International developments

Financial markets

Tensions easing

Tensions on the European sovereign debt market have eased following the announcement by the European Central Bank (ECB) of the set-up of a new programme of European bond purchases. As a result the yield spreads between European states came down sharply in Q4 2012.

This drop in tensions surrounding sovereign debt has filtered through to the stock markets, where performances have improved and volatility has dropped since the summer. However, although tensions are also lower on the money markets, these markets have not yet returned to normal functioning since the massive intervention by the ECB at the end of 2011 and start of 2012. The conditions for transmission of monetary policy within the Eurozone are therefore still unstable.

Against this backdrop the European bank credit market did not show any signs of easing in Q3 2012. The gloomy business prospects in the Eurozone have led banks to tighten their credit terms compared to Q2, and these terms may not improve through to the end of the year.

In the United States the credit market is showing signs of a long-term easing. The Federal Reserve is also pursuing its unconventional monetary measures with a new quantitative easing operation in place since September.

Over the forecasting period the conventional assumptions used for the exchange rate are 1.29 dollars, 102 yens and 0.80 pounds sterling to the euro in Q4 2012 and in H1 2013.

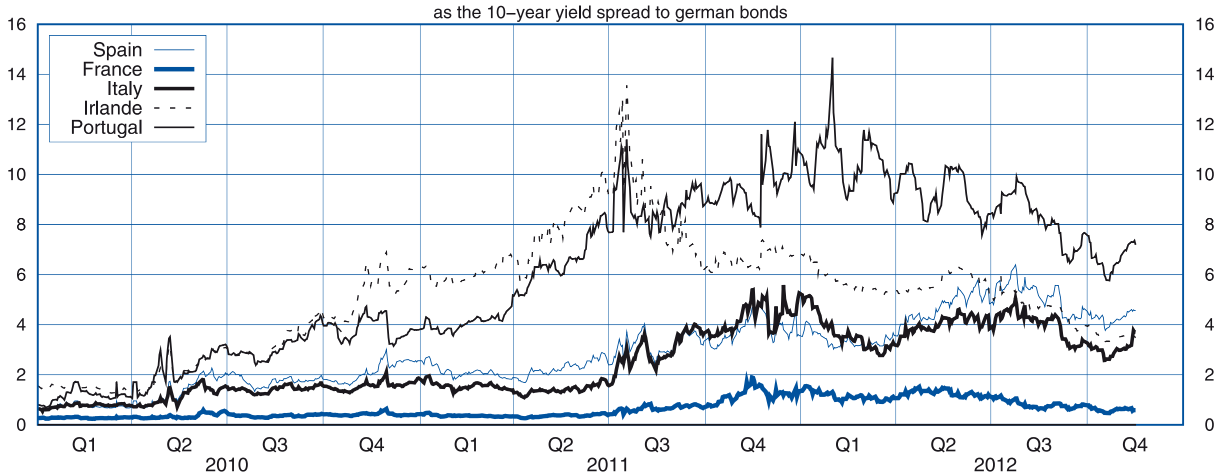
Tensions easing on the sovereign bond market since the summer...

In order to reduce tensions on the sovereign debt market, the ECB launched its new sovereign bond-buying programme in September 2012, the Outright Monetary Transactions (OMT). Medium-term bonds (1 to 3 years) from countries that have sought aid from the European Stability Mechanism can now be purchased in unlimited quantities by the ECB.

The announcement of this programme by the ECB has led to a clear improvement in the financing conditions of European states on the sovereign debt market. The yield spreads between German bonds and those of the lowest-rated Eurozone countries were globally down in Q3 2012 *(see Graph 1)*. In November the spread between Spanish and German sovereign yields stood at 430 basis points, down by 130 points from the July average. Similarly, the spread between Italian and German sovereign yields fell from an average of 440 points in July to 330 points in November.

The countries in the most difficulty since the start of the sovereign debt crisis (Greece, Portugal, Ireland) have seen a sharp improvement in their situation. After reaching a high of 1100 basis points on average in January 2012, the spread between Portuguese and German 10-year yields was down to 670 points on average in November 2012, allowing the country to successfully complete its first medium-term issue since seeking aid from the IMF in May 2011. Portugal may also

1 – Tension eases on the European sovereign debt market



Source: DataInsigh

return to the long-term debt market by the end of 2013. In Q3 2012, Ireland returned to the long-term (8-year) debt market after two years out. In November, the sovereign debt yield spread between Ireland and Germany stood at 360 basis points, compared to its high-point of 520 points in July.

... but the money market still tight despite an accommodating monetary policy

The long-term refinancing operations (LTRO) conducted at the end of 2011 and start of 2012 by the European Central Bank eased the financing difficulties of European banks, but also caused the interbank money market to dry up. This market is therefore characterised by very low rates showing little in the way of volatility (*see Graph 2*). So even through tensions appear to be at a low point, the money market has not actually returned to normal functioning in Q4. As a result the ECB has preferred to implement unconventional monetary policies. Its base interest rate, lowered to 0.75% in July, is unlikely to change over the forecasting period.

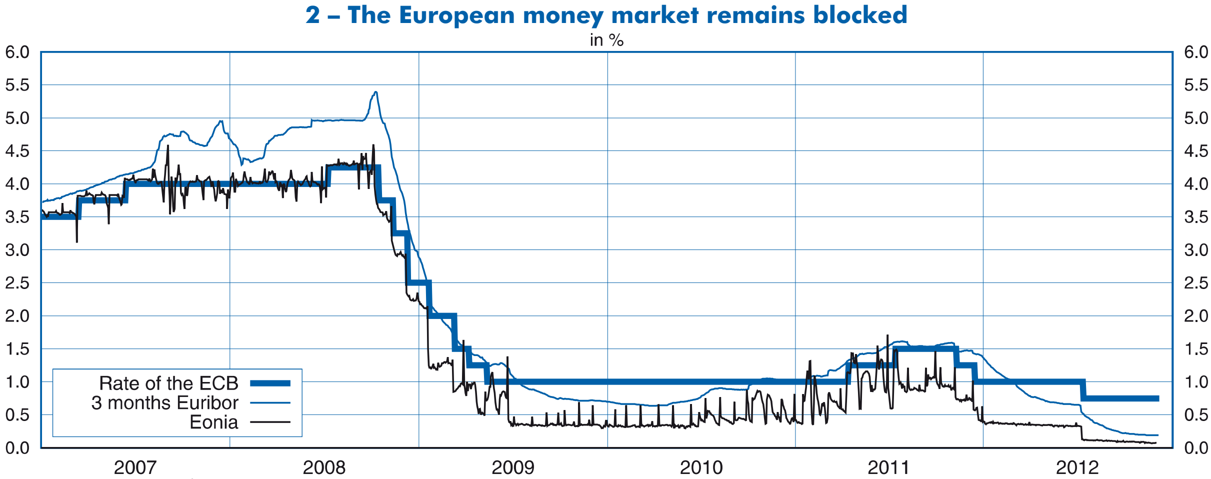
In the United States however, the money market has returned to normal functioning. Additionally, the Fed, concerned about the high unemployment rate, has set up a new quantitative easing operation. Each month since October 2012 and for an open-ended period, it has been buying 40 billion dollars of mortgage backed securities. Its base rate, set at the exceptionally low level of 0.25% since December 2008, should remain unchanged until mid-2015 at the earliest.

Financing conditions of the economy still difficult in the Eurozone

The lower level of uncertainty on the European sovereign debt market has not brought renewed growth in bank credit, mainly because of the poor business prospects in the Eurozone. According to the ECB quarterly survey on European banks, credit terms tightened in Q3 2012 (*see Graph 3*). In Italy and Germany particularly, the number of banking institutions reporting a renewed tightening of credit terms increased, while this number was stable in Spain and slightly down in France.

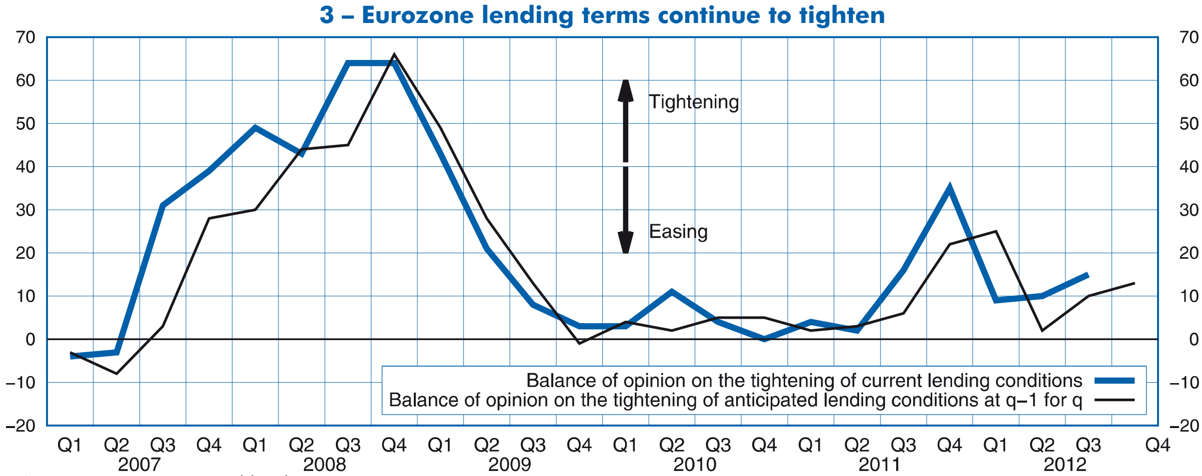
In this context the interest rates granted by banks to non-financial companies have continued to differ from one country to the next: Germany and France

2 – The European money market remains blocked



Sources: DataInsigh, INSEE

3 – Eurozone lending terms continue to tighten



Source: European central bank

still benefit from far lower rates than Spain and Italy, particularly for small loans, even though rates were lowered across all countries of the Eurozone in Q3 (see *Graph 4*). At the start of December Spain was nonetheless granted a first instalment of 40 billion euros from the European Stability Mechanism to recapitalise its nationalised banks, a factor that may have a positive influence on credit conditions.

Outstanding loans to non-financial corporations in the Eurozone declined in Q3 2012 for the fourth consecutive quarter (-1.7% of annualised quarterly growth in September against -0.6% in June). They grew slightly in France in Q3 (+0.4% of annualised quarterly growth in September). Consumer credit was also down in the Eurozone in Q3 (-0.4% in September), while it grew by 1.6% in France over the same period.

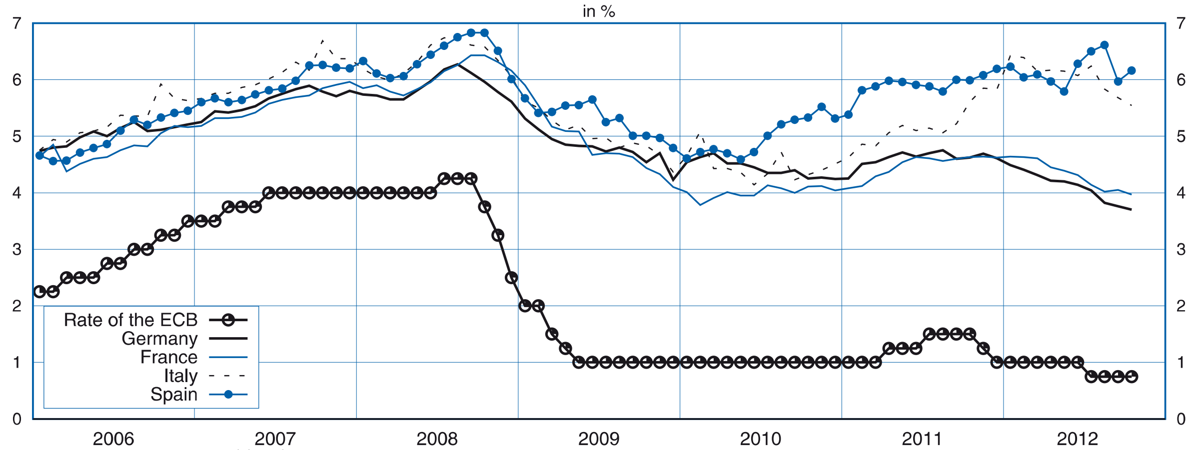
Upbeat conditions on the stock markets

Thanks to the easing of financial tensions in the Eurozone, in September the stock markets returned to their levels of Q1 2012 and have since stabilised. German and American stock market indices have even surpassed their levels of 1st January 2011. As a sign of the global easing of uncertainty, the implied volatility of American and German stock market indices has diminished since the summer and is now at its level of the start of 2011.

Depreciation of the euro halted

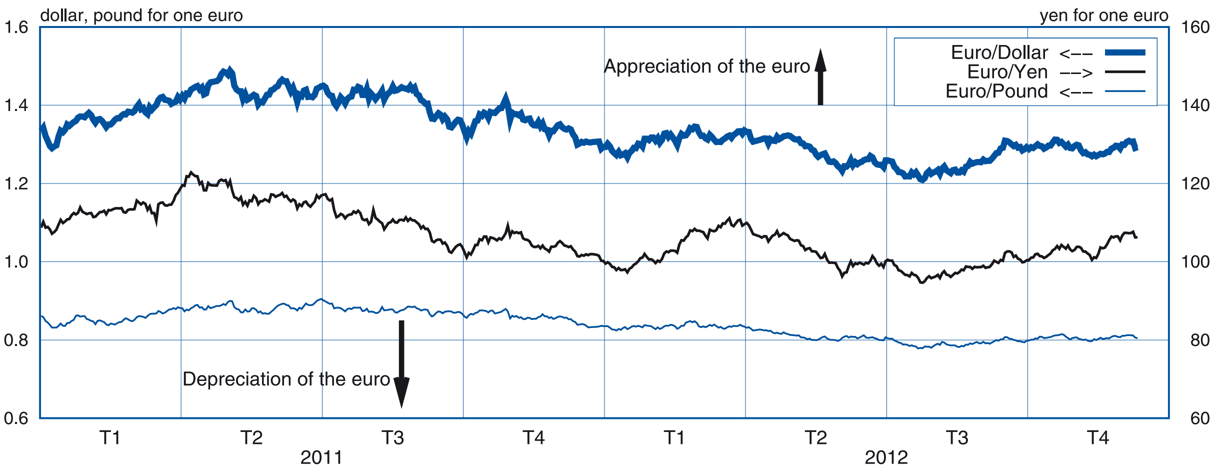
After an almost continuous fall since May 2012, the euro profited from the easing of financial tensions in the Eurozone and appreciated once again in August. Over the forecasting period, the value of the European currency should stabilise at around 1.29 dollars to the euro (*see Graph 5*). ■

4 – Interest rates granted to non-financial corporations diverge between countries



Source: European central bank

5 - Changes to the euro exchanges rates



Source: European central bank

Eurozone

Gradual recovery expected for the Eurozone

Economic activity in the Eurozone contracted once again in Q3 2012 (down 0.1%, after a 0.2% drop in the preceding quarter). Activity increased in France and Germany, but decreased again in Italy and Spain. Domestic demand continued to fall. However the export sector was dynamic, particularly in Spain and Germany.

Based on the business tendency surveys the short-term outlook for Q4 looks set to remain poor, and the available economic activity figures are not good. Activity is thus expected to fall again (-0.3%), even in Germany. Nonetheless the Eurozone should begin to recover slowly in early 2013. GDP should remain stable in the first quarter (0.0%), growing slightly in the second quarter (0.1%). The effects of reduced tensions on the sovereign debt market should gradually make themselves felt in the real economy, with greater access to financing for private agents. Investment, which has been traversing a period of major readjustments since summer 2011, is expected to stabilise. Household purchasing power should continue to suffer the effects of the decrease in earned income, but the impact of fiscal consolidation measures will be less severe in 2013 than it was in 2012. Furthermore, the rate of inflation should continue to fall. Household consumption should thus stabilise. Finally, exports are expected to increase slightly thanks to renewed dynamism in demand from outside the Eurozone.

Overall, growth in the Eurozone is predicted to be -0.4% in 2012, and the overhang for 2013 at the end of Q2 should be -0.2%.

In late 2012 the short-term outlook remains poor

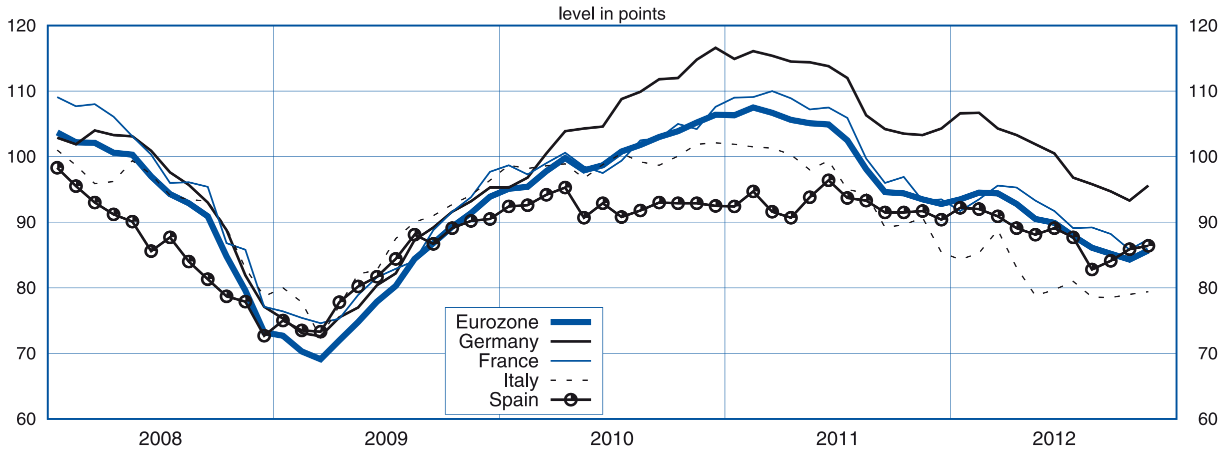
Activity in the Eurozone contracted in Q3 2012 (down 0.1%, after a 0.2% drop in the preceding quarter). Private consumption remained stable, receiving a notable boost from advance purchases in Spain ahead of the rise in the rate of VAT on 1st September. Investment also decreased again, on account of limited opportunities and financing conditions which remain difficult. However exports (0.9%) proved to be surprisingly dynamic, in spite of the general downturn in world trade.

After the slight rebound seen in Q1 2012, the short-term outlook has deteriorated in the Eurozone (see *Graph 1*). Conditions recovered in November, but remain far below average levels. Based on the business tendency surveys, business leaders are expecting a further drop in activity in Q4, a diagnosis backed up by the data from the Industrial Production Index published at the end of October.

Activity set to grow slowly in 2013 thanks to the stabilisation of domestic demand

H1 2013 should see an end to the decline in economic activity, but the recovery will be very gradual: activity should be stable in Q1 (0.0%), growing slightly in Q2 (+0.1%). Several factors should contribute to this recovery in early 2013: the easing of financial tensions, the scaling back of fiscal consolidation measures and the acceleration of world trade.

1 - Business climate composite indicators



Source: European Commission

Circumstances should continue to vary from country to country *(see Graph 2)*. Germany should see several factors conducive to domestic growth, particularly in terms of consumption and investment in construction, with activity set to remain dynamic. On the other hand, domestic demand should continue to fall in Spain and, to a lesser extent, Italy. Finally, France should find itself somewhere between the two, with domestic demand remaining more or less stable.

Exports continue to boost activity

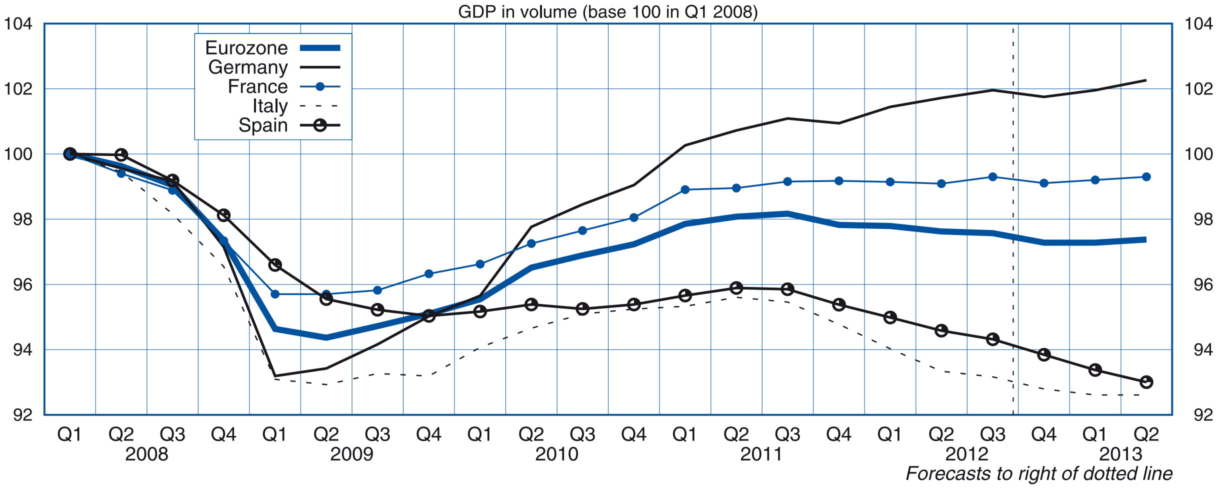
Since 2011, exports from the Eurozone have been systematically more dynamic than international demand would lead us to expect *(see Graph 3)*. The growth in exports is predicted to slow down in Q4 2012 (+0.2%), impacted by sluggish international trade, before picking up progressively during the first half of 2013 (0.6% then 0.7%). Due to the weakness of domestic demand in the Eurozone, the contribution of foreign trade has been positive over the last few quarters (+0.3 GDP points in Q3). This contribution should drop slightly to 0.1 points in 2013, as a result of the stabilisation of domestic demand.

Easing of financial tensions and a return to growth for investment

The recovery of economic activity in the Eurozone should also be driven by internal factors. Since summer 2012 sovereign yields have decreased in the Eurozone, receiving a significant boost from the Outright Monetary Transactions (OMT) scheme announced by the European Central Banks (see "*Financial markets*" *note*). Financing conditions remain difficult for private agents, but the easing of tensions on the sovereign debt market should translate into a progressive reduction in the interest rates charged on loans to businesses.

2 - Divergences in the Eurozone

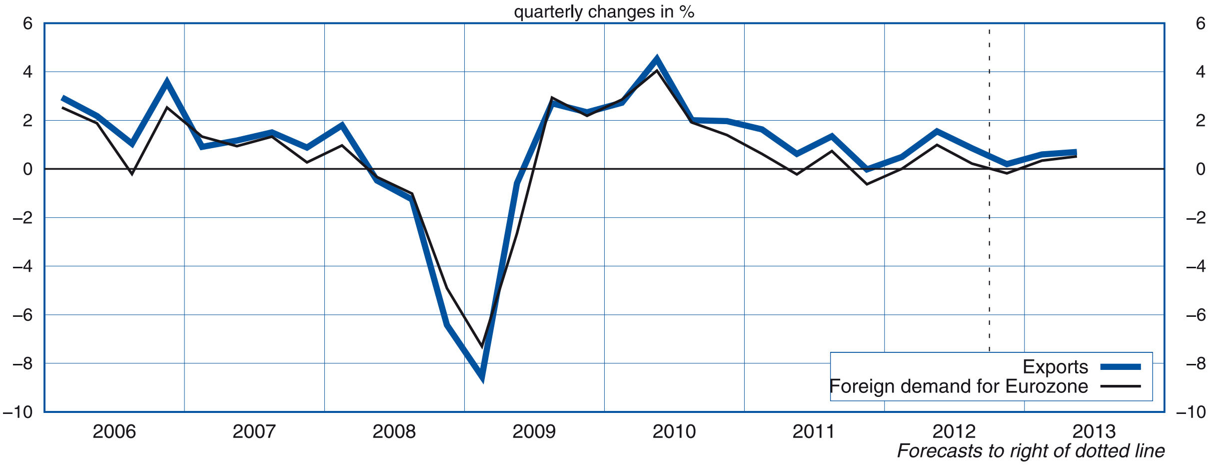
GDP in volume (base 100 in Q1 2008)



Source: Eurostat, INSEE calaculations

World demand for Eurozone products and exports

quarterly changes in %



Source: Eurostat, INSEE calculations

Improved access to credit should help put an end to the uncertain transitional phase which capital goods investment has been through since late 2011. The upturn in global demand should also boost the development of new production capacities over this forecasting period. In the construction sector, however, investment should remain subdued as it continues to suffer the after-effects of the Spanish property bubble. Nonetheless, in early 2013 the sector should benefit from renewed dynamism in Germany.

Consumption down

Employment is expected to fall by 0.2% per quarter in H1 2013, as economic activity remains sluggish. Productivity, which was severely reduced by the economic crisis, has been recovering slowly, and this recovery looks set to continue. The deterioration of conditions on the labour market has had a knock-on effect on employees' bargaining power and, furthermore, wage moderation measures are still in place in Italy and Spain, with pay freezes for public employees and further reforms to the labour market. Nominal earned income is therefore expected to increase very little.

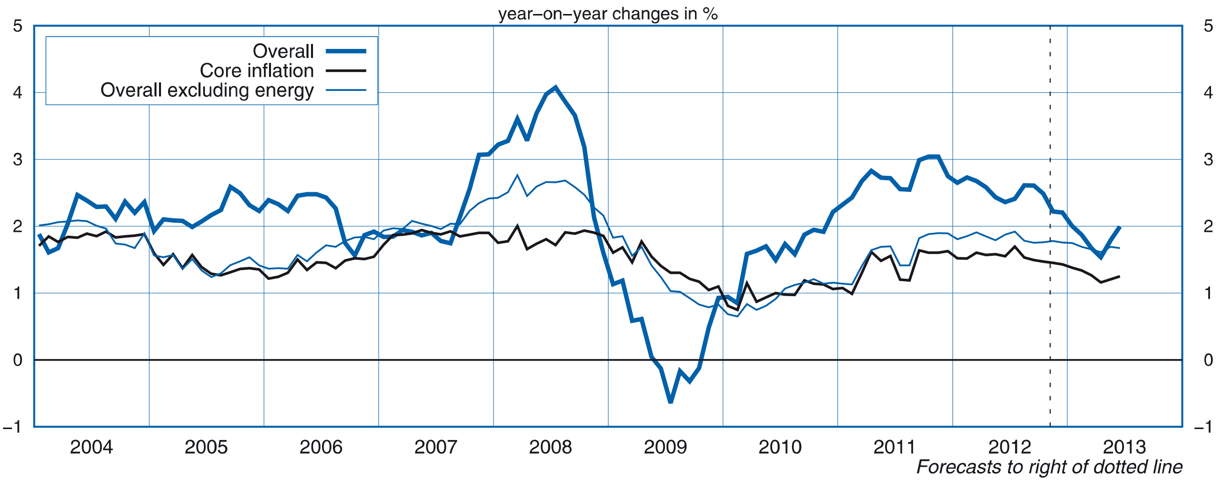
However purchasing power should contract less rapidly in 2013 than it did in 2012. Fiscal consolidation measures (tax rises, cuts to welfare services) will be generally less substantial in 2013 than they were in 2012, particularly in Italy. Moreover, inflation should continue to fall. After a further drop in Q4 (-0.3%), consumption should stabilise over the first half of 2013. Households are expected to continue to partially offset the deterioration of their purchasing power by reducing their savings ratio.

Inflation set to fall again

The rate of unemployment rose in Q3 2012 (reaching 11.7% in October), and should continue to rise until June 2013. Inflationary pressures should thus remain moderate, with core inflation falling from 1.5% in October 2012 to 1.2% in June 2013.

The slide in headline inflation in the Eurozone, substantial since the start of 2012, is also expected to continue (see *Graph 4*). Inflation should thus fall to 2.0% in June 2013, down from 2.5% in October 2012. Indeed, if the price of a barrel of Brent crude remains stable at €81, the annual rise in energy prices should fall considerably to hit 4.7% in June 2013, down from 8% in October 2012. However, the rise in food commodity prices observed since the start of 2012 should have a knock-on effect on food prices.■

4 - Consumer prices in the Eurozone



Sources: Eurostat, INSEE calculations

Cost-competitiveness and margin rate in the manufacturing industry in the Eurozone: what has changed since 2008?

Since 2008, a shift in the growth of unit wage costs in the four biggest countries of the Eurozone

Between 2000 and 2008, unit labour costs[1] in the manufacturing industry of the four biggest countries of the Eurozone evolved in contrasting ways (see *Graph 1*). In Germany they decreased over the period by 16%. However, in Italy and Spain they grew sharply. In France they remained stable.

Since 2008 these trends have altered. Unit labour costs have progressed, on average, at similar speeds in Germany, Italy and France. From Q1 2008 to Q1 2012, they increased by 8% in France, 9% in Germany and 14% in Italy. However, they fell sharply in Spain over the period (-12%).

In Germany productivity has stagnated since 2008

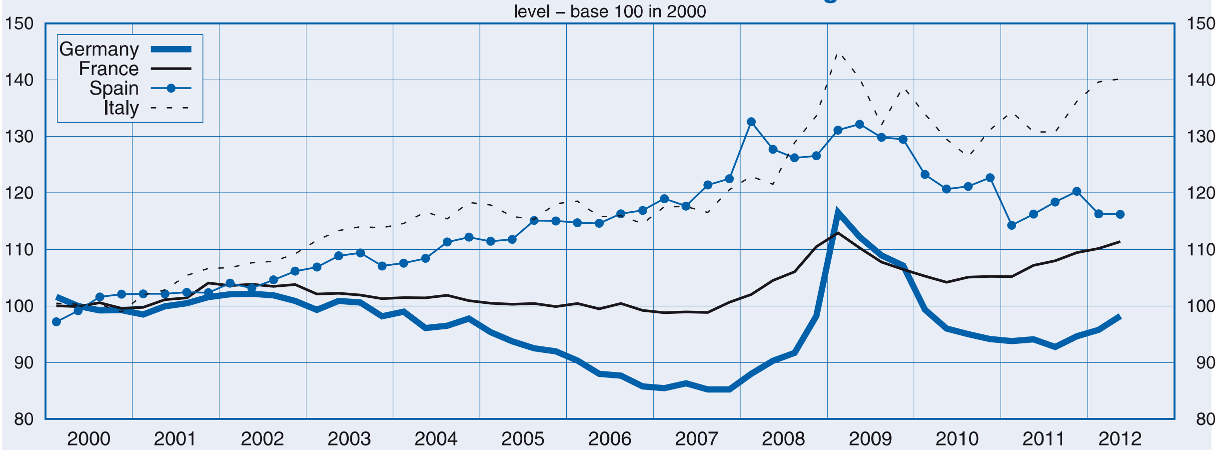
Whereas it fell sharply from 2004 to 2008 due to the combined effects of very dynamic productivity gains *(see Graph 2)* and wage moderation, the unit labour cost in Germany increased between 2008 and 2012 and is now close to its 2004 level. Labour retention during the crisis had a very detrimental effect on hourly productivity, which only just returned in 2012 to its level of 2008.

In Spain the cost of labour has not progressed since 2008

Spain has seen the reverse. Where it had increased since 2000, the unit labour cost has fallen since 2008. There was no labour retention in Spain and productivity in the manufacturing industry continued to grow at the same speed during the crisis. In parallel, the hourly cost has stabilised since 2009 (see *Graph 3*).

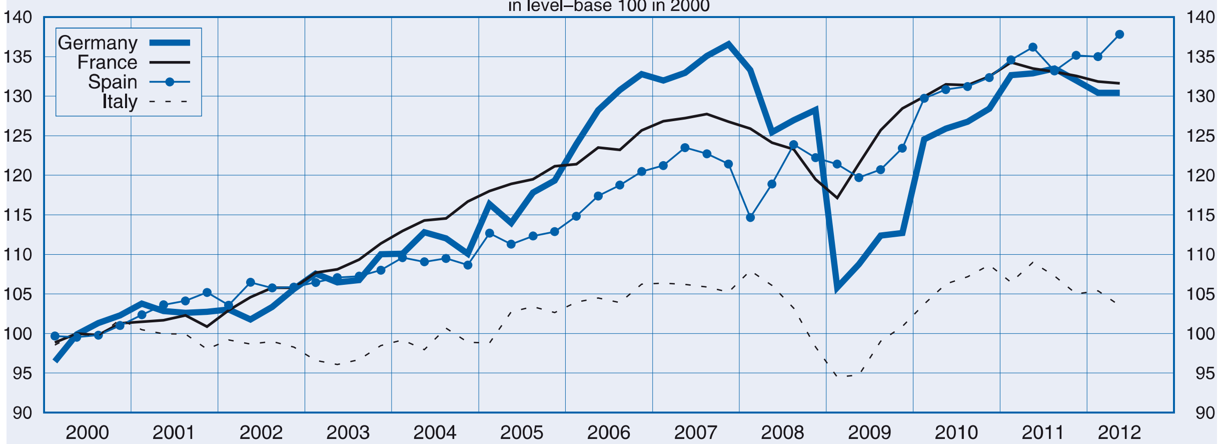
(1)Unit labour costs are labour costs in relation to added value by volume, to measure the "cost per unit produced".

1 - Unit labour cost in manufacturing
level – base 100 in 2000



Source: Eurostat

2 - Hourly productivity in manufacturing
in level–base 100 in 2000



Source: Eurostat

In France productivity has risen more slowly than the cost of labour since 2008

The unit labour cost in France has been increasing since 2008 after being stable between 2000 and 2008. Although the hourly labour cost has continued to rise at the same pace as in the past, productivity declined during the crisis and has not made up for the ground lost on previous trends.

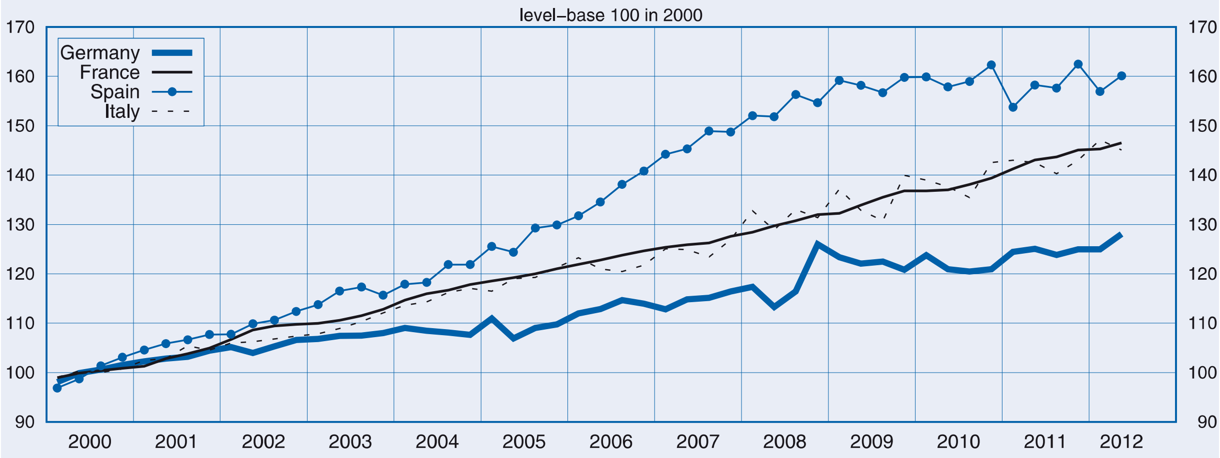
In Italy the unit labour cost has climbed since 2000

The hourly cost in the manufacturing industry in Italy has grown at the same pace as in the other Eurozone countries, but weak productivity gains (just +5% from 2000 to 2012) have weighed very heavily on the unit labour cost, which has been rising since 2000.

Sharp improvement in the margin rate in Spain since 2008

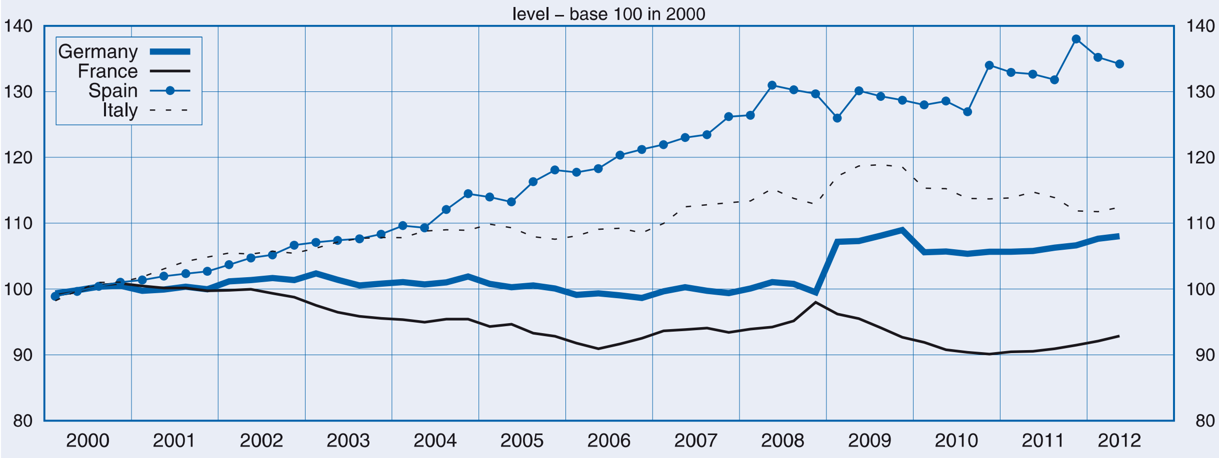
In Germany the rise in unit labour costs came hand-in-hand with a big increase in the prices of value-added at the start of 2009, so much so that in 2012 the margin rate is close to that of 2008. Conversely, companies in Italy and France have not increased the price of value-added since 2008, while unit labour costs have increased and the margin rate has declined. In Spain the prices of value-added have continued to grow (*see Graph 4*), so much so that the drop in unit labour costs has led to a spectacular rise in the margin rate in the manufacturing industry (*see Graph 5*).■

3 - Hourly labour cost in manufacturing



Source: Eurostat

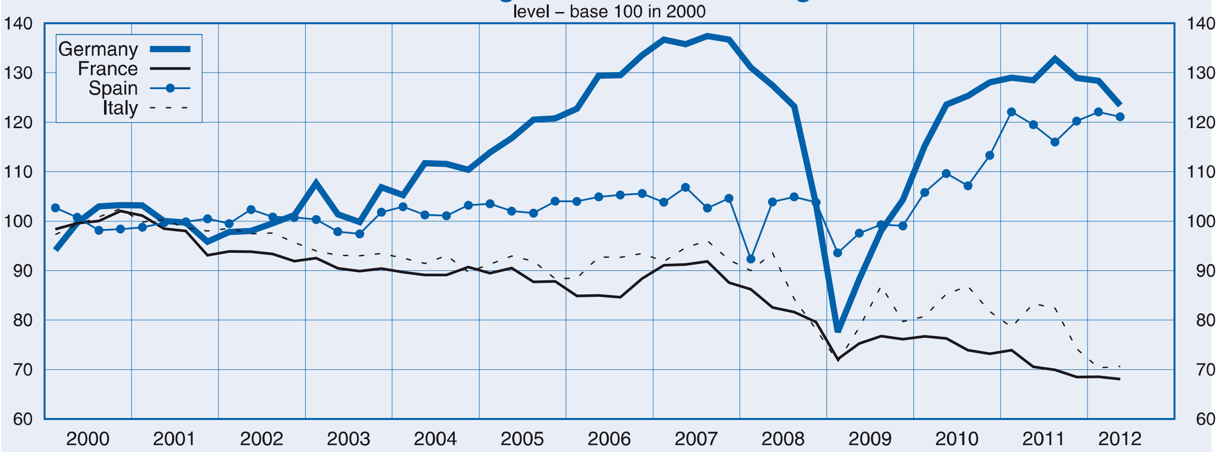
4 - Price of value-added in manufacturing



Source: Eurostat

5 - Margin rate in manufacturing

level – base 100 in 2000



* Calculated as the share of value added remaining after remuneration *(see Appendix)*.

Source: Eurostat

Appendix - From unit labor costs to margin rate: definitions and data used

Breakdown of the margin rate

The margin rate measures the portion of value-added that remunerates capital. Neglecting taxes and subsidies on products, it corresponds to the portion of value-added that remains after remuneration of labour. Several variables modify the share of payroll in value-added: the cost of an hour's work (hourly labour cost), the number of units produced during an hour of work (hourly productivity), and the value of a unit produced (price of value-added). If the hourly labour cost increases faster than hourly productivity, the company's price-competitiveness is reduced (the unit labour cost increases): it costs more and more to produce the same quantity of goods. To maintain margins companies must therefore increase the prices of value-added, i.e. increase their sale prices, usually.

In accounting terms this breakdown is written as follows:

$$TM = \frac{EBE}{VA\_val} \approx 1 - \frac{D1}{VA\_val} = 1 - \frac{D1}{H}\frac{H}{VA\_vol}\frac{VA\_vol}{VA\_val}$$

With
TM = margin rate
EBE = gross operating surplus
D1 = payroll
H = number of hours worked
VA_vol = Value-added in volume, 2005
VA_val = Value-added in value

$\frac{D1}{H}$ represents the hourly labour cost. It is the total cost of an hour of labour

$\frac{VA\_vol}{H}$ represents hourly productivity, indicating the number of units produced per hour of labour

$\frac{VA\_val}{VA\_vol}$ represents the price of value-added. Its value is 1 on average in 2005 (base year) and indicates the changes in prices of value-added.

Data used

The data used are Eurostat data. For France, the Eurostat data are those published by the INSEE.
The variables used encompass all the economic agents in the Manufacturing Industry branch. The margin rate is thus not that of the non-financial companies in the branch but of all the agents. Non-financial companies nonetheless represent the majority of activity in the manufacturing branch.
Payroll (D1) includes gross wages and salaries (D11) and the employer's social contributions (D12). It gives the best possible approximation of the cost of labour by using the data from the quarterly national accounts. However, it does not include vocational training costs, taxes on wages or subsidies received. These latter data (which represent less than 4% of the total cost of labour) are only available once every four years, in the results of the European labour costs survey. Additionally, they are highly stable over time.■

Germany

Still potential for a rebound

Activity in Germany continued to progress at a modest pace in Q3 2012 (+0.2% after +0.3%). Investment in capital goods declined for the fourth consecutive quarter, but exports, household consumption and investment in construction were all on the rise.Penalised by the weak level of world trade and the persistent decline in investment in capital goods, activity is set to stall in Q4 (-0.2%). Nonetheless, the Germany economy should rebound at the start of 2013 (+0.2% then +0.3% in Q1 and Q2 2013). Investment in capital goods should stop negatively affecting growth while household consumption and investment in construction should progress.

Household consumption sustaining activity

The German labour market should remain solid over the forecasting period. Following on from the slump in activity, employment is likely to slow and the unemployment rate should stabilise at its current level (5.5%).The good health of the labour market has strengthened the bargaining power of German employees. Wages, which were dynamic at the start of the year, should once again grow at a sustained pace over the forecasting period. At the start of 2013, the social contribution cuts implemented on 1st January and the slowdown in consumer prices should also sustain the purchasing power of households (*see Graph*). Households may therefore increase their consumption expenditure (+0.3% per quarter in H1 2013) whilst stabilising their savings ratio, which is still at a high level (15%).

Fits and starts in construction

After years of decline, a recovery is underway in the construction sector: since 2011 orders and building permits have been on the rise. But activity in the sector is likely to be uneven, according to building permit data. After rebounding in Q3 (+1.5%) investment in construction is set to fall in Q4. It should then progress in H1 2013 at a sustained rate (+1.0% per quarter).

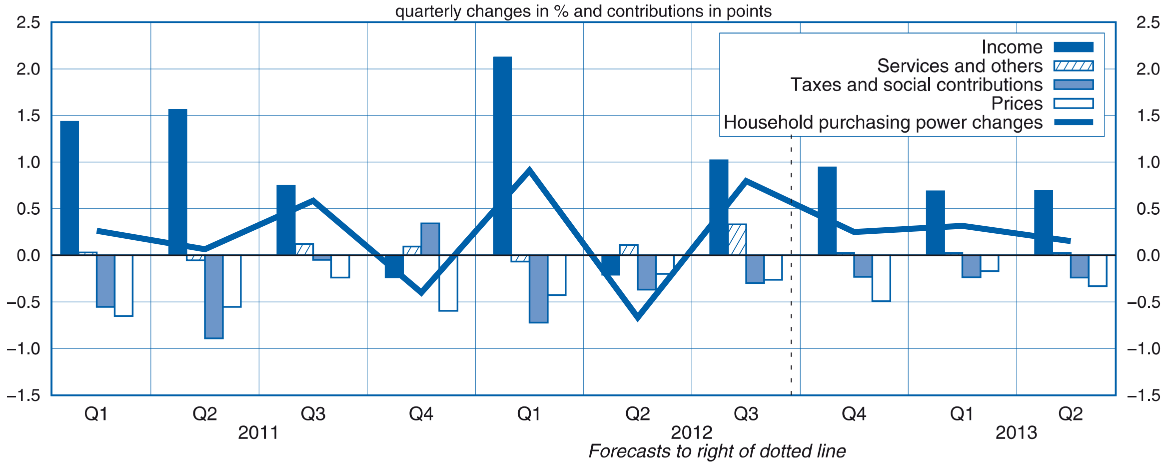
Activity stalling at end 2012...

In Q4 2012, exports are likely to be slowed by sluggish world trade. Additionally, investment in capital goods should continue to decline for the fourth consecutive quarter, despite favourable financing terms for German businesses.

... then getting back on track in early 2013

The dynamism of consumption should continue in H1 2013 and investment in construction is likely to pick up once again. Exports are likely to progress modestly, in line with the resumption of world trade. After a 4.2% drop in 2012, investment in capital goods should stabilise as uncertainties linked to the Eurozone debt crisis ease. Growth in activity should reach 0.2% then 0.3% in Q1 and Q2 2013.■

The increase in wages and the drop in contributions are set to sustain household purchasing power



Source: Destatis, INSEE calculations

Italy

Italy getting back on its feet

The pace at which Italian activity contracted fell in Q3 2012 (-0.2%). Activity is set to decline again in Q4 2012 (-0.4%) and in Q1 2013 (-0.2%), before stabilising in Q2 2013 (0.0%).

The reduction in purchasing power should be slowed in 2013 by a moderation of fiscal consolidation measures on the one hand and a drop in inflation on the other. Additionally, after a sharp adjustment in recent years, investment in capital goods should stabilise, all the more so as the banking environment, although still unfavourable, is improving.

The financial and fiscal environment improving

Tensions surrounding Italian sovereign debt have diminished since the announcement by the ECB at the end of summer 2012 of its sovereign bond-buying operation. Sovereign debt thus dropped in Q3 2012, allowing private rates to come down. Provided that financial tensions do not return, financing conditions should gradually improve. Additionally, although the fiscal consolidation efforts should continue to slow activity in 2013, they should be far less extensive than in 2012, especially if there is no new VAT increase.

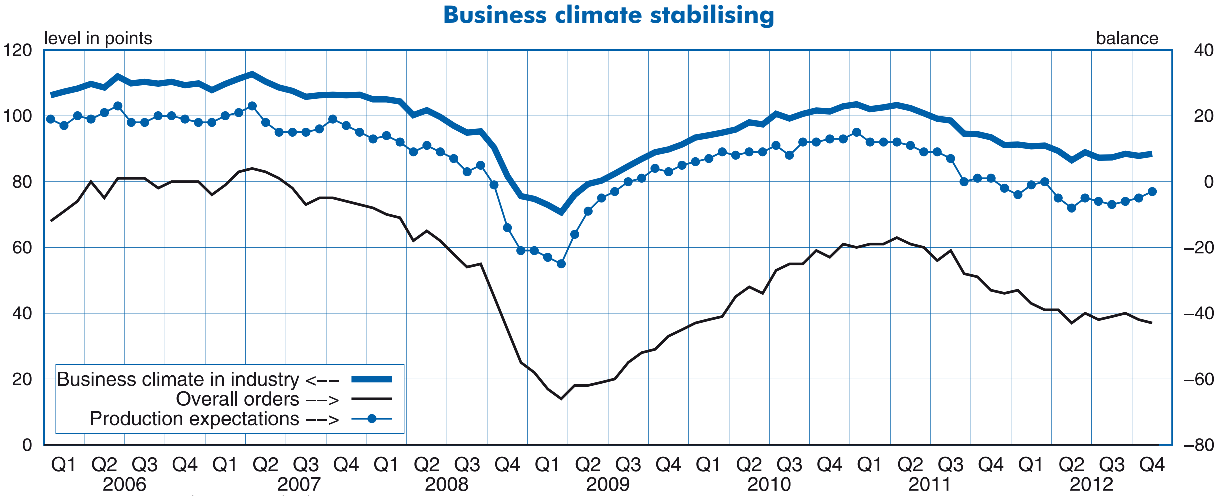
The business climate stabilising

The business climate, most notably in industry, is still at a low level but is no longer deteriorating (see *Graph*). Opinion on the future economic situation in the capital goods industry is improving and production perspectives in industry are recovering slightly, while foreign order books also seem to be stabilising. New orders in industry are still poor, however. Activity should thus continue to contract in Q4 2012 (-0.4%) and in Q1 2013 (-0.2%), then stabilise in Q2 (0.0%).

The decline in domestic demand slowing

Exports are likely to grow slowly but should continue to sustain activity. After a long adjustment phase, investment is set to stabilise in early 2013, sustained by the drop in private-sector interest rates. Furthermore, the drop in purchasing power should be attenuated. The labour market is still poor and the payroll is decreasing in nominal terms. But fiscal consolidation should be less extensive than in 2012, and the increase in consumer prices, still affected in early 2012 by the VAT rise, should gradually slow. All in all, although households are still bringing down their savings ratio, the drop in consumption should slow (-0.4% per quarter against -3.4% as an annual average in 2012).■

Business climate stabilising



Sources: ISTAT and INSEE calculations

Spain
Still adjusting

Spanish activity contracted once again in Q3 2012 (-0.3%) and this trend is likely to continue over the forecasting period: -0.5% in Q4 2012 then -0.5% and -0.4% in Q1 and Q2 2013. Due to the poor labour market situation, the rise in inflation after the increase in VAT in September 2012, and the continuing fiscal consolidation efforts, household consumption should fall sharply. However, despite the lack of dynamism of world trade, exports should continue to progress. After a sharp decline at the end of 2011 and at the start of 2012, investment in capital goods increased slightly in Q3 (+0.3%) and should stabilise through to mid-2013. Over 2012 as a whole, GDP is set to slip back by 1.3% and the growth overhang for 2013 should be -1.4% at the end of Q2.

Spanish exports rock solid

Since mid-2009 Spanish exports have been dynamic and grew sharply once again in Q3 2012 (+4.8%). They are unlikely to keep up this exceptional pace but should nonetheless continue to rise in Q4 2012 (+0.7%) then at the start of 2013 (+0.9% then +1.1% per quarter).

Investment: stabilisation on the horizon

Capital investment progressed slightly in Q3 2012 (+0.3%). Several factors are indeed more favourable to investment: the margins of Spanish entrepreneurs are now high (*see Graph*), the interest rates granted to companies are lower and the sharp decline in investment over the last few quarters has generated the need to renew capital goods. However, as production capacities are still under-used, investment should stabilise by mid-2013. In construction, investment should still decline, depressed by the clean-up of the real-estate bubble and sluggish government investment.

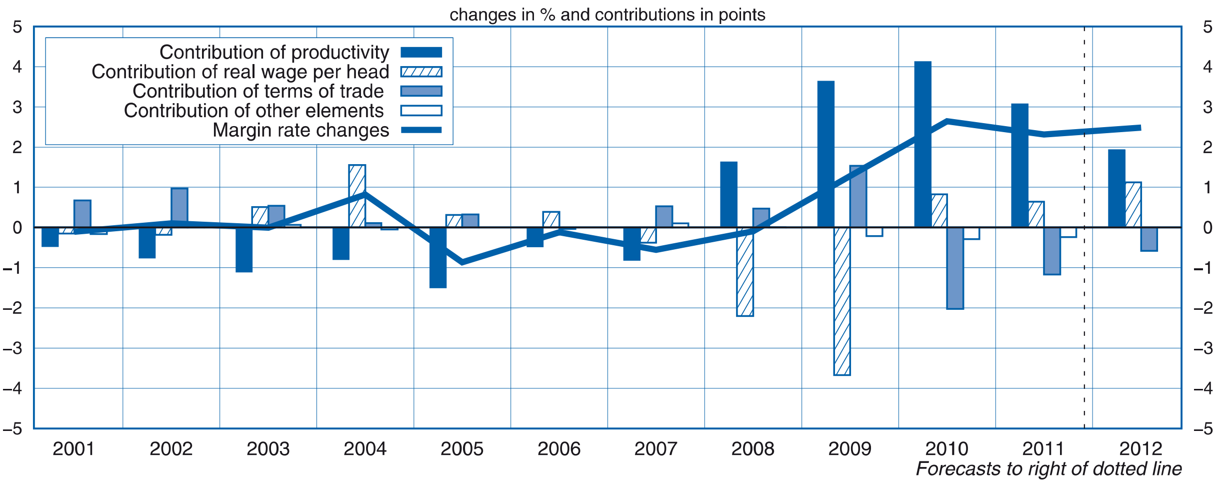
The decline in consumption continuing

Since the start of the crisis, companies have made major adjustments to employment. Job losses are likely to continue through to mid-2013, but at a slower rate.

Additionally, wage gains will likely remain limited bearing in mind the very high unemployment rate (25.6% in Q3 2012) which is set to increase further, and the weakening of the usually strong link between inflation and wages. Lastly, tax rises and cuts in benefits should continue in 2013 at the same pace as in 2012 and inflation should rise, driven by the VAT increase. The purchasing power of gross disposable income should thus continue to decline sharply.

The contraction of household consumption was limited in Q3 by advance purchases before the VAT rise in September 2012. In a backlash effect, consumption is likely to drop sharply in Q4 2012 then more moderately in early 2013. After bringing down their savings ratio significantly over the last three years, households should keep it at a low level, in the order of 7%, through to mid-2013.■

The margin rate of Spanish companies has increased sharply over the last three years



Source: INE and INSEE calculations

United States

America unlikely to fall off the "fiscal cliff"

In Q3 2012 the American economy rebounded (+0.7% after +0.3%), driven by dynamic domestic demand. The American economy is unlikely to keep up the sustained pace of Q3 but should nonetheless enjoy moderate growth over the forecasting period. In Q4 activity should be affected by the consequences of Hurricane Sandy (+0.3%). In Q1 2013, according to our scenario, the American authorities should manage to come to a fiscal compromise that limits tax rises and public spending cuts. The consolidation effort finally put in place is thus unlikely to cause a marked slowdown in activity in H1 (+0.4% then +0.5% in Q1 and Q2 2013).

A gentle consolidation...

As things stand in the American legislation, a set of tax rises and spending cuts is to be applied from 1st January 2013, for an amount of around 4.7 GDP points, including 75% on the gross disposable income of households (the "fiscal cliff"). However, according to our scenario the American authorities should reach a compromise that limits the fiscal shock to around 1 GDP point (*see Focus*). Additionally, the still-accommodating policy of the Federal Reserve and the end of the local finance consolidation measures should sustain activity.

... softened by the private sector

With the high tax rises, household purchasing power is unlikely to grow in Q1 2013 (*see Graph*), although it should still be sustained by low energy inflation. Earned income should also remain dynamic. On the one hand job creations, which came to 789,000 in the five months from July to November 2012, are unlikely to waver over the forecasting period. On the other hand, in H1 2013, employers with very high margins are set to compensate partly for the rise in employee contributions.

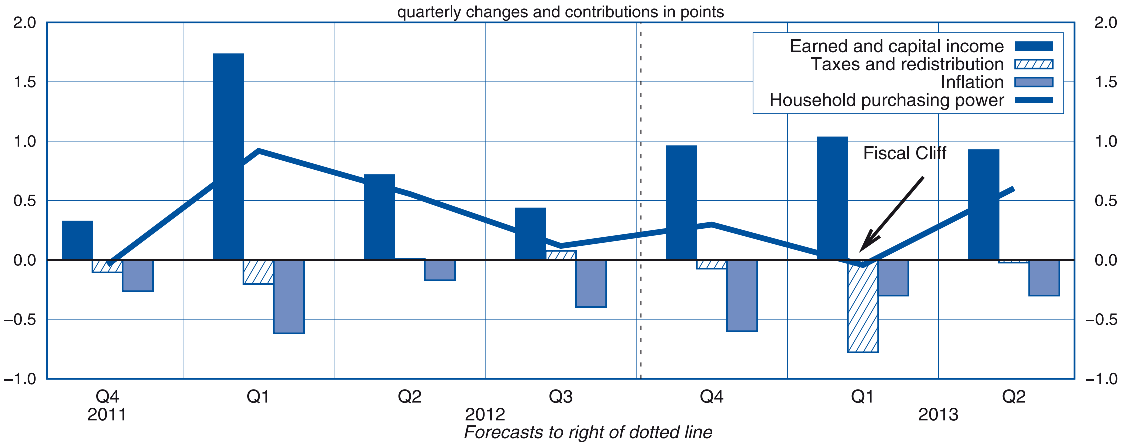
Additionally, the tax rises coming into force at the start of 2013 should mainly concern the wealthiest households, who will likely offset the consequences on their consumption expenditure by bringing down their savings ratio. All in all, American household consumption should have a fairly even profile.

In parallel, corporate investment should continue to be driven by the rise in domestic outlets and by still-favourable credit terms. The recovery of the construction sector should also continue.

Limited foreign support

In Q3 2012 American exports marked time, penalised among other things by weak activity in Asia. They should gradually regain their dynamism thanks to the acceleration in foreign outlets, in particular Asian demand. ■

The increase in wages and the drop in inflation should soften the tax rises in Q1 2013



Sources: Bureau of economic analysis, INSEE calculations

United States: a lower "fiscal cliff" than expected?

The fiscal "cliff": a potential fiscal shock of almost 5 points of GDP that would trigger a marked recession

In the absence of an agreement between Congress and the President, tax rises and spending cuts should come into force on 1st January 2013. This fiscal "cliff" potentially represents 4.7 points of GDP[1] over the year 2013 (see *table 1*). The entry into force of all these measures would certainly induce a contraction in the world's first economy. According to the Congress Budget Office (CBO), activity would contract by 1.0% in Q1 2013, then by a further 0.5% in Q2 (see *table 2*).

Tax rises for households and businesses...

If all these tax rises were applied on 1st January, household disposable income would be cut by almost 4.6 points. A large part of the effort would come from expiry of the tax cuts passed by the Bush administration in 2001 and in 2003, then renewed in 2010. These consisted of various reductions in the tax base, a reduction in income tax rates, lower tax rates on capital gains and dividends and an increase in Alternative Minimun Tax exemption amount. The combined expiry of these measures would cause a rise of over $326 billion in taxes in 2013, representing 2.7% of household income.

In addition to this, to boost activity, at the end of 2010, Congress passed a temporary two points cut in employee Social Security contributions on wages under $107,000 per annum (payroll tax cut) to replace the fixed-sum tax credit on workers earning less than $75,000 a year (Making Work Pay). A return of these payroll taxes to the rate of 6.2% (against 4.2% at present) would automatically increase the amounts paid by households by $126 billion.

Finally, the ramp up of the health insurance reform defended by President Obama (Affordable Care Act) brings an increase in (employer and employee) payroll taxes on 1st January 2013. Regarding transfers, the "exceptional" unemployment insurance system introduced in June 2008 is supposed to expire on 31 December 2012 and physicians' fees (reimbursement of Medicare programme patients) would be cut by almost 28% according to the calculation formula adopted in 1997.

Taxes on businesses, meanwhile, would increase by about $80 billion in 2013, representing 2.8% of their margins. Most of this would come from the expiry of the measures

(1) The amounts given are for the whole of the 2013 calendar year (1st January 2013 to 31 December 2013). They are from the figures of the Congress Budget Office (CBO) in their update of May 2012 (CBO, May 2012, Economic effects of Reducing the Fiscal Restraint that Is Scheduled to Occur in 2013) and August 2012 (CBO, August 2012, An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022) for the 2013 fiscal year (October 2012 to September 2013). The conversion into calendar year values is based on quarterly breakdown hypotheses prepared y INSEE for each type of measures.

Table 1

Integral "Fiscal Cliff", INSEE scenario and "Alternative Scenario" of Congress Budget Office

Households Levy on disposable income in 2013 in billions of $	Integral Fiscal Cliff	INSEE scenario	CBO scenario called "Alternative"
Bush Tax cuts	326	43	0
whose alternative minimum tax exemption amount	180	0	0
whose income from capital and income > 250 000 $	56	43	0
Social security contributions (Payroll Tax cut)	126	32	126
Health Insurance Reform (Affordable Care Act)	24	24	24
Reduction in Medicare's payments rates for physicians	15	0	0
Emergency unemployment benefits	35	18	35
Others (including energy tax credit)	17	17	0
Total	**543**	**134**	**185**
in % of disposable personal income	**4.6**	**1.1**	**1.6**
Enterprise Levy on income in 2013 in billions of $	Integral Fiscal Cliff	INSEE scenario	CBO scenario called "Alternative"
Bonus depreciation	56	30	0
Others tax credits	25		
Total	**81**		
In % of corporate margins	**2.8**	**1.0**	**0.0**
Public expenditure Expenditure drop in 2013 in billions of $	Integral Fiscal Cliff	INSEE scenario	CBO scenario called "Alternative"
Automatic spending cuts (Sequestration)	86	25	0
in % of federal expenditures	**7.1**	**2.1**	**0.0**
Total	Integral Fiscal Cliff	INSEE scenario	CBO scenario called "Alternative"
en 2013 in billions of $	710	159	185
in % of GDP	**4.7**	**1.1**	**1.2**

Sources: Congress Budget Office, INSEE forecasts and calculations authorising enterprises to depreciate 50% of investments made since 2008 in the first year (the rate was even increased to 100% for certain investments in 2011).

... and automatic spending cuts

This fiscal "cliff" also comes from automatic spending cuts scheduled for 1st January 2013: the debt ceiling agreement of summer 2011 (Budget Control Act) linked the debt authorisations to a commitment to make drastic cuts to the deficit within ten years. Failing an agreement between the parties, automatic cuts (sequestration) must be made to welfare and military spending, representing an amount $1,200 billion in ten years. In 2013, these automatic cuts would represent about $86 billion, or 7% of usual Federal expenditure (0.6 points of GDP).

An agreement between Congress and the President: the most probable hypothesis, a way of limiting the scale of the fiscal "cliff"

It is probable that the US authorities will seek to avoid a total fiscal cliff and the CBO therefore proposed an "alternative scenario" in March 2012 (*see tables 1 and 2*). The scenario taken here is close to that of the CBO.

We also suppose that the agreement between Republicans and Democrats is likely to come before 31 December 2012. However, we cannot rule out the possibility that in the event of continuing disagreement, Congress might choose to extend all the measures that expire on 31 December 2012 by two months: on the one hand, the debt ceiling negotiated in 2011 will probably be exceeded sometime around March 2013 and, on the other, the new members elected in November 2012 will only take up office in January 2013. The different measures can therefore be divided into groups according to the degree of probability of their effective application.

Some tax rises will very probably take effect

Certain measures have a very high likelihood of coming into force. This is the case notably of the payroll tax increases linked with the introduction of health insurance ($24 billion). The Affordable Care Act has been passed and also confirmed by the Supreme Court to which it had been referred by the Republican opposition. It is also an emblematic reform of Barack Obama's first term which will probably be maintained.

Other measures will probably be ruled out

On the contrary, certain measures appear to be unlikely, unless the situation becomes completely gridlocked. Such is the case of the reduction in physicians' fees: by the terms of the 1997 Budget Control Act, an automatic formula can be used to make automatic adjustments to physician reimbursement rates in the Medicare programme in order to limit the progression in programme spending. However, since 2002, Congress has systematically decided to increase physicians' fees without taking account of the application of the formula (*see table 3*).

Likewise, in 2001 and 2003, the Bush administration increased the fixed-sum allowance applied to the tax base to calculate minimum tax. Since then, Congress has passed an annual renewal of the allowance each year. In the absence of a vote, it is supposed to return automatically to its 2000 level, which seems highly improbable (*see table 4*).

Finally, both Democrats and Republicans have defended the extension of the Bush administration's tax cuts for income bands of below $250,000 per annum, and also the deductions for children. All in all, these three measures affecting households and representing almost half of the fiscal cliff ($285 billion) are likely not to be applied on 1st January 2013.

Certain tax and spending cuts are likely to be part of a political agreement

Other measures, meanwhile, have a good chance of expiring in their present form, to be replaced by new systems. This is notably the case of the Social Security payroll tax cut ($126 billion). Not a single Senator or Congressman has filed a proposal to extend them in their present state[2] and neither

(2) *cf. An overview of Tax Provisions Expiring in 2012, Congressional Research Service*, september 2012.

Table 2

GDP growth according selected assumption

GDP growth		Half-year on half- year changes and annual change in %			
		H 2012	**H1 2013**	**H2 2013**	**2013**
CBO scenario	With no fiscal restraint	1.1	1.7	1.7	3.1
	Under Current Law Fiscal policy ("Fiscal Cliff")		-1.0	0.4	-0.3
	Alternative scenario		0,8	1,0	1,8
INSEE scenario		1.0	0.8	-	1.4 (ovhg)

Table 3

Automatic formula Automatic formula revaluation for rates of doctors from Budget Control Act of 1997 and revaluation voted by the Congress

Annual change in %	jan-09	jan-10	jan-11	jan-12	jan-13
Automatic formula	-5.3	-11.5	-5.9	-10.2	-27.5
Revaluation voted by the Congress	0.5	1.1	1.3	0.9	?

Source: Centers for Medicare and Medicaid Services side defended such a position during the presidential campaign. However, the Obama administration has expressed the wish to return to a system that is closer to that which existed until 2010 (Making Work Pay), in order to focus tax cuts on lower and middle-class categories (*see graph 1*). If a compromise should emerge around this proposal, the net effect would be a rise in taxes of about $32 billion.

Finally, for the remaining measures, there does not seem to be any consensus for the moment. President Obama has defended the idea of letting the tax cuts expire for the top two income tax bands, and also for the taxation of income from capital ($56 billion), something the Republican-controlled House refuses. Likewise, the debate remains open on corporate taxation ($84 billion), expiry of the «exceptional» unemployment insurance system ($35 billion) and the sequestration resulting from the debt ceiling agreement ($86 billion). The hypothesis we have taken is that of a compromise in which only the top tax band and taxation on capital would be increased ($43 billion), the unemployment system would be reformed but not repealed ($18 billion) and the automatic cuts would be kept down to $25 billion.

The effect on activity should remain limited, thanks to the fall in inflation and the savings ratio.

All in all, the impact of the fiscal "clif" should come to around 1.1 points of GDP in 2013, which is to say about one quarter of the potential effect of the total fiscal cliff *(see table 1)*.

Several factors are likely to soften the macroeconomic effect of this fiscal tightening. First of all, inflation should fall in H1 2013 due to the decline in energy prices (see *United States note*). Also, a large part of the tax rises that are maintained should hit the wealthiest US households, those with the strongest tendency to save. On the whole, the savings ratio of households should thus fall back in H1 2013, easing the effect of the tax rises on consumption *(see graph 2)*.

It is probable that most companies had anticipated the cut in accelerated depreciation from 100% to 50% for investments made in 2012. Therefore, even if their cash flow continues to be hit by this measure in early 2013 with the payment of the outstanding balance of corporation tax for 2012, the effect on investment may already have occurred during 2012. For 2013, we suppose that accelerated depreciation of 50% is likely to be maintained. Also, the additional taxation on companies should be around $30 billion in 2013, or 1% of their margins. The very high level of corporate margins *(see graph 3)* should allow them to soften the effect of this fiscal tightening. ■

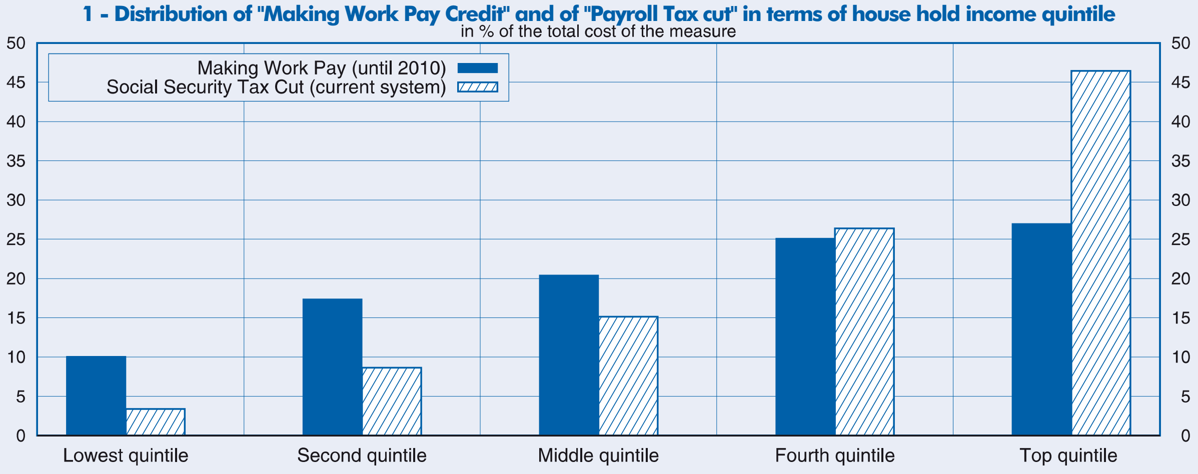
Table 4

Alternative Minimum Tax exemption amount for singles ans married couples since 1991 (in $)

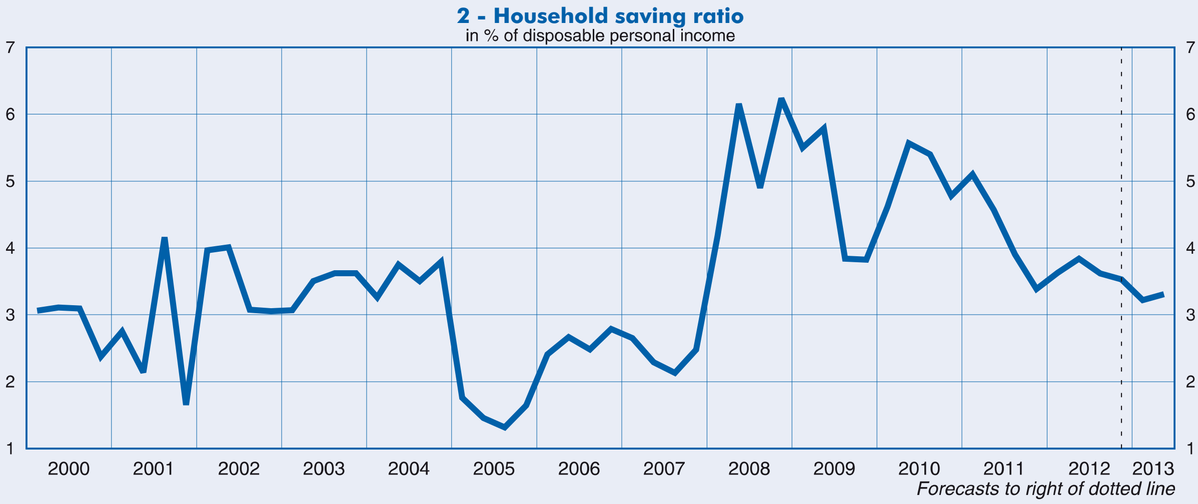
	1986-1990	1991-1992	1993-2000	2001-2002	2003-2005	2006	2007	2008	2009	2010	2011	2012 (fiscal cliff)
Married couples	40 000	40 000	45 000	49 000	58 000	62 550	66 250	69 950	70 950	72 450	74 450	45 000
Singles	30 000	30 000	33 750	35 750	40 250	42 500	44 350	46 200	46 700	47 450	48 450	33 750

Source: Tax Policy Center

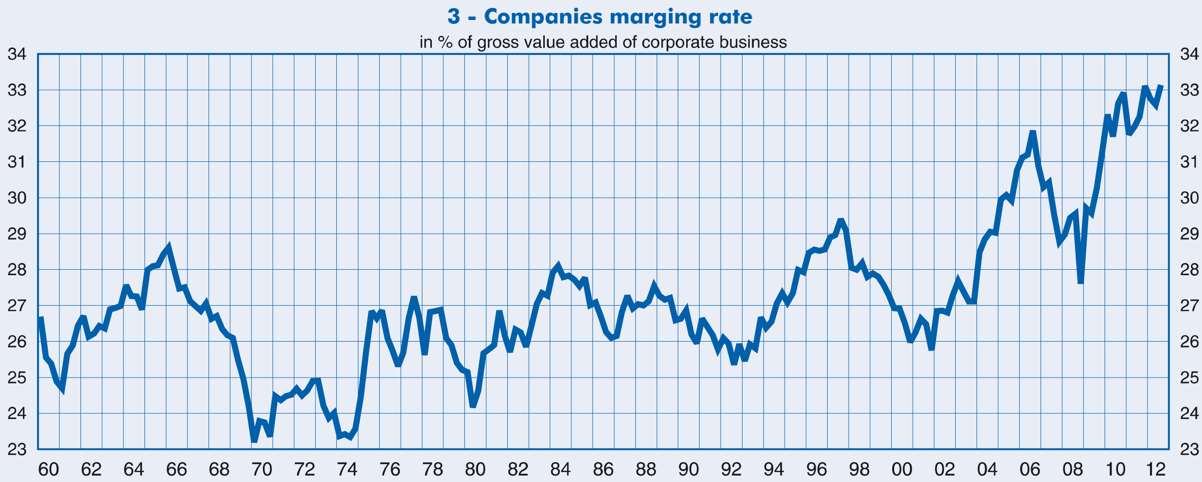
1 - Distribution of "Making Work Pay Credit" and of "Payroll Tax cut" in terms of house hold income quintile



Source: Tax Policy Center



Sources: BEA, INSEE calculations



Source: BEA

United Kingdom

Games Over

In Q4 2012, the one-off factors that sustained activity in the United Kingdom in Q3 are likely to be wiped out and activity is set to decline once again (-0.1%). Growth is also likely to suffer due to weak foreign outlets and the fall in energy production. In H1 2013, the fiscal consolidation measures should continue to take their toll on public and private consumption. All in all, despite stronger investment and the end of the decline in construction, British activity is only likely to grow slightly over the forecasting period.

Temporary rebound in activity in Q3

The rebound in British growth in Q3 2012 (+1.0% after -0.4%) can mainly be explained by technical and transitory factors (an extra working day after the Queen's Jubilee in Q2 and the London Olympics). Disregarding these one-off support factors, British activity would only have grown by 0.2% to 0.3%, a far slower rate than the pre-crisis trend.

Activity set to stall in late 2012

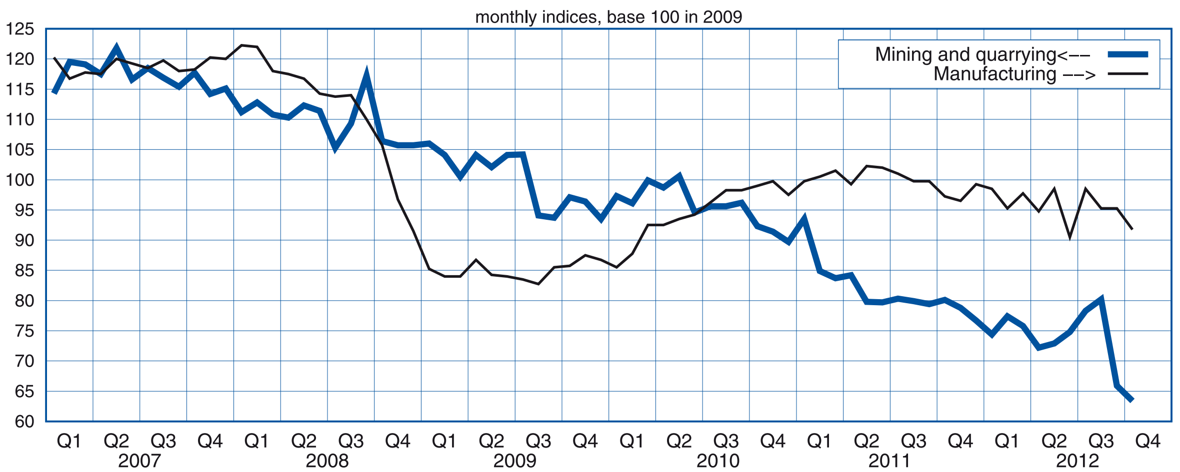
In Q4 2012, according to the business tendency surveys, British activity is likely to decline (-0.1%). Weak foreign outlets are likely to take their toll on growth, which is also likely to suffer from the drop in energy production due to longer than usual maintenance work in the North Sea (*see Graph*). In a backlash effect after the additional demand induced by the Olympic Games, domestic demand is set to fall (-0.1%). Household consumption should also be slowed by the rise in inflation with the pick-up in energy prices and the sharp rise in education prices in September (+19.2%) due to the raised ceiling on university tuition fees. Over the year as a whole the United Kingdom is unlikely to escape a decline in GDP (-0.1% after +0.9% in 2011 and +1.8% in 2010).

Slight improvement in H1 2013

At the start of 2013 British activity should progress only slightly (+0.2% then +0.1% in Q1 and Q2). The country's fiscal climate remains unpromising, due to the continuing adjustment of public finances. The additional savings planned for 2013-2014 will represent 1.3 GDP point (after 1.2 GDP point in 2012-2013). The monetary policy remains however very accommodating and the government is still proposing measures[1] designed to encourage access to credit for households and SMEs. Businesses should therefore increase their production investment expenditure slightly in early 2013. In parallel, after slumping in 2012 with the completion of the main infrastructures for the Games, the construction sector should no longer weigh negatively on growth. Lastly, with stronger world demand, British exports should gradually pick up (+0.1% then +0.3%). ■

(1)Loans to SME, reduced interest rates for banks wich increase their loans to private agents, direct payment to the suplly by the banks banks.

Very sharp drop in energy production



Sources: ONS and INSEE calculations

Japan

A temporary dip

In Q3 2012 activity contracted in Japan (-0.9% after 0.0% in Q2). Industrial output in particular declined sharply under the effect of the collapse of exports and corporate investment. Activity should continue to decline in Q4 2012 (-0.2%).

Diplomatic tensions with China are likely to take their toll on exports and domestic demand looks set to be sluggish.In H1 2013, Japan should return to moderate growth (+0.3% per quarter): exports are likely to benefit from the acceleration in world trade and private demand should see renewed dynamism, particularly investment.

Exports suffering in late 2012 from the tense relations with China

In Q3 2012 Japanese exports slumped (-5.1%), penalised by the contraction in world trade and particularly weak Asian and American demand. Also, since mid-August the retaliatory measures and boycotts by China have led to a sharp drop in sales to this country, which usually absorbs 20% of them. Japanese exports therefore declined very sharply in September and October, and so over Q4 2012 as a whole they are likely to decline once again (*see Graph*). They should however rebound in H1 2013 (+1.2% per quarter).

The effect of the rebuilding plans fading

Japanese domestic demand is also showing signs of running out of steam. In particular, the effect of the rebuilding plans is likely to fade. Since the disaster of 11 March 2011 four stimulus plans have been voted in by Parliament, to the tune of 3.8 GDP points. As a result, government investment has progressed strongly since the start of the year. The budget allocated to the emergency reconstruction should gradually be exhausted but government investment should be sustained by the medium-term plan voted in November 2011. All in all it should grow at a moderate pace (+0.5% per quarter).

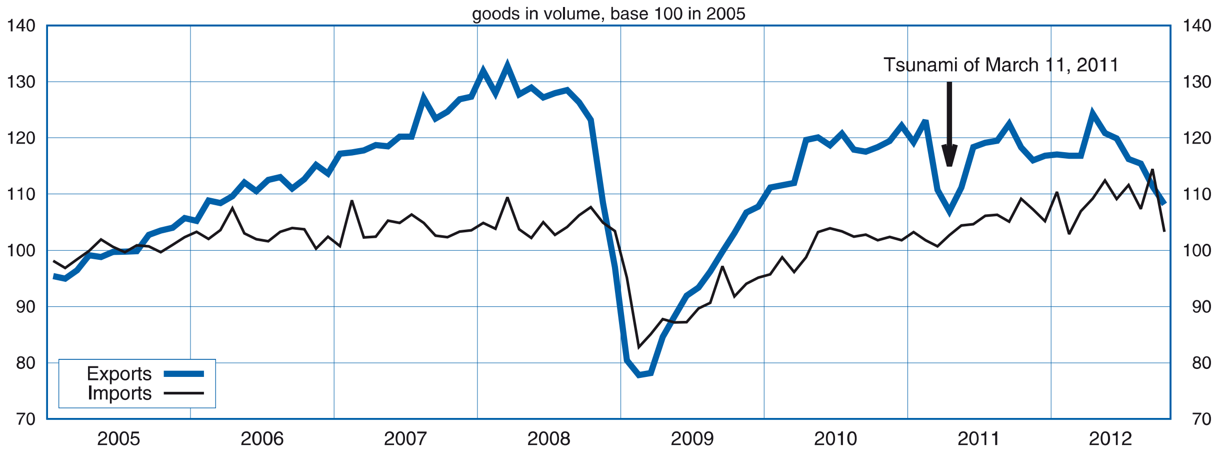
Private demand showing only weak growth

Corporate investment contracted sharply in Q3 and should continue to decline in Q4. Orders to industry are indeed at an extremely low level. Investment should rebound slightly in H1 2013, sustained by the renewed dynamism of exports.

Household consumption ground to a halt in Q3 2012 (-0.4%) due to the end of government support for purchases of green vehicles. It should only grow slightly over the forecasting period. Housing investment should remain fairly dynamic, due to the rebuilding effort.

All in all, Japan should experience a contraction in activity in Q4 2012 (-0.2%), before rebounding modestly in H1 2013 (+0.3% per quarter).■

Diplomatic tensions with China penalising exports at the end of 2012



Source: Bank of Japan, last point: october 2012

China and emerging Asia

On the road to recovery

In Q3 2012, trade stagnated in emerging Asia. Exports from the very open economies of South-East Asia continued to suffer from the slowdown in world trade, particularly Chinese activity in the previous quarters. However, Chinese activity is showing signs of picking up after slowing sharply in H1. In Q3 2012 domestic demand stood firm and GDP accelerated. Thanks to the quantitative easing implemented and fiscal stimulus measures announced, Chinese activity should accelerate over the forecasting period, sustaining world trade and leading to a rebound in activity in the other Asian economies in H1 2013.

A slight rebound in trade at end 2012 after a sharp decline in summer

Between June and August 2012, trade contracted sharply in Asia, almost 5% down on the previous three months. In September trade rebounded strongly, leading to a stabilisation over Q3 as a whole. In China imports stagnated and exports declined, particularly those to the European Union and the United States which absorb almost 40% of Chinese exports. In the rest of Asia imports contracted, notably in Singapore, Taiwan and Korea.

However, according to customs data from September and October and the new exports orders section of the PMI surveys, trade is picking up. The slump in bilateral trade between China and Japan is likely to benefit exports from the emerging economies of Asia. After falling in Q3 2012, activity should thus accelerate in this part of the world, starting in Q4.

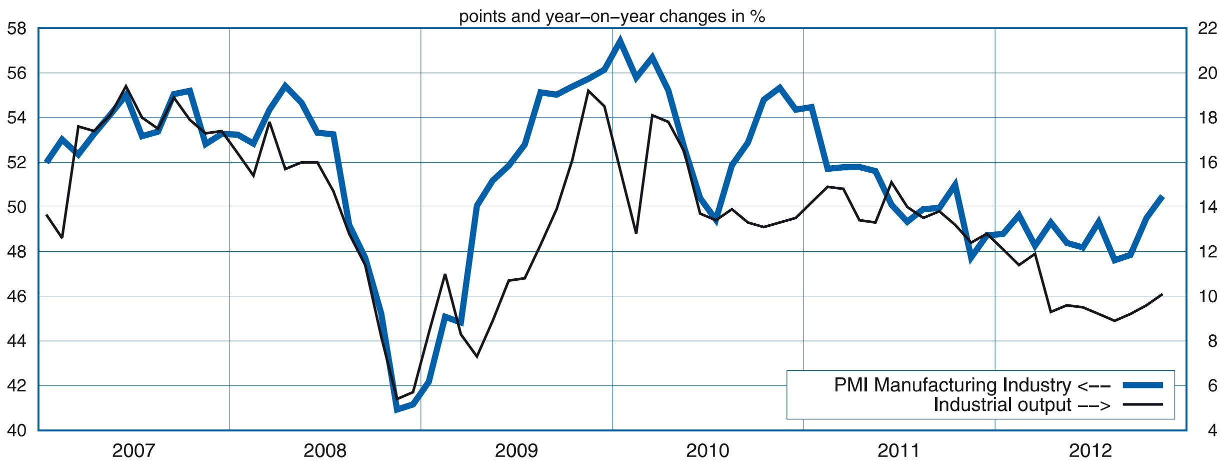
The Chinese economy slowly but surely picking up

In China, activity expressed as a quarterly variation accelerated in Q3 2012, although these figures remain fragile. In particular, domestic demand gained in dynamism in Q3. Additionally, in November industrial production reached 10.1% year-on-year, against 8.9% in August, and according to the PMI surveys by the Markit institute, economic perspectives are rebounding (*see Graph*). The sharp drop in inflation (2.0% in November) allowed the Chinese authorities to pursue its easing of monetary policy. Furthermore, the Chinese government and the local provinces announced the financing of several public infrastructures for an amount arround of 2% of GDP. Activity should therefore continue to accelerate over the forecasting period.

In the wake of China, the "dragons" move up a gear

The domestic demand of the "Asian dragons" showed little dynamism in Q3 2012. In Singapore activity contracted and it continued to weaken in South Korea. As these economies have a delayed reaction to the ups and downs of Chinese growth, they should benefit in 2013 from the renewed dynamism in China: in H1, emerging Asia should therefore accelerate, although without returning to a growth rate equivalent to that prior to 2008.■

Activity gradually picking up in China



Sources: National Bureau of Statistics of China and Markit