weak domestic demand will limit growth to 0.6% in 2011.
- Unemployment stood at 20% during Q3 2010. Given the gloomy outlook for growth, unemployment is not likely to fall significantly from this level before 2011.
- There is more encouraging news coming from public finances, as a series of fiscal consolidation plans implemented since the beginning of 2010 is starting to bear fruit. We forecast the budget deficit to contract to 6.3% of GDP in 2011, not too far from the Government's 6% target.
- The relatively benign outlook for government debt has so far limited the impact of the renewed tensions in bond markets on long-term rates. But, given the current state of high tensions in Eurozone bond markets, any slippage in fiscal restructuring would rapidly translate into higher interest rates.

Figure 29

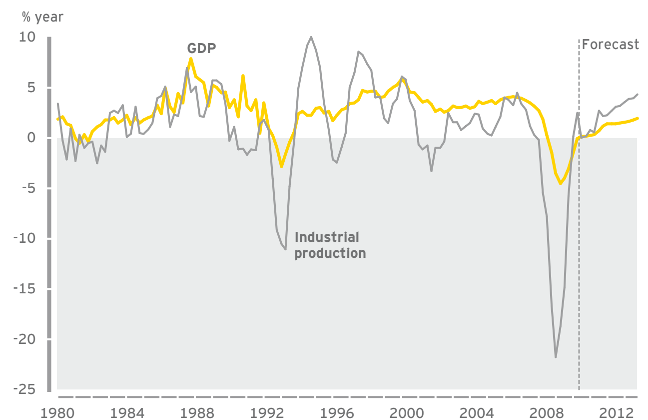
Government balance and debt



Source: Oxford Economics

Figure 30

GDP and industrial production



Source: Oxford Economics

Table 5

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

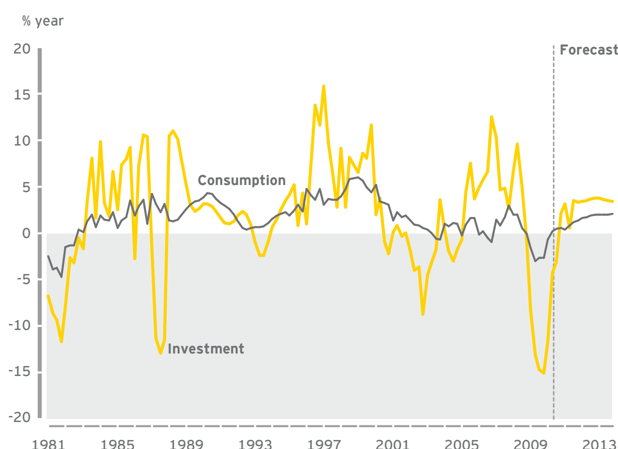
	2009	2010	2011	2012	2013	2014
GDP	-3.7	-0.2	0.6	1.4	1.7	1.9
Private consumption	-4.3	1.1	1.1	1.2	0.9	1.4
Fixed investment	-16.0	-7.5	-2.3	1.7	3.5	4.6
Stockbuilding (% of GDP)	0.4	0.2	-0.3	0.3	0.2	0.3
Government consumption	3.2	-0.1	-1.0	-1.5	0.1	1.3
Exports of goods and services	-11.6	8.9	6.2	8.1	8.0	6.6
Imports of goods and services	-17.8	4.3	1.7	7.2	6.0	7.0
Consumer prices	-0.2	1.6	1.4	1.2	1.3	1.4
Unemployment rate (level)	18.0	20.2	20.4	20.0	19.5	18.9
Current balance (% of GDP)	-5.5	-5.2	-3.8	-3.2	-2.9	-2.7
Government budget (% of GDP)	-11.1	-9.5	-6.3	-4.7	-4.0	-3.8
Government debt (% of GDP)	53.0	62.2	67.8	70.5	72.2	73.5

Netherlands

- After a relatively robust Q1 2010, Dutch GDP suffered a surprise setback in Q3 when it fell by 0.1%. This was largely caused by the earlier boost from stock rebuilding going into reverse. However, we expect the weakness in Q3 GDP to be revised away or reversed in Q4, and our forecast is for relatively healthy GDP growth of 1.7% in 2010, with a modest uptick to 1.8% in 2011.
- The consumer outlook remains weak, with households hampered by high debt levels and having to contend with falling real wages. More encouraging news is coming from the corporate sector, with signs that the investment climate is improving.
- Exports remain key to the Dutch outlook and are expected to remain resilient, given their reliance on Germany and other northern EU markets.
- The combination of relatively low deficit and debt places the Netherlands in the inner core of Eurozone countries that are relatively immune to the mounting fiscal crisis. As such, spreads of Dutch bond yields over German Bunds remain low.

Figure 31

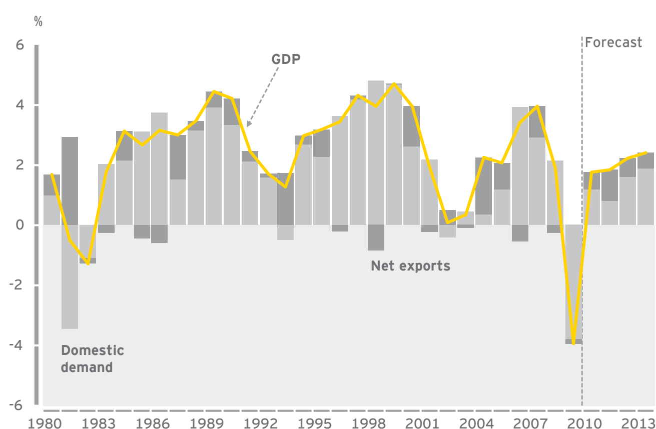
Consumption and investment



Source: Oxford Economics

Figure 32

Contributions to GDP growth



Source: Oxford Economics

Table 6

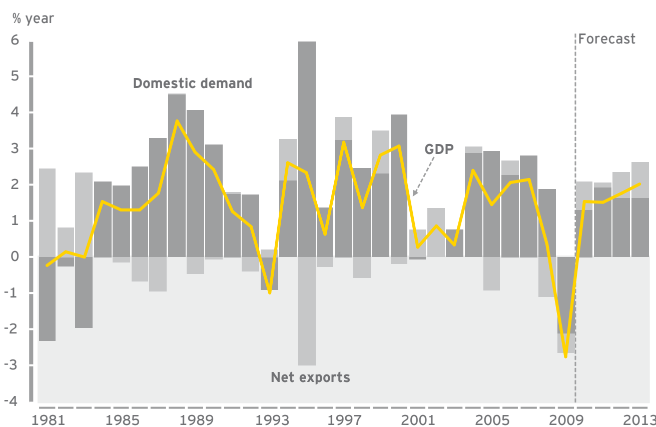
Netherlands (annual percentage changes unless specified) *Source: Oxford Economics*

	2009	2010	2011	2012	2013	2014
GDP	-3.9	1.7	1.8	2.2	2.4	2.1
Private consumption	-2.5	0.2	1.0	1.8	2.0	2.1
Fixed investment	-12.7	-4.4	2.6	3.6	3.6	3.1
Stockbuilding (% of GDP)	-0.7	0.7	0.6	0.4	0.4	0.4
Government consumption	3.7	1.8	0.9	1.0	1.2	1.2
Exports of goods and services	-7.9	10.4	5.8	6.2	6.1	5.4
Imports of goods and services	-8.5	10.7	5.0	6.1	6.2	5.7
Consumer prices	1.0	0.9	1.6	1.7	2.0	2.0
Unemployment rate (level)	3.7	4.5	4.8	4.8	4.3	3.7
Current balance (% of GDP)	4.6	6.1	6.0	6.9	7.5	7.4
Government budget (% of GDP)	-5.4	-6.4	-5.1	-3.2	-1.4	-0.5
Government debt (% of GDP)	61.0	65.3	67.9	68.4	66.9	64.6

Belgium

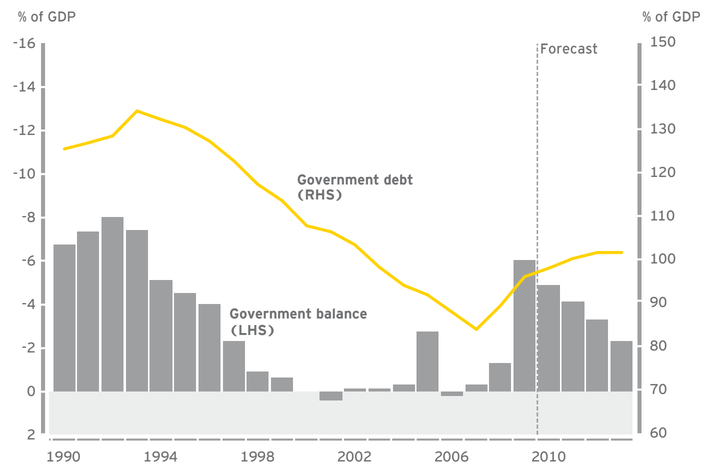
- In the light of the stronger-than-expected outturn for the first three quarters of 2010, we are raising our GDP growth forecast for 2010 as a whole to 2.1% (previously 1.8%). We expect only a moderate acceleration in the pace of activity over the course of 2011, with GDP growth once again averaging 2.1%.
- There appears to have been some stabilization in labor markets in recent months, and it seems likely that unemployment is close to its peak in the current cycle. Still, with economic activity expected to remain fairly subdued in the coming months, any significant recovery in hiring activity appears unlikely before the second half of 2011.
- The latest efforts to form a government have failed after coalition talks broke down. Amid the ongoing sovereign debt crisis, the political stand-off threatens to undermine investor confidence that the Belgian authorities will be able to introduce the structural reforms required to put their public finances on a sustainable long-term path.

Figure 33
Contributions to GDP growth



Source: Oxford Economics

Figure 34
Government balance and debt



Source: Oxford Economics

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

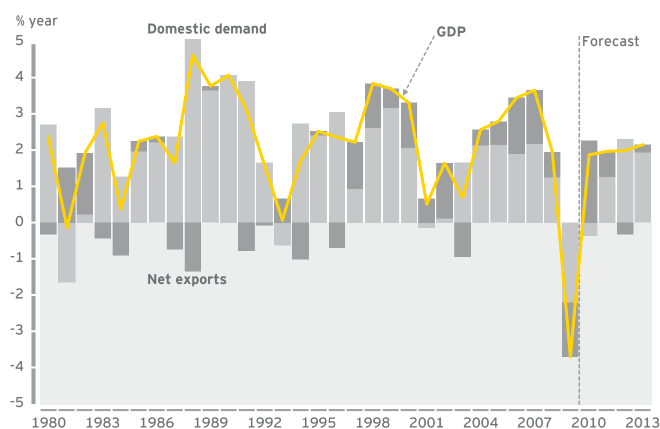
	2009	2010	2011	2012	2013	2014
GDP	-2.7	2.1	2.1	2.4	2.7	2.2
Private consumption	-0.2	1.3	1.5	2.4	2.4	1.9
Fixed investment	-4.9	-1.5	2.5	3.0	4.6	2.6
Stockbuilding (% of GDP)	0.5	1.1	1.5	0.9	0.0	0.2
Government consumption	0.4	1.1	1.2	1.3	1.5	1.6
Exports of goods and services	-11.4	10.3	5.1	5.2	5.9	4.4
Imports of goods and services	-10.9	9.3	5.0	4.5	4.8	4.5
Consumer prices	0.0	2.3	2.1	2.0	2.0	1.9
Unemployment rate (level)	7.9	8.6	8.7	8.1	7.8	7.6
Current balance (% of GDP)	0.9	1.5	1.5	2.4	3.3	3.6
Government budget (% of GDP)	-6.0	-4.9	-4.1	-3.3	-2.3	-1.2
Government debt (% of GDP)	97.5	100.8	102.6	103.6	103.1	102.0

Austria

- Austrian GDP grew by a solid 0.9% in Q3 2010. We forecast GDP to grow by 1.9% in 2010 as a whole and by 2% in 2011. Growth in 2010 so far has been largely accounted for by strong demand for exports, notably from Germany, the destination for around one-third of Austrian exports. However, external demand is expected to decelerate which will dampen the pace of the recovery .
- Domestic demand remains weak. Investment spending seems to have been muted by cautious companies, despite favorable financing conditions and low levels of spare capacity. Consumer spending has been dampened by low increases in wages. Looking forward, we expect both investment and consumption to strengthen, although the recovery is likely to be gradual.
- We estimate that the budget deficit will widen to 4.7% of GDP in 2010. To address fiscal imbalances, the Government will implement tightening measures from early 2011, worth 1.2% of GDP for that year alone.

Figure 35

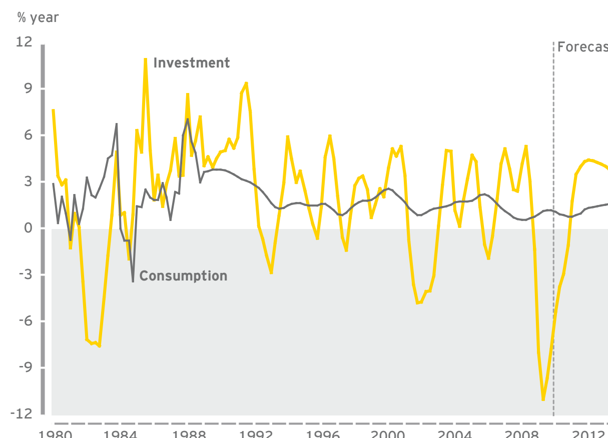
Contributions to GDP



Source: Oxford Economics

Figure 36

Consumption and investment

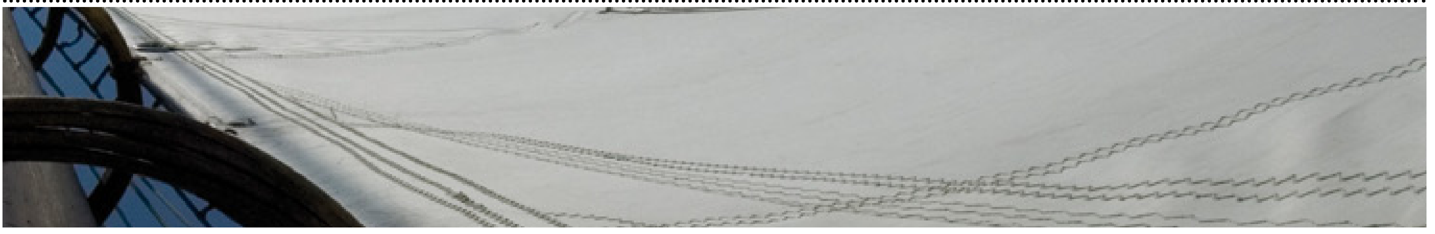


Source: Oxford Economics

Table 8

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

	2009	2010	2011	2012	2013	2014
GDP	-3.7	1.9	2.0	2.0	2.1	2.1
Private consumption	1.1	0.9	1.0	1.4	1.6	1.7
Fixed investment	-9.1	-3.3	3.4	4.3	3.7	3.2
Stockbuilding (% of GDP)	0.6	0.4	0.3	0.8	0.9	0.9
Government consumption	0.4	0.0	0.7	0.7	1.1	1.8
Exports of goods and services	-13.6	10.3	5.9	3.3	4.6	4.9
Imports of goods and services	-12.5	6.8	5.4	4.5	4.8	5.2
Consumer prices	0.4	1.7	1.9	1.9	1.9	1.9
Unemployment rate (level)	4.8	4.5	4.4	4.2	4.2	4.2
Current balance (% of GDP)	2.9	2.6	2.8	2.6	2.4	2.2
Government budget (% of GDP)	-3.5	-4.7	-3.8	-3.2	-2.9	-2.6
Government debt (% of GDP)	68.2	70.4	71.4	71.9	72.1	72.0



Greece

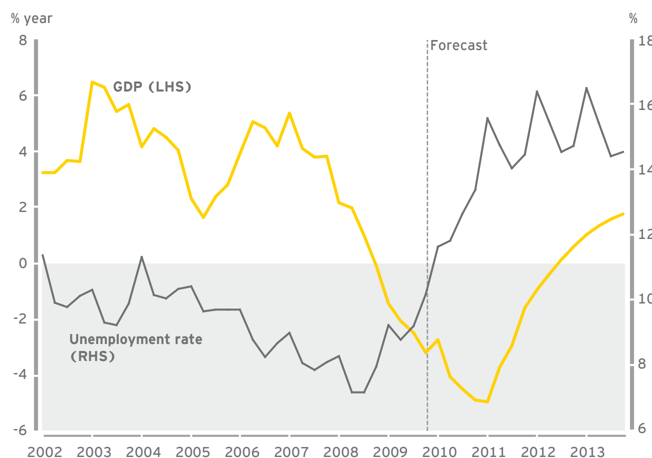
- Although Greece has made some progress in bringing its finances onto a sustainable track, it faces several challenges ahead. Government revenues remain below target, and slippages in local government and social security accounts have offset some of the gains made by the central Government.

- Upward revisions to government finance figures from 2006–09 were released on 15 November, placing the Greek Government in a considerably worse starting position. The 2009 budget deficit was raised to 15.4% of GDP, from 13.6%, with the debt-to-GDP ratio rising to 126.8%, from 115%.

- The austerity program comes at a large cost in terms of output and employment, as Greece faces a prolonged period of falling output. We expect a decline in GDP of over 4% in 2010 and more than 3% in 2011, with the recession lasting until 2012; during this time, all components of domestic demand is expected to see a sharp deterioration, and the unemployment rate will soar above 15%.

Figure 37

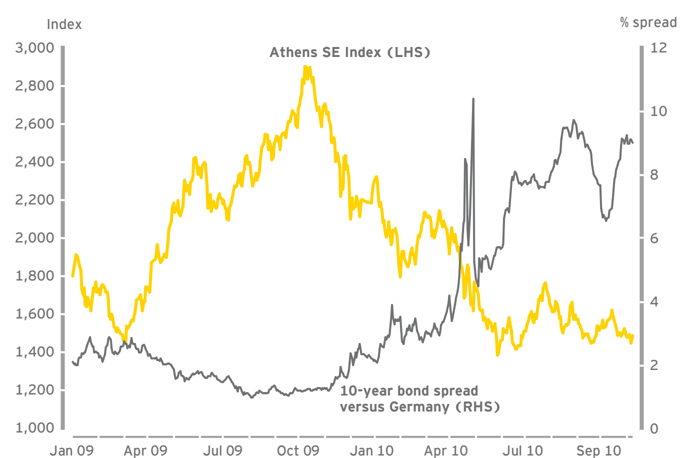
GDP and unemployment rate



Source: Oxford Economics, Haver Analytics

Figure 38

Bond spread and stock market



Source: Oxford Economics, Haver Analytics

Table 9

Greece (annual percentage changes unless specified)

Source: Oxford Economics

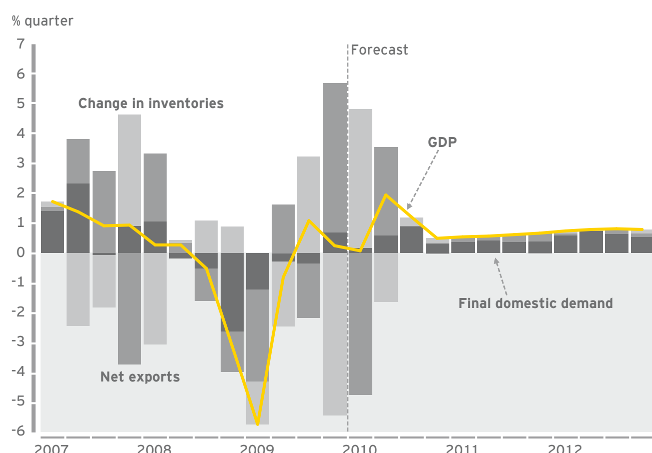
	2009	2010	2011	2012	2013	2014
GDP	-2.3	-4.0	-3.3	-0.2	1.4	2.0
Private consumption	-1.8	-3.7	-4.9	-1.6	0.6	2.0
Fixed investment	-13.9	-16.5	-4.3	1.8	4.3	5.4
Stockbuilding (% of GDP)	0.4	1.9	1.7	1.4	0.9	0.6
Government consumption	9.6	-12.8	-7.7	-2.2	-0.9	0.1
Exports of goods and services	-18.1	-2.2	6.0	9.4	9.9	8.8
Imports of goods and services	-14.1	-10.0	-4.3	2.4	5.1	7.7
Consumer prices	1.3	4.7	1.7	0.6	0.9	1.5
Unemployment rate (level)	9.5	12.5	15.1	15.6	15.6	15.2
Current balance (% of GDP)	-10.9	-10.5	-7.4	-6.7	-6.1	-5.9
Government budget (% of GDP)	-15.4	-9.4	-7.4	-6.7	-4.8	-3.6
Government debt (% of GDP)	126.8	138.6	150.0	157.1	158.2	156.5

Finland

- The Finnish economic recovery is on track, with GDP estimated to have increased by 1.2% in Q3 2010. This was slightly stronger than expected and we have raised our growth forecast. We now expect GDP to increase by 2.8% in 2010 and 2.9% in 2011.
- Exports have rebounded strongly and robust growth is expected further out. With positive developments in the wider economy — particularly the labor market — the outlook for consumption is upbeat. Investment is also expected to increase. In an optimistic economic environment, companies will be willing to invest, and with the banking sector in good shape, financing conditions remain favorable.
- However, the housing market seems to be overheating, presenting a downside risk to our forecast. The main risk is that individuals may become too indebted to cope with a rise in interest rates. In this regard, the increase in housing construction may provide some relief in rebalancing housing supply and demand.

Figure 39

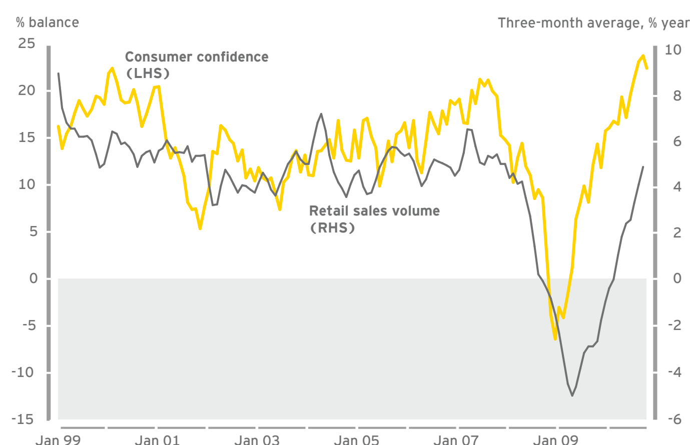
Contributions to quarterly GDP growth



Source: Oxford Economics

Figure 40

Consumer confidence and retail sales



Source: Eurostat, Haver Analytics

Table 10

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

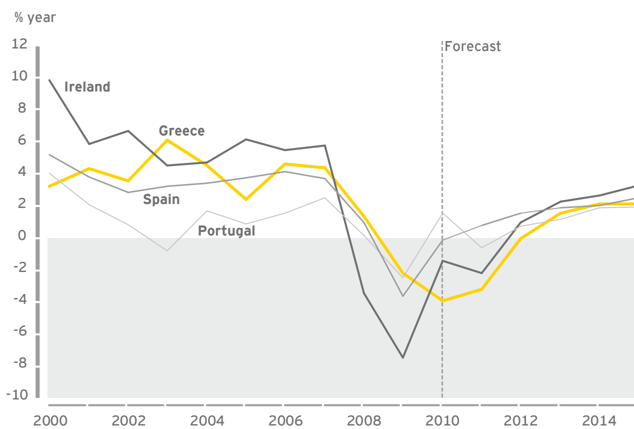
	2009	2010	2011	2012	2013	2014
GDP	-8.1	2.8	2.9	2.9	3.0	3.0
Private consumption	-1.9	2.3	1.7	2.3	3.2	3.4
Fixed investment	-14.5	0.6	3.7	4.5	3.4	3.9
Stockbuilding (% of GDP)	-0.3	0.3	0.2	0.4	0.3	0.1
Government consumption	1.2	0.8	1.2	1.1	0.9	1.1
Exports of goods and services	-20.5	3.3	8.3	8.2	8.7	6.5
Imports of goods and services	-18.1	2.1	7.1	8.6	9.3	6.7
Consumer prices	1.6	1.8	2.7	1.8	1.8	1.7
Unemployment rate (level)	8.2	8.5	8.3	7.8	7.3	6.9
Current balance (% of GDP)	2.7	1.5	1.3	1.0	1.9	2.4
Government budget (% of GDP)	-2.4	-3.8	-2.7	-1.9	-1.1	-0.3
Government debt (% of GDP)	44.1	46.1	47.2	47.0	46.0	44.2

Ireland

- The escalation of the Irish crisis through November reached a climax with the adoption of tougher spending cuts and tax increases for the next four years and a program of financial aid from the EU and IMF. We have revised our growth forecast to -1.5% in 2010 and -2.3% in 2011.
- This is a much bleaker outlook than presented in the government's National Recovery Plan. The Irish government assumed GDP growth to average 2.75% in 2011-14. By contrast, we forecast only 0.8% growth per year during that period. This implies risks that the fiscal targets are not met.

Figure 41

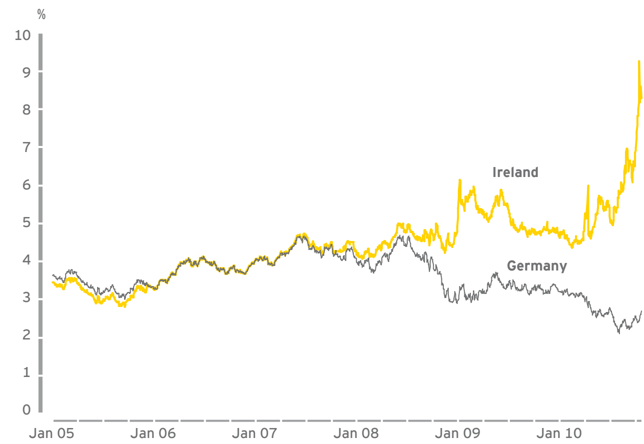
GDP growth



Source: Haver Analytics

Figure 42

Long-term government borrowing interest rate



Source: Haver Analytics

Table 11

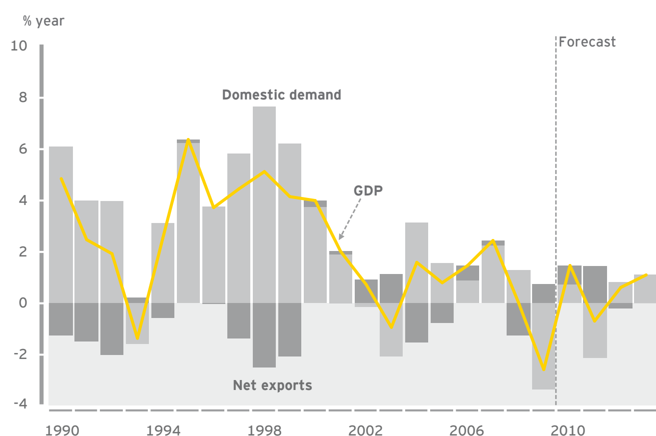
Ireland (annual percentage changes unless specified) *Source: Oxford Economics*

	2009	2010	2011	2012	2013	2014
GDP	-7.6	-1.5	-2.3	0.9	2.1	2.5
Private consumption	-7.0	-1.3	-4.3	-2.2	-0.1	0.4
Fixed investment	-30.9	-19.9	-9.5	-2.4	1.8	2.2
Stockbuilding (% of GDP)	-1.4	-0.5	-0.2	0.0	0.1	0.0
Government consumption	-4.4	-3.4	-3.9	-3.1	-2.6	-2.4
Exports of goods and services	-4.2	8.7	5.1	5.4	5.3	5.7
Imports of goods and services	-9.8	6.7	3.3	3.5	4.0	4.3
Consumer prices	-1.7	-1.3	-1.4	-0.5	0.9	1.0
Unemployment rate (level)	11.8	13.8	15.9	15.4	14.5	14.0
Current balance (% of GDP)	-3.0	-2.4	-0.6	-0.6	-0.7	-0.7
Government budget (% of GDP)	-14.4	-32.3	-9.7	-8.1	-5.8	-3.4
Government debt (% of GDP)	62.3	96.0	108.9	116.1	118.2	117.3

Portugal

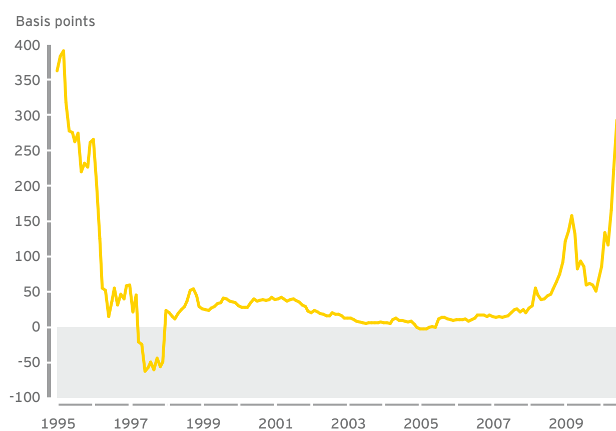
- Portuguese GDP grew 0.4% on the quarter in Q3 2010, underpinned mainly by exports. Due to stronger-than-expected results, we have revised our forecast upwards and now expect GDP to increase 1.4% in 2010. However, with numerous headwinds buffeting the Portuguese economy, the outlook remains bleak and GDP is expected to contract 0.7% in 2011.
- Portugal's sovereign debt troubles are having adverse consequences on the wider economy. Government budget data suggests Portugal will not meet its fiscal target of reducing the deficit from 9.3% in 2009 to 7.3% this year.
- The Government has therefore announced another round of fiscal austerity leading to political tensions and concerns that this will significantly hamper growth. It seems increasingly likely that Portugal will appeal for financial assistance from the EU and IMF which will involve yet more austerity measures with a strict schedule of targets.

Figure 43
Contributions to GDP growth



Source: Oxford Economics

Figure 44
Bond spread over Bunds



Source: Haver Analytics

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

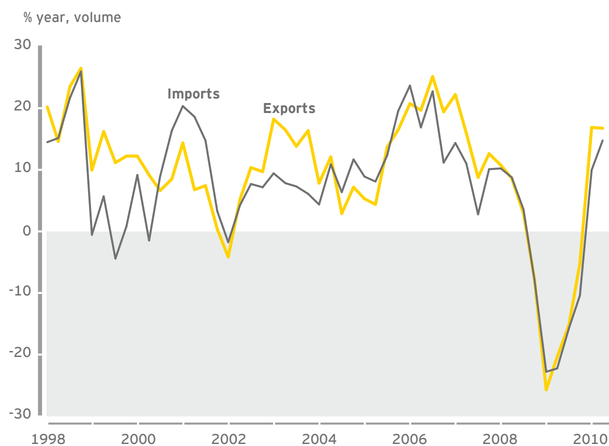
	2009	2010	2011	2012	2013	2014
GDP	-2.6	1.4	-0.7	0.6	1.1	1.7
Private consumption	-1.0	1.5	-0.9	1.2	0.9	1.5
Fixed investment	-11.9	-4.8	-4.0	0.8	2.3	2.4
Stockbuilding (% of GDP)	0.3	0.3	0.6	0.6	0.6	0.6
Government consumption	2.9	2.1	-3.9	-0.8	0.4	1.1
Exports of goods and services	-11.8	7.2	3.6	3.2	4.3	5.1
Imports of goods and services	-10.9	3.6	-0.7	3.2	3.6	4.1
Consumer prices	-0.9	1.2	1.0	0.9	1.9	1.8
Unemployment rate (level)	9.6	10.7	11.1	11.1	11.0	10.7
Current balance (% of GDP)	-10.3	-8.9	-6.7	-6.4	-5.9	-5.3
Government budget (% of GDP)	-9.3	-8.0	-6.0	-3.6	-2.8	-2.6
Government debt (% of GDP)	76.9	83.4	89.4	90.9	91.2	90.7

Slovakia

- GDP growth slowed in Q3 2010. Growth in the industrial sector was hampered by weaker demand from abroad and low capacity utilization.
- We forecast GDP growth to keep slowing in the next few quarters and to average 3.9% in 2010 and 2.8% in 2011.
- Slower output growth is also affecting labor markets, as unemployment continued to rise in Q3. As a result, consumer confidence is falling back to levels not seen since 2009, and we expect consumption to contract slightly this year and recover gradually in 2011–12.
- The right-wing coalition Government led by Prime Minister Iveta Radicova approved the provisional budget for 2011, promising to reduce drastically the deficit compared with the record level reached in 2009–10. We expect the deficit to fall from above 8% of GDP in 2010 to around 5.5% of GDP in 2011.

Figure 45

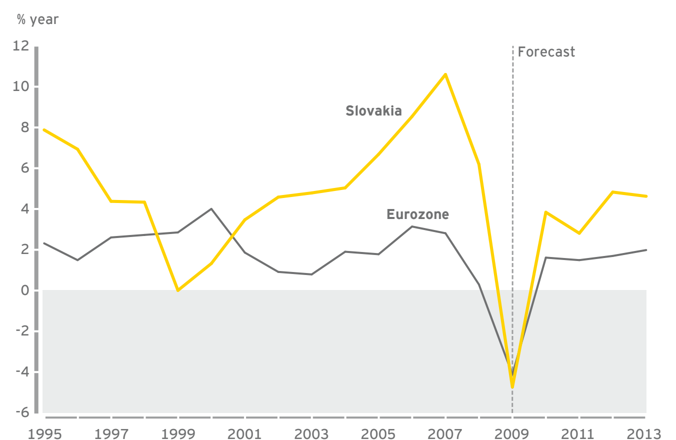
Exports and imports



Source: Haver Analytics

Figure 46

Real GDP growth



Source: Oxford Economics

Table 13

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

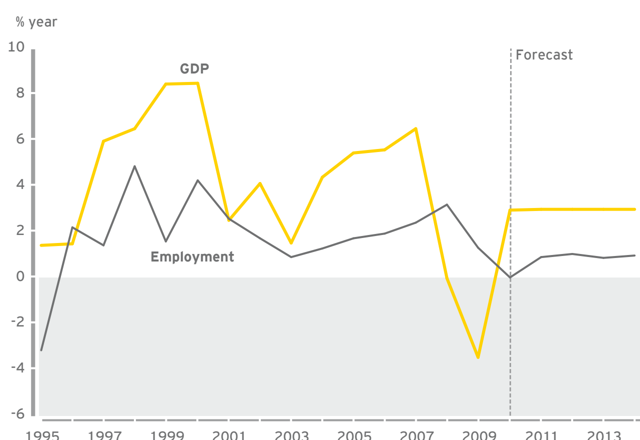
	2009	2010	2011	2012	2013	2014
GDP	-4.7	3.9	2.8	4.8	4.6	3.8
Private consumption	-0.7	-0.4	0.9	3.4	4.2	4.1
Fixed investment	-10.5	-0.5	4.8	6.8	7.4	7.3
Stockbuilding (% of GDP)	-1.1	0.9	0.9	0.8	0.8	0.9
Government consumption	2.8	1.5	-2.2	1.3	2.6	2.5
Exports of goods and services	-16.5	13.1	9.1	10.1	9.4	8.2
Imports of goods and services	-17.6	11.3	8.0	9.4	10.0	9.5
Consumer prices	1.6	1.0	2.9	2.6	2.6	2.5
Unemployment rate (level)	12.0	14.6	13.9	11.4	10.0	9.1
Current balance (% of GDP)	-3.2	-3.7	-2.6	-2.9	-2.7	-2.3
Government budget (% of GDP)	-7.9	-8.5	-5.4	-4.0	-3.4	-2.9
Government debt (% of GDP)	36.9	42.0	43.8	43.2	42.1	40.9

Luxembourg

- Real GDP growth is forecast to average 3% in 2010, making up for much of the loss in the previous year. We forecast slightly slower growth next year, at 2.7%, after which growth at around 3% should resume.
- However, risks are on the downside. In 2011, fiscal tightening could have a more negative impact on growth than we currently estimate. In addition, we could be underestimating the negative impact of new financial regulation on activity and profitability in the sector.
- The budget deficit is expected to narrow to 1.3% of GDP in 2011 from 2.2% in 2010. This budget seems achievable. There is a risk that tax revenues do not increase as strongly as budgeted. But with debt only around 15% of GDP, the Government can afford some small and short-term slippage.

Figure 47

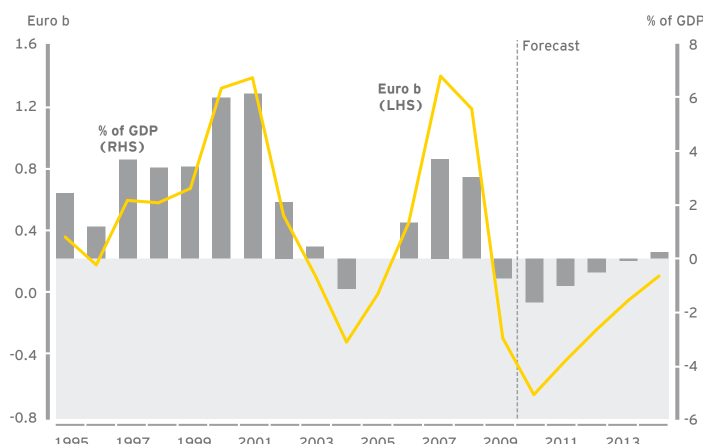
Real GDP and employment



Source: Oxford Economics

Figure 48

Government budget balance



Source: Oxford Economics

Table 14

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

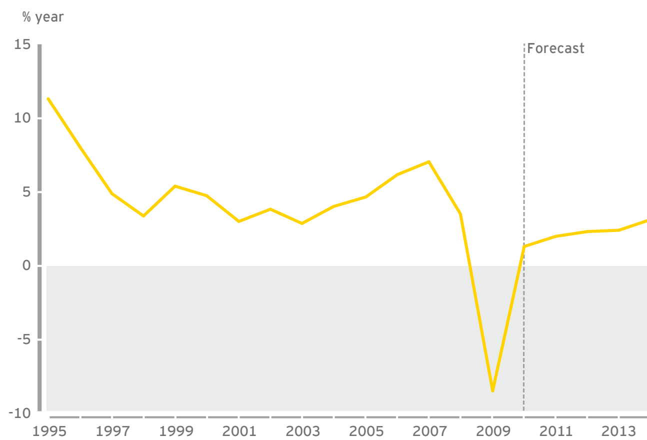
	2009	2010	2011	2012	2013	2014
GDP	-3.7	3.0	2.7	3.0	3.0	3.0
Private consumption	0.3	2.6	2.8	3.0	3.0	3.1
Fixed investment	-19.3	2.9	4.8	6.0	5.0	4.0
Stockbuilding (% of GDP)	0.6	0.0	0.0	0.0	0.0	0.0
Government consumption	2.9	-0.1	1.0	2.0	2.5	2.5
Exports of goods and services	-8.2	9.4	6.1	5.8	5.7	5.4
Imports of goods and services	-10.3	9.7	6.8	6.5	6.3	5.8
Consumer prices	0.0	2.8	2.5	2.2	2.0	2.0
Unemployment rate (level)	5.2	5.5	5.1	4.8	4.4	3.9
Current balance (% of GDP)	6.8	8.5	7.0	6.5	6.0	6.0
Government budget (% of GDP)	-0.7	-2.2	-1.3	-0.8	-0.4	-0.1
Government debt (% of GDP)	14.7	16.0	16.5	16.5	16.1	15.4

Slovenia

- GDP growth is likely to be limited to 1.3% for 2010 as the trade stimulus fades, subduing the recovery in industrial production. Growth should climb gradually toward a cyclical peak of around 3% in 2014. This is significantly lower than before the crisis, reflecting the fact that income convergence with the EU is coming to a close, while long-term growth is dampened by ongoing structural constraints.
- The Government deficit is set to widen to 6.2% of GDP in 2010. The 2011 budget confirms a strategy of gradual deficit reduction, based on containing public administration costs while boosting public capital spending.
- Inflation is set to pick up in the final part of 2010, due to the rise in import prices and the overall lack of efficiency in the service sector. We expect consumer prices to increase by 2.3% in 2010 and 2.8% in 2011. Slovenia's relatively high inflation represents one downside to our forecast as it risks undermining competitiveness.

Figure 49

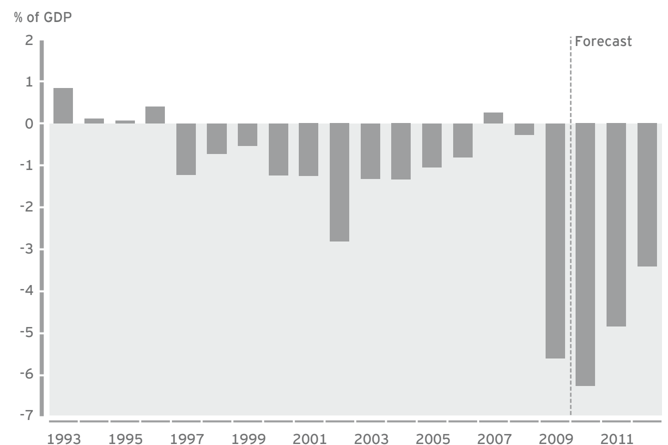
Real GDP



Source: Oxford Economics

Figure 50

Government budget balance



Source: Oxford Economics

Table 15

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

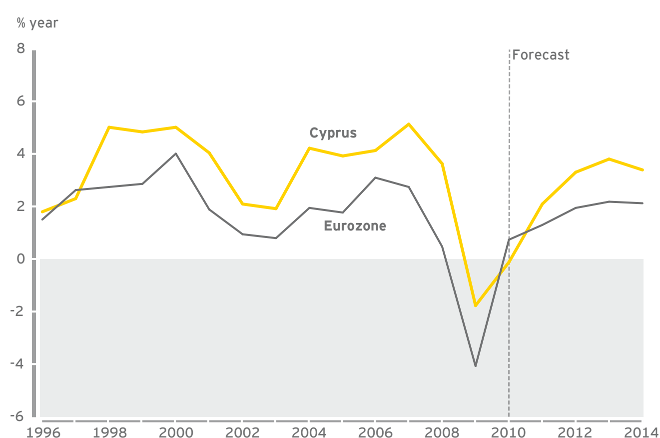
	2009	2010	2011	2012	2013	2014
GDP	-8.4	1.3	2.0	2.3	2.4	3.1
Private consumption	-0.8	-1.5	1.2	1.5	1.8	2.4
Fixed investment	-21.9	-7.1	2.0	3.5	5.1	4.6
Stockbuilding (% of GDP)	-0.7	2.4	3.1	3.8	3.9	3.9
Government consumption	3.0	1.1	0.7	1.2	1.7	2.0
Exports of goods and services	-18.7	8.7	5.0	5.1	5.5	5.6
Imports of goods and services	-20.6	7.6	5.0	5.5	5.8	5.4
Consumer prices	0.8	2.3	2.8	2.7	2.8	2.8
Unemployment rate (level)	5.9	7.2	6.5	5.5	5.1	5.1
Current balance (% of GDP)	-1.5	-1.0	-1.1	-1.4	-1.8	0.1
Government budget (% of GDP)	-5.6	-6.2	-4.8	-3.6	-2.5	-2.0
Government debt (% of GDP)	35.6	40.6	43.5	44.8	45.1	44.5

Cyprus

- GDP growth is forecast at only 0.6% in 2010. The recovery is expected to strengthen during 2011, but will be dampened by ongoing fiscal consolidation. We forecast growth at around 2% in 2011.
- Inflation slowed slightly in Q3 2010, but it is set to remain above the Eurozone average for some years. This may be a serious obstacle to curbing public sector wage growth, with the public sector wage bill the largest component of the government budget. We expect the fiscal deficit to surpass 6% of GDP in 2010 and to be brought down to around 3% by 2013.
- Meanwhile, six months before elections, the coalition Government is divided over how to address the high deficit. This increases the risk of a credit-rating downgrade, resulting in considerably higher borrowing costs. Moreover, tax increases now under consideration will be hard to design in a way that would maintain longer-term incentives for inward investment, a key component of the Cypriot economy.

Figure 51

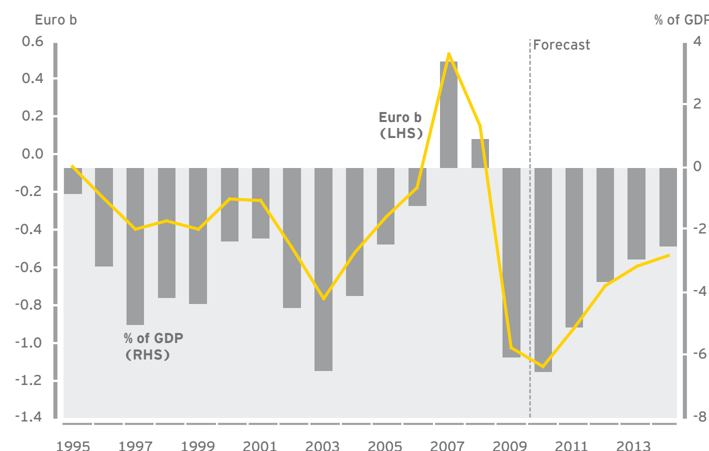
Real GDP growth



Source: Oxford Economics

Figure 52

Government budget balance



Source: Oxford Economics

Table 16

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

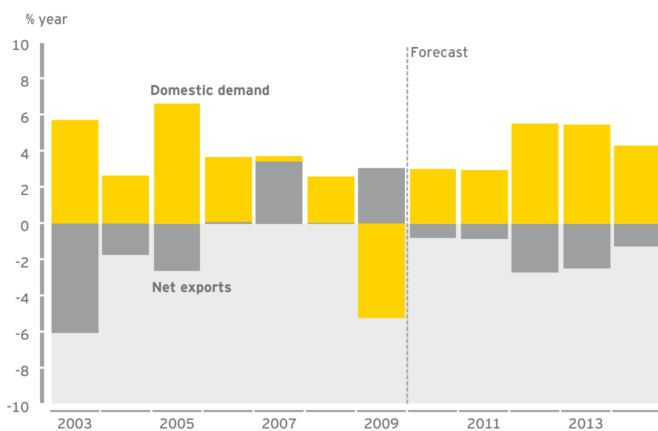
	2009	2010	2011	2012	2013	2014
GDP	-1.7	0.6	1.9	2.8	3.8	3.4
Private consumption	-3.0	0.6	2.8	3.3	4.0	3.5
Fixed investment	-12.0	-3.0	2.0	5.0	7.1	5.5
Stockbuilding (% of GDP)	-2.7	-0.1	0.3	0.5	0.5	0.4
Government consumption	5.8	-2.0	1.0	2.1	2.7	3.0
Exports of goods and services	-11.8	-1.5	3.0	6.4	5.7	5.3
Imports of goods and services	-19.8	1.4	4.7	7.2	6.5	5.6
Consumer prices	0.2	2.8	2.5	2.2	2.3	2.3
Unemployment rate (level)	5.4	6.3	5.8	5.1	4.7	4.6
Current balance (% of GDP)	-8.1	-9.6	-9.0	-9.1	-8.1	-7.2
Government budget (% of GDP)	-6.0	-6.4	-5.3	-3.8	-3.0	-2.5
Government debt (% of GDP)	58.0	62.5	65.1	65.7	64.9	63.9

Malta

- Quarterly GDP growth declined to 0.1% in Q2 2010, from 1.4% in the previous quarter, and the recovery is set to slow further in H2 2010, as export and fiscal stimuli fades.
- Although unemployment remains the fourth lowest in the Eurozone, consumer spending was still very weak in Q3 2010, with retail sales dropping a record 1.3% in September.
- The Government's fiscal measures are likely to maintain the budget deficit below 4% next year, but we believe its 2.8% target for 2011 will be very difficult to achieve. We forecast the deficit to fall below the Maastricht threshold of 3.0% in 2014.
- Consumer price inflation declined slightly, but remained above the Eurozone average, at 2.4% in September. With energy costs up 22% year on year in September, inflationary pressures remain high.

Figure 53

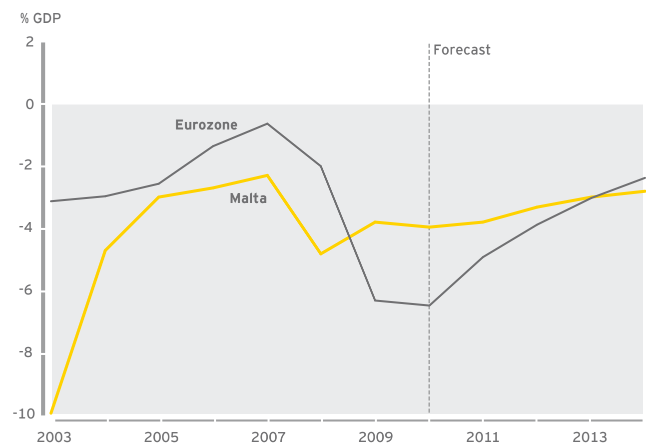
Contributions to GDP



Source: Oxford Economics

Figure 54

Fiscal balance versus Eurozone



Source: The Statistical Offce of the European Community/Haver Analytics

Table 17

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

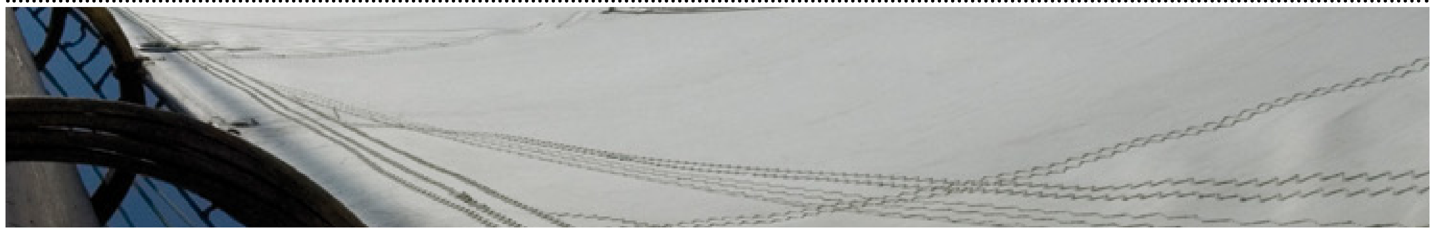
	2009	2010	2011	2012	2013	2014
GDP	-2.1	2.2	2.1	2.8	3.0	3.0
Private consumption	0.2	5.0	2.2	3.0	3.0	3.0
Fixed investment	-28.3	3.7	8.0	13.0	16.0	8.0
Stockbuilding (% of GDP)	0.0	0.5	0.8	2.2	2.5	2.7
Government consumption	-1.3	-5.8	0.3	1.1	3.0	3.0
Exports of goods and services	-7.6	13.2	5.0	4.4	3.8	3.0
Imports of goods and services	-10.6	14.0	5.8	7.0	6.0	4.0
Consumer prices	1.8	1.9	2.6	2.3	2.3	2.3
Unemployment rate (level)	7.0	7.0	6.7	6.0	5.6	4.8
Current balance (% of GDP)	-6.1	-5.6	-5.9	-6.0	-5.5	-5.1
Government budget (% of GDP)	-3.8	-4.0	-3.8	-3.3	-3.0	-2.8
Government debt (% of GDP)	68.6	69.0	69.8	69.7	69.1	68.4

Detailed tables and charts

Forecast assumptions

	2009	2010	2011	2012	2013	2014
Short-term interest rates (%)	1.2	0.8	1.3	2.4	3.2	3.6
Long-term interest rates (%)	3.8	3.5	3.5	4.0	4.7	5.0
Euro effective exchange rate (1995=100)	129.7	121.7	117.8	108.5	106.9	110.0
Oil prices (€/barrel)	44.2	59.0	64.2	75.0	81.8	82.0
Share prices (% year)	-17.3	6.0	2.7	8.4	8.7	8.7

	2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Short-term interest rates (%)	2.0	1.3	0.9	0.7	0.7	0.7	0.9	1.1
Long-term interest rates (%)	3.9	4.0	3.8	3.7	3.7	3.6	3.5	3.4
Euro effective exchange rate (1995=100)	128.0	128.9	130.2	131.8	125.8	118.8	118.1	124.1
Oil prices (€/barrel)	34.2	43.2	47.7	50.5	55.2	61.6	60.1	59.5
Share prices (% year)	-42.9	-28.4	-5.4	21.2	41.5	7.1	-4.3	-9.9



Eurozone GDP and components

Quarterly forecast
(quarterly percentage changes)

	2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	-2.5	-0.1	0.4	0.2	0.3	1.0	0.4	0.3
Private consumption	-0.5	0.0	-0.1	0.2	0.2	0.2	0.1	0.1
Fixed investment	-5.2	-2.3	-1.1	-1.2	-0.3	1.5	0.0	0.2
Government consumption	0.7	0.6	0.5	-0.1	0.2	0.5	0.3	0.3
Exports of goods and services	-8.0	-1.3	2.4	2.0	2.5	4.3	1.9	1.0
Imports of goods and services	-7.5	-2.8	2.2	1.2	4.2	4.0	0.8	0.8

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

	2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	-2.5	-0.1	0.4	0.2	0.3	1.0	0.4	0.3
Private consumption	-0.3	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Fixed investment	-1.1	-0.5	-0.2	-0.2	-0.1	0.3	0.0	0.0
Government consumption	0.1	0.1	0.1	0.0	0.0	0.1	0.1	0.1
Stockbuilding	-1.0	-0.4	0.5	0.0	0.9	0.3	-0.2	0.0
Exports of goods and services	-3.5	-0.5	1.0	0.8	1.0	1.8	0.8	0.4
Imports of goods and services	3.2	1.1	-0.9	-0.5	-1.7	-1.7	-0.3	-0.4

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

	2009	2010	2011	2012	2013	2014
GDP	7,457	7,581	7,690	7,821	7,977	8,139
Private consumption	4,344	4,367	4,400	4,452	4,514	4,583
Fixed investment	1,495	1,476	1,502	1,543	1,598	1,655
Government consumption	1,606	1,624	1,628	1,631	1,643	1,659
Stockbuilding	-42	48	65	81	83	94
Exports of goods and services	3,049	3,341	3,530	3,743	3,990	4,230
Imports of goods and services	2,996	3,277	3,434	3,629	3,850	4,083

Annual levels — Nominal terms
(€ billion)

	2009	2010	2011	2012	2013	2014
GDP	8,952	9,173	9,424	9,744	10,115	10,505
Private consumption	5,169	5,297	5,421	5,568	5,745	5,940
Fixed investment	1,758	1,756	1,808	1,889	1,990	2,096
Government consumption	1,979	2,027	2,051	2,091	2,145	2,210
Stockbuilding	-70	-50	-25	28	42	47
Exports of goods and services	3,249	3,715	4,023	4,365	4,741	5,104
Imports of goods and services	3,133	3,573	3,855	4,197	4,548	4,891

Prices and costs indicators

(annual percentage changes unless specified)

	2009	2010	2011	2012	2013	2014
HICP headline inflation	0.3	1.5	1.6	1.6	1.7	1.8
Inflation ex-energy	1.3	1.0	1.5	1.6	1.7	1.7
GDP deflator	1.0	0.8	1.3	1.7	1.8	1.8
Import deflator	-1.7	5.7	2.3	2.3	1.9	1.6
Export deflator	-9.2	7.6	3.0	2.1	1.4	0.9
Terms of trade	-7.5	1.9	0.7	-0.2	-0.5	-0.7
Earnings	1.5	1.8	1.7	2.4	2.9	3.1
Unit labor costs	3.9	-0.6	0.3	1.0	1.2	1.4
Output gap (% of GDP)	-5.3	-4.0	-3.3	-2.7	-2.0	-1.4
Oil prices (€ per barrel)	44.2	59.0	64.2	75.0	81.8	82.0
Euro effective exchange rate (1995=100)	129.7	121.7	117.8	108.5	106.9	110.0

	2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
HICP headline inflation	0.9	0.2	-0.4	0.4	1.1	1.5	1.7	1.8
Inflation ex-energy	1.7	1.5	1.2	1.0	0.9	0.8	1.0	1.2
GDP deflator	1.7	1.0	0.8	0.3	0.4	0.8	1.0	1.1
Import deflator	-0.1	-1.4	-2.8	-2.6	3.6	6.3	6.4	6.4
Export deflator	-6.8	-9.6	-12.9	-7.4	5.1	10.2	6.9	8.0
Terms of trade	-6.8	-8.2	-10.2	-4.7	1.5	3.9	0.6	1.6
Earnings	2.2	1.3	1.3	1.3	1.8	2.2	1.6	1.6
Unit labor costs	6.0	4.7	3.4	1.4	-0.5	-0.6	-0.7	-0.4
Output gap (% of GDP)	-5.3	-5.5	-5.4	-5.3	-5.0	-4.0	-3.7	-3.5
Oil prices (€ per barrel)	34.2	43.2	47.7	50.5	55.2	61.6	60.1	59.5
Euro effective exchange rate (1995=100)	128.0	128.9	130.2	131.8	125.8	118.8	118.1	124.1

Labor market

(annual percentage changes unless specified)

	2009	2010	2011	2012	2013	2014
Employment	-1.9	-0.5	0.0	0.3	0.4	0.4
Unemployment rate (%)	9.4	10.0	10.0	9.8	9.4	9.0
NAIRU (%)	8.0	8.6	9.1	9.1	9.1	8.9
Participation rate (%)	73.2	73.3	73.4	73.6	73.7	73.9
Earnings	1.5	1.8	1.7	2.4	2.9	3.1
Unit labor costs	3.9	-0.6	0.3	1.0	1.2	1.4

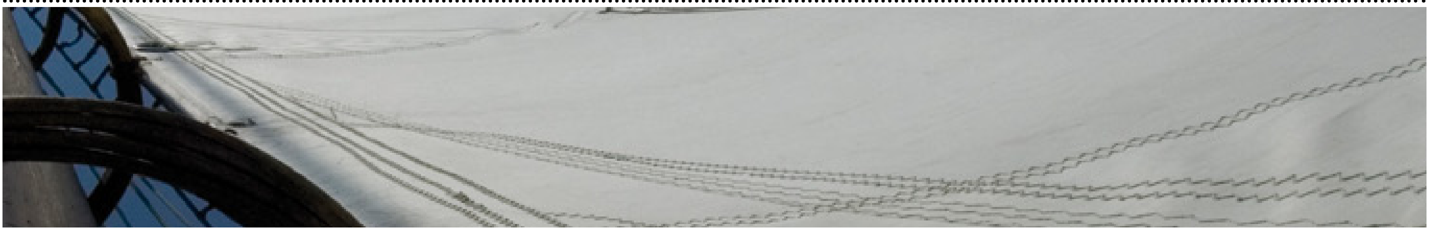
	2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Employment	-1.3	-1.9	-2.2	-2.1	-1.2	-0.7	-0.1	0.0
Unemployment rate (%)	8.8	9.4	9.7	9.9	9.9	10.0	10.0	10.1
NAIRU (%)	7.8	7.9	8.0	8.2	8.3	8.5	8.7	8.9
Participation rate (%)	73.3	73.3	73.2	73.2	73.2	73.3	73.3	73.3
Earnings	2.2	1.3	1.3	1.3	1.8	2.2	1.6	1.6
Unit labor costs	6.0	4.7	3.4	1.4	-0.5	-0.6	-0.7	-0.4

Current account and fiscal balance

	2009	2010	2011	2012	2013	2014
Trade balance (€ b)	15.7	28.5	54.2	65.6	93.7	111.3
Trade balance (% GDP)	0.2	0.4	0.7	0.8	1.2	1.4
Current account balance (€ b)	-67.6	-30.7	0.7	-10.6	2.0	16.9
Current account balance (% GDP)	-0.8	-0.3	0.0	-0.1	0.0	0.2
Government budget balance (€ b)	-565	-592	-461	-375	-301	-244
Government budget balance (% GDP)	-6.3	-6.5	-4.9	-3.9	-3.0	-2.3
Cyclically adjusted surplus (+)/deficit (-) (% GDP)	-4.7	-0.8	1.4	3.0	4.3	5.4
Government debt (€ b)	7,320	7,949	8,446	8,857	9,195	9,475
Government debt (% GDP)	98.2	104.9	109.8	113.3	115.3	116.4

Measures of convergence/divergence within the Eurozone

	1999-2003	2004-2008	2009-2013
Growth and incomes			
Standard deviation of GDP growth rates	1.9	2.2	1.3
Growth rate gap (max–min)	7.3	8.1	5.3
Highest GDP per capita (Eurozone=100)	229.7	245.0	247.6
Lowest GDP per capita (Eurozone=100)	48.8	62.2	68.4
Inflation and prices			
Standard deviation of inflation rates	2.0	0.9	0.7
Inflation rate gap (max–min)	7.7	3.3	2.8
Highest price level (Eurozone=100)	115.5	116.6	116.4
Lowest price level (Eurozone=100)	44.7	59.0	65.7



Cross-country tables

Real GDP
(% year)

Rank		2009	2010	2011	2012	2013	2014	Average 2010-2014
1	Slovakia	-4.7	3.9	2.8	4.8	4.6	3.8	**4.0**
2	Finland	-8.1	2.8	2.9	2.9	3.0	3.0	**2.9**
3	Luxembourg	-3.7	3.0	2.7	3.0	3.0	3.0	**2.9**
4	Malta	-2.1	2.2	2.1	2.8	3.0	3.0	**2.6**
5	Cyprus	-1.7	0.6	1.9	2.8	3.8	3.4	**2.5**
6	Germany	-4.7	3.5	2.1	1.7	2.1	2.1	**2.3**
7	Belgium	-2.7	2.1	2.1	2.4	2.7	2.2	**2.3**
8	Slovenia	-8.4	1.3	2.0	2.3	2.4	3.1	**2.2**
9	Netherlands	-3.9	1.7	1.8	2.2	2.4	2.1	**2.1**
10	Austria	-3.7	1.9	2.0	2.0	2.1	2.1	**2.0**
11	France	-2.5	1.6	1.8	2.0	2.1	2.0	**1.9**
12	Eurozone	-4.0	1.7	1.4	1.7	2.0	2.0	**1.8**
13	Italy	-5.1	1.0	0.8	1.1	1.4	1.5	**1.2**
14	Spain	-3.7	-0.2	0.6	1.4	1.7	1.9	**1.1**
15	Portugal	-2.6	1.4	-0.7	0.6	1.1	1.7	**0.8**
16	Ireland	-7.6	-1.5	-2.3	0.9	2.1	2.5	**0.3**
17	Greece	-2.3	-4.0	-3.3	-0.2	1.4	2.0	**-0.8**

Inflation rates
(% year)

Rank		2009	2010	2011	2012	2013	2014	Average 2010-2014
1	Ireland	-1.7	-1.3	-1.4	-0.5	0.9	1.0	**-0.3**
2	Portugal	-0.9	1.2	1.0	0.9	1.9	1.8	**1.4**
3	Spain	-0.2	1.6	1.4	1.2	1.3	1.4	**1.4**
4	Germany	0.2	1.1	1.5	1.5	1.6	1.7	**1.5**
5	Eurozone	0.3	1.5	1.6	1.6	1.7	1.8	**1.7**
6	Netherlands	1.0	0.9	1.6	1.7	2.0	2.0	**1.7**
7	France	0.1	1.7	1.8	1.8	1.9	1.9	**1.8**
8	Greece	1.3	4.7	1.7	0.6	0.9	1.5	**1.9**
9	Austria	0.4	1.7	1.9	1.9	1.9	1.9	**1.9**
10	Italy	0.8	1.6	1.7	2.0	2.1	2.1	**1.9**
11	Finland	1.6	1.8	2.7	1.8	1.8	1.7	**2.0**
12	Belgium	0.0	2.3	2.1	2.0	2.0	1.9	**2.1**
13	Malta	1.8	1.9	2.6	2.3	2.3	2.3	**2.3**
14	Luxembourg	0.0	2.8	2.5	2.2	2.0	2.0	**2.3**
15	Slovakia	1.6	1.0	2.9	2.6	2.6	2.5	**2.3**
16	Cyprus	0.2	2.8	2.5	2.2	2.3	2.3	**2.4**
17	Slovenia	0.8	2.3	2.8	2.7	2.8	2.8	**2.7**

Cross-country tables

Unemployment rate
(%)

Rank		2009	2010	2011	2012	2013	2014	Average 2010–2014
1	Austria	4.8	4.5	4.4	4.2	4.2	4.2	**4.3**
2	Netherlands	3.7	4.5	4.8	4.8	4.3	3.7	**4.4**
3	Luxembourg	5.2	5.5	5.1	4.8	4.4	3.9	**4.7**
4	Cyprus	5.4	6.3	5.8	5.1	4.7	4.6	**5.3**
5	Slovenia	5.9	7.2	6.5	5.5	5.1	5.1	**5.9**
6	Malta	7.0	7.0	6.7	6.0	5.6	4.8	**6.0**
7	Germany	7.5	6.9	6.6	6.5	6.2	5.9	**6.4**
8	Italy	7.8	8.4	8.0	7.7	7.3	7.0	**7.7**
9	Finland	8.2	8.5	8.3	7.8	7.3	6.9	**7.8**
10	Belgium	7.9	8.6	8.7	8.1	7.8	7.6	**8.1**
11	France	9.5	9.9	9.8	9.5	9.1	8.6	**9.4**
12	Eurozone	9.4	10.0	10.0	9.8	9.4	9.0	**9.6**
13	Portugal	9.6	10.7	11.1	11.1	11.0	10.7	**10.9**
14	Slovakia	12.0	14.6	13.9	11.4	10.0	9.1	**11.8**
15	Ireland	11.8	13.8	15.9	15.4	14.5	14.0	**14.7**
16	Greece	9.5	12.5	15.1	15.6	15.6	15.2	**14.8**
17	Spain	18.0	20.2	20.4	20.0	19.5	18.9	**19.8**

Public deficits
(% of GDP)

Rank		2009	2010	2011	2012	2013	2014	Difference 2010–2014
1	Luxembourg	-0.7	-2.2	-1.3	-0.8	-0.4	-0.1	**0.7**
2	Austria	-3.5	-4.7	-3.8	-3.2	-2.9	-2.6	**0.9**
3	Malta	-3.8	-4.0	-3.8	-3.3	-3.0	-2.8	**1.0**
4	Germany	-3.0	-4.1	-3.6	-2.8	-2.1	-1.5	**1.5**
5	Finland	-2.5	-3.8	-2.7	-1.9	-1.1	-0.3	**2.2**
6	Italy	-5.3	-5.0	-4.5	-4.1	-3.5	-2.9	**2.4**
7	Cyprus	-6.0	-6.4	-5.3	-3.8	-3.0	-2.5	**3.5**
8	Slovenia	-5.6	-6.2	-4.8	-3.6	-2.5	-2.0	**3.6**
9	Eurozone	-6.3	-6.5	-4.9	-3.9	-3.0	-2.3	**4.0**
10	France	-7.5	-7.8	-6.1	-4.8	-3.8	-3.0	**4.5**
11	Belgium	-6.0	-4.9	-4.1	-3.3	-2.3	-1.2	**4.8**
12	Netherlands	-5.4	-6.4	-5.1	-3.2	-1.4	-0.5	**4.9**
13	Slovakia	-7.9	-8.5	-5.4	-4.0	-3.4	-2.9	**5.0**
14	Portugal	-9.3	-8.0	-6.0	-3.6	-2.8	-2.6	**6.7**
15	Spain	-11.1	-9.5	-6.3	-4.7	-4.0	-3.8	**7.3**
16	Ireland	-14.4	-32.1	-9.7	-8.1	-5.8	-3.4	**11.0**
17	Greece	-15.4	-9.4	-7.4	-6.7	-4.8	-3.6	**11.8**

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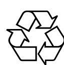

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