

Eurozone Scenario Analysis

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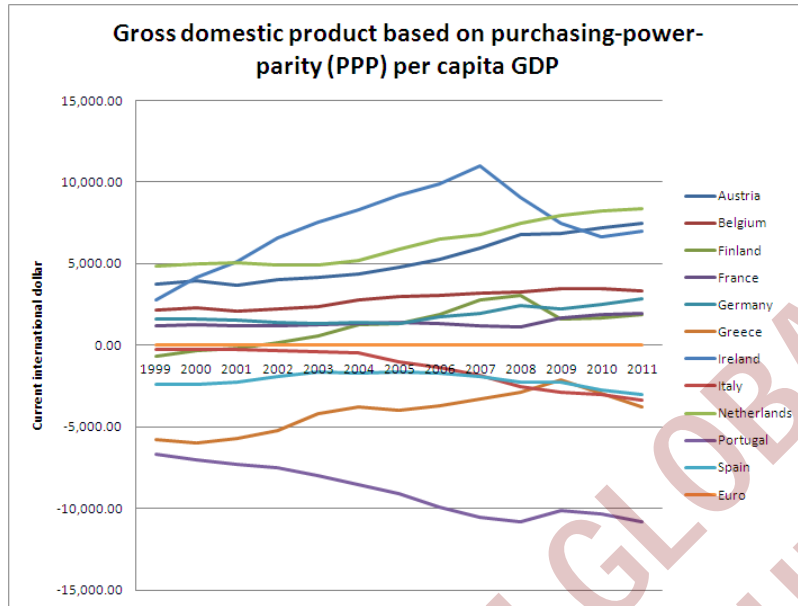
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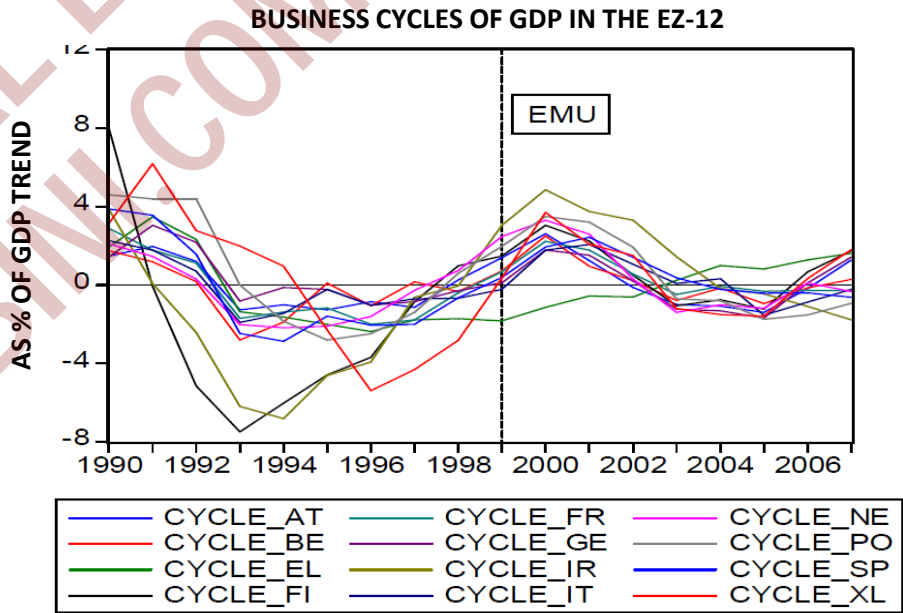


Years of living divergently under the same roof



Source: IMF

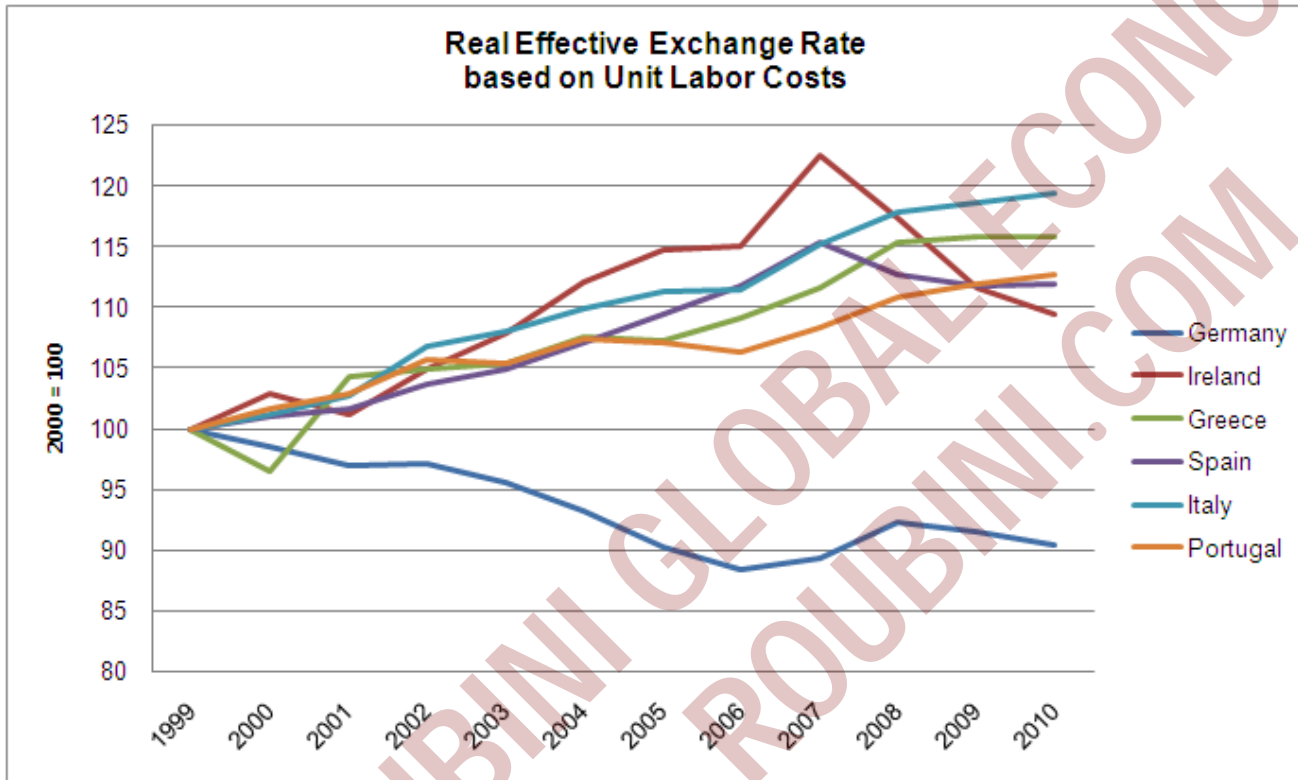
- We have long highlighted [eurozone \(EZ\) divergences and lack of burden-sharing](#) as risks to European Economic and Monetary Union (EMU)



Source: Hellenic Observatory, The European Institute



Years of living divergently under the same roof

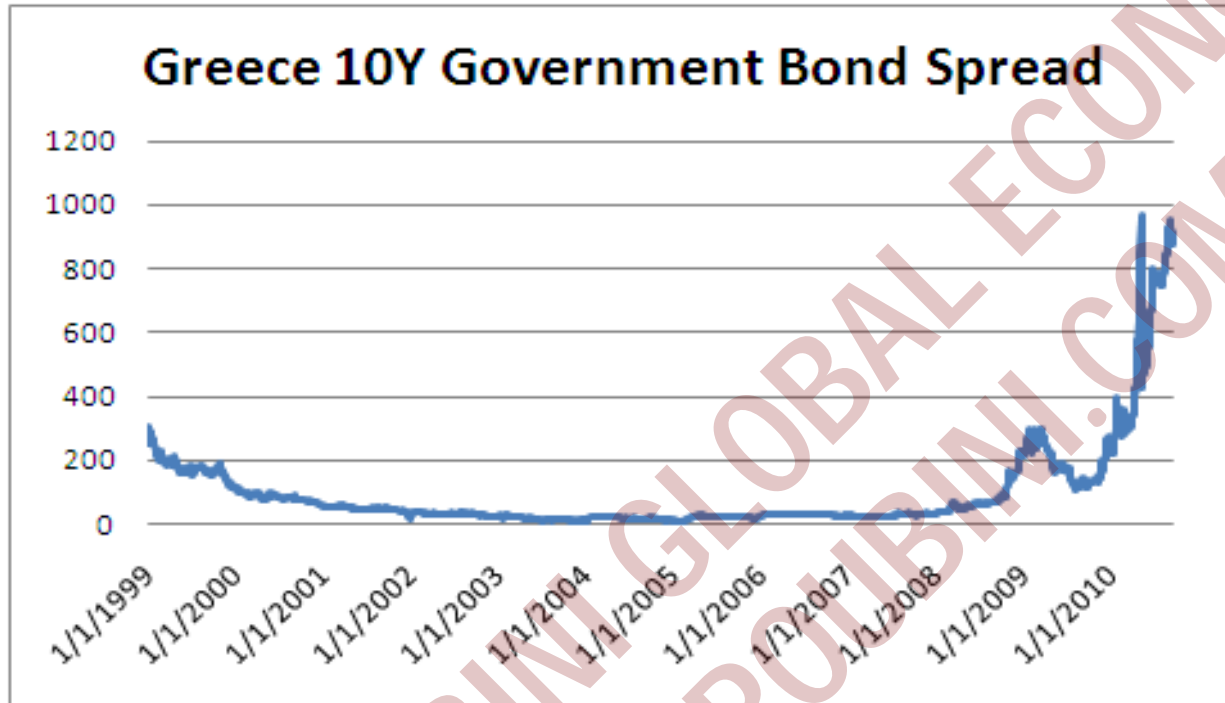


Source: AMECO

- Rigid wages and labor market while global demand shocks did not lead to a slowdown in wage growth.
- High wage growth cum low productivity growth led to an increase in unit labor costs that exacerbated the initial competitiveness loss.
- Thus, in Spain, Portugal and Italy the external adjustment mechanism has worked in destabilizing – rather than stabilizing ways: the misalignment of the currency has continued and become worse since the onset of the EMU.



The calm before the storm...

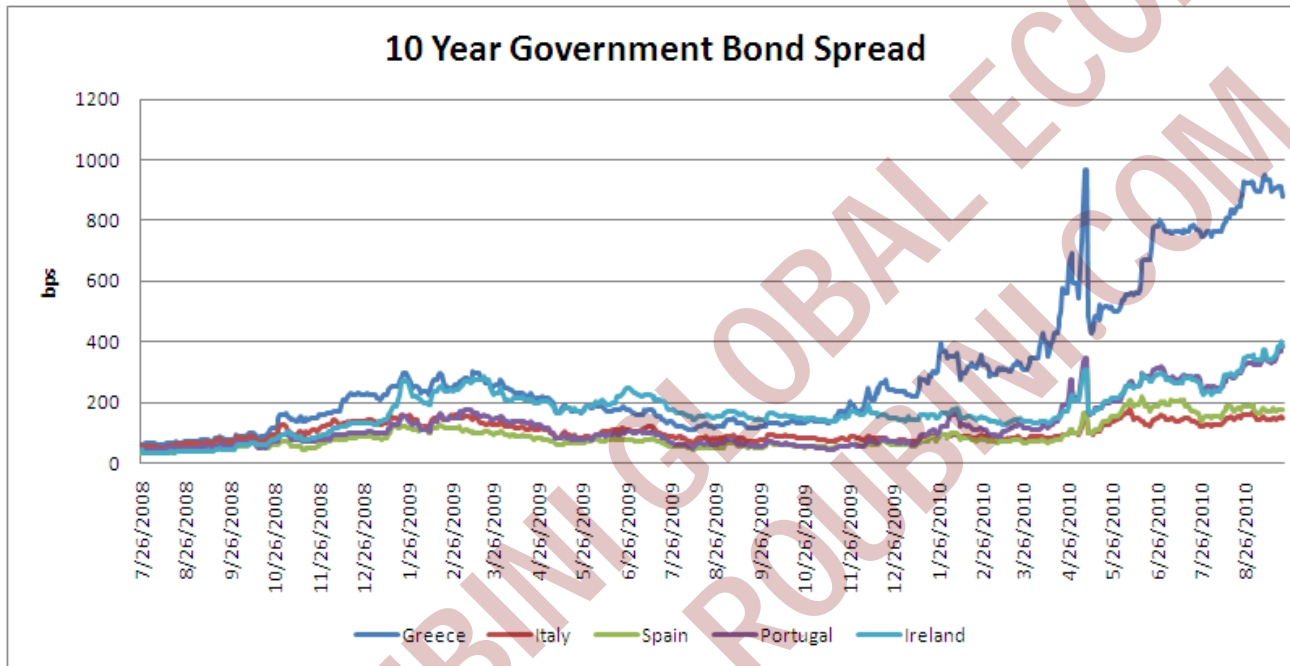


Source: Bloomberg

- So strong was the apparent convergence in national risk premia, despite divergent macroeconomic performance and imbalances, that the Global Crash of 2008 seemed to enhance EZ financial stability
- These risks finally surfaced with a vengeance in Q2 2010, after being suppressed in the first decade of EMU by booming global liquidity, credit and growth



The calm before the storm...



Source: Bloomberg

- These risks finally surfaced with a vengeance in Q2 2010, after being suppressed in the first decade of EMU by booming global liquidity, credit and growth.
- EZ officials and politicians congratulated themselves on the shelter EMU offered during the storm; and small countries in trouble looked for EZ succor (Iceland, Baltics, Balkans).
- It took the revelation that Greece's fiscal deficit was far worse than stated and a resulting breakdown in political unity to precipitate a divergence in national risk premia that threatened to tear apart the EZ.



Scenario analysis: three main blocks

European Endgame Scenarios

Scenario Block	EZ Policy Response	RGE Diagnosis
Breakdown (with one or multiple exits)	Deflationary fiscal, structural adjustment	<ul style="list-style-type: none"> • EMU unsustainable - nationalism trumps regionalism • Greece cannot adjust; rest of Periphery gives up too
		<ul style="list-style-type: none"> • Liquidity / partial solvency / competitiveness problem
		<ul style="list-style-type: none"> • EZ members cooperate to separate given political constraints to integration
Muddle Through	Financial engineering; fiscal / structural adjustment fudges	<ul style="list-style-type: none"> • Liquidity problem
		<ul style="list-style-type: none"> • Liquidity / partial solvency / competitiveness problem
Deeper Integration	Structural reform; cyclical adjustment - intra-EZ rebalancing A more perfect Economic and Monetary Union with a partial fiscal union	<ul style="list-style-type: none"> • EU/EZ commitment overcomes national sovereignty constraints
		<ul style="list-style-type: none"> • EU/EZ commitment so strong that member states cede sovereignty enough to deploy tax/spending to manage asymmetric shocks



Scenario analysis: 8 scenarios

RGE Prognosis			RGE Probability		
Macro Factors	Denouement	Market Conditions	Scenario	By end of 2012	Between 2013-2020
<ul style="list-style-type: none"> Politically unsustainable; economically destructive 	<ul style="list-style-type: none"> Germany/North exit, sparking run on Periphery 	<ul style="list-style-type: none"> Escalating risks precipitate capital flight, financial crisis 	1	2.0%	3.0%
<ul style="list-style-type: none"> Intra-EZ divergences persist, escalate as demand is weak 	<ul style="list-style-type: none"> Greece defaults/exits disorderly; contagion, Periphery domino effect 	<ul style="list-style-type: none"> Steepening Periphery government, financials long-term curves point to refinancing crisis 	2	12.0%	20%
<ul style="list-style-type: none"> Greece proves insolvent and unable to stay in the EZ; but rest of Periphery adjusts successfully 	<ul style="list-style-type: none"> Greece restructures/exits orderly; Periphery ring-fenced; EZ survives. Threat of exit constrains policy, imbalances 	<ul style="list-style-type: none"> High volatility before exit subsides after, but national risk premia divergences are both structural and cyclical 	3	20%	20%
<ul style="list-style-type: none"> Growth prospects lowered; EZ faces weak domestic & global demand 	<ul style="list-style-type: none"> Orderly separation, as with EMU creation; high EU/IMF funding to avoid crisis 	<ul style="list-style-type: none"> High volatility, diverging risk premia amid huge uncertainty about success 	4	1.0%	2.0%
Breakdown Probability				35%	45%
<ul style="list-style-type: none"> Bank stress tests fudged; fiscal/structural measures accepted as ESM/EFSF, easy money/global recovery restore EZ stability 	<ul style="list-style-type: none"> Current crisis contained but EZ viability / governance & national weaknesses not fully addressed, may resurface 	<ul style="list-style-type: none"> Volatility remains high; moral hazard remains the main anchor for divergent national risk premia 	5	10%	5.0%
<ul style="list-style-type: none"> Greece proves insolvent; rest of Periphery adjusts successfully 	<ul style="list-style-type: none"> Current crisis contained but EZ viability / governance & national weaknesses not fully addressed, may resurface 	<ul style="list-style-type: none"> Volatility remains high; moral hazard remains the main anchor for divergent national risk premia 	6	30%	10%
Muddle Through Probability				40%	15%
<ul style="list-style-type: none"> Insolvency regime mitigates moral hazard of a permanent ESM/EMF type BoP/fiscal financing facility 	<ul style="list-style-type: none"> Economic & Monetary Union with harmonized economic structure and strong, credible fiscal rules 	<ul style="list-style-type: none"> Volatility subsides; national risk premia converge once again, but less than before, and with cyclical variability 	7	20%	25.0%
<ul style="list-style-type: none"> Gradual, thorough EZ governance, national compliance, structural reform, with popular legitimacy via Treaty change 	<ul style="list-style-type: none"> Structural / fiscal convergence enhanced by partial fiscal union so that the EZ becomes fully credible and viable 	<ul style="list-style-type: none"> Volatility subsides; national risk premia converge significantly and permanently 	8	5%	15.0%
Deeper Integration Probability				25%	40%
Cumulative Probability				100%	100%



Macro scenario analysis

European Endgame Scenarios

Scenario Block	EZ Policy Response	RGE Diagnosis	RGE Prognosis			RGE Probability					
			Macro Factors	Denouement	Market Conditions	Scenario	By end of 2012	Between 2013-2020			
Breakdown (with one or multiple exits)	Deflationary fiscal, structural adjustment	• EMU unsustainable - nationalism trumps regionalism	• Politically unsustainable; economically destructive	• Germany/North exit, sparking run on Periphery	• Escalating risks precipitate capital flight, financial crisis	1	2.0%	3.0%			
		• Greece cannot adjust; rest of Periphery gives up too	• Intra-EZ divergences persist, escalate as demand is weak	• Greece defaults/exits disorderly; contagion, Periphery domino effect	• Steepening Periphery government, financials long-term curves point to refinancing crisis				2	12.0%	20%
		• Liquidity / partial solvency / competitiveness problem	• Greece proves insolvent and unable to stay in the EZ; but rest of Periphery adjusts successfully	• Greece restructures/exits orderly; Periphery ring-fenced; EZ survives. Threat of exit constrains policy, imbalances	• High volatility before exit subsides after, but national risk premia divergences are both structural and cyclical				3	20%	20%
		• EZ members cooperate to separate given political constraints to integration	• Growth prospects lowered; EZ faces weak domestic & global demand	• Orderly separation, as with EMU creation; high EU/IMF funding to avoid crisis	• High volatility, diverging risk premia amid huge uncertainty about success				4	1.0%	2.0%
Breakdown Probability							35%	45%			
Muddle Through	Financial engineering; fiscal / structural adjustment fudges	• Liquidity problem	• Bank stress tests fudged; fiscal/structural measures accepted as ESM/EFSF, easy money/global recovery restore EZ stability	• Current crisis contained but EZ viability / governance & national weaknesses not fully addressed, may resurface	• Volatility remains high; moral hazard remains the main anchor for divergent national risk premia	5	10%	5.0%			
		• Liquidity / partial solvency / competitiveness problem	• Greece proves insolvent; rest of Periphery adjusts successfully	• Current crisis contained but EZ viability / governance & national weaknesses not fully addressed, may resurface	• Volatility remains high; moral hazard remains the main anchor for divergent national risk premia	6	30%	10%			
Muddle Through Probability							40%	15%			
Deeper Integration	Structural reform; cyclical adjustment - Intra-EZ rebalancing A more perfect Economic and Monetary Union with a partial fiscal union	• EU/EZ commitment overcomes national sovereignty constraints	• Insolvency regime mitigates moral hazard of a permanent ESM/EMF type BoP/fiscal financing facility	• Economic & Monetary Union with harmonized economic structure and strong, credible fiscal rules	• Volatility subsides; national risk premia converge once again, but less than before, and with cyclical variability	7	20%	25.0%			
		• EU/EZ commitment so strong that member states cede sovereignty enough to deploy tax/spending to manage asymmetric shocks	• Gradual, thorough EZ governance, national compliance, structural reform, with popular legitimacy via Treaty change	• Structural / fiscal convergence enhanced by partial fiscal union so that the EZ becomes fully credible and viable	• Volatility subsides; national risk premia converge significantly and permanently	8	5%	15.0%			
Deeper Integration Probability							25%	40%			
Cumulative Probability							100%	100%			



Scenario analysis: breakdown

European Endgame Scenarios

Scenario Block	EZ Policy Response	RGE Diagnosis
Breakdown (with one or multiple exits)	Deflationary fiscal, structural adjustment	• EMU unsustainable - nationalism trumps regionalism
		• Greece cannot adjust; rest of Periphery gives up too
		• Liquidity / partial solvency / competitiveness problem
		• EZ members cooperate to separate given political constraints to integration



Scenario analysis: breakdown

RGE Prognosis			RGE Probability		
Macro Factors	Denouement	Market Conditions	Scenario	By end of 2012	Between 2013-2020
<ul style="list-style-type: none"> Politically unsustainable; economically destructive 	<ul style="list-style-type: none"> Germany/North exit, sparking run on Periphery 	<ul style="list-style-type: none"> Escalating risks precipitate capital flight, financial crisis 	1	2.0%	3.0%
<ul style="list-style-type: none"> Intra-EZ divergences persist, escalate as demand is weak 	<ul style="list-style-type: none"> Greece defaults/exits disorderly; contagion, Periphery domino effect 	<ul style="list-style-type: none"> Steepening Periphery government, financials long-term curves point to refinancing crisis 	2	12.0%	20%
<ul style="list-style-type: none"> Greece proves insolvent and unable to stay in the EZ; but rest of Periphery adjusts successfully 	<ul style="list-style-type: none"> Greece restructures/exits orderly; Periphery ring-fenced; EZ survives. Threat of exit constrains policy, imbalances 	<ul style="list-style-type: none"> High volatility before exit subsides after, but national risk premia divergences are both structural and cyclical 	3	20%	20%
<ul style="list-style-type: none"> Growth prospects lowered; EZ faces weak domestic & global demand 	<ul style="list-style-type: none"> Orderly separation, as with EMU creation; high EU/IMF funding to avoid crisis 	<ul style="list-style-type: none"> High volatility, diverging risk premia amid huge uncertainty about success 	4	1.0%	2.0%
Breakdown Probability →				35%	45%



Breakdown: inflation and growth


GDP growth % (ranges)								
Breakdown								
Period 2010-2012				Period 2013-2020				
	1	2	3	4	1	2	3	4
Greece	-3.5 to -4		-3 to -3.5		0.9 to 1.3		1.1 to 1.4	
Portugal	-0.5 to 0		-0.3 to 0.1		0.7 to 0.9		0.6 to 0.8	0.7 to 0.9
Ireland	0.0 to 0.4		0.6 to 0.8		1 to 1.5		0.8 to 1.2	1.2 to 1.6
Spain	-0.5 to 0		-0.2 to 0.2		0.8 to 1		0.7 to 0.9	1.1 to 1.5
Italy	0.0 to 0.4	0.2 to 0.5	0.5 to 0.8	0.1 to 0.5	1.0 to 1.2	0.9 to 1.1	1.0 to 1.3	1.2 to 1.4
Belgium	0.8 to 1.0	1.0 to 1.2	1.2 to 1.4	1 to 1.2	1.2 to 1.4	1.0 to 1.3	1.3 to 1.5	1.2 to 1.4
Austria	0.9 to 1.1	1.0 to 1.2	1.3 to 1.5	1.1 to 1.3	1.3 to 1.5	1.4 to 1.6	1.5 to 1.7	1.4 to 1.6
Netherlands	0.9 to 1.1	1.1 to 1.3	1.3 to 1.5	1.1 to 1.3	1.3 to 1.5	1.4 to 1.6	1.5 to 1.7	1.4 to 1.6
France	0.8 to 1.0	1.0 to 1.2	1.2 to 1.4	1 to 1.2	1.2 to 1.4	1.0 to 1.3	1.3 to 1.5	1.2 to 1.4
Germany	0.9 to 1.1	1.1 to 1.3	1.3 to 1.5	1.1 to 1.3	1.3 to 1.5	1.4 to 1.6	1.5 to 1.7	1.4 to 1.6

Inflation % (ranges)									
Breakdown									
Period 2010-2012				Period 2013-2020					
	1	2	3	4	1	2	3	4	
Greece	10.0 to 12.0				7.0 to 8.0				
Portugal	10.0 to 12.0		2.0 to 2.5	10.0 to 12.0	7.0 to 8.0		1.9 to 2.1	7.0 to 8.0	
Ireland	7.0 to 10.0		2.0 to 2.5	7.0 to 10.0	5.0 to 7.0		1.9 to 2.1	5.0 to 7.0	
Spain	8.0 to 11.0		2.0 to 2.5	8.0 to 11.0	6.0 to 8.0		1.9 to 2.1	6.0 to 8.0	
Italy	12.0 to 15.0	2.0 to 2.5	2.0 to 2.5	12.0 to 15.0	10.0 to 13.0	1.9 to 2.1	1.9 to 2.1	10.0 to 13.0	
Belgium	4.0 to 5.0	2.0 to 2.5	2.0 to 2.5	4.0 to 5.0	2.5 to 3.5	1.9 to 2.1	1.9 to 2.2	2.5 to 3.5	
Austria	3.0 to 4.0	2.0 to 2.5	2.0 to 2.5	3.0 to 4.0	2.5 to 3.5	1.9 to 2.1	1.9 to 2.2	2.5 to 3.5	
Netherlands	3.0 to 4.0	2.0 to 2.5	2.0 to 2.5	3.0 to 4.0	2.5 to 3.5	1.9 to 2.1	1.9 to 2.2	2.5 to 3.5	
France	4.0 to 5.0	2.0 to 2.5	2.0 to 2.5	4.0 to 5.0	2.5 to 3.5	1.9 to 2.1	1.9 to 2.2	2.5 to 3.5	
Germany	2.5 to 3.5	2.0 to 2.5	2.0 to 2.5	2.5 to 3.5	1.5 to 2.0	1.7 to 2.0	1.7 to 2.0	1.5 to 2.0	



Scenario analysis: muddle through

European Endgame Scenarios

Scenario Block	EZ Policy Response	RGE Diagnosis
 <p data-bbox="92 825 465 868">Muddle Through</p>	<p data-bbox="614 796 1168 882">Financial engineering; fiscal / structural adjustment fudges</p>	<ul data-bbox="1290 639 1566 668" style="list-style-type: none">• Liquidity problem
		<ul data-bbox="1290 872 1715 939" style="list-style-type: none">• Liquidity / partial solvency / competitiveness problem



Scenario analysis: muddle through

Central scenario in the short term

RGE Prognosis			RGE Probability		
Macro Factors	Denouement	Market Conditions	Scenario	By end of 2012	Between 2013-2020
<ul style="list-style-type: none"> Bank stress tests fudged; fiscal/structural measures accepted as ESM/EFSF, easy money/global recovery restore EZ stability 	<ul style="list-style-type: none"> Current crisis contained but EZ viability / governance & national weaknesses not fully addressed, may resurface 	<ul style="list-style-type: none"> Volatility remains high; moral hazard remains the main anchor for divergent national risk premia 	5	10%	5.0%
<ul style="list-style-type: none"> Greece proves insolvent; rest of Periphery adjusts successfully 	<ul style="list-style-type: none"> Current crisis contained but EZ viability / governance & national weaknesses not fully addressed, may resurface 	<ul style="list-style-type: none"> Volatility remains high; moral hazard remains the main anchor for divergent national risk premia 	6	30%	10%
Muddle Through Probability →				40%	15%



Muddle through: inflation and growth


GDP growth % (ranges)		Muddle Through	
	Period 2010-2012	Period 2013-2020	
	5&6	5&6	
Greece	-2.3 to -2.7	0.8 to 1.2	
Portugal	0.3 to 0.5	0.7 to 0.9	
Ireland	0.7 to 0.9	1.0 to 1.3	
Spain	0.3 to 0.5	0.8 to 1.2	
Italy	0.8 to 1.0	1.0 to 1.3	
Belgium	1.4 to 1.6	1.4 to 1.6	
Austria	1.2 to 1.4	1.5 to 1.7	
Netherlands	1.4 to 1.6	1.5 to 1.7	
France	1.2 to 1.4	1.4 to 1.6	
Germany	1.4 to 1.6	1.5 to 1.7	

Inflation % (ranges)		Muddle Through	
	Period 2010-2012	Period 2013-2020	
	5&6	5&6	
Greece	3.0 to 3.5	2.0 to 2.5	
Portugal	1.4 to 1.6	1.5 to 1.7	
Ireland	-0.1 to 0.4	0.9 to 1.1	
Spain	1.4 to 1.6	1.5 to 1.7	
Italy	1.5 to 1.7	1.5 to 1.7	
Belgium	1.5 to 1.7	1.7 to 1.9	
Austria	1.4 to 1.6	1.6 to 1.8	
Netherlands	1.4 to 1.6	1.6 to 1.8	
France	1.5 to 1.7	1.7 to 1.9	
Germany	1.3 to 1.5	1.5 to 1.7	



Scenario analysis: deeper integration

European Endgame Scenarios

Scenario Block	EZ Policy Response	RGE Diagnosis
 Deeper Integration	Structural reform; cyclical adjustment - intra-EZ rebalancing	<ul style="list-style-type: none">• EU/EZ commitment overcomes national sovereignty constraints
	A more perfect Economic and Monetary Union with a partial fiscal union	<ul style="list-style-type: none">• EU/EZ commitment so strong that member states cede sovereignty enough to deploy tax/spending to manage asymmetric shocks



Scenario analysis: deeper integration

RGE Prognosis			RGE Probability		
Macro Factors	Denouement	Market Conditions	Scenario	By end of 2012	Between 2013-2020
<ul style="list-style-type: none"> • Insolvency regime mitigates moral hazard of a permanent ESM/EMF type BoP/fiscal financing facility 	<ul style="list-style-type: none"> • Economic & Monetary Union with harmonized economic structure and strong, credible fiscal rules 	<ul style="list-style-type: none"> • Volatility subsides; national risk premia converge once again, but less than before, and with cyclical variability 	7	20%	25.0%
<ul style="list-style-type: none"> • Gradual, thorough EZ governance, national compliance, structural reform, with popular legitimacy via Treaty change 	<ul style="list-style-type: none"> • Structural / fiscal convergence enhanced by partial fiscal union so that the EZ becomes fully credible and viable 	<ul style="list-style-type: none"> • Volatility subsides; national risk premia converge significantly and permanently 	8	5%	15.0%
Deeper Integration Probability →				25%	40%



Deeper integration: inflation and growth

GDP growth % (ranges)	Deeper Integration	
	Period 2010-2012	Period 2013-2020
	7&8	7&8
Greece	-2.0 to -2.7	1.0 to 1.5
Portugal	0.4 to 0.5	0.8 to 1.0
Ireland	0.7 to 0.9	1.0 to 1.5
Spain	0.4 to 0.6	1.0 to 1.4
Italy	0.8 to 1.0	1.0 to 1.3
Belgium	1.3 to 1.5	1.5 to 1.7
Austria	1.4 to 1.6	1.6 to 1.8
Netherlands	1.4 to 1.6	1.6 to 1.8
France	1.2 to 1.4	1.5 to 1.7
Germany	1.3 to 1.5	1.6 to 1.8

Inflation % (ranges)	Deeper Integration	
	Period 2010-2012	Period 2013-2020
	7&8	7&8
Greece	3.0 to 3.5	2.0 to 2.5
Portugal	1.4 to 1.6	1.5 to 1.7
Ireland	-0.1 to 0.4	1.0 to 1.2
Spain	1.4 to 1.6	1.5 to 1.7
Italy	1.5 to 1.7	1.5 to 1.7
Belgium	1.5 to 1.7	1.7 to 1.9
Austria	1.4 to 1.6	1.6 to 1.8
Netherlands	1.4 to 1.6	1.6 to 1.8
France	1.5 to 1.7	1.7 to 1.9
Germany	1.3 to 1.5	1.5 to 1.7



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Point forecasts: growth

GDP growth %	Deeper Integration		Muddle Through		Breakdown							
	Period 2010-2012	Period 2013-2020	Period 2010-2012	Period 2013-2020	Period 2010-2012				Period 2013-2020			
	7&8	7&8	5&6	5&6	1	2	3	4	1	2	3	4
Greece	-2.3	1.3	-2.5	1	-3.8		-3.3		1.1		1.3	
Portugal	0.45	0.9	1.4	1.8	-0.3		-0.1		0.8		1.7	0.8
Ireland	0.8	1.3	1.8	1.2	0.2		0.7		1.2		1	1.4
Spain	0.5	1.2	1.4	1	-0.3		0.0		0.9		0.8	1.2
Italy	0.9	1.2	1.9	1.2	0.2	0.3	0.6	0.3	1.1	1	1.1	1.3
Belgium	1.5	1.6	1.5	1.5	0.9	1.1	1.3	1.1	1.3	1.1	1.4	1.3
Austria	1.5	1.7	1.3	1.6	1.0	1.1	1.4	1.2	1.4	1.5	1.6	1.5
Netherlands	1.5	1.7	1.5	1.6	1.0	1.2	1.4	1.2	1.4	1.5	1.6	1.5
France	1.3	1.6	1.3	1.5	0.9	1.1	1.3	1.1	1.3	1.2	1.4	1.3
Germany	1.4	1.7	1.5	1.6	1.0	1.2	1.4	1.2	1.4	1.5	1.6	1.5



Point forecasts: inflation

Inflation % (ranges)	Deeper Integration		Muddle Through		Breakdown							
	Period 2010-2012	Period 2013-2020	Period 2010-2012	Period 2013-2020	Period 2010-2012				Period 2013-2020			
	7&8	7&8	5&6	5&6	1.0	2	3	4	1	2	3	4
Greece	3.2	2.2	3.2	2.2	11				7.5			
Portugal	1.5	1.6	1.5	1.6	11	2.3	11	7.5	2	7.5		
Ireland	0.5	1.1	0.5	1	8.5	2.3	8.5	6	2	6		
Spain	1.5	1.6	1.5	1.6	9.5	2.3	9.5	7	2	7		
Italy	1.6	1.6	1.6	1.6	13.5	2.2	2.3	13.5	11.5	2	2	11.5
Belgium	1.6	1.8	1.6	1.8	4.5	2.2	2.3	4.5	3	2	2.1	3
Austria	1.5	1.7	1.5	1.7	3.5	2.2	2.3	3.5	3	2	2.1	3
Netherlands	1.5	1.7	1.5	1.7	3.5	2.2	2.3	3.5	3	2	2.1	3
France	1.6	1.8	1.6	1.8	4.5	2.2	2.3	4.5	3	2	2.1	3
Germany	1.4	1.6	1.4	1.6	3.0	2.2	2.3	3	1.8	1.9	1.9	1.8

