1. Global economy

Global economic growth moderated during 2011 : it is estimated at 3.8 %, compared to 5 % in 2010. Among the factors restraining growth were the new rise in commodity prices, the tightening of fiscal and monetary policy in the emerging countries prone to rising inflation, the persistence of imbalances on the property and labour markets of certain advanced economies, and the sovereign debt crisis in the euro area. Fiscal consolidation measures were taken in most countries, sometimes under pressure from the financial markets. Central banks again resorted to non-conventional measures to safeguard the financing of the economy.

1.1 Economic activity

Summary

The vigour underpinning the revival in international economic activity for two years ebbed away in 2011, in a context of temporary shocks and financial tensions. Thus, by the spring, the global economy experienced a sharp, widespread slowdown in activity and international trade, which was more pronounced than might have been expected from a normalisation at the end of a strong recovery period. The slackening pace of growth was initially due to temporary factors : the rise in commodity prices depressed household purchasing power ; the earthquake, tsunami and nuclear disaster in Japan in March disrupted production, not only in that country but also elsewhere, especially in Asia and the United States. The motor vehicles and electronics sectors felt that impact owing to the disruption of global supply chains. Later, the slowdown was amplified by rising tensions on the financial markets and the erosion of consumer and business confidence.

Indeed, during the summer, doubts emerged about the ability of policy-makers to resolve public debt sustainability problems in a number of countries. The crisis in the private financial sector, which had triggered the great recession of 2008-2009, therefore ultimately led to a sovereign debt crisis. The heated debate over raising the public debt ceiling in the United States, the discussions surrounding the establishment of safeguard mechanisms for euro area countries with financing difficulties, particularly in regard to the involvement of the private sector in a restructuring of Greece's sovereign debt, and the cumulative delays in implementing the Greek adjustment programme added to the general mood of uncertainty. The epicentre of these tensions was on the sovereign bond markets of the euro area Member States, and a growing number of those countries were faced with a new, rapid increase in spreads vis-à-vis the yields on German Bunds. These developments also had a serious impact on financial institutions – especially in the euro area – holding large portfolios of public debt securities. The crisis thus entered a new phase in which concerns about the sustainability of sovereign debt and fears over the soundness of financial institutions became closely intertwined, so that many of those institutions encountered difficulties in raising funds on the interbank markets.

Apart from the impact of these tensions on financing conditions and on confidence among economic agents, plus the disappearance of the positive effect of inventory rebuilding in 2010, the recovery in the advanced economies was hampered by the loss of the impetus provided by the fiscal stimuli, by efforts to consolidate public finances that sometimes had to be speeded up under pressure from the financial markets, as well as by the persistence of imbalances on property and labour markets, especially in the United States.

TABLE 1 GDP IN THE MAIN ECONOMIES

(percentage volume changes compared to the previous year, unless otherwise stated)

	2009	2010	2011	*p.m. 2010, share of world GDP* [1]	*p.m. 2011, contribution to world GDP growth* [1]
United States	–3.5	3.0	1.7	*19.9*	*0.3*
Japan	–6.3	4.1	–0.3	*5.9*	*0.0*
Euro area [2]	–4.2	1.8	1.6	*14.7*	*0.2*
Denmark, United Kingdom and Sweden	–4.6	2.3	1.4	*3.9*	*0.1*
Other EU Member States [3]	–3.6	2.1	3.0	*1.6*	*0.0*
Other advanced OECD countries [4]	–1.1	2.3	1.6	*3.6*	*0.1*
China	9.2	10.4	9.3	*13.7*	*1.3*
India	7.0	9.9	7.7	*5.5*	*0.4*
Other emerging Asian countries [5]	0.2	7.8	4.8	*7.2*	*0.3*
Latin America [6]	–1.8	6.4	4.7	*8.1*	*0.4*
Main oil-exporting countries [7]	–2.2	4.0	4.4	*7.4*	*0.3*
World [1]	–1.2	5.0	3.8	*100.0*	*3.8*
p.m. World trade [8]	*–10.7*	*12.6*	*6.7*		

Sources: EC, IMF, OECD.
(1) Based on purchasing power parities.
(2) Excluding Cyprus and Malta.
(3) Bulgaria, Cyprus, Czech Republic, Hungary, Latvia, Lithuania, Malta, Poland and Romania.
(4) Australia, Canada, Iceland, New Zealand and Switzerland.
(5) Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand.
(6) Excluding Venezuela.
(7) Oil-exporting countries recording a current account surplus in excess of $ 40 billion over the period 2008-2010 (Algeria, Iran, Kuwait, Nigeria, Norway, Qatar, Russian Federation, Saudi Arabia, United Arab Emirates and Venezuela).
(8) Average exports and imports of goods and services.

In this context, though the beginning of the year had brought clear signs of more self-sustaining growth, based to a greater extent on domestic components, and of an improvement in the labour market, those signs vanished in some countries. Thus, the recovery stalled in the euro area in the autumn of 2011. Conversely, in Japan, activity was stimulated in the second half of the year by a catch-up in consumption and by reconstruction work.

Although emerging economies continued to exhibit great dynamism, the rate of growth of their GDP was lower than in previous years, partly owing to the weakening of foreign demand and the continuing efforts of the authorities to contain the risks of overheating.

Main economies outside the euro area

The economic recovery in the **United States**, which had begun during 2009, continued but at a much slower pace than in 2010, owing to the less vigorous domestic demand. The growth of that demand was still supported by the very accommodating policy of the US central bank. Conversely, it was no longer bolstered by fiscal policy. GDP growth, which amounted to 1.7 % in real terms over the year as a whole, was mainly driven by household consumption expenditure and business investment, and to a lesser extent by net exports; in contrast, changes in inventories, investment in housing, and public spending made a negative contribution.

Quarterly GDP growth was down from 0.6 % in the second half of 2010 to an average of 0.2 % in the first half of 2011. This slowdown was attributable to the temporary negative impact of the rise in commodity prices and the disaster in Japan, and to public spending cuts. With the disappearance of the first two of these factors, growth accelerated to 0.5 % in the third quarter. This was the first time that GDP exceeded its pre-recession level, more than two years after the recession had ended in the second quarter of 2009.

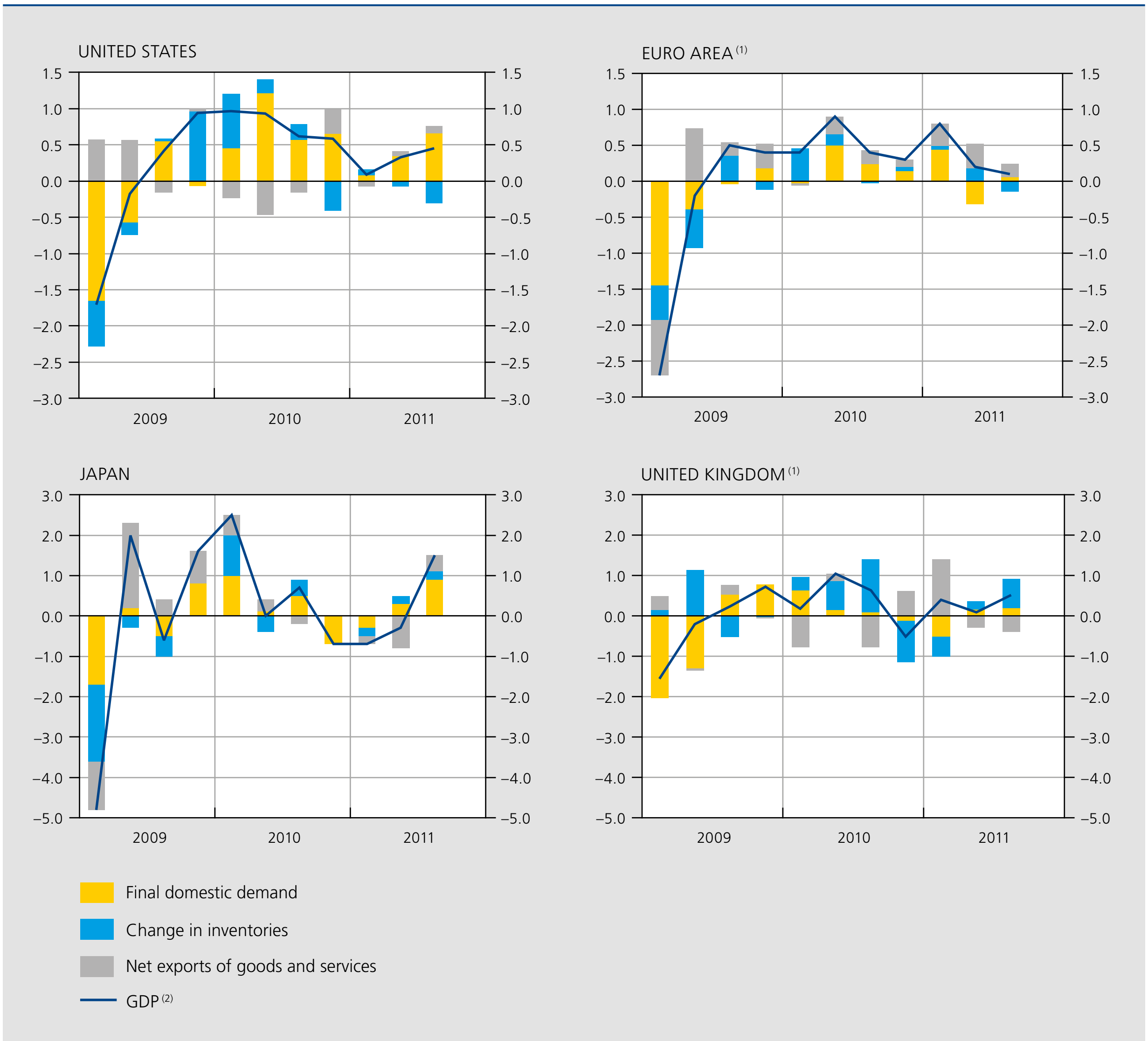
That bears witness to the depth of the recession and the relatively weak recovery. The effect of government policies continued to wane in 2011, and the transition to more autonomous growth was not easy because the traditional drivers of a recovery, namely household consumption expenditure and investment in housing, were still hampered by a number of factors, such as the continuing efforts of households to save in order to rebuild their net assets, the more prudent attitude to lending on the part of financial institutions, and the difficulties in the property sector and the labour market. In particular, long-term unemployment remained at a historically high level.

Private consumption expenditure therefore recorded modest growth of 2.3 %, one reason being the meagre increase in real disposable incomes, which were not supported by any noticeable improvement in employment and were eroded by the rising prices of energy and food. The uncertain economic outlook and the volatility on the financial markets also inhibited the reduction in the household savings ratio, which declined from 5.3 to 4.6 % of disposable income, although remaining well above the pre-crisis levels.

Private residential investment, down for the sixth year running, fell by 2.1 % in 2011. This renewed fall was due

CHART 1 QUARTERLY PROFILE OF GDP AND OF THE MAIN EXPENDITURE CATEGORIES IN THE LEADING ADVANCED ECONOMIES

(seasonally adjusted data ; contribution to the volume change in GDP compared to the previous quarter, percentage points, unless otherwise stated)



Sources : EC, BEA, ESRI, ONS.
(1) Data also adjusted for calendar effects.
(2) Percentage changes compared to the previous quarter.

to the still large stock of housing offered for sale or repossessed, the continuing prudent attitude of many financial institutions in regard to mortgage loans, and the prospect of further reductions in house prices. Conversely, business investment, essentially expenditure on equipment and software, increased by 8.4 % in 2011, thanks to the sound financial position of companies and the favourable financing conditions. Public investment contracted sharply by 6.4 %, while public consumption dipped by 1 %.

Following a significant decline in the first half of 2011, economic activity in Japan began expanding again. However, over the year as a whole, real GDP was down by 0.3 %, whereas it had grown by 4.1 % in 2010. The contraction recorded in the first half of the year was due mainly to the tsunami on 11 March, which devastated part of the Tohoku region and triggered a nuclear crisis and electricity shortages. This caused much disruption in the production chain, especially in the motor vehicles and electronics industries, two sectors which represent 35 % of Japanese exports. In the first half of the year, industrial output thus contracted by 4 %, and exports were down by 3 %. In the first phase of the recovery, it was exports that had been the main driver of growth. Their strong expansion in the third quarter of 2011, once the production chain had been restored, was a decisive factor in the revival of activity.

As a result of the tsunami, household consumption declined in the first quarter. Retail sales collapsed in March owing to voluntary restraint (*jishuku*) on the demand side and supply shortages. Private consumption more or less stagnated in the following quarter, before becoming the second largest contributor to GDP growth in the third quarter, as consumer confidence returned to its pre-tsunami level, reinforced by a gradual improvement in the labour market situation. Nonetheless, as an annual average, this expenditure category recorded a 0.2 % fall in 2011.

Investment in property began rising again in the second half of the year. It was devoted mainly to reconstruction, and surged by 6 % in 2011. Public investment had not yet started to contribute to growth, but some reconstruction budgets were approved. Public consumption expanded by 2.3 %.

In the United Kingdom, growth of economic activity was weak : real GDP growth came to 0.9 % in 2011. Domestic demand contracted while net exports contributed 1.5 % to growth.

Household consumption was down by 0.9 %, owing to the combined effects of flagging confidence and a decline in real disposable incomes. Apart from the impact of the energy price rise, the main factor eroding household purchasing power was the ongoing fiscal consolidation. This implied an increase in direct taxes, a rise in VAT rates, and job cuts in the public sector. During the year, unemployment rose to levels not seen for 15 years. Nor were households still able to count on an increase in the value of their assets, since the improvement seen on the housing market in 2010 came to a halt. That prompted households to continue saving at a historically high level, namely 6.8 % of their disposable income, in order to rebuild their assets and make further reductions in their excessive gross debt burden.

As the housing market remained weak, investment in residential property declined further. There was only a small increase in business investment, which is still well below its pre-crisis level. Companies continued to postpone some of their projects, despite substantial financing capacity and an exceptionally accommodating monetary policy. The reasons lie, in particular, in a low capacity utilisation rate, mediocre demand prospects both on the home market and for exports, and limited access to bank credit for some firms.

Net exports of goods and services were the main factor supporting growth in 2011, partly owing to the stagnation of imports. The rebalancing of the British economy in favour of the sectors exposed to foreign competition is nevertheless relatively slow, despite the 25 % depreciation in the effective sterling exchange rate since the start of the financial crisis in 2007. Though the trade balance has ceased to deteriorate since then, there has not been any major reversal of the trend. The crisis in public finances in the euro area and the worsening global external environment may also be part of the reason, however.

In China, growth remained vigorous, but its deceleration which had begun in 2010 persisted throughout the year under review. As an annual average, the volume growth of GDP dropped from 10.4 % in 2010 to 9.3 % in 2011.

Household consumption continued to grow strongly, owing to the expansion of employment and real wage increases, but as in previous years, gross fixed capital formation was the main driver of the expansion. While the continuing withdrawal of some key measures supporting activity depressed public investment, private investment maintained strong growth, thanks in particular to residential construction. However, the repeated interest rate hikes and the tightening of conditions for mortgage loans ultimately curbed activity and price rises on the housing market.

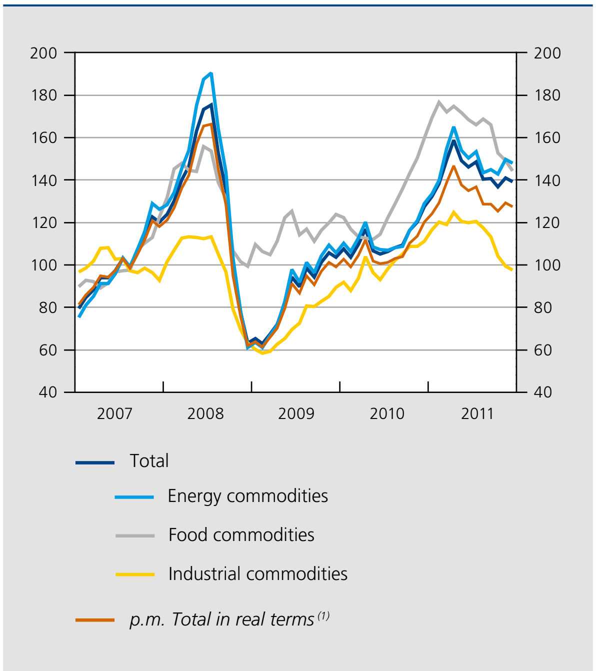
Output also slowed owing to the weakening of foreign demand. While exports to neighbouring countries continued to expand strongly, the marked dip in demand from the advanced economies, especially the EU, practically brought export growth to a halt at the end of the year. Thus, taking an average for the year, exports grew by only 10 % compared to 28 % in 2010.

1.2 Commodities and international trade

Commodities

The movement in commodity prices during 2011 was divided into two distinct periods. During the first four months, the upward trend which had begun at the start of 2009 persisted, driven by the sustained recovery of the global economy, the upheaval in North Africa and the Middle East, and the weakening of the US dollar. Prices of several commodities thus reached new record levels. From May onwards, a decline set in, following the slowdown in economic growth – the slackening pace of the Chinese economy was decisive for the commodity markets – and the deteriorating economic outlook. Moreover, increased risk aversion also depressed prices. However, the decline was limited overall so that, at the end of the year, commodity prices expressed in US dollars according to the HWWI index were still 9.2 % above their year-end 2010 level. The year-on-year rise in the index came to 28.6 % in 2011.

CHART 2 COMMODITY PRICES
(monthly data, US dollars, indices 2007 = 100)



Source : HWWI.
(1) Deflated by the US consumer price index.

Although the rise in commodity prices was fairly general, there were considerable variations between the main product categories.

On average, it was energy commodities that recorded the biggest price rise, at 31.4 %. Brent crude oil prices climbed by 38.3 %. During the first four months of the year, they rocketed, peaking at $ 125.6 per barrel at the beginning of May, owing to sustained demand combined with uncertainty over supplies, particularly on account of the events in North Africa and the Middle East. The deteriorating economic climate, the release of strategic oil reserves by IEA member countries, the increased oil production in Saudi Arabia and, finally, the raising of the production limit set by OPEC led to a fall in prices during the rest of the year ; they declined to around $ 108 at the end of December, though that was still 15.1 % above the year-end 2010 level. The prices of other key energy commodities such as natural gas and coal also increased in 2011, though to a lesser extent than oil prices.

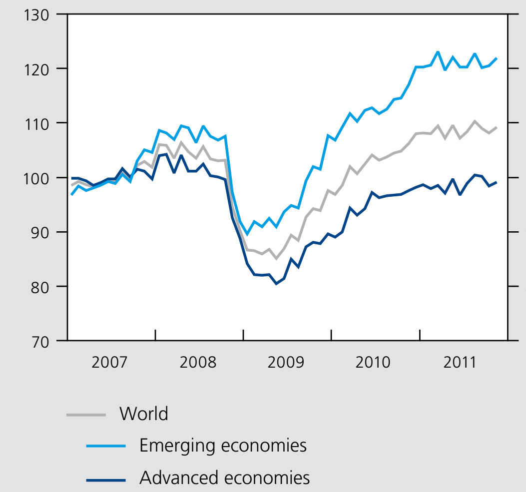
Food commodities recorded an average increase of 29.2 %. During the initial months of the year, they rose strongly, owing to the vigour of demand combined with uncertainty over supplies caused by bad weather in the southern hemisphere. Prices thus reached an all-time high in February. They began declining in March, thanks to the better outlook for the harvest, and by the end of the year they were 9.8 % below the level seen at the end of 2010.

Industrial commodity prices were up by 14.4 % over the year as a whole. At the start of the period under review, they exceeded their 2008 peak before beginning to decline in the spring, falling more sharply than other product categories since they are more sensitive to the business cycle. At the end of the year, prices were 12 % lower than at the end of 2010.

The gold price, which is not included in the HWWI index, increased by an average of 28.2 %. The main factors were the rise in demand for gold as a secure investment in uncertain times, the further weakening of the US dollar in the first half of the year, and the gold purchases made by various central banks. After reaching the unprecedented level of $ 1 898 per ounce at the beginning of September, the gold price declined steeply for the rest of the year.

CHART 3 INTERNATIONAL TRADE IN GOODS

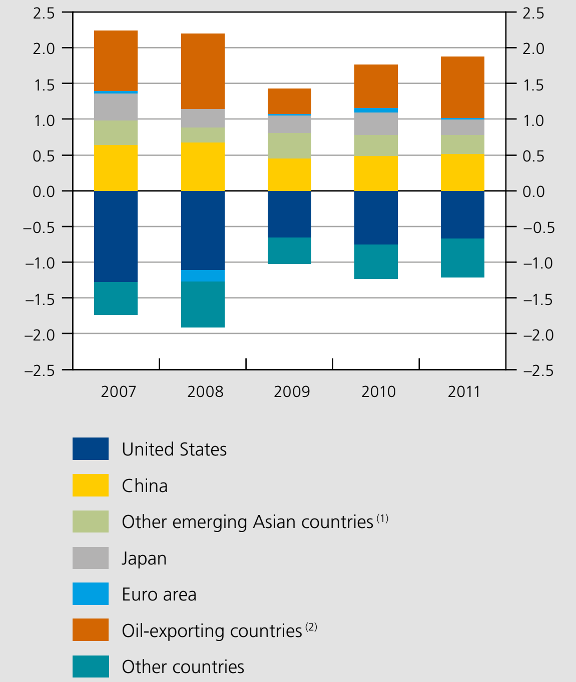
(seasonally adjusted monthly data, average volume of exports and imports, indices 2007 = 100)



Source : CPB.

CHART 4 CURRENT ACCOUNT BALANCES IN THE MAIN ECONOMIES

(in % of global GDP)



Source : IMF.

(1) Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand.

(2) Algeria, Angola, Azerbaijan, Bahrain, Congo, Ecuador, Equatorial Guinea, Gabon, Iran, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russian Federation, Saudi Arabia, Syria, Turkmenistan, United Arab Emirates, Venezuela and Yemen.

World trade and current account balances

World trade was less dynamic during 2011. Further expansion at the start of the year gave way, in the second quarter, to a contraction attributable largely to the disruption of international trade caused by the Japanese earthquake. That event had a negative impact on Japan's exports and disrupted global production chains. The recovery which emerged in the third quarter was fairly fragile.

Elimination of the imbalances in the global economy remains a cause for concern, as confirmed by the G20 summit in Cannes in November 2011. In fact, the global imbalances on the balance of payments current accounts increased again in 2011, though they were still smaller than during the years preceding the economic and financial crisis. The main reason for this development was the rising price of commodities, which inflated the surplus of the oil-exporting countries. The US trade deficit worsened further, owing to the deterioration in the terms of trade. However, thanks to the rise in income from foreign direct investment by the United States, the US current account deficit declined from 3.2 to 3 % of GDP. In China, despite the brake applied to import growth by weaker economic expansion, the even more marked deceleration in exports cut the current account surplus from 5.2 % of GDP in 2010 to 3.1 % in 2011.

1.3 Fiscal and monetary policy

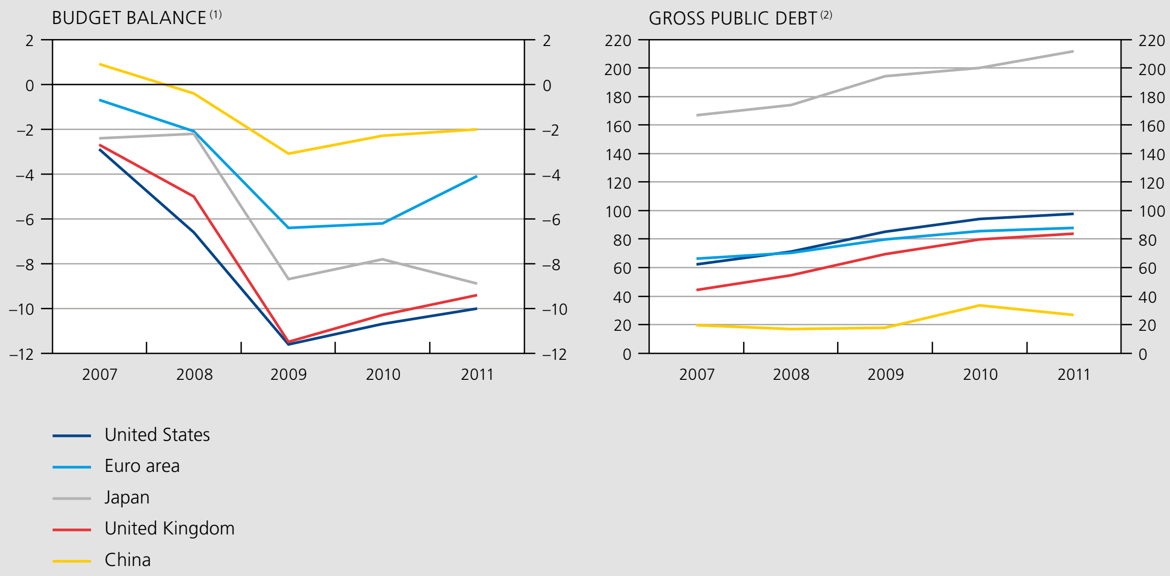
Fiscal policy

The budget deficits, which had risen sharply in 2009 as a result of the great recession, continued their gradual decline in 2011 in most countries, with the notable exception of Japan, whose government budget felt the repercussions of the March 2011 tsunami. In the euro area, fiscal consolidation was speeded up in view of the mounting tensions on the sovereign debt markets of several Member States (cf. chapter 2).

In the **United States**, the general government deficit recorded a further decline, from 10.7 to 10 % of GDP. In fact, as the economic recovery continued, revenues again grew faster than expenditure, which was curbed by the gradual extinction of the fiscal stimuli. Gross public debt continued to rise from 94.2 to 97.6 % of

CHART 5 GENERAL GOVERNMENT BUDGET BALANCE AND DEBT IN THE MAIN ECONOMIES

(in % of GDP)



Sources: EC, IMF, OECD.

(1) For the euro area and the United Kingdom, under the rules laid down for the excessive deficit procedure (EDP), the figures include net interest gains on certain financial transactions such as swaps.

(2) For the euro area and the United Kingdom, the figures concern the consolidated gross debt, i.e. excluding debts which have as their counterpart assets in the general government sector.

GDP. The sustainability of US public finances remained the focus of intense international attention for much of the year, having regard in particular to the protracted debate over increasing the federal debt ceiling. Agreement was finally reached at the beginning of August, in the form of the Budget Control Act. This provides for raising that ceiling in three stages by a total of $ 2 100 billion (around 16 % of GDP), and cutting the cumulative federal public deficit by a similar amount over the period from 2012 to 2021. That agreement did not stop the ratings agency Standard & Poor's downgrading the rating of the US long-term public debt from AAA to AA+.

Japan remained one of the last OECD economies yet to begin consolidating its public finances. The Japanese government announced that, over a five-year period, it will spend the equivalent of 4 % of 2011 GDP on reconstruction ; that amount will be funded partly by a tax increase. Owing to the expansionary fiscal policy and a slight dip in activity, the public deficit rose by 1.1 percentage points to 8.9 % of GDP. The public debt continued to grow, reaching 211.7 % of GDP.

In the **United Kingdom**, notwithstanding the marked slowdown in the international economy and the anaemic domestic demand, the government kept to the fiscal consolidation schedule established in the spring of 2010. The deficit was cut from 10.3 % of GDP in 2010 to 9.4 % in 2011, while the public debt to GDP ratio increased from 79.9 to 84 %.

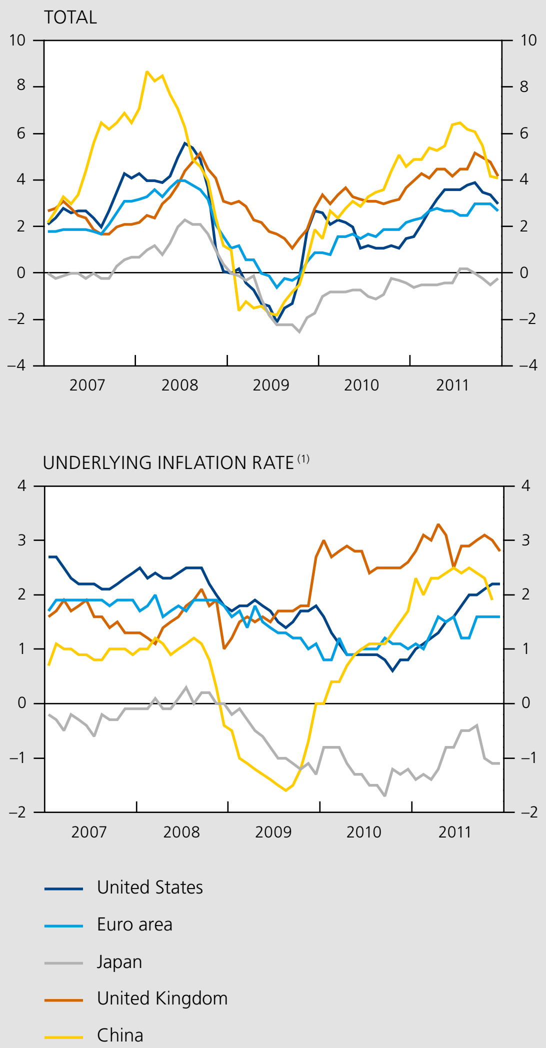
In **China**, the general government deficit dropped from 2.3 % of GDP in 2010 to 2 % in 2011. This largely structural improvement was due mainly to an increase in public revenues as a percentage of GDP. Following the strong rise in public debt in 2010, which had resulted from substantial infrastructure investment by local and quasi-governmental authorities, the ratio of debt to GDP fell by almost 7 percentage points to 26.6 % in 2011, owing to the strong nominal GDP growth.

Monetary policy

The central banks of the advanced countries held their key interest rates at very low levels in 2011. Moreover, while the need for non-conventional measures appeared to be waning at the start of the year, the worsening of the public debt crisis during the summer prompted a number of central banks to take a whole range of measures to

CHART 6 CONSUMER PRICES IN THE MAIN ECONOMIES

(monthly data, changes compared to the corresponding period of the previous year)



Sources: CEIC, Thomson Reuters Datastream, Statistics Bureau of Japan.
(1) Measured by the consumer price index excluding food and energy.

safeguard financial stability. In the emerging economies, signs of overheating caused the central banks to tighten their monetary policy further at the beginning of the year; this tightening was not generally continued in the second half of the year.

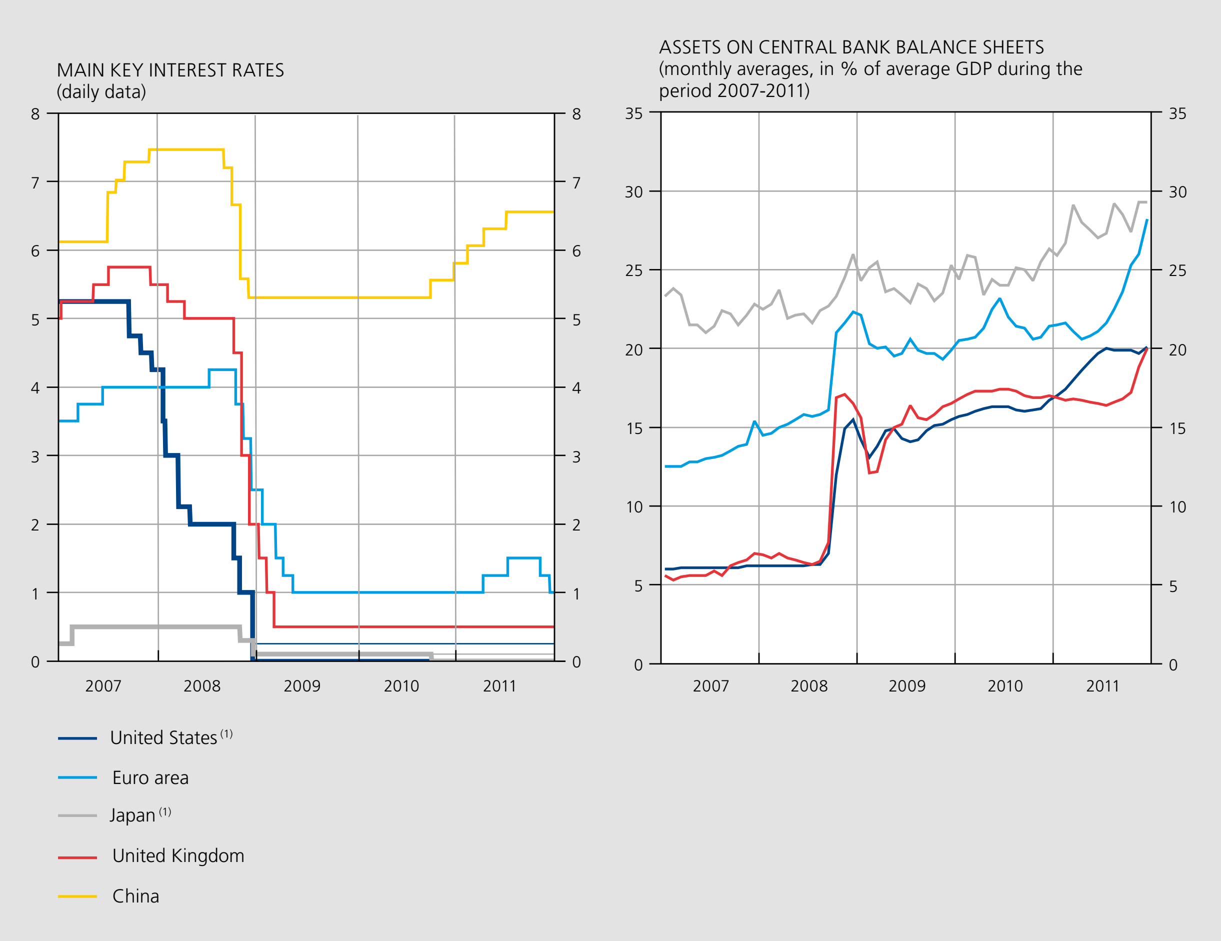
In the **United States**, during the first seven months of the year, the Federal Reserve pursued the policy which it had set the previous year, in particular the programme of additional purchases of sovereign securities announced in November 2010. From August, its policy became still more accommodating in view of the deterioration in the economic situation during the summer and taking account of the moderate outlook for inflation in the medium term. First, following the meeting of the Federal Open Market Committee (FOMC) on 9 August, it was announced that the federal funds target rate might be held at an exceptionally low level, probably until mid-2013. In addition, at its meeting on 20 and 21 September, the FOMC decided to extend the average duration of the Federal Reserve's portfolio of government bonds ("Operation Twist"). This entails selling government bonds with a short maturity (of three years or less) for a sum expected to reach $ 400 billion in June 2012, and spending up to the same amount on the purchase of long-dated government loans (maturing in between six and thirty years). The aim is to drive down long-term interest rates and thus stimulate economic activity. Apart from "Operation Twist", it was decided that the proceeds from redemption of the debt instruments of the US government-sponsored mortgage agencies and of the mortgage-backed securities would be reinvested in the latter securities from October onwards, to support the housing sector.

The Bank of **Japan** held its key interest rate at between 0 and 0.1 %, notably in order to encourage reconstruction and limit deflation. It regularly intervened on the foreign exchange market in an attempt to reverse the yen's tendency to appreciate, by trying to stabilise the exchange rate at around 80 yen to the dollar. After the tsunami, the Bank of Japan also increased the provision of liquidity for commercial banks, and likewise stepped up its securities purchase programme by 15 000 billion yen, or 3.3 % of GDP. The consumer price index excluding energy and food nevertheless declined by 0.8 % in 2011.

In the **United Kingdom**, the Bank of England held its key interest rate unchanged at 0.5 % throughout the year, despite the high inflation, which was considered temporary. That was insufficient to revive lending to non-financial corporations, and the outstanding amount continued to contract. The funding problems encountered by many British banks on the wholesale markets as a result of the tensions in the euro area were the main reason for their reluctance to lend more. Consequently, in October, the Bank of England decided to expand the asset purchase programme by £ 75 billion, to £ 275 billion, or 18 % of GDP.

In **China**, faced with a rapid rise in inflation which far outstripped its 4 % target, the central bank continued the tightening of monetary policy begun in the final quarter of 2010. It raised its key interest rate by 25 basis points three times, increasing the interest rate on one-year bank loans to 6.56 % from July. But the downside to the higher interest rates is that they stimulate the inflow

CHART 7 KEY INTEREST RATES AND ASSETS ON THE BALANCE SHEET OF THE MAIN CENTRAL BANKS



Sources: IMF, Bank of England, Bank of Japan, People's Bank of China, Federal Reserve, ECB.
(1) For the key interest rates, the line is divided if the central bank set itself a target range, the upper limit of the range being indicated by a finer line in the same colour.

of foreign capital. Therefore, to restrain the growth of domestic credit, the central bank also raised the banks' compulsory reserve ratios by around 3 percentage points to 21.5 % for the big banks from June, and allowed the renminbi to continue appreciating against the dollar, a trend which had begun in September 2010. However, on 30 November 2011, for the first time since early 2009, the central bank announced a small cut in the compulsory reserve ratios, since the outlook for growth and inflation had been revised downwards.

1.4 International financial markets

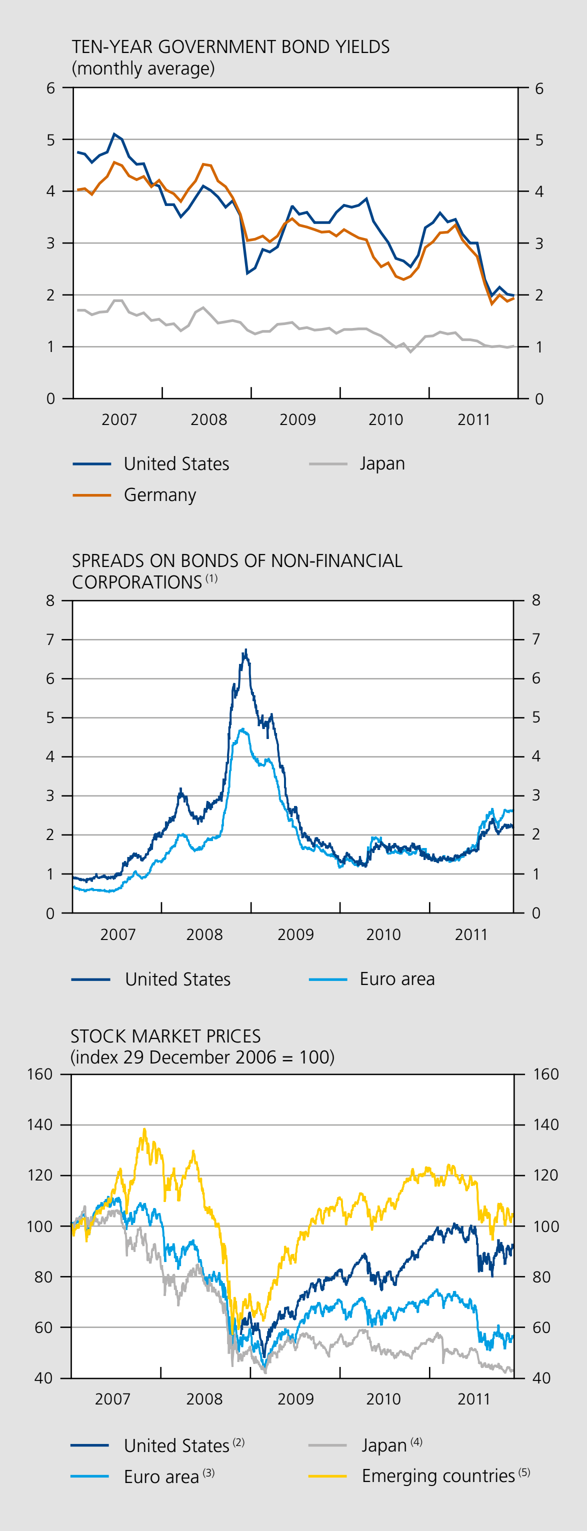
During the year under review, international financial markets were nervous about financial stability, mainly on account of the lack of a speedy and coherent response to the sovereign debt crisis in the euro area, and fears of a sharp deterioration in the economic outlook.

Sovereign bonds

The year 2011 was dominated by the sovereign debt crisis in the euro area. Whereas, during the first decade of European Monetary Union, financial operators had taken little notice of macroeconomic and fiscal developments in the individual countries, from 2009 onwards they reacted increasingly strongly. There was a further sharp increase in heterogeneity on the sovereign bond market in 2011, and spreads in relation to the German Bund widened in varying degrees. Chapter 2 examines in detail all the developments on the government securities markets of the euro area, while this chapter focuses on the benchmark bond with the best rating in the euro area, namely the German Bund.

The rise in long-term yields on sovereign loans in Germany and the United States, which had begun in November 2010, continued at the start of the year under

CHART 8 WORLD MARKETS IN SECURITIES



Sources: BIS, Thomson Reuters Datastream.

(1) Spreads in relation to the German Bund for the euro area and Treasury bills for the United States; bonds with a maturity of five to seven years.
(2) Wilshire 5000 index.
(3) Dow Jones EuroStoxx Large index.
(4) Topix index.
(5) MSCI Emerging Markets index.

review, reflecting the economic dynamism of the United States and the euro area at that time.

The upward trend in long-term benchmark yields in Europe and the United States came to an abrupt end from the second quarter of 2011. This reversal was due to the increasingly gloomy economic outlook on both sides of the Atlantic; the United States was the first to record weaker growth, which explains the slight divergence between the respective interest rate movements. At the same time, the mounting political tension in North Africa and the Middle East together with the tsunami in Japan triggered a flight to quality which also exerted downward pressure on sovereign bond yields, both in Germany and in the United States.

In August, the marked deterioration in the prospects for a global economic recovery accelerated the decline in long-term interest rates on government loans. These developments were also amplified by downward revisions in expectations regarding short-term interest rates, particularly in the United States, and the growing turbulence caused by the sovereign debt crisis in the euro area. These periods of tension were reflected in a significant increase in investors' risk aversion and drove up demand for traditional safe-haven assets. Yields on the most liquid top-rated sovereign bonds – US, German, Japanese and Swiss – therefore declined in the third quarter of 2011, falling to historically low levels. At the beginning of August, the decision by Standard & Poor's to downgrade US long-term debt had hardly any impact on interest rates on US sovereign securities, which remained a safe haven for investors facing extreme uncertainty.

In the final quarter of the year, yields on government loans tended to stabilise in both the United States and Germany. On the one hand, certain data suggested that the economic downturn in the United States might be limited. Also, the sovereign debt crisis in the euro area seemed to have spread to the countries with the best ratings, since a tender for government debt securities in Germany failed to generate the amount expected.

Corporate bonds

During the year, and more particularly in the latter six months, investors' risk aversion and their search for safe-haven assets drove up the risk premiums included in the yields on bonds issued by financial and non-financial corporations, in both Europe and the United States.

The deteriorating solvency of sovereign borrowers thus continued to inflate the funding costs of banks, especially in the euro area (cf. chapter 2). The risk premiums demanded for holding bonds of non-financial corporations in the euro area were less affected; nevertheless, in the second half of 2011, they rose by more than the premiums required for bonds issued by US non-financial corporations.

Shares

During the initial months of the year, the main stock market indices maintained the rise which had begun in mid-2010, thanks to investors' optimism about the trend in activity in the main advanced economies. In contrast, the deteriorating outlook in the emerging economies due to the impact of mounting inflationary pressure in a number of these countries brought a fall in share prices from the beginning of the year.

The tsunami in Japan in early March depressed stock market prices, both in the United States and Europe and in Japan itself. Contrary to expectations, however, these events had little impact and share prices rapidly recovered, at least in the United States and Europe, though in Japan the main stock market index did not regain the level prevailing before the disaster.

From May onwards, stock market prices declined, with a slump in September; compared to the spring 2011 peak, losses averaged 20%. The fall was particularly steep in the case of shares in the euro area's financial sector, where prices collapsed by around 50% during this period, as the mounting concern over the public debt depressed the stock market value of European financial institutions holding a large volume of those assets.

In addition, downward revisions to the growth outlook at the beginning of the third quarter, following the publication of disappointing macroeconomic indicators in the main advanced countries, also had an adverse influence on share prices.

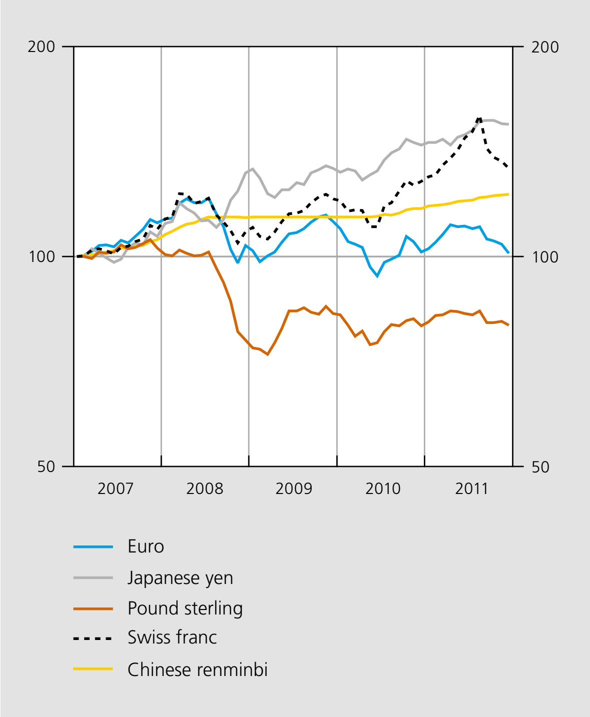
In the fourth quarter, share prices were more stable. However, they rallied slightly in the United States whereas they continued to fall in Japan.

Exchange rates

At the start of the year under review, the faster – than – expected recovery in the euro area – while growth stagnated in the United States – and expectations of ECB interest rate rises caused an appreciation of the euro exchange rate, which reached 1.49 dollar per 1 euro

CHART 9 EXCHANGE RATES OF THE LEADING CURRENCIES AGAINST THE US DOLLAR

(monthly averages, indices January 2007 = 100, semi-logarithmic scale)



Sources: BIS, Thomson Reuters Datastream.

on 4 May, the highest level for the year. The euro then remained more or less steady until August, before depreciating sharply in September with the worsening sovereign debt problems in the euro area. After strengthening temporarily in October, when details of the euro area's safeguard measures emerged, it continued to depreciate until the end of the year. The euro/dollar exchange rate thus ended the year under review slightly below its year-end 2010 level. The reason for this relative stability is that the economies of the United States and the euro area both faced problems relating to debt and economic gloom in 2011.

In line with the past two years, the sterling-dollar exchange rate followed a pattern similar to that of the euro, though it was less volatile.

In contrast, the financial turmoil led to a strong appreciation of the Japanese yen and the Swiss franc, two currencies which investors regard as a safe haven, and which were therefore much in demand when market nervousness prompted a flight to quality.

Thus, during the year under review the yen continued to appreciate against the US dollar, a trend which had begun in April 2010. Following the tsunami on 11 March, the yen climbed steeply owing to expectations that Japanese insurers would repatriate funds in dollars to meet compensation claims in yen. On 18 March, to curb the strengthening of the yen, the Ministry of Finance and the Bank of Japan, acting in concert with the monetary authorities of other G7 countries, intervened jointly on the foreign exchange market; for a time, this proved successful. The yen later resumed its appreciation, causing the Japanese authorities to conduct non-concerted interventions at the beginning of August and the end of October.

In 2011, the Swiss franc recorded a rapid appreciation against the euro which accelerated strongly from May onwards. At the beginning of August, when the Swiss franc was approaching parity with the euro, the Swiss National Bank considered that the currency was extremely overvalued, representing a serious threat to the national economy and implying a risk of deflation. It initiated steps to restrain the appreciation of the franc, and began by stating that it aimed at a three-month Libor in Swiss franc which was as close as possible to zero. To that end, it augmented the expansion of liquidity in francs on several occasions. Since these measures had only a limited impact, the SNB announced on 6 September that it would no longer tolerate an exchange rate of less than 1.2 Swiss franc per 1 euro on the foreign exchange markets. Following this statement, the exchange rate between the Swiss franc and the euro was effectively held at just above that level.

Since 19 June 2010, when the Chinese central bank announced that it would increase the flexibility of the renminbi exchange rate, that rate has strengthened steadily against the dollar, despite the depreciation of various emerging country currencies. Over the year as a whole, the renminbi gained 5 % against the dollar.