1. Global economy and euro area

With the easing of the sovereign debt crisis in the euro area, fluctuating expectations regarding the American monetary policy stance were the main factor influencing global financial market developments in 2013. The economic recovery which emerged in the advanced economies remained subdued, notably on account of the fiscal consolidation in the United States. Activity growth ran out of steam in the emerging economies, where it was affected both by the drying up of capital inflows and by cyclical factors, but also by a downward trend in their potential growth. In the euro area, GDP declined by 0.4% in 2013, given its low level at the start of the year. The pace of the revival later during the year varied from one Member State to another, with the recession easing in the adjustment programme countries. The latter continued to correct the macroeconomic, fiscal and financial imbalances revealed by the financial crisis. The labour market situation deteriorated further in the euro area, and inflation slowed significantly, dropping to an annual average of 1.4%. Against that backdrop, the ECB continued to offer the banks all the liquidity they needed in exchange for adequate collateral, in order to compensate for the enduring inequalities between countries regarding access to market finance for credit institutions. Faced with persistently sluggish economic activity, weak underlying pressure on prices and subdued monetary dynamics, the Governing Council decided to make two cuts in the interest rate on the main refinancing operations, in May and November respectively, reducing that rate to 0.25%. It also introduced a forward guidance policy, announcing in July that it expected the ECB's key rates to remain low for an extended period.

1.1 Global economy

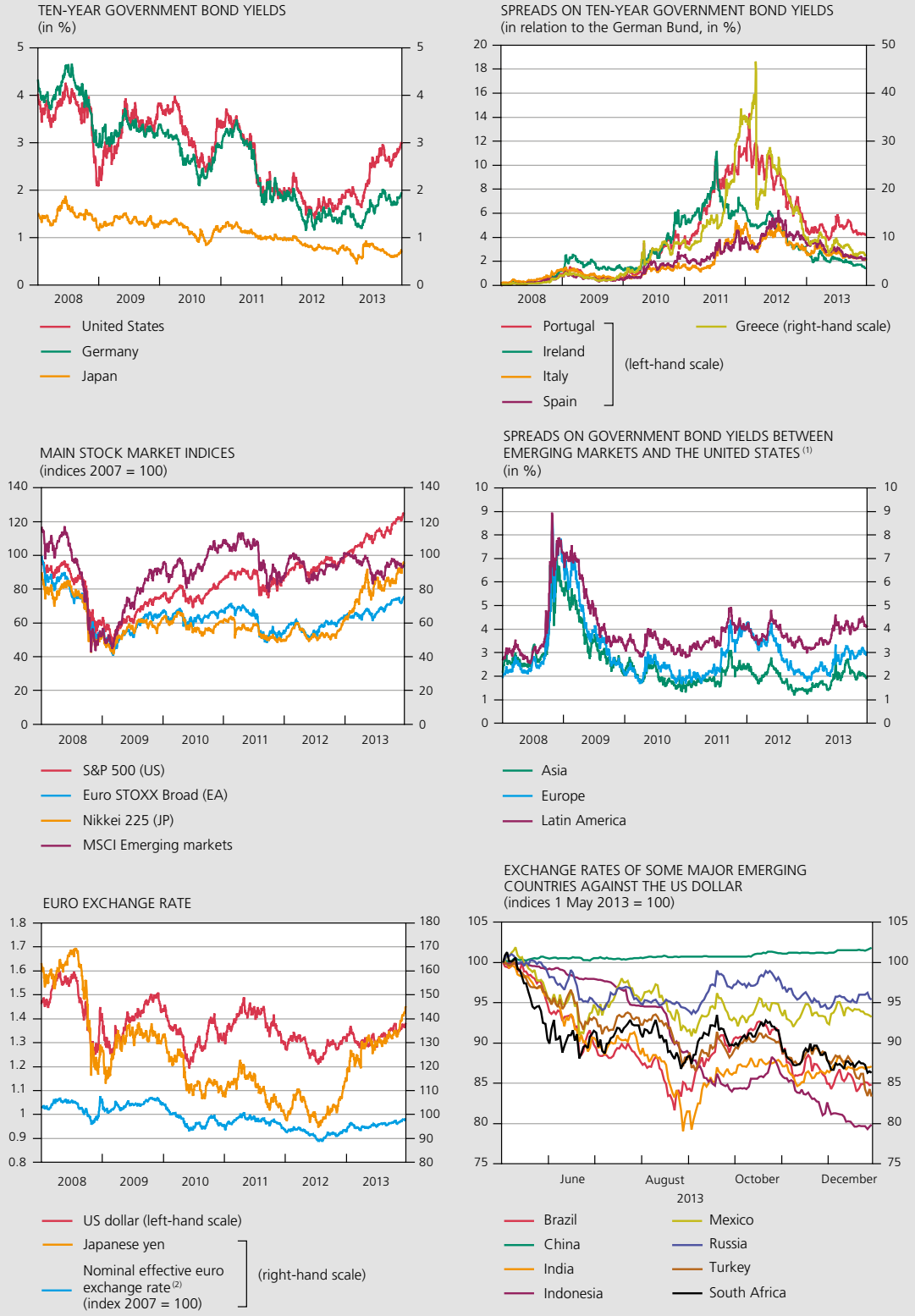
Financial markets: easing of the euro area crisis and new volatility associated with the improvement in the economic outlook

After the sovereign debt crisis in the euro area had unleashed severe financial tensions, which were fuelled by fears of possible euro reversibility if a Member State were to leave the euro area, and which reached their peak in the summer of 2012, the crisis continued to ease during the year under review. A renewed appetite for risk and attenuation of the systemic uncertainties bolstered the market in the advanced economies, maintaining the trend which had become increasingly clear in the second half of 2012. At the time, calm was gradually restored by the ECB's announcement and introduction of outright monetary transactions (OMTs), and by other decisions adopted at European level, such as the single supervisory mechanism (SSM) for credit institutions, forming the first practical step towards the banking union.

In a context of renewed confidence in finding a solution to the sovereign debt crisis in the euro area, the perception of the outlook for economic activity in the main regions and the resulting expectations regarding the economic policy stance increasingly dominated financial market developments. Fluctuating expectations concerning the American monetary policy stance had a particularly strong influence, not only in the United States but also in the euro area. Conversely, financial market developments in the emerging economies deviated significantly from those in the advanced economies, as any adjustments to injections of liquidity by the Federal Reserve might cause capital flows into the emerging economies to dry up. This divergence was evident against the backdrop of a general slackening of economic growth in those countries, while activity gradually picked up in the advanced economies, albeit to varying degrees.

CHART 1 INTERNATIONAL FINANCIAL MARKET DEVELOPMENTS

(daily data)



Source : Thomson Reuters Datastream.

(1) Index EMBI+, spreads for loans of similar maturity, in US dollars.

(2) Weighted average euro exchange rate against the currencies of the euro area's 20 main trading partners.

In the advanced economies, the vigour of activity and demand proved slightly disappointing at the beginning of 2013, and that depressed financial market sentiment. However, there was an improvement from May onwards as the published indicators confirmed the strengthening of activity in the United States. The yield on long-term US government bonds rose sharply, partly as a result of the publication of favourable figures, but mainly because of the debate on phasing out the Federal Reserve's securities purchase programme (tapering). In June, at the end of the Federal Open Market Committee (FOMC) meeting, the Chairman of the Federal Reserve confirmed that the pace of the securities purchases might be moderated if the economy continued to recover as expected. This signal, which implied that the provision of abundant and cheap liquidity by the Federal Reserve might come to an end, took market operators by surprise. Moreover, they began to allow for an earlier, steeper rise in the key interest rate. Thus, the yield on ten-year government bonds in the United States practically doubled between May and August, reaching around 3 % at the beginning of September, its highest rate for two years.

The effects of the announcement of a possible tapering of securities purchases by the Federal Reserve were not confined to the United States. Indeed, the yield on long-term government bonds with an AAA rating also started rising in the euro area, despite the ECB Governing Council's decision to cut its key interest rate by 25 basis points at the beginning of May. This rise only came to a brief halt in July when the ECB Governing Council decided to give forward guidance on its key interest rates. Overall, the increase in yields was less marked in the euro area, so that the negative differential in relation to yields in the United States widened considerably.

The increase in yields on long-term government bonds in the United States and in the euro area came to an end, at least temporarily, in mid-September, and those yields even dipped somewhat when the Federal Reserve's decision to leave the volume of its securities purchases unchanged brought a considerable change in expectations of a steady attenuation of the accommodative monetary policy stance in the United States. However, in November, interest rates resumed their upward trend in the United States, as better-than-expected employment figures revived expectations of an impending reduction in quantitative easing. Subsequently, the American central bank decided in December to make the first cut in the amount of securities purchases from January 2014, while further cuts would follow during the year. Overall, the yield on ten-year US government bonds came to around 3 % at the end of December compared to 1.8 % at the beginning of the year under review. In the euro area, the yield on top-rated long-term bonds stabilised in November, following the ECB Governing Council's decision to cut the key interest rate by 25 basis points, then began rising again in December.

In Japan, as in the United States and the euro area, the yield on long-term government bonds initially dropped to a very low level during the first months of 2013, with the prospect of a renewed easing of monetary policy. In April, it displayed some volatility when the Bank of Japan made fundamental changes to its monetary policy framework, Subsequently, the yield on long-term government bonds rose steeply in May following an upward revision in inflation expectations, before starting to decline in July. Following a modest rebound in December, it came to 0.7 % at the end of the year, roughly matching its level at the beginning of 2013.

Against the backdrop of waning uncertainty and a growing appetite for risk, the stock market indices of the advanced economies continued to climb strongly in 2013. That movement was more pronounced in the United States – where the indices reached record levels – than in the euro area; the volatility caused in the spring by the question mark over the US monetary policy stance had little impact on it. On the contrary, in the second half of the year, stock market sentiment was boosted by the forward guidance issued by the ECB Governing Council in July, and by the decision which the Federal Reserve took in September to leave the volume of its securities purchases unchanged. Since it confirmed the favourable market view of the American economic recovery, and since the American central bank had simultaneously indicated that the downward pressure on long-term interest rates and the accommodative financial conditions would be maintained for an extended period, the December announcement of the forthcoming reduction in securities purchases did not reverse the rise in stock market prices. In Japan, the stock market expansion was even more vigorous than in the United States and Europe, primarily during the first five months of the year. Prices there were initially supported by the announcement of new monetary policy measures, and later by favourable market expectations regarding the growth outlook, measures to combat deflation, and the rapid depreciation of the yen, with the corollary of the upward revision of export sector profit forecasts. In all, Japanese stock markets gained around 60 % during 2013.

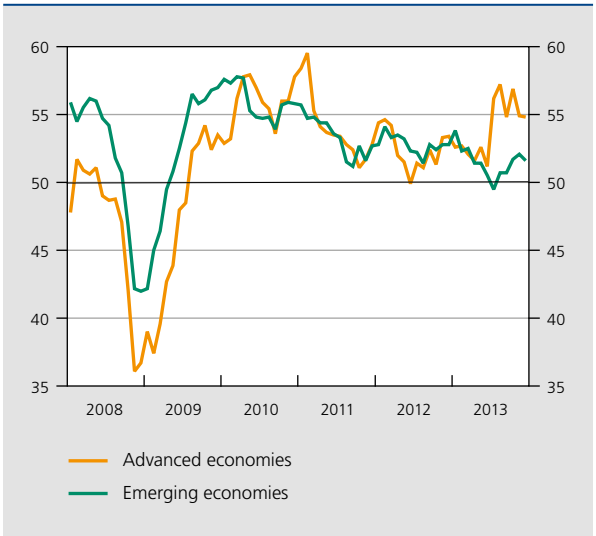
The favourable financial market situation in the advanced economies in 2013 did not prevent occasional nervousness, often due to country-specific factors. In the United States, markets reacted to the waves of uncertainty triggered by the deadlock resulting from the

budgetary procedures. In the euro area, spreads between government bond yields in countries where the crisis had revealed vulnerabilities, on the one hand, and Germany on the other, continued to narrow during the year under review. However, the negotiations concerning the financial assistance programme for Cyprus, and the announcement of the agreement concluded in April, temporarily halted the reduction in these differentials in view of fears over the potential implications for other countries of this agreement or of similar deals. The Federal Reserve's announcement of a possible slackening of the pace of its securities purchases likewise prompted a temporary widening of the spreads owing to the heightened volatility on financial markets. Subsequently, spreads in relation to the German Bund nevertheless continued to diminish overall. Conversely, yields on government securities in Portugal reached a new peak in July, owing to the political crisis; it then took some time before the Portuguese yield differential resumed the downward trend. Overall, spillover effects within the euro area were fairly modest and short-lived during the year under review.

With improving investor sentiment in relation to the euro area in 2013, the euro continued the appreciation which had begun in mid-2012. It thus partly made up for the depreciation which had occurred during the sovereign debt crisis. Its external value fluctuated according to changing market expectations regarding the outlook for the euro area compared to other major advanced economies, and changes in interest rate expectations and uncertainty over economic policy outside the euro area. Overall, the nominal effective exchange rate of the euro at the end of the year was around 5 % above its level a year earlier. The euro appreciated by 4.5 % against the US dollar and 27 % against the Japanese yen, the latter rise being linked to the depreciation of the Japanese currency which had begun in mid-2012.

CHART 2 BUSINESS CONFIDENCE

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



Source : Thomson Reuters Datastream.

Conversely, financial markets in the emerging countries displayed a very different picture from those in the advanced economies. Thus, stock markets there began falling from the beginning of the year under review, while growth already appeared to be slowing. The announcement of a possible adjustment to the injection of liquidity in the United States exerted severe pressure on emerging market assets when investors scaled down their positions, thus triggering a capital flight. Stock markets therefore plummeted, and spreads between yields on the government securities of emerging countries and those of the US Treasury widened considerably in mid-2013, although they were still only half as large as during the 2008 financial crisis. At the same time, the exchange rates of the currencies of the main emerging countries were down sharply against the US dollar, with the exception of the Chinese renminbi, which maintained its gradual rise. Overall, it was the currencies of the countries with the weakest fundamentals and a substantial need for external funding that lost the most ground, such as Brazil, India, Indonesia, Turkey and South Africa. From September, there were signs of some recovery on the asset markets of emerging countries, and their exchange rates picked up with the publication of more encouraging figures for the Chinese economy and ebbing uncertainty over a possible reduction in liquidity injections by the Federal Reserve.

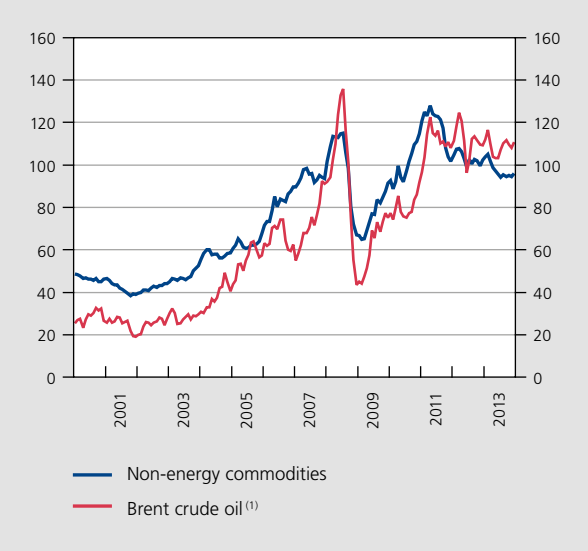
Commodities and international trade affected by the slowdown in the emerging economies

Since the emerging economies have been key players in demand for commodities and world trade over recent decades, their growth slowdown was bound to have an impact for both. According to the HWWI index, commodity prices expressed in dollars declined by an average of 2 % in 2013, thus maintaining the downward trend which had started in the spring of 2011.

The fall in commodity prices was fairly widespread, but varied in scale according to the commodity in question. On average, the largest price falls concerned non-energy commodities, and more especially food commodities, which were down by 10.9 %. This decline in prices began in the autumn of 2012 and persisted throughout

CHART 3 COMMODITY PRICES

(monthly data ; US dollars ; indices 2010 = 100, unless otherwise stated)



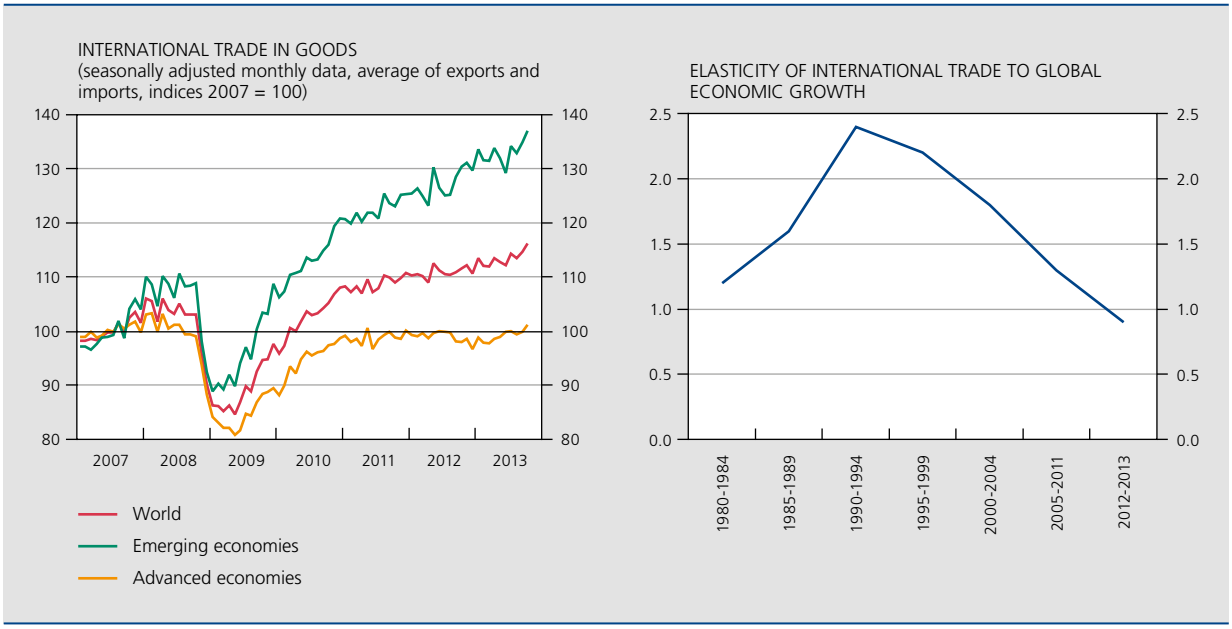
Sources : HWWI, Thomson Reuters Datastream.
(1) Price per barrel.

the year under review, the main factor being better harvests. Industrial commodity prices, which are more sensitive to the business cycle, were down by 2.7 % on average against 2012, reflecting the movement in economic activity and prospects, primarily in the emerging countries.

Prices of energy commodities fell by an average of 1.4 %, with prices of Brent crude down by 2.7 %. After being bolstered temporarily in February by adverse weather conditions in the northern hemisphere, prices rose significantly from June onwards owing to the heightened geopolitical uncertainty over the situation in North Africa and the Middle East. They thus reached $ 116 per barrel at the beginning of September. The agreement on the destruction of Syria's chemical weapons under United Nations surveillance and the rapprochement between Iran and the United States then eased the tensions somewhat, so that the price subsided to around $ 111. As in previous years, other key energy commodities exhibited a varying pattern. This uncoupling is due partly to the increase in the production of unconventional oil and natural gas in the United States. This factor weakened the historical links between prices of various types of energy commodities, especially as price-setting of natural gas was uncoupled from that of oil in a number of regions.

Growth of international trade in goods and services was still modest in 2013, at 2.7 %, the same rate as in 2012. The upsurge in international trade in goods at the end of 2012 continued in the first quarter, driven by the emerging countries. During the next quarter, that growth slowed sharply following the temporary dip in trade in

CHART 4 INTERNATIONAL TRADE IN GOODS



Sources : IMF, CPB.

those countries. At the same time, the international trade of the advanced countries gathered momentum, regaining from the summer a level comparable to that prevailing before the outbreak of the financial crisis. In the third quarter, that effect was combined with a revival in international trade in the emerging economies. Consequently, in October – despite the slowdown apparent in general in 2013 – the trade volume of those countries was about 40% above its pre-crisis level.

The muted dynamism of international trade in goods in recent years in any case reflects the sluggishness of economic growth. Furthermore since mid-2011, the elasticity of international trade – i.e. the growth of international trade in relation to activity growth – has remained fairly weak by historical standards. In fact, that elasticity has been barely 1, whereas in the past it was twice that figure, on average. This decline could be due in particular to the limited demand for consumer durables and investment goods in the advanced countries, since these expenditure components have a relatively high import content. More difficult access to trade finance and the strengthening of trade barriers could also have played a role, albeit a minor one. Apart from these cyclical factors, it is possible that other, more structural determinants are also at work here, such as a slowing of the rate of expansion of economic activity and trade in the emerging economies. Thus, the average annual growth rate of foreign trade in those countries dropped from 12 % during the five years preceding the global recession to 4.5 % in 2012-2013.

Modest growth of global activity and rebalancing between advanced and emerging economies

Worldwide, GDP grew by 3 % in 2013, which was slightly less than in the previous year and considerably below the 2011 figure. The improvement in the economic climate was barely reflected in the average year-on-year growth in the advanced economies, either because the improvement came too late or was too hesitant, or because it was cancelled out by the effects of fiscal consolidation or structural adjustments. In particular, contrary to what was seen in the other leading economies, activity in the euro area contracted

TABLE 1 GDP OF THE MAIN ECONOMIES [1]

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

				p.m. Contribution to global GDP growth [1]	p.m. Share of global GDP [1]	
	2011	2012	2013	2013	2007	2012
Advanced countries	1.7	1.4	1.3	0.7	56.1	50.4
of which:						
United States	1.8	2.8	1.9	0.4	21.5	19.5
Japan	–0.4	1.4	1.7	0.1	6.3	5.5
Euro area	1.6	–0.7	–0.4	–0.1	15.7	13.5
United Kingdom	1.1	0.3	1.3	0.0	3.3	2.8
Emerging countries	6.2	4.9	4.7	2.3	43.9	49.6
of which:						
Central and Eastern Europe	5.4	1.4	2.5	0.1	3.5	3.4
Emerging Asia	7.8	6.4	6.5	1.6	19.7	25.0
of which:						
China	9.3	7.7	7.7	1.1	10.8	14.7
Latin America and Caribbean	4.6	3.0	2.6	0.2	8.4	8.7
World	3.9	3.1	3.0	3.0	100.0	100.0
World excluding the euro area	4.3	3.7	3.5	3.1	84.3	86.5
p.m. World trade [2]	6.1	2.7	2.7			

Sources: EC, IMF, OECD.
(1) For regions outside the euro area, GDP is calculated according to the IMF definitions and on the basis of purchasing power parities.
(2) Average of exports and imports of goods and services.

again on average in 2013, although the decline was rather less steep.

United States

As in the previous year, the US economy continued to show signs of robustness in 2013, supported by a still very accommodative monetary policy, favourable financing conditions and steady progress in the correction of a number of structural imbalances which had previously hampered growth. However, that dynamism was considerably impeded by the fiscal policy and by the uncertainty which it caused.

Thus, the average annual GDP growth dropped to 1.9 %, which is well below the figure of 2.8 % seen in 2012. That sharp deceleration is due largely to the low starting point, attributable to stagnating activity at the end of 2012, while quarter-on-quarter growth gathered pace during the year to reach 1 % in the third quarter of 2013. The expansion of activity was driven by the traditional engines of final private domestic demand, and in particular by household consumption expenditure and investment in housing. Conversely, the contribution of government spending was negative, at 0.4 percentage point.

Households' consumption expenditure was buttressed by the further rise in their net wealth, derived mainly from the surge in stock markets and house prices during the past year. The improvement in the situation and outlook on the labour market likewise helped to strengthen private consumption, as employment continued to rise and unemployment declined to 6.7 % in December, though that is still considerably above the pre-crisis level. It is possible that the fall in unemployment overstates the improvement in the labour market, notably because the participation rate has fallen, partly as a result of cyclical factors. Despite the progress on the labour market, the increase in household disposable income remained very modest, as the rise in net labour incomes was largely restrained by the increase in fiscal pressure at the beginning of the year.

Investment in housing was the second major factor driving growth during the year under review. It was supported amongst others by the persistently low interest rates, despite the rise which had begun in the spring. The prospect of a continuing rise in residential property prices and the increase in the number of households also stimulated house building. Business investment likewise continued to support economic expansion, but to a much lesser extent than in 2012. Following the strong growth in the two preceding years, fuelled partly by a backlog of demand for commercial premises and equipment goods following the great recession, business investment growth slowed sharply, one contributory factor being uncertainty over the impact of government policy on the economic outlook.

CHART 5 OVERVIEW OF THE AMERICAN HOUSING AND LABOUR MARKETS

(indices 2000 = 100, unless otherwise stated)

Sources : Standard & Poor's, Thomson Reuters Datastream.
(1) Case-Shiller index of 20 metropolitan regions.

During the year under review, public spending was the main brake on economic growth. Apart from the direct effect of public consumption or public investment expenditure on activity, the short-term negative impact of fiscal policy was reinforced by the aforementioned rise in fiscal pressure, but also by the adverse repercussions on business and household confidence resulting from the uncertainty surrounding that policy for much of 2013. At the beginning of the year, the agreement concluded between the Obama administration and Congress, the American Tax Relief Act, did permit a significant reduction in the fiscal tightening which – by law – was to take effect automatically at the beginning of 2013 (the "fiscal cliff"). In addition, the decision to cut a number of public spending items was delayed until the beginning of March. However, in the end, it was not possible to come to any arrangement on that date, so this expenditure was subject to severe, systematic and across-the-board cuts until the 2021 fiscal year ("sequester"). After the summer, fiscal policy again took centre stage. At the end of September, the American Congress was unable to reach a consensus on the renewal of the federal government's "spending authority", enabling it to make certain discretionary expenditure. As a result, some non-essential federal services had to close for the first time since 1996 ("government shutdown"). In addition, it was necessary to raise the ceiling on the federal debt by 17 October. In the end, agreement was reached *in extremis*, so that this limit was suspended until 7 February 2014. At the same time, the federal government's spending authority was extended until 15 January 2014. That decision ended the shutdown of public services. Finally, in mid-December, an agreement was concluded on the budget for 2014 and 2015. The tightening of fiscal policy and the improvement in the economic climate brought a significant reduction in the public deficit during the year under review, namely from 9.3 to 6.5 % of GDP. However, the public debt continued to rise, reaching 104.1 % of GDP.

In view of the particularly negative impact of fiscal policy on growth, the Federal Reserve continued to pursue a very accommodative monetary policy throughout the year under review. Thus, its key interest rate remained within the 0 to 0.25 % range prevailing since the end of 2008. It also confirmed its intention to maintain the rate at this exceptionally low level, at least so long as unemployment remained above 6.5 % and provided inflation expectations remained firmly anchored. At the end of its December meeting, the Federal Reserve made it clear that the key rate would probably be held at its then prevailing low level for some time after unemployment had fallen below 6.5 %. The main change in monetary policy during the year under review was that the focus of the forward guidance shifted to the securities purchase programme, for which the monthly amount had been set at $ 85 billion since the end of 2012. During May, Fed Chairman Ben Bernanke intimated at a question-and-answer session that the monthly amount of bond purchases might be revised downwards at one of the forthcoming FOMC meetings if the labour market situation continued to improve in a context of stable inflation. That message was particularly important for the financial markets, reminding them that the Federal Reserve could terminate its particularly accommodative policy. At the end of the June FOMC meeting, Mr Bernanke gave more specific indications of the possible phasing out of the securities purchase programme. According to the suggested scenario, those purchases could be scaled down from the end of 2013, before being suspended in mid-2014, though this path could be adjusted up or down according to economic and financial circumstances. After having left the amount of the purchases unchanged for three consecutive meetings, the American central bank decided at the December FOMC meeting to reduce it to $ 75 billion per month from January 2014, in view of the improvement in the labour market situation. It also announced that the amount would be further reduced during the year.

United Kingdom

In 2013, with GDP growth of 1.3 %, the United Kingdom saw a stronger-than-expected recovery which is increasingly becoming self-sustaining. Nevertheless, in the third quarter, GDP was still 2 % below the level prevailing before the start of the great recession.

The expansion of economic activity gradually gathered momentum during the year, and became more broadly based. Supported by the marked improvement in the employment situation since 2012, by the growth of household wealth – driven by the rise in share prices and property prices – and by the easing of credit conditions, household consumption expenditure was the main engine of GDP growth as it had been in 2012, despite the limited rise in real disposable income. Growth was also underpinned by a revival in investment in housing triggered by government decisions. Key factors here were the Funding for Lending programme introduced in 2012 on the initiative of the Bank of England and the Treasury, and the Help to Buy programme launched by the government. As fears emerged of potential rapid overheating of the property market, the Bank of England and the Treasury decided to terminate the financing of mortgage loans via the Funding for Lending programme from February 2014. Finally, the strengthening of GDP was also stimulated by a positive contribution from

stock-building and, in contrast to 2012, from net exports of goods and services.

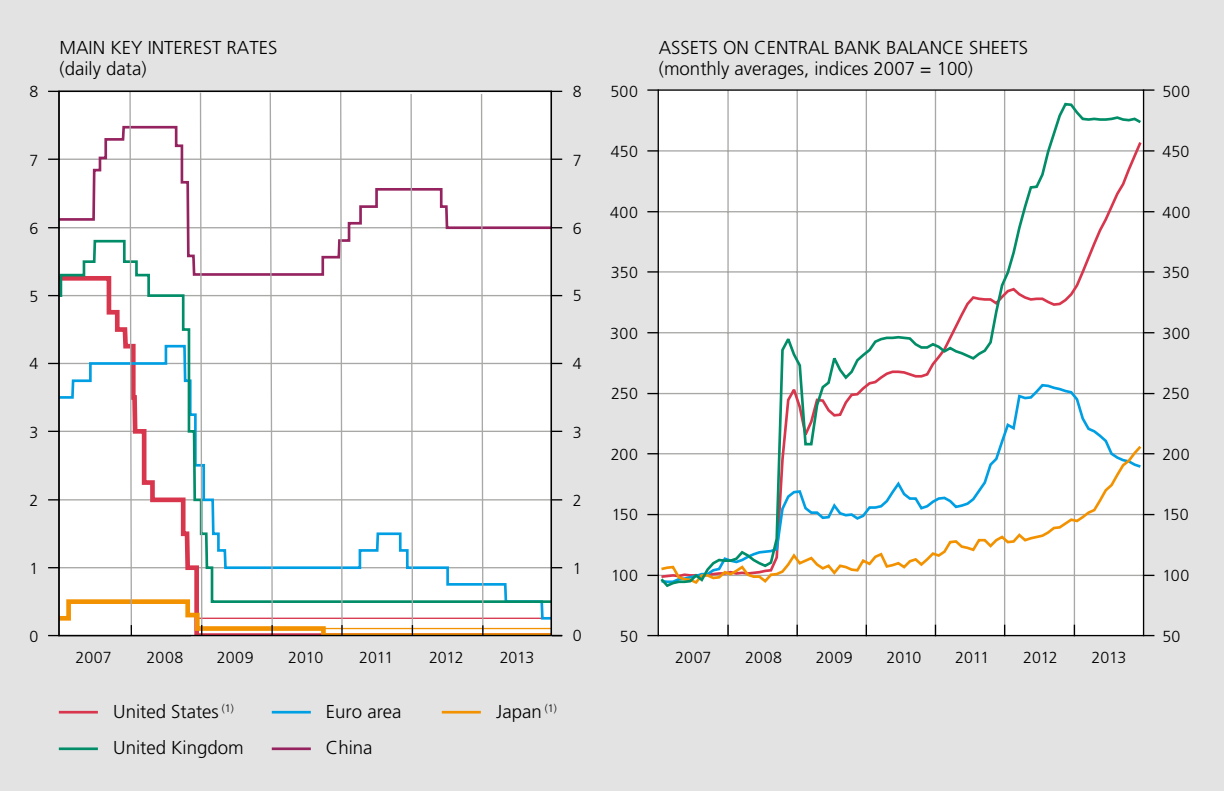
In August, after the government had adjusted its mandate accordingly in the spring, the Bank of England further eased its already very accommodative policy, characterised by a particularly low key interest rate of 0.5 % and a large portfolio of securities, by introducing conditional forward guidance. As a result, there would be no rise in the key interest rate and no reduction in the volume of the portfolio of securities purchased on the market so long as the unemployment rate remains above 7 % and provided a range of conditions relating to price stability and financial stability are met. By this means, the Bank of England indicated that it would not tighten its monetary policy unless the economic recovery had taken hold sufficiently to become self-sustaining. In regard to fiscal policy, the government maintained the medium-term fiscal consolidation plan devised in 2010. However, the public sector borrowing requirement increased from 6.1 to 6.4 % of GDP, as the transfer of the Royal Mail pension fund to the government sector in 2012 had temporarily flattered the budget balance in that year. The public debt continued to grow, reaching 94.3 % of GDP.

Japan

After the volatility of recent years, 2013 brought a recovery due to government measures so that the Japanese economy grew by 1.7 %. At the end of the third quarter, however, GDP had still not exceeded the level attained before the great recession.

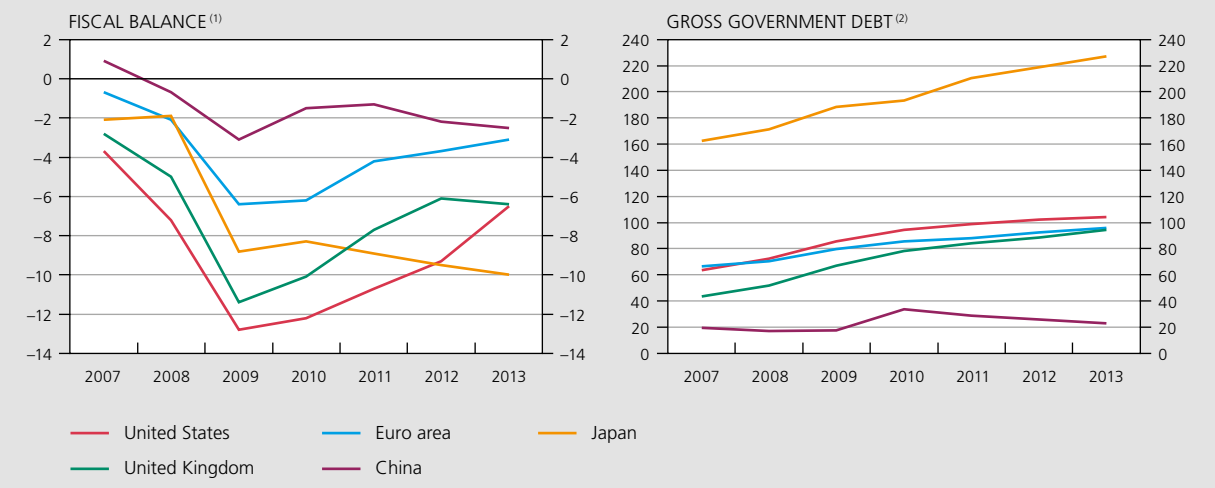
The recovery was supported by domestic demand, particularly private consumption, which benefited from the surge in share prices and a labour market revival. Public investment was also a significant engine of growth, driven by the government's new expansionary policy. Whereas quarterly GDP growth had been highly volatile in the two preceding years, frequently dipping into negative territory, the first two quarters of the year brought vigorous growth averaging 1 %. However, that dropped to 0.3 % in the third quarter, owing to the extremely negative contribution of net exports. Stimulated partly by the depreciation of the yen plus the strengthening of activity and the announced monetary policy stance, average annual inflation became positive again for the first time since 2008. In November 2013, overall inflation stood at 1.5 %, with underlying inflation at 1.2 %.

CHART 6 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.

CHART 7 FISCAL BALANCE AND GENERAL GOVERNMENT DEBT IN THE MAIN ECONOMIES
(in % of GDP)



Sources : EC, IMF, OECD.
(1) For the euro area and the United Kingdom, according to the rules laid down for the excessive deficit procedure (EDP), including net interest gains on certain financial transactions such as swaps.
(2) For the euro area and the United Kingdom, this is the consolidated gross debt, i.e. after deduction of the debts with the counterpart of assets within the general government sector.

The expansion of the Japanese economy was fuelled mainly by a set of measures which the government, headed by Prime Minister Abe, announced from the beginning of the year. These measures, known as "Abenomics", aimed at ending a long period of deflation and providing permanent support for economic growth; they are based on three pillars. The first is a policy of short-term fiscal stimulus. From the start of the year under review, a recovery package equivalent to 2 % of GDP was announced for the period 2013-2014, supplemented by further measures amounting to 1.1 % of GDP in September, to offset the April 2014 increase in VAT from 5 to 8 %. During the year under review, the government's budget deficit continued to rise from 9.5 to 10 % of GDP, notably on account of these fiscal recovery measures. The public debt increased further, reaching 227.2 % of GDP. In the medium term, the Japanese government has confirmed that it will pursue the aim of reducing the primary deficit to half its 2010 level by the 2015 fiscal year and producing a surplus by 2020. However, additional measures will probably be needed in the coming years to guarantee the medium-term sustainability of public finances. The second pillar comprises a very accommodative monetary policy. In April, the Bank of Japan decided on a drastic expansion of its liquidity provision in order to combat deflation, hoping to achieve 2 % inflation within two years by both quantitative and qualitative monetary easing. For that purpose, it will double the monetary base over that period, essentially by purchasing public sector bonds. The third pillar consists of structural reforms aimed at boosting economic growth in the medium term. A package of measures had already been announced in the summer, but additional provisions will be needed to improve the operation of the markets and provide permanent reinforcement for the economy's growth potential.

Emerging economies

The slower growth of global GDP in 2013 is largely attributable to the fairly widespread slowdown in the emerging economies. Since 2012, their growth has weakened following the phasing out of the stimulus measures and as a result of sluggish external demand. The latter initially reflected the weak demand for imports in the advanced economies, and especially the euro area, which the debt crisis had plunged back into recession. More recently, however, it was mainly the deceleration of growth in a number of large emerging economies that has produced negative spillover effects. Moreover, financing conditions became tighter in the emerging economies after the American central bank had announced its intention to limit its purchases of securities. As already mentioned, that news led to higher financing costs, exchange rate depreciation and capital outflows, primarily in the emerging economies suffering from weak fundamentals – such

as serious current account deficits, high inflation or heavy dependence on inward portfolio investment. Apart from these largely cyclical factors, many emerging economies also saw their potential growth decline (see Box 1).

Although **emerging Asia** was still the region with the highest growth rates, an average GDP growth rate of 6.5 % in 2013 nevertheless represents a sharp reduction compared to the pre-crisis period. Growth has suffered mainly from the increased volatility in capital flows and anaemic foreign demand. More particularly, the less dynamic demand from China has produced negative spillover effects in the rest of Asia owing to the increased fragmentation of regional production chains and the intensification of intra-regional trade relations. At 2.6 %, growth in **Latin America and the Caribbean** slowed further, owing largely to structural bottlenecks and a decline in prices of commodities for which some countries in that region are major exporters. Likewise, the decline in growth which had begun in 2012 in the oil-exporting countries persisted, mainly as a result of the fall in oil production prompted by hesitant foreign demand and domestic supply disruptions. In contrast, the **Central and East European countries** saw their growth rise to 2.5 % in 2013, thanks to relaxation of their monetary policy, improved access to external financing and the slow economic recovery in some major euro area trading partners.

In **China**, GDP growth remained stable compared to 2012, at 7.7 %. In the first half of 2013, economic activity was less dynamic, partly owing to the temporary weakness of investment at the start of the year. However, the subsequent investment rebound was not enough to offset the decline in net exports and moderate consumption. In the second half of the year, growth picked up slightly, notably as a result of the launch of a mini stimulus programme in July, and consumption also strengthened a little. The property market enjoyed significant price rises, concentrated mainly in the large cities.

In order to support growth, the Chinese central bank pursued an accommodative monetary policy in the first half of 2013. Inflation remained well below the 3.5 % target. The very strong credit expansion and quality of lending nevertheless continued to give cause for concern, with finance increasingly coming from the shadow banking sector. That situation prompted the Chinese central bank to send a warning signal to the markets by engineering a liquidity squeeze in June. Consequently, interbank interest rates briefly spiked above 10% before reverting to their previous levels of around 4 %. Since then, the growth of credit has also weakened. In addition, the People's Bank of China has made progress towards liberalising market interest rates, since in July it abolished the lower limit on lending rates. However, it maintained the upper limit on deposit rates.

Thanks to restrained public spending and an increase in tax revenues following the upturn in economic activity during the year, the central government budget deficit, at 2.5 % of GDP, remained close to the 2012 figure. The public debt contracted by around 3 percentage points compared to 2012, dropping to 22.9 % of GDP.

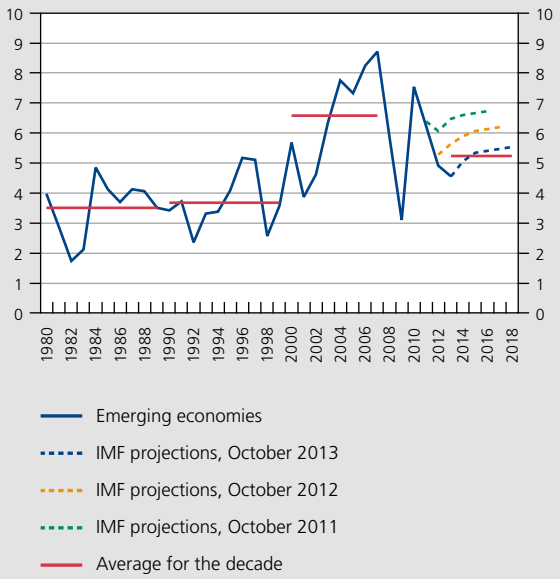
Box 1 – Growth slowdown in the emerging economies

The past decade featured extremely vigorous growth in the emerging economies, but the outbreak of the crisis brought that to an abrupt halt. Nevertheless, partly thanks to stimulus measures, most of those economies soon returned to their previous development path : their average real GDP growth increased from 3 % in 2009 to 7.5 % in 2010. However, in 2012 that growth dropped sharply, falling to 4.9 %, then to 4.7 % in 2013. For the coming years, most projections also predict relatively moderate growth in many emerging economies. For instance, for the period 2013-2018, the IMF expects an average growth rate of only 5.2 %, which is weaker than the 6.6 % recorded between 2000 and 2007. This slowdown is largely due to a downward revision of the growth outlook, since in October 2011 the IMF was still predicting 6.5 % growth in the medium term. The period of spectacular growth in the emerging economies therefore appears to be at an end.

While such slowdowns are hardly exceptional, the present one is remarkable in being simultaneous (according to the IMF, it affects 80 % of the emerging economies), more severe than expected, and potentially harmful for the fragile economic recovery in the advanced economies. Since Brazil, Russia, India, China and South Africa (the BRICS countries) account for a large part of the overall decline in growth in the emerging economies, this box focuses

RECENT GROWTH SLOWDOWN IN THE EMERGING ECONOMIES

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



Source : IMF.

more particularly on the underlying factors in those countries. It then examines the potential effect of such a slowdown on the advanced economies.

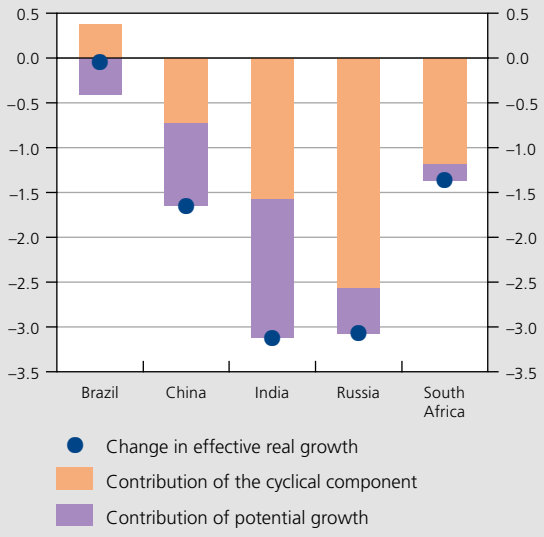
The importance of cyclical and structural factors

On the one hand, the recent weakening of GDP growth in the BRICS countries reflects a correction compared to above-trend growth in 2010 and 2011. Common cyclical factors, such as the implementation of post-crisis stimulus measures, rising commodity prices, a rebound in foreign demand, low interest rates due to the exceptionally accommodative monetary policy in the advanced economies, and an upsurge in credit supply, contributed to a strong recovery in the BRICS countries. From 2011-2012, however, the positive effects of some of those factors diminished: the impact of the stimulus measures weakened, commodity prices began to fall and international trade lost momentum. Thus, Brazil's growth dropped from its cyclical peak of 7.5 % in 2010 to 1 % in 2012, while growth dipped from 10.4 to 7.7 % in China, from 10.5 to 3.2 % in India, from 4.5 to 3.4 % in Russia and from 3.1 to 2.5 % in South Africa.

On the other hand, the current weakening of growth is also due to a transition towards lower potential growth rates, i.e. the estimated pace at which an economy is considered capable of developing without causing imbalances. While, according to the IMF, the decline in potential growth is likely to be limited in South Africa, Brazil and Russia (0.25, 0.5 and 0.5 percentage point respectively), it could be significantly greater in China and India (1 and 1.5 percentage points respectively). These declines point to the presence of major structural constraints. Most of the BRICS countries thus face a less favourable demographic situation, with the growth of the labour force in those countries falling, or even becoming negative in the case of Russia. It also seems that the effect of the

CHANGE IN GROWTH BETWEEN 2011 AND 2013 (1)

(in percentage points)



Source : IMF.

(1) The cyclical component is calculated as the difference between effective real growth and estimated potential growth.

reforms implemented in the emerging economies in the wake of the crises of the late 1990s is fading. At the same time, new reforms needed to improve the efficiency of the financial, labour and product markets, infrastructure and education are still lacking, and that is hampering productivity gains. Thus, China and India, in particular, are seeing a downward trend in their productivity growth. In addition, in most of the BRICS countries except China, investment growth is only moderate. In Brazil and India, that situation is due mainly to the presence of structural bottlenecks in both legislation and infrastructure, while in Russia the main factor discouraging investment is an unfavourable business climate.

Reflection on a new growth model

In some countries, including China and Russia, the growth slowdown in recent years indicates that they are gradually approaching the limits of their development model. China relied on investment and exports to produce strong growth. However, the high rate of investment has led to surplus capacity and declining returns, while the influx of cheap labour from the countryside, employable in export-oriented industries, is gradually shrinking. In addition, it is not possible to gain market share *ad infinitum*. The new Chinese government is apparently aware of that. It has announced its intention to phase in a new growth model, giving a greater role to domestic consumption, resulting in perhaps weaker but more sustainable growth. That policy stance is currently only a statement of intent, and most of the structural reforms needed have yet to be introduced. Concrete results should therefore only be expected in the longer term. As in previous years, gross fixed capital formation was still the main contributor to GDP growth in 2013. The mini stimulus plan in July also illustrates the Chinese government's strong preference for investment as the engine of GDP growth, the aim being to maintain growth above the 7% minimum in accordance with the five-year plan for 2011-2015.

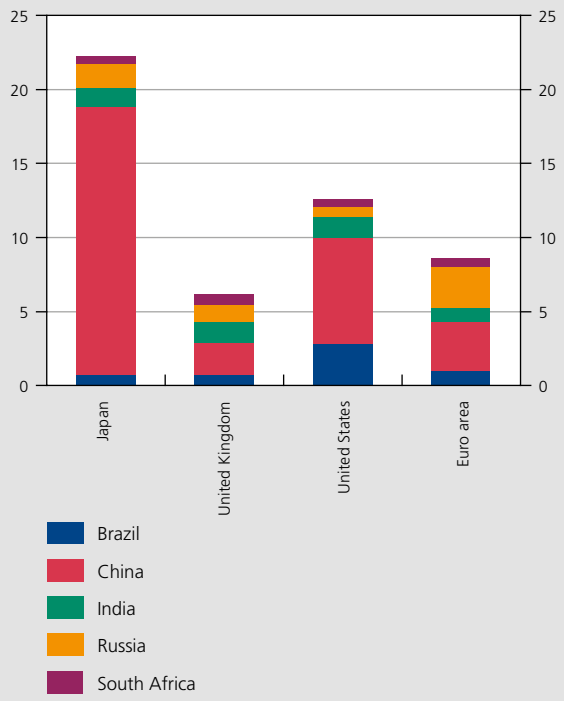
In Russia, economic development was based mainly on rising oil revenues and capital inflows, making the country particularly dependent on those resources. In addition, a lack of investment led to inadequate production capacity in many sectors. Adverse demographic trends also contributed to lower growth. These indicators therefore show that Russia also needs to devise a new growth model.

Impact on the advanced economies

In general, the effects of weaker structural dynamism in the emerging economies should be largely confined to those same economies. A decline in their demand for imports should have only a modest, albeit significant, effect on exports from advanced countries, as their trade exposure to the emerging economies is limited. According to the European Commission's calculations, the recent growth slowdown in the emerging countries will cause the EU's export markets in those countries to contract by 1.7 % in 2013-2014, reducing GDP growth in the EU by 0.2 percentage point. In a similar exercise, the OECD found that a one-off 2 % reduction in the growth of domestic demand in non-OECD countries except China could give rise to a 0.4 percentage point fall in growth in the OECD countries. However, the impact may vary considerably from one country to another depending on the importance of the emerging economies as export markets for the country in question. For instance, the impact could be more severe in the case of Japan, mainly owing to its close trade links with China, and in the Baltic states, primarily because of their close links with Russia.

TRADE EXPOSURE OF THE ADVANCED ECONOMIES TO THE BRICS COUNTRIES

(in % of total exports of the advanced economies, 2012)



Source : IMF.

Owing to the globalisation of financial markets, the impact on the world economy of a growth slowdown in the emerging economies could be more severe if accompanied by a period of great financial instability. But here too, it is necessary to take account of the rather limited exposure of the OECD countries, since barely 5 % of their portfolio investment and direct investment is concentrated in the BRICS countries. In addition, as a result of international banking transactions and bank holdings, developments originating in the emerging economies may also affect the advanced economies. Among the OECD countries, Spain and the United Kingdom seem to have a particularly high exposure.

1.2 The economy in the euro area and its Member States

The recession gives way to a modest, fragile recovery of activity in the euro area

After a protracted recession lasting six quarters, activity in the euro area finally picked up during 2013. GDP grew by 0.3 % in the second quarter, though that performance was slightly inflated by temporary factors, notably by an investment revival following the bad weather in the first quarter, and by calendar effects. In the third quarter, growth subsided to 0.1 %. The pace of the recovery in the euro area was therefore modest. Thus, taking account of the low starting point recorded at the beginning of the year owing to the recession, GDP contracted by an average of 0.4 % in 2013 against the previous year.

The nascent recovery was attributable to the removal of some factors which had previously put a strong brake on demand. However, it remained fragile, as some of the constraints revealed by, or resulting from, the economic and financial crisis had not been fully removed.

Overall, both private consumption and business investment were down again as an annual average in 2013, though the decline was slower than in the previous year. However, they picked up slightly from the second quarter of 2013 after a protracted, steep fall. That recovery was accompanied by an improvement in household and business confidence, beginning in May and lasting until the end of the year. Moderate inflation and less severe fiscal consolidation than in previous years attenuated the contraction of households' purchasing power. Conversely, the new deterioration in the labour market situation and the debt reduction efforts in certain countries once again depressed consumer spending. The renewed business optimism was triggered by some improvement in the outlook for demand in the euro area and in the other advanced economies. However, the boost provided by foreign demand was moderate in 2013, particularly that from the emerging economies. Moreover, while there were generally still significant reserves of unused production capacity, investment in some Member States was also hampered by continuing unfavourable financing conditions, the need for further corporate deleveraging and the persistence of some uncertain factors, including in the political sphere, such as the crises afflicting Italy since the spring and the impediments to further fiscal consolidation in Portugal during the summer. Public consumption, which had fallen in 2012, remained stable.

While domestic demand showed signs of recovery during the year under review, activity was once again driven by net exports, albeit to a less marked degree than in 2012. Despite strengthening demand in the advanced countries, export growth was more modest than in recent years owing to the loss of momentum in the emerging economies and the appreciation of the euro. At the same time, imports were down, but by less than a year previously.

Growth at varying speeds

The hesitant, fragile recovery which began in 2013 varied in pace from one euro area country to another. Over the year as a whole, the highest GDP growth rates were seen in certain core euro area economies – in Germany, but also in Austria and Luxembourg – and in some Member States which continued the process of catching up, such as Malta, Estonia and Slovakia. At the same time, most of the economies undergoing a fundamental adjustment process, which in some cases has lasted several years, remained in recession in 2013, with Cyprus, Greece and Slovenia recording the most negative performance.

The relatively clear distinction which had prevailed at the height of the crisis between the core economies of the euro area and the peripheral economies is becoming blurred. While some of the core countries maintained a better performance overall, others went backwards.

TABLE 2 OVERVIEW OF THE MAIN MACROECONOMIC VARIABLES IN THE EURO AREA

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

	2011	2012	2013
GDP	1.6	–0.7	–0.4
Household final consumption expenditure	0.3	–1.4	–0.7
General government final consumption expenditure	–0.1	–0.5	0.0
Gross fixed capital formation	1.6	–4.0	–3.3
Change in inventories (1)	0.3	–0.5	–0.1
Net exports of goods and services (1)	0.9	1.5	0.6
Exports	6.5	2.5	1.3
Imports	4.5	–0.9	–0.1
Inflation	2.7	2.5	1.4
Unemployment rate (2)	10.1	11.4	12.2
General government fiscal balance (3)	–4.2	–3.7	–3.1
Gross public debt (3)	88.0	92.7	95.7

Source: EC.
(1) Contributions to the change in GDP, percentage points.
(2) Ratio between the number of persons unemployed and the labour force, in %.
(3) In % of GDP.

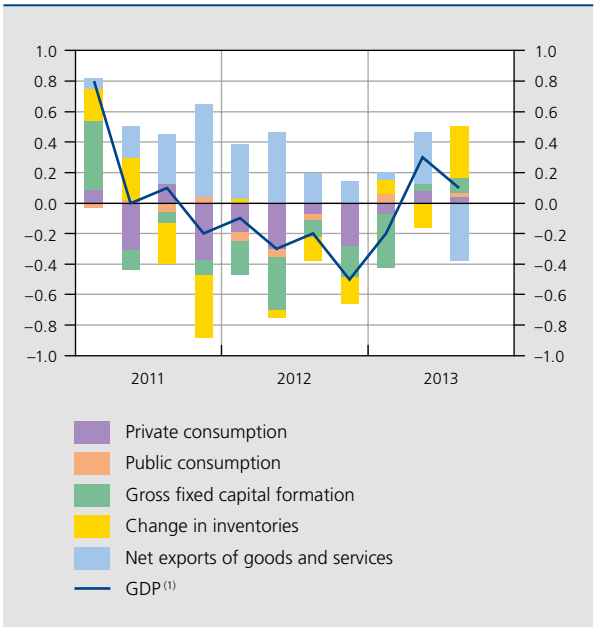
In particular, major structural changes in the industrial fabric are under way in Finland, notably the restructuring of the electronics sector, which has become less competitive in recent years. In the Netherlands, negative wealth effects due to the housing market correction and to previous losses on pension fund assets, the process of reducing the heavy household debt levels, and fiscal consolidation are all factors which have seriously curbed private consumption. Even though these two countries emerged from recession during the year, their GDP growth remained negative over 2013 as a whole for the second year running. In France, the second largest economy in the euro area, activity was less dynamic than in Germany, with annual growth only just in positive territory.

The peripheral countries likewise posted varying results, but the recession eased there overall. Ireland continued to perform better, with modest growth in 2013 against the backdrop of initial signs of stabilisation on the property market and an improvement in the labour market. Following the latest assessment by the Troika – the team of experts from the EC, ECB and IMF – which concluded that the programme conditions had been met, so that the go-ahead was given for the final disbursement of the planned assistance, and taking account of the improvement in its economic and financial situation, Ireland exited its financial assistance programme in December 2013. That programme had been launched in November 2010, and comprised a total of € 85 billion. Portugal and then Spain technically came out of recession from the second quarter, thanks to exports and the gradual improvement in their depressed domestic demand. In those countries, year-on-year GDP growth remained negative in 2013, but less so than in 2012. The recession also moderated in Greece.

In contrast, the situation deteriorated in Slovenia, and especially in Cyprus, in 2013. Excessive financial and macroeconomic imbalances became apparent later there, and their correction caused domestic demand to collapse, particularly in Cyprus. In Slovenia, apart from the debt reduction process in non-financial corporations, the fragility of the banking sector has led to several waves of restructuring, recapitalisation and privatisation since 2009, and that has had an impact on the worsening public deficits, including in 2013. Cyprus even had to ask for external financial assistance in the face of the costs of recapitalising its banking sector which had become unaffordable for such a small economy. The Cypriot banking industry, which is over-large and over-exposed to Greece, had incurred substantial losses when the private banks had

CHART 8 QUARTERLY PROFILE OF GDP AND MAIN EXPENDITURE CATEGORIES IN THE EURO AREA

(data adjusted for seasonal and calendar effects; contributions to the change in volume GDP compared to the previous quarter, in percentage points, unless otherwise stated)



Source : EC.
(1) Percentage changes compared to the previous quarter.

TABLE 3 GDP AND MAIN MACROECONOMIC INDICATORS IN THE EURO AREA COUNTRIES IN 2013 (1)

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

	GDP	Employment	Unemployment rate (2)	Youth unemployment rate (3)	Inflation
Germany	0.5	0.5	5.4	7.5	1.6
France	0.2	–0.2	11.0	25.6	1.0
Italy	–1.8	–1.6	12.2	41.6	1.3
Spain	–1.3	–3.6	26.6	57.7	1.5
Netherlands	–1.0	–1.2	7.0	11.4	2.6
Belgium	**0.2**	**–0.2**	**8.5**	**22.8**	**1.2**
Austria	0.4	0.5	5.1	8.6	2.1
Finland	–0.6	–0.6	8.2	19.6	2.2
Greece	–4.0	–3.5	27.0	59.2	–0.9
Ireland	0.3	1.2	13.3	24.8	0.5
Portugal	–1.8	–3.9	17.4	36.8	0.4
Slovakia	0.9	–0.3	13.9	33.3	1.5
Luxembourg	1.9	1.7	5.7	19.9	1.7
Slovenia	–2.7	–2.4	11.1	20.6	1.9
Estonia	1.3	1.6	9.3	17.3	3.2
Cyprus	–8.7	–7.8	16.7	40.0	0.4
Malta	1.8	2.3	6.4	13.7	1.0
Euro area	–0.4	–0.9	12.2	24.2	1.4

Sources: EC, NBB.

(1) Euro area countries are ranked according to the size of their GDP in 2013.

(2) Ratio between the numbers unemployed and the labour force, in %.

(3) The youth unemployment rate indicates the number of unemployed persons aged between 15 and 25 years as a percentage of the labour force of the same age. Data relating to November 2013, except for Greece, Estonia (October), Slovenia and Cyprus (September).

to participate in the restructuring of the Greek sovereign debt in March 2012. Following a request made by Cyprus in June 2012, the Troika eventually agreed an economic adjustment programme with the Cypriot government on 2 April 2013, aimed at restoring a sound banking sector in Cyprus and covering a period from 2013 to 2016. The programme's financial package covers up to € 10 billion, with the IMF providing around € 1 billion and the European Stability Mechanism (ESM) contributing up to € 9 billion. At the same time, the Cypriot authorities are required to continue the current fiscal consolidation process so as to correct the excessive public deficit, while also implementing structural reforms. The assessments carried out during the year – in July and November – showed that the programme was on track and the first corresponding disbursements of aid were therefore paid out.

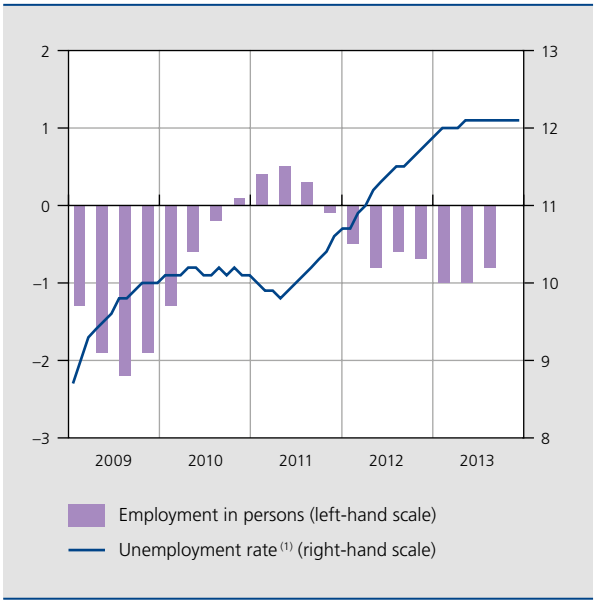
New deterioration on the labour market

The decline in activity up to the first quarter of 2013 and the process taking place in several economies concerning the reallocation of resources between sectors led to a new deterioration in the labour market situation in 2013. However, there were signs of stabilisation during the year. For instance, the unemployment rate went up in April but then remained steady at 12.1 % of the labour force. At the same time, quarterly job losses gradually subsided. However, taking account of the labour reserves which firms still have available and the persistent uncertainty over demand prospects, the revival in activity during the year is still too recent and too fragile to encourage firms to take on more staff.

In this respect, there were still wide variations between Member States in 2013. Employment continued to fall significantly in a number of peripheral economies, such

CHART 9 LABOUR MARKET IN THE EURO AREA

(percentage changes compared to the corresponding quarter of the previous year, unless otherwise stated)



Sources : EC, ECB.
(1) Ratio between the numbers unemployed and the labour force, in %.

as Cyprus, Portugal, Spain and Greece, even though in the case of these last three countries, the decline was less steep than in 2012. Thus, at the end of the year, unemployment rates ranged from around 5 % in Austria, Germany and Luxembourg to over 26 % in Greece and Spain.

While the deterioration on the labour market affected all age groups in the labour force, the problem of youth unemployment remained particularly acute during the year. In November, the unemployment rate for the under-25 age group averaged 24.2 % in the euro area, while it had been around 18 % at the end of 2008. Germany and Austria recorded the lowest rates (7.5 and 8.6 % respectively), while the most worrying levels – close to 60 % - were seen in Greece and Spain. However, it should be noted that the unemployment rate of the 15 to 24 age group is expressed in relation to the labour force – people in work or available for work – in that age group, and not in relation to the total population of young people. Since many young people are outside the labour market, notably because they are pursuing studies or training, the denominator has a smaller base. Measures were taken at European level to combat youth unemployment. At the European Council on 28 June 2013, the Heads of State or Government approved a general plan, including the speedier implementation of the Youth Employment Initiative (in order to help the jobless into work in regions with high unemployment), and the Youth Guarantee Scheme (which aims to help them into employment or training within four months), plus an increase in the mobility of young people and the involvement of the social partners.

Marked easing of inflation

Consumer price inflation in the euro area slowed significantly during the year under review, falling to an average of 1.4 %. That decline is due to the sharp fall in the rate of energy price inflation compared to the high levels seen in the past two years, following the drop in oil prices and the appreciation of the euro. In addition, underlying inflation – i.e. excluding the components relating to food and energy – also declined steadily in a context of flagging economic activity, but also owing to the fading effect of the increases in taxation and regulated prices previously implemented in certain euro area economies. Like economic activity, the year-on-year change in the HICP varied widely between Member States in 2013. Inflationary pressure was extremely weak in some countries, such as Portugal, Ireland and Cyprus – and was even negative in Greece – while Finland and Austria recorded year-on-year inflation of just over 2 %. In the Netherlands, inflation stood at 2.6 %, as a result of an increase in the standard rate of VAT and some regulated prices.

Continued internal and external rebalancing

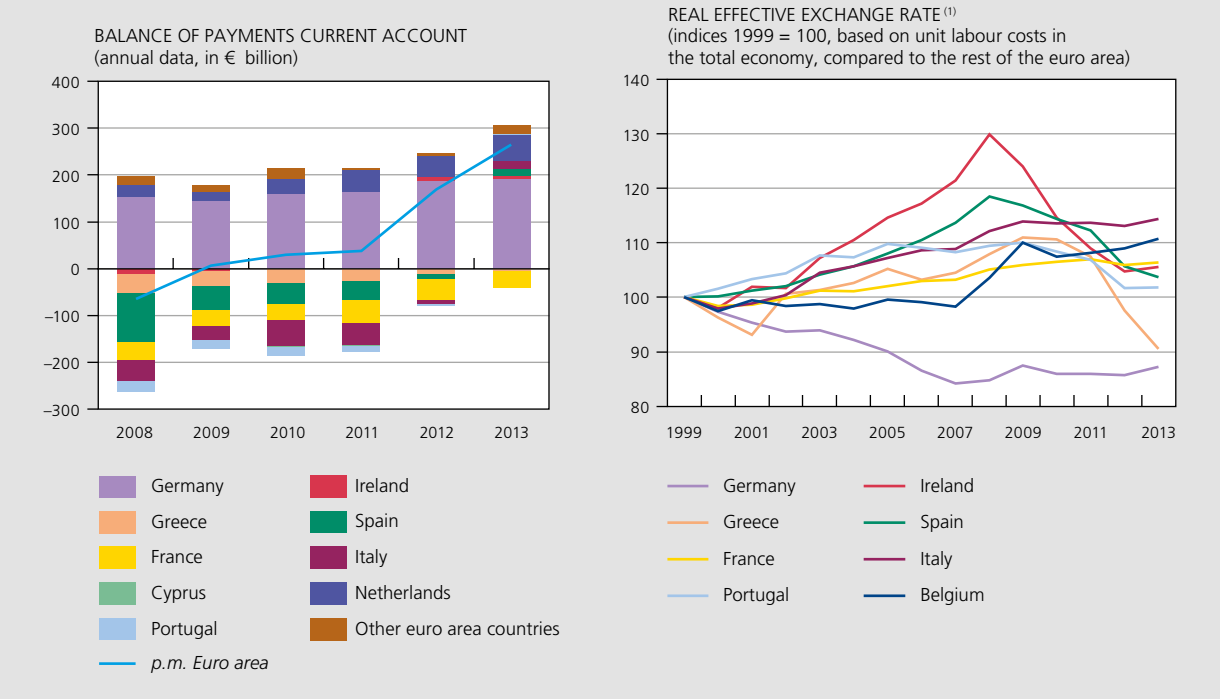
The correction of the macroeconomic, fiscal and financial imbalances revealed by the financial and economic crisis continued in 2013, though at a slower rate than in previous years. While these adjustments may temporarily restrain the vigour of the recovery which had emerged during the year, they are essential to lay the foundations for sustainable development in the various euro area economies, and thus ensure that the smooth operation of EMU is maintained. In general, progress was most apparent in the countries where the situation was the most fragile. Often, it was achieved under adjustment programmes agreed by national governments with the IMF, the EC and the ECB (the Troika), imposing conditions on the financial assistance granted. The other Member States are subject to regular examination by the EC and the European Council under the European Semester, more particularly via the macroeconomic imbalance procedure (MIP) and the excessive deficit procedure (EDP). Where appropriate, they are issued with recommendations designed to reduce the risk of structural imbalances or vulnerability.

Overall, the greatest progress was made with eliminating external imbalances, and in the sphere of competitiveness and public deficits. However, that has not yet reduced debt levels to a position which is sustainable in the long term.

In countries that had a very large deficit on their current account with the rest of the world prior to the crisis, the gradual improvement since 2008 continued in 2013, albeit more slowly. In Greece and Cyprus, the current account deficits were down sharply against their 2008 record levels, but were still in the region of 2 % of GDP in 2013. In Spain and Portugal, the deficits of around 10 % of GDP recorded in 2008 gave way to surpluses in 2013. Ireland, which already had a positive balance in 2010, maintained a surplus in 2013 amounting to around 4 % of GDP, more or less equalling the 2012 figure. At the same time, the balances of countries traditionally in surplus have not declined since 2008. More particularly, the German current account surplus, the largest in absolute terms, again came to 7 % of GDP in 2013. In November 2013, the EC decided to conduct an in-depth review on Germany as part of the MIP, in order to analyse its external position more closely and examine the pattern of domestic demand. In the Netherlands, in a context of depressed domestic demand, the current surplus has actually expanded little by little in the past three years, reaching 10 % of GDP in 2013. In all, the recovery of the current account balances of countries initially in deficit, combined with the stabilisation, or even expansion, of those already in surplus, resulted in a growing surplus for the euro area as a whole, amounting to over 2 % of GDP in 2013.

The restoration of the trade balance did much to improve the current accounts of the countries which had previously faced deficits. Depending on the country, that was due either to a decline in imports as a result of lower domestic demand, or to the dynamism of exports bolstered by competitiveness gains. In Greece and Cyprus, countries which saw domestic demand contract sharply, the reduction in imports was a dominant factor in the restoration of the trade balance, although Greek exports ultimately gathered momentum in 2013. In Ireland, Portugal and Spain, the expansion of exports was the main factor in the correction of the trade balances. In those countries, export growth benefited not only from their competitive position but also from increased geographical diversification towards emerging markets, particularly Asia but also Latin America, especially in the case of Portugal and

CHART 10 EXTERNAL ADJUSTMENTS IN THE EURO AREA



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

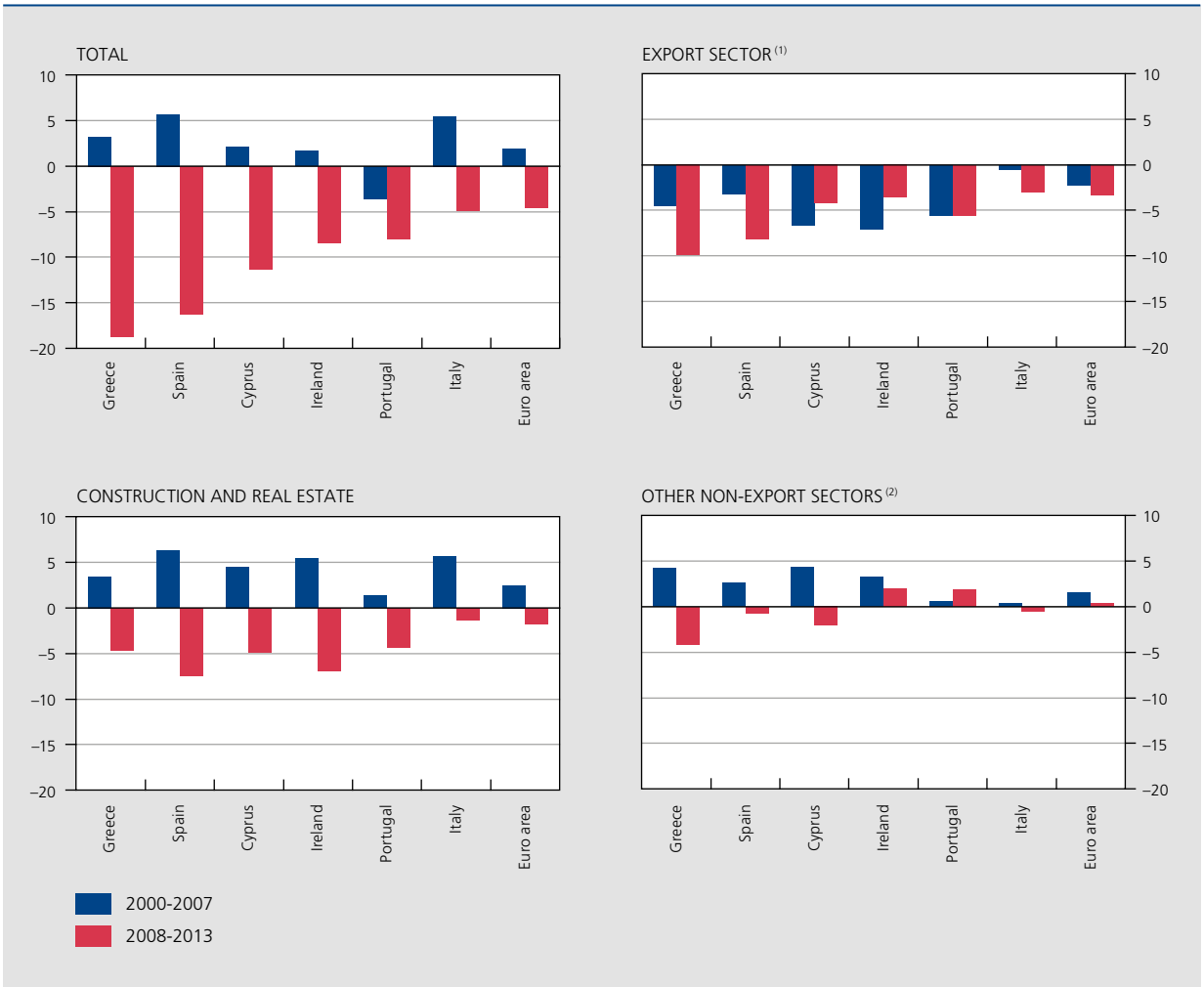
Spain, and from an extension of the export product range. Conversely, in Italy, following a rebound immediately after the 2008 financial crisis, exports were subsequently less dynamic.

Since 2008, the real effective exchange rate indicator in relation to euro area partners has been clearly declining for the deficit countries. That movement, reflecting an increase in their competitiveness – assessed here on the basis of unit labour costs for the economy as a whole – more than made up for the cumulative deterioration experienced by those countries between the start of EMU and 2008. In some of those countries, such as Spain, that may be due partly to the first tangible effects of the structural reforms on the labour market. In 2013, the real effective exchange rate in relation to the rest of the euro area depreciated again in Greece and Spain, while the correction faltered in Ireland, and to a lesser extent in Portugal. At the same time, in other Member States such as Italy, France and even Germany, exchange rates appreciated in real terms in 2013, contributing to narrowing the competitiveness gaps within the euro area.

To put the economy back on a balanced footing, the adjustments in progress in vulnerable or programme countries ultimately need to result in a process whereby the resources initially concentrated excessively on construction or other branches with little exposure to international competition are reallocated to more productive branches and sectors geared more to external demand. The employment picture over the past five years shows that the process has so far barely begun.

CHART 11 REALLOCATION OF EMPLOYMENT IN THE EURO AREA COUNTRIES UNDERGOING ADJUSTMENT

(change in employment, expressed in relation to the labour force, in percentage points)



Source : EC.
(1) Agriculture, industry, trade and transport.
(2) Information and communication, professional services, general government, education, health and other non-market services.

True, there have been many job losses in the construction industry and the property sector since 2008. That was particularly the case in Spain and Ireland, following the bursting of the property bubble, but also in Greece, Cyprus and Portugal, owing to the deep and widespread recession which those economies suffered. However, in all these countries, employment also declined in the export branches, even though they were expected to absorb the surplus workers. Ireland alone recorded a slight revival in employment in that respect in 2013. In an environment of generalised recession, the efforts to boost competitiveness have not yet led to any increase in the workforce. In the short term, those efforts may actually themselves depress employment where it is a question of improving firms' productivity. Between 2008 and 2013, the fall in employment was thus greater in the export branches than in other branches protected from international competition. In the latter, employment was relatively spared, except in Cyprus and Greece where a downward trend emerged from 2010, with the fiscal consolidation efforts affecting public sector employment.

While significant progress was achieved in correcting the external imbalances, though without eliminating them altogether, less progress was made in reducing the debt of the non-financial private sector. In a context of low interest rates and abundant liquidity, that debt had expanded rapidly during the decade preceding the crisis, reaching excessive levels which were hard to sustain in some countries. Despite balance sheet adjustments and very slow or even negative expansion of lending in many Member States, the level of outstanding debt remains high in many countries. After having peaked at 144 % of GDP in the euro area at the end of 2010, the non-financial private sector debt ratio measured on a consolidated basis – i.e. excluding reciprocal financial assets and liabilities within the same sector – was down slightly at 139 % of GDP in mid-2013. Even though the adjustment has speeded up since the end of 2012, it therefore remains limited.

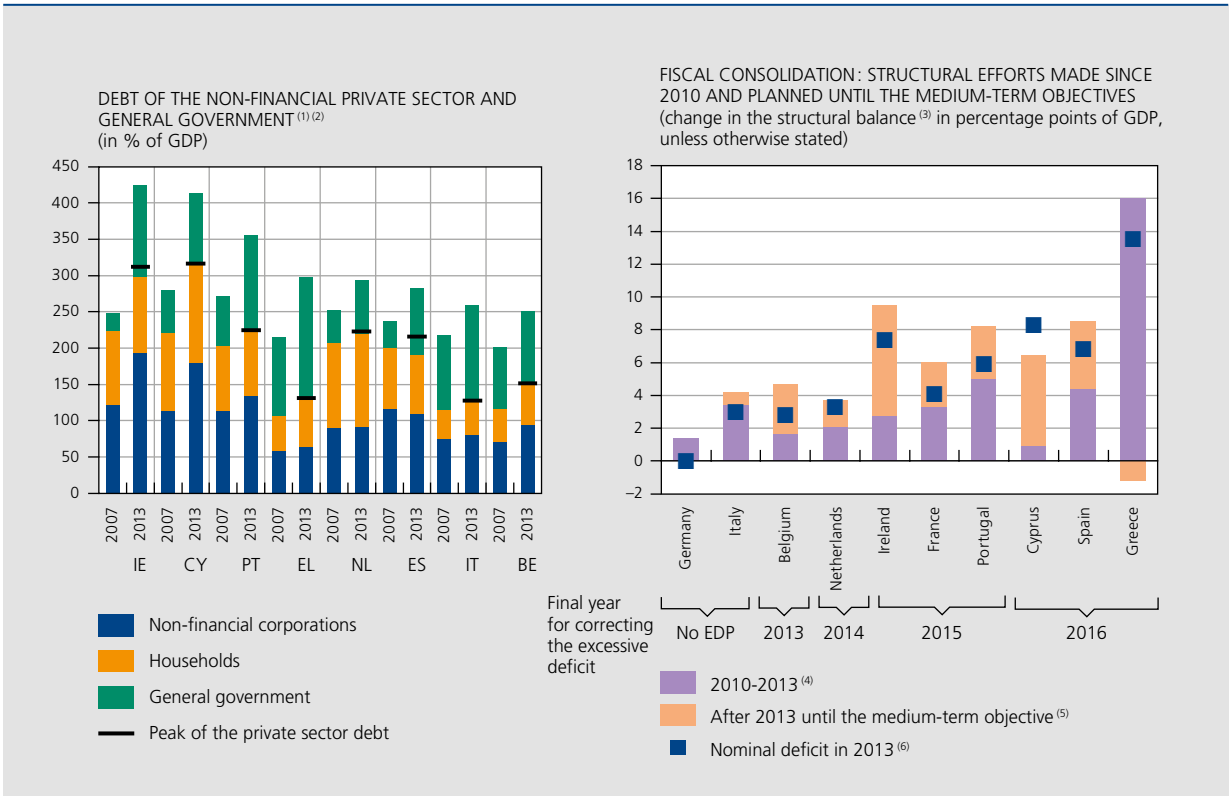
Within the euro area, private debt levels vary greatly between countries and sectors. In the second quarter of 2013, private debt levels of around 200 % of GDP or more were recorded in particular in Cyprus, Ireland, Portugal, the Netherlands and Spain. In those countries, it is non-financial corporations that generally have the heaviest debts. The Netherlands is an exception here, since it is household debt that has expanded excessively there, in the context of a property boom which began during the 1990s. That was sustained by the specific features of the Dutch mortgage market, notably loans with the principal repaid in full at maturity, and generous tax concessions for borrowers. The adjustments which those Member States embarked on display a very varied picture. The biggest corrections since the peak debt levels have been achieved in Ireland, and especially in Spain, in relation to both households and businesses. In the Netherlands, it is mainly the debt of non-financial corporations that has fallen, although the decline in household debt did gather pace in the first half of 2013. Finally, in Cyprus and Portugal, there have been very small reductions in debt levels, and only in the case of households.

In regard to the government accounts, the authorities have continued their consolidation efforts which began in 2010. The euro area's deficit thus continued to diminish; according to the EC's autumn forecast, it declined from 3.7 % in 2012 to 3.1 % of GDP during the year under review, which is half the record figure for 2009. In 2013, all euro area countries recorded deficits except for Germany, whose public finances were more or less in balance. Among those countries, only Estonia, Luxembourg, Finland, Austria and Belgium managed to keep the deficit below 3 % of GDP. Conversely, the biggest deficits were still recorded in the programme countries, namely Greece (13.5 % of GDP), Cyprus (8.3 % of GDP), Ireland (7.4 % of GDP), Spain (6.8 % of GDP) and Portugal (5.9 % of GDP). In Greece and Cyprus, the previous year's figure was exceeded, as exceptional transactions pushed up the deficit in 2013; this concerned the substantial cost of bank recapitalisation in Greece and payment of an indemnity by the Cypriot government to compensate for the large losses incurred by the provident and retirement funds of the Cyprus Popular Bank. Excluding these one-off factors, the deficits in Greece and Cyprus came to around 4 and 6.5 % of GDP respectively.

While the economic climate was once again unfavourable in the euro area, the further correction of the budget balance in the government accounts in 2013 reflects the impact of discretionary measures. Thus, the structural budget balances in the euro area – which exclude the impact of cyclical effects and temporary measures – continued to improve, particularly in the countries which had made major efforts at fiscal consolidation from 2010 onwards, notably Greece but also Portugal, Spain and Italy. However, the adjustment appears to have lost some momentum, on average, in the euro area, with the improvement in the structural balance declining from 1.5 percentage points in 2012 to 0.7 percentage point in 2013.

In 2013, only five euro area Member States were not undergoing an excessive deficit procedure (EDP), namely Finland, Estonia, Luxembourg, Germany and Italy. In the case of the last two countries, the Ecofin Council terminated the procedures in June 2012 and June 2013 respectively. Faced with a difficult macroeconomic situation

CHART 12 EURO AREA DEBT AND BUDGET BALANCES



Sources : EC, ECB.
(1) Consolidated debt in the fourth quarter of 2007 and the second quarter of 2013.
(2) Countries are ranked according to their total debt level in the second quarter of 2013.
(3) The structural balance corresponds to the general government balance adjusted for cyclical effects and temporary measures.
(4) Calculated on the basis of the EC's autumn 2013 forecasts.
(5) According to the 2013 stability programmes.
(6) In % of GDP.

in recent years, the European authorities have focused on the question of fine-tuning the rate of fiscal consolidation, in order to strike the right balance between, on the one hand, the risk that if consolidation is too abrupt it may give too much power to recessive forces in the short term, whereas on the other hand, there is a need for sustainable consolidation of public finances. While retaining the nominal threshold of 3 % of GDP to determine the existence of an excessive deficit, they are now placing more emphasis on structural consolidation efforts. In that respect, the corrective arm of the reinforced Stability and Growth Pact provides for budgetary adjustment defined in structural terms; this takes account of differences between countries and allows the automatic stabilisers to operate throughout the adjustment process. In June 2013, since the recovery was taking longer and the contraction of GDP in 2012 was sharper than initially expected, the Ecofin Council granted five euro area countries extra time to correct their excessive deficit: two years for France (2015), Slovenia (2015) and Spain (2016), and one year for the Netherlands (2014) and Portugal (2015). In so doing, it set corresponding new deficit targets. Conversely, the Council decided to launch a new procedure against Malta, which has to correct its deficit by 2014. In addition, under the preventive arm of the Pact, the euro area Member States have to pursue a national objective in the medium term corresponding to a target structural deficit. The aim is to make sure that the fiscal consolidation efforts continue once the excessive deficits have been corrected, and to ensure that the public debt tends towards a sustainable position. Apart from certain countries such as Germany and Finland, which have already met their medium-term objective, most euro area Member States will be unable to relax their efforts in the future if they are to achieve their national objectives.

Despite the deficit reduction, the public debt ratio in the euro area increased again, albeit more slowly than in 2012, reaching 95.7 % of GDP at the end of 2013. About two-thirds of this rise in the debt ratio is due to the

"snowball effect" - the level of the primary balance being insufficient to compensate for nominal GDP rising at less than the implicit interest rate on the public debt – and, to a lesser extent, to stock-flow adjustments (i.e. the change in the debt attributable to factors other than the fiscal balance). Those adjustments reflect among other things public interventions in favour of the financial sector or aid granted to certain countries under the European support mechanisms. The public debt-to-GDP ratio rose in all countries except Germany and – according to the Bank's estimates – Belgium, where the debt was down slightly. At the end of 2013, the level of the public debt was well over 100 % of GDP in Greece, Italy, Portugal, Ireland and Cyprus.

1.3 Eurosystem monetary policy

Financial fragmentation in the euro area and intermediation role of the Eurosystem

A calmer financial environment

The financial tensions afflicting a number of euro area countries during the summer of 2012 had significantly increased the fragmentation of the euro area's financial markets along national borders. That fragmentation had become apparent in the spring of 2010 in the context of the sovereign debt crisis. The tensions had threatened to drive a number of Member States into a negative spiral, together with their financial system, and to generate a situation of systemic instability jeopardising medium-term price stability. To preserve the singleness of monetary policy and ensure its appropriate transmission to the real economy, the ECB Governing Council had announced, after its August 2012 meeting, that it was therefore prepared to conduct OMTs on the secondary market for government bonds.

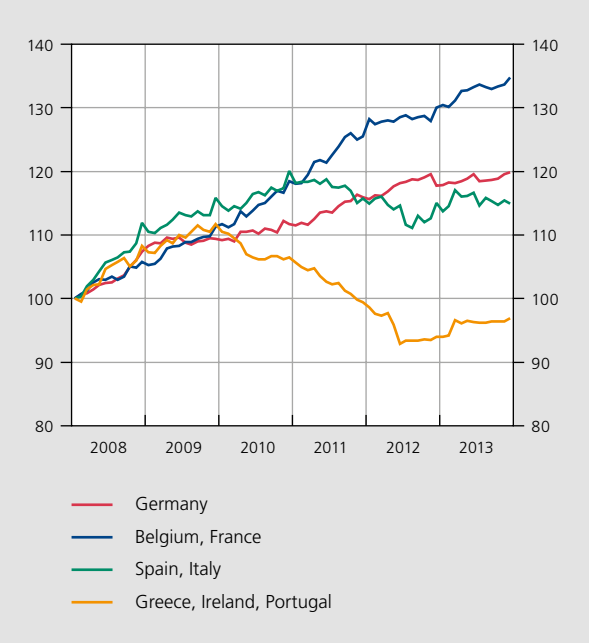
In the closing months of 2012, that announcement had averted the risk that a Member State might leave the euro area, and led to a rapid, clear easing of financial tensions, particularly on the sovereign debt markets of the countries giving greatest cause for concern, such as Italy and Spain. Moreover, once more favourable financial conditions were restored, banks gradually cut back their use of Eurosystem liquidity from September onwards.

During the initial months of 2013, the easing of tension on the financial markets gave way to renewed optimism. Despite persistent macroeconomic weaknesses and occasional domestic uncertainty in some euro area countries, premiums on the riskiest assets fell sharply and the financial fragmentation diminished somewhat. This was due to the particularly accommodative monetary policy stance of the central banks in the main advanced economies, the progress towards establishing a European banking union, and the increased confidence among investors. The dissipation of market tensions and the easing of the sovereign debt crisis continued throughout the year under review, so that the OMT programme was not activated.

Against this backdrop, the banks' access to the funding markets improved steadily, both for retail and interbank funding and for funding in the form of debt security issuance and securitisation, as is evident from responses to the *ad-hoc* question in the Eurosystem's quarterly bank lending survey (BLS). More specifically, in the countries which were at the heart of the sovereign debt crisis, the deposit base – which had been seriously eroded during the financial turmoil – became stronger.

CHART 13 TOTAL DEPOSITS (1) WITH NATIONAL BANKING SECTORS

(indices January 2008 = 100)



Source : ECB.

(1) Total deposits of non-bank customers excluding central governments, total amount outstanding at the end of 2007 and subsequent cumulative monthly flows.

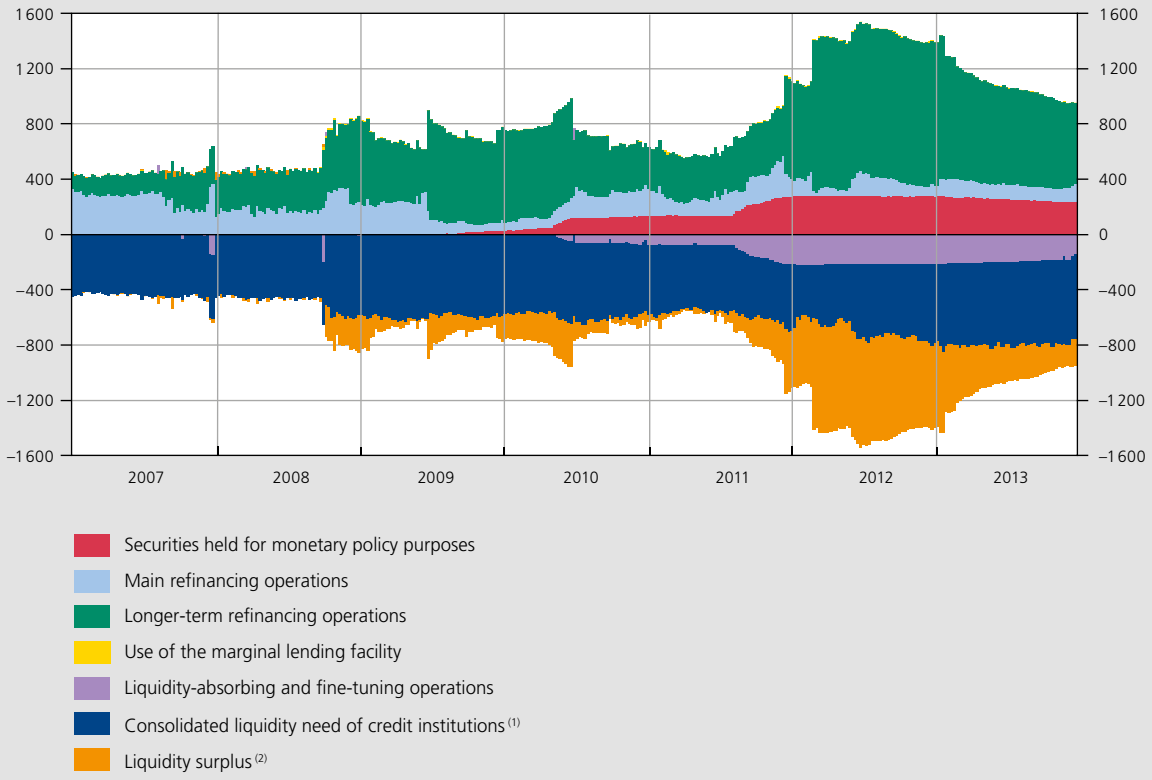
A reduced intermediation role for the Eurosystem

The general improvement in their market access and funding conditions has made the banks less dependent on the Eurosystem. That is evident, in particular, from the scale of the early repayments of funds taken up at the time of the two three-year longer-term refinancing operations conducted on 21 December 2011 and 29 February 2012.

It had been decided in December 2011 to conduct those operations in order to guarantee the banks access to stable, longer-term funding and thus avoid an abrupt squeeze on their lending to the economy in an environment of acute tensions on various segments of the euro area's financial markets. The funding problems facing numerous institutions at the time and the attractive terms offered had resulted in the allocation of around € 489 and 530 billion respectively on the occasion of the first and second operations, corresponding to a total net injection of liquidity of around € 500 billion, as less liquidity was taken up via other operations. Given the clear segmentation of the financial markets along national borders at that time, it was mainly banks facing funding difficulties in the countries most affected by the sovereign debt crisis that resorted to the Eurosystem for their refinancing. Conversely, the banks of countries regarded as more stable, which had withdrawn from the interbank market and enjoyed an inflow of liquidity, had placed their surpluses with the Eurosystem. As a result, the Eurosystem was obliged to perform a greater intermediation role between national banking sectors, with the corollary of an unprecedented expansion of its balance sheet. That contrasted to some extent with the developments at the start of the crisis, in late 2008 and in 2009, when the Eurosystem's

CHART 14 LIQUIDITY IN THE EUROSYSTEM

(outstanding amounts, weekly data, in € billion)



Source : ECB.

(1) Liquidity need due to "autonomous factors" (such as demand for banknotes) and reserve requirements.

(2) The liquidity surplus is equivalent to the difference between the outstanding amount of transactions leading to an expansion of liquidity – namely the refinancing operations, the purchases of securities for monetary policy purposes and the use of the marginal lending facility – and the sum of the outstanding amount of liquidity-absorbing operations and the consolidated liquidity need of the banking system. It corresponds to the sum of the amounts placed in the deposit facility and on current accounts in excess of the reserve requirements.

intermediation role tended to concern individual banks in the various euro area jurisdictions. In order to offer the banks a high level of flexibility and facilitate the management of their liabilities, the three-year longer-term refinancing operations had included an option permitting total or partial repayment of the amounts allotted after a period of about one year.

As initially agreed, liquidity granted via these operations was repaid on a weekly basis, entirely at the banks' discretion. Repayment of the first operation began on 30 January 2013, while in the case of the second operation it began on 27 February 2013. Over the year as a whole, repayments totalled € 259 billion and € 187 billion respectively for the first and second operations, corresponding to almost 90 % of the total net amount initially injected into the banking system. The larger amounts repaid in respect of the first operation essentially imply that institutions want to keep liquidity with a longer residual maturity.

Early repayment of amounts that regularly exceeded expectations reinforced the feeling that tensions in the banking sector were waning. Apart from the general improvement in funding conditions in the various Member States, some more specific factors also seem to have motivated the banks' repayment decisions. Two factors in particular emerge from an ECB survey of a sample of banks. The first concerns a widespread tendency on the part of the banking sector to turn to more stable funding sources, such as retail deposits. The second concerns the balance sheet adjustment of euro area banks, often characterised by a more moderate increase, or even a reduction, in the size of those balance sheets, reducing the need for funding overall.

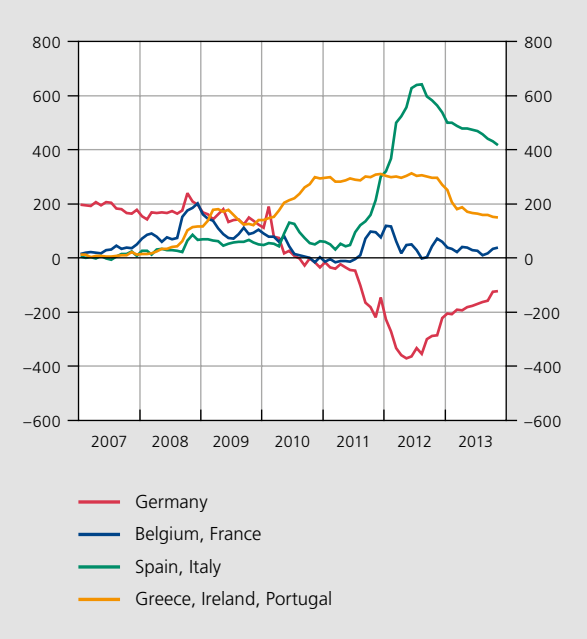
In parallel with the repayments, demand for liquidity via the other Eurosystem operations only expanded slightly over the last year, so that the total net liquidity provided via the open market operations declined by about € 274 billion to reach € 740 billion at the end of December. That decline was due solely to weaker demand from the banks since, under the fixed-rate full-allotment policy, they can obtain as much liquidity as they want via the various Eurosystem liquidity-providing operations, so long as they have the necessary collateral. The consolidated liquidity need of the banking system as a whole increased following the rise in autonomous liquidity-absorbing factors (such as banknotes in circulation), while the reserve requirements were down slightly; that was a purely mechanical effect of the fall in short-term deposits at the banks which form the basis of their calculations. In that context, the surplus liquidity, which corresponds to the sums granted by the Eurosystem in excess of the consolidated liquidity need of the banking system, declined to around € 275 billion at the end of December 2013, compared to over € 600 billion at the end of 2012. Since the euro area banking system is a closed circuit, the banks with a surplus naturally placed their excess liquidity with the Eurosystem, either in the deposit facility or on their current account, on top of the reserve requirements. Since the Governing Council's decision in July 2012 to cut the deposit facility rate to 0 %, the two facilities offer identical terms.

Persistent financial fragmentation

As the liquidity surplus diminished, the Eurosystem's intermediation role in the euro area banking system naturally declined and its balance sheet became considerably smaller. Against the backdrop of persistent financial fragmentation, the Eurosystem nevertheless remained a significant source of refinancing for embattled countries. Moreover, owing to divergences in banks' market access and funding conditions, there were wide variations in the terms of bank loans offered to households and non-financial corporations. The divergences between countries – be it in terms of interest rates or credit growth – remained large, also pointing to considerable discrepancies in the

CHART 15 NET BORRROWING [1] BY BANKING SECTORS FROM NATIONAL CENTRAL BANKS

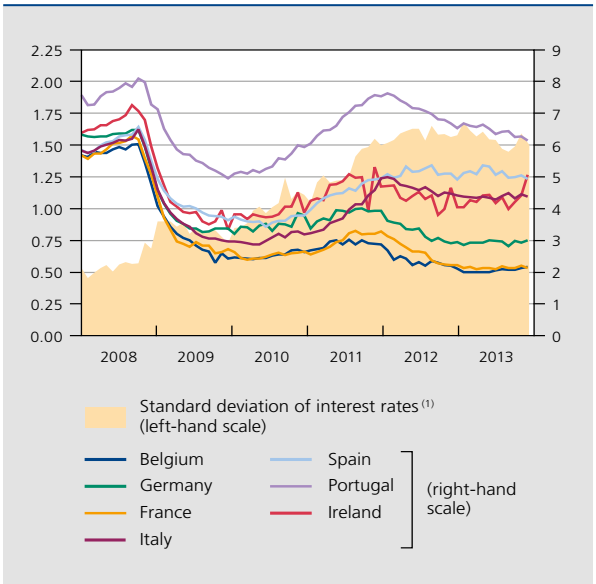
(outstanding amounts, monthly data, in € billion)



Sources : NCBs.
(1) Difference between amounts lent by the NCBs to the resident banking sectors and amounts deposited by resident banking sectors with the NCBs.

CHART 16 DEBIT INTEREST RATES ON NEW BANK LOANS TO NON-FINANCIAL CORPORATIONS

(monthly data, original maturity of less than one year, up to € 1 million)



Source : ECB.

(1) Standard deviation of interest rates for the twelve euro area Member States on 1 January 2002, except Luxembourg.

macroeconomic environment and the need for deleveraging in the financial and non-financial sectors. Specific factors influencing bank interest rates include, in particular, the size of impaired loans and the capital position of the various banking sectors.

In order to guarantee access to liquidity for all euro area banks, and thus support lending, the Governing Council decided at its meeting on 2 May 2013 to continue conducting Eurosystem refinancing operations in the form of fixed-rate tenders with full allotment for as long as necessary, and at least until 8 July 2014. It stated that the ECB's main refinancing rate would apply to the main refinancing operations and to those with a maturity coinciding with a reserve maintenance period – or around one month – and that the interest rates on the longer-term refinancing operations would be equal to the average rates on the main refinancing operations conducted during the period of the operation concerned. After its meeting on 7 November 2013, the Governing Council announced that this procedure would be extended for as long as necessary, and at least until 7 July 2015. This new extension offers credit institutions guaranteed access to Eurosystem liquidity beyond the maturity date of the three-year longer-term refinancing operations in the first quarter of 2015.

Monetary policy stance

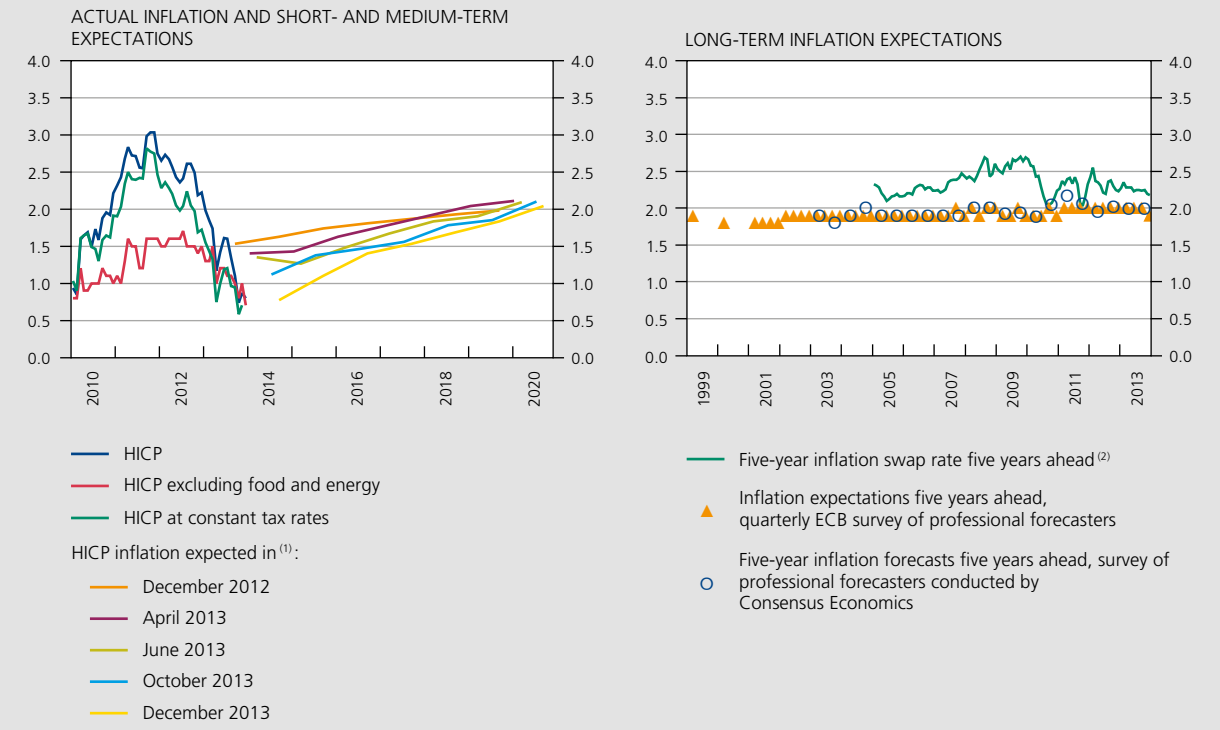
Economic and monetary analyses confirm sluggishness of economic activity in the euro area

Despite the improvement in the financial sphere, economic activity remained very weak in the first months of the year under review. Growth projections for the euro area, which had already been revised downwards in September and December 2012, were downgraded again in March 2013 and, against the backdrop of balance sheet adjustments in the financial and non-financial sectors, it was expected that economic activity would remain sluggish over the year as a whole. From May onwards, the business climate began to brighten up and gradually there emerged signs that activity was stabilising, although it remained at a low level. In the second quarter, the positive real GDP growth marked the end of six consecutive quarters of contraction, while the virtual stabilisation in the third quarter confirmed the expected scenario of a modest, hesitant recovery. Despite these encouraging signs, the outlook still remained subject to downside risks in a constantly uncertain and very mixed global macroeconomic environment.

As expected, inflation measured by the HICP maintained the downward trend which had begun at the end of 2011, dropping below 2 % from February, mainly as a result of lower prices for energy and other commodities. However, in the autumn, inflation fell more sharply than expected, reflecting in particular a smaller rise in food prices, a steeper decline in energy prices and some moderation in service price inflation. Overall, inflation was down by 1.4 percentage points over the past year, dropping from 2.2 % to 0.8 % between December 2012 and December 2013. Underlying inflation – the movement in consumer prices excluding energy and food – also exhibited a marked downward trend, though it was not so steep, falling from 1.5 % to 0.7 % over the same period. It should also be noted that these inflation measures tend to slightly overstate the underlying domestic inflationary pressure, since the increase in indirect taxes over the past year drove total inflation up by around 0.3 %. In view of the generally weak economic situation, the baseline scenario has always assumed that price rises would be moderate, and in the autumn, inflation was expected to remain at low levels for an extended period. In the medium term, and taking account of the Governing Council's decisions, the risks surrounding the price outlook were systematically assessed as balanced overall, with downside risks caused by the weakness of activity and upside risks relating to increases in regulated

CHART 17 INFLATION AND INFLATION EXPECTATIONS IN THE EURO AREA

(year-on-year percentage changes)



Sources : EC, Bloomberg, Thomson Reuters Datastream, ECB.

(1) Measured by implied forward inflation swap rates. Since consumer price indices are published after some delay, inflation swap contracts reflect the inflation expected in the month three months ahead of their due date. For instance, one-year contracts dated December 2012 reflect inflation rates expected in September 2013.

(2) Implied inflation rate derived from swaps covering the inflation risk in the euro area, for a period of five years beginning five years after the conclusion of the contract.

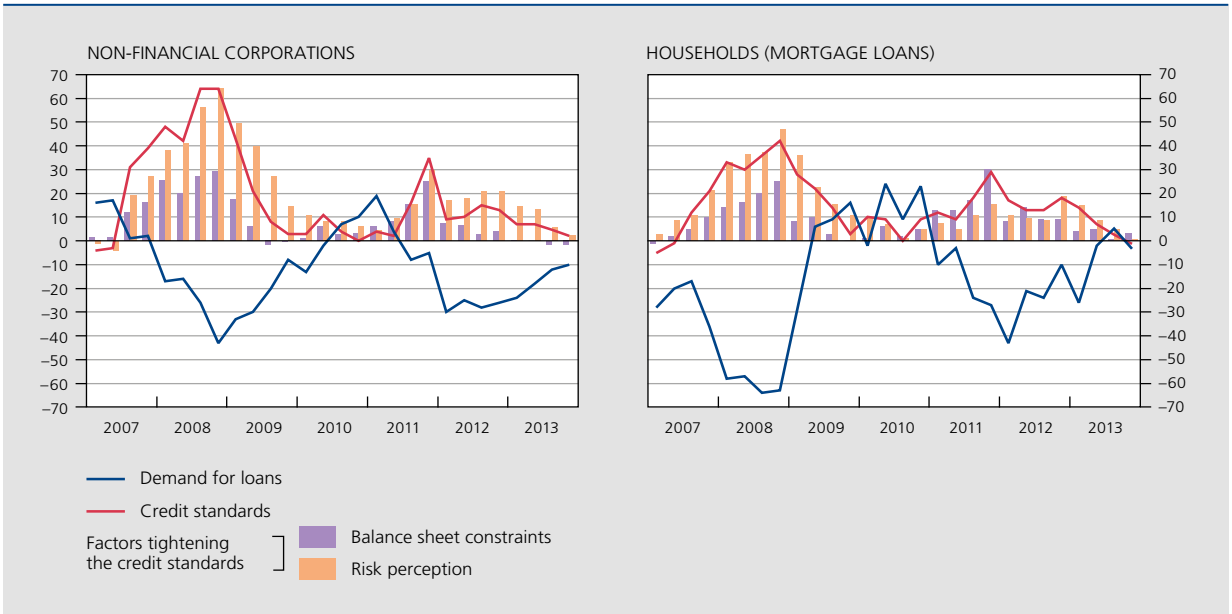
prices and indirect taxes, plus price rises for oil and other commodities.

The short- and medium-term expectations of the private sector confirmed the Governing Council's assessment that inflation would remain very low for an extended period. On the basis of inflation swap contracts, it seemed that inflation was only expected to return very slowly to a level compatible with the Governing Council's objective of keeping inflation below, but close to, 2 % in the medium term. In reality, the expected slow pace of the increase in inflation is particularly striking since these financial instruments incorporate risk premiums. However, the longer-term expectations derived from survey data and financial data remained firmly anchored at a level compatible with the ECB's definition of price stability.

Monetary developments, and particularly lending figures, remained sluggish, confirming the scenario of weak inflationary pressures in the medium term. Credit standards remained restrictive, though they became less tight over time, both for lending to non-financial corporations and for mortgage loans. In view of the uncertain macroeconomic context, risk perception was still the main concern for euro area banks, whereas, in a calmer financial environment, balance sheet constraints now only played a very minor role, or even contributed slightly to the easing of credit standards at the end of the year. Demand for loans continued to decline overall, though to a lesser extent with each passing quarter.

Despite the improvement in banks' funding conditions, the general dynamism of bank lending to the private non-financial sector therefore remained weak overall; it was curbed in particular by the anaemic economic activity and the ongoing process of balance sheet adjustment. Between December 2012 and December 2013, the year-on-year growth of business lending fell sharply from –1.3 to –2.9 %, while the growth of lending to households declined from 0.7 to 0.3 % between December 2012 and May 2013, stabilising thereafter. Although that trend was very widespread, the picture for the euro area still masked

CHART 18 EUROSYSTEM BANK LENDING SURVEY IN THE EURO AREA [1]



Source : ECB.

(1) Net percentages of replies from banks to the Eurosystem's bank lending survey indicating the degree of tightening (+) or easing (–) of credit standards and the movement in demand for loans.

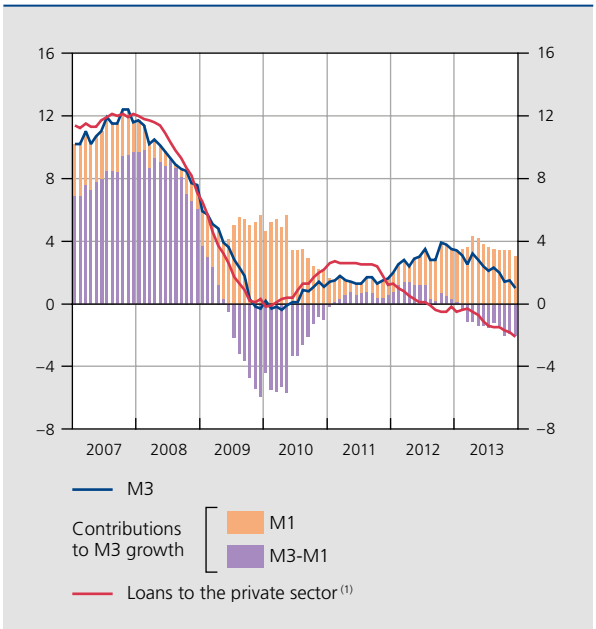
considerable divergences between countries. While large firms in many jurisdictions were able to use alternative sources of funds, such as self-financing and direct access to the capital market via the issue of debt instruments, this had little effect on total demand for loans in the euro area as a whole.

Since bank loans form the basis of monetary expansion – "Loans make deposits" – the weakness of private sector lending contributed to the slackening of growth of the monetary aggregate M3 during the year under review; year-on-year growth of M3 declined from 3.5 % in December 2012 to 1 % in December 2013. That slower growth also reflects the portfolio decisions of investors who, in a climate of reduced risk aversion and very low interest rates, sought higher yields by turning to assets outside M3. That is evident from last year's positive flows in favour of investment funds, with the exception of money market funds.

Despite the slower growth of M3, the movement in the money supply remained largely decoupled from the growth of loans to the private sector, as it had been throughout 2012. That reflects the role played by a number of factors supporting M3 including, in particular, net capital inflows – against the background of renewed confidence in the euro area – and banks' declining longer-term financial liabilities. The banks'

CHART 19 M3 AND LOANS TO THE PRIVATE SECTOR IN THE EURO AREA

(year-on-year growth unless otherwise stated; seasonally adjusted data)



Source : ECB.

(1) Namely households, non-financial corporations, insurance companies, pension funds or occupational pension institutions and other non-monetary financial intermediaries. Data adjusted for securitisation effects.

claims on the government continued to support monetary growth, even though their influence diminished. All these factors, probably temporary but apparently persistent, were such that the broad M3 aggregate is likely to overestimate the underlying monetary dynamics, which are relevant for the situation regarding risks to price stability.

In regard to the components of M3, the movement in this broad monetary aggregate was due mainly to steady growth of the narrow monetary aggregate M1 as a result of the persistent preference of households and firms for liquid deposits, since other monetary assets offered only low yields. More specifically, movements in M1 were due to large inflows of sight deposits which offset the outflows relating to negotiable instruments and the slower growth of other short-term deposits. The reasons behind the preference for M1 therefore differed from those applicable at the end of 2011 and in early 2012 when flows into M1 served mainly to create substantial precautionary assets in response to the uncertainty on the financial markets. Overall, the steady decline in the less liquid components of M3 during the year under review reflects arbitrage by investors weighing returns against liquidity. However, the small volume of short-term debt instruments issued by the banks was also due to the regulations encouraging banks to raise finance via deposits rather than via the market.

Monetary policy easing and maintenance of its accommodative stance

Throughout the year under review, the developments evident from the economic and monetary analyses, the two pillars of the Eurosystem's monetary policy strategy, constantly called for an accommodative monetary policy. Moreover, certain disruptive factors prompted the Governing Council to take specific measures to ensure the accommodative stance of its monetary policy.

In a large liquidity surplus situation, which has very frequently prevailed since the introduction on 15 October 2008 of fixed-rate tenders with full allotment, the overnight money market rate Eonia usually remains at the lowest level within the corridor of key interest rates, close to the deposit facility rate. However, changes in the liquidity surplus may influence the overnight rate and hence the monetary policy stance. In fact, while the link between Eonia and the level of the liquidity surplus is neither mechanical nor stable, a reduction in that surplus below a certain threshold may apparently cause Eonia to rise towards the ECB's main refinancing rate. Changing expectations regarding the future level of the liquidity surplus may thus trigger changes in expectations regarding the future overnight interest rate.

At the beginning of the year, the markets had interpreted the higher-than-expected initial repayments relating to the three-year liquidity-providing operations as a sign that repayments would be speedier than anticipated. That led to a rise in the short-term interest rates expected on the money market. The Governing Council consequently feared that its monetary policy stance might be derailed by money market fluctuations, and it therefore reaffirmed its determination to preserve the accommodative stance of its policy. The improvement in market confidence and in banks' funding conditions was not in fact accompanied by a similar improvement in the macroeconomic outlook.

Faced with the persistently weak economic activity, the steep fall in inflation and the low medium-term underlying inflationary pressures, the Governing Council decided at its meeting on 2 May 2013 to ease its monetary policy stance still further by cutting the interest rate on the Eurosystem's main refinancing operations by 25 basis points to 0.5 %, and cutting the marginal lending facility rate by 50 basis points to 1 %. The interest rate on the deposit facility, which had been cut to 0 % in July 2012, remained unchanged.

Since the rate on the deposit facility puts a floor under Eonia, the fact that it was kept unchanged did not cause the overnight interest rate to fall as had happened on the occasion of previous rate reductions. However, the decision to cut the other key interest rates did reduce the cost of Eurosystem refinancing for the banks and established a new ceiling for Eonia, which is in principle constrained by the ECB's main refinancing rate in a system of fixed-rate tenders with full allotment.

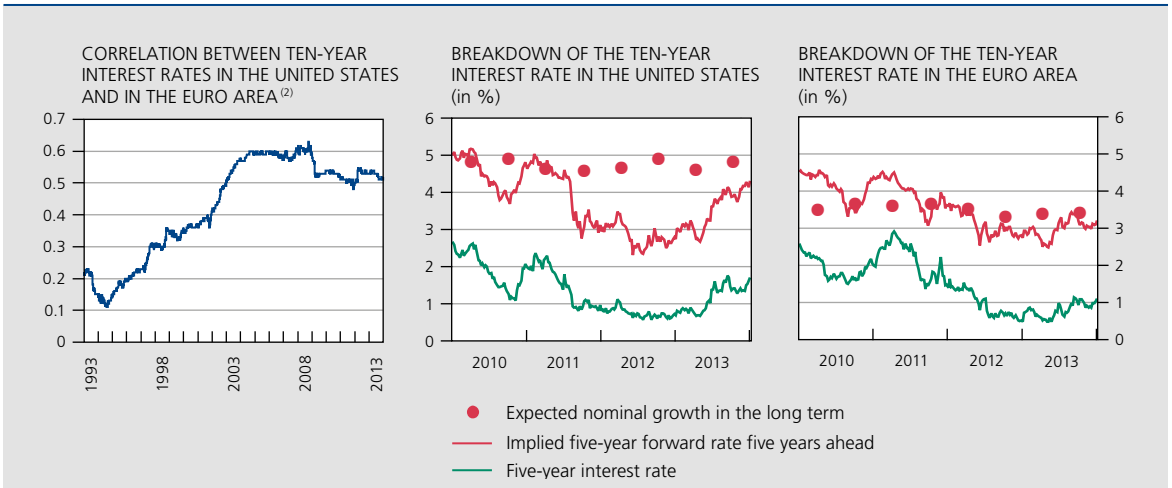
Although the Eurosystem was technically able to let the interest rate on the deposit facility become negative, the Governing Council decided against that because the potential benefits of such a move would not at present outweigh the uncertainty over its effects. However, the Governing Council did not rule out the possibility of a reduction in the future, and the announcement of the interest rate cut was thus accompanied by a marked decline in expectations regarding Eonia. The narrowing of the corridor of key interest rates reduced Eonia's potential volatility. The decision to cut the key interest rates and the aforesaid decision to extend the fixed-rate tenders with full allotment thus complement one another. By guaranteeing access to liquidity in the long term, this last decision also helps, in principle, to prevent excessive upward volatility in money market rates.

During May, together with expectations regarding the future change in the liquidity surplus, a second factor disrupted the Eurosystem's accommodative monetary policy stance by generating upward pressure on money market rates. This concerned communications by Federal Reserve policy-makers regarding future US monetary policy, the spillover effects of which for the euro area are discussed in Box 2 below.

Box 2 – American monetary policy and monetary conditions in the euro area

In deciding on 2 May 2013 to cut its key interest rate, the Governing Council initially managed to ease monetary conditions in the euro area. However, that effect proved short-lived, as the Federal Reserve indicated on several occasions from the beginning of May onwards that, in view of the improvement in the economic outlook, it was considering reducing the pace of its purchases of longer-term US government securities and mortgage-backed securities (MBS) in the near future. During the ensuing weeks, that triggered not only a marked rise in the long-term risk-free interest rate in the United States but also an increase in longer-term interest rates worldwide. Consequently, monetary conditions also became tighter in the euro area. In fact, it is mainly via its effect on medium- and long-term interest rates that monetary policy influences economic activity and, ultimately, price stability. Longer-term interest rates determine the borrowing costs applicable to the financing of a major part of expenditure, particularly consumption of consumer durables and investment.

TEN-YEAR INTEREST RATES IN THE UNITED STATES AND THE EURO AREA [1]



Sources : Consensus Economics, Thomson Reuters Datastream.

(1) The respective interest rates for the euro area correspond to the average interest rates on government debt securities of five euro area Member States with an AAA rating, namely Germany, Austria, Finland, France and the Netherlands. Since France lost its AAA rating on 12 July 2013, its interest rate ceased to be taken into account from that date.

(2) The time-varying correlation between day-to-day changes in the ten-year interest rate in the United States and the euro area is calculated on the basis of a moving sample over three years.

Owing to the acceleration of economic and financial integration at international level, financial developments in the various countries have converged much more closely in recent decades [1]. That is also true for the United States and the euro area. Long-term interest rates in these two economies have displayed an increasing correlation, although that has been a little less marked since 2009. The first reason for this closer correlation is that the

(1) See, for example, Bordo M. and T. Helbling (2011), "International Business Cycle Synchronization in Historical Perspective", *The Manchester School*, 79, 208-238.

economic cycles of the euro area and the United States are currently converging to a greater extent owing to the intensification of international trade. Expectations regarding future short-term interest rates, which are under the direct control of central banks, therefore display a more similar pattern in the two economies. Since long-term interest rates are determined essentially by expectations regarding future short-term rates and by a term premium, they likewise show a closer correspondence between the two economies. Moreover, owing to more cross-border arbitrage, the closer financial integration also reinforced the long-term interest rate correlation between countries, especially prior to the crisis. That effect is due mainly to a more uniform movement in the term premium, i.e. the component of long-term interest rates that reflects the remuneration which investors require for the risk of price fluctuations of longer-term assets.

To gain a better understanding of developments during the year under review, the ten-year interest rate can be split into two components: a long-term component – the implied five-year forward interest rate five years ahead – and a short-term component, the five-year interest rate[(1)]. Movements in the long-term component are due mainly to expectations of nominal growth in the long term and a term premium, as it can be assumed that monetary policy is neutral for that long-term horizon and the expected nominal interest rate for that period is therefore around the expected nominal growth. Since these expectations have remained more or less unchanged in recent years, the gap between the implied five-year forward rate five years ahead and the nominal growth expectation for that same period shows that the recent movements in that rate were caused mainly by movements in the term premium. In the last few years, the Federal Reserve's purchase of longer-term securities, i.e. its policy of quantitative easing, has been a major factor – via a reduction in the term premium – in lowering long-term interest rates not only in the United States but also at global level via international arbitrage. In May 2013, the Federal Reserve's announcement that it might soon start tapering its purchases of longer-term securities therefore triggered a sharp rise in the term premium in the United States. Despite a more moderate rise in the long-term component in the euro area, there is every indication that the term premium in the euro area also rose from May 2013, whereas it had been down sharply in the preceding years.

On the financial markets, the Federal Reserve's communication regarding its future asset purchases and the improvement in the economic outlook also gave rise to the perception that, despite its unchanged forward guidance, the Federal Reserve might end its policy of low interest rates sooner than expected. As a result, expectations regarding future short-term interest rates rose significantly, leading to a substantial increase in the short-term component of the American ten-year interest rate, namely the five-year rate. During that same period, the five-year rate initially rose in the euro area as well. Despite the absence of any significant improvement in the economic outlook for the euro area in May, and in spite of the Governing Council's decision to ease the monetary policy stance at the beginning of May, the international financial markets were apparently convinced that the improvement in the US economic prospects would also benefit the euro area's economy and would thus drive up interest rates there.

However, in July, the Governing Council considered that the outlook for price stability in the euro area did not justify any tightening of monetary conditions. It therefore decided to provide forward guidance on its future key interest rates. Consequently, the rise in short-term interest rates in the summer was smaller in the euro area than in the United States. In September 2013, the Federal Reserve decided for the time being to wait for more definite signs of economic recovery before adjusting the pace of its asset purchases; that led to a slight fall in long-term interest rates in the United States and in the euro area. However, in December, it announced that it would start tapering its asset purchases from January 2014. In November, the ECB Governing Council decided to cut the ECB's main refinancing rate by 25 basis points; together with the forward guidance, that helped to keep longer-term interest rates under control in the euro area. These Eurosystem measures therefore made it possible to counteract the potential undesirable effects that an expected tightening of US monetary policy might have on monetary conditions in the euro area.

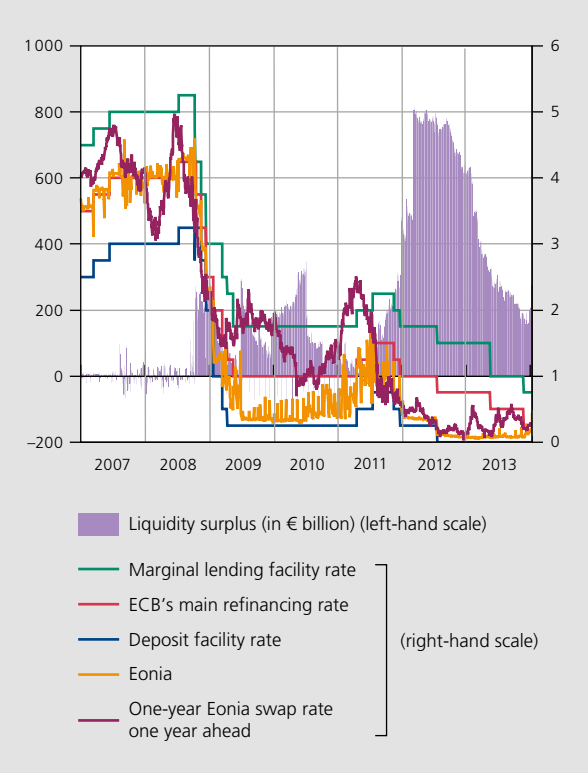
(1) See Boeckx J., N. Cordemans and M. Dossche (2013), "Causes and implications of the low level of the risk-free interest rate", *Economic Review*, NBB, September, 67-94.

While term rates on the money market had been slightly volatile in the early months of the year, an upward trend emerged in the spring, and at the beginning of the summer the tightening of money market conditions had in practice partly cancelled out the effects of the easing of monetary policy decided on in May. In addition, expectations regarding the monetary policy stance seemed to have become too vulnerable to shocks unconnected with the euro area's macroeconomic conditions.

Against that backdrop, the Governing Council considered at its July meeting that it was necessary to provide indications of the future path of its key interest rates and thus pursue a policy of forward guidance. It therefore announced that the ECB's key interest rates were expected to remain at or below their current level for an extended period of time. That expectation, subsequently reaffirmed at each Governing Council meeting, was based on the overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics.

More specific communication regarding the Eurosystem's future monetary policy stance was thus deemed useful to safeguard the hesitant recovery of economic activity and the improvement in financing conditions on the euro area's financial markets. In giving assurance that it would maintain an accommodative monetary policy for an extended period, and that it was determined to respond to changes in the macroeconomic prospects, the Governing Council intended to promote more stable money market conditions, ensure that market expectations were more firmly anchored, and hence maintain closer control over its monetary policy stance.

CHART 20 KEY INTEREST RATES, MONEY MARKET RATES AND LIQUIDITY SURPLUS IN THE EURO AREA



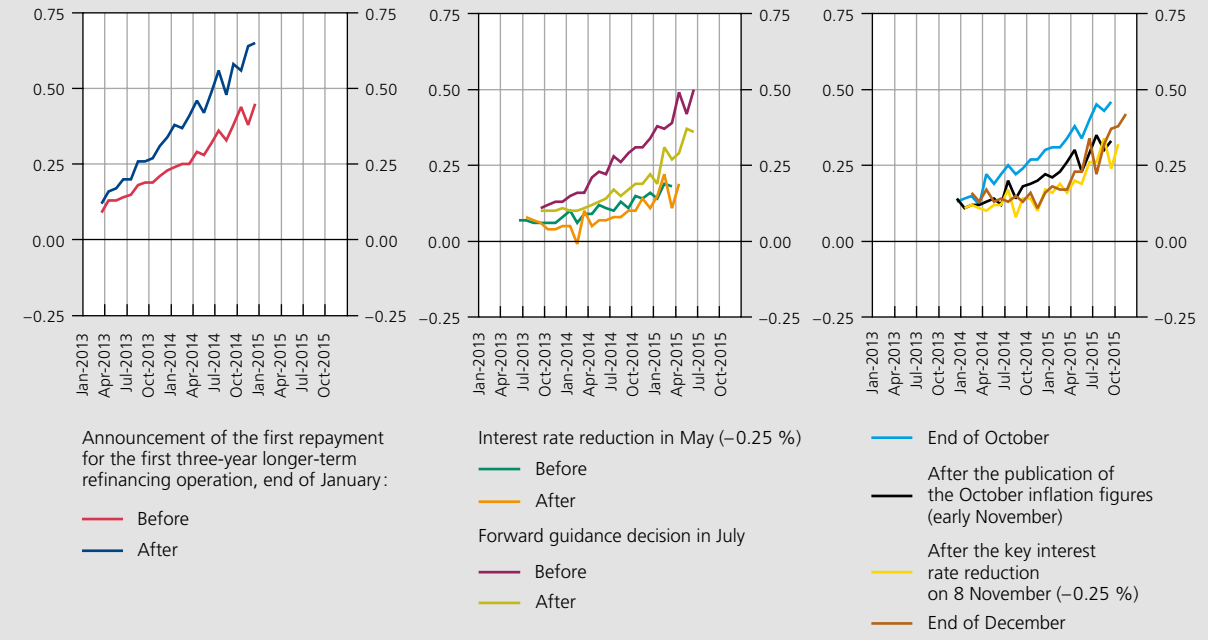
Sources : Thomson Reuters Datastream, ECB.

The forward guidance policy in place since July has three important features. First, the policy was announced before the key interest rates had reached their absolute minimum. Should any change in the outlook for price stability so require, it is therefore possible to cut the rates further. Next, this forward guidance is consistent with the Governing Council's decision to prolong the fixed-rate full-allotment procedure, as that procedure is possible regardless of the level of the key interest rates. Finally, and above all, the forward guidance is totally compatible with the Eurosystem's mandate and its monetary policy strategy. In particular, movements in the key interest rates will continue to depend on the outlook for price stability in the medium term.

It is not easy to assess how effective the forward guidance on monetary policy has been. While expectations regarding future money market rates declined following the Governing Council's announcement on 4 July, they subsequently made up part of that fall. However, there are several signs suggesting that, in the absence of forward guidance, interest rates would have displayed greater upward volatility. In fact, the uncertainty over future monetary policy has waned, as has the sensitivity of expected money market rates to surprises in the published macroeconomic figures and new information unconnected with the euro area's macroeconomic fundamentals. That includes, more particularly, communication by other central banks concerning their own monetary policy. However, the effects of forward guidance cannot be judged on the basis of what has happened since it was announced; instead, it will be assessed on the basis of developments during the period for which the measures apply, which means in the longer term.

In the autumn, in view of the persistent and unexpectedly sharp weakening of underlying pressures on prices together with the subdued monetary picture and particularly the sluggish lending, the Governing Council considered that it needed to ease its monetary policy further. So, at its meeting on 7 November 2013, it cut the interest rate on the Eurosystem's main refinancing operations from 0.50 to 0.25 % and reduced the interest rate on the marginal

CHART 21 EXPECTATIONS REGARDING OVERNIGHT INTEREST RATES IN THE EURO AREA [1]



Sources : Bloomberg, NBB.
(1) Measured on the basis of the implicit one-month interest rate derived from the rates on Eonia swaps with different maturities.

lending facility by 25 basis points to 0.75 %. As in May, the interest rate on the deposit facility was held at 0 %.

That decision again reduced the cost of refinancing from the Eurosystem and, together with the extension to July 2015 of the fixed-rate tenders with full allotment, it further reduced any potential upward volatility in Eonia for an extended period. Following the decision to cut interest rates, after which the forward guidance was also maintained with a downward bias, expectations regarding money market rates fell sharply, amplifying the fall that had occurred at the end of October following the publication of particularly weak inflation figures for that month. That decline is consistent with the aim of forward guidance, which is specifically intended to clarify the Eurosystem's strategy. This flattening of the term structure of money market interest rates should help to support lending to households and businesses, in view of the importance of longer-term money market rates in determining the interest rates on new and existing financial contracts.

The highly accommodative monetary policy stance adopted is intended to prevent the emergence of deflationary forces, which would be extremely damaging in a situation where many euro area countries are trying to make macroeconomic adjustments and regain competitiveness. In an environment of excessively low inflation – or even worse, deflation – at euro area level, it is in fact particularly difficult for the countries concerned to cut their relative costs, taking account of the nominal downward rigidities which generally affect prices and wages. In addition, since economic agents' debts are expressed in nominal terms, a deleveraging process becomes more difficult the lower the level of inflation. Thus, it is worth noting that the clarification of the definition of price stability adopted by the Governing Council in May 2003 – year-on-year inflation rates at levels below, but close to, 2 % over the medium term in the euro area – was specifically motivated by awareness that there are inflation differentials between euro area countries, and that nominal rigidities do exist.

By continuing to offer banks all the liquidity they need against adequate collateral, the Eurosystem has also continued to compensate for the inequalities in access to market funding for credit institutions and prevented the latter from being forced to cut the size of their balance sheet too hastily. In so doing, it has helped to support lending to the private sector and ensure that its accommodative monetary policy stance has been properly transmitted to the real economy.

All the decisions and measures adopted in the past year were thus intended to safeguard an appropriate monetary policy stance while also responding to the persistent fragmentation of the financial markets in the euro area. Together, these measures supported economic activity in the euro area and helped to preserve the Eurosystem's objective of price stability in the medium term, making it easier to implement the necessary structural adjustments.