1. The crisis in the euro area

Throughout 2012, financial markets experienced varying but severe tensions in a context of widespread uncertainty, dominated by the euro area crisis. The feedback loops between the financial sector and sovereigns in the euro area intensified, constituting a major driver behind the fragmentation of financial markets along national borders. The actions undertaken by the ECB and governments succeeded in stabilising financial markets from the summer onwards. However, the weakness of demand and activity spread to the core of the euro area, while countries on the periphery continued their structural adjustment efforts. GDP declined by 0.4 % in the euro area, with unemployment reaching very high levels in some countries. More generally, world growth also slowed in 2012. Apart from the impact of the euro area crisis, it was affected in particular by the uncertainty over fiscal policy that prevailed until the end of the year in the United States, and by the loss of momentum in emerging economies.

1.1 Unfolding of the crisis in the euro area

In a fragile macroeconomic context, financial market sentiment fluctuated in line with the actions taken by governments

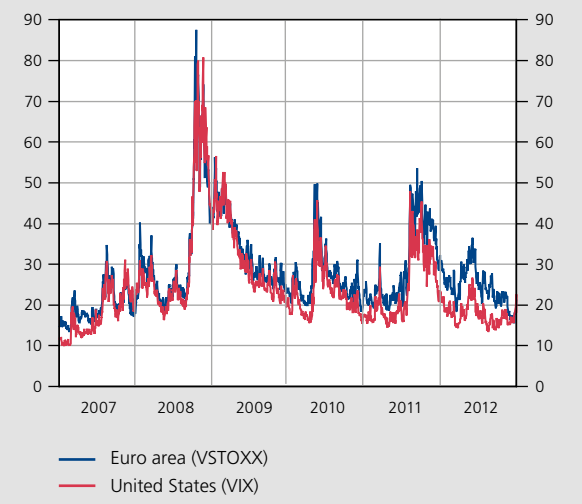
The global financial crisis and the deep, widespread recession of 2008-2009 brought to the fore a range of macroeconomic imbalances in the euro area, such as unsustainable public finances, excessive growth of private debt, and extremely weak competitiveness in certain Member States. They also revealed weaknesses in the institutional framework of the Economic and Monetary Union (EMU). Indeed, the inadequacy of the mechanisms established for the supervision and coordination of economic policies had allowed these imbalances to emerge in various countries. Moreover, the absence of any crisis management tool significantly limited the euro area's ability to address the various sources of disruption. In that situation, contagion effects became apparent on the financial markets, facilitated by the close mutual links which had been greatly amplified since the creation of EMU. They particularly affected the most vulnerable countries, and adverse bank-sovereign feedback loops emerged.

Since the outbreak of the crisis, various measures have been taken to correct these structural shortcomings in the EMU. At first, these measures were often *ad hoc*, specific and temporary. They gradually became more general in scope, aiming to provide a structural strengthening of the governance and the EMU institutional framework. Member States meanwhile embarked on adjustment and structural reform paths which should ultimately enable them to restore their sound fundamentals.

However, from the viewpoint of economic agents in general, and financial market participants in particular, the process of European institutional reorganisation and national structural reforms gave rise to successive phases of optimism and doubt. The moments of doubt were fuelled by concerns about the genuine resolve of governments to make determined and consensual progress towards further integration, and the sometimes imprecise character of the measures announced, as well as implementation risks, both at the national and at the euro area level.

The developments on financial markets in 2012 continued against this backdrop of uncertainty, amplified by a widespread deterioration in the global economy. The macroeconomic outcomes generally fell short of expectations, especially in the euro area, as is evident

CHART 1 EQUITY MARKET VOLATILITY INDICES
(daily data)



Source : Thomson Reuters Datastream.

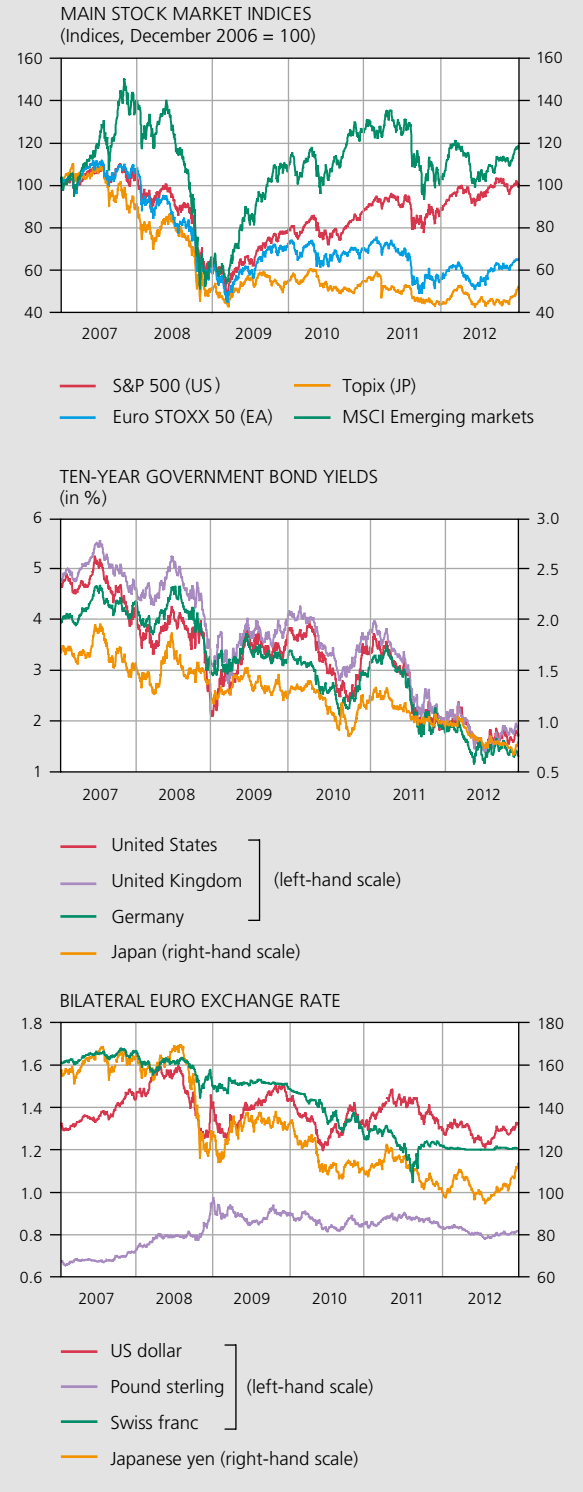
from the successive downward revisions of the growth forecasts. Within the euro area, the slowdown in activity gradually became widespread, also affecting the stronger economies.

In this gloomy and uncertain economic environment, movements in the main financial indicators were determined both by country-specific factors and common euro area factors. In general, market nervousness as measured by the VIX volatility indicator (based on the S&P 500 index) and the VSTOXX indicator (based on the Euro STOXX 50 index) was no longer as acute as in the summer of 2011, but fluctuated in line with the political uncertainty. There were three successive phases during the year: first, a period of calm from the beginning of 2012 to mid-March, followed by renewed tensions fuelled by the increasing fragmentation of financial markets in the euro area, which then gave way to relative tranquillity again from the end of July when the Eurosystem and the European Council took new measures to break the link between sovereign risk and financial risk.

Beginning of the year to mid-March: monetary policy decisions and institutional reforms engender calm

The beginning of 2012 brought a somewhat calmer atmosphere on the various financial markets, following a significant escalation of the sovereign debt crisis in the second half of 2011. That escalation had been fuelled by growing concern over the deteriorating sustainability

CHART 2 INTERNATIONAL FINANCIAL MARKET DEVELOPMENTS
(daily data)



Source : Thomson Reuters Datastream.

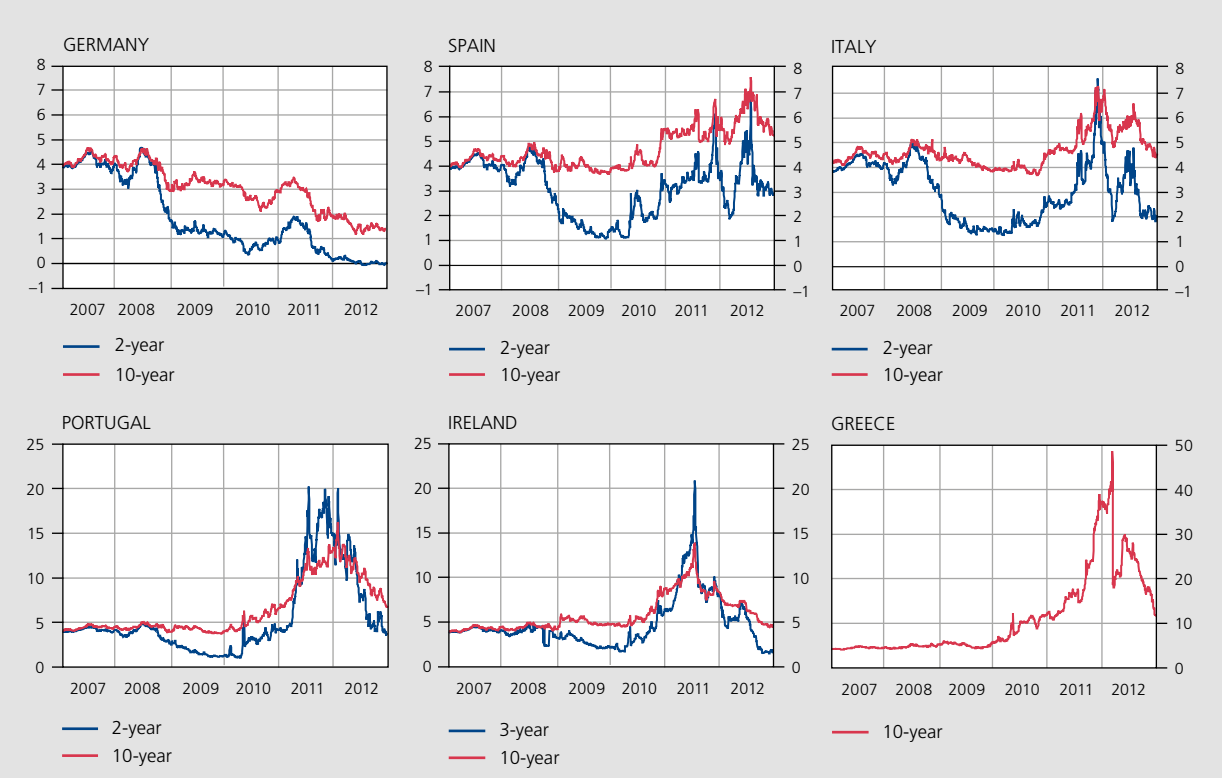
of public finances in certain euro area countries and the perception of inadequate resolve on the part of governments to tackle the crisis. The easing of tension at the start of the year under review was due to the emergence of signs that activity was stabilising, and prospects of a growth revival during the year, accompanied by a series of government measures.

In general, markets welcomed both the budgetary and structural measures adopted by some Member States, notably Spain and Italy, in the autumn of 2011 and the decisions taken at European level in late 2011 and early 2012. Among the latter, the agreement on a Fiscal Compact concluded at the December 2011 European summit – and later incorporated in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union – aims to strengthen the preventive aspects of the institutional framework, while the new version of the Treaty establishing the European Stability Mechanism (ESM), signed on 2 February 2012, equips the euro area with a more effective crisis management instrument. On the monetary policy side, the two three-year refinancing operations conducted by the Eurosystem in December 2011 and February 2012 – which supplemented a series of non-standard measures approved in August 2011 and two cuts in the key interest rates at the end of the year – appreciably reduced the risk of a funding crisis in the European banking sector. On the bond markets, this injection of liquidity revived demand for bonds issued by peripheral States, notably Ireland, Italy and Spain, causing a narrowing of their yield differentials in relation to the bonds of core euro area countries, particularly the German Bund. Over the same period, the market relief drove up the leading European stock market indices, such as the Euro STOXX 50, which gained 10 % by mid-March.

During that same period, the specific situation of Portugal and Greece remained a cause for concern, but the contagion effects were limited. At the end of January 2012, owing to speculation over the possible restructuring of the public debt, yields on ten-year Portuguese government bonds climbed to 16.2 %, their highest level since the introduction of the euro. The signing of the Treaty establishing the ESM helped to dissipate those fears. In Greece's case, the increasingly obvious unsustainability of its sovereign debt, combined with the uncertainty over

CHART 3 BOND YIELDS OF A SELECTION OF EURO AREA COUNTRIES

(daily data, in %)



Source : Thomson Reuters Datastream.

the arrangements for the voluntary participation of the private sector in a debt exchange drove up the yields on government bonds to almost 50 %. In the absence of any significant trading activity, that level is however purely indicative. The finalisation of a second assistance programme for Greece in February, and the successful restructuring of the Greek debt at the beginning of March, were well received even though Greek interest rates remained at a very high level.

From mid-March to the end of July: fears over euro area disintegration fuel market tension

However, the relative optimism prevailing in the first months of the year began to fade from early spring, when doubts about the financial soundness of certain countries resurfaced – to the point where it was feared that the euro area might disintegrate – and when signs of an economic slowdown were proliferating throughout the world.

At that time, in various euro area countries the feedback loop between the national banking sector and the State began to have a much more serious effect on market perception of their respective solvency. This phenomenon was particularly marked in Spain, where attention increasingly focused on the weakness of the savings banks confronted by the consequences of rising defaults on their mortgage loan portfolio. The prospect of a need for recapitalisation by the Spanish government generated upward pressure on the latter's financing costs which in turn imperilled the sustainability of its public finances. This in itself cast doubts upon the solvency of the Spanish banking sector, considering its exposure to national sovereign risk.

The other major concern weighing on financial markets during this period was the political uncertainty in Greece. Following the early parliamentary elections at the beginning of May, all attempts to form a government ended in failure, so that new elections had to be called, which finally took place on 17 June. This period of political upheaval exacerbated doubts about Greece's determination to respect the commitments given to international lenders. Any failure to abide by the conditions of the adjustment programme could have led to suspension of the financial assistance with the inevitable consequence of a Greek default. The threat of such a scenario – like the more extreme speculation about a possible Greek exit from the euro, the so-called "Grexit" – was very keenly felt on the bond markets, where the contagion effect further accentuated the differentiation between the core and the periphery, illustrated by the widening of yield spreads. The Greek ten-year bond yield thus leapt by around 1 000 basis points to reach 30 % in May.

In this context, Spain applied for a European Financial Stability Facility (EFSF) programme of financial assistance amounting to € 100 billion, for the purpose of restructuring and recapitalising its banks, while the new government formed in Greece endorsed the adjustment programme. At European level, the decision by the euro area summit on 29 June 2012 to set up a single supervisory mechanism for banks and, following that, to allow the ESM the conditional option of arranging direct recapitalisation of the banks, opened up the prospect of finally breaking the feedback mechanisms between national banking sectors and sovereigns.

More generally, the fragmentation of financial markets along national borders continued, exacerbated by macroeconomic disparities between countries. On the bond markets, concern over the solvency of public finances and the possible reversibility of the euro prompted a sudden widening of yield spreads in the euro area, which reached record levels. At the same time, the yield curves for securities of peripheral countries, notably Spain and to a lesser extent Italy, flattened out abruptly following a very strong rise in short-term interest rates. Thus, after having bounced back by almost 200 basis points, the Spanish two-year yield peaked at 6.7 % on 24 July. Conversely, owing to increased demand for safe-haven securities, the sovereign yield curve of certain core countries, such as Germany, dropped to a historically low position, taking its short end into negative territory. The paralysis of the European interbank market persisted, in practice representing a return to national banking systems within the euro area. One consequence of that situation is the unevenness of the transmission of the common monetary policy, as is evident from the wide dispersion of interest rates at which businesses and households can raise finance in the euro area countries.

The altered mood also erased the gains made at the beginning of the year on European stock markets. Between its temporary peak in March and 25 July, the Euro STOXX 50 dropped by more than 17 %, while the Spanish, Italian and Greek reference indices recorded even heavier losses. On the foreign exchange markets, at the end of July the euro was trading at its lowest level for the year against the other main international currencies, which were acting as a safe haven in times of nervousness about the euro area.

From the end of July: measures by the Eurosystem and the EU stabilise markets

To address this fragmentation, the Eurosystem set up a new instrument: the Outright Monetary Transactions (OMTs). Although the details were not formally revealed until the beginning of September, the markets responded favourably to this prospect from the end of July, after the ECB President had stated that, within its mandate, the ECB was determined to do whatever it takes to preserve the euro. The OMTs enable the Eurosystem to intervene on secondary sovereign debt markets, subject to strict conditions (see section 2.1). In their implementing conditions, the OMTs thus mitigate the risk of a liquidity crisis in public debt securities, without however dissuading the Member States from implementing the necessary reforms to restore a stable growth path.

By alleviating investors' fears of a possible reversibility of the euro and by containing the centrifugal forces at work in the euro area, the introduction of the OMTs also stabilised the financial markets, as is evident from the gains on European stock markets, the narrowing of the "core-periphery" yield spreads, and the appreciation of the euro since they were announced. Other notable decisions contributed towards this restoration of calm, such as the launch of the ESM on 8 October 2012 and the agreement concluded by the European Council at the summit on 18 and 19 October concerning a road map for the single supervisory mechanism for credit institutions, reflecting its determination to make progress on EMU integration. A decision concerning the legislation establishing this mechanism was passed in December. The revision of the terms of the second adjustment programme for Greece at the end of November and the restoration of the sustainability of Greek debt allowed the release of the payment planned for a new instalment of financial assistance, thus preventing renewed doubts about Greece's financial capability.

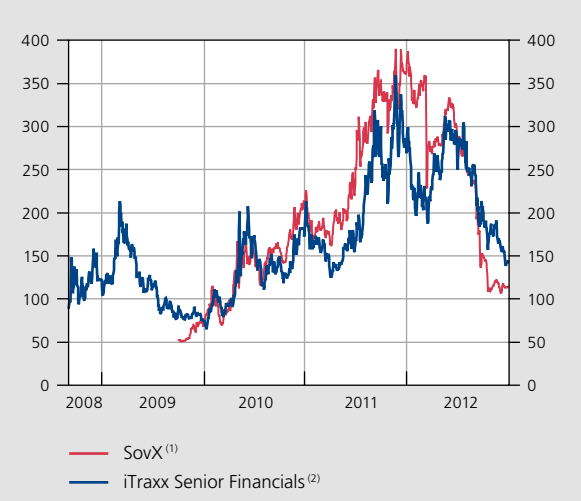
Other reassuring factors became evident outside Europe: in particular, the Federal Reserve and the Bank of Japan announced the establishment of new quantitative easing measures in support of the real economy. The doubts surrounding the conclusion of an agreement to avoid a sudden, abrupt tightening of fiscal policy in the United States did to some extent reignite nervousness on financial markets towards the end of the year, though the leading international stock market indices nevertheless concluded the year with gains: the S&P 500 and the Euro STOXX 50 progressed by around 13 to 14 % over the year as a whole.

The financing conditions of governments and banks go hand in hand

The strong correlation seen again in 2012 between the movement in the price of protection against sovereign default, measured on the basis of sovereign credit default swaps (CDS), and that of CDSs linked to the senior debt of European financial institutions reflects the importance of the interactions between these two sectors. Those interactions come via various routes. First, an increased credit risk on government securities in their portfolio may weaken the banks' balance sheets: their risk profile deteriorates and they may find it more difficult and expensive to raise finance. Next, the decline in the value of government securities leads to a reduction in the quality of many of these instruments and makes them less eligible as collateral, thus hindering the banks' access to guaranteed funding. Finally, the weakened financial position of a government also leads to a reduction in the financing advantages that banks may enjoy as a result of the implicit and explicit guarantees which the government offers. The cause and effect relationship may also work in the opposite direction: the weakness of the banks may make government intervention more likely, and hence trigger expectations of a deterioration in the public debt

CHART 4 INDICES OF CREDIT DEFAULT SWAPS FOR EUROPEAN SOVEREIGN DEBT AND FOR THE SENIOR DEBT OF EUROPEAN FINANCIAL INSTITUTIONS

(daily data, basis points)



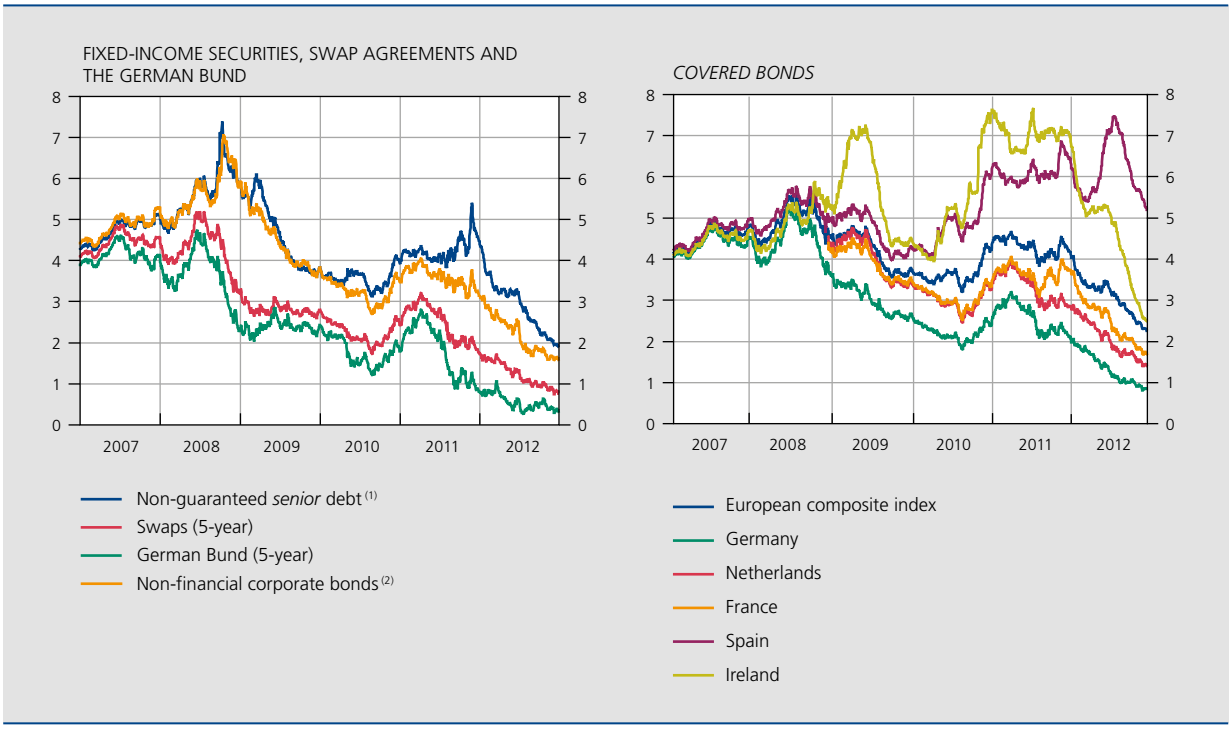
Sources: Bloomberg, Thomson Reuters Datastream.

(1) Index measuring the average level of premiums on 5-year credit default swaps referencing the sovereign debt of 19 western European countries.

(2) Index measuring the average level of premiums on 5-year credit default swaps referencing the senior debt of 25 large European financial institutions.

CHART 5 BOND YIELDS, SWAP CONTRACTS AND THE GERMAN BUND

(daily data, in %)



Sources : Markit Economics, Thomson Reuters Datastream.
(1) iBoxx euro corporate banks senior index referencing euro-denominated non-guaranteed bank senior debt.
(2) iBoxx corporate non-financial index referencing bonds with a term of 5-7 years issued by non-financial corporations.

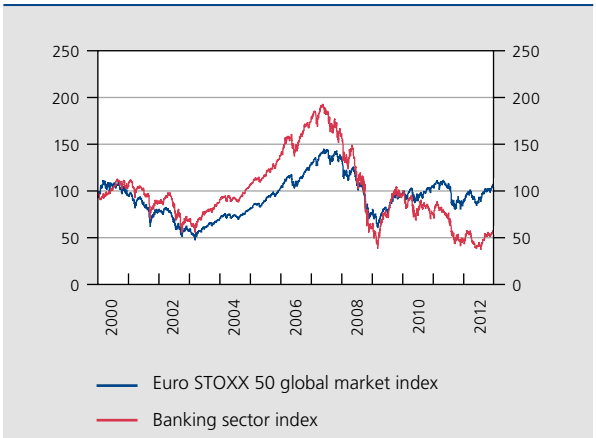
level, completing the vicious circle of a perceived decline in bank solvency.

Like the prices of sovereign CDSs, bank CDS prices also benefited from the growing market confidence in the second half of the year. The price for protection against a bank default dropped by 137 basis points in 2012, much less than the cost of insuring against a sovereign default, though that price was distorted somewhat by the rescheduling of the Greek debt in March.

This reduced credit risk led to more favourable financing conditions for the banks, as they themselves stated in their responses to the Eurosystem's bank lending survey. Thus, in 2012, the average cost of the non-guaranteed euro-denominated senior debt of European banks more than halved. This significant fall was partly due to the decline in benchmark yields, but also and primarily to the marked shrinking of the gap in relation to interest rates on five-year swaps or five-year Bund yields. The banks also saw a noticeable decline in the excess cost of financing compared to non-financial corporations, an excess which had appeared after the financial crisis and had increased considerably in 2011. Yields on covered bonds were also down, though to a lesser extent overall than those on uncovered bonds. This movement was fairly widespread; Spain was the sole exception, recording no change over

CHART 6 EUROPEAN STOCK MARKET INDICES

(daily data, 31 December 1999 = 100)



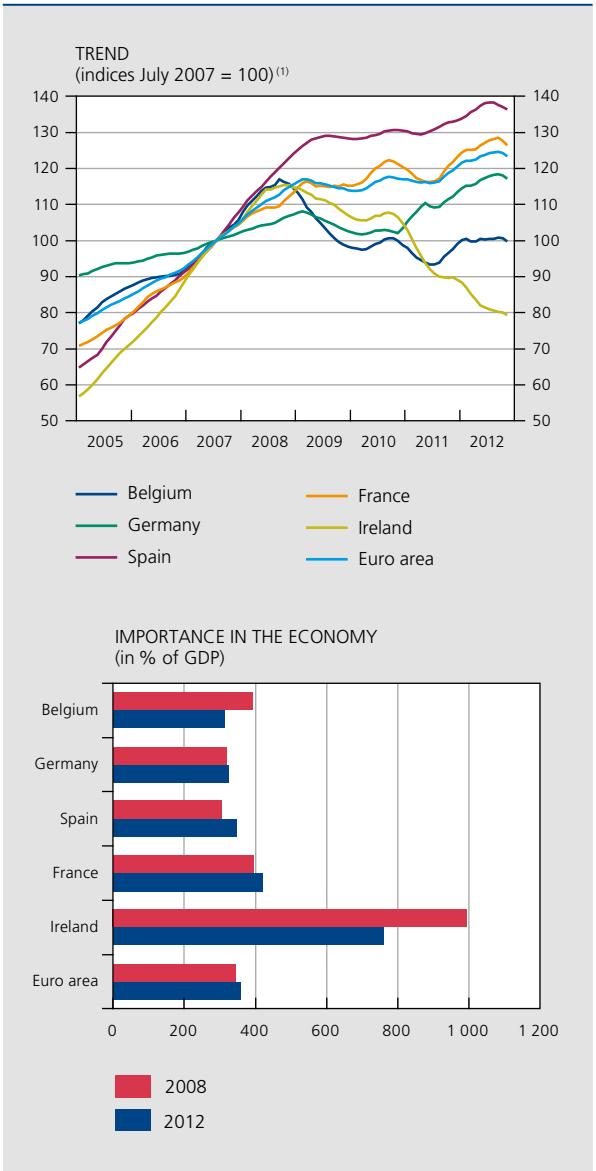
Source : Thomson Reuters Datastream.

the year as a whole. During 2012, the yield on the covered bonds of Spanish banks increased sharply up to the middle of the year, but then recorded a significant fall.

On the equity markets, financial institutions saw their financing conditions stabilise after three years of decline. However, they continued to underperform against the global market index.

Despite the improvement in financing conditions, euro area banks continued to make only modest use of the bond and equity markets.

CHART 7 TOTAL BANK ASSETS [1]
(consolidated data)



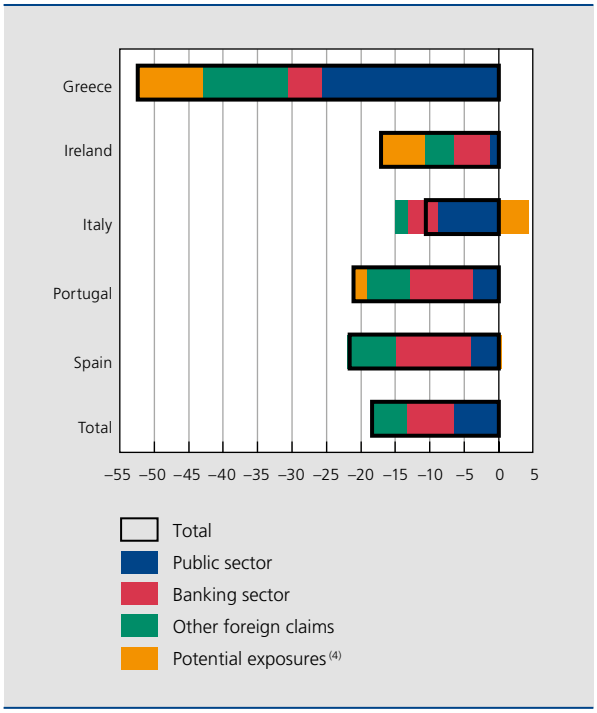
Sources : EC, Thomson Reuters Datastream, ECB.
(1) Six-month moving average.

In Europe, the downsizing of bank balance sheets came to a halt in 2012

The overall reduction in assets made by many euro area banks during the period 2009-2011 seems to have come to an end in many euro area Member States.

That is probably due to the success of the recapitalisation plans which the European Banking Authority (EBA) recommended in December 2011 and which led to capital totalling more than € 200 billion being injected into the European banking sector, largely in the form of retained profits and hybrid instruments converted into capital. Between December 2011 and September 2012, the solvency of the banking sector, which still had marked weaknesses according to the results of stress tests at the end of 2011, thus improved, mainly thanks to an increase in its capital and to a lesser extent to the continuing contraction of the volume of its risk-weighted assets.

CHART 8 CROSS-BORDER CLAIMS OF EUROPEAN BANKS [1] ON PERIPHERAL MEMBER STATES OF THE EURO AREA
(change between the end of December 2010 and the end of September 2012, on a consolidated basis) [2] [3]



Source : BIS.
(1) Banks controlled by residents and established in Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and the United Kingdom.
(2) Overall % change broken down into various claim categories.
(3) Data from the reporting of consolidated international bank statistics. The assets are broken down on the basis of final risk, i.e. after risk transfer.
(4) Cross-border claims resulting from exposures in the form of derivatives, guarantees and credit commitments.

However, there are still divergences between Member States regarding the total bank asset situation. In Ireland, where the banking sector had clearly become too large before the crisis, the reduction in bank assets continued unabated. Conversely, in Spain, which had also recorded marked growth of bank lending, there has not yet been any significant reduction in bank balance sheets.

Also, not all bank assets were influenced to the same degree by the policy of balance sheet adjustment. In that respect, lending to resident non-financial sectors was hardly affected, and reductions focused more particularly on risky assets, often with non-resident counterparties.

Thus, the cross-border claims of European banks on certain peripheral euro area countries continued to diminish. Between December 2010 and September 2012, there was a fall of around 18 %. This decline mainly concerned Greece (around 52 %), where it was essentially the public sector exposure that was reduced, notably as a result of the participation in the Greek government debt rescheduling in March 2012. Compared to Spain and Portugal, this decline was more modest (just over 20 %), the assets on the banking sector being the main ones affected. This refocusing of banks' business on their domestic markets is one of the symptoms of the tendency towards fragmentation of financial markets in the euro area. Box 1 describes the features of that fragmentation.

Box 1 – Financial fragmentation in the euro area

While the creation of Monetary Union had quickly induced interest rate convergence in the euro area, financial market developments are currently in a phase of marked fragmentation along national borders. The euro area is therefore effectively splitting into two, with the peripheral countries facing high financing costs for both public debt and private sector loans, while the core countries are enjoying historically low interest rates. This box looks at the chain of causes behind this situation, and its consequences.

Structural cause : emergence of macrofinancial imbalances

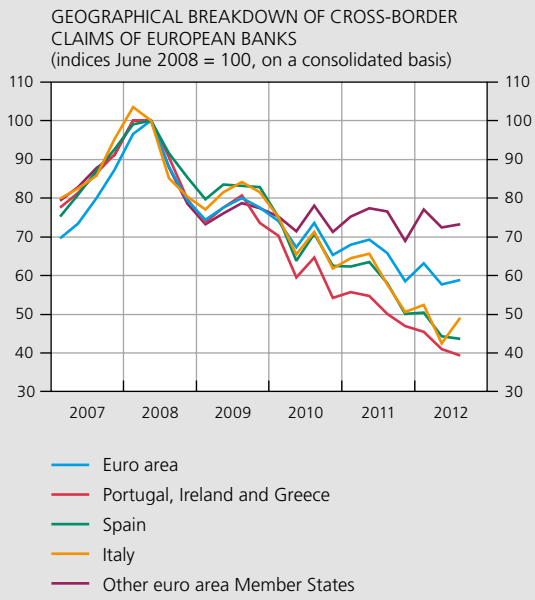
The financial fragmentation in the euro area, which has become much more marked and widespread since 2011, originated right at the start of the crisis, when financial operators began to take a different view of the heterogeneity of the fundamentals of the various economies in the euro area. During the first stage of the EMU, investors took very little notice of the differing fiscal, macroeconomic or financial positions. Quite the reverse : low interest rates and underestimation of the macrofinancial risks specific to each country helped to create these imbalances.

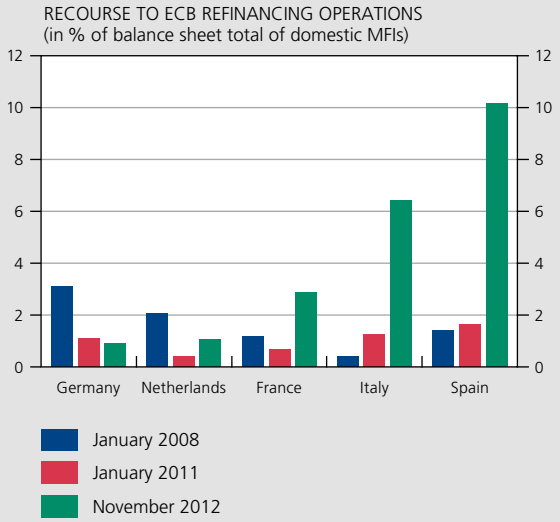
From 2008, when the financial crisis erupted in Europe, the international decrease in liquidity – particularly at the interbank level – and the absence of any credible safeguard mechanism at the level of the euro area brought country-specific concerns into the foreground for risk assessment. Depending on the case, those concerns relate to a weakened financial sector, excessive debt, unsustainable fiscal positions, a loss of competitiveness, low growth potential, or a combination of these factors. By triggering negative, mutually reinforcing, interactions between the financial sector and the public sector, the fragmentation eventually influenced the financing conditions of households and non-financial corporations in countries subject to structural imbalances. At the same time, in the absence of resolute action by the authorities, contagion mechanisms were seen on the financial markets between countries exhibiting similar weaknesses.

Fragmentation of lending at international level

The risk reappraisal and the decrease in confidence in counterparties that marked the eruption of the financial crisis were at first reflected in a drying up of international financing flows. From the third quarter of 2008, the foreign claims of European banks recorded a significant, widespread fall, particularly in the euro area. From the second

REFOCUSING BY FINANCIAL INSTITUTIONS





Sources : BIS, NCB.

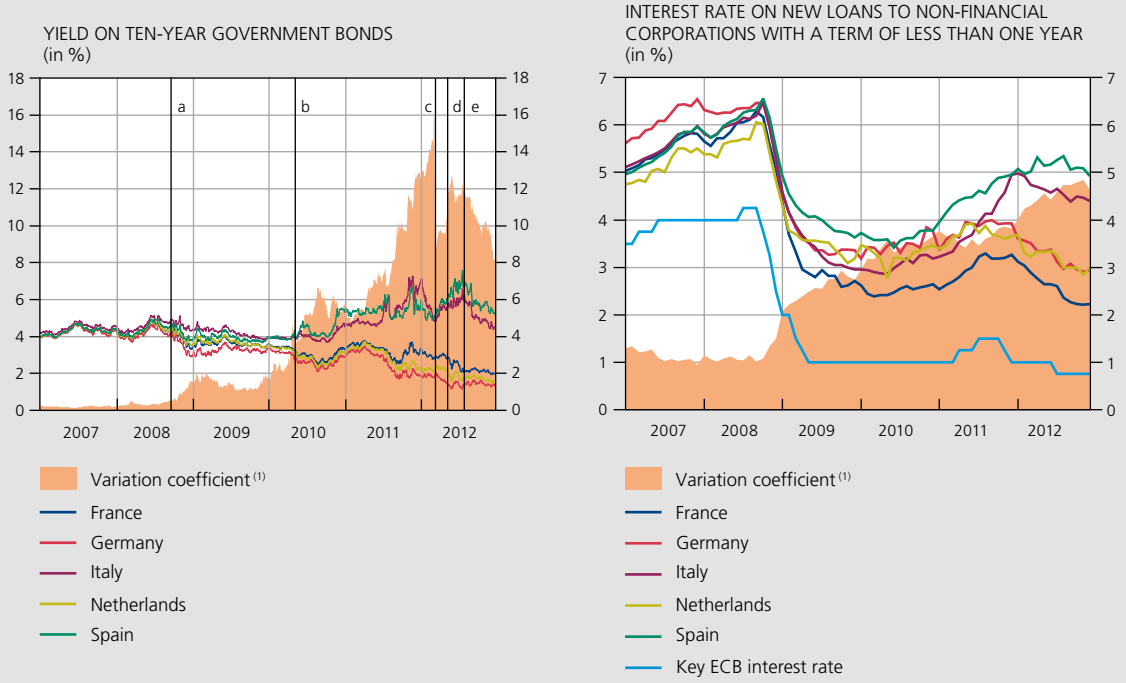
quarter of 2010, there was also a marked differentiation and segmentation which aggravated the depletion of flows to countries facing serious macroeconomic imbalances. To remedy this situation, the ECB implemented a series of non-standard measures to ensure that banks had access to long-term liquidity; these included the Longer-Term Refinancing Operations (LTROs) conducted in 2011 and 2012. If the amount of liquidity thus obtained is compared to the banks' balance sheet total, it is evident that banks in the peripheral countries made the most use of ECB refinancing, indicating greater problems in accessing market financing.

Impact on financing conditions of the non-financial sector

Since international financing had dried up, the national imbalances had a serious impact on the risk premiums on each country's public debt. Ten-year government bond yields serve as a guide in this respect: the fragmentation in the euro area can be measured by the interest rate variation coefficient. A first wave of divergences was evident from September 2008 (line a on the chart below), when the financial crisis began. In 2010 and 2011, when the crisis became mainly a sovereign debt crisis (line b), a tendency towards divergence became apparent in the euro area, in response to two developments: first, the transfer of capital to very liquid government bonds issued by States with unanimously acknowledged solvency, and second, the upward trend in yields concerning countries facing serious imbalances. Despite the temporary respite offered by the ECB's non-standard measures and the restructuring of the Greek debt in March 2012 (line c), the bond markets came under new pressure from April 2012 (line d). From the end of July 2012, the heterogeneity started a downward movement after the ECB President had announced decisive actions (line e), which took concrete form with the adoption of the OMT programme in September 2012.

The divergences in terms of the financing conditions of financial institutions and public authorities spread to the conditions for lending to the non-financial private sector, notably in regard to the interest rates charged on bank

HETEROGENEITY OF INTEREST RATES



Sources: Thomson Reuters Datastream, ECB.

(1) A higher variation coefficient indicates greater heterogeneity between all euro area countries at a given moment. The variation coefficient was multiplied by a factor of 10.

loans. Thus, the cuts in the key ECB interest rates in 2011 and 2012 led to a fall in interest rates on bank loans to non-financial corporations in a number of core countries, while conversely, interest rate increases were recorded in other countries. Similarly, there was greater heterogeneity in mortgage rates for households. These developments testify to a change in the way the monetary policy transmission channels are working.

In view of the importance of financial integration for the euro area – not only from the angle of uniform transmission of monetary policy but also with a view to efficient risk allocation and optimum use of growth potential – there have been several recent initiatives to provide structural protection against any new fragmentation. The creation of a banking union and the measures adopted at the Eurosystem level are important steps in that respect; they undeniably help to combat the redenomination risk – i.e. the risk of a forced conversion of euro-denominated assets into another, probably weaker currency – and to confirm that the EMU is here to stay.

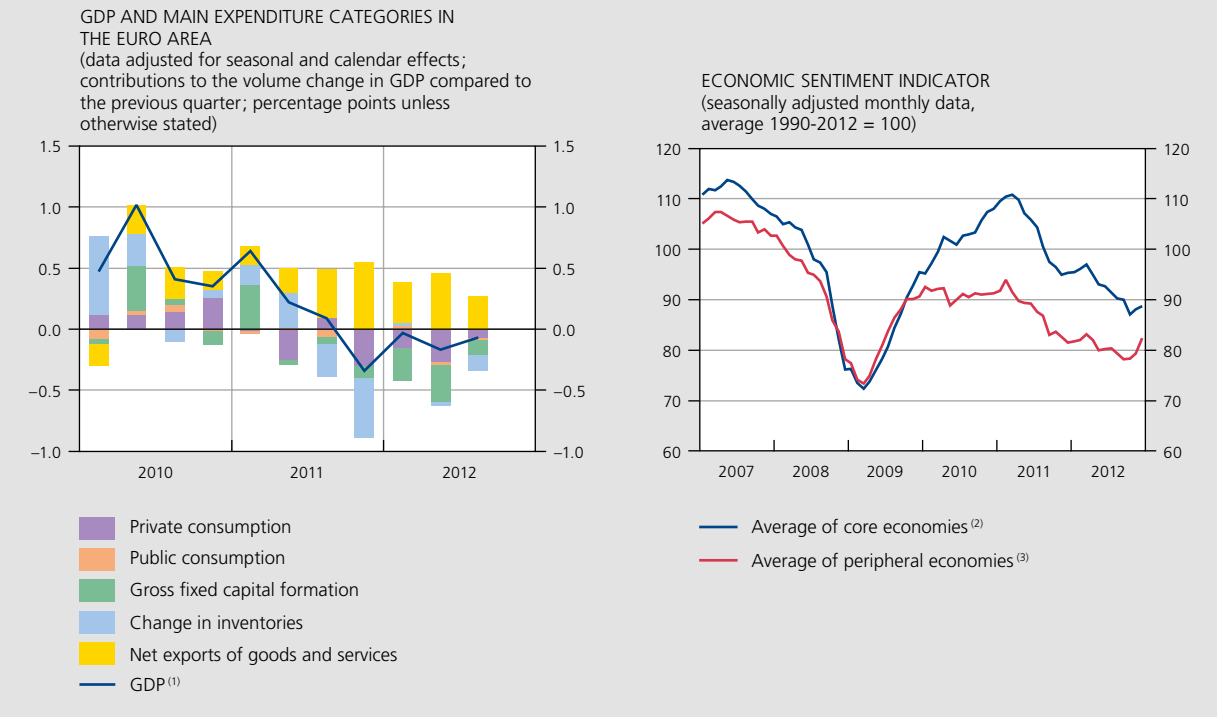
1.2 The economy in the euro area and its Member States

General weakness of activity and demand in the euro area

After GDP had contracted in the fourth quarter of 2011, at the height of the sovereign debt crisis, 2012 started under more promising auspices in the euro area. At that time, the easing of financial market tensions had been accompanied by strengthening business and household confidence and a stabilisation of activity. However, this improvement was short-lived. GDP growth reverted to negative territory from the second quarter and stayed there in the third; according to the usual definition, these two quarters of GDP contraction marked a new recession. This relapse, after two years of revival, followed the much deeper recession in 2008-2009. In a climate of renewed turbulence and anxiety over the sovereign debt crisis in the euro area, the moderate but persistent weakening of activity was due to both a gradual downturn in domestic demand and a loss of momentum in foreign trade. These factors continued to depress economic activity in the closing months of the year, as the easing of financial market tensions resulting from the decisive measures by the authorities had by then had little positive impact on household or business confidence. On the contrary, pessimism tended to become widespread, extending to other countries, including Germany. Over the year as a whole, the GDP of the euro area thus contracted by 0.4 % after a rise of 1.4 % in 2011.

Each domestic demand component was sluggish in 2012. Public consumption was down slightly (–0.2 %), owing to fiscal consolidation efforts, which also had a more general effect on other domestic demand components, including private consumption. The latter, down by 1 % against 2011, was inhibited by a number of other factors. Households' real disposable income was thus also eroded by job losses, wage moderation and the rising cost of energy. In addition, consumer confidence was undermined by such factors as the debt crisis in the euro area and the rise in unemployment, prompting consumers to become more cautious and to postpone their consumer durable spending plans and housing investments.

CHART 9 ECONOMIC DEVELOPMENTS IN THE EURO AREA



Source : EC.
(1) Percentage change compared to the previous quarter.
(2) Austria, Belgium, Germany, Finland, France, Luxembourg, Netherlands.
(3) Greece, Italy, Portugal, Spain.

The slackening pace of activity in the euro area and the increased uncertainty also dented the confidence of business managers, who cut back their investment plans in view of the deteriorating demand outlook. Furthermore, particularly unfavourable credit conditions and the need to reduce debt levels were additional restraining factors in some euro area countries. In the euro area as a whole, gross fixed capital formation thus fell by 3.5 % in 2012. Moreover, the worsening outlook for activity since the summer of 2011 led firms to cut their inventories.

Foreign trade in goods and services alone continued to support growth in 2012, by 1.3 percentage points, thus maintaining a trend which had begun in mid-2010. While the weakening of global economic activity, and hence of foreign demand, significantly affected the rate of export growth compared to the preceding two years, exports continued to benefit from the boost to competitiveness of the depreciation of the real effective euro exchange rate since 2011. At the same time, imports declined as a result of flagging domestic demand.

All euro area countries felt the effects of the deteriorating economic climate in 2012, but with varying intensity, the impact being greater for the countries weakened by sizeable macroeconomic imbalances. Those countries, which had embarked on essential adjustments requiring considerable efforts in terms of fiscal consolidation, private sector deleveraging, strengthening of competitiveness and reallocation between the various economic sectors, saw a collapse in domestic demand in a context of escalating unemployment. Since they also faced less favourable financing conditions, these economies plunged once more into recession. Thus, in 2012, GDP growth became decidedly negative again in Spain, Italy and Cyprus, while the slump in activity persisted in Portugal, and even more so in Greece. Ireland was an exception, as activity continued to grow, albeit more slowly. The countries without any major macroeconomic imbalances, which had already benefited from the temporary rebound following the 2008-2009 recession, proved more resilient even though they were unable to maintain their momentum. In Germany and Austria, GDP growth slowed in 2012, although it remained positive. France and Finland recorded virtual stagnation, while activity was down slightly in Belgium and the Netherlands. The effects of the sovereign debt crisis, initially confined to a small number of countries, therefore spilt over into the economies which had hitherto displayed greater resilience.

Labour market conditions in the euro area deteriorated steadily in 2012, responding more sharply to the decline in activity and to mounting uncertainties than at the start of the financial crisis. During the 2008-2009 recession, labour market adjustments had involved a cut in the number of hours worked per worker, rather than a reduction in jobs. Since then, there have been considerable changes to the economic context. The lack of budgetary scope has curtailed the ability to implement new government support measures, such as incentives for reductions in working time which had contributed to the resilience of employment in the euro area during the great recession, while firms' reserve absorption capacity was seriously impaired in the absence of a vigorous and prolonged recovery in recent years. Thus, in most countries, the slowdown in economic activity in 2012 and the gloomy medium-term outlook caused firms to scale down their workforce rather than to reduce working time again. Employment in the euro area thus contracted by 0.8 % compared to 2011, while unemployment continued to rise, reaching 11.7 % in December, its highest level since 1999. Among the euro area countries, trends in employment and unemployment varied greatly. The biggest falls in employment accompanied by the largest increases in unemployment occurred in Greece, Spain, Portugal and Cyprus. They reflect the adjustment of the macroeconomic imbalances mentioned above, which continued in 2012. Apart from a fairly steep

TABLE 1 GDP AND THE LABOUR MARKET IN EURO AREA COUNTRIES IN 2012 (1)

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

	GDP	Employment in persons	Unemployment rate (2)
Germany	0.8	1.1	5.5
France	0.2	–0.1	10.2
Italy	–2.3	–1.3	10.6
Spain	–1.4	–4.5	25.1
Netherlands	–0.3	–0.2	5.4
Belgium	–0.2	0.2	7.4
Austria	0.8	1.1	4.5
Greece	–6.0	–7.9	23.6
Finland	0.1	0.3	7.9
Portugal	–3.0	–4.0	15.5
Ireland	0.4	–1.2	14.8
Slovakia	2.6	0.3	13.5
Luxembourg	0.4	1.9	5.4
Slovenia	–2.3	–1.6	8.5
Cyprus	–2.3	–4.0	12.1
Estonia	2.5	1.8	10.5
Malta	1.0	0.9	6.3
Euro area	–0.4	–0.8	11.3

Sources: EC, NBB.
(1) Euro area countries are ranked according to the size of their GDP in 2012.
(2) Number of unemployed as a percentage of the labour force.

decline in their activity, these countries also needed to reallocate the resources of domestic demand-oriented sectors, particularly the construction sector in Spain, by switching them to export-oriented sectors. In addition, unemployment rate differentials between Member States have widened since 2011. Thus, in December, the lowest unemployment rates were recorded in Austria (4.3 %), Luxembourg and Germany (5.3 % each) and the Netherlands (5.8 %), and the highest in Spain (26.1 %) and Greece (26.8 % in October 2012). In the latter countries, youth unemployment exceeded 50 %.

Continuing structural adjustment efforts

Despite the rather unfavourable economic environment in the euro area as a whole, the countries suffering from the most serious macroeconomic imbalances continued their structural adjustment efforts in 2012. Those efforts are either defined by programmes which national governments have concluded with the IMF, the EC and the ECB (the Troika), laying down the conditions for the financial assistance which they are granted – as in the case of Ireland, Greece and Portugal – or they are steered by financial market tensions which would become unsustainable if they persisted, as in Spain and Italy, in particular. While these adjustments may depress domestic demand and the labour market in the short term, they are vital to lay a lasting, structural basis for growth potential.

The imbalances revealed by the 2008-2009 economic and financial crisis, and in some circumstances exacerbated by this crisis, necessitated various types of adjustment. The financial sector restructuring, already mentioned briefly for the euro area as a whole in the previous section, will be examined in more detail for Belgium in chapter 3. Apart from this aspect, depending on the case, the necessary adjustments concern consolidation of the government's fiscal position, deleveraging by non-financial corporations and households, in parallel with property market stabilisation, and more generally the strengthening of competitiveness and the absorption of large, recurrent deficits on the economy's current account balance.

Public finances

In an adverse economic climate, structural discretionary measures, amounting to 1.3 percentage points of GDP, brought a significant reduction in the general government deficit in the euro area. According to the EC's autumn 2012 forecasts, the deficit was down from 4.1 % of GDP in 2011 to 3.3 % in 2012. Overall, it declined more slowly than in 2011, but some countries, where public finances were in a particularly precarious situation and which were under pressure from the markets, intensified their efforts. A number of governments – e.g. in Italy, Spain, Portugal and Greece – even had to implement additional measures during the year to pursue their objectives, despite the economic slowdown. Besides, the Ecofin Council also relaxed those objectives during the year for the last three countries mentioned. Despite these efforts, according to the same EC forecasts, some countries were still recording substantial budget deficits: in 2012, they were highest as a percentage of GDP in Ireland (8.4 %), Spain (8 %), Greece (6.8 %) and Portugal (5 %), and in Cyprus (5.3 %). Conversely, seven euro area countries recorded a deficit of 3 % of GDP or less, namely Germany, Estonia, Finland, Luxembourg, Malta, Italy and Belgium; at the end of the year, the first five of these were not, or were no longer, subject to an excessive deficit procedure (EDP). In the case of Germany and Malta, the Ecofin Council decided to close these procedures during 2012.

The government debt ratio increased from 88.1 % of GDP at the end of 2011 to 92.9 % at the end of 2012, outpacing the previous year's rise despite the reduction in the deficit. That acceleration was due not only to the "snowball effect" – in which nominal GDP growth is less than the implicit interest rate on the public debt – but also to government interventions in favour of the financial sector and to the assistance granted to certain euro area countries under the European support mechanisms. According to the conventions applied in the national accounts, those outgoings should not generally be included in the deficit, but they do increase the debt.

No euro area Member State managed to record a reduction in the public debt in 2012. Nevertheless, the countries subject to a programme, as well as other vulnerable countries, have made considerable efforts to cut the budget deficit since 2010, despite an adverse economic climate. Thus, excluding interest charges, cyclical components and exceptional temporary measures, the deficit reductions achieved between 2010 and 2012 were largest in Greece, Portugal, Ireland and Spain, at 13 percentage points of GDP in Greece and from 4 to 6 points in the other three countries. However, these economies still need to make a major effort to meet the budget targets set in their national stability programmes.

Private debt and property markets

In various European countries, the 2008-2009 economic and financial crisis and the bursting of the property bubble, which accompanied it in a number of cases, revealed that households and non-financial corporations had

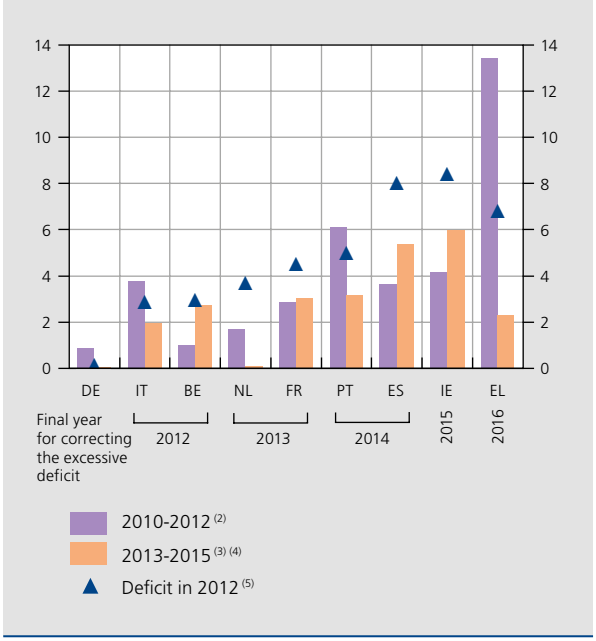
excessive debts. Those debts had swollen in the preceding decade, in parallel with a surge in property prices. Measured on a consolidated basis – i.e. excluding reciprocal financial assets and liabilities within the same sector – the debt-to GDP ratio in the private sector peaked at 144 % in mid-2010. After that, a modest decline set in, since the debt ratio subsided to 141 % in the third quarter of 2012. Thus, just as the debt accumulation in the private sector had occurred sooner than that in the public sector, where debts only built up during the past five years, the reversal likewise occurred earlier. The debt therefore shifted between sectors, in that public finances felt the recessive effects of the efforts to reduce private debt.

The debt level of the private non-financial sector varies greatly from one country to another. Levels well above the euro area average are seen, *inter alia*, in Ireland, the Netherlands – in view of the specific characteristics of the mortgage market in that economy –, Portugal and Spain. Conversely, other countries such as Germany, Italy and Greece record the lowest private sector debt ratios in the euro area. Up to now, the adjustment of private sector debt levels in the various countries has generally been very limited. In the case of households, up to the end of 2011, significant reductions from the peak levels had been recorded in Ireland and Spain, while in the case of non-financial corporations there had been substantial corrections in Greece and Spain.

These developments confirm the lessons of the past which indicate that debt reduction, particularly in the private sector, tends to be very slow. The speed of debt reduction seems to depend on the various means used – such as an increase in savings or debt relief options. While the latter are widespread in the United States, they are relatively limited in most European countries, particularly for households which, in many countries, are under a stricter legal obligation to meet their financial liabilities. As in the case of the public debt, account must also be taken of the

CHART 10 FISCAL CONSOLIDATION: DEFICIT LEVEL IN 2012, EFFORTS MADE SINCE 2010 AND EFFORTS PLANNED ACCORDING TO THE BUDGET TARGETS

(changes in the structural primary balance [1]; in percentage points of GDP, unless otherwise stated)



Source : EC.

(1) The structural primary balance corresponds to the general government balance excluding interest charges, adjusted for cyclical effects and temporary measures.

(2) Calculated on the basis of the EC's autumn 2012 forecasts.

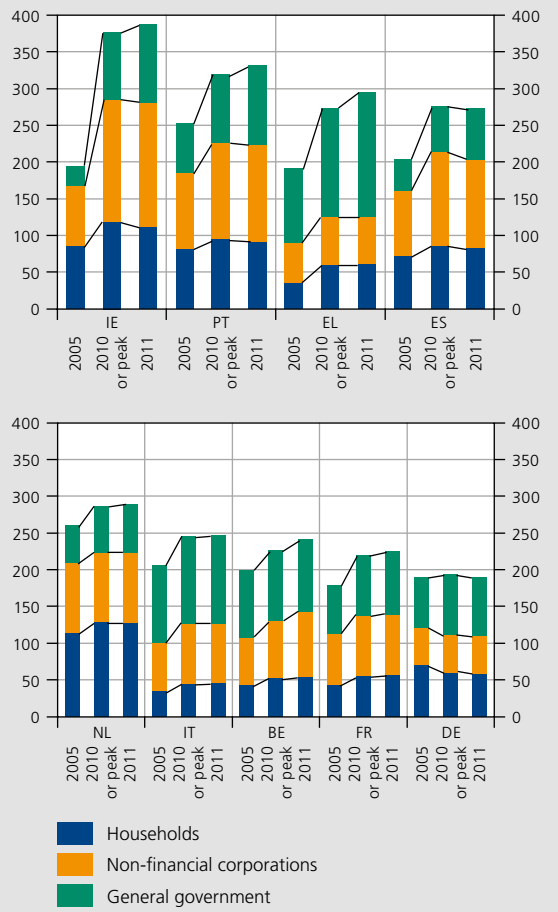
(3) Calculated on the basis of the 2012 national reform and stability programmes, or deficit targets as revised by the Ecofin Council (for Spain, Portugal and Greece).

(4) 2016 for Greece. Between 2013 and 2016, the primary balance is only adjusted for cyclical effects.

(5) Nominal deficit in % of GDP.

CHART 11 DEBT OF THE NON-FINANCIAL PRIVATE SECTOR AND OF GENERAL GOVERNMENT [1] [2]

(annual data, in % of GDP)



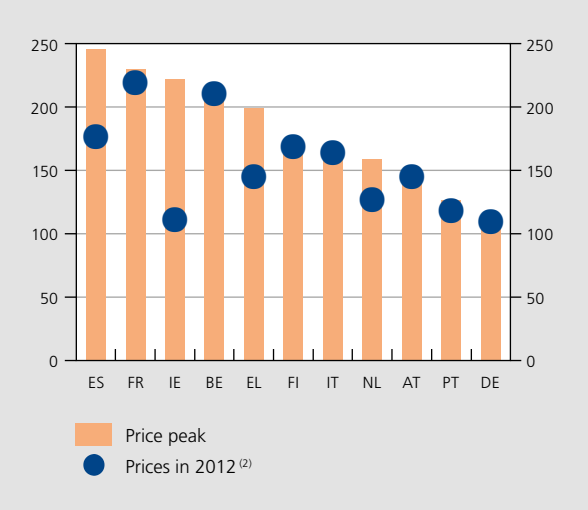
Source : EC.

(1) Consolidated concept.

(2) The countries shown are ranked according to their total debt in 2011.

CHART 12 RESIDENTIAL PROPERTY PRICES IN THE EURO AREA [1]

(indices 1st quarter of 2000 = 100)



Sources : OECD, ECB.

(1) The countries are ranked according to the rise in property prices up to the respective peak in each country.

(2) Second or third quarter of 2012 depending on the country.

so-called "denominator effect", as the fall in nominal GDP drives up the debt ratio in times of recession.

At the same time, the large discrepancies between residential property prices and their fundamentals which had built up in a number of euro area countries before the crisis continued to diminish during the year under review. Compared to the peak recorded for each country, the total property price correction up to the second quarter of 2012 was largest in Ireland, followed by Spain. In the latter country, it came to 28 %, bringing average prices down to their early 2004 level; in Ireland, the fall was even steeper (around 50 % since the peak), with prices equalling those at the end of 2000. In the case of the other euro area countries, prices likewise continued to fall in Greece and the Netherlands, and to a much lesser extent in Portugal, France and Italy. In contrast, Germany, which is in an atypical situation compared to its European neighbours following the reunification, saw prices maintain the upward trend which had set in at the end of 2009.

External imbalances

Between 2003 and 2007, the differences between euro area Member States in terms of the balance of payments on current account widened substantially. For the countries whose situation had deteriorated the most, this reflected both a lack of competitiveness on foreign markets and the internal macroeconomic imbalances mentioned previously. A country's current account balance on the balance of payments in fact corresponds to the difference between savings and investment of the public and private sectors taken together. Excess demand, which curbs savings or boosts investment, or conversely, too weak demand at the level of the economy as a whole, will therefore be reflected respectively in a current account deficit or surplus. In the three countries with an assistance programme (Greece, Ireland and Portugal), and in Spain, the current account deficits were substantial up to 2007. But a change occurred in 2008 and since then these deficits have declined steeply, even giving way to a surplus in the case of Ireland. In France and Italy, the current account balance as a percentage of GDP had also been falling since the beginning of this century, though without reaching the deficit level of the first four countries mentioned. However, in contrast to what happened in those four countries, the balance then continued to deteriorate, though Italy did record an improvement during the year under review. In parallel with the falling deficit in the three programme countries and in Spain, the countries with a current account surplus saw their surplus diminish, though the contraction was generally smaller and more short-lived. Germany – the country which, in absolute terms, has by far the biggest surplus in the euro area – thus saw its surplus expand slightly again in 2010, before stabilising at a high level.

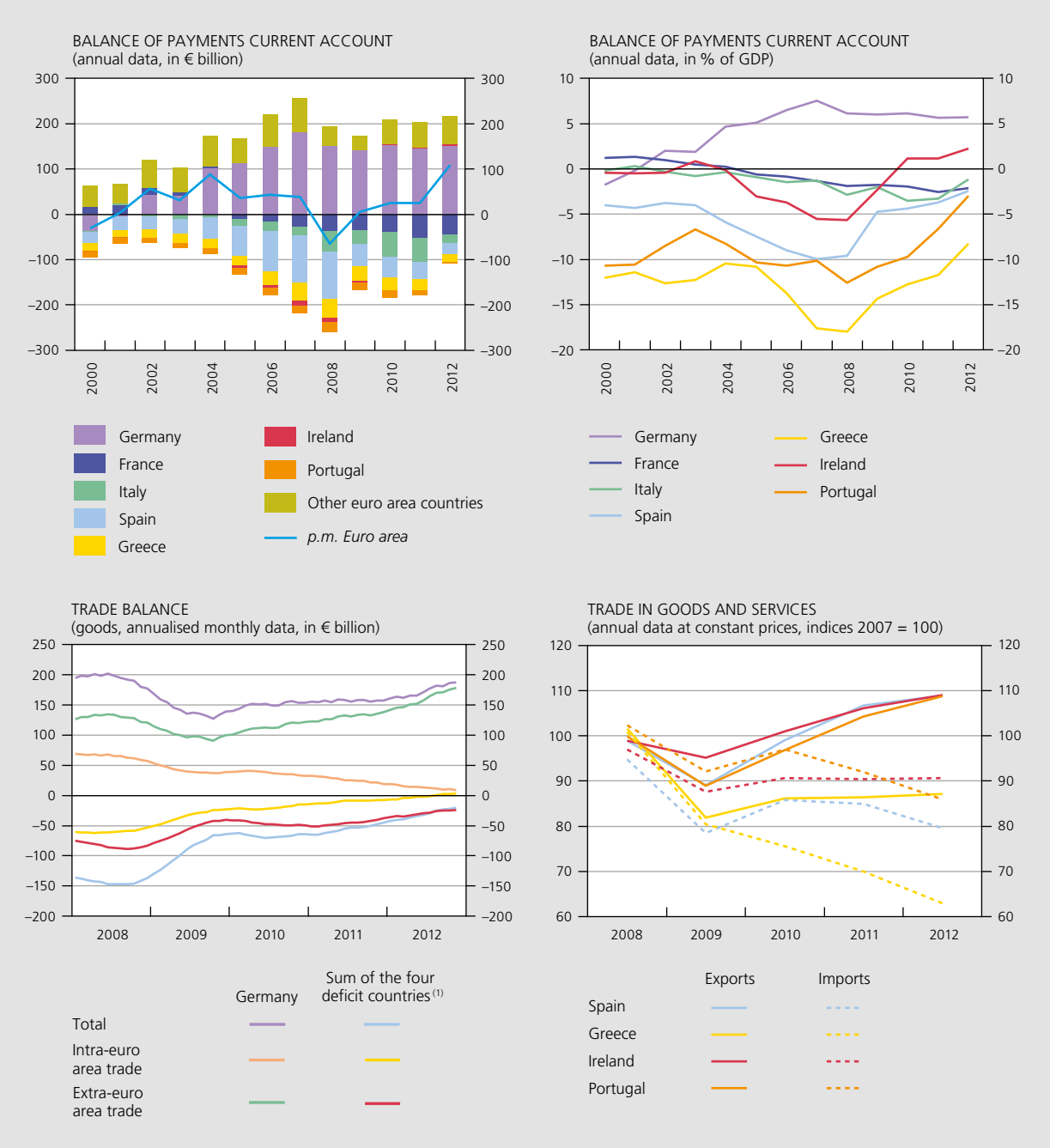
According to the breakdown of the data on international trade in goods, the reduction in the trade balances in the three programme countries and in Spain since 2008 largely reflects the variations in trade with other euro area countries – known as intra-euro area trade. About half of the decline in the trade deficit in those four countries is thus due to a smaller deficit in relation to their euro area trade partners. The adjustment at the level of intra-euro area trade was more marked in Spain and Portugal. The picture is different for Ireland, whose trade balance has essentially recovered in relation to countries outside the euro area. Concerning the countries in surplus, Germany also saw its trade surplus decline at first, in relation to euro area Member States and third countries alike. From 2010, however, a divergence became apparent: while the trade surplus generated by intra-euro area trade steadily dwindled, the surplus on trade with countries outside the euro area began to expand. So it is the growth of the surplus vis-à-vis the rest of the world that has kept the German surplus at a high level.

The breakdown of trade into exports and imports shows that the improvement in the balances of Spain, Portugal and Ireland is largely attributable to an export recovery, while imports have stagnated or even declined since 2010. However, in Greece, the export revival was

weaker than in the other three countries, but at the same time, imports fell more sharply, explaining much of the improvement in that country's deficit.

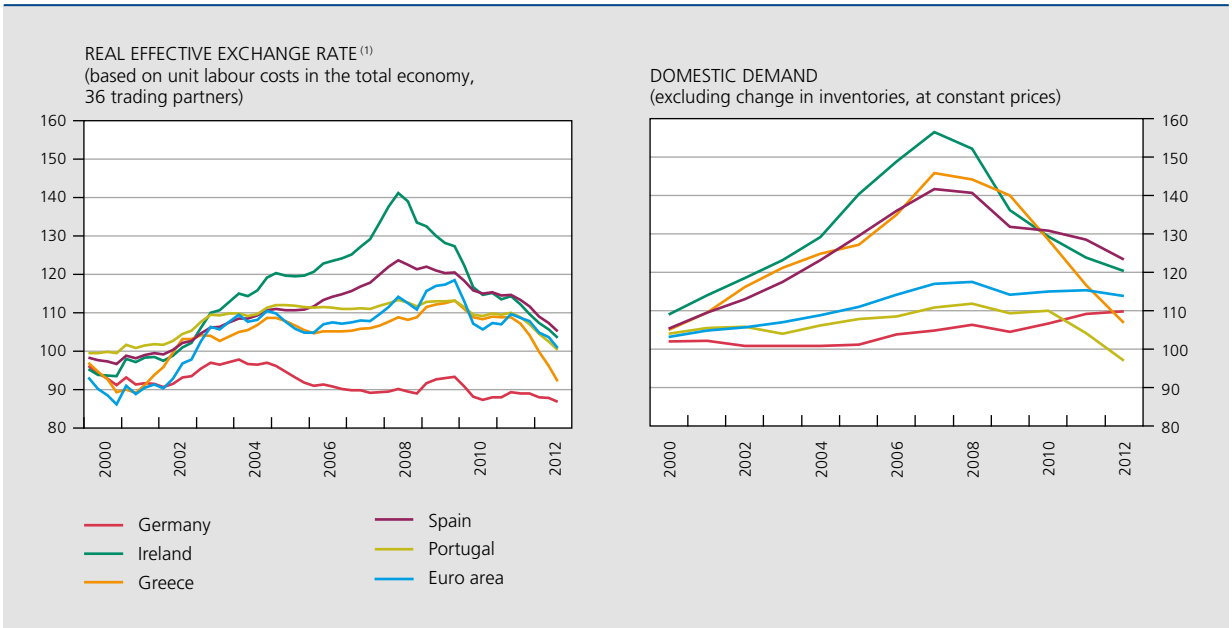
These variations in foreign trade flows stem partly from progress in terms of competitiveness. The real effective exchange rate indicators based on unit labour costs show that a considerable correction has taken place in Ireland and Spain since mid-2008. In Portugal, it occurred later and more gradually, but in the past few quarters it has clearly gathered pace. In Greece, however, competitiveness continued to deteriorate up to the end of 2009, before turning around, especially from mid-2011 when the catching-up movement gained momentum. Developments in imports are also linked to the contraction of domestic demand in the context of the need for

CHART 13 ADJUSTMENTS TO BALANCE OF PAYMENTS CURRENT ACCOUNTS IN THE EURO AREA



Source : EC.
(1) Greece, Ireland, Portugal and Spain.

CHART 14 COMPETITIVENESS AND DOMESTIC DEMAND IN SOME EURO AREA MEMBER STATES
(indices 1999 = 100)



Source : EC.
(1) An appreciation of the real effective exchange rate reflects a deterioration in competitiveness.

debt reduction in the public and private sectors between 2008 and 2012. During that period, Greece saw the steepest decline in domestic demand. In Portugal, demand held up for a little while longer, but has likewise slumped in the past two years.

The improvement in the flow variables, such as the current account balance on the balance of payments, indicates that a return to a more balanced functioning of the economy is in progress, particularly in the three programme countries and in Spain. It is due partly to the effect of structural improvements in competitiveness or public finances. However, the inertia of the stock variables, such as the public debt and the debt of the non-financial private sector proves that this is a lengthy process, in view of the imbalances built up in the past.

1.3 Global context

Global economic slowdown, due partly to the crisis in the euro area

In 2012, the crisis in the euro area had a significant impact on the global economy, its effect spreading throughout the world via various channels. Thus, the weak demand from the euro area undermined the dynamism of its main trading partners' exports, and the uncertainty associated with the euro crisis similarly dampened the risk appetite on financial markets elsewhere, as well as eroding household and business confidence. However, the expansion of activity outside the euro area was also held back by a number of country-specific factors, such as the uncertainty over fiscal policy in the United States and Japan, or the impact of policy tightening in the emerging market economies in 2011.

Furthermore, outside the euro area too, the ongoing correction of various macroeconomic imbalances continued to weigh on demand and activity. The simultaneous debt reduction process by the private and public sectors in many of the advanced countries played a dominant role here. Households scaled down their debts in order to strengthen their financial position in the face of an uncertain future. They therefore kept their savings ratio at a high level and restricted their expenditure. Banks likewise continued to strengthen their financial position, which in some countries, had repercussions on lending to the private sector. Finally, many countries persevered with their fiscal consolidation. Since this consolidation was taking place simultaneously in most of the advanced economies, the demand components capable of compensating for its adverse impact on activity were rather inactive worldwide.

Overall, global GDP growth weakened further in 2012, falling to a modest 3.2 %. In the advanced countries, it dropped to an average of 1.3 %, a slowdown which was relatively widespread with the notable exception of the United States and Japan. Several economies actually sank into recession. The loss of momentum in the global economy in 2012 also affected the emerging countries. Here, the expansion of activity was gradually restrained by the deterioration in the external economic environment, but also in some cases by domestic factors. Although as a group these countries still topped the league in terms of growth rates, the slowdown had a more serious impact on certain economies, such as those exporting commodities. During the year under review, international trade flagged to a much greater extent even than economic activity, with growth dropping from 5.9 % to 2.8 %. Commodity prices were highly volatile during the year, falling by an average of 2.8 % in dollars, against the backdrop of the global slowdown. Industrial commodity prices – more sensitive to the business cycle – recorded the sharpest fall at 15.9 %, while food and energy commodities were down in price by 5 % and 0.4 % respectively, despite a steep but temporary rise during the summer, caused by uncertainty surrounding supply.

CHART 15 BUSINESS CONFIDENCE

(diffusion indices, seasonally adjusted data, PMI of output in the manufacturing industry and the service sector, monthly data)

Source : Markit Economics.

In the **United States**, the gradual recovery which had begun in 2009 persisted, with GDP up by 2.3 % in 2012. The acceleration compared to 2011 was due partly to a substantial carry-over effect following the surge in activity at the end of that year. In 2012, expansion was moderate, with quarterly growth averaging 0.5 % over the first nine months. The growth of activity was fuelled by domestic demand and, more specifically, by household consumption expenditure and business investment. Residential investment also made a positive contribution, for the first time since 2005. However, that contribution was modest in comparison with previous cycles, the reasons being the continuing caution which many financial institutions exhibit in regard to new mortgage lending, the acute uncertainty over the economic outlook, and the still high stock of properties in foreclosure and mortgage loans with substantial arrears. A highly accommodative monetary policy which was further eased during the year continued to support growth. Conversely, US fiscal policy weighed on growth not only because of the lower public expenditure but also on account of doubts regarding the "fiscal cliff". The latter refers to the substantial fiscal tightening which should have been implemented automatically, by law, at the beginning of 2013, resulting from an increase in various taxes combined with public spending cuts, in the absence of an agreement between the Obama administration and Congress. On the basis of the figures produced by the Congressional Budget Office, an independent body, the ECB estimated the scale of the fiscal cliff at almost $ 700 billion (4.1 % of GDP) for the 2013 calendar year. In the end, a partial agreement was approved on New Year's Day. Its main element was an extension, for most income groups, of the tax cuts introduced in 2001 and 2003. In all, this agreement should reduce the size of the fiscal cliff by two-thirds. The deadline for an agreement on the reduction of certain expenditure was postponed by two months to 1 March 2013. On the American labour market, the recovery has been only gradual, so that the situation remains precarious, with a high unemployment rate and large numbers of long-term unemployed.

After a slight recovery in the two preceding years, the **United Kingdom** recorded negative growth of 0.3 % in 2012. The decline which had begun at the end of 2011 persisted throughout the first half of 2012. However, the economy grew strongly in the third quarter, supported by several one-off factors such as the surge in activity generated by the London Olympic Games. The negative growth for the year as a whole was partly the result of an extremely negative contribution from net exports, resulting from stagnant exports and higher imports, and partly of a very modest expansion of domestic demand, attributable largely to the weakness of households' final consumption expenditure. The reason lies in the modest increase in real disposable income of households, due in particular to the continuing fiscal consolidation and the high inflation in the first half of the year, and also in their

TABLE 2 GDP IN THE MAIN ECONOMIES[1]

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

	2010	2011	2012	*p.m. 2011, share of global GDP*[1]	*p.m. 2012, contribution to global GDP growth*[1]
Advanced countries	3.0	1.6	1.3	*51.1*	*0.7*
of which:					
United States	2.4	1.8	2.3	*19.1*	*0.4*
Japan	4.7	–0.6	2.0	*5.6*	*0.1*
Euro area	2.0	1.4	–0.4	*14.3*	*–0.1*
United Kingdom	1.8	0.9	–0.3	*2.9*	*0.0*
Emerging countries	7.4	6.3	5.1	*48.9*	*2.5*
of which:					
Central and eastern Europe	4.6	5.3	1.8	*3.5*	*0.1*
Emerging Asia	9.5	8.0	6.6	*25.0*	*1.7*
of which:					
China	10.4	9.3	7.8	*14.3*	*1.1*
Latin America and Caribbean	6.2	4.5	3.0	*8.7*	*0.3*
World	5.1	3.9	3.2	*100.0*	*3.2*
World excluding euro area	5.6	4.3	3.8	*85.7*	*3.3*
p.m. World trade[2]	*12.6*	*5.9*	*2.8*		

Sources: EC, IMF.
(1) For regions according to the IMF definitions and calculated on the basis of purchasing power parity.
(2) Average of exports and imports of goods and services.

steady debt reduction. In addition, domestic demand growth was also restrained by the decidedly negative contribution of stock-building and the sharp cuts in public investment.

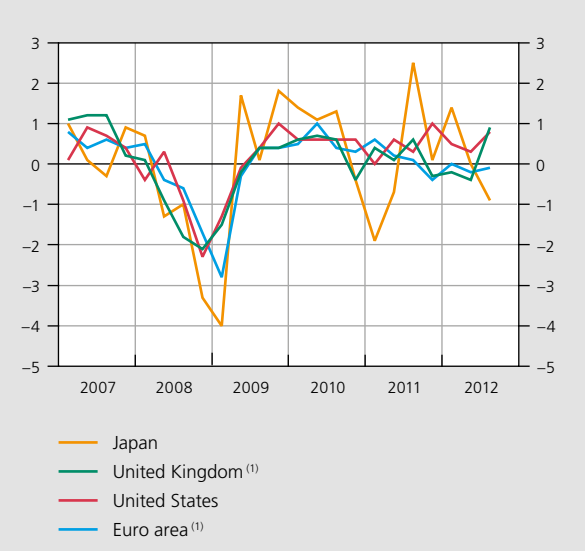
In **Japan**, after a 0.6 % contraction in 2011, the economy recorded growth of 2 % in 2012, a key factor being the reconstruction following the earthquake and the tsunami which had struck the country in March 2011. However, after a continuing recovery in the first quarter of the year, activity fell again following the slowdown in foreign demand and the loss of momentum in domestic demand attributable, among other things, to the abolition of the public subsidies for car purchase and the deceleration of reconstruction expenditure. During the year under review, the growth of economic activity was bolstered mainly by investment and consumption expenditure. Net exports made a very negative contribution owing to the very meagre export growth. This was due to the strength of the yen and the slower expansion of foreign demand, combined with a steep rise in imports, primarily energy commodities.

In **China**, the downturn in growth seen since 2010 persisted in 2012, with year-on-year GDP growth falling to 7.8 %, the lowest figure since 1999. Nonetheless, signs of recovery appeared towards the end of the year. This slowdown was mainly the result of weaker export growth, but also to a slackening of domestic demand, particularly for investment, as a result of the restrictive policies implemented in 2010 and 2011. Those policies were in fact intended to correct the effects of substantial recovery measures introduced after the 2008 financial crisis. Although those measures had enabled China to shelter itself from the global economic crisis, at the same time they created risks of overheating and posed a threat to financial stability, emanating from the housing sector in particular.

For the **central and eastern European** EU Member States, the effects of the slowdown in the euro area were particularly evident in 2012. They spread via various channels, amplified by geographical proximity. On the one hand, the export sectors of those countries were hit, while on the other hand, capital flows from the euro area slowed.

CHART 16 QUARTERLY PROFILE OF GDP IN THE MAIN ADVANCED ECONOMIES

(seasonally adjusted data, percentage changes in the volume of GDP compared to the previous quarter)



Sources : EC, BEA, ESRI.
(1) Data also adjusted for calendar effects.

Some relaxation of monetary and fiscal policy

As the weakening of activity and demand became obvious, macroeconomic policies adopted a more accommodative stance throughout the world. However, the extent of this easing differed according to the monetary and fiscal policy space available in the various economies.

In advanced economies, the easing of monetary policy was continued, mainly via new unconventional measures. Outside the euro area, their primary objective was to support economic activity, particularly via further substantial purchases of securities. In the United States, at the end of its June meeting, the Federal Open Market Committee (FOMC) decided to extend until the end of the year the programme known as Operation Twist, designed to lengthen the average maturity of the Federal Reserve's portfolio of government bonds. After its September meeting, the FOMC announced a new programme providing for additional monthly purchases amounting to $ 40 billion of agency mortgage-backed securities. Finally, in December, it announced additional monthly purchases amounting to $ 45 billion of long-term government securities starting in January 2013. The Bank of Japan meanwhile increased the volume of its securities purchase programme in five stages to a total of 101 000 billion yen, or 21.3 % of GDP. The Bank of England expanded its securities purchase programme in two stages to £ 375 billion, or 24.2 % of GDP. The unconventional measures also took the form of programmes to support lending to the private sector. For instance, in consultation with the Treasury, the Bank of England launched a Funding for Lending scheme, which offers financial institutions funding on favourable terms for a maximum period of four years, in order to encourage them to lend to households and non-financial corporations in the United Kingdom. In Japan, the central bank expanded the scale of its programme encouraging lending to businesses by financial institutions and included loans in US dollars. As a result of these measures, the balance sheets of the main central banks grew still larger. Another significant form of unconventional intervention consisted in central banks modifying their communication strategy. The Federal Reserve adopted the forward guidance strategy, giving an indication on the future movement in its key interest rate so as to anchor interest rate expectations: the period in which the key interest rate would remain at its current very low level was extended in two stages during the year, to at least mid-2015. Following its December meeting, the FOMC modified its forward guidance strategy by linking the period in which the key rate would remain at the very low level prevailing for the past four years to the movement in the unemployment rate and inflation. It also applied forward guidance to its securities purchase policy by undertaking to buy agency mortgage-backed securities and long-term government securities for as long as there is no substantial improvement in the labour market situation.

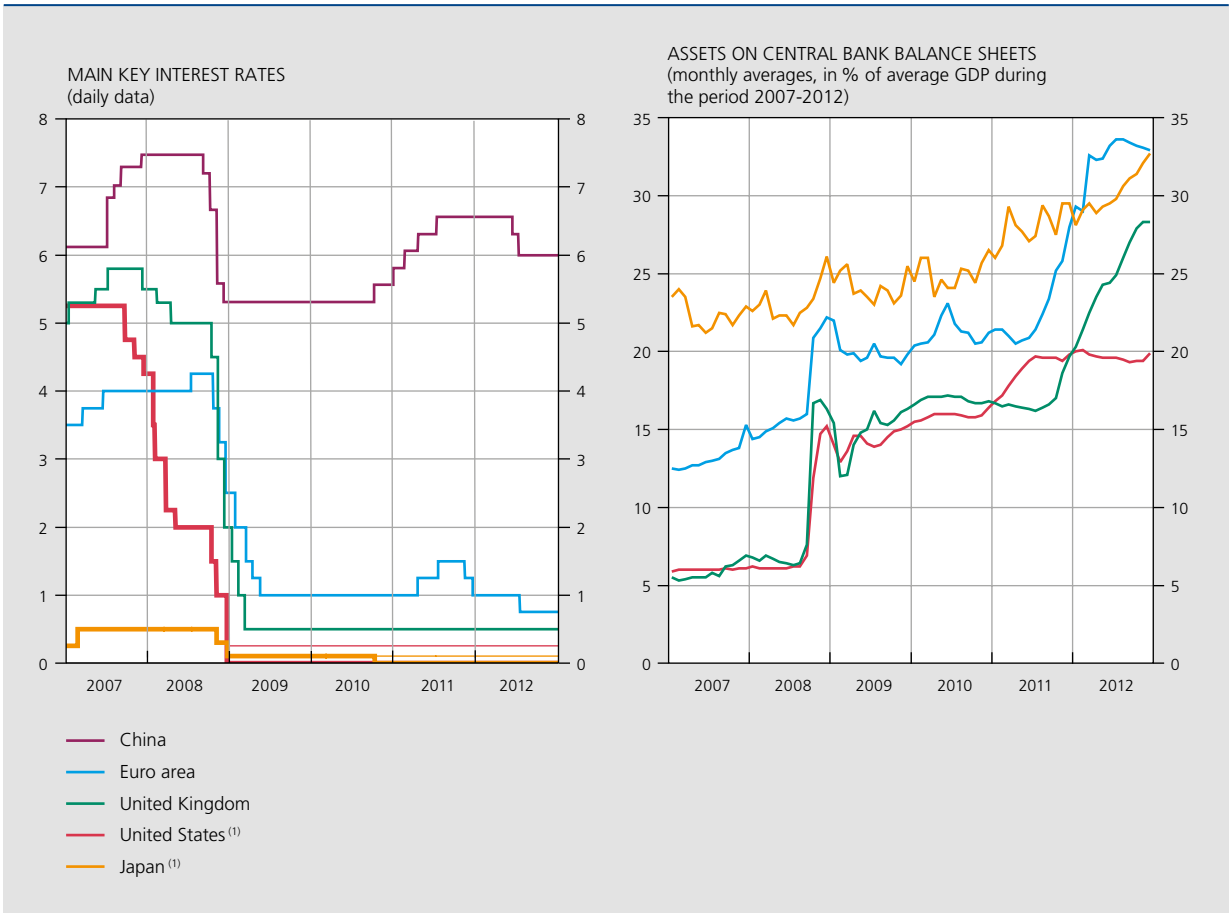
Most central banks in the emerging countries also eased their policy or refrained from tightening it. In China, as inflationary pressures ebbed away, the central bank cut the rate on one-year loans in two stages to 6 %, and the one-year deposit rate to 3 %. It also adjusted its liquidity policy by lowering the minimum lending rate and the reserve requirement ratio. In a context of slackening activity and with a generally narrow fiscal scope, a number of central banks in central and eastern Europe also eased their monetary policy.

Just as in 2011, the fiscal policy of the advanced countries was geared mainly to the continuing consolidation of public finances. There were further reductions in budget deficits in 2012, with the notable exception of Japan, where the general government accounts suffered for the second consecutive year from the reconstruction efforts following the March 2011 tsunami, combined with more general recovery measures. In the United States, the budget deficit narrowed further while remaining at a relatively high level. Future developments in American public finances and their potential impact on the economic situation were

monitored very closely throughout the year, pending a solution to the fiscal cliff; that solution, which was partly provisional, was not found until the end of the year. In addition, the US authorities still need to approve a credible plan ensuring the medium-term sustainability of the country's public finances. In the United Kingdom, the government adhered to the medium-term fiscal consolidation plan presented in 2010, despite the downturn in activity.

In the emerging countries, where the situation of public finances is generally more favourable, the fiscal consolidation which started in 2010 was interrupted by the unexpected weakening of growth. However, the situation varies among the main countries. In China, where the public deficit remained stable overall, rising from 1.2 % of GDP in 2011 to 1.3 % in 2012, the government announced funding for new investment in infrastructure projects.

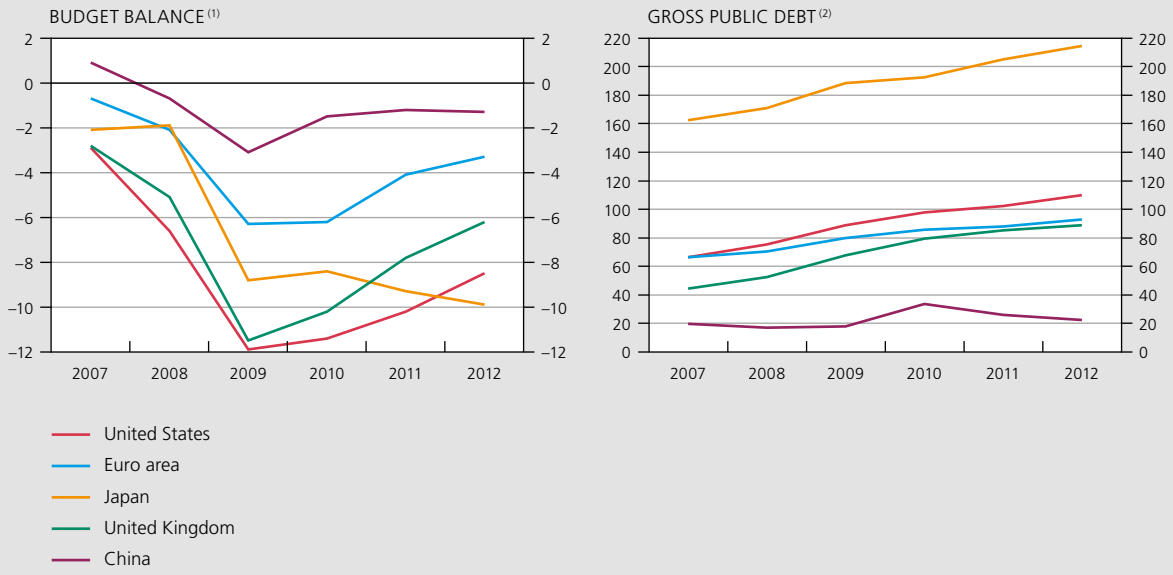
CHART 17 KEY INTEREST RATES AND ASSETS ON THE BALANCE SHEETS OF THE MAIN CENTRAL BANKS



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.

CHART 18 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.