Eco WEEK

BNP PARIBAS
ECONOMIC RESEARCH
DEPARTMENT

/// 11 May 2012 /// 12-19

Summary

Also in

Eco TV WEEK

Is Germany going to be lax ?

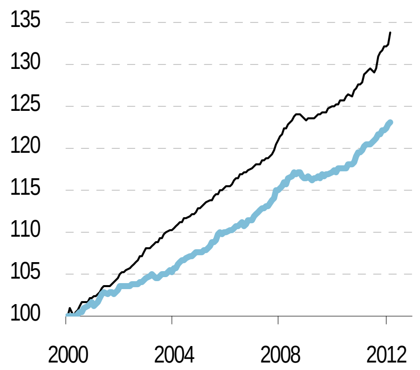
■ The Commission points splits in the euro zone ■Greece near the breaking point ■Germany thinks of more inflation

The European Commission just issued its Spring economic forecasts. Eurozone GDP is likely to contract by 0.3% in 2012 and activity will resume progressively during H2 2012 so that GDP growth could be up 1% in 2013. In this context, public finances consolidation is likely to be slower. Cyprus and Austria will be the only two new euro zone members to join the club of countries with a public deficit below 3% in 2013. According to the Commission, the euro zone will continue to show a split between countries with large spreads that support huge public and / or external deficits and need to implement structural reforms and other countries (northern ones) that are urged not to overreact concerning austerity measures. To this extent, M.r Schaüble, the German Finance Minister, has made an unexpected proposal. According to him, inflation in Germany could be higher than eurozone average inflation in the future. Higher real wages coupled with higher prices for German goods would thus trigger a fall in German price competitiveness and rebalance trade flows in favour of the rest of the euro zone. A revolution.

SPLIT DIET

Harmonized consumer price indices (2000=100)

— Italy ; — Germany



Source : Eurostat

THE WEEK ON THE MARKETS

Week 7-5 12 > 10-5-12

↘ CAC 40	3 162	▸	3 130	-1.0 %
↘ S&P 500	1 369	▸	1 358	-0.8 %
↘ Volatility (VIX)	19.2	▸	18.8	-0.3 %
↘ Euribor 3M (%)	0.70	▸	0.69	-0.7 %
↗ Libor $ 3M (%)	0.47	▸	0.47	+0.1 %
↘ OAT 10y (%)	2.85	▸	2.83	-1.9 %
↘ Bund 10y (%)	1.51	▸	1.44	-6.9 %
↘ US Tr. 10y (%)	1.88	▸	1.85	-2.9 %
↘ Euro vs dollar	1.31	▸	1.30	-1.2 %
↘ Gold (ounce, $)	1 638	▸	1 594	-2.7 %
↗ Oil (Brent, $)	112.4	▸	112.8	+0.4 %

Overview
Greece in limbo

Fears have been confirmed by the general election results in Greece: the new Parliament is too divided; the formation of a coalition government is uncertain.

The vote brought a collapse of the traditional parties, which support the Troika's programme, in favour of extremist, and for some of them anti-system, parties. New Democracy, the conservative party, and PASOK, the socialists, won 32.1% of the votes between them, compared with nearly 77.4% in the 2009 elections. The votes lost by these two parties went to dissidents, and were split between the 30 other candidates. There are now seven political parties in the Parliament, of which six have more than 20 representatives. The percentage of 'valid' votes (ie going to the parties getting at least 3% of the vote) amounted to only 81.1% of votes cast. The leading party, New Democracy, garnered 18.9% of the votes, which is well below the abstention rate of 34.9%. In 2009, the Parliament consisted of five parties, of which only three had more than 20 members. The percentage of 'valid' votes amounted to 90.6%. PASOK, the leading party at the time, won 43.9% of the votes.

In principle, the Greek voting system enables a stable majority to be delivered even in a fragmented Parliament. The 300 Greek legislators are elected under a system that allocates 50 seats to the party that leads in votes while the 250 others are awarded by proportional representation among all parties winning at least 3% of the votes. The winner's bonus therefore makes it possible for one party to have an absolute majority of seats even if it wins fewer than half the votes cast, as long as it wins at least 39%. That was not the case in May 2012. The extreme fragmentation of the vote has also made the formation of a coalition government very unlikely. With a valid vote rate of 81.1%, New Democracy (1st) and PASOK (3rd) would have needed a total between them of 32.8% of the votes cast to form a coalition. They only won 32.1%, which gives them 149 seats out of the 300 in parliament. As required by the Constitution, the President of Greece has given each of the leaders of the three main parties in turn a mandate to form a coalition of at least 151 members of Parliament within three days.

So far, neither the leader of New Democracy, nor the leader of SYRIZA (radical left), which came second, managed to form an alliance. At the time of writing, the leader of the third party, PASOK, is in talks to form a national-unity government. But the chances of success appear slim. In addition to the dispersion of seats in Parliament, there are major ideological divisions between the political parties. New Democracy and PASOK support the Troika's plan, but the five other parties with seats in Parliament oppose it. However, even though these five have a total of 151 seats between them, the differences between them are too profound to believe that they could form an alliance and a government.

Unless a last- minute agreement is reached, new elections are likely to be held. These could take place as early as 17 June. Such an outcome would inevitably be accompanied by a period of major uncertainty during which speculation about another Greek default and exit from the euro zone will probably intensify. It looks as if it will be hard to reform Greece and, without progress in applying the measures in the programme[1], there is little chance that official creditors will agree to release further tranches of the financial aid. Since the second rescue plan was agreed in March, the euro zone countries, through the EFSF, and the IMF have lent €74.3bn to the Greek government[2]. This is almost as much as the €75.5bn which was provided by the Troika between May 2010 and December 2011. €59.3bn have been used to deal with the costs of the debt swap and bank recapitalisation, while €15bn have been used to cover the government's financing requirements. The government still has a liquidity cushion, but it is very small. According to the Minister of Finance, public spending is only covered until the end of June.

What is left to offer hope? First, a very large majority of Greeks (between 70% and 75%) is in favour of their country staying in the euro zone, although the 6 May vote may be interpreted as expressing the opposite. It seems that the link has not been clearly established between keeping the euro and implementing the measures in the Troika plan. Let us assume that, if there were to be a second election, the pro-European politicians, under pressure from their euro zone partners, would link these two aspects to make them the dividing line in an election that would look like a referendum. In addition, if the Greek government were to run short of cash and be forced to stop making payments (civil service salaries, pensions, social transfers), the sense of emergency this would generate could drive a 'useful' vote that would benefit the traditional parties. With a 35% abstention rate and 19% of the electorate voting for parties not represented (winning fewer than 3% of the votes), the outcome of a second election could be quite different.

That leaves the fundamental question unanswered: how can the confidence of both creditors and the electorate in European democracies be maintained to avoid the economic crisis evolving into a profound political crisis? Clearly, growth would help. But that cannot be decreed.

[1] *The Greek Parliament must pass austerity measures worth €11.5bn (5.5% of GDP) in addition to implementing 77 structural measures by the end of the second quarter.*
[2] *On Wednesday, €4.2bn of the €5.3bn scheduled for May was approved. This will make it possible to repay the €3.3bn of bonds held by the ECB, which mature next week. The remainder will only be released if Greece has a stable government.*

The week in the US

Neither for nor against (quite the contrary)

Next week will be way busier than the one that just ended, during which the only data of interest was international trade in March. As we expected, the US trade deficit, after a marked narrowing in February probably due to the Lunar New Year Holyday in Asia, was more or less back to it January level. For 2012 Q1 as a whole, the deficit stood at USD 773 bn (annualised), or 5.0% of GDP. Details show strength in both exports (especially cars and capital goods) and imports (rather broad-based with the exception of non-car consumer goods and food).

Next week, we will get news from household spending (April retail sales due on Tuesday), inflation (April consumer prices due on Tuesday), manufacturing activity (April industrial production and May surveys from the New York Fed on Tuesday and the Philadelphia Fed on Thursday), but the main focus will definitely be on the Minutes of the April FOMC meeting (due on Wednesday).

There is little suspense about those Minutes, though, since FOMC members released their updated economic forecasts following the meeting, on April 25th. In line with the optimism of the latest Beige Book – our A2F Index, a balance of references to "weaknesses" and "strengths", reached its highest reading since November 2005 – FOMC members upwardly revised their GDP forecasts for this year and next, but more crucially, lowered their projections for the unemployment rate. As shown on Charts 1 & 2, GDP forecast for 2012 was marginally amended between March and April meetings, while the median forecast for the unemployment rate was harshly downward revised: it was as high as 8.6% as of November 2011 and 8.5% in March 2012, and as low as 7.9% in April, a recognition that the US GDP growth, even if still to limited for complacency, is high enough to create jobs… or at least, to lower the unemployment rate.

Indeed, as it is often the case, you can see the 1 point fall in the unemployment rate since last August as the result of a strengthened labour market or as the result of a growing number of discouraged job seekers. The truth lies somewhere the middle. Between August and April, and according to data from the household survey, 2.1 million jobs were created. The strength is unquestionable. At the same time, the labour participation ratio dropped from 64.1% to 63.6%. If it had remain unchanged, the fall in the number of unemployed would have been was smaller, and the fall in the unemployment rate way smaller: it would currently stand at 8.8% versus an actual 8.1%. The numbers are striking.

The latest labour market data have not been helpful in providing a clear-cut. In March and April, job creations markedly slowed down, from an average of 252k per month between December and February to only 135k. The pessimists analyse this as the sign that the dynamism of late-2011 and early 2012 was abnormal, partly reflecting an effect of unusually warm weather.

But why not betting on March and April being the abnormal months? There are several reasons for being confident about US prospects, indeed, such as the strength in private consumption and external demand, or the more and more numerous signs that the housing sector bottomed out, while the recent decline in oil prices will support real disposable income in the coming months.

A little bit more of growth…

FOMC members projections, GDP growth, %

◆ *lowest* ▲ *highest and* ■ *median forecast as of November 2011, January 2012 and April 2012*

Chart 1 Source : FOMC

A lot less of unemployment

FOMC members projections, unemployment rate, %

◆ *lowest* ▲ *highest and* ■ *median forecast as of November 2011, January 2012 and April 2012*

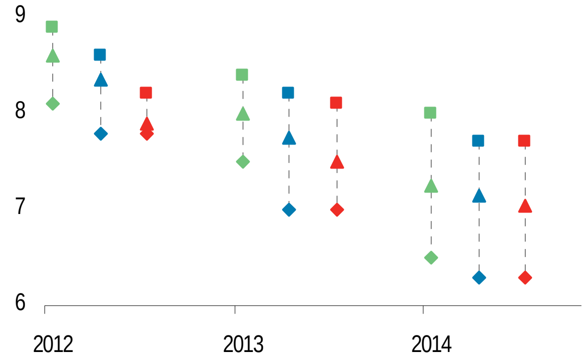


Chart 2 Source : FOMC

The week in the Eurozone

Manufacturing shows signs of life

Slight rally in Germany

After remaining sluggish since the end of summer, industrial production suddenly picked up in March (+2.8% m/m). This rally was fuelled in part by the strong rebound in construction activity (up 30.7% m/m, after contracting 16.9% m/m in February), lifted by mild weather conditions. Manufacturing activity also contributed to the rally, up 1.4% m/m, with a particularly strong increase in the production of capital goods (+2% m/m). With this rebound and the revision of February production figures (to +0.3% m/m, from -0.3% m/m previously), manufacturing activity increased very slightly in Q1 (+0.2% q/q).

Although this is still mild compared to the dynamic momentum of manufacturing activity from fall 2009 to summer 2011, it follows on a contraction of 2% q/q in Q4 2011. This performance is also compatible with a slight increase in Q1 GDP (which we estimate at about +0.2% q/q).

Recent trends in manufacturing orders, however, suggest only a moderate expansion in activity in the months ahead. Domestic demand and orders from countries outside of the eurozone should continue to fuel growth over the next few months. Indeed, the rebound in manufacturing orders in March (+2.2% m/m) is largely due to domestic orders (+1.3% m/m in March) and orders from countries outside of the eurozone (+4.8% m/m, after +4.9% m/m in February).

Yet the strength of demand from countries outside of the eurozone hardly offsets the sluggishness of Eurozone demand. As a result, foreign orders declined 0.8% q/q in Q1 (vs. -1.4% q/q in Q4 2011). Merchandise exports rose 0.9% m/m in March and 2.7% q/q in Q1 (vs. -1.2% q/q in Q4 2011), but are expected to be weak in the months ahead with the contraction of activity in the eurozone, which absorbs nearly 40% of German merchandise exports. Inversely, Germany's main trading partners, like France, should continue to benefit from strong domestic demand and imports from Germany, up 2.4% q/q in Q1 (vs. -2% q/q in Q4 2011).

France: a ray of sun amidst cloudy skies

Industrial production contracted 0.9% m/m in March, the expected payback to the positive impact of the cold wave on February's figure (revised upwards to +0.9% m/m). Outside industry, activity in the construction sector rebounded strongly, buoyed by the return of warm weather. The key figure to note is the strong growth of manufacturing production (+1.4% m/m), which trims the year-on-year decline to 0.3% from 3.2%. This solid rebound more than corrects February's sharp decline (-0.9% m/m), and is supported by the upturn in activity in all sectors at the aggregated level.

The gap widens

Trade balance (cummulative, 12 months) (€bn)

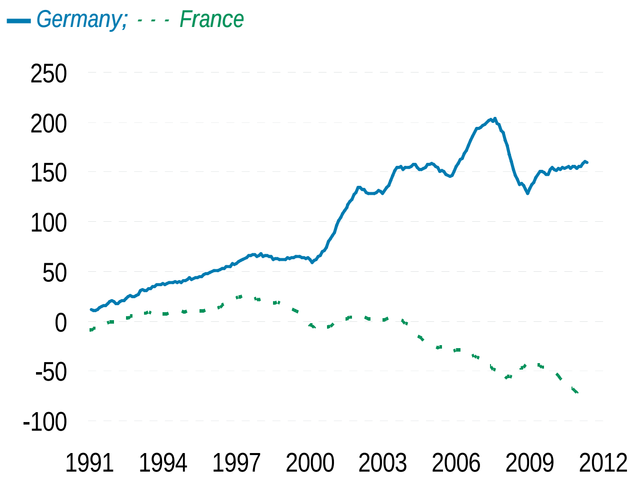


Chart Source: Bundesbank, French Customs

For Q1 as a whole, industrial production barely declined (-0.1% QoQ), which is a significant improvement over the 1% QoQ decline reported in Q4 2011.

Yet these favourable trends should not be allowed to mask the fact that the latest business sentiment surveys point to another downturn in manufacturing activity. And unlike Q4, this Q1 decline in production is likely to be carried over to GDP growth as well, which is expected to contract 0.2% QoQ.

March figures for foreign trade were mixed. Goods exports contracted 1.5% m/m, but imports declined nearly twice as much, resulting in a slight narrowing of the deficit to €5.7bn from €6.3bn. For Q1 as a whole, the trade deficit nonetheless widened to €17.4bn, a €2bn increase compared to Q4, after three consecutive quarters of improvement equivalent to nearly one point of GDP (-3.9% in Q1 2011; -3.1% in Q4). The wider deficit is due to stronger growth of imports than exports (in nominal terms), which is not necessarily bad news if it reflects strong domestic demand. As to exports, we can see a slight acceleration in exports to the eurozone (+1% after +0.5%), driven by Germany and Spain (but hampered by another severe contraction in exports to Italy) and a slowdown in exports outside of the eurozone (+1.6% after +2.6%). These growth rates are still very mild and their volatility makes them difficult to interpret.

Focus

Spain: the government increases its support to banks

- Under pressure from recession, the final details of reform of rules governing provisions for the banking sector lead to a more substantial increase in provisions than estimated by the measures announced in February.
- At the same time, banks are forced to create their own run-off entities for impaired property assets.
- That leaves unanswered the funding issue of possible recapitalisation needs of certain banks. Wanting not to invoke European financial rescue mechanisms would amount to shifting the banking problem onto the sovereign, fuelling into market mistrust.

Contagion

Deterioration in the quality of property exposure (EUR bn)

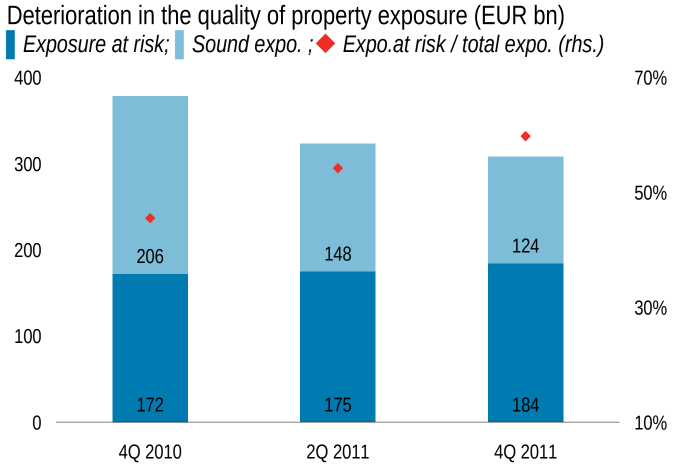


Chart.1 — Source : Bank of Spain

Risks are mounting with the recession

The Spanish banking sector is still far from seeing light at the end of the tunnel, as the difficulties it has faced since 2008 are intensifying (the last event to date being the nationalisation of Bankia). Nor is there any sign of when the intensity will start to decrease.[1] The main cause of the derailment of a previously exemplary bank restructuring process in terms of objectives and execution is the recession. Recession has returned this year (-1.9%) and is expected to continue in 2013 (-0.4%) as austerity is pursued. The unemployment rate is expected to climb to 25.4% in 2013. Credit outstanding to the non-financial sector fell by 3% year on year in February 2012. Private debt as a proportion of GDP remains among the highest in the euro zone, and deleveraging will continue. Renewed pressure on long-term government bond yields means it is not easy for banks to finance themselves in the markets, as suggested by the still large usage of ECB liquidity since the two long-term refinancing operations in December and February.

The banking sector is managing credit risk that is deteriorating constantly, while property prices have continued to decline since the peak in 2007. The correction already amounts to 27% according to the central bank, and the abundant stocks of unsold residential property in the hands of the banks suggests a much harsher adjustment to come. Doubtful loans (unpaid for more than 90 days) are growing rapidly, and as a share of all non-financial sector lending they rose to 8.16% (€144bn) in February. The deterioration is still more pronounced in construction and property development-related segments. To get a full understanding of the problem of deteriorating property asset quality, the Bank of Spain includes not only doubtful loans to builders and developers, but also sub-standard loans (where there has been no payment event, but where there is a significant risk of non-repayment in the short term) in those segments, as well as all real assets on the balance sheets resulting from repossessions (housing completed and under construction, and land for development). In December 2011, out of a total property exposure so defined of €308bn, the problematic exposure amounted to €184bn (5% of assets) or 60% of the total portfolio. A year earlier, these toxic assets totalled €172bn on a total exposure of €378bn or a ratio of 46% (chart 1).

Nationalisation of Bankia

The partial nationalisation of Bankia (45.4% of its capital), which became the third actor of the sector behind Santander and BBVA after the merger of seven savings banks in early 2011, was not surprising given the particularly heavy risky property portfolio it inherited from the original *cajas*. Rumours were going round since the start of the year about the future of the group, while the government openly wished it to merge with a sounder entity. Eventually, the option chosen illustrates the limits of the process of mergers on which the authorities had been largely relying to reduce capacities and try to clean up balance sheets. Indeed, mutual benefits drawn from these operations appeared increasingly hypothetical along the ballooning of problematic exposures under the effect of the recession. Moreover, synergies, when they exist, only materialise at a medium-term horizon.

Deconsolidation of property assets

This is in this context that new measures just announced must be replaced and understood. First, provisioning rules are slightly tightened in order to better cover *ex ante* still sound property exposures (*see below*). Second, drawing lessons from Bankia's experience, the government has made progress in its reflexion about the opportunity to create asset management companies.

[1] *See Conjoncture n.7-8 of July-August 2011, « Spanish banks: work in progress ».*

Early 2012, it discarded the Irish *bad bank* model, too much expensive for public finances.[2] It finally followed the German model by making it mandatory for each Spanish bank to segregate property assets from the rest of the balance sheet. This formula should reconcile big and smaller banks. Santander and BBVA had always signalled their reluctance to share losses, wishing to continue to manage themselves their exposure at risk, less substantial than those of former *cajas*. As required by the European Commission, two independent audits will evaluate toxic assets. The deconsolidation of real assets aims at improving the overall perception of Spanish risk.

Provisions: rewritten by government

February's royal decree unveiled the first major measures of the Rajoy government that took over the process of cleaning up the banking sector. In substance, following the mergers between savings banks and the strengthening of their capital, efforts had now to be concentrated on improving provisioning against problematic assets, particularly those for which valuation is made difficult (land for development and programmes under construction) by the frozen market. The central bank has estimated total additional provisions of €54bn (5% of GDP) at the sector level, to be made by the end of 2012. This figure comes from a contribution to general provisions against healthy exposures, and above all an increase in specific provisions against problematic exposures through tougher cover ratios, and in certain cases extension of the compulsory provision period, for each type of asset. In addition, the Bank of Spain has imposed a special surcharge of provision for land and construction in progress, calculated by putting greater emphasis on new relative cover ratios. Given the fact that the Spanish banking sector has already provisioned about €105bn since 2008, this reform will raise the outstanding of provisions to 15% of GDP by the end of 2012.

However, these measures had done little to reassure the markets. They failed to outsource banking sector property risk, and the effect of recessionary conditions also seemed not to have been taken into account sufficiently on two levels. Within the scope of property-related exposure, the cover ratio for the healthy part of the portfolio (€124bn) was still limited to 7%, whereas the risk of migration to the problematic part could have been deemed more serious. Outside this scope, the central bank also did not deem it necessary to assume a sharper deterioration in the quality of the loan portfolio to households (€841bn, including €645bn of mortgage loans in February 2012) and corporations (€839bn). Some restructured loans are not considered as non-performing loans but could turn so under the effect of recession. Nevertheless, expected losses on these loans would remain less important than those on property assets. The bad loan ratios for households and non real estate corporations still stand at modest levels and should increase only moderately.

The new measures announced today make up for the weakness of the February reform on the first point mentioned above through an increase in provision on the still sound part of the property assets. The coverage requirement is raised from 7% to 30%, implying a further EUR30bn increase in provisions on top of the EUR54bn already needed. Banks unable to comply with this new rule will be able to ask for the support of the FROB, which will subscribe to convertible bonds. However, banks will have to pay a high rate of 10% on these bonds. The action capacity of the FROB is nevertheless quite limited. There are only EUR27bn left out of an available amount EUR42bn for this year. Were the FROB have to cover a significant part of additional provisions required, it would need the authorisation of the government to raise funds on markets. Its financial leverage can be increase to 6x its capital, which should shortly be increased from EUR9bn to EUR15bn.

Banks have two weeks to revise and present their provisioning plans to the central bank. Were this new reform fail to convince on the improved resilience of the Spanish banking sector to the real estate risk, the State's cost funding would no doubt experience new tensions.

[2] *See Ecoweek 12-03 of the 20 January 2012, « Spain: banking sector overhauled from top to bottom ».*

Focus 2

Were the 3-year LTROs a success?

- The ECB's recent Longer-Term Refinancing Operations (LTROs) have reduced significantly tail risks in the eurozone.
- Thanks to these operations, money market conditions have improved considerably. The impact on debt markets in the first quarter was also impressive.
- Nevertheless, they have still had very little impact on the real economy. There is obviously a lagging effect. But survey data suggest that the real problem is due to the lack of demand rather than supply-side restrictions on credit.
- Against a backdrop of excessive liquidity and extremely low interest rates, further ECB actions are unlikely to have more than a marginally beneficial impact. In contrast, more can and must be done at the national and EU levels.

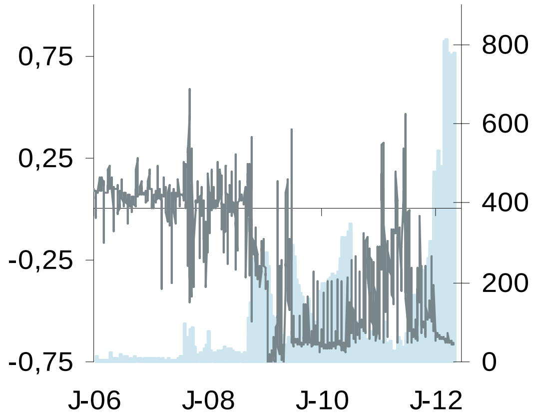
Late last year, the ECB decided to launch two special Longer Term Refinancing Operations (LTROs) with a 3-year maturity. The ECB decided to introduce these special operations at a time when the intensification of financial distress in the last months of 2011 could have created serious problems for the banking sector. A large amount of banking sector debt securities would mature in 2012, with a big chunk concentrated in Q1 2012. Faced with very tight financial market conditions, many institutions risked encountering difficulties when rolling over their debt. Pressures on bank funding costs are easily transmitted to the rest of the economy, given the banking sector's importance as a source of external funding for non-financial corporations in the eurozone.

Impact on the money market

Through these operations, the ECB lent around €1trillion to private banks, significantly swelling its balance sheet. The huge liquidity injection, combined with reduced reserve requirements, massively increased the excess liquidity in the money market (measured as the difference between open market operations and reserve requirements plus autonomous factors). Thanks to better bank funding conditions, the credit quality assessment of banks improved throughout Q1 2012, as signalled by the decline in banking sector CDS. Less stress on funding needs, combined with excess liquidity, significantly eased money market tensions. OIS/BOR spreads have been narrowing at different maturities, although, despite the huge increase in liquidity, they are still above the levels prevailing in the first three quarters of 2011. Excess liquidity has significantly pushed down the Eonia rate, which is now trading close to the interest rate on the deposit

Excess liquidity is holding down the Eonia

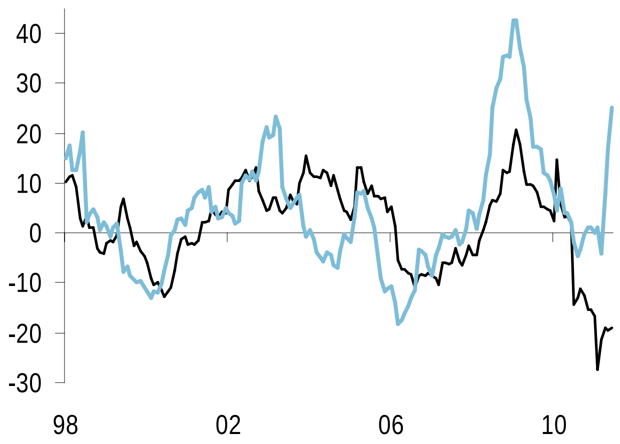
Excess liquidity ; —Eonia-Refi Spead ;



Graph.1 Sources : ECB, Reuters

Peripheral MFIs have increased sharply their holding of debt securities

Stocks of sovereign debt securities held by MFIs Annual growth rates
— Core ; — Peripheral;



Graph.2 Source: ECB

facility, whereas in normal times it fluctuates around the refi rate. This means the monetary policy stance is even more accommodating than suggested by the *refi* rate.

Impact on the sovereign government bond markets

Banks clearly used the funds to cover their positions. Yet the LTROs also presented a good opportunity. Interest rates on several sovereign debt securities, senior bank debt and some corporate bonds are well above the expected rate on the 3-year LTRO. This rate is determined based on the average minimum bid rates of the Main Refinancing Operations (the refi rate) over the life of the respective operation. Even assuming the ECB leaves its keep policy rates unchanged until the end of 2014, and then progressively raises the *refi* rate on a quarterly basis by 25bp, the actual rate on this 3-year LTRO would be only slightly above 1.25%. Clearly the advantages would be even bigger if the ECB were to cut policy rates even more, to counter a drastic downturn in economic conditions, for example.

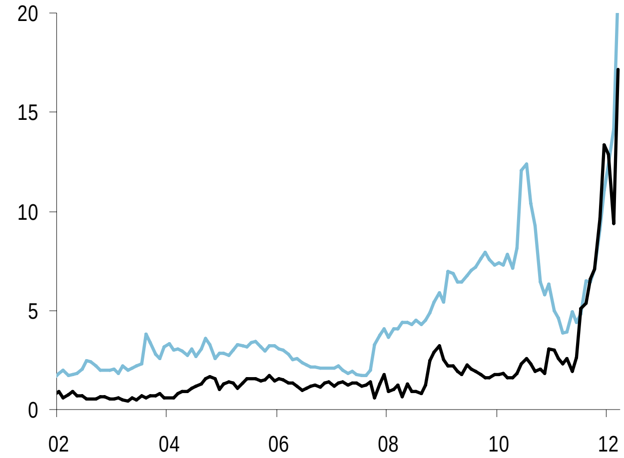
Yields on sovereign bonds from the peripheral countries have been decreasing throughout Q1 2012. The ECB provides data on monetary financial institution (MFIs) purchases of debt securities issued by eurozone governments. Yet these figures do not differentiate between issuers. Several studies and analysis show that MFIs have a country bias, purchasing debt securities issued mainly by their own country. Since the turn of the year, MFIs of the peripheral countries have significantly increased their holdings of sovereign debt securities, while MFIs' demand for the sovereign securities of core countries has contracted sharply (see chart 2).

Unsurprisingly, there has been a sharp increase in central bank liquidity flows to peripheral countries. At the end of Q3 2011, most of the demand for ECB liquidity was from Portuguese, Irish and Greek banks. Since the end of last year, however, there has also been an increase in demand from Italian and Spanish banks. Before the crisis, central bank liquidity ranged between 1% and 2% for both countries. In March 2012 (the latest figures available), it rose to 16% of GDP in Italy and around 20% in Spain (see chart 3). As we pointed out above, the two LTROs clearly represented an attractive opportunity. Between November 2011 and February 2012, the stock of sovereign debt securities held by Italian and Spanish MFIs rose by EUR 54bn (+22%) and EUR 68bn (+38%), respectively. For the eurozone as a whole, MFI holdings of sovereign debt securities rose by €115bn over the same period, equivalent to 22% of the net liquidity increase of the two 3-year LTROs[1]. Therefore, the ECB's non-standard measures produced the same effects as the pure quantitative easing measures adopted by other central banks like the Bank of England and the Federal Reserve.

Nevertheless, strong demand for ECB liquidity may also signal that banks are having a hard time accessing the interbank market. In March, the total demand for liquidity from the peripheral countries was more than 70% of the total demand from the eurozone as a whole, which is extremely high considering that these economies account for around 32% of eurozone output. Clearly, higher exposure to the sovereign debt securities of peripheral countries could exacerbate their weakness.

Italian and Spanish banks raised their demand for ECB liquidity

ECB liquidity in % of GDP



Graph.3 Sources National central Banks, Eurostat:

What about the impact of LTROs on lending to households and NFCs?

Despite these side effects, the ECB probably averted a credit crunch in the economy. Funding conditions for the banking sector have eased. Nevertheless, the effects on the real economy are not evident yet. According to the latest monetary policy trends, the annual growth rate of M3, the second pillar of the ECB's monetary policy, was 3.2% in March, the highest rate since June 2009. At first, this sounds like positive news, since it signals that monetary conditions are becoming less tightened . An analysis of the counterparts of M3, in contrast, is less encouraging. The annual growth rate of lending to the private sector is slowing. From a cyclical peak of 2.8% in October 2010, growth had dropped to 0.6%in March 2012, the lowest level since June 2010. The breakdown shows that loans to households and non-financial corporations continued to ease. By contrast, credit to governments continued to grow, to 7.3% in March, from 5.6% and 4.5% in the previous two months. *Securities other than shares,* one component of credit to governments, rose by more than 15% on an annual basis, up from around 10% in January, which is not surprising based on the above analysis.

The country breakdown shows that lending is extremely weak in the peripheral countries. Demand is actually falling in the peripheral countries, while conditions are much better in the core countries. We can also see this kind of heterogeneity when looking at the interest rates on new loans for NFCs. Interest rates are much higher for NFCs in the peripheral countries than in the core countries (see chart 4).

It is hard to disentangle problems of demand and supply from the weakness of lending growth data and the divergence in retail interest rates. Undoubtedly, austerity measures will strain domestic demand in several eurozone countries, reducing

[1] The net increase in liquidity by the two 3-year LTROs (liquidity injected net of the amount which reached maturity) is equivalent to around €520bn. Assuming that €115bn were used to buy sovereign debt securities, these special LTROs cover more than 60% of bank debt maturing in 2012 (around €630bn according to the IMF d

demand for credit. Interest rate spreads may also be associated with higher risk *premia* demanded by credit institutions to offset the rising default risk of counterparts. Even so, the structural weakness of some credit institutions could produce a kind of credit restriction.

The ECB Bank Lending Survey provides some helpful information. According to the survey, the net tightening of credit conditions has eased significantly in Q1 2012 with respect to Q4 2011, and banks expect conditions to ease further in Q2 2012. Banks reported that their access to markets and their liquidity positions improved markedly in Q1 2012.

Although supply constraints are improving, banks are still facing serious demand problems. Demand for loans was extremely weak in Q1 2012, and despite some improvement, conditions will remain tough in the current quarter as well. Another drop in the financing needs of firms for investment purposes was the main factor behind the decline in credit demand.

How effective is monetary policy in this environment? Should the national authorities do more?

All in all, we cannot conclude from an analysis of the data that the lack of liquidity was the root cause of sluggish credit growth in the eurozone. Although the availability of funding was probably a problem at the end of last year, conditions on this front have improved significantly. In contrast, available data seem to reflect a lack of demand for credit. Households and firms in many eurozone economies are still deleveraging. Moreover, weak banking sectors in some countries (notably Spain) may also contribute to some sort of credit rationing.

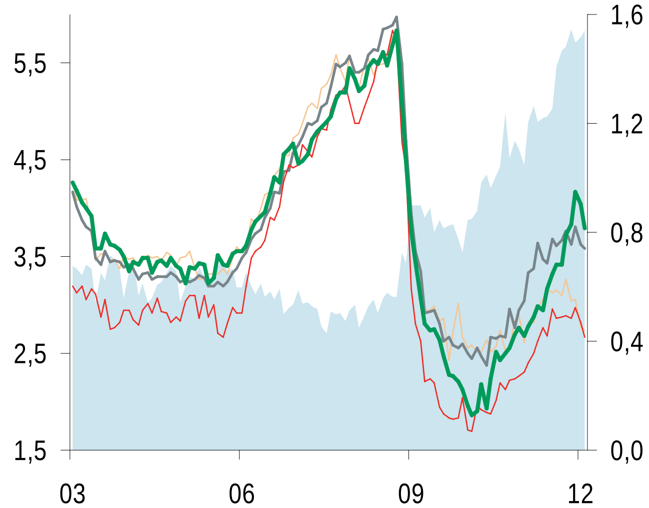
If these are the main problems, then further liquidity injections and interest rate cuts will only be able to improve conditions marginally. In this environment the effectiveness of monetary policy is reduced. Surely, the ECB's commitment to maintain interest rates at low levels and to continue supplying liquidity to banks within the current framework (full allotment at fixed rate, probably at longer maturity) should help ease tensions. However, actions to restore business and consumer confidence and to strengthen the banking sector where needed, are more likely to bear fruit.

So far, the response of EU leaders has not been as big and as fast as the crisis warranted. Yet the eurozone is now equipped with a stabilisation mechanism to counter crises, even though there are still doubts about its size and full implementation. Moreover, recent events have shown that the tensions in the debt markets are far from over. The lack of a clear vision of a sustainable solution for the eurozone (transforming the EMU into something closer to a fiscal union) is not helping. To be fair, something has been done on this point as well. Indeed, you cannot have any mutualisation in the EMU without mutual trust. The fiscal compact is a step in the right direction. Nevertheless, EU leaders are far from reaching an agreement on further integration.

Tighter in peripheral than in core countries

Interest rates on new loans for NFCs

Standard deviation (rhs) ; —Germany ; France; — Italy, —Spain;



Graph.4 Sources: ECB, BNPP

The national authorities have taken steps to put their fiscal houses in order (a pre-condition for growth) and to stimulate long-run growth through structural reforms. These measures will produce results only in the medium term. In the short term, austerity measures risk exacerbating the problems of sluggish demand. Recently, there has been more talk about the possibility of stimulating demand through better use of European structural funds or through investment in education and infrastructure financed by the European Investment Bank. Given the weakness of domestic demand, any investment that helps resolve some of the bottlenecks in the economy are welcome. More flexibility regarding fiscal measures would also be welcome. Even though governments are implementing measures to reduce deficit, they might not achieve their fiscal targets since the recession risks being much more severe than previously expected.

Against this backdrop, taking additional austerity measures to meet debt reduction targets could make things worse. In this case, the European Commission and EU leaders would have to recognise the efforts the national authorities are making in a tough economic environment, rather than asking for further belt tightening. This could also calm the financial markets, which become extremely nervous every time a country slips behind on its targets. Unfortunately, we are in a situation in which the national authorities are taking painful measures to resolve imbalances and push long-run growth, but they are not obtaining any beneficial effects, the first of which should be a drastic reduction in interest rates. EU leaders can do something on this point.

To watch from 14 May to 18 May 2012

Monday 14 May 2012

EUROZONE: Industrial production (March)

In February, industrial production rose by 0.8% m/m. Output probably increased further in March, albeit at a slower pace.

Tuesday 15 May 2012

UNITED STATES: CPI (April)

Thanks to lower oil prices, consumer prices probably remained flat in April, driving the inflation rate down from 2.6% to 2.3%. Core prices are likely to have gained 0.2% m/m, leaving the y/y rate of change unchanged, at 2.3%

Retail sales (April)

Lower oil prices, together with disappointing car sales, and early summer-clothes shopping due to warm weather in March, will result in weak retail sales data in April. We are looking for a negative number that will undoubtedly be reversed as soon as in May

EUROZONE: Q1 12 GDP growth (flash estimate)

GDP contracted by 0.3% q/q in Q4 2011. Survey data suggest that output might have contracted again in Q1 2012 (by around 0.2% q/q).

GERMANY: GDP (Q1 2012)

GDP, down by 0.2% q/q in Q4 2011, probably recovered to a positive trend in Q1 2012. However GDP growth, around 0.2% q/q, remained moderate.

FRANCE: GDP (Q1 2012)

Q1 GDP is expected down by 0.2%. It surprised on the upside in Q4 but this time, the economy should not escape a mild contraction, supported by the deterioration of confidence surveys and the decline in production.

FRANCE: CPI (April)

Inflation should ease in April, at the headline level (+0.1% on the month, +2.1% on a year-on-year basis) as well as the core (+0.1% on the month, +1.5% compare to one year ago) thanks to a less rapid rise in energy and manufactured goods prices.

Wednesday 16 May 2012

JAPAN: Machinery Orders (March)

Core machinery orders are forecast to have declined 3.5% m/m in March following substantial gains in the previous months. Orders have been underpinned by spending on infrastructure.

JAPAN: Tertiary index (March)

Tertiary activity is projected to have increased by 0.2% m/m in March, as retail sales are likely to have rebounded after their sharp decline (-1.4%) in the previous month.

EUROZONE: Inflation (final estimate, April)

In April, inflation edged down to 2.6% from 2.7%. The final estimate should confirm the preliminary reading. Core inflation is likely to have increased, while energy price should have moderated.

Thursday 17 May 2012

JAPAN: GDP (Q1)

GDP could have expanded by 0.9% q/q in Q1, inflated by some temporary factors such as the leap-year, the reinstatement of 'green' car subsidies.

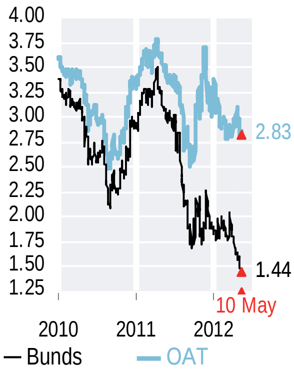
Markets overview

The essentials

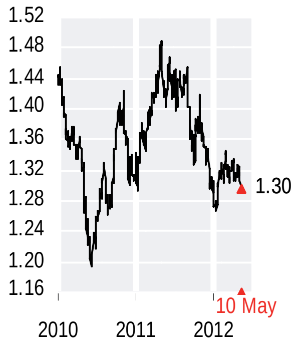
Week 7-5 12 > 10-5-12

↘ CAC 40	3 162	▸ 3 130	-1.0	%
↘ S&P 500	1 369	▸ 1 358	-0.8	%
↘ Volatility (VIX)	19.2	▸ 18.8	-0.3	%
↘ Euribor 3M (%)	0.70	▸ 0.69	-0.7	%
↗ Libor $ 3M (%)	0.47	▸ 0.47	+0.1	%
↘ OAT 10y (%)	2.85	▸ 2.83	-1.9	%
↘ Bund 10y (%)	1.51	▸ 1.44	-6.9	%
↘ US Tr. 10y (%)	1.88	▸ 1.85	-2.9	%
↘ Euro vs dollar	1.31	▸ 1.30	-1.2	%
↘ Gold (ounce, $)	1 638	▸ 1 594	-2.7	%
↗ Oil (Brent, $)	112.4	▸ 112.8	+0.4	%

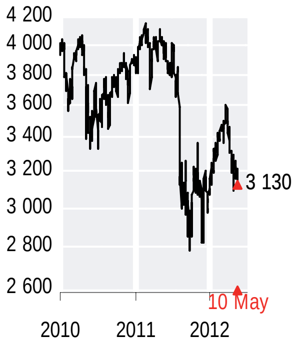
10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



Money & Bond Markets

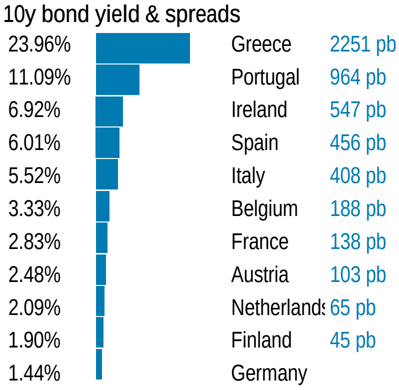
Interest Rates		highest 12			lowest 12		
€ ECB	1.00	1.00	le	02/01	1.00	le	02/01
Eonia	0.35	0.40	le	03/01	0.34	le	25/04
Euribor 3M	0.69	1.34	le	02/01	0.69	le	10/05
Euribor 12M	1.28	1.94	le	02/01	1.28	le	10/05
$ FED	0.25	0.25	le	02/01	0.25	le	02/01
Libor 3M	0.47	0.58	le	03/01	0.47	le	16/04
Libor 12M	1.05	1.13	le	04/01	1.05	le	18/04
£ BoA	0.50	0.50	le	02/01	0.50	le	02/01
Libor 3M	1.01	1.09	le	12/01	1.01	le	10/05
Libor 12M	1.86	1.90	le	25/01	1.86	le	11/04

At 10-5-12

Yield (%)		highest 12		lowest 12	
€ AVG 5-7y	2.82	3.67	09/01	2.65	13/03
Bund 2y	0.08	0.33	20/03	0.08	09/05
Bund 10y	1.44	2.04	20/03	1.44	09/05
OAT 10y	2.83	3.37	06/01	2.79	01/03
Corp. BBB	4.53	6.25	02/01	4.47	02/04
$ Treas. 2y	0.27	0.39	20/03	0.21	26/01
Treas. 10y	1.85	2.38	19/03	1.80	31/01
Corp. BBB	3.79	4.30	03/01	3.75	08/05
£ Treas. 2y	0.43	0.54	14/03	0.35	31/01
Treas. 10y	1.90	2.36	16/03	1.82	09/05

At 10-5-12

10y bond yield & spreads

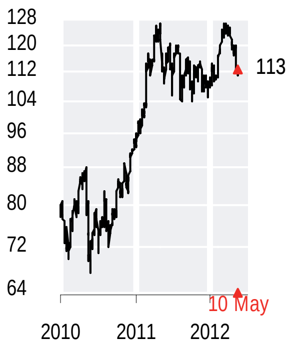


Commodities

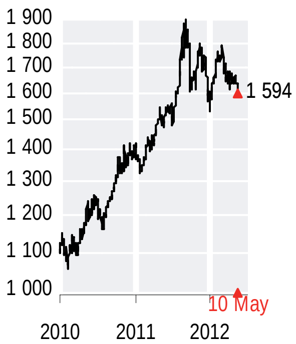
Spot price in dollars		lowest 12			2012(€)
Oil, Brent	113	108	le	02/01	+4.4%
Gold (ounce)	1 594	1 575	le	02/01	+1.4%
Metals, LMEX	3 448	3 297	le	05/01	+4.5%
Copper (ton)	8 207	7 488	le	09/01	+8.3%
CRB Foods	418	418	le	09/05	-3.9%
wheat (ton)	227	223	le	18/01	-2.4%
Corn (ton)	243	231	le	18/01	-4.6%

At 10-5-12 *Variations*

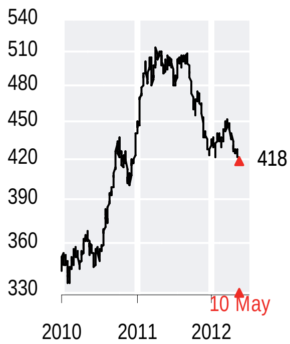
Oil (Brent, $)



Gold (Once, $)



CRB Foods ($)



Exchange Rates

1€ =		highest 12			lowest 12			
USD	1.30	1.35	le	24/02	1.27	le	13/01	-0.2%
GBP	0.80	0.85	le	24/02	0.80	le	10/05	-4.0%
CHF	1.20	1.22	le	04/01	1.20	le	27/04	-1.0%
JPY	103.62	110.76	le	27/03	97.21	le	16/01	+3.7%
AUD	1.28	1.29	le	09/05	1.22	le	16/02	+1.2%
CNY	8.18	8.48	le	24/02	7.99	le	13/01	+0.2%
BRL	2.53	2.53	le	03/05	2.24	le	06/02	+4.6%
RUB	39.04	41.70	le	02/01	38.40	le	15/03	-6.4%
INR	69.19	70.29	le	03/05	63.89	le	03/02	+0.4%

At 10-5-12 *Variations*

Equity indices

	Index	High 12			Low 12			2012	2012(€)
CAC 40	3 130	3 595	le	16/03	3 098	le	23/04	-0.9%	-0.9%
S&P500	1 358	1 419	le	02/04	1 258	le	02/01	+8.0%	+8.2%
DAX	6 518	7 158	le	16/03	6 017	le	09/01	+10.5%	+10.5%
Nikkei	9 010	10 255	le	27/03	8 378	le	16/01	+6.6%	+2.7%
China*	57	62	le	29/02	53	le	02/01	+7.5%	+7.8%
India*	370	454	le	21/02	348	le	02/01	+7.2%	+6.9%
Brazil*	2 775	3 487	le	02/03	2 765	le	09/05	+2.9%	-1.7%
Russia*	790	940	le	16/03	737	le	02/01	+1.4%	+7.3%

At 10-5-12 *Variations*

(1) Informations: Tarik Rharrab (2) 95.56 ; Veary Bou (2) 05.27 ; Patrick Capeillere (2) 95.57

* MSCI Indices

Most recent articles

MAY	4 May	12-18	Overview	United Kingdom: on a razor's edge
				The week in the US
				The week in the Eurozone
				Fortnight in France
			Focus	Netherlands: Stepping up austerity
APRIL	27 April	12-17	Overview	France, key themes missing from the presidential debate
				The week in the US
				The week in the Eurozone
			Focus	Germany : Signs of recovery in the real estate
	20 April	12-16	Overview	D-2
				The week in the US
				The week in the Eurozone
			Focus	Netherlands : Fragile housing market weighs on economy
	13 April	12-15	Overview	890 days
				The week in the US
				The week in the Eurozone
	6 April	12-14	Overview	Spanish flu
				The week in the US
				The week in the Eurozone
			Focus	France: a well-targeted fiscal deficit
MARCH	30 Mars	12-13	Overview	Spain : hard work ahead
				The week in the US
				The week in the Eurozone
				Fortnight in France
			Focus	Switzerland : just a phase
	23 March	12-12	Overview	European governance : a neverending story
				The week in the US
				The week in the Eurozone
			Focus 1	United Kingdom : A conservative budget
			Focus 2	Bank stress tests : the American touch
	16 March	12-11	Overview	ECB : what are the risks of an overweight balance sheet
				The week in the US
				The week in the Eurozone
	9 March	12-10	Overview	Austerity doesn't exclude growth
				The week in the US
				The week in the Eurozone
	2 March	12-09	Overview	Shopping at the ECB
				The week in the US
				The week in the Eurozone
				Fortnight in France
			Focus	The Greek PSI: Closing A Chapter
FEBRUARY	24 February	12-08	Overview	Greece: all set for a new start
				The week in the US
				The week in the Eurozone
	17 February	12-07	Overview	North-South spread
				The week in the US
				The week in the Eurozone
				Fortnight in France
			Focus 1	Aren't you over-optimistic, Mr President ?

Economic Research Department

Philippe d'ARVISENET Chief Economist	33.1.43.16.95.58	philippe.darvisenet@bnpparibas.com

ECONOMIES OECD

Jean-Luc PROUTAT Head	33.1.58.16.73.32	jean-luc.proutat@bnpparibas.com
Alexandra ESTIOT Deputy Head – Globalisation, United States, Canada	33 1.58.16.81.69	alexandra.estiot@bnpparibas.com
▸France, Belgium, Luxembourg Hélene BAUDCHON	33.1.58.16.03.63	helene.baudchon@bnpparibas.com
▸Public finance – European institutions Frédérique CERISIER	33.1.43.16.95.52	frederique.cerisier@bnpparibas.com
▸Euro Zone, Italy - Monetary issues - Economic modelling Clemente De LUCIA	33.1.42.98.27.62	clemente.delucia@bnpparibas.com
▸Spain, Portugal, Greece Thibault MERCIER	331.57.43.02.91	thibault.mercier@bnpparibas.com
▸United Kingdom, Ireland, Nordic Countries - Supervision of publications Caroline NEWHOUSE	33.1.43.16.95.50	caroline.newhouse@bnpparibas.com
▸Germany, Austria, Switzerland Catherine STEPHAN	33.1.55.77.71.89	catherine.stephan@bnpparibas.com
▸Japan, Australia, Nederlands - Environnement - Pensions Raymond VAN DER PUTTEN	33.1.42.98.53.99	raymond.vanderputten@bnpparibas.com

BANKING ECONOMICS

Laurent QUIGNON Head	33.1.42.98.56.54	laurent.quignon@bnpparibas.com
Delphine CAVALIER	33.1.43.16.95.41	delphine.cavalier@bnpparibas.com
Céline CHOULET	33.1.43.16.95.54	celine.choulet@bnpparibas.com
Laurent NAHMIAS	33.1.42.98.44.24	laurent.nahmias@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

François FAURE Head	33.1 42 98 79 82	francois.faure@bnpparibas.com
Christine PELTIER Deputy Head - Methodology, China, Vietnam	33.1.42.98.56.27	christine.peltier@bnpparibas.com
▸Africa, French-speaking countries Stéphane ALBY	33.1.42.98.02.04	stephane.alby@bnpparibas.com
▸Latin America, Turkey - Methodology Sylvain BELLEFONTAINE	33.1.42.98.26.77	sylvain.bellefontaine@bnpparibas.com
▸Middle East – Scoring (CRISTAL) Pascal DEVAUX	33.1.43.16.95.51	pascal.devaux@bnpparibas.com
▸Russia and other CIS countries – Commodities Anna DORBEC	33.1.42.98.48.45	anna.dorbec@bnpparibas.com
▸Asia Hélène DROUOT	33.1.42.98.33.00	helene.drouot@bnpparibas.com
▸Africa, English and Portuguese – speaking countries Jean-Loïc GUIEZE	33.1.42.98.43.86	jeanloic.guieze@bnpparibas.com
▸Asia – Capital Flows Johanna MELKA	33.1.58.16.05.84	johanna.melka@bnpparibas.com
▸Latin America Valérie PERRACINO-GUERIN	33.1.42.98.74.26	valerie.perracino@bnpparibas.com
▸Central and Eastern Europe Alexandre VINCENT	33.1.43.16.95.44	alexandre.vincent@bnpparibas.com

Ours publications

- **Conjoncture** focuses each month both on the main economic issues and structural problems.
- **Economic Market Monitor** provides a detailed follow-up of the economic situation whilst analysing interest and exchange rate developments in OECD countries (8 issues per year).
- **EcoWeek** focuses on specific and current economic issues (every Friday).
- **EcoFlash** comments and analyses the main economic events (data releases, economic policy decisions) in the hours following their release.
- **EcoTV** the monthly broadcast programme from BNP Paribas economists. Each month, Philippe d'Arvisenet and his teams will help you to make sense of the economic and financial news in both French and English. These interviews are available on our website.
- **EcoTV Week** the weekly broadcast programme from BNP Paribas economists. In a succinct two-minute format, the new show, presented by one of the Group's economists, covers the economic and financial events of the previous week as well as those that are expected in the coming days. These interviews are available on our website, in both French and English

To receive our publications, please subscribe on our website