International developments

Financial markets

Financing remains difficult for European economies

Accommodating monetary policies have been adopted by all advanced economies, with Central Banks extending or intensifying the non-standard measures put in place in H2 2012. As a result, tensions on the European sovereign debt market have continued to ease.

However difficulties still remain in the Eurozone: the money markets are still not functioning absolutely normally, and restrictions on access to credit are not easing. As a result, lending continues to fall within the Eurozone. In the United States, on the other hand, lending has rediscovered a certain dynamism.

The abundance of liquidity provided by the central banks and the reduction of some of the risks hanging over the Eurozone have also led to a rise in share prices, with market indices equalling or even surpassing 2011 levels in most advanced economies.

Moreover, as uncertainty has subsided over the future of the European single currency, and as a result of the expansionary monetary policies implemented in the USA, UK and particularly Japan, the Euro was up slightly against the dollar, yen and pound sterling. Over the forecasting period, the conventional assumptions as to the exchange rates are as follows: 1 Euro = 1.31 dollars, 121 yen and 0.85 pounds sterling.

Monetary policies remain highly expansionary

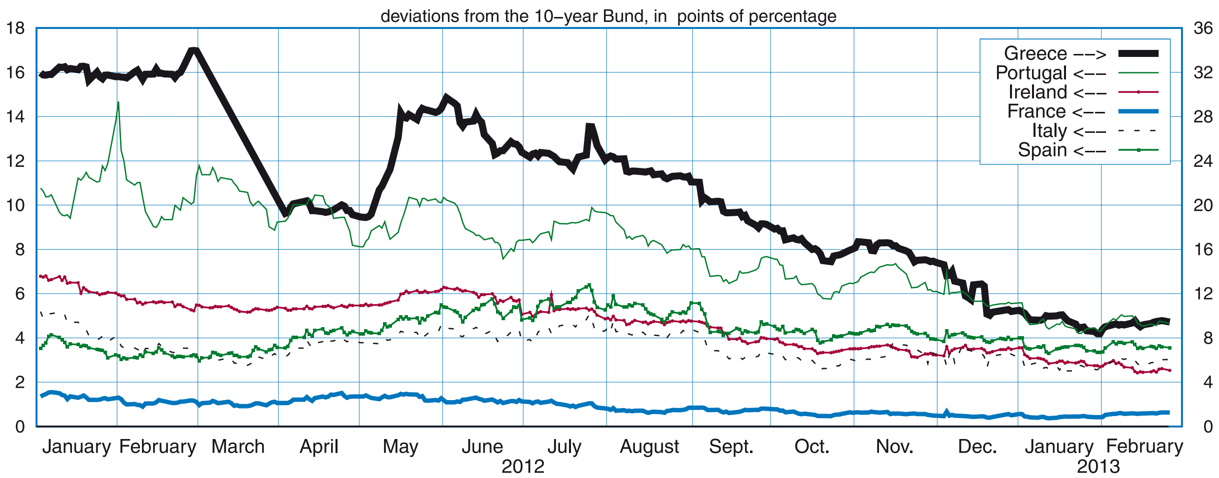
Monetary policy remains highly accommodating in all advanced economies, with the central banks in Britain, America and Japan further intensifying their support in early 2013.

The ECB has maintained interest rates at 0.75%, while preparing to activate the sovereign bond acquisition programme (Outright Monetary Transactions, OMT) announced in Q2 2012. Moreover, advanced repayments of the three-year loans contracted by the banks in late 2011 and early 2012 (VLTRO, see definition) have so far been limited. In the UK the Bank of England has also maintained a very low base rate of 0.5%, and has declared itself ready to take further non-standard measures if necessary.

In the USA, the Federal Reserve has maintained a base rate of 0.25% while intensifying its policy of quantitative easing: each month since January 2013, in addition to the 40 billion dollars' worth of mortgage-backed securities which it has been acquiring monthly since October 2012, the American central bank has purchased 45 billion dollars' worth of long-term treasury bonds in order to expand the monetary base.

Faced with a weak economy, the Japanese central bank also expanded its government securities purchasing programme in January 2013, a programme which should be worth around €925

1 – Tensions ease on the European sovereign debt market



Source: DataInsigh, INSEE

billion by the end of 2014. The Bank of Japan has also maintained its base rate at 0.1%, while raising its inflation target to 2%.

Tensions continue to ease on the sovereign debt markets

The easing of tensions on the sovereign debt markets which began in summer 2012 has continued into Q1 2013 *(see Graph 1)*. In Spain and Italy in particular, financing conditions for sovereign debt have improved considerably. The yield spread between ten-year Spanish bonds and their German equivalents dropped to an average of 354 base points in January 2013, down from 558 in July 2012. Similarly, the spread between German and Italian sovereign yields fell from 442 base points in July 2012 to 267 in January 2013. Nonetheless, political uncertainty stemming from the Italian elections led to a rise in Italian sovereign yields in late February 2013. The direction they will take over the course of this forecasting period remains uncertain.

In those European countries where financing conditions were most difficult, these conditions have improved considerably since Q2 2012. Thus the Irish sovereign yield rate hit 4.1% in early February, the lowest level recorded since January 2007. Portuguese and Greek sovereign bond yields have also fallen significantly since summer 2012. In January 2013 the yield on Portuguese sovereign bonds was 6.3% on the secondary market (compared to 10.5% in July 2012) while the Greek yield stood at 11.3% (compared to 25.6% in July 2012). The most reliable European countries (France and Germany) along with the USA and the UK still enjoy low financing rates on their sovereign debt. However a generalised easing of the uncertainty regarding the sovereign debt markets is encouraging investors to take on greater risk, causing the rates enjoyed by these countries to rise slightly since Q4 2012.

The European money market remains tight

The long term-refinancing operations (LTRO) conducted in late 2011 and early 2012 by the European Central Bank alleviated the financing difficulties affecting European banks, but did not succeed in restoring the interbank market to normal working order *(see further explanation)*. The interbank market is therefore characterised by very low rates showing little in the way of volatility *(see Graph 2)*. So even through tensions appear to be at a low point, the money market has not actually returned to normal functioning.

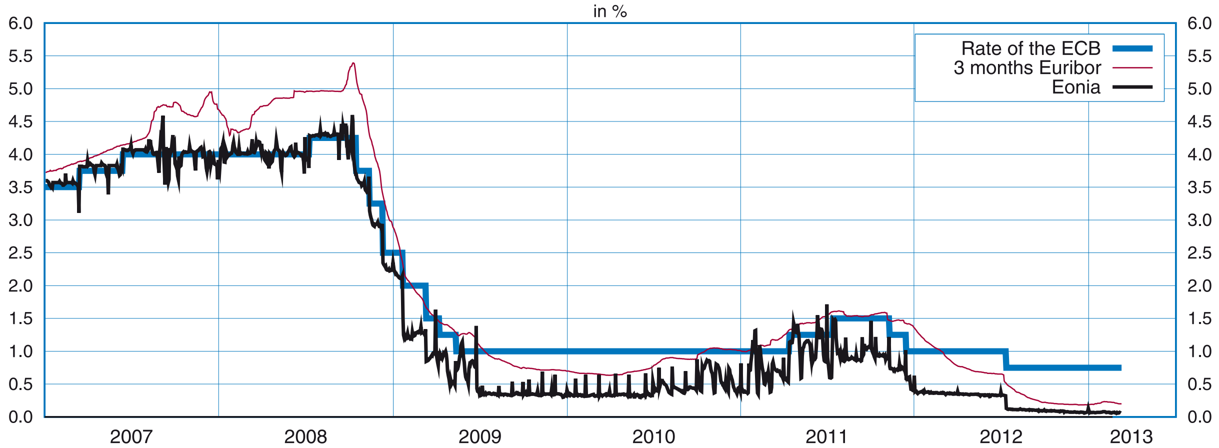
Still no increase in lending in the Eurozone

Despite the abundance of liquidity available in the Eurozone, outstanding loans are not growing in the Eurozone *(see Graph 3)*. Indeed the banks have indicated that they have no intention of relaxing their lending conditions given the poor economic outlook. But amid generally poor lending conditions there is considerable variation between countries: in Germany and France the private lending rates are lower than those seen in Spain and Italy, particularly for small loans.

In France, contrary to the prevailing trend in the Eurozone, outstanding loans to non-financial companies rose slightly in Q4 2012 (+1.0% of annualised quarterly growth in December). Consumer credit also grew in Q4 2012 (+1.7% in December), as did property lending (+2.6% in December).

In the USA, lending conditions for non-financial companies have been easing for a year now and, supported by the Fed's policy of buying mortgage-backed securities, property lending is also on the increase.

2 – The European money market remains blocked



Sources: DataInsigh, INSEE

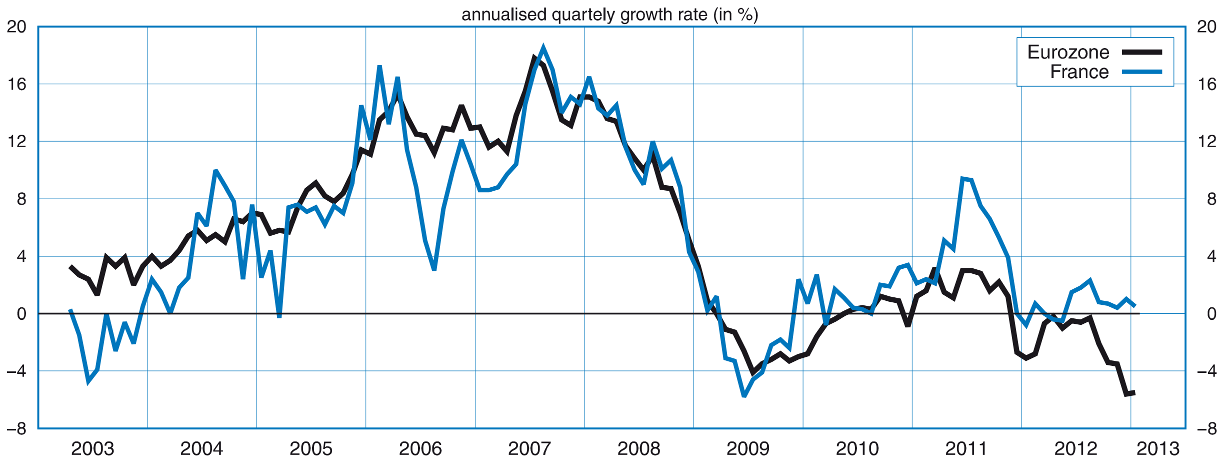
Stock markets continue to grow

After stabilising in Q3 2012, the European, American and Japanese financial markets were back in growth in Q4 2012 *(see Graph 4)*. In Q1 2013 the market indices surpassed their January 2011 levels, with the exception of the CAC40. This growth came in a context of abundant liquidity provided by all major central banks and a general decrease in uncertainty, as witnessed by the low volatility of the American and German market indices.

Euro stronger on the currency markets

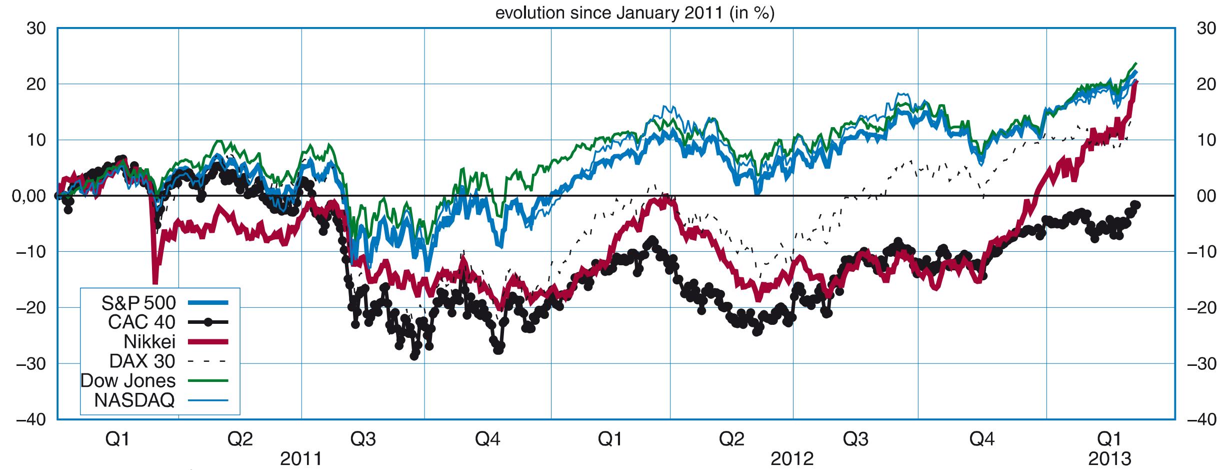
The Euro has seen a slight appreciation against the dollar, pound and yen since Q4 2012 *(see Graph 5)*. In late January 2013 the Euro-dollar exchange rate hit 1.35, its strongest level since November 2011. This appreciation reflects both the easing of tensions in the Eurozone and the increasingly expansionary bent of monetary policy in other advanced economies. In late February this appreciation was halted following declarations from Mario Draghi and the results of the Italian elections. Over this forecasting period the Euro exchange rate should stabilise at around 1.31 dollars = 1 Euro. ■

3 – Outstanding loans to non-financial corporations have not increased in the Eurozone.



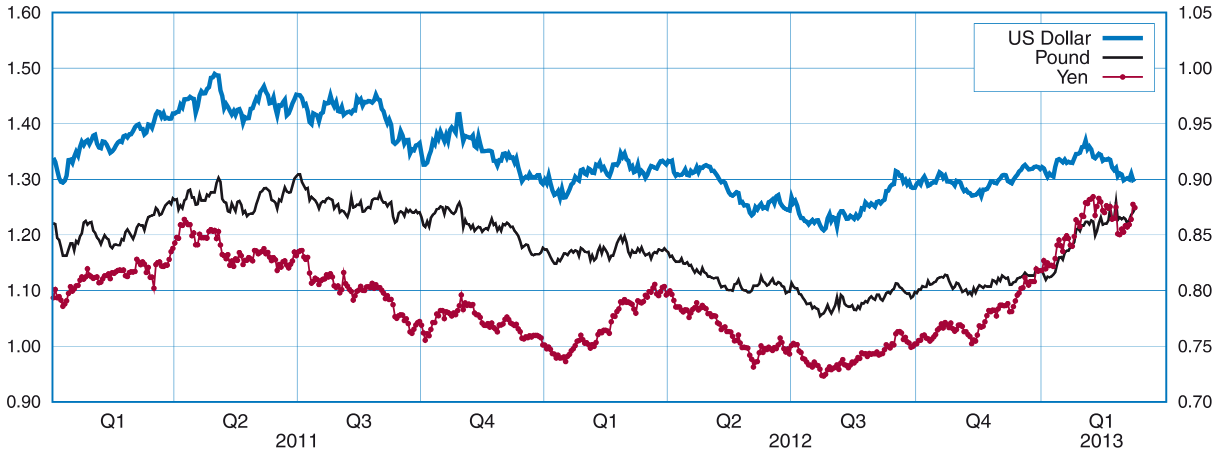
Source: European central bank and Bank of France

4 – The market indices have been rising since summer 2012.



Source: DataInsigh, INSEE

5 - Changes to the euro exchanges rates



Source: DataInsigh

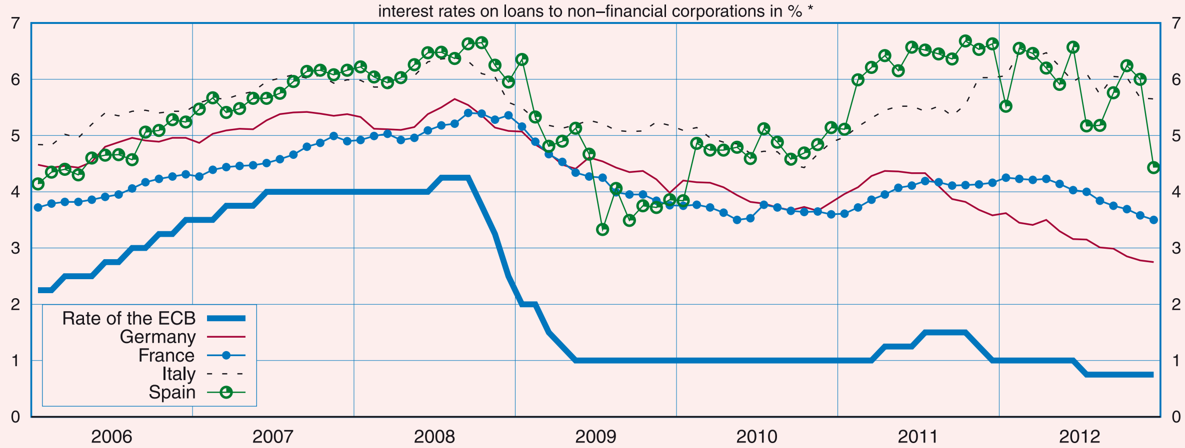
Eurozone monetary policy: have the VLTRO fulfilled their objectives?

The ECB conducted two exceptional refinancing operations at the end of 2011 and the beginning of 2012

In response to the worsening sovereign debt crisis in the Eurozone, which was causing rising tensions on money markets (in particular growing fragmentation of the Eurozone interbank market) due to the exposure of bank balance sheets to sovereign risk, the European Central Bank gradually stepped up the expansionist nature of its monetary policy from Q3 2011 onwards. In this context, in December 2011 and at the end of February 2012, it carried out two exceptional three-year refinancing operations for the banks of the Eurozone (Very Long Term Refinancing Operations, VLTRO): the Central Bank's standard refinancing operations have one-week maturity, while so-called «long-term» operations usually have maturities of 3, 6 or 12 months. The declared objective of the Central Bank was to ensure that transmission of its monetary policy was not blocked by the liquidity conditions of European banks. These had been deteriorating sharply and diverging between the Eurozone countries, resulting in different credit financing terms between countries *(see graph 1)*. The aim of the two operations was to remedy this fragmentation, avoid a generalised liquidity crisis and the credit crunch that might have followed (brutal drop in lending to economic agents).These two operations led the ECB to grant loans of €489 billion in December 2011 to 523 banks (respectively €530 billion in February 2012 to 800 banks). This was done in the form of loans of unlimited amounts with three-year maturity, at a rate equal to the average of the reference interest rate over the period, which is to say 1.0% prior to July 2012 and 0.75% since then. However, given that a part of these long-term loans derived from the renegotiation of maturities on pre-existing shorter-term loans, the operation resulted in the net creation of €210 billion and then €311 billion (€521 billion in all) of currency by the ECB.

1 - Fragmentation of Eurozone financing terms

interest rates on loans to non–financial corporations in % *



* Less than $ 1 million, maturity of more than 5 years
Source : European Central Bank

To guarantee the loans, as is usual in refinancing operations, the ECB demanded the temporary transfer of assets (referred to as collateral) by the banks taking the loans to protect against the risk of default by the borrowers. At the same time as the decision to conduct the VLTRO operations, the list of collateral considered eligible by the Central Bank was extended, which contributed to bolstering the prices of certain classes of assets, notably sovereign debt securities. In order to control the level of risk on its balance sheet, the ECB defined discounts (haircuts) applied to eligible assets according to their intrinsic risk levels.

Banks started repaying the VLTRO in early 2013

The December 2011 and February 2012 VLTRO are three-year-maturity loans, but are repayable in full or in part after a one-year period. At the beginning of March, of the gross amount of €1,019 billion allocated, European banks have repaid about €155 billion on VLTRO 1 and €68 billion on VLTRO 2, representing about 22% of the total gross amount and 43% of the net amount allocated.

Who borrowed in the VLTRO?

As for all refinancing operations decided upon by the ECB, the tenders were handled by the National Central Banks of the Eurozone, meaning that the exposure of the banking sectors of the different Euro Zone countries to the two VLTRO is known. Among the major European countries, Italy and Spain are those that made the most extensive use of the VLTRO, with their banks borrowing more than 60% of the total net amount allocated (€521 billion). French banks, meanwhile, borrowed about 14% of the total net amount and started making significant repayments at the beginning of 2013.

What have been the effects of the VLTRO?

The VLTRO have led to a massive increase in the surplus liquidity in the Eurosystem

The two VLTRO granted by the ECB created a large liquidity surplus on the European money market. With the nomenclature of the ECB,[1] a liquidity supply and requirement are defined. Supply is the liquidity injected into the money market by the Central Bank. It is derived from the sum of the amounts allocated in refinancing operations and the amount of day-to-day loans granted by the ECB to these banks (via lending facilities). The liquidity requirement is the quantity of currency the banks must keep in liquid form. It results from the sum of the minimum reserves required by the Central Bank and so-called autonomous liquidity factors that the ECB does not directly control (for example the need for notes and coins of players in the real economy). The liquidity surplus is defined as the difference between liquidity supply and requirements and is therefore an indicator of money market imbalance.

Between 2008 and 2011, the liquidity surplus only rarely exceeded €200 billion. Just before the first VLTRO in December 2011, it stood at €300 billion and, under the impulsion of the two VLTRO, the liquidity surplus reached a peak of €808 billion in March 2012. In mid-February 2013, this liquidity surplus remained high, at close to €500 billion.

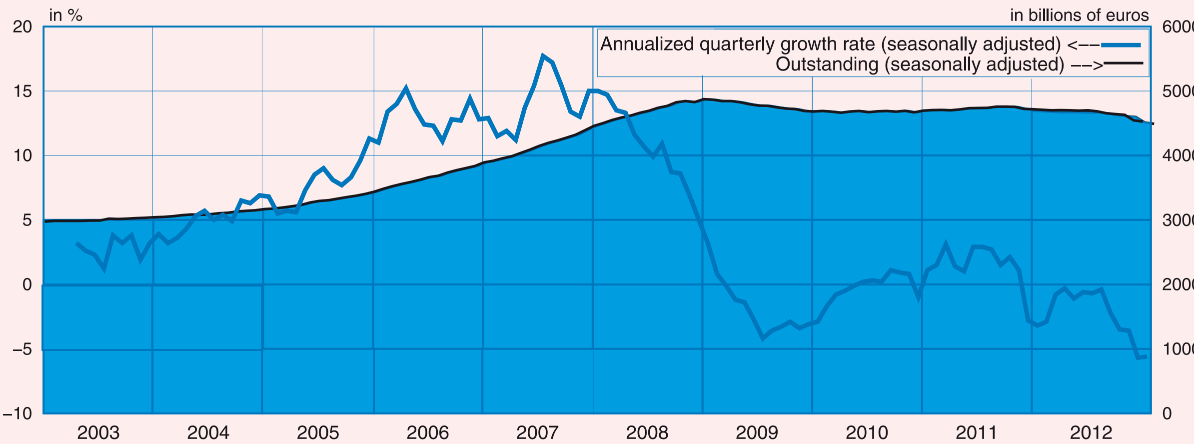
This surplus liquidity has eased money market tensions, but has not brought their working back to normal

The plentiful liquidity lent at low rates to the banks in the VLTRO eased the interbank market as the ECB supplied the liquidity required to cover banks' liquidity needs. Since then, the money market has been characterised by very low rates and volatility, indicating the still very important role played by the central bank in financing the financial sector *(see graph 2)* in the note on Financial Markets). The surplus liquidity supply as against requirements thus forces those banks wishing to lend their surplus liquidity to do so at very low rates. At the beginning of March, VLTRO repayments did not trigger a rise in interbank rates, showing that the liquidity surplus continues.

The relatively small amount of these repayments confirms the fact that the workings of the money markets continue to be affected and that confidence between the banks has not been restored. The terms of access to financing remain uneven:

(1) http://www.ecb.int/mopo/liq/html/index.en.html

2 - Growth in outstanding lending to non-financial enterprises in the Eurozone



Source : European Central Bank

some banks have not returned to financing terms with sufficiently advantageous rates or on a sufficiently long-term basis to be able to repay the ECB, while other, sounder banks have found means of financing on the market (by interbank credit but also by debt issues, for example) and are now in a position to repay the Central Bank (and all the keener to do so for the effect on their reputation).

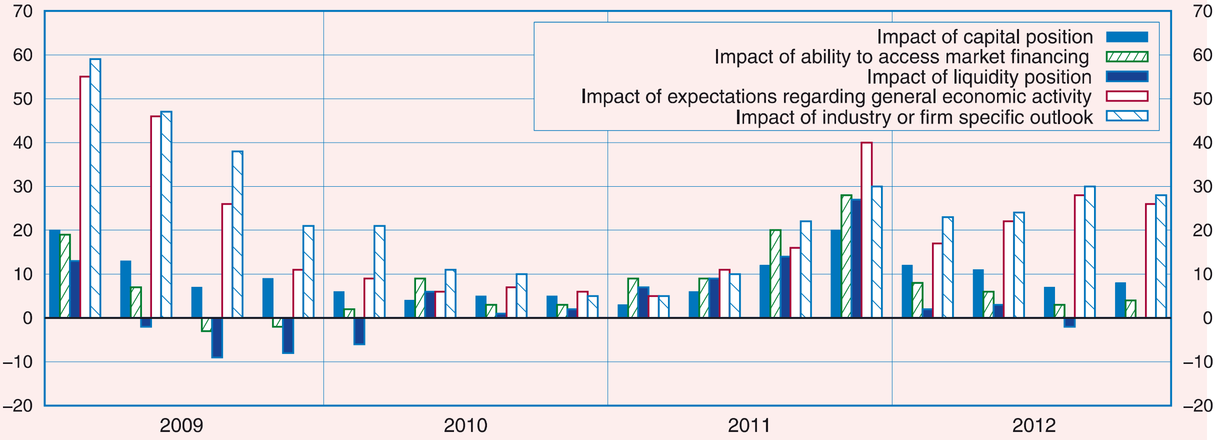
The fall in credit in the Southern European countries has been temporarily halted

By eliminating the risk of a liquidity shortage that was facing European banks at the end of 2011, the VLTRO put an end, in early 2012, to the fall in outstanding credit that had been accelerating at the end of 2011 in the Eurozone *(see Graph 2)* due to particularly negative developments in the programme countries, as well as in Spain and in Italy. Outstanding credit has been declining again since mid-2012 in the Eurozone, due to the weakness of demand for credit, according to the surveys conducted among banks and non-financial enterprises (BLS and SAFE surveys by the ECB). Thus, the concerns about liquidity or financing no longer contribute to tightening lending conditions *(see graph 3)*. More generally, the strong creation of monetary base (the money created by the Central Bank via bank refinancing operations among other things) has not been followed by an acceleration in the money supply (the money created by the banks when they finance the economy, taken here in its broadest sense (M3), *see graph 4*)

The VLTRO have contributed to bringing sovereign rates down

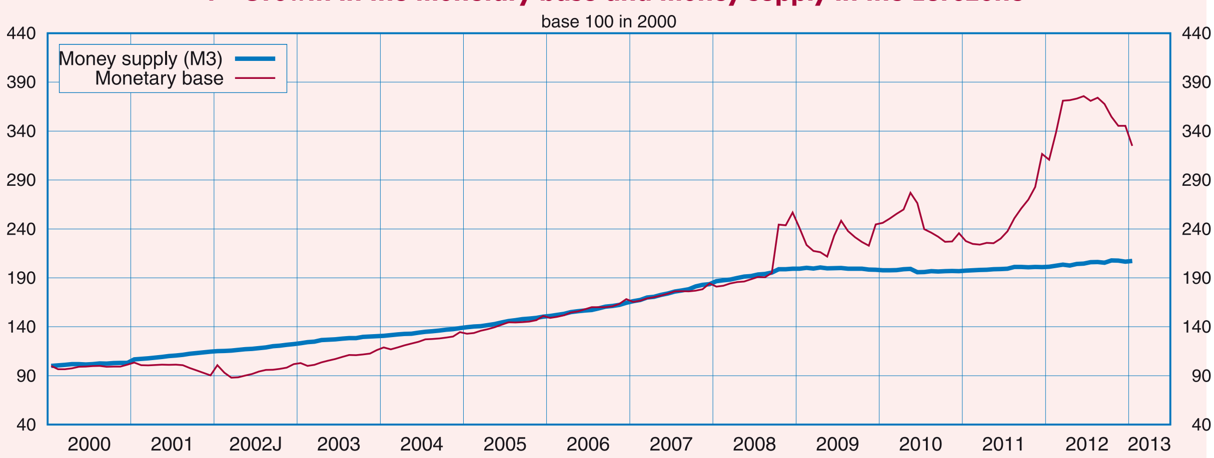
The VLTRO were followed by a drop in long-term sovereign rates on the European debt market *(see graph 5)*. On the one hand, the risk of bank default, and therefore of recapitalisation by the States, has been revised downwards. Also, certain European banks have started buying sovereign securities again, usually domestic ones, whereas the European banks were net sellers on the whole in 2011.

3 - Factors contributing to tightening of credit



Source : European Central Bank

4 - Growth in the monetary base and money supply in the Eurozone



Source : European Central Bank

Between December 2011 and November 2012, almost €300 billion in sovereign debt securities were bought up by European banks *(see graph 6)*. There were massive Treasury bond purchases by banks in early 2012 in Italy and in Spain.

This decline in sovereign debt tensions came to halt in the Spring, however, and it was only with the European Council meeting in June 2012 and the declarations of Mario Draghi on the future of the Eurozone in July that a new downwards trend was triggered, driven from September onwards by the introduction of Outright Monetary Transactions.

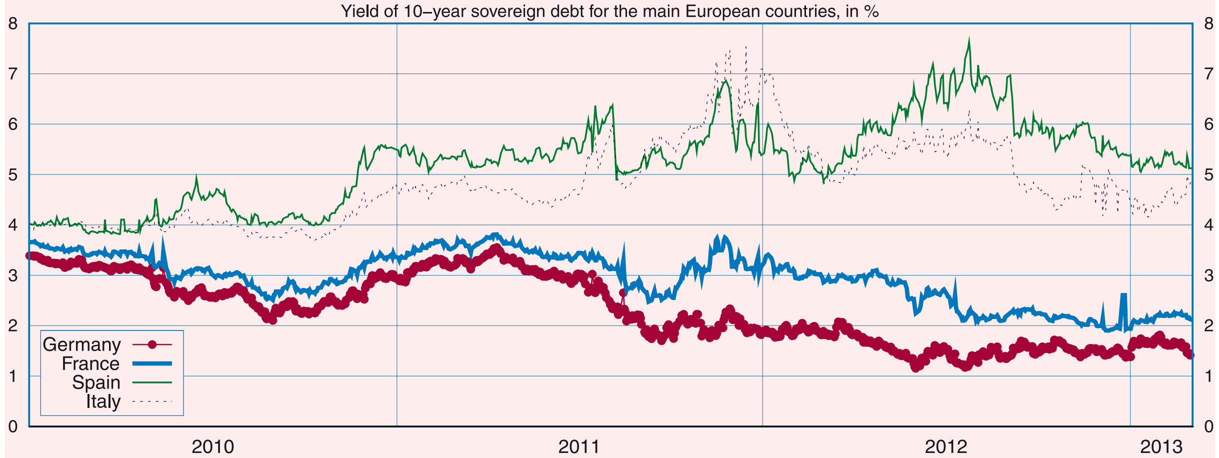
Has the liquidity created by the VLTRO circulated?

The first result of the surplus liquidity in the banking system was a rise in the amounts placed by the banks with the ECB deposit facility. Initially, the European banks sharply increased their overnight deposits with the ECB (from €205 billion in November 2011 to €771 billion in April 2012). The immediate relocation of a large part of the funds injected in the VLTRO came at a cost for the banks, since what had been borrowed at the reference rate of the ECB was largely lent at the floor interest rate of the deposit facility, which is to say 0.25% prior to July 2012. This is a sign of the prevailing risk aversion on the market. After the drop of the deposit facility rate to 0% from 11 July 2011 (at the same time as the cut in the reference rate to 0.75%), the European banks moved en masse to stop placing their surplus liquidity in the deposit facility and simply left it in their current accounts in the form of surplus reserves, the interest rate being zero in both cases (apart from the mandatory part of the reserves on which the ECB pays 0.75%). The amount of the reserves placed with the ECB by the banks thus rose from €109 billion in June 2012 to €539 billion in August 2012, well above the required ratios (€107 billion in August 2012).

This does not mean that the liquidity did not circulate in the economy. Those banks that borrowed liquidities in the LTRO and those that deposited their funds overnight at the ECB were different ones,[2] a sign that the money created by the ECB was used for payments between banks (corresponding to transactions between households and businesses in the Eurozone). The large scale of the banks' reserves with the ECB is indeed a sign of the poor working of the interbank market, but not, in principle, of the circulation of liquidity in the economy.

(2) cf. Benoît Coeuré, "Financer l'économie de la zone euro: le rôle de la BCE", 11 Avril 2012 (http://www.ecb.int/press/key/date/2012/html/sp120411.fr.html)

5 - European sovereign rates



Source : Data Insight

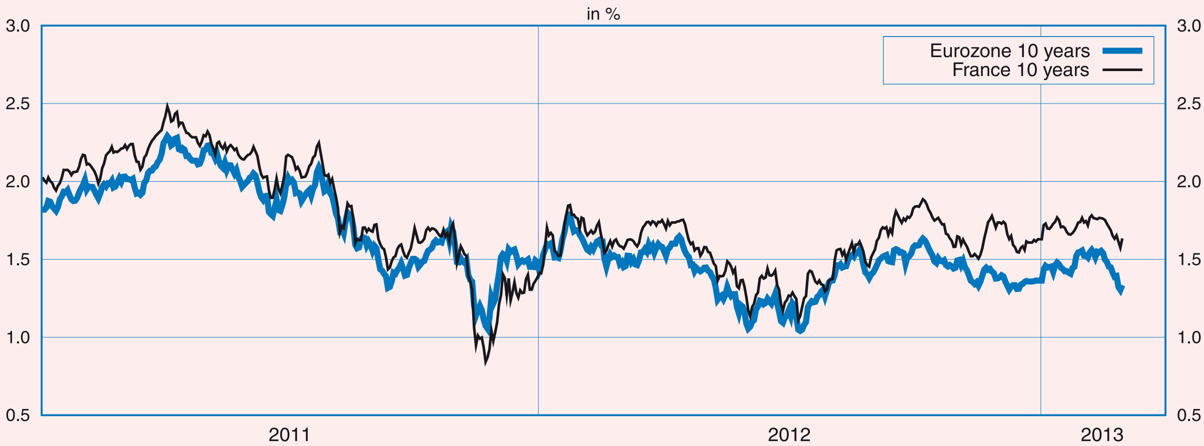
6 - Sovereign bond purchases by the banks

Source : European Central Bank

No shift in inflation expectations

The VLTRO and the resulting strong growth in the monetary base rekindled fears as to a possible surge in inflation in the Eurozone. For the moment, however, the preference of the banks for liquidity and their high risk aversion, plus weak demand for lending due to still-poor activity prospects, have slowed down transmission to the real economy. Inflation expectations therefore remain low today, at levels comparable to ECB objectives *(see graph 7)*. ■

7 - Break-even inflation rate[1] in France and the Eurozone until February 2013



Note: In February 2013, 10-year expected inflation stood at 1.7 % on average in France and 1.5% on average in the Eurozone.

(1): The break-even inflation rate is the difference between the yield on a sovereign bond and the yield on a bond of similar maturity which is index-linked to inflation. In certain conditions, it can be likened to the future inflation expected by the market.

Source : Bank of France

Eurozone

A slow recovery against a backdrop of divergences

In Q4 2012, activity in the Eurozone contracted sharply (-0.6% after -0.1%). Despite the acceleration of world trade, exports declined for the first time since 2009 and foreign trade no longer sustained growth. Domestic demand continued to slide at the same pace as in previous quarters.

In H1 2013 the Eurozone should return to growth, +0.1% per quarter, as suggested by the clear recovery of the business climate. The Eurozone should indeed benefit from the pick-up of foreign outlets, and the decline in domestic demand is likely to drop in intensity. After a marked adjustment phase, the investment ratio is low and production capacity renewal requirements are high: investment in capital goods should no longer fall in 2013.Purchasing power should still be penalised by weak earned income, but the impact of the fiscal consolidation measures should also be smaller in 2013 than in 2012 and inflation is expected to come down. In such conditions, consumption should contract less strongly in early 2013 than in 2012.

Over the forecasting period divergences should persist between Germany, where activity is likely to rebound sharply as early as Q1 2013, and Spain and Italy where it is set to continue its decline. In France activity should remain almost stable. All in all, after -0.5% growth in 2012, the overhang for 2013 at the end of Q2 should be -0.3%.

A sharp decline in activity in Q4 2012

Activity in the Eurozone contracted very sharply in Q4 2012 (-0.6% after -0.1%). For the first time for three years exports slipped back (-0.9%). Despite the upswing in demand from the emerging economies, these countries were penalised by the decline in trade in the developed countries. Furthermore, consumption and investment both continued to fall at the same pace as in previous quarters.

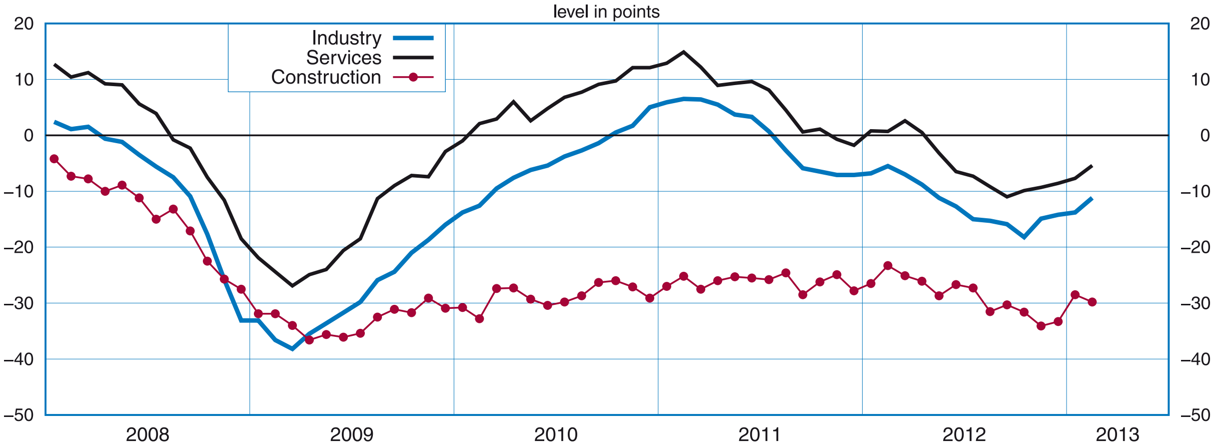
A slow recovery in early 2013...

After reaching a low point in October 2012, the business climate has picked up significantly in the Eurozone, especially in Germany *(see Graph 1)*. According to the business tendency surveys in both industry and services, business leaders expect an improvement in activity in Q1 2013. After just over a year of decline, the Eurozone GDP should see a return of very slight growth in H1 2013 (+0.1% per quarter). The growth overhang for 2013 at the end of Q2 should nonetheless remain negative (-0.3%).

...but the various dynamics are still divergent

The gap between the Eurozone countries is likely to widen further *(see Graph 2)*. Activity should be dynamic in Germany, driven by the rebound in investments in fixed assets and in construction. At the other end of the scale, in Italy and Spain activity is set to continue its slide, although the pace of the

1 - Business climate in the Eurozone



Source: DG ECFIN

contraction should slow somewhat. In France activity should increase little, slowed by sluggish domestic demand.

Support for exports

According to the business tendency surveys, export prospects should improve significantly in early 2013 *(see Graph 3)*. After slipping back in Q4 2012 (-0.9%), exports should therefore rebound in H1 2013 (+0.7% then +0.9%). They are expected to benefit from the rebound in trade within the Eurozone, particularly via the rise in imports in Germany. Additionally, demand should continue to progress in the other advanced economies and accelerate in the emerging countries. The recent appreciation of the euro should however take its toll on exports, particularly in Spain and Italy.

Investment set to stabilise

After several quarters of marked decline investment in fixed assets should gradually pick up at the start of 2013. Prospects according to the business tendency surveys are improving sharply and the production capacity utilisation rate at long last grew in January. However, this upturn in investments should only be gradual. The financing terms afforded to private agents remain tight in Italy and Spain, although they are steadily improving. In these two countries the interest rates on loans granted to businesses remain high. Additionally, investment in construction is expected to continue its decline, although this should be less marked in 2013 because the construction sector is set to pick up in Germany.

Consumption still struggling

The past weakness of activity is likely to take a further toll on the labour market, and employment should slide once more. The deterioration of the labour market has diminished the bargaining power of employees, and wages are unlikely to progress much in Spain and Italy. Earned income is thus set to increase only slightly in early 2013.

Additionally, the fiscal consolidation measures are likely to slow down the disposable income of households, although overall the measures voted for 2013 are less extensive than in 2012. They are likely to temper the support from automatic stabilisers (a «mechanical» rise in social benefits and a drop in taxes during a downturn). However, the moderation of inflation should help sustain purchasing power, which is expected to fall back less quickly in early 2013 than in 2012.

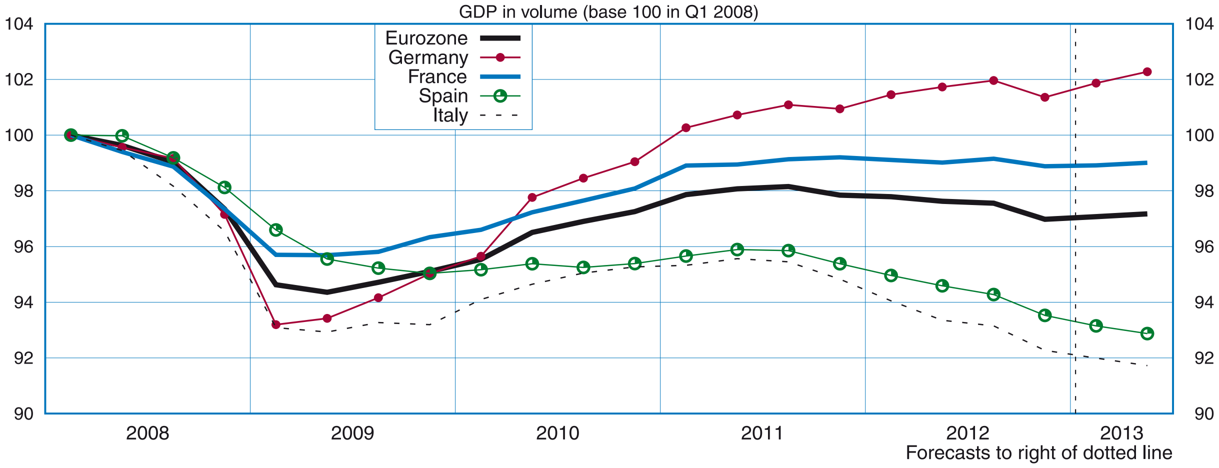
Consumption should therefore continue to fall in H1 2013 (-0.2% then -0.1%), but not as sharply as in 2012, in line with the expected profile of purchasing power. The savings ratio of households should be stable at 13.0%, as in 2012.

Inflation still heading downwards

In Q4 2012 the rise in the unemployment rate continued (11.9% in January). Bearing in mind the weak level of activity, it should continue to rise through to June 2013. So inflationary pressure should be limited and core inflation should slip back to 1.2% in June 2013, after 1.3% in January 2013 *(see Graph 4)*.

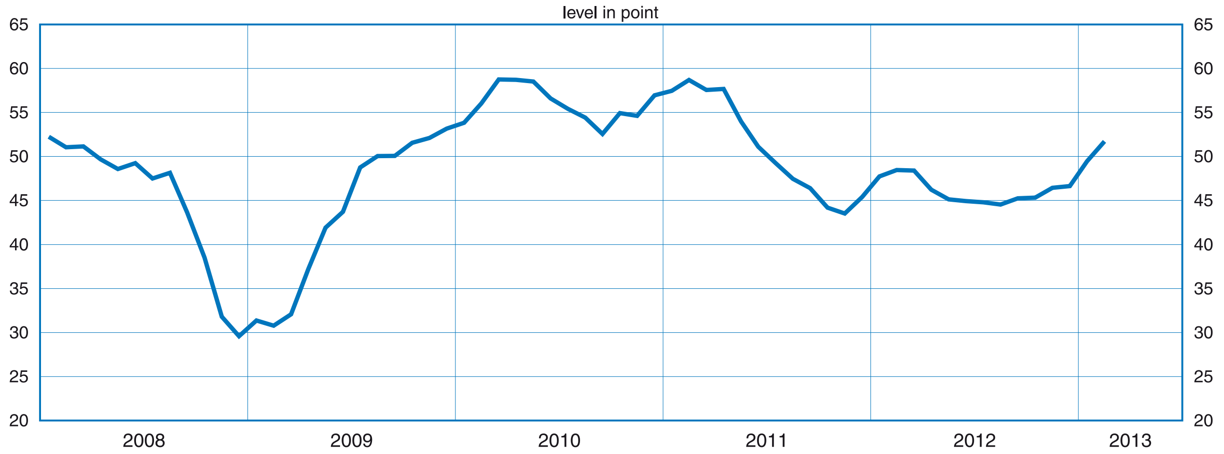
The drop in headline inflation in the Eurozone has been sharp since the start of 2012, and should continue up to April 2013. It is then likely to rise, following the profile of energy inflation. Indeed on the assumption that Brent remains stable at around $110 (€84), the year-on-year increase in energy prices should fall to 1.4% in April 2013, after 5.2% in December 2012. It should then rise to 5.1% in June, as the drops of May and June 2012 cease to affect year-on-year values. Additionally, the sharp rises in commodity prices since the start of 2013 should filter through to food prices. All in all, headline inflation, standing at 2.0% in January, should retain this level in June 2013. ■

2 - Divergences in the Eurozone



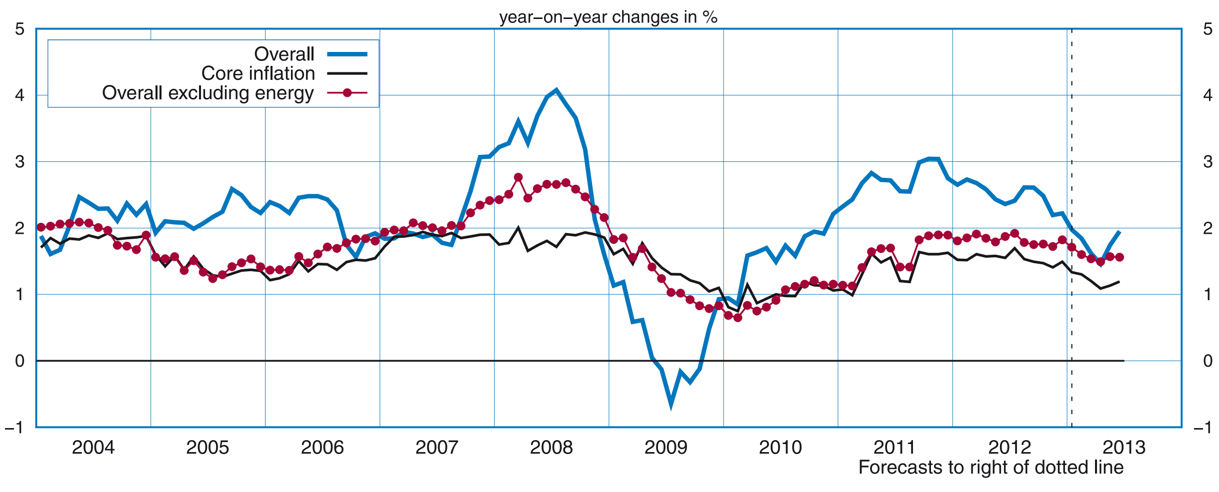
Source: Eurostat, INSEE calculations

3 - Export perspectives in the manufacturing industry



Source: Markit

3 - Consumer prices in the Eurozone



Sources: Eurostat, INSEE calculations

Germany

Upturn

Activity fell sharply in Q4 2012 in Germany (-0.6%). Foreign trade weighed down heavily on growth: exports fell back (-2.0%), while imports held up somewhat given the fall in activity. Investment in capital goods also fell for the fifth consecutive quarter. Only consumption, both public and private, showed a slight increase.

According to the business tendency surveys, the German economy is set to show an upturn in H1 2013. Exports are likely to rise once again, as should investment, and household consumption should remain firm. Activity should increase by 0.5% in Q1 2013 and by 0.4% in Q2. The growth overhang for 2013 at the end of H1 should come to +0.5%.

German exports likely to pick up again

After dropping at the end of 2012, German exports should pick up again at the start of 2013, thanks to strong demand from outside the Eurozone: the new export orders component in PMI surveys has been rising since October 2012, as have foreign demand prospects in the IFO Institut surveys *(see graph)*.

Investment set to bounce back

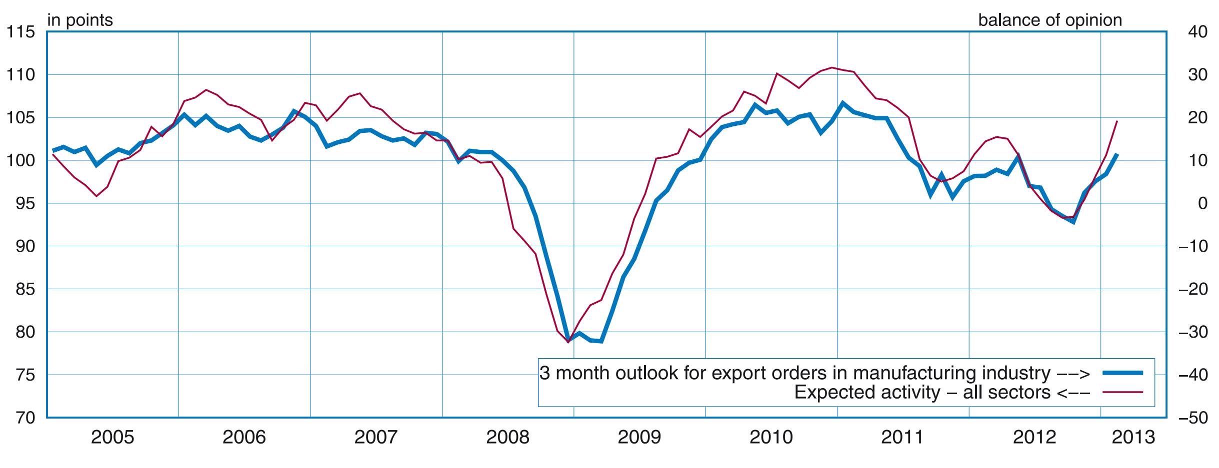
After falling by 4.1% in 2012, investment in capital goods should rise again over the forecasting period, driven by exports (+0.7% in Q1 2013 and +2.0% in Q2). Orders for capital goods did show an upturn in 2012, as did production capacity utilisation rates. Most importantly, optimism in business tendency surveys since October shows a return in confidence in the economic outlook.

After falling in 2012 (-0.9%), investment in construction is set to bounce back in 2013. The number of building permits and orders in construction has been on an upward trend since 2010.

Household consumption should remain strong

The labour market situation in Germany remains in favour of employees. The slight fall in productivity observed since the beginning of 2011 was accentuated in Q4 2012, with employment continuing to rise despite the fall in activity. At the beginning of 2013, productivity should show an upturn, with employment growing less than activity. The unemployment rate should remain stable at 5.3% over the forecasting period. Wage increases are likely to continue and household purchasing power should progress again, also buoyed up by a fall in social contributions on 1st January 2013. In this context, household consumption, which increased in 2012 despite jolts in activity, should progress by 0.3% a quarter through early 2013 and the savings ratio should remain stable at 15.3%. ■

The business climate is improving



Source: Business tendency surveys of IFO-institut

Italy

Easier on the brakes

Italian activity fell back sharply in Q4 2012 (-0.9%) and should continue to slip through H1 2013 (-0.3% a quarter), although less steeply. At the beginning of 2013, business surveys are showing signs of improvement. Exports would appear to be accelerating and investment in fixed assets levelling out, buoyed up by the need to restore production capacities. Households are likely to continue cutting back on their consumption in 2013, however, with purchasing power falling sharply in H1 2013 despite moderate inflation.

Signs of recovery in manufacturing sector surveys

Manufacturing output is likely to continue falling in H1 2013, but much less sharply than at the end of 2012. On the one hand, purchasing manager surveys in manufacturing industry (PMI) have been showing a clear upturn since the summer, especially as regards their new export order component *(see graph)*. In addition to this, the industrial production index rebounded slightly in December (+0.4%) after falling for three months. The slide in Italian GDP should therefore ease in H1 2013 (-0.3% a quarter). The growth overhang for 2013 at the end of Q2 should be -1.5%.

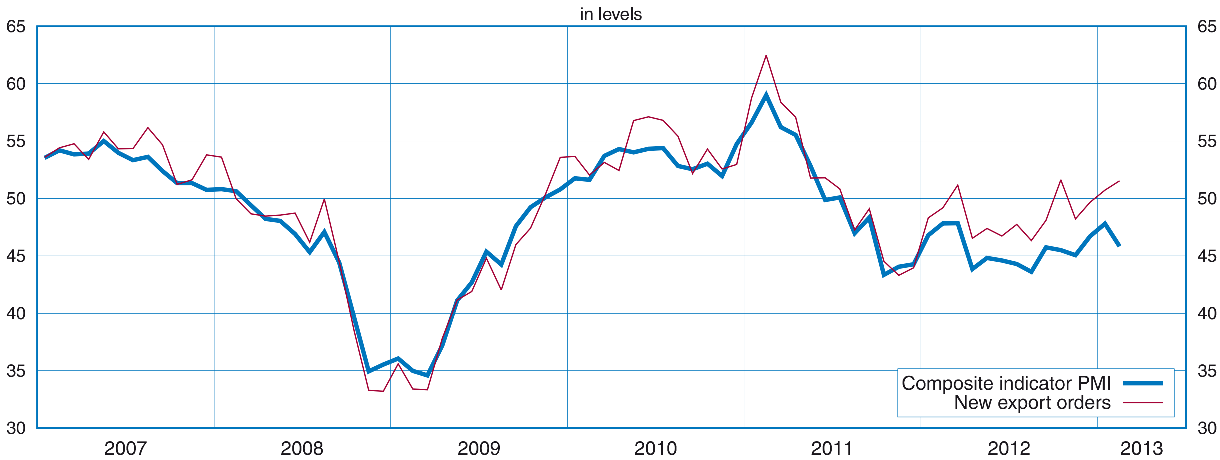
Fiscal consolidation efforts ease but continue to hold back consumption

Based on the measures passed to date, the fiscal consolidation effort should continue in 2013, although at a lesser rate than in 2012. The additional burden on households should reach 1.7% of their income, which is slightly less than in 2012 (2.1 points of gross disposable income). Inflation should also fall, after the VAT shock in 2012. The deterioration in employment is likely to continue however, and the unemployment rate should reach 11.6% in Q2 2013: in this context, employees are unlikely to be able to maintain their real wages, despite moderate inflation. Household purchasing power is therefore set to continue falling through to mid-2013. In an uncertain political situation, the savings ratio should remain stable, as it has since mid-2011, and households are likely to cut back on their consumption in H1 2013 (-0.6% per quarter).

Upturn in exports and gradual levelling out of investment

The fall in investment in capital goods (-9.2% in 2012) should gradually ease, as activity prospects look up, according to the business tendency surveys. Also, the interest rates granted to small companies have been falling since the beginning of 2012 and exports continue to be stimulated by foreign demand, despite being held back by the recent rise in the Euro. The need to renew production capacities is growing on account of the under-investment in recent years. However, political uncertainties could hold back the upturn in investment to some extent. ■

The global climate in manufacturing industry is improving



Source: Markit

Spain

Keeping up the rate of adjustment

Activity in Spain has been contracting since the end of 2011 and the trend is set to continue over the forecasting period: -0.4% and -0.3% in Q1 and Q2 2013. Due to the poor job market situation and continuing fiscal consolidation efforts, household purchasing power should continue falling, despite the drop in inflation. Households are therefore likely to continue cutting back sharply on their consumption. Exports should progress, however, thanks to the upturn in world trade, even though they are likely to suffer from the recent rise in the Euro. Investment in capital goods should level out by mid-2013, buoyed up by foreign demand, the easing of financial tensions and the need to renew production capacities.

Spanish exports held back by the rise in the Euro

Although they fell back slightly in Q4 2012 (-0.9%), hit by the fall in trade in developed countries, Spanish exports have been strong since 2009. They have benefited notably from the fall in the Euro over the past three years. In H1 2013, Spanish exports are likely to profit from the upturn in world trade, although they should be hit by the recent rise in the Euro, rising again moderately (+0.8% then +1.2% a quarter). With domestic demand still falling, foreign demand is likely to continue to be the sole driver of growth in Spain.

Investment: restoring production capacities

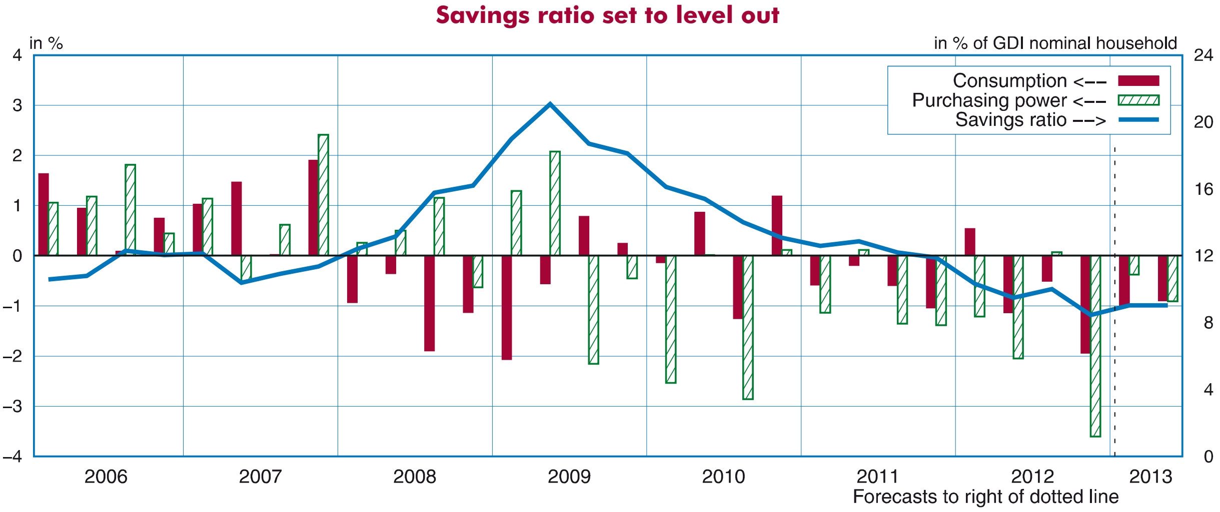
The sharp fall in investment over several quarters has generated needs for renewal. Investment in capital goods should therefore enter a catch-up phase, driven by the high level of corporate margins. Investment in capital goods should level out by mid-2013, without really progressing, given low demand for production capacities. In construction, investment is set to continue falling, depressed by the clearing up of the property bubble and the drop in public investment.

Consumption down and savings ratio stable

Job losses are set to continue in early 2013 and the unemployment rate, which stood at 26% at the end of 2012, should continue to rise. The rise in the level of unemployment on the one hand and the effort to keep wages down on the other are likely to limit earned income, while the rises in taxes and cuts in welfare benefits passed for 2013 are on a comparable scale to those in 2012. Thanks to the fall in inflation, however, purchasing power of gross disposable income is set to fall back in H1 2013 at a lesser rate than in 2012 *(see graph)*.

After falling sharply through to the end of 2012, the household savings ratio should stabilise at a low level (see graph) and consumption is set to contract again in 2013 (-1.0% in Q1 then -0.9% in Q2 2013). ■

Savings ratio set to level out



Sources: INE and INSEE calculations

United States

Despite tax burden increases, domestic demand is holding up

The US economy stalled in Q4 2012 (0.0%): while domestic private demand was strong (+0.9%), public and defence spending contracted sharply. Activity should accelerate significantly in Q1 2013 (+0.6%). Residential investment should continue to rise again and US exports should benefit from the acceleration in world trade. In Q2, household consumption is likely to be hit by the rise in taxes and public spending should contract again: activity is likely to slow down significantly (+0.3%)

A «fiscal cliff» of some 1.5 points of GDP...

The agreement found at the end of December between Congress and the President makes an additional burden of $195 billion on household income in 2013. The bulk of this sum comes from the rise in wage contributions. Tax rates will also rise on revenues from capital and for the highest income tax bracket. The burden on households should thus increase by more than 7% from Q1 2013. Regarding spending, the automatic cuts coming into force on 1st March potentially represent 7% of the spending scheduled by the Federal State in 2013. The forecast is based on the hypothesis of an agreement being found and of public consumption contracting moderately in Q2 (-0.5%).

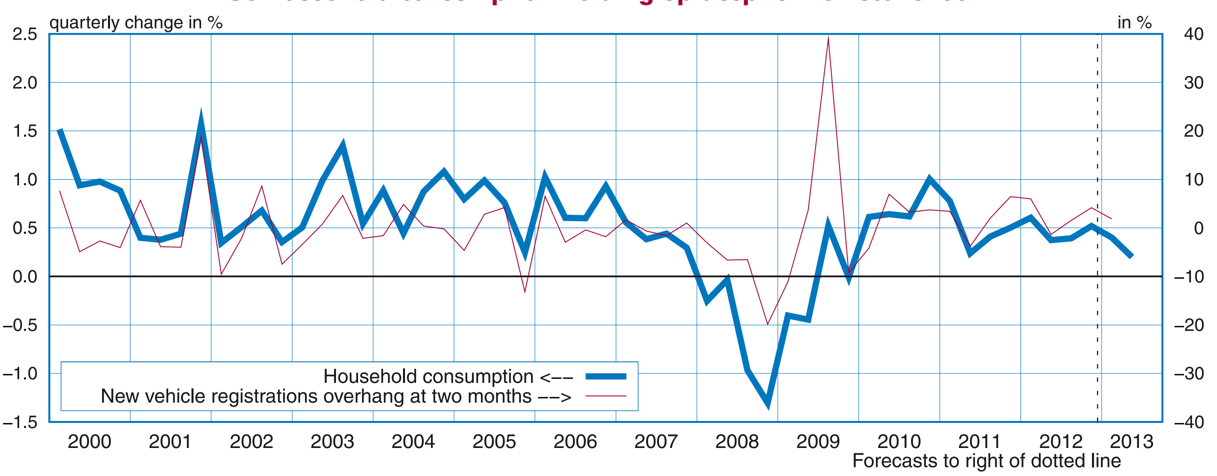
...causing a slowdown in consumption

Under the effect of the fiscal shock, household purchasing power is likely to fall in H1 2013.The drop, however, should be softened by the moderate level of inflation and strong employment. Job creations, at an average of 180,000 a month in 2012, should barely weaken over the forecasting period and the unemployment rate should fall back slightly (see *Focus*). Several factors should also favour a fall in the savings ratio: on the one hand the rise in certain taxes on the wealthiest households; on the other, the rise in the price of assets should generate wealth effects. All in all, consumption should hold up in Q1 2013 (+0.4%), as suggested by new vehicle registrations until February 2013 *(see graph)* but then slow down sharply in Q2 (+0.2%).

Investment remains dynamic as the foreign-trade driver starts up again

After falling sharply in Q4 2012, US exports should benefit from the acceleration in trade, and notably in Asian demand, and rise again significantly. Over the forecasting period, companies are set to profit from their high margin levels and still-favourable financing terms to continue developing their production capacities. In parallel, the construction sector should continue to grow at a sustained rate. ■

US household consumption holding up despite the fiscal shock



Sources: Bureau of economic analysis, INSEE calculations

Can the fall in the activity rate in the United States be explained by flexion effects?

The unemployment rate has been falling in the US since the end of 2009

After rising sharply and very quickly from the beginning of the crisis, from 4.5% in mid-2007 to a peak of 10.0% in October 2009, the US unemployment rate has fallen significantly. It stood at 7.8% in December 2012 *(see graph 1)*.

The labour force participation rate is also falling

In parallel, the labour force participation rate of over-16s has also fallen sharply. Since 2007, it has dropped by about 2.5 points and by 1.4 points since the end of 2009. This fall which has continued during the labour market improvement phase, also seems much more pronounced than in previous economic cycles *(see graph 2)*. It is therefore only natural that we should wonder to what extent the fall in unemployment might not be a sign of discouragement among unemployed workers, leading them to withdraw from the labour market.

Age structure explains about half the drop in the labour force participation rate

The labour force participation rate is the ratio of the active population to the population of working age. Taking account of the age and gender structure of the population, a change in the overall labour force participation rate between two dates can be broken down into two contributions (*see appendix*): on the one hand, the changes in the participation rates of each age and gender group (referred to here as the "underlying variation") and, on the other hand, the variation in the respective weights of the different age and gender classes in the population of working age for a given labour force participation rate in each of those classes (referred to here as the "structure by age and gender[1]).1In particular, ageing of the population leads to an increase in the proportion of seniors in the population. As the latter have a lower labour force participation rate than the average, the overall participation rate tends to fall quite mechanically, even if rates per age group remain constant.

An underlying labour force participation rate is therefore constructed, in which the weight of each age bracket and gender group is fixed at a given date.[2] The decline observed between 2007 and 2012 in this underlying participation rate, by about 1.2 points, is half that in the overall rate *(see graph 3)*.

Changes in the labour force participation rate trends of the different age brackets

This underlying labour force participation rate shows the trends in the participation rate in the different age groups. Some are structural, such as the fall in labour market participation among young people as they study longer, but the crisis has amplified this shift (*see graph 4*). Conversely, it seems to have had little effect on the structural rise in labour force participation rates of the over-55s *(see graph 5)*. For the median age groups (25-54 years), the fall in rates has been about 1.5 points since 2007 and has been homogenous between the different age brackets *(see graph 6)*.

Flexion effects have probably been weaker since 2008 than those observed in previous crises

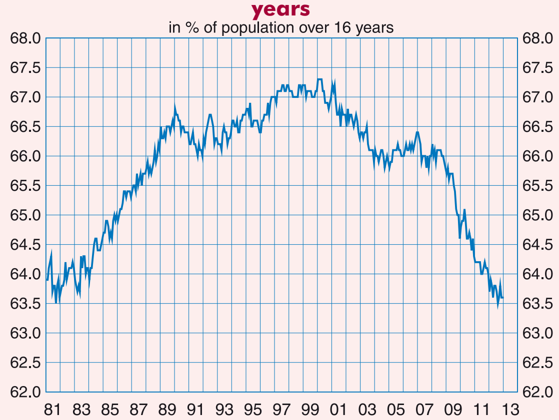
In addition to the structural changes in activity behaviour, the economic situation can induce modifications in labour market participation behaviour, through "flexion effects": a part of the population may withdraw from the active

(1) The data of the Bureau of Labor Statistics defines 13 age brackets with 5 year intervals from 16-19 years to over 75, making a total of 26 categories when the stratification takes account of age and of gender.

(2) The result is sensitive to the base year used. However, by testing several base years in the period 1981-2012, we conclude that the result is always qualitatively the same, i.e. that half of the drop in the participation rate between 2007 and 2012 is due to the population's age and gender structure. Quantitatively, the underlying rate lost between 1 and 1.5 point between 2007 and 2012 depending on the base year used. In all that follows, the breakdown of the structure of the active population in 1981 is used as a reference.

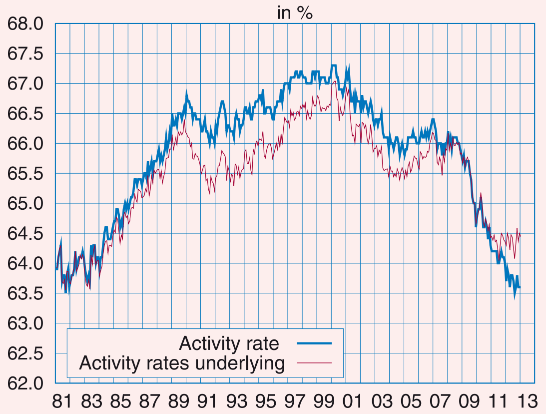
1 - Unemployment rate

2 - Labour force participation rate of more than 16 years

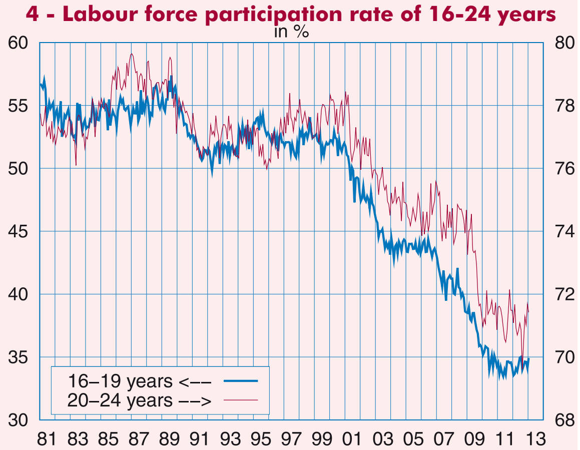


Source: Bureau of Labor Statistics

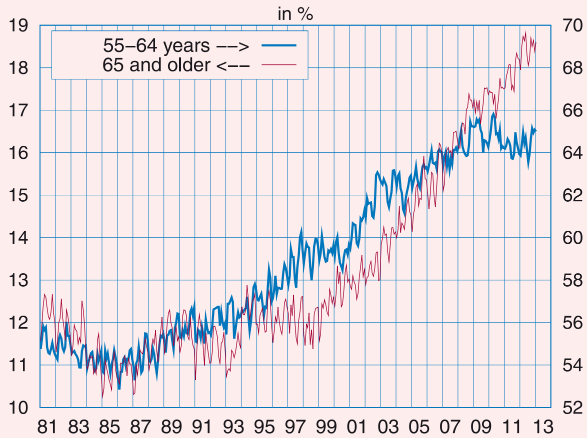
3 - Underlying labour force participation rate



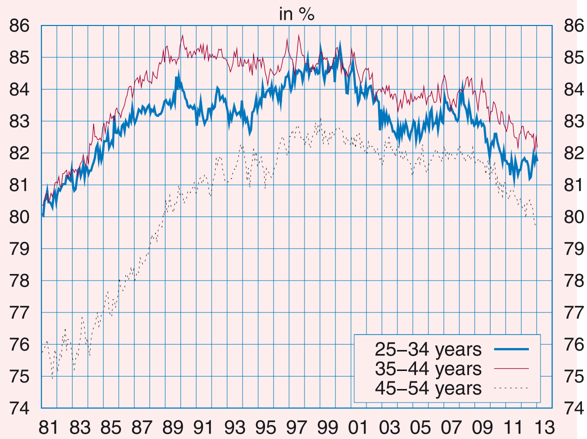
4 - Labour force participation rate of 16-24 years



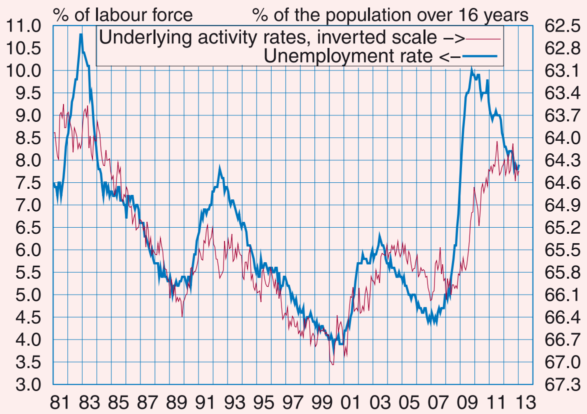
5 - Labour force participation rate of more than 55 years



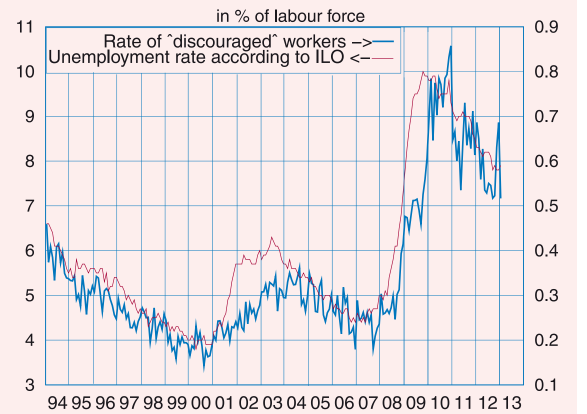
6 - Labour force participation rate of 25-54 years



7 - Unemployment rate and underlying labour force participation rate



8 - Unemployment rate and rate of «discouraged» workers



Source: Bureau of Labor Statistics

population when the labour market deteriorates and come back when employment prospects improve. This behaviour appears clearly in the relative changes in the unemployment rate and the "underlying" labour force participation rate *(see graph 7)*.

In 2008, for example, the fall in the labour force participation rate was rather moderate, given the scale and speed of the rise in the unemployment rate. Conversely, since 2010, the labour force participation rate has not been rising, although the unemployment rate has been falling. All in all, the labour force participation rate level seems to be in line with the situation on the labour market.

Another sign of the relative resilience of the US active population during the crisis is provided by the trend, among those who are inactive, in the number of people who do want a job but do not meet the statistical definition of the unemployed (*see appendix*). Among these people, US statistics distinguishes those people who have recently stopped looking for a job by discouragement. The «discouragement» rate of the population of working age but does seem in line with what would have been expected given the scale and speed of the rise in the unemployment rate (see graph 8). On the other hand, the number of people who would like a job but have given up looking altogether for over a year has increased since 2007, by about 700,000 people (0.4% of the active population). Almost 2% of the active population is now in this case, a level comparable to that at the end of the 1990s.

All in all, the labour force participation rate in the United States corresponds today to what would be expected on the basis of the level of employment, demographic structure and the usual phenomena of discouraged workers. ■

Appendix

1. Definitions

US labour-market statistics are taken from the Current Employment Statistics (CES) programme, the results of which are published each month by the Bureau of Labor Statistics (BLS). For each month, the reference week is that including the 12th day of the month.

The figure for **employed persons** includes all those people who, in the reference week:

- were paid for work, no matter what its duration,
- were self-employed in their own company or farm,
- or worked unpaid in a family-run company or farm for at least 15 hours.

Anyone who was absent from work for reasons of sickness, bad weather conditions, leave, professional conflicts or personal reasons is also counted as being in employment.

Unemployed persons refers to all the people who meet the following criteria: they did not have a job in the reference week, they were available for work immediately and took specific steps to find a job during the four-week period ending with the reference week. This definition complies with that of the International Labour Organisation (ILO). The **active population** includes people in employment and those who are unemployed.

The **labour force** participation rate is defined as being the ratio of the active population to the population of working age. Among those who are inactive, the BLS makes a distinction between those persons wanting to work but not counted as unemployed either because they were not available in the reference week or because they were no longer actively looking for a job.

2. Breakdown of the trend in the labour force participation rate according to age and gender structure

The labour force participation rate is written as the weighted sum of the labour force participation rates of the different age and gender classes, in the form:

$$Activity\_rate = TA = \frac{Active-population}{Total-population} = \frac{\sum_i PA_i}{\sum_i PT_i}$$

$$= \sum_i \frac{PA_i}{PT_i}\frac{PT_i}{PAi}$$

where i represents the age and gender classes. Thus, the variation (in points) in the labour force participation rate between date 1 and date 2 may be written:

$$TA_2 - TA_1 = \sum_i \left(\frac{PA_{2i}}{PT_{2i}}\frac{PT_{2i}}{PT_2} - \frac{PA_{1i}}{PT_{1i}}\frac{PT_{1i}}{PT_1} \right)$$

$$= \sum_i \left\{ \left(\frac{PA_{2i}}{PT_{2i}} - \frac{PA_{1i}}{PT_{1i}} \right) \frac{PT_{1i}}{PT_i} + \left(\frac{PT_{2i}}{PT_2} - \frac{PT_{1i}}{PT_1} \right) \frac{PA_{2i}}{PT_{2i}} \right\}$$

$$= \underbrace{\sum_i \left\{ \left(\frac{PA_{2i}}{PT_{2i}} - \frac{PA1i}{PT_{1i}} \right) \frac{PT_{1i}}{PT_1} \right\}}_{\text{underlying variation}} + \underbrace{\sum_i \left\{ \left(\frac{PT_{2i}}{PT_2} - \frac{PT_{1i}}{PT_1} \right) \frac{PA_{2i}}{PT_{2i}} \right\}}_{\text{effect of age and gender structure}}$$

■

United Kingdom

Short of energy

After falling back in Q4 2012, British activity is likely to rise again in H1 2013. Although fiscal consolidation is set to continue, domestic demand should hold up well: with the fall in inflation and buoyant private employment, households should increase their consumer spending moderately, while firmer demand from abroad should support corporate investment. Activity should continue to be hit by weak energy production, however.

Still short of energy in early 2013

British activity fell again at the end of 2012 (-0.3%) as the one-off boosts in Q3 faded out (London Olympics, additional bank holiday for the Queen's Jubilee) and due to the extended shutdown of part of North Sea oil production. After quarterly ups and downs, activity slowed down overall in the UK in 2012 (+0.2%). Energy production is likely to remain weak in Q1 2013, hit by the shutdown of the Schiehallion platform (North Atlantic). All in all, activity is likely to progress moderately: + 0.2% per quarter.

Fiscal consolidation continues...

For the fiscal year ending in March 2013, new fiscal consolidation measures represented an effort of around 1.2 points of GDP. The great majority of these measures were based on spending cuts: social welfare benefits paid to households increased by less than inflation, abolition of family benefit from January 2013 for the highest-earning households and cuts to the budgets of government departments. Around 300,000 public-sector jobs have been cut since 2011. Budget cuts are set to continue at the same rate in 2013-2014 and the cuts in welfare benefits are likely to be stepped up. Households should benefit, however, from a further rise in the income tax payment threshold.

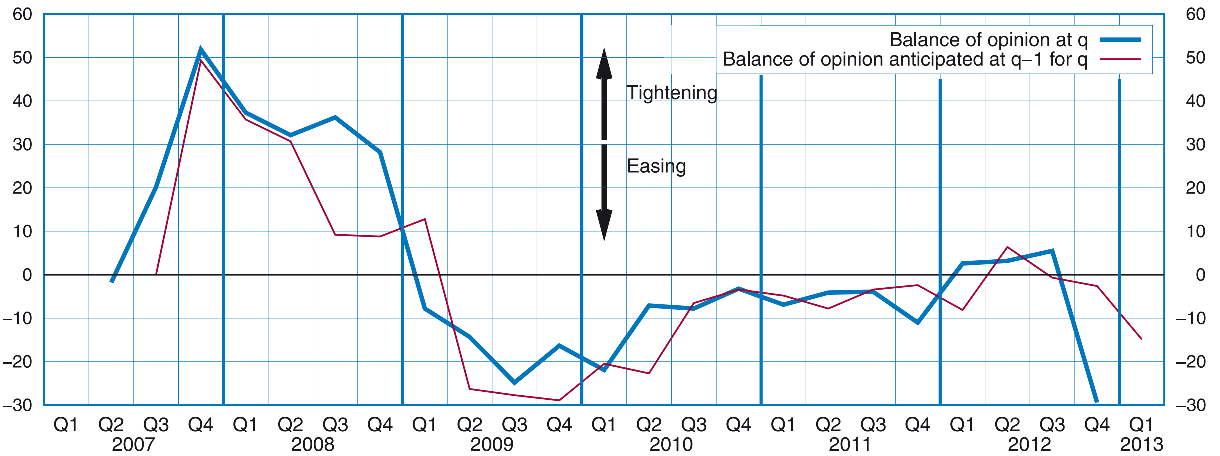
... but private employment should support household purchasing power

At the beginning of 2013, household purchasing power should be hit by further reductions in benefits, but inflation should fall after the rises at the end of 2012 (university fees, electricity prices). Above all, purchasing power should be buoyed by strong private employment which is likely to continue progressing despite weak activity. British households should therefore increase their consumer spending moderately.

Financing terms are easing

Despite the negative effect on their margins of the lack of productivity gains, companies are set to slightly increase their investment on production assets in early 2013. On the one hand, they should benefit from a monetary policy that remains accommodating and also from government measures aimed at enhancing their access to credit (Funding For Lending and Supply Chain Finance schemes). These brought a very significant easing of lending terms at the end of 2012 *(see graph)*. On the other hand, foreign trade outlets should be stronger, buoyed by the acceleration in world demand and the recent depreciation of the Pound Sterling. ■

Easing of corporate lending terms at the end of 2012



Source: Bank of England

Japon

Going for a stimulus

In Q4 2012, activity stagnated in Japan (0.0% after -1.0% in Q3), under the effect of a contraction in corporate investment and, above all, a further fall in exports, hit by diplomatic tensions with China.

In H1 2013, Japanese activity should start growing again (+0.6% in Q1 and +0.4% in Q2). Exports are likely to be boosted by the recent fall in the Yen and accelerating Asian demand. In addition to this, the new stimulus plan passed in February 2013 should buoy up activity.

Industrial production to bounce back in Q1 2013

After falling back sharply in Q3 (-4.2%) and in Q4 2012 (-1.9%), the industrial production index rose again in December 2012 and January 2013 *(see graph)*. According to the survey of production forecasts in industry from the Ministry for the Economy (METI), it should increase again sharply in February 2013, notably in the automobile and electronics branches. The business climate as measured by the business tendency surveys is also showing a significant improvement in expectations in the manufacturing sector in early 2013.

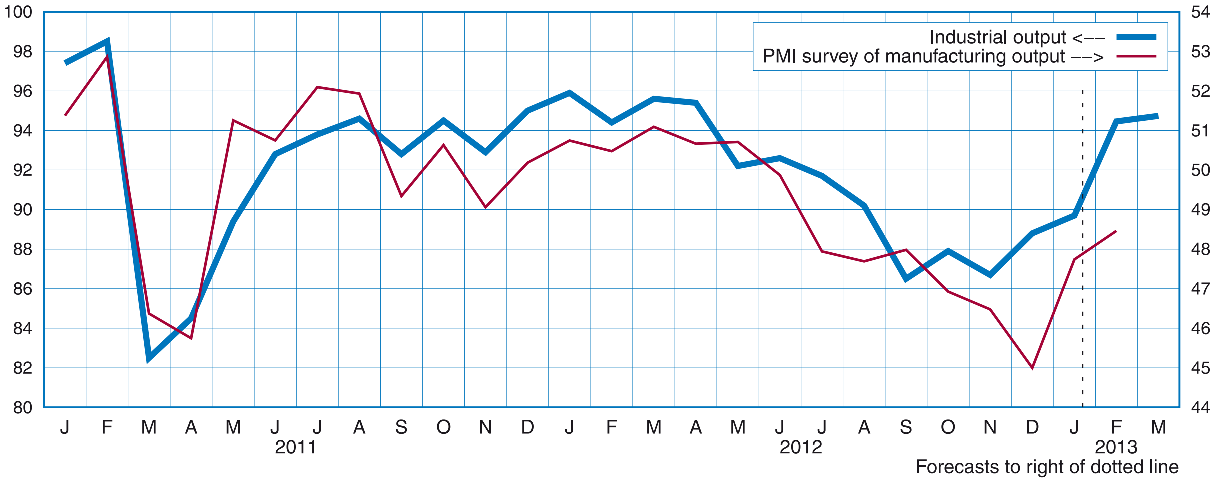
Domestic demand set to be stronger

In Q4 2012, private consumption showed an upturn (+0.5% after -0.5%). In particular, new vehicle registrations, which had collapsed in the summer with the end of public subsidies for purchases of "ecological" cars, have risen again significantly since October. The low unemployment rate, which fell back to 4.2% in January 2013, is also enabling employees to negotiate real wage rises and household consumption should continue to increase moderately over the forecasting period. Also, the 10.3 billion Yen stimulus plan (2.2% of GDP) announced by the new Shinzo Abe government should boost public spending. To meet this stronger demand, companies are likely to increase their investment expenditure.

The sharp fall in the Yen should boost exports

Japanese exports fell sharply in Q4 2012 due to diplomatic tensions with China. They should grow significantly in H1 2013, buoyed by accelerating demand from Asian countries other than China and by the sharp fall in the Yen. The vast asset-purchasing programme launched by the Bank of Japan *(see Financial Markets)* has brought a sharp drop in the Yen against the other major currencies since December (-12% from November 2012 to February 2013 against the US Dollar). ■

Japanese industrial production to bounce back in Q1 2013



Source: Japanese Ministry of Economy Trade and Industry, Markit

China and emerging Asia

Acceleration confirmed

In Q4 2012, activity, and notably industrial activity, accelerated in China and in all the emerging countries of Asia, while trade bounced back strongly in the zone. According to the January business tendency surveys and production data, activity is set to accelerate further in H1 2013. The sharp rise in Chinese domestic demand, and notably in household consumption and in investment, should benefit the whole of the région.

Trade on the up in Asia

Trade in Asia was very strong during the world economic upturn, but slowed down suddenly from mid-2011 onwards. As an illustration, the exports of Asian countries other than Japan progressed by 0.8% between Q3 2011 and Q3 2012 and imports by 4.0%, against an average annual progression of around 12% between 2000 and 2007. The fall in final demand from advanced countries, notably in Europe, and tighter monetary policies, notably in China, would seem to have slowed down the whole of the Asian production chain.

In Q4 2012, however, trade bounced back strongly in Asia and Chinese exports to Europe levelled out. According to Customs data and business tendency surveys in early 2013, this upturn in activity would appear to be confirmed.

Domestic demand accelerating in China

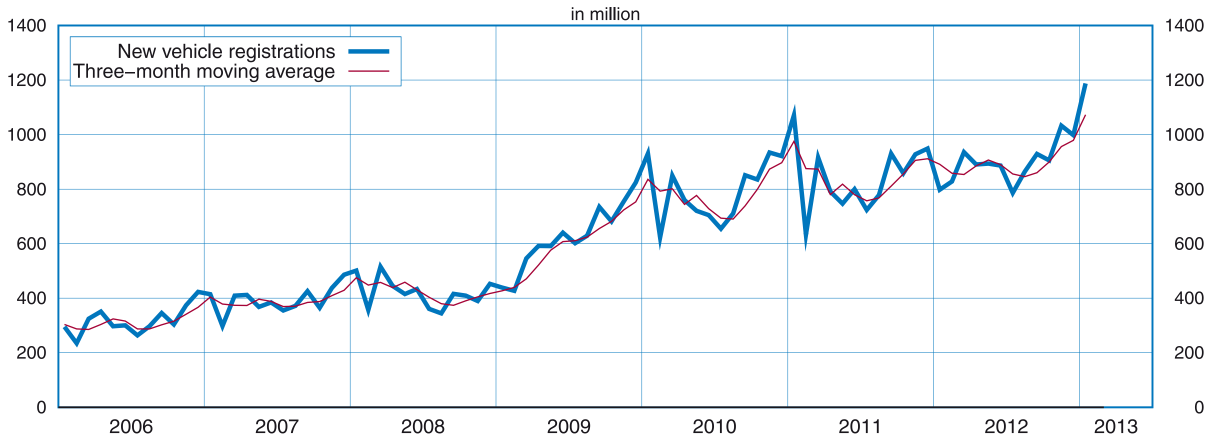
Activity should be buoyed up in particular by strong Chinese domestic demand. For example, private consumption accelerated in Q4 2012 and this trend is set to continue in H1 2013: new vehicle registrations reached an exceptionally high level in January, exceeding even their January 2011 peak *(see graph)*. This upturn in domestic demand has been favoured by macroeconomic policies.

Since the beginning of 2012, the sharp drop in inflation, back down to 2.0% in January 2013, has allowed the Chinese authorities to continue easing their monetary policy. The Chinese government and local provinces have also announced the financing of several public infrastructures for an amount of close to 2% of GDP. To meet this increasing demand, industrial production should remain strong: the PMI survey for manufacturing industry has been above the expansion threshold since December 2012 (50.4 points in February 2013).

The «dragons» profit from the Sino-Japanese dispute

In Q4 2012, activity accelerated significantly in South Korea and Taiwan, and rose again in Singapore. In particular, manufacturing production was very dynamic, buoyed by exports, notably to China. While Sino-Japanese tensions caused a considerable drop in Chinese imports from Japan, China's biggest supplier, Korean and Taiwanese products would seem to have played the role of substitutes for Japanese products. Over the forecasting period, they should continue to benefit from the strength of Japanese and Chinese demand. ■

Rise in new vehicle registrations in China



Sources: China Association of Automobile Manufacturers