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THE SPANISH ECONOMY

Monthly Report

HEALTH AND HEALTHCARE: SQUARING THE CIRCLE

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2009	2010	2011	2009		2010			
				3Q	4Q	1Q	2Q	3Q	4Q
INTERNATIONAL ECONOMY		Forecast						Forecast	
Gross domestic product									
United States	–2.6	2.7	2.2	–2.7	0.2	2.4	3.0	3.1	2.4
Japan	–5.2	2.8	1.4	–4.8	–1.4	4.4	2.4	2.7	1.9
United Kingdom	–4.9	1.6	2.4	–5.3	–3.1	–0.2	1.6	2.8	2.4
Euro area	–4.0	1.5	1.7	–4.0	–2.0	0.8	1.9	1.7	1.8
Germany	*–4.6*	*3.1*	*1.9*	*–4.4*	*–2.0*	*2.0*	*3.7*	*3.3*	*3.4*
France	*–2.2*	*1.5*	*1.7*	*–0.4*	*0.4*	*1.3*	*1.7*	*1.7*	*1.6*
Consumer prices									
United States	–0.3	1.6	1.2	–1.6	1.5	2.4	1.8	1.2	0.9
Japan	–1.4	–0.8	–0.2	–2.3	–2.0	–1.1	–0.9	–0.6	–0.4
United Kingdom	2.2	3.1	2.5	1.5	2.1	3.3	3.4	3.1	2.6
Euro area	0.3	1.5	1.6	–0.4	0.4	1.1	1.5	1.7	1.7
Germany	*0.3*	*1.1*	*1.4*	*–0.2*	*0.4*	*0.8*	*1.1*	*1.2*	*1.3*
France	*0.1*	*1.5*	*1.5*	*–0.4*	*0.4*	*1.4*	*1.6*	*1.5*	*1.6*
SPANISH ECONOMY		Forecast						Forecast	
Macroeconomic figures									
Household consumption	–4.3	0.4	0.7	–4.2	–2.6	–0.3	2.0	–0.1	0.1
Government consumption	3.2	–0.2	–1.0	2.7	0.2	–0.2	0.4	–0.5	–0.6
Gross fixed capital formation	–16.0	–6.6	–0.7	–16.4	–14.0	–10.5	–7.0	–5.1	–3.7
Capital goods	*–24.8*	*3.7*	*6.3*	*–25.5*	*–16.9*	*–4.8*	*8.7*	*6.0*	*5.0*
Construction	*–11.9*	*–10.0*	*–3.9*	*–11.7*	*–11.9*	*–11.4*	*–11.4*	*–9.5*	*–7.6*
Domestic demand (contribution to GDP growth)	–6.4	–1.4	0.0	–6.5	–5.3	–2.8	–0.5	–1.3	–0.9
Exports of goods and services	–11.6	10.3	5.7	–11.0	–2.1	8.8	10.5	10.9	10.9
Imports of goods and services	–17.8	5.2	2.9	–17.2	–9.2	2.0	8.1	4.9	5.9
Gross domestic product	**–3.7**	**–0.3**	**0.7**	**–3.9**	**–3.0**	**–1.3**	**–0.1**	**0.0**	**0.2**
Other variables									
Employment	–6.6	–2.4	–0.4	–7.2	–6.0	–3.7	–2.5	–1.9	–1.3
Unemployment (% labour force)	18.0	19.8	20.0	17.9	18.8	20.0	20.1	19.8	19.9
Consumer price index	–0.3	1.7	1.4	–1.1	0.1	1.1	1.6	1.9	2.2
Unit labour costs	1.0	–1.0	–0.5	0.3	0.0	–0.7	–1.0		
Current account balance (% GDP)	–5.5	–5.1	–4.2	–4.0	–4.7	–6.0	–5.0		
Net lending or net borrowing rest of the world (% GDP)	–5.1	–4.6	–3.7	–3.7	–4.4	–5.3	–4.3		
General government financial balance (% GDP)	–11.1	–9.6	–6.5						
FINANCIAL MARKETS		Forecast							Forecast
International interest rates									
Federal Funds	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	1.2	1.0	1.1	1.0	1.0	1.0	1.0	1.0	1.0
10-year US bonds	3.2	3.1	2.8	3.5	3.4	3.7	3.5	2.8	2.5
10-year German bonds	3.3	2.7	2.7	3.3	3.2	3.2	2.8	2.4	2.4
Exchange rate									
$/Euro	1.39	1.33	1.33	1.43	1.48	1.38	1.27	1.29	1.37

Contents

Health and healthcare: how to square the circle?

The health systems of developed countries are facing escalating costs and increasing demand both in terms of quantity and quality. Since the provision of healthcare and health is mainly the responsibility of the public sector in most countries, we can easily imagine the budget tensions caused by the sector, especially at times of spending cuts. So is it possible to achieve excellence in national health systems without breaking the budget?

From the perspective of demand, it's not easy to stop its rising cost. For the countries of the Organization for Economic Cooperation and Development as a whole, growth in public healthcare spending per capita over the last ten years up to 2007 was 4.3% as an annual average. Between 1980 and 2007, healthcare went from 10.9% to 16.1% of the public budget. In terms of gross domestic product, total healthcare spending reached 9.0% in 2008.

Why is healthcare spending growing? According to the same international organization, the main factor behind its rise is actually the increase in citizens' standard of living: the higher the income, the greater the demand for healthcare services. Better education, a greater awareness of the benefits of good health and improved information on treatments, therapies and the healthcare available result in demand for more healthcare services. Given that we can expect per capita income to continue to rise in the medium term, this factor will not be the one to help to contain spending on public health services.

The second factor behind growth in spending is the incorporation of new medical techniques. It has been observed that average healthcare tends to incorporate tests or treatments using innovative technologies that are usually more expensive than the existing ones and that are prescribed to improve and ensure the patient receives suitable healthcare, although their use is not always justified. This is a delicate point and one that requires a precise economic assessment of new technologies and an adjustment in the extent to which they are provided to patients.

Among the rest of the factors behind growing healthcare costs we find demographics. However, contrary to what we might suppose, the ageing population has a very moderate effect on the rise in healthcare spending. Studies show that the years «gained» in terms of life expectancy are healthy years, which may require spending on social services related to dependency but not healthcare per se, which will still be concentrated in the period prior to death. In any case, we can't expect healthcare demand to be contained via this route either.

Given that this growth in healthcare demand seems to be inexorable, how can the budget problem be tackled? Insofar as it's not socially acceptable to cut health cover or to limit the care provided by national health systems, the alternatives are either to provide more resources (financed by higher taxes), improve the sector's productivity (by introducing greater competition and implementing new healthcare models) or introduce co-payment systems for medical treatment or drugs that help to rationalize healthcare consumption. We need to debate and reflect on these issues if we hope to preserve and improve one of the most significant achievements of our welfare state.

EXECUTIVE SUMMARY

The United States and Japan confirm a slowdown in their pace of growth.

The measures they can use to stimulate their economies are now more limited.

The Fed's expected new plan to buy up public debt is pushing the dollar down against the main currencies.

After monetary and fiscal stimuli, a currency war?

The recovery in global economic growth, both in developed and emerging countries, had led to optimism in terms of the economic prospects for 2010 and 2011. However, in the last few months a change in trend has been confirmed in the pace of recovery of the United States and Japan that might also affect the rest of the economies.

In the United States, the fact that fiscal stimuli have gradually been used up highlights that household consumption and investment are still not ready to take over the reins of growth. Something similar is happening in Japan, although it has recently implemented a new package of stimuli. The problem is that the scope to boost an economy with new measures, be they fiscal or by cutting interest rates, is now practically exhausted. This means that governments have a much more limited range of resources they can use. However, the top countries, with the notable exception of the euro area, seem to be giving in to the temptation of influencing their currencies to protect their foreign sector and thereby preserve their growth rates.

A swing to protectionism in the style of the 1930s? For the moment, no, but in order to stop history from repeating itself, the finance ministers of the G-20, meeting in Korea to prepare November's summit, have agreed to combat the different forms of protectionism and to encourage an exchange rate system based on market rules.

The initial signs of a possible shift towards protectionism have led the press to resurrect the spectre of a currency war, although this time the mechanisms used to act on exchange rates are more subtle. One of the main protagonists is the United States, which has already announced that it will implement a second package of public debt purchases at the beginning of November, as a monetary stimulus to get activity going again. The mere announcement of this measure was enough to cause a significant drop in the value of the US dollar against the main currencies and a slight increase in inflation expectations.

There are two justifications for this measure. Firstly, because of the downward slide in the growth rate of its gross domestic product (GDP). In the third quarter, this grew by 0.5% compared with the previous quarter, a lower figure than at the end of 2009 and the beginning of 2010. What has also kept the American authorities on tenterhooks is the continuing fall in inflation, with a core consumer price index (CPI), excluding food and energy, that grew by just 0.8% in September, the lowest rate of growth in prices since February 1961.

For its part, the Japanese government has been one of the first to react in the old style, i.e. by intervening directly in the currency market. Its economy is also immersed in a delicate slowdown process: private consumption has stagnated and exports are suffering from the yen's appreciation and the slowdown in the economy of its main trading partners. Given this scenario, the Japanese Finance

Minister ordered the Bank of Japan to sell yen against dollars to counteract the strength of the Japanese currency. However, its impact on the markets was temporary and, for the moment, it has not managed to halt the downward slide of the dollar against the yen.

The emerging countries are also suffering from monetary tension. They are attracting capital because of the low interest rates in advanced economies, which find the emerging economies in expansion an attractive place to invest. Brazil has therefore been forced to slow up the appreciation of its currency, almost 40% against the dollar since the beginning of 2009. In the last few weeks, this trend has become more acute. To stop this upward spiral, Guido Mantega, the Brazilian Tax Minister, has raised the duty levied on foreign capital inflows in bonds twice in one month. Brazil's central bank has also intensified its purchase of dollars and the government has announced that it is thinking of implementing further measures to contain the rise in the real. Switzerland is a different case, as its currency often becomes a safe haven in turbulent times and it has also now intervened in the currency market. Although without much success, as the Swiss franc has continued to appreciate.

However, the epicentre of this convulsion is China and its currency. In his recent trip to Europe, the Chinese Prime Minister, Wen Jiabao, argued that a higher appreciation in the renminbi could damage the tight margins that Chinese firms operate with and that this would therefore harm competitiveness and the Asian giant's capacity to grow. However, China's high accumulation of international reserves goes against the Prime Minister's argument, as it highlights that the current exchange rate is not in line with the country's structural economic conditions.

Keeping the renminbi devalued helps to boost Chinese exports, which are largely responsible for its strong growth in GDP, in the third quarter standing at 9.6% in year-on-year terms. However, this policy is not without its risks. Inflationary tension and the possibility of a real estate bubble continue to be the major concerns. On the other hand, the growth in credit is still failing to adjust as the Chinese government would like, and it has therefore raised its reference rate by 25 basis points to 5.56% and has once again increased the cash reserve ratio for the country's six largest banks.

For the moment, the euro area is remaining on the sidelines of this protectionist virus among the main economic powers. In spite of the euro's strong appreciation against the dollar, 11.9% since June, the recovery for the euro area as a whole is progressing apace, although there are also certain signs of a slowdown. However, this progress is far from equal among the different countries. It is particularly worth noting the strength of the German economy, which is unquestionably acting as the region's driving force this time. In August, its industrial production continued to progress well, the trend in the purchasing managers' index (PMI) has been good throughout the third quarter and the unemployment rate continues to fall, now at its lowest level since reunification. The German government now predicts 3.4% growth in GDP in 2010, the best figure since reunification.

The European Central Bank is happy with the gradual improvement in the sovereign debt markets of its periphery countries, as well as noting the increasing signs that the interbank market is getting back to normal. The 3-month Euribor, which has been below 1% since July 2009, has passed the level of the reference rate. Improved liquidity and the relaxation in tension in

Japan intervenes in the currency market and Brazil raises its duty on foreign capital inflows.

China continues to defend a devalued exchange rate.

The euro area remains on the sidelines thanks to improved growth prospects.

The economic recovery in Spain loses steam in the third quarter.

the interbank market have also affected the 12-month Euribor rate, going above 1.5% in October.

In Spain, the economic recovery, which became stronger in the first half of the year and recorded two consecutive quarters of growth, has slowed up in the third quarter. Available indicators point towards a decline in private consumption and public investment, after consumption was brought forward in the second quarter given July's imminent hike in value added tax (VAT). The counterpart to bringing consumption forward, together with the gradual removal of economic stimuli, has led to a certain downturn in the third quarter.

The decline in the labour market is less acute.

In spite of the signs of economic decline in this period, there are indications of a more dynamic core to the economy. In August, the number of new start-ups was 4.0% higher than a year earlier, with a substantial increase in the average capital subscribed. We should also note the trends in the real estate sector. The significant drop in housing prices, low interest rates and the expected withdrawal of discounts for buying housing as from 2011 for some taxpayers have been boosting transactions over the last few months, up 29.6% year-on-year in August.

However, the improvement in economic activity is still not enough to stop the labour market from deteriorating. In September, the average monthly number of people registered as employed with Social Security fell by almost 45,000 compared with the previous month, a higher fall in employment than expected. In the third quarter as a whole, the Labour Force Survey noted a 1.7% drop in employment compared with the same period a year ago (a 2.5% drop in the second quarter) and an improvement in the unemployment rate, basically for seasonal reasons. In short, the data confirm that the employment situation is continuing to get worse, although with much less intensity than in the preceding periods, and the same thing is happening with the unemployment figures.

Given this situation of weak demand, inflation trends might be somewhat misleading. After taking a break in August, the year-on-year change in the CPI rose once again in September, standing at 2.1%. Nevertheless, this rise in inflation is due to higher fuel and oil prices and not to any increase in demand. These factors are, however, temporary and, for 2011, weak demand and the knock-on effect of VAT as from July will tend to reduce the rate of inflation.

One of the keys to the future trends in the Spanish economy is meeting its targets for adjusting public sector budgets. Available data reveal a notable cut in the central government deficit for this year to date, thanks to the improved tax revenue and cost cutting measures. The 2011 budget, currently being discussed in parliament, proposes a public sector deficit of 6%, an ambitious target that must be achieved if the Spanish economy is to maintain the necessary flow of financing from international markets.

The cabinet reshuffle might boost the reform of the pension system and collective bargaining.

On the other hand, the cabinet resulting from October's big reshuffle is faced with the challenge of boosting the reform of the pension system and reviewing collective bargaining. All this must help to restore confidence in the Spanish economy, both among economic agents and foreign investors. These are decisive actions that will help to remove the uncertainty still hovering over the immediate future.

29 October 2010

CHRONOLOGY

2009

November	**27**	The central government presents its draft bill for the **Sustainable Economy Act**.
December	**1**	The **Lisbon Treaty** comes into force, reforming certain aspects of the European Union.

2010

January	**29**	The government passes a package of **budget austerity measures** and proposes to raise **the retirement age** to 67.
February	**9**	Agreement for employment and **collective bargaining 2010, 2011 and 2012** between representatives of employers and trade unions.
April	**7**	The government presents its **extraordinary Infrastructure Plan**, which will involve 17 billion euros in the coming two years.
	9	The government passes a **new package of measures to boost economic activity**.
	10	The Finance Ministers of the euro area announce the **conditions for helping Greece**.
	12	The government proposes **a new plan to reform the labour market**, to be discussed within the context of social dialogue.
May	**2**	Countries in the euro area **approve financial aid for Greece**, totalling 110 billion euros.
	10	The European Union adopts a **European Stabilization Mechanism**, provided with 750 billion euros, with the involvement of the International Monetary Fund.
	20	The government approves a Decree-Law to adopt **extraordinary measures to speed up the planned reduction in its public deficit**.
June	**17**	The European Council decides to publish the **stress tests** for the main European banks, to levy a **new tax on banks** and improve the **budget discipline and macroeconomic standards**.
	22	The Spanish parliament **approves a Decree-Law with urgent measures to reform the labour market**, proposed by the government.
	26	One year after the Fund for Orderly Bank Restructuring (FROB) was set up, the Bank of Spain considers the **process of restructuring savings banks** in Spain to be almost complete.
	27	The **G-20** summit decides to halve the deficits of advanced economies by 2013.
July	**1**	**Rise in the general VAT** rate from 16% to 18%, and the reduced rate from 7% to 8%.
	9	The government approves the **reforms of the Savings Bank Governing Body Act**.
	22	The Ministry of Public Works specifies its **cuts in public works spending**.
	23	The Committee of European Banking Supervisors publishes the results of the **stress tests** on European banks.
September	**9**	The Spanish lower house passes the **labour reforms**.
	24	The government passes the bill for the **2011 General State Budget**, involving strong adjustments aimed at reducing the public deficit.
	29	**General strike**, called against the labour reforms.
October	**20**	Extensive reshuffle in the **Spanish government**.

AGENDA

November

2 Fed Open Market Committee
3 Registration with Social Security and registered unemployment (October).
Fed Open Market Committee.
4 Governing Council of the European Central Bank.
5 Industrial production index (September).
11 GDP flash estimate (third quarter).
12 CPI (October).
EU GDP flash estimate (third quarter).
16 EU HCPI (October).
17 Quarterly national accounts (third quarter).
Governing Council European Central Bank.
23 International trade (September).
Central government revenue and spending (October).
25 Producer prices (November).
29 Retail and consumer goods (October).
HCPI flash estimate (November).
30 Balance of payments (September).

December

2 Registration with Social Security and registered unemployment (November).
EU industrial production index (October).
Governing Council of the European Central Bank.
3 Industrial production index (October).
14 Fed Open Market Committee
15 CPI (November).
16 Labour costs (third quarter).
EU inflation (November).
21 Government revenue and expenditure (November).
International trade (October).
23 Producer prices (December).
29 Retail and consumer goods (November).
30 Balance of payments (October).

INTERNATIONAL REVIEW

IMF forecasts: a complicated 2011

The IMF expects 4.2% global growth in 2011.

In its World Economic Outlook for October, the International Monetary Fund (IMF) revised its July forecasts downwards. Growth for 2010 remained at a robust 4.8%, thanks to the push from emerging economies, but a weakness can be seen in the recovery, particularly in advanced economies, which is likely to lose steam in 2011, a year in which 4.2% global growth is forecast.

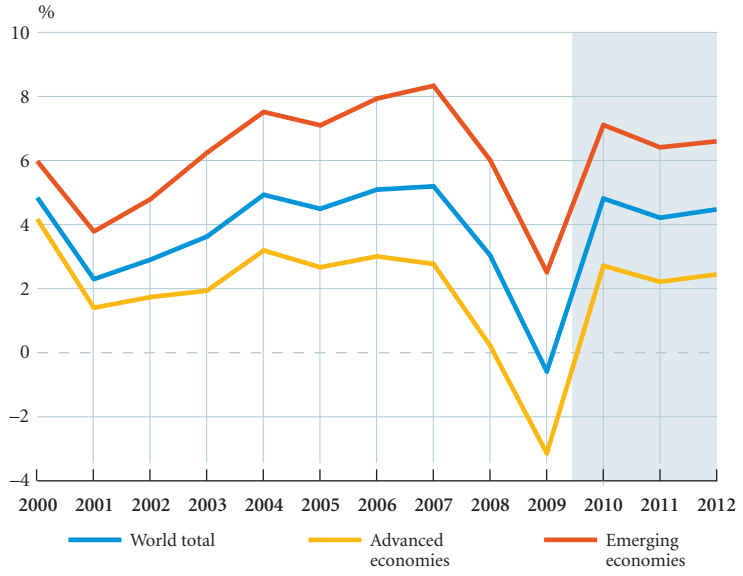
Private demand doesn't manage to take over from fiscal stimuli in advanced economies.

According to the IMF, in order for the recovery to be sustained, rebalancing is required between domestic and external growth that is only taking place to a limited extent. In domestic rebalancing, the IMF notes that private demand in advanced economies has not managed to take over from government stimuli, while externally it underlines the need to reduce the large trade surpluses in those countries such as China where growth is still overly dependent on foreign demand.

The Fund expects the recovery in advanced economies to lose steam in 2011, with the rise in prices also slowing up. Forecasts for the United States have been reduced, with growth expected to be 2.6% in 2010 and 2.3% in 2011, hit by its weak labour and housing markets.

EXITING THE RECESSION

Year-on-year change in gross domestic product



NOTE: 2010, 2011 and 2012 are forecasts.
SOURCE: International Monetary Fund.

In contrast, the euro area's prospects have improved, although still far from a robust recovery, with a growth forecast of 1.7% and 1.5% for 2010 and 2011, respectively.

The main increase in forecasts in the euro area is for Germany, with an expected growth of 3.3% in 2010 thanks to its strong exports. This boost should abate slightly in 2011, with growth forecast at 2.0%. The case of Japan is similar, forecast to grow by 2.7% in 2010 but, according to the Fund, slowing up to 1.5% in 2011. Although it has improved its prospects, Spain is a latecomer to recovery, with a 0.3 drop forecast for 2010 and meagre growth of 0.7% in 2011. The outlook for emerging economies continues to be robust, particularly in East Asia, where Chinese growth particularly stands out which, according to the IMF, will reach 10.5% in 2010 and 9.6% in 2011.

The lack of external and domestic rebalancing has reduced the risks of this core scenario. Firstly, the IMF suggests that the central banks' monetary policies should still be expansionary wherever demand is weak. Secondly, bank recapitalization should continue. Thirdly, governments must tackle fiscal consolidation, more in the sense of offering credible plans to reduce their deficits in the medium term than by immediately withdrawing fiscal stimuli, if possible. Lastly, emerging economies must sort out their large trade surpluses by supporting domestic demand, either through consumption or investment, according to each case.

The 2011 growth forecast for the United States has been lowered, now at 2.3%, while the forecasts for the euro area and Spain are 1.5% and 0.7%, respectively.

Risks are falling. Expansive monetary policies are recommended, as well as tackling fiscal consolidation but avoiding drastic withdrawals of stimuli.

IMF FORECASTS

Annual change as percentage (*)

	GDP		Consumer prices		Unemployment rate (**)	
	2010	2011	2010	2011	2010	2011
United States	2.6	2.3	1.4	1.0	9.4	8.3
Japan	2.7	1.5	–1.0	–0.3	5.1	5.0
China	10.5	9.6	3.1	2.4	4.1	4.0
Germany	3.3	2.0	1.3	1.4	7.1	7.1
France	1.6	1.6	1.6	1.6	9.8	9.8
Italy	1.0	1.0	1.6	1.7	8.7	8.6
United Kingdom	1.7	2.0	3.1	2.5	8.3	7.9
Spain	–0.3	0.7	1.5	1.1	19.9	19.3
Euro Area	**1.7**	**1.5**	**1.6**	**1.5**	**10.1**	**10.0**
Advanced economies	**2.7**	**2.2**	**1.4**	**1.3**	**8.3**	**8.1**
Developing countries	**7.1**	**6.4**	**6.2**	**5.2**	...	...
Latin America	*5.7*	*4.0*	*6.1*	*5.8*	...	...
Eastern and Central Europe	*3.7*	*3.1*	*5.2*	*4.1*	...	...
Emerging Asia	*9.4*	*8.4*	*6.1*	*4.2*	...	...
World Total	**4.8**	**4.2**	**3.7**	**3.1**	...	...
World trade by volume (***)	**11.4**	**7.0**				

NOTES: (*) Forecasts at October 2010.
(**) Percentage of labour force.
(***) Goods and services.
SOURCE: International Monetary Fund.

The United States: lacking growth

Private consumption is hit by unemployment and the housing crisis...

The US economy is going through a precarious recovery. Private consumption, 70% of the gross domestic product (GDP), cannot provide robust enough growth to take over from government stimuli, hit by household debt, the weak housing market and the labour market. For their part, public stimuli are restricted by a deficit that has reached 11% of GDP. Growth must therefore rely largely on capital goods investment and the foreign sector. However, the latest data available do not point towards these two elements taking over in the near future.

...but is showing underlying resistance that makes a relapse less likely.

At the time of writing this report, the US Bureau of Economic Analysis announced that third quarter GDP grew by 0.5% quarter-on-quarter (3.1% year-on-year). The national accounts show a clear slowdown compared with the situation at the start of the year. The main reason for this slowdown is the deceleration in investment and the continued decline in the foreign sector. However, a relapse is looking less likely, given the underlying resistance of consumption that grew by 0.6% quarter-on-quarter in the third quarter. One reason for this is that, while almost all the increase in disposable income for households had gone to savings in the second quarter, in the third it was all spent on consumption. On the down side, however, is the weak Conference Board Consumer Confidence index for September, at its lowest level since February this year and underlining the fact that consumption will still need to be tackled throughout 2011.

As private consumption is unlikely to maintain its robust growth, capital goods investment has become a key player in the economy's reactivation. The good performance of non-financial firms has been crucial to the US economy and, in this respect, capital goods investment was

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	0.0	–2.6	–2.7	0.2	2.4	3.0	–	3.1	–
Retail sales	–1.0	–6.3	–7.1	1.9	5.7	6.9	5.6	4.1	7.3
Consumer confidence (1)	58.0	45.2	51.8	51.0	51.7	58.2	51.0	53.2	48.5
Industrial production	–3.3	–9.3	–8.6	–3.8	2.7	7.3	7.5	6.4	5.4
Manufacturing (ISM) (1)	45.5	46.2	51.4	54.6	58.2	58.8	55.5	56.3	54.4
Housing construction	–32.9	–38.4	–32.0	–14.8	16.5	12.2	–6.3	3.9	4.1
Unemployment rate (2)	5.8	9.3	9.6	10.0	9.7	9.7	9.5	9.6	9.6
Consumer prices	3.8	–0.4	–1.6	1.4	2.4	1.8	1.2	1.1	1.1
Trade balance (3)	–698.8	–374.9	–414.5	–374.9	–398.9	–450.1	–459.6	–474.9	...
3-month interbank interest rate (1)	2.8	0.7	0.4	0.3	0.3	0.5	0.5	0.3	0.3
Nominal effective exchange rate (4)	74.5	77.7	75.3	72.8	74.8	77.6	76.7	75.9	75.0

NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative figure for 12 months in goods and services balance. Billion dollars.
(4) Exchange rate index weighted for foreign trade movements. Higher values imply currency appreciation.
SOURCES: OECD, national statistical bodies and own calculations.

markedly on the up in the first half of the year, with growth rates in excess of 5.0% in quarter-on-quarter terms. However, these rates are unlikely to continue in what remains of 2010 and throughout 2011, given that in corporate prospects are cooling off.

The business sentiment index of the Institute for Supply Management is therefore clearly falling. The manufacturing index has gone from 60.4 points in April to 54.4 points in September while the index for services, which accounts for four fifths of private employment, fell from 61.1 to 52.8 points between May and September, a level consistent with very moderate growth. In line with this dynamic, in September industry halted its modest recovery when it had regained two thirds of what it had lost during its worst crisis since 1982. Industrial capacity utilization also fell, standing at 74.7% of the total, three percentage points below its secular trend.

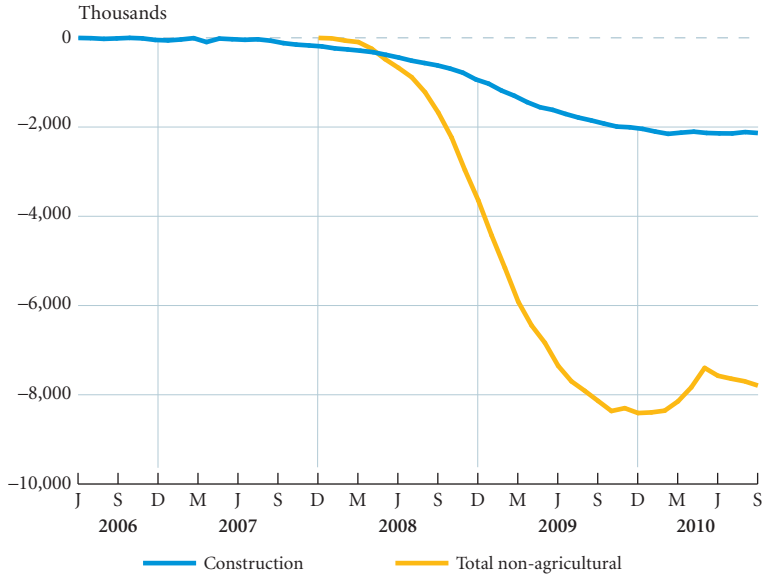
Entrepreneurs become less optimistic and industry halts its recovery.

Economic growth will continue, albeit hindered by housing investment, whose outlook is still grim. The sector, which in the period of 2004-2006 accounted for 18% of the economy's growth, has undergone its largest correction since the end of the Second World War. New homes started have remained stagnant for the last 23 months at around 600,000 in annual terms, only slightly higher than a third of the historical average. After the end of incentives for buying a primary residence, real estate sales fell by more than expected while, in the area of prices, the Case-Shiller index is enjoying only an insipid recovery after losing 30% between April 2006 and April 2009. There are reasons to believe there's a higher risk of relapse than of any imminent recovery at present. Firstly, there are still nearly million mortgages

Housing doesn't pick up, hindered by excess supply, fed by mortgage foreclosures.

THE UNITED STATES: TWO RELATED JOB LOSSES

Job losses: total non-agricultural and construction (*)



NOTE: (*) Losses since the last peak in employment (construction, April 2006; total jobs, December 2007).
SOURCES: Department of Labor and own calculations.

The 9.6% unemployment rate sees its improvement hindered by the proportion of long-term unemployed and discouraged workers.

that have either defaulted or are being foreclosed, which will add to the excess supply of property in spite of the low rate of construction and, secondly, continuing high unemployment makes it difficult to see any significant improvement in non-performing loans and sales.

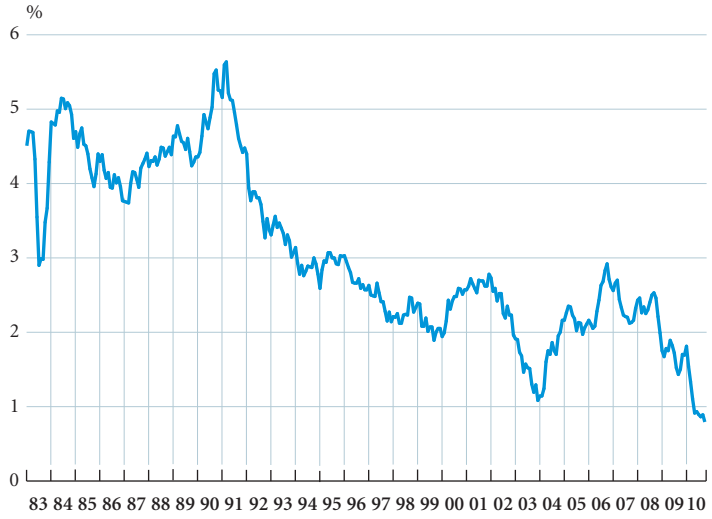
The relation between construction and the labour market operates in both directions. While the former is affected by the weakness of the latter, the latter's recovery is hindered, in turn, by past excesses in the real estate market. Since April 2006, construction has lost 2.1 million jobs, one quarter of the 8.4 million jobs lost during the crisis. The nature of construction employment makes it difficult for its workers for find other kinds of jobs. This means that the share of long-term unemployed is more than 40%, doubling the rate of 1982, which was previously the indicator's highest figure. It's therefore no surprise that, in this year of recovery, job creation is insipid, as shown by the 64,000 private jobs created in September, with construction once again losing 21,000 jobs. All this, added to the large number of discouraged workers or people working part-time involuntarily, makes it difficult to predict any substantial drop in the unemployment rate, standing at 9.6% in September.

The CPI rises by 1.1% and the core CPI by 0.8%, the slowest pace since 1961.

The easing of inflation continues to be in line with the low utilization of production capacity. In September, the general consumer price index (CPI) remained stable compared with the previous month, seasonally adjusted, with its year-on-year change staying at a moderate 1.1%. More significant was the stagnation in the core CPI, the general without food or energy, whose 0.8% year-on-year rise represented the slowest growth in prices since February 1961. Low inflation makes life difficult for households with large debt, as the

THE UNITED STATES: PRICES, UNDERLYING MODERATION

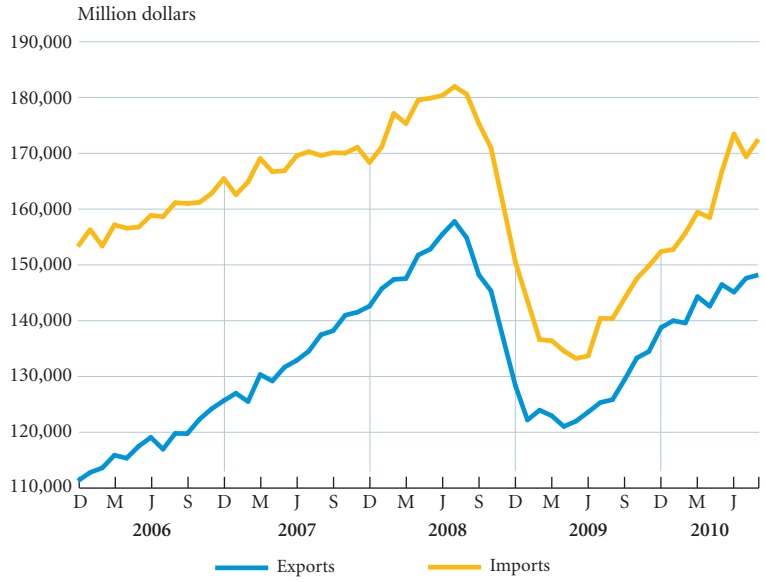
Year-on-year change in the core consumer price index (*)



NOTE: (*) Core inflation excludes food and energy.
SOURCES: Department of Labor and own calculations.

THE UNITED STATES: A SLOWDOWN IN EXPORTS

Monthly change in exports and imports excluding oil



SOURCES: Department of Trade and own calculations.

amount of their debt does not fall in real terms. In order to avoid a drop in prices, the Fed is planning a second quantitative expansion by buying more public debt, although the extent of this measure is still uncertain.

In the foreign sector, the trade deficit for goods and services widened again to 46 billion dollars in August, close to its pre-crisis level. This was even closer in the case of the trade deficit without oil and its derivates, offsetting the corrective trend for the US trade imbalance occurring before the crisis. The last few months have been dominated by strong imports, particularly from countries in the Far East. More crucial for the performance of the US economy are exports, a sector that should take over the reins of growth and that, nonetheless, is showing a slight slowdown in spite of the relatively weak dollar, so that this seems unlikely to be a consistent driver for activity over the coming months.

Japan: no growth without exports

The Japanese economy is slowing up, with stagnant private consumption and exports losing pace. Although, at the beginning of the year, exports were boosted by capital purchases by China and the United States, a volatile component, the combination of exports, a rising yen and the economic slowdown of its main trading partners are suffocating an engine that has been responsible for almost all growth over the last nine years.

Given this situation, it's no surprise that, in order to reactivate demand, a new fiscal stimulus plan was announced in October worth 5 trillion yen, 1.0% of the economy. The liberal nature of Naoto Kan's government, a stalwart of fiscal discipline, is less than it may appear as this stimulus is to offset unspent items of the 2009 budget and higher than expected tax revenue.

The correction in the foreign deficit loses steam while exports slow down.

Japan's growth is slowing up, with stagnant consumption and exports that losing pace.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	–1.2	–5.2	–4.8	–1.4	4.4	2.4	–	...	–
Retail sales	0.3	–2.3	–1.9	–0.7	3.8	3.7	3.8	4.3	...
Industrial production	–3.4	–21.8	–20.5	–5.1	27.1	21.1	15.8	13.5	...
Tankan company Index (1)	–2.8	–40.8	–33.0	–24.0	–14.0	1.0	–	8.0	–
Housing construction	2.5	–27.6	–35.9	–20.7	–6.7	–1.1	4.3	20.4	...
Unemployment rate (2)	4.0	5.1	5.4	5.2	4.9	5.2	5.2	5.1	...
Consumer prices	1.4	–1.4	–2.2	–2.0	–1.1	–0.9	–0.9	–1.0	...
Trade balance (3)	4.2	4.0	1.8	4.0	6.7	7.4	7.8	7.8	...
3-month interbank interest rate (4)	0.8	0.6	0.5	0.5	0.4	0.4	0.4	0.4	0.4
Nominal effective exchange rate (5)	86.6	98.6	97.0	99.6	101.1	102.8	107.5	109.6	110.2

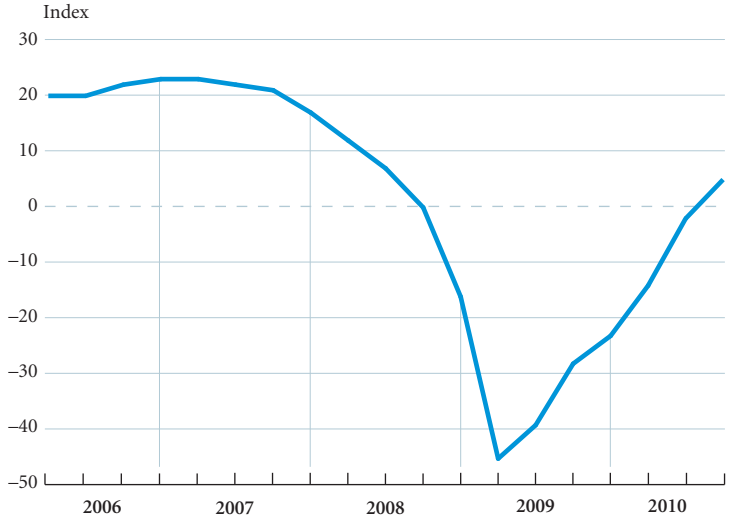
NOTES: (1) Index value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Trillion yen.
(4) Percentage.
(5) Index weighted for foreign trade movements. Higher values imply currency appreciation. Average in 2000 = 100.
SOURCES: OECD, national statistical bodies and own calculations.

The government proposes a new stimulus of a modest nature.

Japan's weak growth can be seen in its industrial production index, in August suffering its third consecutive fall and standing at 13.7% below the pre-crisis level. Less clear is the interpretation of the Tankan business sentiment index

JAPAN: ENTREPRENEURS IMPROVE EXPECTATIONS, ALBEIT WITH CAUTION

Tankan large manufacturers



SOURCES: Japanese Ministry of Communications, Bank of Japan and own calculations.

published by the Bank of Japan, which in the third quarter improved for large manufacturing firms, reaching 8.0 points for the first time since the first quarter of 2008, although caution revealed itself in the component of expectations, which fell to a negative value. On the plus side, the outlook continued to improve for investment in August, with rises in machinery orders if we discount the effects of singular contracts.

In prices, weak demand continued to encourage deflationary trends that, according to the Bank of Japan, are likely to continue until early in 2012. April's CPI therefore fell by 1.1% year-on-year while core inflation, the general index without energy or food, dropped 1.5% year-on-year. Within this deflationary context, the Bank of Japan discarded its traditional caution and, in October, announced the purchase of public debt worth 5 trillion yen (1.0% of GDP), a small amount, nevertheless, when compared with the size of the debt monetarization carried out by the US Fed during the crisis.

China: the risk of overheating is increasingly imminent

Chinese GDP grew 9.6% in the third quarter of the year, showing a moderate slowdown in line with the consensus forecasts (9.5%) and according to the wishes of its government, well aware of the risk of overheating that is hovering over the country.

China grows by 9.6% in the third quarter, showing a moderate slowdown.

Inflationary tension and the possibility of a real estate bubble are catching the attention of the Chinese authorities. Inflation set a new record high in September, namely 3.6% year-on-year. This can be explained by food prices, however, which we expect to moderate over the coming months. Moreover, housing prices stood at 9.1% year-on-year in September, lower than August's figure of 9.3%. And although the sector's sales have started to grow more quickly again, after several months of slowing down, it's still too soon to become alarmed.

On the other hand, the growth in credit still doesn't show any sign of the desired

Potential real estate bubbles continue to attract attention.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	9.6	9.1	9.6	11.3	11.9	10.3	–	9.6	–
Industrial production	12.6	12.5	12.3	17.9	19.8	16.0	13.4	13.9	13.3
Electrical power generation	6.7	6.7	8.0	24.3	22.6	17.8	12.9	13.4	8.9
Consumer prices (*)	5.9	–0.7	–1.3	0.6	2.2	2.9	3.3	3.5	3.6
Trade balance (**)	298	197	250	197	149	156	174	179	183
Reference rate (***)	5.31	5.31	5.31	5.31	5.31	5.31	5.31	5.31	5.56
Renminbi to dollar (*)	6.9	6.8	6.8	6.8	6.8	6.8	6.8	6.8	6.7

NOTES: (*) Average.
(**) Cumulative balance for 12 months. Billion dollars.
(***) Percentage at end of period.
SOURCES: National Statistics Office, Thomson Reuters Datastream and own calculations.

Trade surplus and an improvement in capital in-flows once again boost international reserves.

correction in spite of the measures taken by the Chinese government. In order not to exceed the annual figure of 7.5 trillion renminbi (RMB) established by the central bank, new bank lending over the coming months must be around, on average, 400 billion RMB monthly, clearly below the 700 billion on average to date, and the 593 billion granted in September.

Related to this is October's rise of 0.25 basis points in the reference rate, up to 5.56%, and the further rise in the cash reserve ratio for six of the country's largest banks. This adjustment aims to slow up growth in credit and, consequently, also help to contain prices in the real estate sector.

Similarly, other countries continue to insist that the Asian giant should allow its currency to appreciate further against the dollar, pointing out the need to reduce global imbalances. In particular, and in spite of the slight fall in September, the trade balance surplus reached 16.9 billion dollars. Such strong trade figures and the rise in capital inflows, partly anticipating the future appreciation of the RMB, continue to boost the international reserves.

Nonetheless, we could also see the «unexpected» rise in the interest rate as a sign of change in monetary policy towards a greater use of market instruments and, therefore, as a first step towards liberalizing capital flows and making its currency more flexible. As always, given the gradual nature of policies carried out by the Chinese authorities, we will have to wait for some time to discover their true intent.

Brazil: Tobin and Dilma are back on the attack

Brazil raises its duty on capital inflows for bonds for the second time in one month, up to 6%.

Brazil continues to fight for its currency, a real immersed, like few others, in the «currency war» (in the words of its own Finance Minister, Guido Mantega) in which several countries have been involved recently in order to improve the competitiveness of their exports (or slow up their decline). At the same time, Dilma Roussef, the governing party's candidate to take over from Lula, is preparing her last assault on a presidency

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	5.1	–0.2	–1.3	4.4	9.0	8.7	–	...	–
Industrial production	2.9	–7.2	–8.6	6.2	17.3	14.2	9.9	8.5	...
Consumer confidence (*)	140.4	138.3	141.9	154.2	158.1	154.6	155.2	162.3	...
Unemployment rate São Paulo (**)	13.0	12.8	13.1	11.8	12.3	13.2	12.6	...	...
Consumer prices	5.7	4.9	4.4	4.2	4.9	5.1	4.6	4.5	4.7
Trade balance (***)	24.8	25.3	26.4	25.3	23.2	19.3	17.7	17.1	16.9
Interest rate SELIC (%)	11.25	11.25	8.75	8.75	8.75	10.25	10.75	10.75	10.75
Reales to dollar (*)	1.8	2.3	1.8	1.7	1.8	1.8	1.8	1.8	1.7

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion dollars.
SOURCES: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

that got away from her in the first round. Just when everything suggested a resounding victory, the involvement of one of her top level collaborators in a corruption case turned voters towards Marina Silva, a former minister for Lula and the current candidate for the green party, forcing Dilma and José Serra to fight it out once again at the ballot boxes on 31 October.

At the beginning of 2009, and with very few let-ups, the real started on an upward trend that has seen it appreciate by almost 40% against the dollar. In the last few weeks, this trend has sharpened: in September, the real crossed the psychological barrier of 1.7 BRL/$ and, since then, has gained more than 6% compared with the US currency.

Continued upward pressure on the Brazilian currency has led Guido Mantega to raise the duty levied on foreign capital inflows in bonds twice in less than one month. At the beginning of October, the IOF or tax on financial operations was raised to 4% (the rate levied on capital inflows for short-term equity remained at 2%), and, on 18 October, was raised again to 6%. In this last intervention, the duty levied on earnings from derivative transactions was also raised from 0.38% to 6%. The aim of both measures is none other than to reduce the appetite of foreign investors with a taste for speculation and to thereby slow up the real's appreciation and the resulting deterioration in the current account balance.

Although these measures may provide short-term relief, the IMF already warned of their limited effectiveness a year ago, when Brazil reintroduced the IOF. Consequently, with the Brazilian economy growing more than 7% in 2010 and around 5% in 2011, and given the abundance of global liquidity searching for high returns in emerging markets, pressures are very likely to continue. This will be uncomfortable both for exports and for industry, whose production has stagnated over the last few months in spite of sales continuing to be surprisingly energetic.

In short, the first point on the agenda of the new president is clear.

The real is still immersed in an upward trend and has appreciated 37% since the start of 2009.

Mexico: a new engine

Most indicators point towards a moderation in the pace of growth of the world's economy and particularly in advanced economies over the coming months. This is something that cannot be ignored in Mexico under any circumstances, given the dependence of Mexico's recovery on its exports, fundamentally to the United States and, consequently, on healthy economic activity to the north of the Río Grande.

The IMF raises its growth forecast for Mexico in 2010, although it's likely to moderate in the future.

Nonetheless, the IMF has raised its growth forecast for this year, not only for Mexico but for the whole of Latin America, and the latest economic indicators point towards a change in the engine behind the Aztec recovery: in August, retail sales surprised with significant growth, up year-on-year by 4.4%, with domestic confidence continuing to rise towards pre-crisis levels (see the graph below). This looks like an imminent upswing in domestic expenditure, hard hit for some time now by the ravages of the recession.

Although industrial activity, spurred on by foreign demand, continues to support Mexico's economic growth, renewed fervour in domestic expenditure is great news. Within a scenario of easing foreign demand and fiscal adjustment, private demand offers the chance to maintain a GDP growth rate of around 3.8% in 2011.

Retail sales grow surprisingly and point to a change in track in terms of drivers of growth.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	1.5	–6.6	–6.2	–2.3	4.3	7.7	–	...	–
Industrial production	–0.9	–7.0	–6.6	–2.0	5.7	7.6	6.0	7.9	...
Consumer confidence (*)	92.2	80.5	83.0	78.4	81.5	84.9	87.4	88.7	91.6
Leading business index (*)	118.0	110.4	110.9	113.4	114.2	116.7	117.3	117.8	...
General unemployment rate (**)	4.0	5.5	6.3	5.3	5.4	5.2	5.7	5.4	5.7
Consumer prices	–11.8	0.0	5.1	4.0	4.8	4.0	3.6	3.7	3.7
Trade balance (***)	–17.3	–4.6	–12.9	–4.6	–1.9	–2.4	–2.2	–2.3	–2.0
Official Banxico rate (%)	7.50	6.75	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	10.6	14.2	13.5	13.1	12.3	12.8	12.6	13.2	12.6

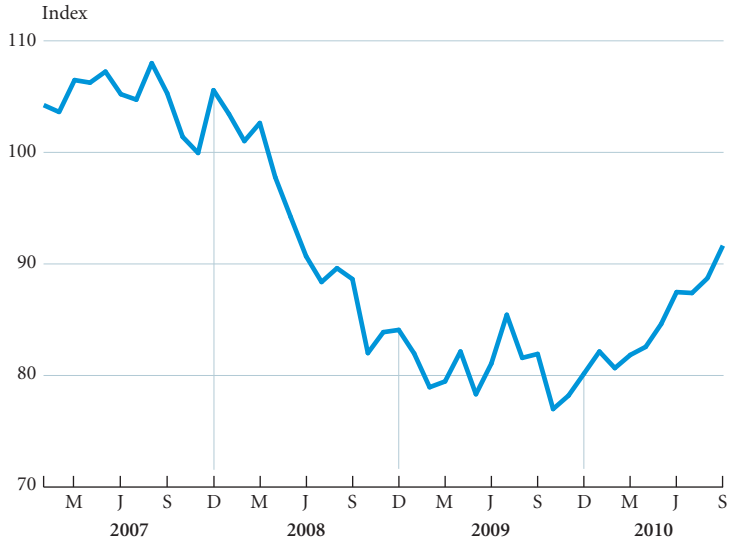
NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion dollars.
SOURCES: Banco de México and own calculations.

The fiscal coffers' overdependence on oil continues to pose risks in the long term.

Although monetary policy has a certain room to manoeuvre, given the context of low inflation and well-anchored expectations, fiscal consolidation in Mexico is definitely required due to the medium-term risks posed by the public coffers' overdependence on oil. Moreover, in spite of resorting to exceptional measures to incur a deficit during the crisis, the Mexican fiscal responsibility act requires the government to maintain a balanced

CONSUMER CONFIDENCE PICKS UP IN MEXICO

Consumer confidence index



SOURCES: INEGI and own calculations.

budget (excluding PEMEX investment costs), so the government has had to specify an adjustment plan that aims to eliminate its deficit by 2012.

The bulk of the evidence available suggests that this plan is viable. However, eliminating fiscal dependence on oil continues to be a priority in Mexico and the main structural obstacle faced by growth in the medium and long term for the second Latin America power.

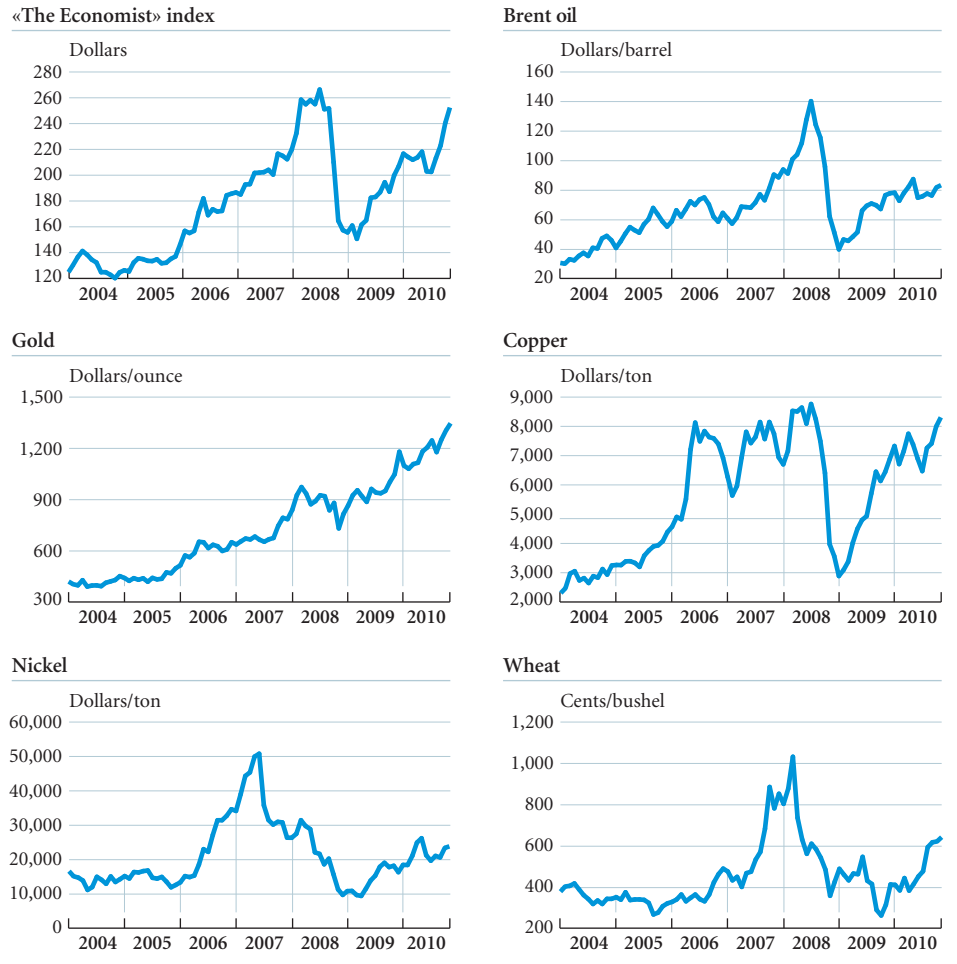
Metals and foods rise more than oil

Oil prices continue steady, with a slight rise that remains below the threshold of 85 dollars. Between 20 September and 20 October, the price of crude rose 4.3% to 82.93 dollars per barrel (Brent quality, for one-month deliveries), an increase of 6.6% this year to date.

The expansion of emerging economies will continue to boost oil prices in the rest of 2010 and the first half of 2011.

Oil continues to rise moderately and comes close to 83 dollars per barrel.

TREND IN VARIOUS COMMODITIES (*)



NOTE: (*) Figures for last day of month (last date October 20).
SOURCES: «The Economist», Thomson Reuters Datastream and own calculations.

The price of crude is supported by the weak dollar and the recovery in emerging economies.

However, with advanced economies stuck in low growth rates and stocks at high levels, no huge changes are expected in global demand, so that crude should only rise moderately. The biggest variations should be due to fluctuations in the dollar.

The rest of commodities rise more sharply due to the demand from emerging countries and supply problems.

The rest of commodities are continuing to rise more decisively than crude due to the combination of growing demand from emerging economies – copper and steel in China – with various problems in supply, either because of outdated steel plants in China, old copper mines in Chile or the problems of illegal tin mining in Indonesia. In the case of food, the drought in the Ukraine and bad corn harvests in the United States have also pushed up prices. Consequently, between 20 September and 20 October, the *Economist* index was up 8.4% with an accumulated growth of 22.7% over three months. For its part, gold hit a new record high and will continue at this level, which many believe is sustainable in the medium term.

What determines healthcare spending: much more than demographic ageing

Spain will have 52 million inhabitants by 2060, of which approximately a third will be over 65 years of age and 14% over 80. The current figures are around 17% and 5%, respectively. In absolute terms, in fifty years the number of Spaniards over 65 will have gone from 8 to 17 million people, and those over 80 will total 8 million, compared with 2 million today. These figures, which come from Eurostat's population projections, are good news. They draw a picture of a country that continues to prosper in terms of life expectancy, a fundamental indicator of human development. However, this undeniably good news may also lead to legitimate concern on how the country's healthcare spending will evolve in the future.

We all intuitively understand that, on average, the older the person the higher the spending on their healthcare and this assumption is supported by the data: in the countries of the Organization for Economic Cooperation and Development (OECD), per capita healthcare spending for those over 65 is at least four times higher than for those under this age. Consequently, if a country ages, its total healthcare spending is likely to increase. However, this issue can't be dealt with so simply. First, because in addition to ageing per se, a person's state of health in those additional years provided by greater longevity is also important. But also because there are other factors that affect a country's healthcare spending that are not strictly related to demographic trends, in particular growth in income and the development of new medical technologies.

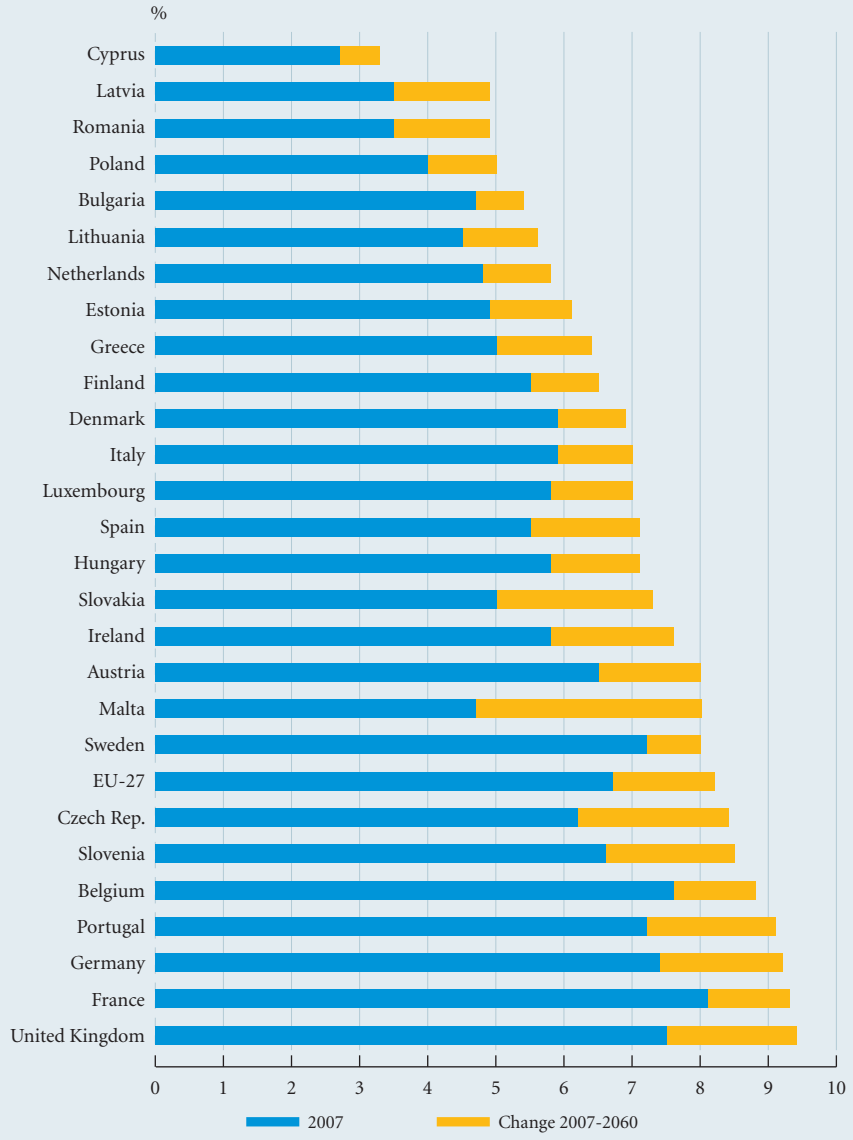
With regard to the impact of increasing longevity, we must ask ourselves what quality of health we can expect for the additional years of life enjoyed in 2060. In general terms, three different situations might occur. The first, which the literature calls «compression of morbidity», claims that people will not only live longer but healthier, i.e. the number of years lived in illness will decrease. The opposing hypothesis («expansion of morbidity») has also been proposed: we will live more years in worse conditions of health. Lastly, an intermediate position proposes a balance between living longer and better (in health terms), i.e. that some years «gained» due to longer life expectancy will be lived healthily but the rest not. The empirical evidence available, although not entirely conclusive, suggests that the recent trend in the OECD is in line with a

scenario in which the years «gained» in terms of life expectancy are healthy years. This has a neutral effect in terms of its impact on the healthcare spending per inhabitant, as the number of years of bad health remains constant.

Finally, another group of factors are those that are not strictly demographic. The relationship of healthcare spending with income level and the development of medical techniques usually come under this category. In the first of these cases, current empirical literature on the relationship between income and healthcare spending in the European Union (EU) tends to suggest that healthcare spending grows, on average and over the long

HEALTHCARE COSTS FORCED UPWARDS OVER THE COMING DECADES

Public expenditure on healthcare as % of GDP



SOURCES: European Commission and Economic Policy Committee of the European Union.

term, faster than the rise in income. With regard to technology, the evidence points towards the acceleration in the cost of new medical developments and treatments as a key factor behind the rise in healthcare spending. According to the most customary interpretation, this is due to the fact that the very availability of new treatments (usually more expensive than the existing ones, largely a result of the high research and development costs involved) generates a demand for them. Institutional aspects of the different national health systems might also be important, such as the distribution of public-private functions or the incentive system for suppliers and prescribers of medical products.

What is the relative weight of each of these factors that determine healthcare spending? According to OECD estimates, in the period 1981-2002, the average annual rise in healthcare spending (expressed in per capita terms) of its member countries was 3.6%. Purely demographic effects (ageing and change in health status due to greater longevity) account for 0.3 percentage points, the effects of higher income, 2.3 percentage points, and the change in medical techniques, one percentage point.

The relevant question to ask is how these determining factors will evolve in the future, both demographic and non-demographic, for healthcare spending in Spain and its neighbouring countries. A recent EU study offers some clues in this respect.[1] According to these projections, healthcare spending in the Union as a whole would go from levels equivalent to 6.7% of the gross domestic product (GDP) in 2007 to 8.2% in 2060. Nonetheless, this aggregate result comes from disparate national trends. In general terms, the new member states of the EU, those from Eastern Europe, will see the highest increases in healthcare spending, a result of the combination of a quickly ageing demographic and a relatively lower starting point.

The Spanish case tends to resemble the situation of Eastern Europe due to its fast ageing and relatively low healthcare spending as a starting point. Healthcare spending, which accounted for 5.5% of GDP in 2007, is expected to rise to 7.2% by 2060. This rise occurs in three, clearly distinct stages. Up to 2020, demographic pressure and that of other factors is relatively contained. In 2020, and always according to the EU projections, healthcare spending would account for 5.9% of GDP. The following two decades will see the greatest pressure on healthcare spending: by 2040 this will reach 6.8% of GDP. Afterwards there will be two decades of a more contained rise so that, by 2050, healthcare spending would have reached 7.1% of GDP, only adding one tenth of a percentage point by 2060.

Although this exercise is highly uncertain, it has the virtue of pointing out when the current trends, if they continue, will exert the greatest pressure on healthcare spending. Given that the timescale and trend for Spain is similar to the one expected for the Union as a whole, we know that, if we want to contain healthcare spending, we should act quickly in order to avoid reaching the critical period of 2030-2040 without any room for manoeuvre. Especially because relatively moderate improvements in the initial situations are going to lead to great changes in the long-term. If, as the Chinese sage, Lao Tse, once said, «a journey of a thousand miles starts with a single step», then we should take our first few paces without losing sight of a future that may seem distant in personal terms but is extremely close in historical terms.

(1) European Commission (2009): «2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-2060)», European Economy, 2.

This box was prepared by Àlex Ruiz
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EUROPEAN UNION

The euro area: at a turning point

The economy of the euro area as a whole is at a turning point. After the strong advance in gross domestic product (GDP) recorded in the second quarter, namely 1% quarter-on-quarter, the bulk of the evidence available suggests that it won't be able to keep up this pace of growth in the coming quarters. Now all eyes are on whether the slowdown will be slight or whether weak growth rates will once again be recorded, such as those in the previous quarters.

The tension concerning this slowdown is due to the highly divergent trends in the different economies that make up the euro area. On the one hand, we have Germany's outstanding performance. In August, industrial production continued to improve apace; the trend in the purchasing managers' index (PMI) has been good throughout the third quarter; and unemployment continues to fall, now at its lowest level since reunification.

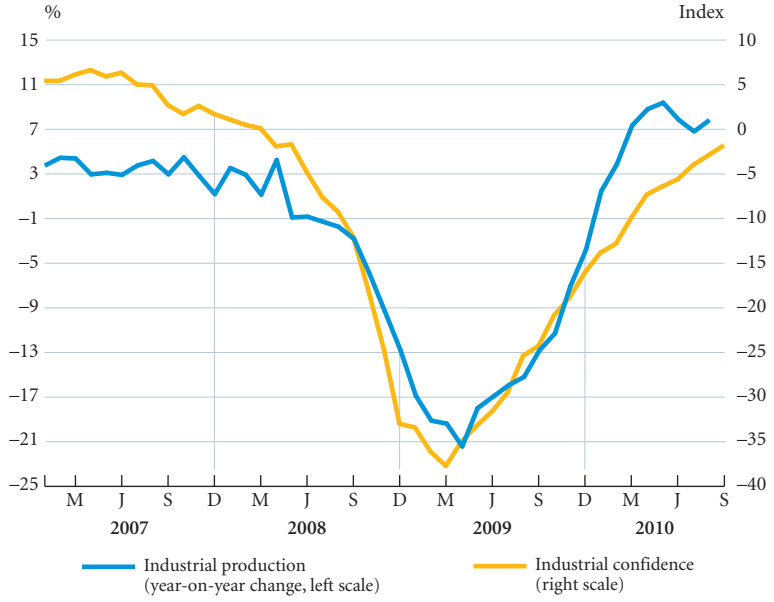
Germany leads the euro area's recovery.

At the other extreme we find Greece, Ireland and Portugal. Due to the significant deterioration in their public accounts, these countries have been forced to cut back on spending and public investment. For the present, Greece's

Greece, Ireland and Portugal bring up the rear.

ACTIVITY IMPROVES APACE

Supply indicators



SOURCES: Thomson Reuters Datastream and own calculations.

Investment might surprise us in the third quarter.

austerity plans are being effective, suggesting that its economy will meet its target of reducing the public deficit for this year. Portugal's case is a similar one. The Irish government, however, has had to inject more capital into its financial sector and this has made the public deficit forecasts for this year shoot up to values higher than 30% of GDP.
In any case, the threat hovering over these economies is that this overhaul of the public sector will not manage to generate enough confidence in either investors or in each country's own consumers. This, together with the cuts in spending and public investment, reduces these economies' capacity to grow and might force them to increase their fiscal adjustment.

Fortunately for the euro area as a whole, in the short term the trend in its economy will resemble that of Germany more than the group of countries on the periphery. At least, this is what the different indicators that provide data on the third quarter suggest.
On the supply side, it's worth noting the good performance of industrial production. After a somewhat weak July with just a small increase of 0.1% month-on-month, in August this rise was 1.0%, leaving the year-on-year rate of change at 8.2%. Trends in industrial orders and the different confidence indices are also good, all continuing to show a clearly upward trend. It's particularly worth noting the recovery in industrial capacity utilization. During the recession, this suffered a sharp drop that took it to a record low of 69.6% but in just one year it has managed to get back up to 77.4% and is only four percentage points from its historical average. This suggests that the recovery in investment seen by the euro area in the second quarter might continue in the coming periods.

Consumption continues to show signs of weakness.

The picture for demand is not so encouraging. Retail sales still show a very weak upward trend. After a highly

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
GDP	0.3	–4.0	–4.0	–2.0	0.8	1.9	–	...	–
Retail sales	–0.7	–2.3	–2.3	–1.0	0.5	0.6	1.4	0.8	...
Consumer confidence (1)	–18.1	–24.7	–21.4	–17.0	–16.8	–16.7	–14.0	–11.4	–11.0
Industrial production	–1.7	...	–14.4	–7.4	4.6	9.0	7.1	8.2	...
Economic sentiment indicator (1)	93.5	80.8	84.1	91.9	96.6	99.3	101.1	102.3	103.2
Unemployment rate (2)	7.5	9.4	9.7	9.9	9.9	10.1	10.1	10.1	...
Consumer prices	3.3	0.3	–0.4	0.4	1.1	1.5	1.7	1.6	1.8
Trade balance (3)	–1.2	–15.1	–6.4	13.8	26.6	22.5	12.8	11.3	...
3-month Euribor interest rate	4.6	1.2	0.9	0.7	0.7	0.7	0.8	0.9	0.9
Nominal effective euro exchange rate (4)	110.6	111.7	112.1	113.8	108.8	103.2	102.5	102.1	102.5

NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Billion euros.
(4) Change weighted for foreign trade flows. Higher values imply currency appreciation.
SOURCES: Eurostat, European Central Bank, European Commission and own calculations.

modest rise in July of 0.1% month-on-month, August saw a drop of 0.4%. The trend in the consumer confidence index was somewhat more positive in the months of July and August but has stagnated since then. Inflation isn't showing any signs of demand reactivating either. It's true that the underlying component of the year-on-year change in the consumer price index has stopped falling and has been at 1.0% for the last three months, but this is a very low level. The general index stood at 1.8% in the month of October and, after a few months of fluctuating around 1.5%, seems likely to remain close to 2% in the short term, but this is due to the performance by energy prices and has little to do with any upswing in demand.

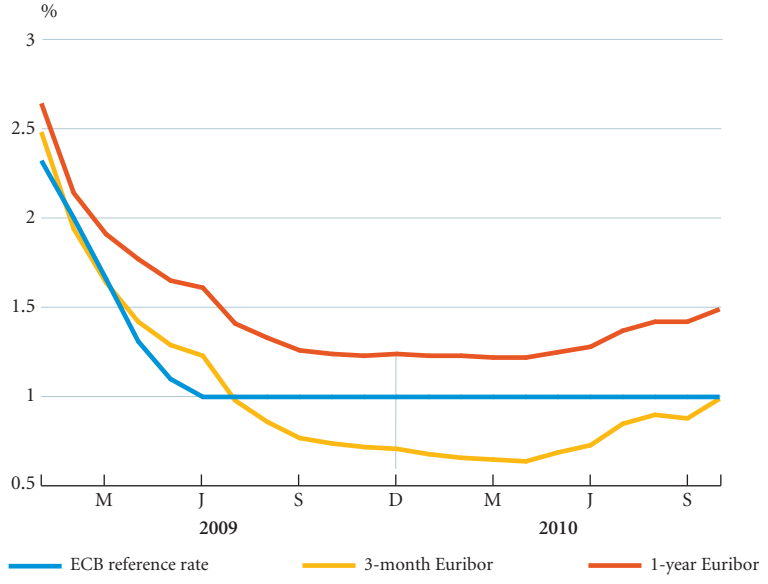
The response given by the European Central Bank to this scenario is once again vital. On the one hand, it might be under greater pressure to raise the reference rate. A good example of this are the statements made by Axel Weber, the Bundesbank governor and candidate to replace the current president, Trichet, next year. However, the euro's recent appreciation against the dollar advises caution, at the very least. The real effective exchange rate has remained stable over the last few months but the ECB should keep a close eye on the effect on the currency market of the policies being implemented by countries such as the United States, Brazil and Japan.

On the other hand, the ECB has a significant number of countries whose recovery is still very weak and which might be greatly harmed by a rise in interest rates. According to our forecast scenario, the European monetary authority will not start to raise the interest rate until the last quarter of

The ECB must stay on the alert because of the currency war.

INTERBANK NORMALIZATION MAKES THE ECB'S POLICY EASIER

Interbank and ECB interest rates



SOURCES: Thomson Reuters Datastream and own calculations.

Interbank normalization has reduced the need for unorthodox monetary policy.

the coming year. This is when household consumption and private investment will be able to start to lead a more robust recovery. However, during this period we don't think that the ECB will return to a quantitative expansion programme for its balance sheet, like the one the Fed looks like implementing. Europe's financing terms are improving at a good rate. One sign of this is the improvement in the interbank market. The 3-month Euribor, which had been below 1% since July 2009, once again normalized its differential with the reference rate. The improvement in liquidity and the easing of tension in the interbank market have also been reflected in the trend of the 12-month Euribor, which went above 1.5% in October.

In short, the euro area's development continues to be immersed within a process of high uncertainty that has recently got worse due to the currency war some countries have encouraged. At the G-20 meeting it was agreed that the exchange rate should be set according to market criteria. If these agreements are kept, the European economy is very likely on the right path for recovery to continue at a good pace.

Pharmaceutical policy: a real headache of a regulation

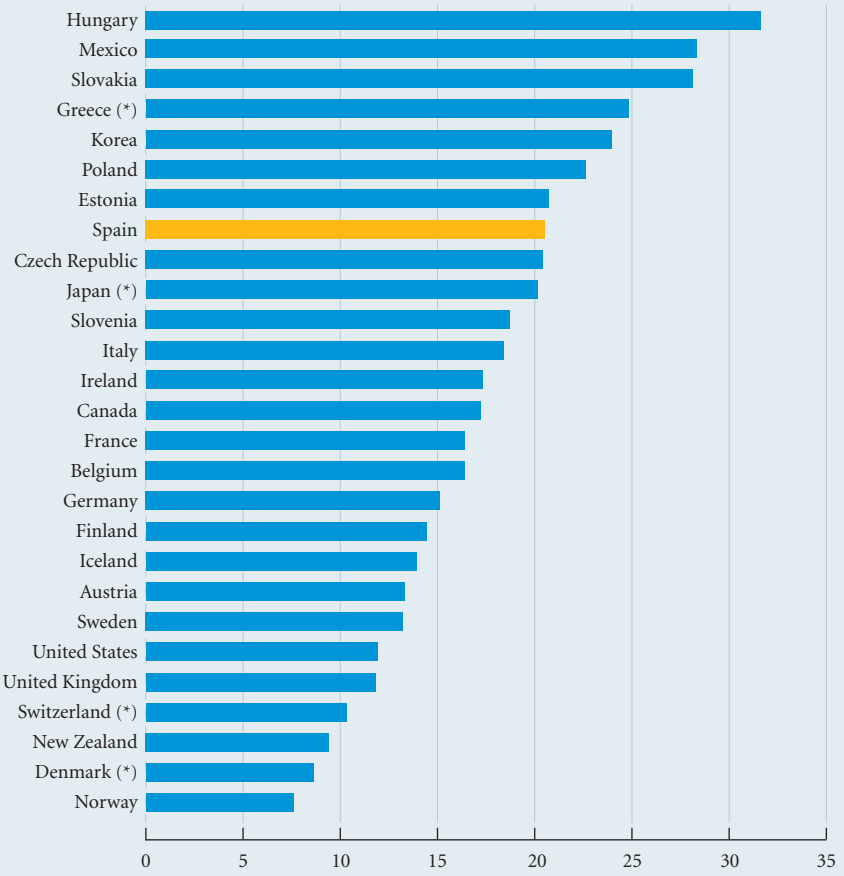
Pharmaceutical expenditure is one of the most decisive determinants of total expenditure on healthcare in most developed countries and its sustained growth at rates higher than that of GDP causes a headache in times of crisis, such as the present. According to OECD data for Spain, between 2000 and 2008 pharmaceutical expenditure per capita grew at an annual accumulated rate of 7.8%. Given this situation, the government has recently acted by cutting the prices it pays for drugs financed by the National Health System. This is therefore a market where the central government directly intervenes by altering prices. The aim of this box is to discuss the reasons for such intervention, as well as how this is carried out.

There are basically two, very closely related arguments to justify a state intervention that facilitates access to medicines at an affordable price. The first is based on each country's preference for equity among its citizens. Subsidising the cost of pharmaceuticals is a way of redistributing wealth and, to a certain extent, helps to ensure equal opportunities. These same preferences also lie behind other health and labour policies that complement pharmaceutical policy. The second argument claims that consumers do not fully realise the value of medicines. This might be either because they don't have all the information regarding the consequences for their future health of not following the pharmaceutical treatment prescribed or because they don't take into account how their decision might harm the rest of society. Examples of this harm can be the economic cost of their lower productivity, the cost for the central government of possible complications in their state of health or the negative effects on the health of others with whom they have contact. However, we should realise that the extent of these indirect social costs depends on the overall health and labour policies in each country, as the greater the protection for individuals, the greater the incentive not to continue a treatment and to wait and see what happens.

In any case, governments have to balance their goal of ensuring affordable prices with that of providing pharmaceutical firms the right incentives to develop new products that improve the prevention and treatment

THE SHARE OF PHARMACEUTICAL EXPENDITURE

Pharmaceutical expenditure as a percentage of total health expenditure, 2008



NOTE: (*) Data from 2007.
SOURCE: OECD.

of diseases. In fact, the pharmaceutical industry stands out for its particularly high research costs, unrecoverable in the case of failure, together with low average production costs. For pharmaceutical firms to decide to invest, they must expect to be able to sell their products with a sufficiently high margin to recoup the cost of their investment plus some profit. If they foresee strong competition once they launch their products onto the market, their incentives to invest will be reduced, to the detriment of society. Patents are used to maintain these incentives, protecting the research carried out by the pharmaceutical firm and allowing it to monopolize the sale of its product for a certain period of time.

The problem for the public sector is thus complex, as it needs to subsidize the sector but in such as way as to achieve three goals. On the one hand, ensuring that pharmaceutical firms secure sufficiently high prices; on the other, ensuring that citizens pay a sufficiently low price and, lastly, accomplishing all this while sticking to a tight budget. So let's look at the mechanisms used by the public sector to achieve this.

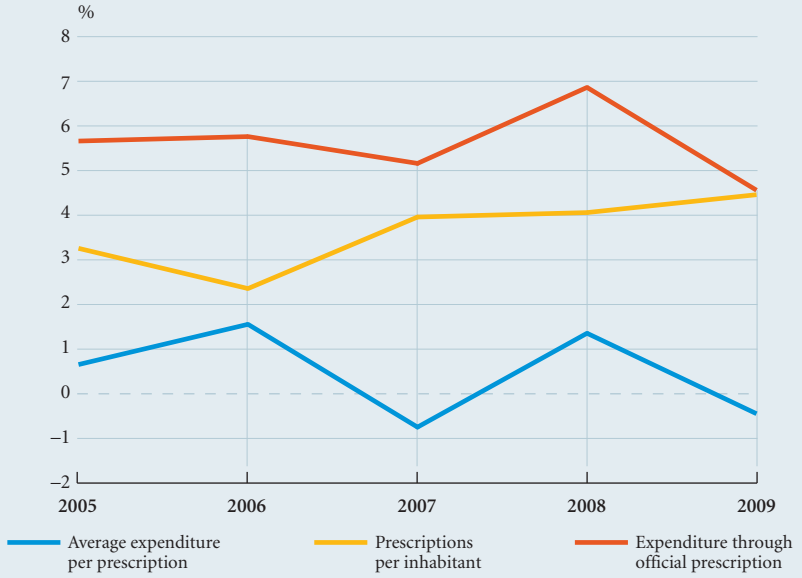
The regulatory framework for most OECD countries is similar in structure. The regulations establish which drugs will be financed by the state and whether this coverage will be total or partial. If drugs are selected following cost-effectiveness criteria and taking into account the existence of alternative treatments, this system should provide the relevant authority with some negotiation power to contain the price of drugs under patent. The extent of coverage should also act as an additional element of pressure, since one can assume that, given the choice between different treatments, consumers would choose those with greater coverage.

Once a drug's patent has expired, the entry of new competitors into the market with products using the same active pharmaceutical ingredient (the so-called «generics») should bring its price more in line with its average production cost. However, this can be hindered by the fact that producers of «branded» drugs enjoy certain advantages (e.g. greater facilities for promoting their product among doctors, to whom consumers frequently delegate their decision). To ensure this convergence takes place, numerous countries have implemented reference price systems that fix, for a group of equivalent drugs, the same maximum amount to be financed by the public sector. This reference amount is usually an average of the lowest prices observed in the market. Firms can set a higher price for their drug but would then rely on consumers being willing to pay the difference.

Is this regulatory framework enough to achieve the three goals of the public sector? The answer is «not always», and the Spanish case is proof of this. The main problem is that competition between pharmaceutical firms, which should push consumer prices down, is hindered by several aspects of its health policy.[1]

PHARMACEUTICAL EXPENDITURE IN SPAIN: THE RISE IN PRESCRIPTIONS OFFSETS THE FALL IN PRICES

Annual growth



SOURCE: Own calculations with data from the Ministry of Health and Consumer Affairs.

(1) Puig-Junoy, J. (2004), «Los medicamentos genéricos pagan el precio de ser referencia», *Administración Sanitaria*, no. 2 (1), 2004.

Firstly, the benefits of this greater competition are limited to significant discounts for pharmacies, as the applicable regulations prevent them from passing these lower prices on to the end consumer. Secondly, another problematic aspect is how easy it is for pharmaceutical firms to avoid the reference price system per se. On the one hand, the regulation's lack of clear criteria for therapeutic effectiveness allows them to secure patent extensions for innovations providing little additional therapeutic benefit. On the other hand, the fact that products under patent enjoy greater promotion among doctors means they can substitute part of the consumption that would have otherwise been met by generics. Lastly, for competition to be truly effective, consumers need to be reasonably sensitive to the price of drugs. It is also argued that the low percentage of cost-sharing in Spain gives very few incentives to citizens to shop for the best price and to control their expenditure on drugs.

Due to all this, drug prices in Spain seem to respond only to direct government reductions of reference prices. In addition, their positive effect on pharmaceutical expenditure tends to be reversed in the short term due to the abovementioned substitution by more expensive drugs. The government must therefore find another remedy for the headache caused by pharmaceutical expenditure. A remedy that must include more incentives for doctors and consumers to take into account the cost of drugs in their decisions, greater price competition between pharmacies and clear criteria of therapeutic effectiveness in financing decisions. Without these modifications, any price intervention runs the risk of becoming a temporary symptom relief.

This box was prepared by Sandra Jódar Rosell
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Germany: the time for consumption?

In the second quarter of the year, the German economy posted its highest increase since reunification, exceeding even the most optimistic expectations. Since then the forecasts for the growth expected this year have been raised several times, most of them falling between 3.0% and 3.5%. The German government's new forecast is within this range, raising the expected growth for the economy by almost two percentage points up to 3.4% year-on-year. A figure that would be close to the 3.6% year-on-year of 2006, the highest in the last twenty years.

If these forecasts are correct, Germany's actual gross domestic product (GDP) this year would only be 0.7% below the maximum reached in 2008. So, in spite of the economy shrinking extensively in 2009, it will have recovered more quickly than in the country's other recessionary periods. As can be seen in the graph below, this is reflected in the trends in German industrial production during the last big episodes of economic recovery. From April 2009 to last August, industrial activity grew by 18.6%, coming close to pre-crisis levels. A rise that was larger than those recorded in 1975 and 1993, thanks to the boost in the economy observed as from March 2010.

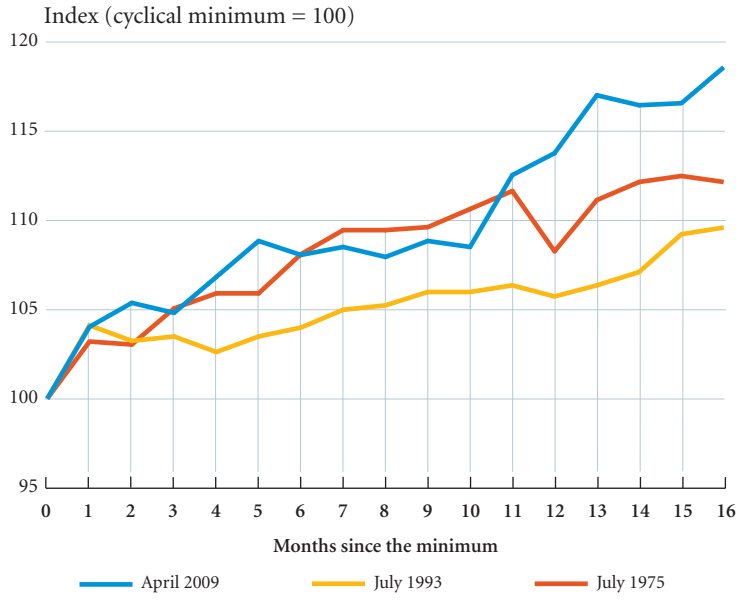
The German government raises its growth forecast for 2010 to 3.4%.

Supply indicators point to further increases in activity over the next few months. Industrial orders, usually a good leading indicator of future production,

Industrial activity continues to enjoy strong growth.

GREATER BOOST TO INDUSTRIAL PRODUCTION IN THE CURRENT RECOVERY

Industrial production



SOURCES: German Statistics Institute and own calculations.

The foreign sector reduces its contribution to growth in the third quarter.

grew by 3.4% month-on-month in August. For its part, the business climate index (IFO) picked up once again in October after two months of slight rises, thanks to the better performance of its future component.

In spite of the good news from supply, the latest forecasts for the economy predict a logical slowdown in activity for the remainder of 2010, returning to growth levels that are more in line with a developed economy. The most frequent demand indicators point in this direction. In August, retail sales were down 0.4% month-on-month, leaving behind four consecutive months of growth, while automobile sales continued to fall in September.

With regard to the foreign sector, exports also lost steam in August, down 0.4% month-on-month. This figure, together with the rise in imports over the same period, led to a 7.4% reduction in the trade balance surplus in August compared with the previous month. A figure that, combined with the slight rise in July's surplus, suggests that foreign demand will contribute little to GDP growth in the third quarter.

This lower share of foreign sector in the German economy's growth contrasts with its important role during the last expansionary cycle. Between the year 2000 and 2007, close to three quarters of the overall increase in German GDP was due to foreign demand, pushing other components such as private consumption into second place. This dependency on the foreign sector, as became evident later on, made the recession notably worse, when international trade collapsed.

Private consumption is more dynamic.

It seems, however, that the recovery has involved a certain change in the pattern

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
GDP	0.7	–4.7	–4.4	–2.0	2.0	3.7	–	...	–
Retail sales	0.0	–2.5	–2.6	–2.0	0.8	0.4	2.3	3.0	...
Industrial production	–0.1	–15.4	–15.0	–8.0	6.0	12.3	11.2	11.0	...
Industrial activity index (IFO) (*)	96.8	87.7	89.8	93.5	96.5	101.7	106.2	106.7	106.8
Unemployment rate (**)	7.8	8.2	8.3	8.2	8.1	7.7	7.6	7.6	7.5
Consumer prices	2.6	0.4	–0.3	0.4	0.7	1.0	1.2	1.0	1.3
Trade balance (***)	195.1	140.2	130.9	129.3	140.5	148.4	148.7	149.5	...

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion euros.
SOURCES: Eurostat, European Central Bank, European Commission, national statistical bodies and own calculations.

of German growth, with domestic demand and particularly consumption becoming more important. The fall, since June last year, in the unemployment rate to 7.5%, and the lower savings of German households have made this possible. Consequently, given the expected lower contribution by the foreign sector, the dynamism of private consumption will determine the trend in GDP in the coming quarters.

With regard to public accounts, the German economy's greater growth meant that government spending could decrease and its revenue increase, improving the public deficit accumulated between January and August. Leading German economic institutes have therefore revised their deficit forecasts for this year by nearly one percentage point, to 3.8% of GDP (it was 3.0% in 2009). Moreover, the budget imbalance is expected to be below 3% in 2011. Given this good news, the Finance Minister, Wolfgang Schäuble, plans to put forward tax reforms, as promised during the last election campaign.

The public deficit will fall below 3% in 2011.

Strong protests against pension reform disturb the French recovery

Since it started in the second quarter of 2009, the reactivation of the French economy has been characterized by gentle growth rates. As a result, after five quarters of rises, in the second quarter of 2010 French GDP was still 2% below the peak reached before the crisis. The bulk of the evidence available suggests that this relatively moderate pace of growth will continue in the second half of the year.

In general, supply indicators suggest a stable economic situation. In spite of industrial production stagnating in August, after growing by 0.8% in July, most variables for activity were more optimistic. According to the French statistics institute (INSEE), the number of industrial orders increased in August by 0.8%, placing the year-on-year rate of growth at 10.8%. Another positive factor was the fact that the number of new start-ups continued to rise, with the total up by 26% in one year. As regards industrial confidence indicators as a whole, these also showed a certain

The Bank of France estimates 0.3% growth in GDP in the third quarter of 2010.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
GDP	0.1	–2.5	–2.7	–0.5	1.2	1.7	–	...	–
Domestic consumption	–0.3	0.8	0.3	4.2	1.8	0.4	2.4	1.2	...
Industrial production	–2.7	–12.1	–11.5	–4.6	5.1	7.3	5.6	3.2	...
Unemployment rate (*)	7.8	9.4	9.6	9.8	9.9	9.9	10.0	10.1	...
Consumer prices	2.8	0.1	–0.4	0.4	1.3	1.6	1.7	1.4	1.6
Trade balance (**)	–50.2	–49.0	–45.4	–41.7	–42.3	–44.1	–47.6	–49.3	...

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion euros.
SOURCES: OECD, Eurostat, INSEE, European Commission and own calculations.

Industrial and consumer confidence improve.

improvement. Based on these figures, the Bank of France's report published on 8 October estimates a growth in activity of 0.3% in the third quarter of 2010 compared with the previous period.

Along these lines, the French Minister for the Economy, Christine Lagarde, announced that the proposed budget for the coming year was based on growth in GDP of 1.5% in 2010 and 2.0% in 2011. The minister also pointed out that the labour market seems to have stabilized this year, although she did not rule out a sporadic upswing in unemployment. This improvement in the employment figures might partly explain the slight rise in the consumer confidence index in August and September.

Domestic demand progresses slowly.

On the other hand, figures suggest that demand will continue to progress at a moderate rate. Household consumption is expected to rise over the next few months, although falling in August, placing the year-on-year growth rate at 1.2%. Meanwhile, in September the surprise came from the 4.9% increase in the total of vehicle registrations, halting the downward slide of the last few months caused by the removal of a large part of the aid for buying a car.

With regard to investment, this tends to grow when the index of production capacity utilization exceeds its long-term average (around 80 points). According to the Bank of France's report, this variable increased in September to 76.8 points, thereby continuing its recovery, albeit at a slower pace. Looking at the foreign sector, the rise in exports was lower than for imports in the month of August, helping to increase the trade deficit.

In short, French activity looks like continuing its gradual recovery in spite of the strong protests against pension reform, which have paralyzed some of the key sectors in the economy, such as energy.

Italy: indicators show the economy slowing down

The Italian economy will grow in 2010 after two years of recession.

The Italian economy consolidated its recovery in the second quarter of 2010 with 0.5% growth quarter-on-quarter, dissipating any doubts regarding another relapse. Italian GDP will

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
GDP	–1.3	–5.1	–4.7	–2.8	0.5	1.3	–	...	–
Retail sales	–0.3	–1.6	–1.9	–0.6	–0.3	–0.3	0.5	...	...
Industrial production	–3.8	–18.2	–17.5	–9.1	3.4	8.1	5.4	9.2	...
Unemployment rate (*)	6.7	7.8	7.9	8.3	8.4	8.5	–	...	–
Consumer prices	3.3	0.8	0.1	0.7	1.3	1.5	1.7	1.6	1.6
Trade balance (**)	–10.0	–10.2	–9.1	–6.6	–7.7	–12.7	–16.9	–18.5	...

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion euros.
SOURCES: OECD, national statistical bodies and own calculations.

therefore grow again in 2010, after two consecutive years of decline. An increase that, according to the latest forecasts by the International Monetary Fund (IMF), will be 1.0%. This figure implies that its rate of growth will slow down in the second half of the year.

The available indicators for demand point in this direction which, in spite of the estimated drop in unemployment in August, show consumption weakening in the third quarter. Retail sales stagnated in July and August compared with the previous month, as automobile sales continued to fall during the third quarter because of the end of tax incentives. Moreover, the further deterioration in households' gross disposable income in the first half of 2010 does not point towards any great progress in private consumption over the next few months.

Looking at foreign trade, in August exports and imports recorded their highest growth of the last fifteen years, largely due to the low value recorded for these variables a year ago. Moreover, in the case of exports, with a growth of 31.5% compared with the same month in 2009, of note is the penetration of Italian products in the emerging markets such as China, where exports grew by 60.9% year-on-year in August. However, exports' good performance was not enough to neutralize the rise in imports, 38.1% year-on-year, having a negative effect on the balance of trade that month.

Exports to emerging countries are growing strongly.

On the supply side, Italian industrial production grew in August by 1.6% month-on-month, reaching levels similar to 2008, although far from the pre-crisis peak. The good performance by industrial orders, also up 7.3% month-on-month in August, leads us to expect further rises in activity over the next few months.

Given the good economic outlook, the Italian Treasury improved its forecasts for the deficit over the coming years, going from 5.3% in 2009 to 2.7% of GDP in 2012 as a result of the significant reduction in government spending. A figure that might be excessively optimistic if we take into account the fact that the growth forecasts for the Italian economy exceed its average growth over the last fifteen years by more than half a point.

The Italian Treasury expects its deficit to fall to 2.7% in 2012.

The UK government tightens its belt

The British government details its measures to contain public spending.

On 20 October the British government provided details of its austerity plan, announced in its budget last June, which aims to reduce the deficit from the current 11% of GDP to 1.1% by 2015-2016. To this end, the government will reduce its spending by 81 billion pounds sterling over the next four years. The document specifies that these cuts will largely be made through improvements in efficiency and a reduction in some social benefits. However, these cost-cutting plans do not affect those items that help long-term growth, such as health, education and capital investment.

Among the measures to reduce spending, of note is public sector employment. According to forecasts by the Office for Budget Responsibility, used to draw up the budgets, the total number of civil servants will be cut by 490,000 by the 2014-2015 tax year. As stipulated in the proposed budget, another significant measure is the 11 billion pound cut in benefit for households with children, subsidies for buying housing and invalidity benefit. The wage freeze for civil servants earning more than 21,000 pounds as from 2011-2012 will also reduce public expenditure by 3.3 billion.

As from 2011, a banking tax will be applied to boost the government's revenue.

Regarding revenue, in addition to the VAT hike from 17.5% to 20% in January 2011, a new banking tax was also confirmed, at 0.04% in 2011 and 0.07% in 2012. This will be applied to financial institutions operating in the United Kingdom, either national or foreign, whose liabilities exceed 20 billion pounds, without including retail deposits and Tier 1 capital. Although the legislation governing this rate will not be available until the end of 2010, the government estimates revenue of 2.5 billion per year through this measure.

With these reforms, the British government hopes to increase belief that their public finances will meet their targets, following the advice of international bodies. In fact, September's article on the state

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
GDP	–0.1	–5.0	–5.4	–3.0	–0.3	1.7	–	...	–
Retail sales	1.7	1.0	2.1	2.7	0.0	1.1	1.6	0.7	0.5
Industrial production	–3.1	–10.1	–10.4	–5.9	0.3	1.7	2.1	4.2	...
Unemployment rate (1)	2.8	4.7	4.9	5.0	4.9	4.6	4.5	4.5	4.5
Consumer prices	3.6	2.1	1.5	2.1	3.2	3.4	3.1	3.1	3.1
Trade balance (2)	–93.6	–86.8	–84.1	–82.4	–82.8	–85.0	–88.5	–90.5	...
3-month Libor interest rate (3)	5.5	1.2	0.8	0.6	0.6	0.7	0.7	0.7	0.7
Nominal effective pound exchange rate (4)	97.6	73.9	83.7	79.1	80.4	78.2	81.5	82.3	81.3

NOTES: (1) Percentage of labour force.
(2) Cumulative balance for 12 months. Billion pounds.
(3) Average for the period.
(4) Index weighted for foreign trade flows. Higher values imply currency appreciation.
SOURCES: OECD, Bank of England, ONS, European Commission and own calculations.

of the British economy by the IMF rates positively the efforts made to contain public spending. This report also stresses that the benefit of reducing public spending to reduce the risk of debt outweighs the short-term losses in terms of growth.

Regarding the British economy, supply variables have behaved erratically. While industrial production was up 0.2% in August, placing its year-on-year rise at 4.2%, the surveys on industrial confidence fell slightly in September.

On the other hand, demand indicators were quite weak. Both household consumption and consumer confidence fell back in August and September. This coincides with the halt in the labour market's recovery, as the total number of unemployed rose in September for the second month in a row.

The recovery in the British labour market slows up.

This stagnation in consumption contrasts with the trends in prices. Although inflation in September remained stable at 3.1%, this level was higher than the European Union's average, which stood at 2.2%, and was once again higher than expected. Moreover, clothing and food were the main elements that pushed inflation up this month and not the energy component. Inflation therefore continued at somewhat uncomfortable levels for the Bank of England to manage monetary policy, so that a rise in interest rates has not been ruled out, which might be advisable given the slowdown in the recovery of economic activity.

Emerging Europe: economic expansion with budgetary adjustment

After an excellent first half of 2010, in which the region benefited appreciably from the push provided by the global cycle of industrial expansion, there were concerns as this source of activity lost steam over the second half of the year. The cycle of stock accumulation is tending to weaken in the euro area and other advanced economies and, logically, there were fears that this development might be the precursor to a generalized slowdown in manufacturing. The figures for activity in the third quarter have helped to dissipate these gloomy forecasts. Industrial production has accelerated in practically all the countries in emerging Europe up to August, recording notable growth rates. The good performance by industrial orders and the maintenance of entrepreneurs' confidence at high levels practically guarantee that this drive will continue throughout the rest of the year. For their part, exports tended to speed up until August in all economies in the zone.

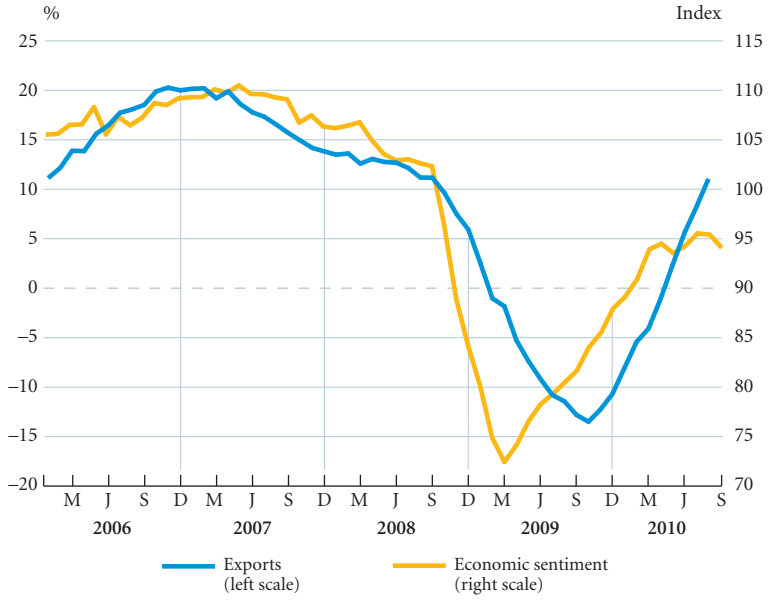
In emerging Europe, the good figures for activity in the third quarter relieve concerns about the cycle.

This consolidation of the recovery is a factor that will relieve the fiscal adjustment that, to a greater or lesser extent, is being carried out by these countries. We should remember that there are three different situations in emerging Europe in terms of sorting out their public accounts. Hungary and Romania have had to implement severe, far-reaching budget adjustments in 2010 in order to stop their public deficits from exceeding the levels required by their international commitments. Others such as Slovakia and the Czech Republic are benefiting from lower macroeconomic imbalances so they have been able to delay the adjustment to 2011 and take advantage of 2010 to consolidate their recovery. Lastly, a third situation is that of Poland which, as its economic cycle is more benign than the rest of the region, has been able to postpone really

Promising activity makes it easier to carry out the necessary fiscal adjustment.

EMERGING EUROPE: EXPORTS SUPPORT ECONOMIC RECOVERY

Indicator of economic sentiment and year-on-year change in exports (*)



NOTE: (*) Average balance accumulated over 12 months for exports and for indicators of economic sentiment for Slovakia, Hungary, Poland, the Czech Republic and Romania.
SOURCES: European Commission, national statistics institutions and own calculations.

While Hungary opts for specific taxes on different sectors, Slovakia is cutting spending and raising indirect taxes.

substantial measures to control public finances until 2012.

Now that details are being provided of the proposed budgets for 2011, the different ways being followed can be seen. The Hungarian and Slovakian case could serve as an example of these alternatives. It seems that Hungary has opted to boost tax revenue through specific taxes on sectors (together with the already known banking tax, new taxes were announced in October on energy, telecommunications and retail chains) and the freezing of certain transfers, such as payments from the state budget to the obligatory private pillar of the pension system. Both lines of adjustment come to approximately 1.9% of GDP.

In 2011, the region will record positive growth rates in the order of 3% in most of its countries.

An adjustment of similar intensity but much more orthodox characteristics is the one being followed by the Slovakian government. To achieve an adjustment of 2.5% of GDP, a rise in revenue is expected that will total 1.1% of GDP and a reduction in public spending that will add a sum of 1.4% of GDP. Higher tax revenue will fundamentally be achieved through a VAT hike and increases in different special taxes.

In addition to seeing cuts in public deficits in the region, what else awaits us in 2011? According to our forecasts, all the previously mentioned economies –Slovakia, Hungary, Poland, the Czech Republic and Romania– will record positive rates of change in GDP. Poland and Slovakia will grow by more than 3% annually, while we expect the Czech Republic to grow just below this figure. For its part, Hungary's growth will be around 2.5%, approximately double the rate of Romania. In most of the countries, the exports-stocks combination that has

driven growth in 2010 will give way to the double act of exports and investment.

This benign scenario is notably uncertain, however. One initial concern is that economic growth in the euro area is actually slightly worse than expected. Given this drawback, emerging Europe has been penalized by a lower contribution of its foreign sector (very much oriented towards the market of the single currency countries) and lower international capital inflows. These flows of trade and capital, which have recovered significantly in 2010 and are expected to make a major contribution in the coming year, are one of the key factors supporting the aforementioned growth scenario. Foreign capital might also fall if there's an increase in risk aversion, be it global, regional or national in nature. In this last case, one of the aspects that will probably affect investor sentiment would be public accounts performing worse than expected.

One last factor of risk, together with that of the economic and financial cycle we have just mentioned, is the one resulting from the political situation. This is particularly evident in the case of Romania, a country where the coalition government is attempting to juggle structural reforms with weakened social and political support. Nonetheless, this is not a problem exclusive to Romania. For example, the ups and downs of economic policy in Hungary remind us of the difficulties of governing a recovery that is highly dependent on others outside the region.

There are still risks from the economic and financial dependence on the euro area.

FINANCIAL MARKETS

Monetary and capital markets

Financial markets await the Fed's new quantitative expansion measures.

The central banks catch the markets' attention

The IMF predicts that the world's economic growth will exceed 4% throughout 2010 and 2011. This rate of expansion would be similar to the years before the crisis that started in summer 2007. However, this aggregate figure hides very disparate situations. The contribution to global GDP of the different blocks of countries will not be even and will rest mainly on emerging economies, while developed countries will see notably slower rates.

The United States, the traditional engine for the world's economy, is one of the countries recording low levels of inflation and growth below its potential. Moreover,

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2009									
September	1.00	0.75	1.24	0.25	0.29	0.35	0.50	0.54	0.31
October	1.00	0.72	1.24	0.25	0.28	0.33	0.50	0.59	0.34
November	1.00	0.72	1.23	0.25	0.26	0.30	0.50	0.61	0.32
December	1.00	0.70	1.25	0.25	0.25	0.28	0.50	0.61	0.35
2010									
January	1.00	0.67	1.23	0.25	0.25	0.26	0.50	0.62	0.34
February	1.00	0.66	1.22	0.25	0.25	0.25	0.50	0.64	0.36
March	1.00	0.63	1.21	0.25	0.29	0.24	0.50	0.65	0.28
April	1.00	0.66	1.24	0.25	0.35	0.24	0.50	0.68	0.21
May	1.00	0.70	1.26	0.25	0.54	0.25	0.50	0.71	0.13
June	1.00	0.77	1.31	0.25	0.53	0.24	0.50	0.73	0.28
July	1.00	0.90	1.42	0.25	0.45	0.24	0.50	0.75	0.42
August	1.00	0.89	1.42	0.25	0.30	0.24	0.50	0.73	0.59
September	1.00	0.89	1.43	0.25	0.29	0.22	0.50	0.73	0.32
October (1)	1.00	1.03	1.52	0.25	0.29	0.20	0.50	0.74	0.23

NOTES: (1) October 22.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-10-08 (3.75%), 6-11-08 (3.25%), 4-12-08 (2.50%), 5-03-09 (1.50%), 2-04-09 (1.25%), 7-05-09 (1.00%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).
(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 4-12-08 (2.0%), 7-01-09 (1.5%), 5-02-09 (1.0%), 5-03-09 (0.50%).
(5) Interbank rate.
SOURCES: National central banks, Bloomberg and own calculations.

the most recent indicators suggest this situation might continue for some time yet. The Federal Reserve has repeatedly expressed its great concern regarding this situation and its firm commitment to employing those instruments within its reach to boost the economy. Within this context, the meeting held by the Fed on the 2 and 3 November is of great importance. Investors' attention is focused on the content and tone of its communication, given that this is expected to announce a new package of measures for quantitative expansion. The market consensus expects the Fed to decide to implement a new programme of public debt purchases but of a lower amount than that announced in 2009 and with an open, flexible agenda, i.e. without committing itself to dates or amounts, unlike last time.

Given this panorama, dollar interbank rates have remained very low and everything points towards there being no significant modifications in the short or medium term, mainly due to the fact that the liquidity provided by the Fed will increase with the expected new programme of public debt purchases.

On the old continent, the situation facing the European Central Bank (ECB) is different. On the one hand, the institution is happy with the gradual improvement in the markets for sovereign debt from periphery countries, at the same time as noting the growing evidence of the interbank market getting back to normal. On the other hand, the central bank is facing a situation where Germany's economic activity is looking very dynamic, while other countries are still tackling significant obstacles.

Within this scenario, one of the possibilities that look increasingly more likely is the ECB starting to reformulate its strategy to tackle the liquidity problems encountered by the region. Taking these into account, the President of the European Central Bank, J.-C. Trichet, has stated that the institution is keeping all the credit facilities and bond purchase mechanisms in place for the moment but that it will assess whether these should be withdrawn at the beginning of 2011. In this respect, leading members of the central bank, such as the German Axel Weber, would prefer exceptional measures to be withdrawn sooner rather than later.

The upswing in interbank rates in the euro area is in response to greater market normalization.

The consolidation of improvements in the euro area's money markets can be seen in the notable upswing in Euribor rates over the last few months. This is in response to the banking crisis gradually being overcome, encouraging financial institutions to stop stockpiling liquidity, reducing excess reserves in the system and, as a result, increasing interbank interest rates.

China shows its determination to keep inflation under control.

In Asia, and more specifically in China, the central bank (PBoC) is facing a situation that, although different to the one the United States or the euro area are going through, is not without its own big dilemmas. The PBoC surprised everyone by deciding to raise the interest rate for one-year deposits (considered to be the reference rate), as well as for loans, by 25 basis points (100 basis points is 1%), to 2.5% and 5.56%, respectively. This decision reveals the authority's desire to keep inflation expectations under control, as well as inflationary pressures and house prices.

Public debt looks to the central banks

Rises in the price of sovereign debt in the United States and in Japan due to the actions taken by their central banks.

Over the last month, the movements in public debt have been the result, primarily, of announcements by the

In the euro area, the public debt of periphery countries has narrowed its spread with Germany.

central banks and, secondly, of the latest macroeconomic and budgetary figures.

In the case of the United States, the statements made by the Fed President, B. Bernanke, pointing towards a new round of quantitative expansion by the institution and presumably bond purchases, have led to an additional fall in yields, particularly in intermediate tranches (5-7 years). In addition to the expected rise in Treasuries demand by the Fed is the expectation of a smaller supply of issues for the coming 12 months. In fact, the 2010 fiscal deficit in the United States is lower than estimated and the expected withdrawal of a series of temporary tax reductions has reduced the fiscal deficit forecast for 2011. These two factors have raised the price of public debt in the United States.

However, European public debt has tended to perform differently. The bonds of countries in the centre of the euro area – Germany and France – have recorded slight rises in the long-term tranche. For example, 10-year bonds in Germany currently have a return of 2.35% and France of 2.70%, 4 and 3 basis points higher than at the end of September, respectively. More striking are the movements in the interest rates or yields for the short and medium tranches (from 3 months to 7 years), which have risen by around 20 basis points over the last month. This trend in yields is due to three factors. Firstly, the

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

10-year government bonds at end of period as annual percentage

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2009								
September	3.22	3.54	3.81	4.02	3.31	1.30	3.59	1.99
October	3.23	3.53	3.79	4.07	3.38	1.42	3.62	2.02
November	3.16	3.42	3.75	4.02	3.20	1.27	3.52	1.84
December	3.39	3.59	3.98	4.14	3.84	1.30	4.02	1.90
2010								
January	3.20	3.46	4.12	4.12	3.58	1.33	3.91	2.00
February	3.10	3.40	3.86	4.00	3.61	1.31	4.03	1.90
March	3.09	3.42	3.82	3.98	3.83	1.40	3.94	1.88
April	3.02	3.29	4.03	4.02	3.65	1.29	3.85	1.78
May	2.66	2.92	4.26	4.14	3.28	1.27	3.58	1.54
June	2.58	3.05	4.56	4.09	2.93	1.09	3.36	1.48
July	2.67	2.95	4.21	3.95	2.91	1.07	3.33	1.46
August	2.12	2.47	4.05	3.83	2.47	0.97	2.83	1.13
September	2.28	2.66	4.12	3.88	2.51	0.94	2.95	1.40
October (*)	2.38	2.77	3.98	3.76	2.53	0.88	2.95	1.49

NOTE: (*) October 18.
SOURCE: Bloomberg.

aforementioned rise in monetary interest rates due to the reduction in excess liquidity. Secondly, the publication of economic data in Germany that are better than expected. And, thirdly, the gradual redirection of the sovereign debt crisis in periphery countries, which has partly eased the «flight to quality» of flows.

With regard to the public debt of the euro area's periphery countries, it seems that this has actually got over the worst of the crisis, leading to a sharp reduction in spreads with German debt on the part of Greek, Irish and Portuguese bonds. However, this situation is far from being fully back to normal and the spreads are still wide, indicating that investors continue to perceive great risk in these countries.

Over the coming months, and in line with the announcements and effective actions carried out by the Fed, the US public debt yields are likely to become more volatile and fluctuate somewhat more sharply than we have seen this year. In any case, the Fed's potential action is a powerful factor that will contain and limit any possible sustained upward trends in yields. For this to happen, it will be necessary for the perspectives of economic recovery and the distancing of the risk of deflation to become consolidated in the eyes of investors and of the central bank. For its part, the sovereign debt for the core of the euro area is also likely to remain at its current levels for a time, rising gently throughout the coming year. With regard to the debt of periphery countries, its spreads will gradually narrow with Germany, although there might be some fleeting disturbances.

The yields for US public debt are likely to become more volatile.

Turbulence in the currency markets

After more than three years since the current crisis erupted in August 2007, some countries are succumbing to the temptation to apply measures of a protectionist nature, directly or indirectly. If, at the beginning of the crisis, governments remembered and took on board the bad results achieved by this kind of policy during the depression of the 1930s, as time has passed some of them seem to have forgotten that lesson and are causing some friction in trade with their decisions.

Expectation regarding the Fed's new quantitative expansion programme and the reluctance of the Chinese authorities to allow their currency to appreciate form the basis of the turbulence in the currency markets.

Announcements by the Fed and the Chinese authorities lead to tension in the currency markets.

Given the risk of rising unemployment, some export-oriented countries have intervened in foreign exchange markets with different kinds of measures in order to avoid losing competitiveness as a consequence of their currencies appreciating. The financial press has called this situation the «currency war» as currencies have become the ammunition in this battle. Several supranational organizations, including the International Monetary Fund, have noted that countries should resist the temptation to adopt protectionist policies that, although attractive in the short term, could end up harming world growth.

For example, at the end of September the Japanese Finance Minister ordered the Bank of Japan to intervene in the currency market, selling yen and buying dollars in order to stop the Japanese

This friction in trade translates into increased volatility in the currency markets.

The Chinese currency continues to attract all eyes after good reserve accumulation figures.

currency from appreciating. However, the impact on the markets has been modest, as on 15 October one dollar was exchanged for 80.88 yen, higher than when the intervention took place. This level is very close to the record, since the Second World War, of 79.75 yen per dollar, reached in April 1995.

But China and its currency is the focus of all attention. During his recent trip to Europe, the Chinese Prime Minister, Wen Jiabao, explained that pressures in his country regarding this issue are counterproductive, as a more expensive renminbi would cause losses for Chinese firms given their tight margins, creating an even greater global problem. However, the publication of high figures for the accumulation of foreign reserves by China provided an argument for those claiming that the Chinese currency is artificially depreciated.

Given this scenario, several governments are asking for the currency market situation to be covered at the next G-20 summit.

In any case, there are more countries that have intervened in the currency market on the list. For example, on 18 October Brazil announced its second rise in two weeks in the tax charged on foreigners investing in bonds (from 4% to 6%) in an attempt to slow up the real's appreciation. Brazil's central bank has also intensified its purchase of dollars. The Brazilian Tax Minister, Guido Mantega, stated that his government was looking at implementing other measures to contain the real's rise, although he did not reveal any details.

Due to the current situation, several governments have officially asked for the situation of the currency market to be covered at the next G-20 summit, which will be held in November in South Korea. This is more than likely and the agreements reached, possibly not formal

THE BANC OF JAPAN'S INTERVENTION IN SEPTEMBER HAD NO LONG-LASTING EFFECTS

Trends in the dollar-yen exchange rate

SOURCE: Bloomberg.

EXCHANGE RATES OF MAIN CURRENCIES

October 18, 2010

	Exchange rate	% change (*)		
		Monthly	Over December 2009	Annual
Against US dollar				
Japanese yen	81.2	–5.5	–14.5	–11.5
Pound sterling	0.630	2.1	–1.9	–3.4
Swiss franc	0.962	–4.5	–7.7	–5.2
Canadian dollar	1.019	–0.9	–3.3	–0.9
Mexican peso	12.481	–2.3	–4.9	–3.7
Against euro				
US dollar	1.388	–6.2	3.1	7.3
Japanese yen	112.7	0.7	–18.2	–20.3
Swiss franc	1.334	1.6	–11.2	–13.4
Pound sterling	0.874	3.9	–1.4	–4.2
Swedish krona	9.279	1.4	–10.5	–11.6
Danish krone	7.457	0.1	0.2	0.2
Polish zloty	3.922	–0.5	–4.6	–6.2
Czech crown	24.53	–0.4	–7.8	–5.0
Hungarian forint	275.7	–1.8	1.9	4.1

NOTE: (*) Plus sign indicates appreciation of dollar (first group) or euro (second group).
SOURCE: Bloomberg.

or official, will be fundamental in avoiding severe instability in currency and trade terms.

Corporate bond markets continue to perform well

The trend in corporate bonds remains very positive. In the last few weeks, this upward trend has been reinforced by expectations of an increase in monetary liquidity on the part of several central banks, including the Fed, the Bank of England and the Bank of Japan. This higher liquidity might head for the private bond market, which is offering higher returns than sovereign debt within a context where most companies that are sufficiently large to be able to access capital markets are announcing good results.

In fact, the economic cycle is in their favour and corporate profits have recovered quite quickly; both factors, and the little investment being made by firms, are giving rise to sharp growth in cash flow, with the acid test ratio of large firms reaching a record high in historical terms.

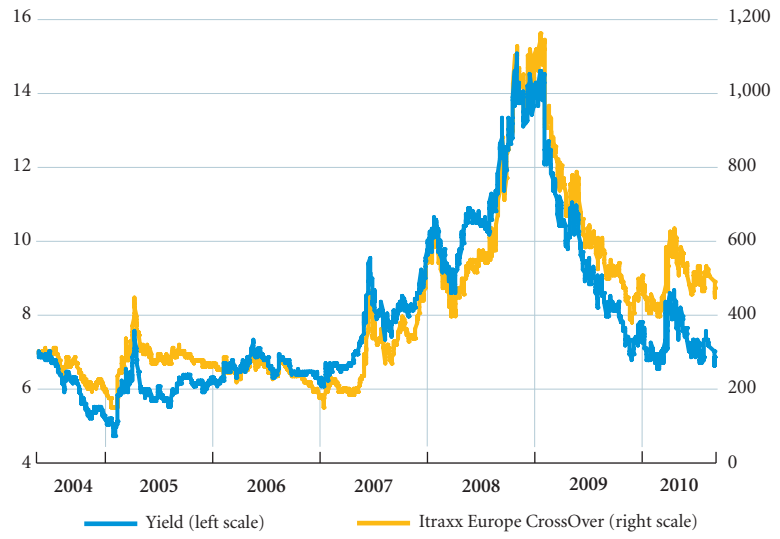
The corporate bond market remains strong.

Within this situation, large and medium-sized firms are taking advantage of low interest rates in the capital markets to refinance their debt at very attractive levels. Whereas, during 2009, it was companies with high credit ratings that could take advantage of better opportunities, this year this possibility has spread to companies with not so good credit profiles. This can be seen in the historical increase in corporate bond issuance, as well as in the low interest rates of many

The potential increase in liquidity and good corporate results continue to favour corporate bonds.

HIGH RISK BOND SPREADS AND YIELDS CONTINUE TO FALL

Spread in basis points and yield as percentage of the Itraxx at 5 years in the euro area



SOURCE: Bloomberg.

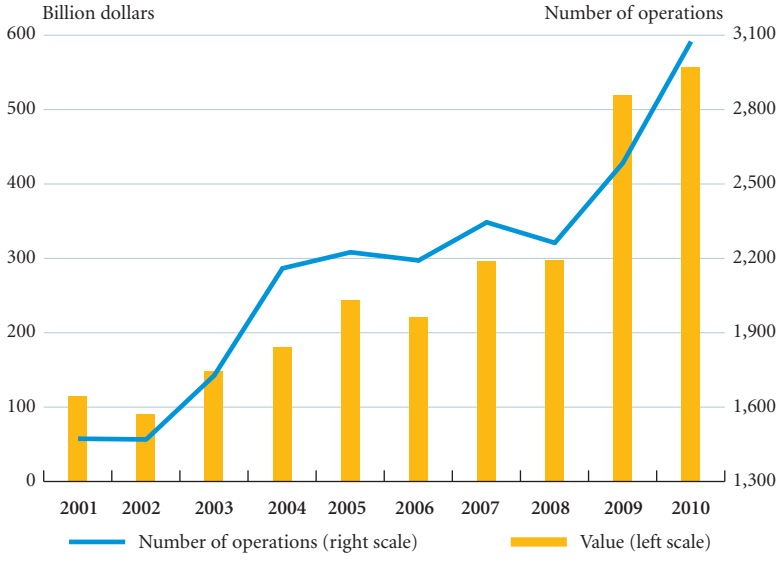
The potential increase in liquidity and good corporate results continue to favour corporate bonds.

issues, in some cases falling to record lows for some segments.

But how far can financial conditions improve in private bond markets? In the medium term, everything points towards

INVESTORS DEMAND EMERGING BONDS

Emerging bonds issued. Value and number of operations



NOTE: From the beginning of the year 15 October.
SOURCE: Bloomberg.

a positive tone overall, due to the aforementioned factors continuing and also because, although returns from numerous sectors are at record lows, credit spreads might still narrow in the medium and long term. However, some excesses can be seen in certain segments of the corporate bond market (in particular high yield issuers), in the form of abnormally large volumes of issues and trading, a deterioration in issuers' debt ratios and very fast reductions in spreads, to the extent of wondering whether the significant risks that still hover over the future of the economy are being duly considered.

Stock markets creep up

The main stock market indices have continued to behave irregularly and disparately in October, within an overall pattern of wide fluctuations and slight movements seen throughout the year. In spite of this state of affairs, the balance at the end of the month has been positive for most equity markets. In this respect, it should be noted that the emerging economy markets, followed by the North American, are enjoying more solid, consistent trends than those observed in Europe.

Two factors lie behind European equity's worse performance. The first comes from the sovereign debt crisis which, although it is now being overcome, has left behind scars in the form of slow growth and restrictions on those sectors that depend most heavily on state budgets. The second has been the euro's appreciation against the dollar, given that strongly export-oriented companies have a significant presence in European indices.

In any case, the current situation contains several favourable elements for global equity. Firstly, the expansionary monetary policies. Secondly, and thanks to the significant contribution from emerging countries, the macroeconomic data published this autumn have been better than expected by the consensus of economists and the prospect of a double-dip recession continues to fade. Thirdly, investor confidence is growing, little by little. One of the indicators that best reflect this lower risk aversion is precisely the fall in volatility in equity markets. In fact, the moderation of risk premia is making markets less vulnerable, bringing about a more attractive investment situation in terms of yield compared with other assets such as public debt.

Companies are still tending to increase debt in emerging countries.

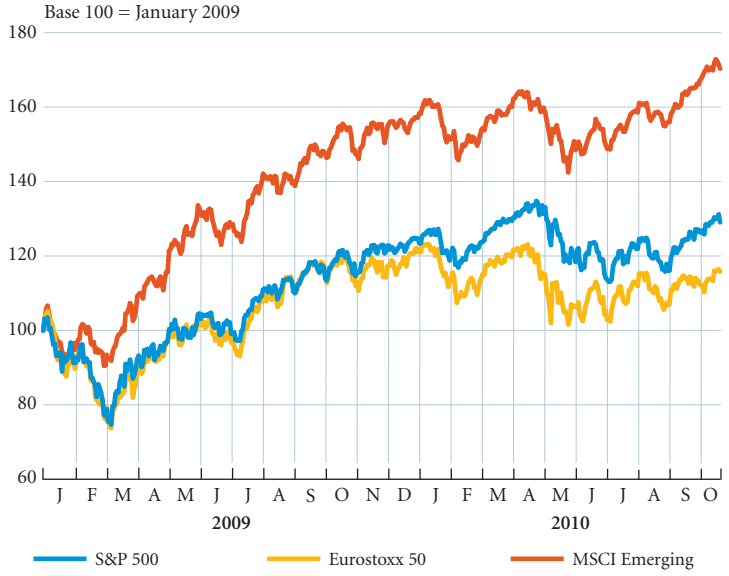
From a corporate point of view, the month of October has been dominated by the start of companies announcing their results for the third quarter. In the case of the United States, this is a critical period for seeing how the recovery and the situation of firms are progressing: after six consecutive quarters of increasing profit estimates, between July and September the consensus of analysts moderated their forecast for growth in earnings. Analysts have justified these decisions using the macroeconomic data published during the summer, which pointed towards a slowdown in the economic recovery. This fear was shared by supranational organizations and managers of economic policy. However, the announcements of corporate results have started on a very positive note. One example is the S&P 500 index, where 79.1% of the firms that have announced their quarterly earnings have bettered the forecasts by stock market analysts.

North American equity is performing better than European.

Expectations for economic growth boost the stock markets.

TRENDS IN THE MAIN INTERNATIONAL STOCK MARKETS

Stock market indices



SOURCE: Bloomberg.

INDICES OF MAIN WORLD STOCK EXCHANGES

October 25, 2010

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*10,978.6*	*2.1*	*5.3*	*9.3*
Standard & Poor's	*1,165.9*	*2.0*	*4.6*	*6.9*
Nasdaq	*2,437.0*	*3.4*	*7.4*	*12.6*
Tokyo	*9,381.6*	*–2.5*	*–11.0*	*–9.2*
London	5,711.1	1.9	5.5	8.9
Euro area	2,838.1	1.3	–4.3	–3.0
Frankfurt	6,498.2	3.2	9.1	11.8
Paris	*3,806.8*	*0.5*	*–3.3*	*–1.7*
Amsterdam	*338.6*	*–0.4*	*1.0*	*4.2*
Milan	*21,331.7*	*2.8*	*–8.2*	*–12.0*
Madrid	*10,873.2*	*1.2*	*–8.9*	*–7.8*
Zurich	6,476.4	0.2	–1.1	0.8
Hong Kong	23,556.5	7.2	7.7	5.2
Buenos Aires	2,727.9	7.7	17.5	21.5
São Paulo	69,863.6	2.5	1.9	7.0

NOTE: (*) New York: Dow Jones Industrials, Standard & Poor's Composite, Nasdaq Composite; Tokyo: Nikkei 225; euro area: DJ Eurostoxx 50; London: Financial Times 100; Frankfurt: DAX; Paris: CAC 40; Amsterdam: AEX; Milan: MIBTEL; Madrid: Ibex 35 for Spanish stock exchanges; Zurich: Swiss Market Index; Hong Kong: Hang Seng; Buenos Aires: Merval; São Paulo: Bovespa.
SOURCE: Bloomberg.

Looking at the coming months, and assuming the global macroeconomic situation will improve steadily, the forecasts for equity are positive. Among the elements supporting an upward trend, it is worth noting the possibility of new measures to inject liquidity by some central banks, higher capital flows towards risk assets (with a particular preference for emerging markets), good corporate results and, lastly, the intensification of corporate mergers and acquisitions. However, news concerning disturbances in currency markets, as well as exceptional and unexpected decisions regarding monetary policy, might bring these figures down in the short term.

Healthy investment: the healthcare industry on the stock market

Over the last few years, healthcare spending[1] by OECD countries has gradually gained weight in their overall economies, with the emerging countries also joining this trend recently. Given that its basic underlying factors are unlikely to change, this trend will probably continue in the medium and long term.[2] However, the world economic crisis is currently posing a serious obstacle in the form of government budget cuts. Given this situation, it's even more important to analyse this sector from a financial perspective and specifically its presence on the stock markets: its weighting, composition, risk-return profile, trends and outlook.

The relative capitalization of health firms on stock markets has generally lagged behind the sector's overall share of GDP. Particularly of note is the case of Spain, with just one company in the Ibex-35 index. In fact, the weighting is relatively low for all countries in the euro area, which have similar social and institutional features. This figure increases when we also include countries such as Switzerland and the United Kingdom, homes to powerful pharmaceutical firms, but it's in the United States where the health industry's stock market presence is strongest, both in terms of overall weighting and in the diversity of subsectors and firms' business models. To a large extent, this is due to institutional differences regarding the provision and production of this kind of service: the overwhelming presence of the public sector in Europe compared with the leading role played by private enterprise in the United States. For their part, in the emerging countries the overall weight is still relatively modest, although expanding rapidly.

The health sector is usually identified with the pharmaceutical industry due to the prominence and size achieved by large companies by selling so-called blockbusters (drugs with annual sales in excess of 1 billion dollars). In the world's main stock market indices for the sector, pharmaceutical firms account for approximately 70% of the total. The rest of the health-related firms are, with more or less weight, made up of biotechnology companies, medical equipment firms, health insurers, providers of medical services (managers of hospitals, ambulances, etc.) and healthcare suppliers (such as analytical products, syringes, etc.). Equally, another very important dimension to bear in mind in this sector is the geographical aspect, with the United States vastly dominating the range of companies and achieving total sales, for drugs alone, of 80 billion dollars in 2009. European firms come second, where drug price regulations (through which governments control the industry via refunds) limit their room for manoeuvre and the return on their investment. Recently, in the last decade, emerging countries have also secured a foothold in the pharmaceutical industry, such as India and China, where sales are growing rapidly.

(1) This text uses the terms health and healthcare as one and the same.
(2) See the rest of the boxes in this number.

In terms of stock market characterization, the healthcare sector has traditionally been identified as relatively defensive insofar as, at times of economic crisis, it still offers prospects of sustainable growth, attractive returns on capital for investors and moderate risk (with the exception of segments such as biotechnology). This impression is based on two aspects: on the one hand, the prospect of a steady rise in demand irrespective of the economic cycle and, on the other, the limited role of the public sector in researching and developing new drugs (especially in the US market).

RELATIVE WEIGHT OF THE HEALTH SECTOR IN THE MAIN STOCK MARKET INDICES

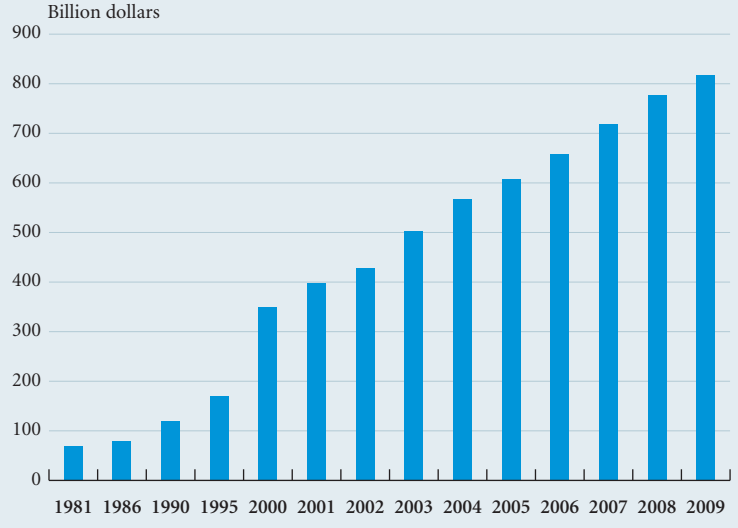
Data at 15 October 2010. In percentages

	IBEX 35	General index Madrid	Euros Stoxx	Europe Stoxx 600	S&P 500	NIKKEI 225	Shanghai Composite	Bombay 500
Total health	**0,51**	**0,91**	**3,98**	**9,4**	**11,06**	**9,56**	**2,68**	**4,37**
Pharmaceuticals and biotechnology	0,51	0,87	2,91	8,35	7,59	6,8	2,61	4,21
Pharmaceuticals	–	*0,51*	*2,66*	*8*	*6,16*	*n.a.*	*2,5*	*4,11*
Biotechnology	*0,51*	*0,36*	*0,24*	*0,35*	*1,43*	*n.a.*	*0,11*	*0,09*
Equipment and services	–	0,04	1,07	1,36	3,47	2,76	0,07	0,16
Medical equipment	–	*0,02*	*0,04*	*0,5*	*1,28*	*n.a.*	*0,03*	*n.a.*
Health services	–	*0,02*	*0,62*	*0,3*	*1,61*	*n.a.*	*0,01*	*n.a.*
Supplies	–	–	*0,41*	*0,26*	*0,58*	*n.a.*	*0,03*	*n.a.*

SOURCE: Bloomberg.

OVERALL SALES OF THE PHARMACEUTICAL INDUSTRY

1981-2009



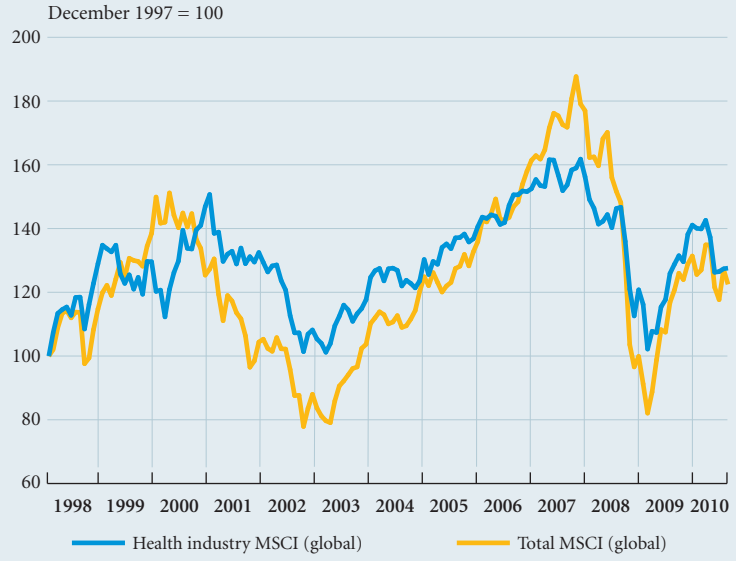
SOURCE: IMS Health.

It's complicated to value these companies and such a valuation needs to take many different factors into account. In order to achieve sustained growth, today these companies, and particularly western pharmaceutical firms, have to overcome the negative effect on their margins and revenue of the slowdown in the economy and adjustments to government budgets, fundamental agents in providing health services. They must also handle some critical aspects that set this sector apart. Firstly, the ageing of product portfolios and the impending end to the protection provided by numerous patents. Secondly, the escalation of the risks inherent in the sector, including the need for health authority licences administrative obstacles. Thirdly, the regulatory and fiscal changes made by some governments affecting the sale of health products and services (e.g. the recent healthcare law reform promoted by Obama's administration in the United States).

Companies try to tackle such difficulties by looking for new ways to grow and create value for their shareholders, primarily through researching and developing new drugs and by improving clinical processes. Breaking into emerging countries is also a promising way to expand, although not without its problems. Mergers and acquisitions are another important way of quickly changing the value of health firms quoted on the stock market. Combining companies is one of the most widely used ways to secure sustained growth and there are several aspects in the market that encourage this kind of operation. Firstly, advantages in terms of efficiency, synergies and the diversification of risk resulting from bringing together the manufacturers of products under patent with producers of generic and biotechnological products. Secondly, the greater investment possibilities in emerging economies for companies with a big enough scale. Thirdly, the current valuation of pharmaceutical firms is low compared with the historical average, making financial operations more appealing in relation to the prices negotiated in the past.

THE HEALTH INDUSTRY ON THE STOCK MARKET: A GENTLER CYCLICAL TREND

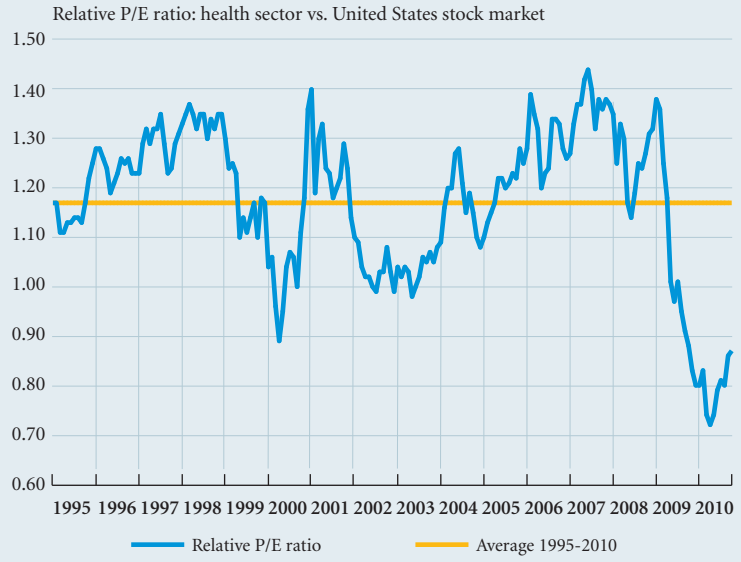
Stock market trends in the global health industry



SOURCE: Bloomberg.

It's true that the stock market performance of health companies has not escaped the poor results characterizing global equity as a whole over the last few years but nevertheless their profits have tended to perform better, so that their relative value has become more attractive. Once the current short term challenges have been overcome thanks to the capacity to adapt being demonstrated by these firms, we can expect the leverage on which the sector's growth has been based (research and development, demographics, globalisation and rising incomes and wealth) to also boost sales, profits and possibly[3] the stock market valuation of the sector as a whole.

THE SECTOR IS ATTRACTIVE IN TERMS OF VALUE



SOURCE: Thomson Reuters Datastream.

(3) Various studies have shown that, although they may be known, factors with a long-term effect are not entirely included or left out from the share price at any given time, which might result in abnormal returns. See, for example, DellaVigna, Stefano and Joshua Pollet, *Demographics and Industry Returns*, The American Economic Review, December 2007.

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SPAIN: OVERALL ANALYSIS

Economic activity

Economic activity shows signs of a downturn in the third quarter

The economic recovery, which picked up in the first half of the year and posted two consecutive quarters of growth, seems to have taken a breather in the third. Available indicators point to a slowdown both in consumption and investment after the boost given to purchases in the second quarter before the hike in value added tax (VAT) in the month of July. The counterpart to purchases being brought forward, together with the gradual removal of economic stimuli, has led to a certain downturn in the third quarter. In the summer months, the indicator of economic sentiment was slightly below its June level.

Consumption weakened in general in the hot months. Retail sales, without including vehicles, fell by 2.3% year-on-year in July-August, the highest fall coming in automobile sales, affected by the direct aid for car purchases running out and posting a year-on-year decrease of 25.0%, in contrast to an annual rise of 35.3% in the second quarter. Car sales therefore fell back t o the levels of 1995. However, the production of consumer goods increased by 1.0% in the first two months of the third quarter compared with the same period the previous year, although this rate is 1.5 points less than in the previous quarter. On the other hand, consumer confidence improved in August and September, although still below its historic average.

The boost provided by purchases being brought forward to avoid the VAT hike has its counterpart in the third quarter.

Retail and car sales fall but consumer confidence improves in August and September.

ELECTRICITY CONSUMPTION SLACKENS OFF

Year-on-year change in electricity consumption

NOTE: Adjusted for labour and temperature effects.
SOURCE: Red Eléctrica Española.

House transactions liven up given the partial withdrawal of tax rebates in 2011.

Looking at investment in capital goods, the production of capital goods fell by 5.9% in July-August compared with the same period a year ago. Truck registrations also fell by 9.3% year-on-year in the third quarter. However, imports of capital goods were up by 13.6% year-on-year in July-August.

With regard to investment in construction, a leading indicator such as apparent cement consumption fell by 13.6% in the third quarter compared with the same period the previous year, 1.5 points more than in the second quarter. Adjustment continues in the residential sector, given that the number of homes completed was still greater than the sales of new homes in the second quarter. This high number of unsold homes continues to push prices down, these falling by 3.4% in the third quarter compared with the same period a year ago, according to data from the Ministry of Housing. This drop in price, together with low interest rates and the prospect of the rebate for purchasing housing being withdrawn as from 2011 for taxpayers with a taxable income higher than 24,170 euros, have all been boosting transactions in the last few months, up 29.6% year-on-year in August.

Regarding supply, industrial production slowed up its rate of year-on-year growth to 0.5% in the first two months of the third quarter and was bound to be affected in September by the one-day general strike on the 29th. Electricity consumption confirms this slowdown. However, the indicator for confidence in industry improved slightly in the third quarter compared with previous quarters.

As regards services, in August the number of businesses rose by 0.8% year-on-year in homogeneous calendar terms,

DEMAND INDICATORS

Percentage change over same period year before

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
Consumption									
Production of consumer goods (*)	–4.7	–8.2	–8.6	–1.7	0.4	2.5	–0.5	3.1	...
Imports of consumer goods (**)	–7.7	–6.1	–3.4	3.7	–10.8	2.8	–13.4	–11.9	...
Car registrations	–28.1	–17.9	–0.6	29.3	44.5	35.3	–24.1	–23.8	–27.3
Credit for consumer durables	3.6	–11.5	–10.8	–9.1	–5.6	–9.6	–	…	–
Consumer confidence index (***)	–33.8	–28.3	–20.7	–20.0	–18.2	–22.9	–26.0	–20.0	–19.0
Investment									
Capital goods production (*)	–8.8	–22.1	–20.2	–10.3	–2.4	–1.7	–3.8	–9.9	...
Imports of capital goods (**)	–19.6	–27.0	–23.4	–16.9	–1.2	13.0	15.8	11.1	...
Commercial vehicle registrations	–43.6	–40.0	–30.8	–7.8	8.5	24.2	–7.6	–9.4	–11.4
Foreign trade (**)									
Non-energy imports	–4.9	–17.5	–13.4	–0.7	10.4	18.1	11.2	7.0	...
Exports	1.9	–9.8	–9.6	4.3	17.4	14.9	9.0	19.7	...

NOTES: (*) Adjusted for public holidays.
(**) By volume.
(***) European Commission survey: difference between percentage of positive and negative replies.
SOURCES: ANFAC, National Institute of Statistics, Bank of Spain, Ministry of the Treasury, European Commission and own calculations.

although this change varied between branches. Trade, transport and professional, scientific and technical activities all posted annual growth, while administrative activities and auxiliary services, information and communications and hotels and restaurants posted a fall in their turnover. However, the estimated value added for the tourism sector in the third quarter suggests moderate growth.

Moderate growth in tourism business.

In spite of the signs of economic decline in the third quarter, there is evidence of a more dynamic base to the economy. In August 4,850 new firms were set up, 4.0% more than a year earlier and with a substantial rise in the average capital subscribed. The number of firms wound up in the month was 981, a lower year-on-year change rate of 0.2%.

We therefore predict that the economy will continue to pick up after the dip in the third quarter. However, for 2010 as a whole we have set the annual change in GDP at –0.3%. Next year economic expansion is likely to be gradual, given the process currently underway of correcting the imbalances accumulated

New start-ups become more dynamic.

SUPPLY INDICATORS

Percentage change over same period year before

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
Industry									
Electricity consumption (1)	0.5	–4.3	–2.1	–1.4	2.8	4.4	3.3	1.7	1.0
Industrial production index (2)	–7.3	–15.8	–14.6	–5.6	0.3	2.9	–0.1	1.4	...
Confidence indicator for industry (3)	–18.0	–31.2	–29.0	–24.1	–20.1	–14.4	–14.0	–13.0	–14.0
Utilization of production capacity (4)	80.1	71.2	69.8	70.6	69.5	71.8	73.9	–	–
Imports of non-energy intermediate goods (5)	–0.7	–21.6	–17.1	0.1	26.9	28.4	26.4	...	...
Construction									
Cement consumption	–23.8	–32.3	–24.3	–16.7	–18.7	–12.0	–15.1	–10.0	–15.1
Confidence indicator for construction (3)	–22.6	–30.6	–26.3	–24.5	–24.9	–24.3	–31.0	–29.0	–24.0
Housing (new construction approvals)	–59.4	–58.1	–52.4	–45.5	–24.4	–10.3	–21.6	...	...
Government tendering	3.0	–8.2	–1.4	–17.0	–50.5	–10.9	–51.8	...	...
Services									
Retail sales (6)	–6.0	–5.4	–4.5	–2.7	0.7	–0.2	–2.2	–2.5	...
Foreign tourists	–2.5	–8.8	–7.7	–3.5	0.3	–3.1	4.5	4.0	...
Tourist revenue inflows	–0.4	–9.0	–9.2	–5.5	0.2	0.4	6.3	...	...
Goods carried by rail (ton-km)	–7.7	–28.4	–32.4	–7.7	4.5	20.9	18.1	12.4	...
Air passenger traffic	–3.0	–8.0	–5.0	–0.8	3.5	–0.6	3.6	3.6	5.6
Motor vehicle diesel fuel consumption	–3.8	–5.1	–3.0	–2.0	–0.5	–0.7	–3.9	...	...

NOTES: (1) Adjusted for number of working days and temperature.
(2) Adjusted for public holidays.
(3) European Commission survey: difference between percentage of positive and negative replies.
(4) Business survey: percentage of utilization inferred from replies.
(5) By volume.
(6) Index (without petrol stations) deflated and corrected for calendar effects.
SOURCES: Red Eléctrica Española, OFICEMEN, AENA, National Institute of Statistics, Bank of Spain, European Commission, Ministry of Public Works, Ministry of Industry, Commerce and Tourism, Ministry of the Treasury and own calculations.

We predict a 0.3% drop in GDP in 2010 and 0.7% growth in 2011.

and the restrictive fiscal policy. We therefore predict an annual rise in GDP of 0.7% in 2011.

Business profits recover but not enough to create net employment

It's interesting to analyse firms' accounts to assess the extent of their adjustment and their investment capability, given this new phase in the economic cycle. Data from the Bank of Spain's Central Balance Sheet Data Office Quarterly Survey confirm that, in the first six months of 2010, Spain came out of the recession as the value added generated by the sample's firms rose by 6.4% compared with the same period in 2009, whereas this had fallen by 13.7% a year earlier. However, in general companies continued to reduce their workforce. This, together with greater wage containment, meant that staff costs fell by 1.6% compared with the first half of last year.

Gross operating profit (EBITDA) therefore improved appreciably and was 14.0% up on the first six months of 2009, contrasting with the sharp drop of twelve months ago. Low interest rates, as well as the stabilisation of debt, meant that both financial costs and spending fell. However, the latter did so to a greater extent because of the lower dividends paid out. Ordinary net profit therefore grew a little less than gross profit, namely 9.3% year-on-year. However, few atypical operations and higher tax payments meant that profit for the year still fell, by 2.6% compared with January-June 2009.

The return on equity for non-financial firms rises by half a point.

The return from net assets was 5.3% in the first half of 2010, 0.3 percentage points more than the previous year. For its part, the return on equity increased by 0.6 percentage points to 7.0%. We can therefore see a recovery in profits, although still not enough to generate employment at present.

INCOME STATEMENT OF NON-FINANCIAL FIRMS

Annual rates of change

	2009	First six months	
		2009	2010
Value of output	–11.7	–19.1	16.1
Intermediate consumption	–13.1	–22.0	21.9
Gross value added (GVA)	**–8.9**	**–13.7**	**6.4**
Personnel costs	–1.5	–1.3	–1.6
EBITDA	**–14.9**	**–23.1**	**14.0**
Financial income	–8.0	–12.1	–13.6
Financial costs	–30.0	–24.9	–3.8
Net depreciation and provisions	–4.1	–2.0	8.0
Ordinary net profit or loss	**–6.5**	**–25.6**	**9.3**
Divestment and deterioration	–	–28.6	–9.8
Changes in fair value and rest of earnings	–	10.0	–7.7
Corporate income tax	7.6	–25.8	40.8
Profit or loss from the year	**5.4**	**–26.8**	**–2.6**

SOURCE: Bank of Spain (Central Balance Sheet Data Office Quarterly Survey).

Labour market

The recovery in the job market comes to a standstill

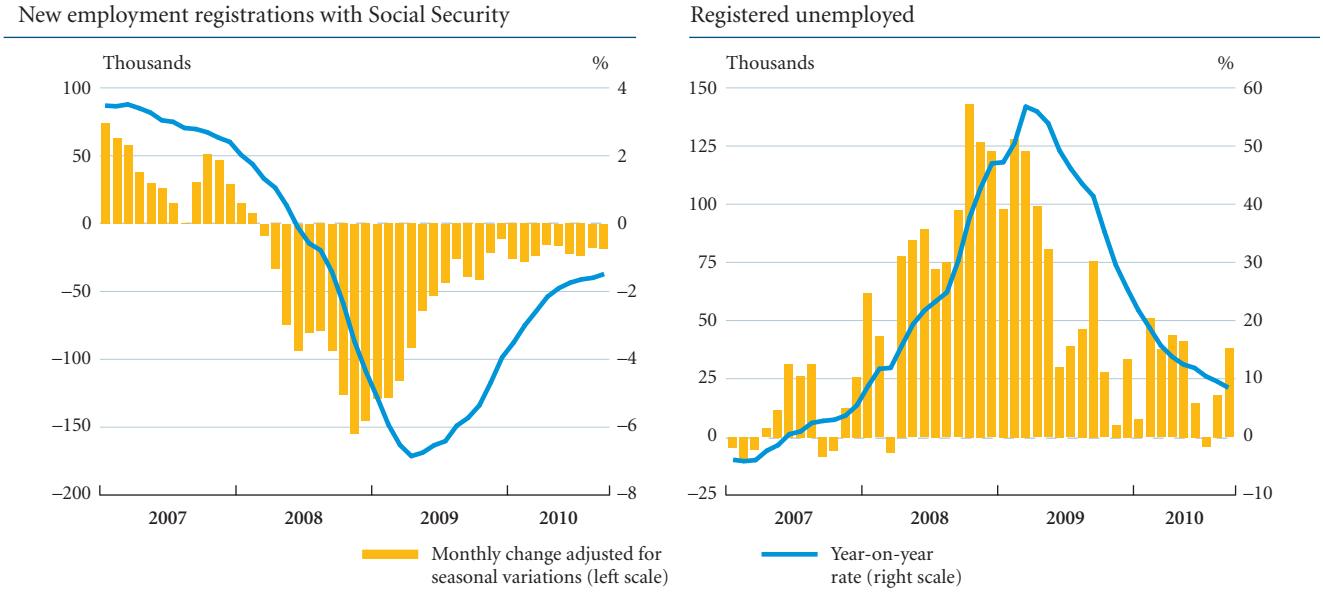
The improvement in economic activity is still not enough to stop the decline in the labour market. In September, the average monthly number of people signed up as employed with Social Security was 17,671,480. This figure is 44,985 less than the previous month, a higher fall in employment than expected. However, it should be noted that the seasonally adjusted figure is somewhat more positive, with the fall in employment being lower than that recorded in September 2008 and 2009. In the last twelve months the number of people registered as employed also fell by 263,615, one fourth of the destruction in employment taking place over the same period a year ago. The data therefore confirm that the employment situation continues to get worse, albeit at a slower pace.

Job losses occurred both among salaried employees and the self-employed, with year-on-year drops of 1.3% and 2.3%, respectively. By sector, only the services sector created jobs over the last year, up 0.5% year-on-year, whereas the fall in employment in construction over the last twelve months was 12.3%, and for industry, 3.7%.

By gender, the drop in employment over the last year was concentrated among men, seeing as women predominate in

Jobs are still being lost.

STILL NO END IN SIGHT TO THE DECLINE IN THE LABOUR MARKET



SOURCES: Ministry of Labour and Social Affairs, Public State Employment Service and own calculations.

EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2008	2009	2009		2010				
			3Q	4Q	1Q	2Q	July	August	September
Persons registered with Social Security (1)									
Sectors of activity									
Industry	*–2.1*	*–10.6*	*–11.5*	*–10.0*	*–7.2*	*–4.9*	*–4.0*	*–3.8*	*–3.7*
Construction	*–10.3*	*–23.1*	*–22.0*	*–18.9*	*–16.4*	*–13.1*	*–12.7*	*–12.5*	*–12.3*
Services	*1.7*	*–2.6*	*–3.0*	*–2.1*	*–0.8*	*0.1*	*0.4*	*0.3*	*0.5*
Job situation									
Wage-earners	*–0.7*	*–6.0*	*–6.2*	*–4.6*	*–2.8*	*–1.8*	*–1.5*	*–1.4*	*–1.3*
Non-wage-earners	*0.4*	*–4.8*	*–5.3*	*–4.9*	*–4.0*	*–3.0*	*–2.4*	*–2.4*	*–2.3*
Total	**–0.5**	**–5.8**	**–6.0**	**–4.6**	**–3.0**	**–1.9**	**–1.6**	**–1.6**	**–1.5**
Persons employed (2)	**–0.5**	**–6.8**	**–7.3**	**–6.1**	**–3.6**	**–2.5**	**–**	**–**	**–**
Jobs (3)	**–0.5**	**–6.6**	**–7.2**	**–6.0**	**–3.7**	**–2.5**	**–**	**–**	**–**
Hiring contracts registered (4)									
Permanent	–14.3	–31.0	–28.6	–22.5	–11.9	–5.6	–13.8	–2.7	–4.9
Temporary	–10.4	–13.5	–9.4	–2.1	3.7	5.2	0.7	7.7	3.4
Total	**–10.9**	**–15.5**	**–11.4**	**–4.3**	**2.0**	**4.2**	**–0.4**	**6.9**	**2.6**

NOTES: (1) Average monthly figures.
(2) Estimate by Labour Force Survey.
(3) Equivalent to full-time work. National Accounting estimate; data adjusted for seasons and public holidays.
(4) At the Public State Employment Service.
SOURCES: National Institute of Statistics, Ministry of Labour and Social Services, Public State Employment Service and own calculations.

The number of contracts grows but only temporary ones.

services, the only big sector to create jobs. The proportion of women registered as employed therefore stood at 44.8%. By nationality, the decline in employment since September 2009 was higher among foreign workers, who are over-represented in construction, this falling by 2.1%. For their part, Spanish workers fell by 1.4%.

The slow reversal in the labour market is also reflected in the weak performance by contracts, whose rate of increase year-on-year stood at 2.6% in September, a relatively small figure when compared with the rises recorded, for example, after the crisis of 1992-93. Nonetheless, this rate is more favourable than the 9.8% fall recorded in the same month of 2009. With regard to contract type, of note is the fact that close to 90% of all contracts signed in the month of September were temporary.

Registered unemployment grows by 8.3% in one year.

Registered unemployment confirms the slowdown in economic recovery

In the month of September, registered unemployment once again rose by 48,102 people to a total of 4,017,763, again topping the figure of four million. This placed the year-on-year rate of increase at 8.3%. Although this was a bigger rise than expected, the growth rate for unemployment continued to fall. Moreover, once this series is seasonally adjusted, the rise in unemployment is somewhat less (around 38,000) and is also lower than the rise in unemployment recorded in the months of September 2008 and 2009. Consequently, in spite of the recovery in the job market losing steam, the situation is still more favourable than during the previous two years.

Almost all monthly increases in registered unemployment were concentrated in the services sector, partly related to the end of the tourist season. Also of note was the rise in the number of people looking for their first job, as it's customary for people to look for work after the holiday period and after completing their education. This coincides with the significant rise in unemployment among those under 25 years of age. By gender, unemployment is distributed more or less evenly among men and women.

Over the last twelve months, the rise of more than 300,000 unemployed people has led to higher spending on unemployment benefit. At the end of August, the total number of people receiving benefit was almost 3 million, up 10.7% compared with the same month last year. However, the total spent in August fell slightly, totalling 2,607 million euros, due to the addition of newly unemployed people who have never worked and the end of benefit for those receiving payments.

The outlook for unemployment over the coming months is still not encouraging as higher growth rates are needed in activity than those recorded over the last few months for the total number of unemployed to fall.

The rise in unemployment benefit spending slows up.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

September 2010

	No. of unemployed	Change over December 2009		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	117,398	11,265	10.6	22,020	23.1	2.9
Industry	484,747	–24,055	–4.7	–3,533	–0.7	12.1
Construction	727,557	–54,167	–6.9	19,479	2.8	18.1
Services	2,337,535	96,470	4.3	197,377	9.2	58.2
First job	350,526	64,647	22.6	72,973	26.3	8.7
By sex						
Males	1,984,933	–27,603	–1.4	133,572	7.2	49.4
Females	2,032,830	121,763	6.4	174,744	9.4	50.6
By age						
Under 25 years	446,624	–145	0.0	2,018	0.5	11.1
All other ages	3,571,139	94,305	2.7	306,298	9.4	88.9
TOTAL	**4,017,763**	**94,160**	**2.4**	**308,316**	**8.3**	**100.0**

SOURCES: Public State Employment Service and own calculations.

Prices

Inflation picks up slightly, boosted by oil

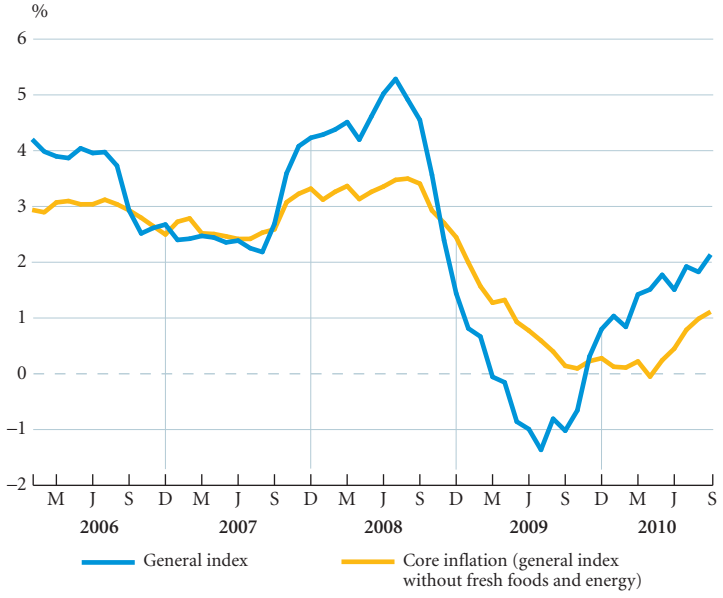
Half the rise in VAT is absorbed by business margins.

After a break in August, inflation in consumer prices rose slightly again in September, boosted by the trend in energy products and, ultimately, oil. The consumer price index (CPI) posted a 2.1% year-on-year change in September, 0.3 percentage points more than the previous month and returning to the levels of the end of 2008. Another factor pushing inflation up in the third quarter has been the rise in the general and reduced rate for value added tax (VAT) in July. After three months, its impact can be estimated at half a point of inflation, i.e. close to half of what would have been the effect had the whole tax hike been passed on to consumers. The other half has been absorbed by business margins, given the weakness in consumption.

Of the 0.3 percentage point year-on-year rise in inflation in September, 0.2 can be explained by the trends in fuel and oil prices, which increased slightly that month compared with a drop twelve months earlier. Fuel and oil prices therefore posted a year-on-year change of 13.9%, 3 points more than in August. On

SLIGHT UPWARD TREND IN CORE INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

	2009			2010		
	% monthly change	% change over December 2008	% annual change	% monthly change	% change over December 2009	% annual change
January	–1.2	–1.2	0.8	–1.0	–1.0	1.0
February	0.0	–1.2	0.7	–0.2	–1.2	0.8
March	0.2	–1.1	–0.1	0.7	–0.5	1.4
April	1.0	–0.1	–0.2	1.1	0.6	1.5
May	0.0	–0.1	–0.9	0.2	0.8	1.8
June	0.4	0.3	–1.0	0.2	1.0	1.5
July	–0.9	–0.5	–1.4	–0.4	0.6	1.9
August	0.3	–0.2	–0.8	0.3	0.8	1.8
September	–0.2	–0.4	–1.0	0.1	0.9	2.1
October	0.7	0.3	–0.7			
November	0.5	0.8	0.3			
December	0.0	0.8	0.8			

SOURCE: National Institute of Statistics.

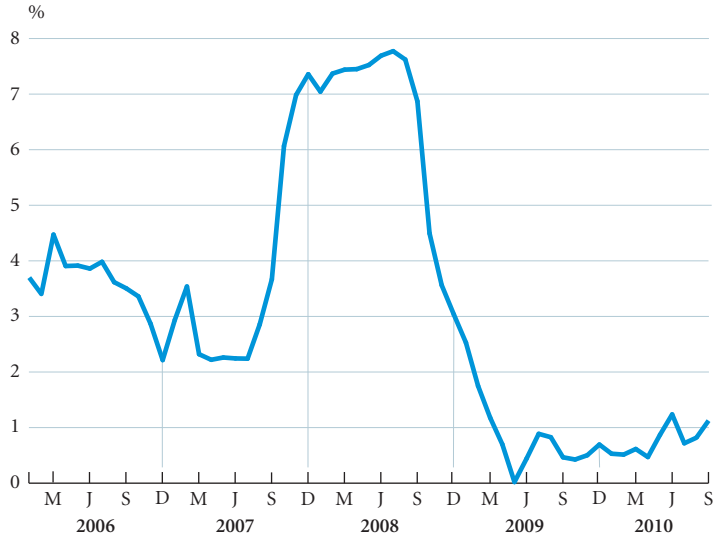
the other hand, prices for the other most volatile component, namely fresh foods, slowed in September, recording a 1.3% year-on-year change rate, 0.3 percentage points less than the previous month.

The most stable core of inflation, also known as underlying inflation, was up one tenth of a percentage point to 1.1%. This was the fifth consecutive rise, some distance from the negative figure

Core inflation's up one tenth of a percentage point to 1.1%, posting its fifth consecutive rise.

SLIGHT UPWARD SWING IN PROCESSED FOODS

Year-on-year change in the price index for processed foods, beverages and tobacco



SOURCE: National Institute of Statistics.

Manufacturing prices pick up.

posted in April 2010 and helped by the VAT hike. The rise in core inflation in September can be put down to non-energy industrial goods and processed foods.

The prices of manufacturing products continued to recover, standing at 0.4% above the figure for a year ago. This rise was helped by car prices, up 2.2% on September 2009, one point more than in August, in spite of a slight drop in month-on-month terms.

Processed food prices rose by 1.1% over the last twelve months to September, 0.3 percentage points more than in the previous month. Milk played its part in this rise, although its price is still 2.8% lower than a year ago.

However, the year-on-year rate of change in services remained at 1.5%, in line with expectations. Nevertheless, this stability was because various movements offset any rise. The biggest drops in package travel prices offset the trend in hotel and

CONSUMER PRICE INDEX BY COMPONENT GROUP

September

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2009	2010	2009	2010	2009	2010
By type of spending							
Food and non-alcoholic beverages	108.1	0.0	0.1	–2.5	0.0	–2.4	0.1
Alcoholic beverages and tobacco	136.8	0.0	0.0	12.7	8.6	13.0	8.6
Clothing and footwear	95.5	3.6	3.7	–12.3	–11.5	–2.2	0.0
Housing	116.6	–0.1	0.1	0.2	3.6	–0.3	4.2
Furnishings and household equipment	107.6	0.2	0.4	0.1	0.1	1.2	0.8
Health	96.9	0.1	0.0	–1.4	–0.6	–1.2	–0.5
Transport	109.6	–1.5	0.1	3.2	6.1	–6.8	6.8
Communications	98.8	0.0	0.0	–0.3	–0.5	–0.8	–0.5
Recreation and culture	98.0	–1.8	–2.3	–1.1	–0.6	–1.2	–0.7
Education	115.3	0.7	0.6	0.9	0.7	3.2	2.5
Restaurants and hotels	114.0	–1.2	–1.0	1.7	1.9	1.3	1.5
Other goods and services	112.3	0.1	0.1	1.8	2.2	2.1	2.6
By group							
Processed food, beverages and tobacco	112.8	–0.2	0.1	0.5	0.9	0.5	1.1
Unprocessed food	108.5	0.3	0.1	–2.8	1.6	–2.5	1.3
Non-food products	107.7	–0.3	0.1	–0.4	0.8	–1.2	2.4
Industrial goods	103.3	0.1	0.8	–2.3	0.1	–4.0	3.2
Energy products	*117.6*	*–1.7*	*0.2*	*6.1*	*9.7*	*–10.2*	*11.1*
Fuels and oils	*114.5*	*–2.3*	*0.3*	*6.0*	*12.0*	*–15.5*	*13.9*
Industrial goods excluding energy products	*98.2*	*0.8*	*1.1*	*–5.2*	*–3.2*	*–2.1*	*0.4*
Services	112.5	–0.7	–0.7	1.6	1.5	1.8	1.5
Underlying inflation (**)	107.4	–0.1	0.0	–1.1	–0.2	0.1	1.1
GENERAL INDEX	**108.7**	**–0.2**	**0.1**	**–0.4**	**0.9**	**–1.0**	**2.1**

NOTES: (*) Base 2006 = 100.
(**) General index excluding energy products and unprocessed food.
SOURCE: National Institute of Statistics.

other accommodation prices, which fell by less than in September 2009.

The EU harmonised consumer price index also rose by 2.1% in the last year up to September. Spain's price differential with the euro area therefore widened by one tenth of a percentage point to 0.3 percentage points. This increase was mostly due to the trend in fuel and oil prices, which play a larger role in the Spanish basket.

With regard to the outlook for inflation, in October it will probably still be increasing slightly, boosted by rising electricity prices. However, weak demand and the knock-on effect of VAT as from July will tend to reduce inflation in 2011, although there's still the risk of a sudden rise due to raw materials.

The rise in wholesale prices eases

Animal feed prices are being driven up.

In August, both industrial and import prices reduced their annual rate of change due particularly to the energy component. In August, inflation measured by industrial prices stood at 2.7% year-on-year, 0.6 percentage points less than July in spite of the boost provided by intermediate goods, mainly due to the rising prices of animal feed. For their part, the annual rate of change in import prices for industrial products fell by 7 tenths of a percentage point to 8.5%.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2009											
June	–17.2	–4.9	–1.3	0.9	–6.9	–10.1	–10.8	1.3	2.4	–6.0	–
July	–17.9	–6.7	–1.3	0.5	–7.8	–16.0	–11.5	2.0	2.2	–7.1	–
August	–14.8	–5.5	–0.9	0.3	–7.7	–11.5	–9.9	0.6	2.0	–7.4	0.1
September	–14.0	–5.4	–0.7	0.4	–7.6	–11.5	–9.3	–0.5	1.7	–7.6	–
October	–12.2	–4.3	–0.7	0.2	–6.3	–8.4	–7.2	–2.1	1.0	–6.7	–
November	–9.3	–1.8	–0.6	0.2	–4.6	–0.7	–3.2	–3.1	0.5	–5.4	0.3
December	–5.5	0.4	–0.5	0.1	–2.7	6.3	1.9	–1.0	0.7	–1.9	–
2010											
January	–5.5	0.9	–0.5	–0.3	–0.9	6.3	3.4	–0.9	0.1	0.2	–
February	1.0	1.1	–0.6	0.0	–0.4	6.8	4.7	–0.4	–0.1	1.5	0.5
March	5.6	2.3	–0.1	0.0	0.4	10.1	7.2	1.2	0.0	4.3	–
April	2.8	3.7	0.1	–0.1	2.4	13.1	8.3	2.1	0.3	6.6	–
May	13.7	3.8	0.2	–0.1	3.5	12.0	10.2	4.2	1.1	9.9	0.3
June	8.6	3.2	0.3	0.1	3.7	8.7	9.9	5.3	1.5	10.9	–
July	...	3.3	0.3	0.2	3.2	9.8	9.2	4.9	1.6	10.5	–
August	...	2.7	0.0	0.5	3.4	7.0	8.5	5.7	1.4	10.1	...

NOTES: (*) Seasonal and calendar effects adjusted data.
(**) Except energy.
SOURCES: National Institute of Statistics, Ministry of Economy and own calculations.

Foreign sector

International trade: the deficit falls again

The deficit falls in August due to its non-energy component.

The start of 2010 saw the end to more than eighteen consecutive months of correction in the trade imbalance. So much so that the accumulated deficit between January and July this year increased by 11.5% year-on-year, driven by the progressive growth in oil prices and rising imports. This trend came to an end last August with a slight fall in the deficit of 1.4% compared with the same month last year. An improvement that can only be explained by the good performance of its non-energy component, whose balance improved by 13.5% year-on-year compared with a 9.2% rise in the energy deficit.

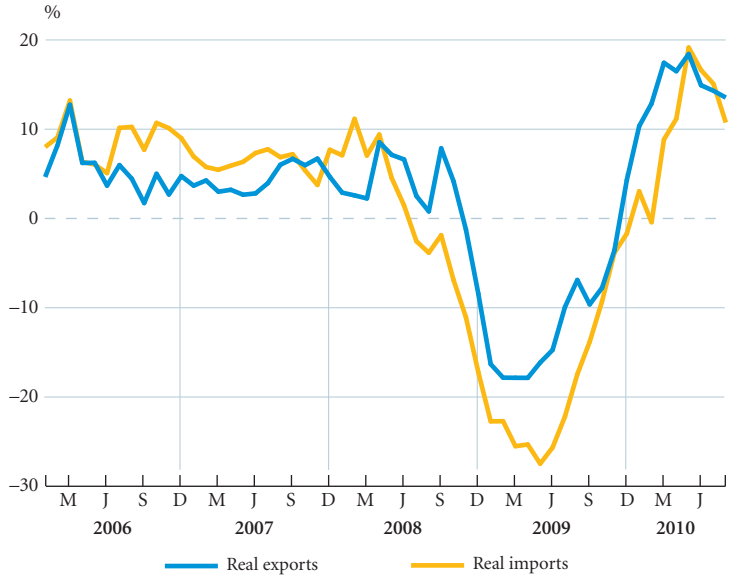
The trend of trade flow volumes shows a smaller rise in real imports.

This reduction in the deficit is the result of the sharp rise in Spanish exports in August, namely 27.8% year-on-year, the highest since the year 2000. A higher increase than in imports, up by 18.8% during the same period. This differential is even wider when we take into account the growth in trade flow volume, i.e. net of price variations. In this case, we can see that exports were actually up by 19.7% year-on-year, while imports rose just 5.8%.

Given this slight slump in imports, it seems logical to wonder about the trend in the trade deficit over the coming months. The answer depends on a wide range of factors. On the one hand, there are those that might widen the trade

REAL IMPORTS LOSE STEAM

Year-on-year change in data accumulated over three months



SOURCES: Ministry of the Economy and own calculations.

FOREIGN TRADE

January-August 2010

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	28,889	29.4	18.8	5,471	24.7	4.6	–23,418	18.9
Consumer goods	38,437	–8.4	25.0	40,217	–1.9	33.8	1,780	104.6
Food	*9,860*	*4.5*	*6.4*	*15,443*	*8.8*	*13.0*	*5,582*	*156.6*
Non-foods	*28,576*	*–12.1*	*18.6*	*24,774*	*–7.5*	*20.8*	*–3,803*	*86.7*
Capital goods	11,388	7.1	7.4	10,075	18.4	8.5	–1,313	88.5
Non-energy intermediate goods	75,301	28.2	48.9	63,261	32.2	53.2	–12,040	84.0
By geographical area								
European Union	84,618	9.0	54.9	80,337	14.6	67.5	–4,281	94.9
Euro area	*67,999*	*5.3*	*44.2*	*65,989*	*14.3*	*55.4*	*–2,009*	*97.0*
Other countries	69,397	23.9	45.1	38,686	22.4	32.5	–30,711	55.7
Russia	*3,954*	*37.8*	*2.6*	*1,200*	*26.8*	*1.0*	*–2,754*	*30.3*
United States	*5,956*	*4.3*	*3.9*	*4,259*	*6.8*	*3.6*	*–1,696*	*71.5*
Japan	*2,324*	*19.3*	*1.5*	*933*	*22.4*	*0.8*	*–1,391*	*40.1*
Latin America	*9,116*	*31.8*	*5.9*	*6,413*	*27.3*	*5.4*	*–2,703*	*70.3*
OPEC	*14,999*	*36.1*	*9.7*	*4,388*	*1.8*	*3.7*	*–10,611*	*29.3*
Rest	*33,049*	*19.9*	*21.5*	*21,494*	*29.8*	*18.1*	*–11,555*	*65.0*
TOTAL	**154,015**	**15.2**	**100.0**	**119,023**	**17.0**	**100.0**	**–34,991**	**77.3**

SOURCES: Ministry of the Economy and own calculations.

imbalance again. The appreciation of the euro over the last few months against the main international currencies might reduce Spanish exports outside the euro area. Moreover, further rises in oil prices would continue to harm the energy deficit.

On the other hand, the coming into force of higher value added tax (VAT) rates and the end of aid for buying cars led to consumption and imports being brought forward in Spain. Imports will therefore lose steam during the second half of the year. In fact, August's figures point in this direction, with a 21.1% fall in imports of finished vehicles compared with the same month last year. Moreover, the growth in imports of consumer durables continued to slow up, namely 3.2% in the same period, much lower than the 29.7% growth year-on-year recorded between January and July.

Lastly, a smaller slowdown than expected in the euro area economies, the destination for 55.4% of Spanish exports in the first eight months of the year, might prevent the trade imbalance from correcting further.

A stronger euro or higher oil prices might slow up the deficit's correction.

Balance of payments: the Eurosystem stops being the source of financing

July's current deficit was 1.9 billion euros, 7.8% lower than in the same month of 2009. This correction, the first after three

The current deficit falls by 7.8% year-on-year in July.

BALANCE OF PAYMENTS

July 2010

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–26,870	10.8	–47,733	8,632	–15.3
Services					
Tourism	*14,900*	*1.2*	*26,211*	*–814*	*–3.0*
Other services	*7*	*–*	*–382*	*648*	*–62.9*
Total	14,907	3.5	25,830	–166	–0.6
Income	–13,293	–35.6	–23,176	13,429	–36.7
Transfers	–6,474	14.9	–8,818	–688	8.5
Total	**–31,731**	**–12.2**	**–53,898**	**21,207**	**–28.2**
Capital account	**4,509**	**89.7**	**6,189**	**2,362**	**61.7**
Financial balance					
Direct investment	5,618	–	5,419	18,428	–
Portfolio investment	–9,508	–	27,444	27,390	–
Other investment	–34,866	–	–50,069	–103,719	–
Total	**–38,756**	**–**	**–17,206**	**–57,901**	**–**
Errors and omissions	–2,903	371.5	–5,297	–4,928	–
Change in assets of Bank of Spain	68,882	–	69,914	39,940	133.2

NOTE: The figure resulting from the sum of current account balance, capital account balance and financial balance is compensated by the change in assets of Bank of Spain plus errors and omissions.
SOURCES: Bank of Spain and own calculations.

The Eurosystem is no longer used for financing in July.

months of rises, was the result of improvements in the balances of services and income, offsetting the sharp drop in the balance of goods, whose deficit was up 39.4% year-on-year. Within services, of note is the bigger surplus for tourism and travel, namely 8.1% year-on-year, the highest in more than two years.

However, in order to see the fundamental trends in the current balance we should analyse the accumulated figures over the last twelve months. These show a slowdown in the deficit's correction, which fell by 28.2% year-on-year, a long way from the reductions recorded at the start of the year. On the other hand, further increases in the capital account's surplus meant that the Spanish economy's net borrowing fell to 47.7 billion euros, a similar level to 2005.

With regard to financial flows, July's lower net borrowing resulted in a fall in foreign capital inflows, with the data showing that the only net source of funding was portfolio investment, with net inflows of 6.6 billion euros in this month. For its part, the use of funds from the Eurosystem through the Bank of Spain was negative, namely 3.5 billion euros. A figure that contrasts with the inflow of 69.9 billion euros that, under this same heading, financed the Spanish economy in June and July as a result of the outbreak of sovereign debt tension.

Public sector

The 2011 budgets: impending austerity

The government has presented its proposal for the 2011 General State Budgets (PGE) for it to be discussed and passed by the Spanish parliament. The main aim of this budget is to rebalance the public accounts due to the commitments acquired through the European Union's Stability and Growth Pact.

Consequently, together with the structural reforms undertaken to improve competitiveness, confidence will increase in the Spanish economy, improving access to financing under affordable terms. After a forecast for the public deficit of 9.3% of gross domestic product (GDP) in 2010 for the public administration as a whole, the forecast for 2011 is 6.0% of GDP and 3.0% in 2013. To achieve this significant adjustment, the main focus has been on reducing spending as well as boosting revenue.

The proposal for the PGE-2011 was drawn up based on a macroeconomic situation that predicts GDP will shrink by 0.3% in 2010 and grow by 1.3% in 2011. It should be noted that this latest rise forecast is markedly higher than the one given by the consensus of analysts, namely 0.6%, as well as by key international organisations.

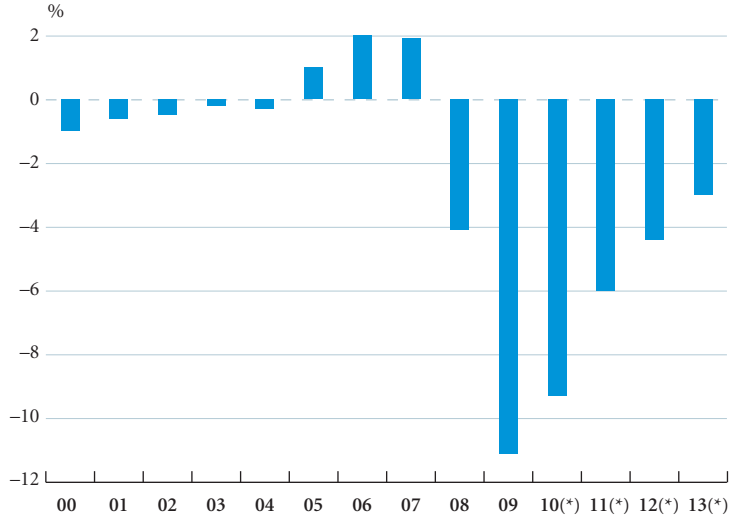
The consolidated expenditure forecast by the proposed PGE-2011 for the central government sector (excluding public companies) totals 315.7 billion euros,

Austere budget for 2011, the main aim being to right the imbalance in the public accounts.

The public deficit is to go from 9.3% in 2010 to 6.0% in 2011 through heavy spending cuts and higher revenue.

THE PUBLIC DEFICIT, ON THE ROAD TO FISCAL CONSOLIDATION

Net lending (+) / Net borrowing (–) of the general government, by percentage of GDP



NOTE: (*) Official forecasts.
SOURCE: Ministry of the Treasury.

Public sector wages frozen, as well as most pensions.

including financial assets. This figure is 10.0% less than the initial budget for 2010. This consolidated expenditure does not include the change in financial liabilities or spending by regional administrations (autonomous communities and local government), nor actions by public companies, foundations or other public bodies. However, a homogeneous comparison cannot be made due to the new financing system for the autonomous communities. Excluding this effect, consolidated expenditure is down 3.5%.

2011 GENERAL STATE BUDGETS: SUMMARY BY AREA

Million euros

	2011 budget	% of total	% annual change (1)	% of estimated GDP	
				2011	2010
Pensions	112,216	35.5	3.6	10.38	10.27
Transfers to other public administrations	42,811	13.6	–41.8	3.96	6.98
Unemployment	30,474	9.7	–1.6	2.82	2.94
Public debt	27,400	8.7	18.1	2.53	2.20
Other economic benefits	13,576	4.3	–5.7	1.26	1.37
Agriculture, fishing and food	8,578	2.7	–4.3	0.79	0.85
Infrastructures	8,493	2.7	–40.7 (2)	0.79	1.36
Citizen security and penitentiary institutions	8,402	2.7	–5.3	0.78	0.84
Services of a general nature	8,185	2.6	–12.1	0.76	0.88
Social Security management and administration	7,771	2.5	22.1	0.72	0.60
Civil research, development and innovation	7,518	2.4	–7.0	0.70	0.77
Promoting employment	7,323	2.3	–5.5	0.68	0.73
Defence	6,868	2.2	–6.6	0.64	0.70
Health	4,254	1.3	–8.2	0.39	0.44
Education	2,841	0.9	–8.1	0.26	0.29
Industry and energy	2,793	0.9	–13.5	0.26	0.31
Foreign policy	2,748	0.9	–22.6	0.25	0.34
Social services and support	2,516	0.8	–8.1	0.23	0.26
Justice	1,713	0.5	–5.8	0.16	0.17
Transport subsidies	1,620	0.5	1.9	0.15	0.15
Trade, tourism and SMEs	1,431	0.5	–5.3	0.13	0.14
Financial and tax administration	1,410	0.4	–6.0	0.13	0.14
Access to housing	1,210	0.4	–19.3	0.11	0.14
Culture	1,051	0.3	–12.3	0.10	0.11
Military research, development and innovation	976	0.3	–17.5	0.09	0.11
Other actions of an economic nature	809	0.3	–4.5	0.07	0.08
Senior management	678	0.2	–17.1	0.06	0.08
TOTAL (3)	**315,663**	**100.0**	**–10.0**	**29.19**	**33.25**
Total (4)	287,629	91.1	–3.5	26.60	28.27

NOTES: (1) Related to the 2010 budget.
(2) If public sector corporations and some asset contributions are included, investment in infrastructures falls to 29.6%.
(3) Includes change in financial assets.
(4) Total with financial assets, excluding the financing system for regional governments.
SOURCES: Ministry of the Treasury and own calculations.

In current operations, staff costs are down 2.7% as the wages for public sector employees have been frozen, with a 5% average wage cut starting to have an effect, applied as from June 2010, and also by only filling one out of every ten vacancies in 2011. The reduction in current payments for goods and services is higher, namely 6.2%.

From a different perspective, namely by spending area, it can be seen that the cuts affect almost all areas. The only group of areas to increase is social spending, up 1.3% annually. Its share of the total has therefore continued to rise, up to 58.0%, the highest level recorded and now accounting for 16.9% of GDP. It should be noted that most of the spending on education and health has been transferred to the autonomous communities and is not included in the PGE-2011.

The largest item, pensions, increases by 3.6% in 2011 and accounts for 35.5% of total consolidated expenditure and 10.4% of GDP. This rise, in spite of the freeze on pensions, reflects the rise in the number of pensioners, the effect of replacing lower pensions with higher ones and a 1% increase in minimum and non-contributory pensions. Moreover, 3.5 billion euros will be allocated to the pension Reserve Fund. The other big item in social expenditure, unemployment, fell by 1.6% to 30.5 billion euros.

The biggest cuts in relative terms have fallen on infrastructures, down 40.7% to 8.5 billion euros, accounting for 2.7% of the budget and 0.8% of GDP. However, if we include investment in public companies and some asset contributions to various public bodies, this drop reduces to 29.6% annually. Nevertheless, investment is still above the average for the European Union.

Research, development and innovation haven't escaped the cuts either. Both civil and military areas have suffered, although the latter to a greater degree. Overall, R&D and innovation is down 8.4% to 8.5 billion euros, 2.7% of the total. This figure represents 0.79% of GDP, one tenth of a percentage point lower than 2010's figure and slightly below the investment level of more developed countries.

Interest payments for the public debt absorb 8.7% of the budget, totalling 27.4 billion euros, 2.5% of GDP. This item rises to 18.1% annually, particularly because of the growth in public debt.

On the other side of the balance sheet, consolidated non-financial income is expected to fall to 4.3%. However, this drop can be put down mainly to the effect on the state budget of the full application of the new financing system for autonomous communities, which will be given a larger proportion of taxes. In fact, net tax revenue for central government before this transfer to the autonomous communities is expected to rise by 6.1% compared to the expected result for 2010.

Revenue from personal income tax is forecast to rise by 6.2%. Some regulatory changes will contribute marginally to this rise, whose main aim is to spread the burden of the crisis more fairly. The state marginal rate therefore increases for taxpayers with a general taxable income equal to or greater than 120,000 euros, by one percentage point from 21.5% to 22.5%, and by one additional point as from 175,000 euros, to 23.5%. Moreover, a 300,000 euro limit has been introduced in the case of income generated over several tax years, so that taxpayers can benefit from a 40% reduction in personal income tax, whose aim is to reduce the effect of escalation. Measures have also

Social spending rises to 58% of all consolidated expenditure, the highest share ever.

Dramatic fall in spending on infrastructures.

R&D and innovation down by 8%.

Rise of 2 points in the marginal rate for personal income tax.

been established to avoid tax deferral by SICAV shareholders (open-end investment companies).

The elimination of the deduction in personal income tax for buying a primary residence for those taxpayers with a taxable base larger than 24,170 euros will have a greater impact on revenue. In the opposite direction, but with the aim of boosting the rental market, the limits to the deduction for renting accommodation have been made comparable to the limits to the deduction for buying a primary residence. The reduction in net profit for leasing property for housing has also been raised from 50% to 60%, and the age of entitlement for applying the 100% reduction to tenants has been lowered from 35 to 30.

Public debt is expected to be 69% of GDP by the end of 2011, slightly below the average for the euro area.

Corporate tax rises to 9.3% compared with the leading figures for 2010 revenue due to the expected recovery in company earnings. On the other hand, in order to support SMEs, the Corporate Tax act has been amended so that small organisations that are no longer SMEs because they exceed the limit of 8 million euros in turnover can still be entitled to the special tax rate they benefit from.

Given these trends in the budget's revenue and spending, the state has a deficit of 44 billion euros in 2011, which becomes 24.4 billion euros on a national accounts and on an accrual basis and after having made the appropriate adjustments. For the central government, the forecast for the public deficit is 2.3% of GDP which, together with a 0.4% surplus in Social Security, a 3.3% deficit for the autonomous communities and 0.8% for local corporations, provides an overall public administration deficit of 6.0%. It is therefore projected that the ratio of public debt to GDP will reach 68.7% by the end of 2011, although this would place it slightly below the 88.5% average for the euro area.

Which measures could make the healthcare system more sustainable?

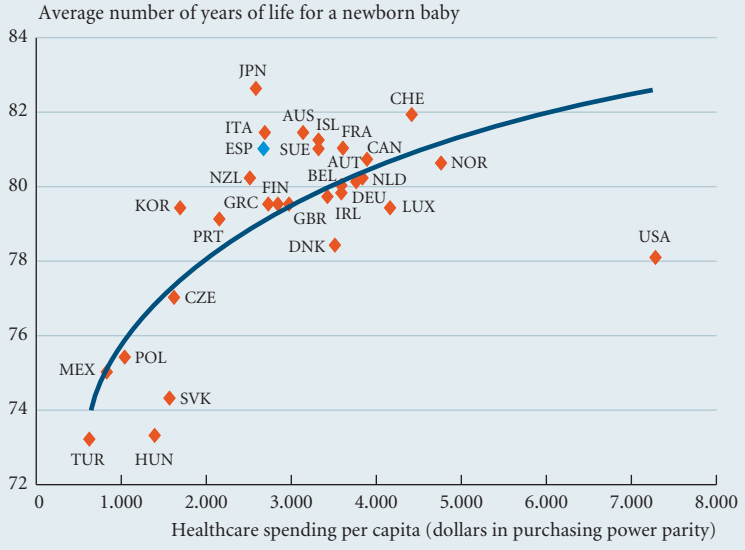
The latest ranking of healthcare system quality by country produced by the magazine *Newsweek* places Spain fourth. In fact, this country has one of the highest life expectancies of the Organization for Economic Cooperation and Development (OECD) with one of the lowest costs in terms of healthcare spending per capita. Clinical results are also at the level of the most advanced countries, as shown, for example, by the cancer survival rates analysed by Eurocare. Spain's healthcare system therefore provides a good service at a low cost, as reflected by these indicators.

However, the current crisis has led to fierce debate regarding how the system's financial situation could be improved. According to data from the Ministry of Health and Social Policy, public healthcare spending rose in real terms by an average of 6% year-on-year over the last six years. It will be difficult to keep up this rate of growth over the next decade as, among other factors, the deficit accumulated by healthcare already accounts for a very high proportion[1] of the total budget for this area.

(1) In the study by McKinsey&Company and Fedea «Impulsar un cambio posible en el sistema sanitario» (2009), it is estimated that the funding deficit accumulated over the period 2003-2007 accounted for 20% of the total healthcare budget in 2007.

SPAIN: HIGH LIFE EXPECTANCY WITH LOWER PER CAPITA COSTS THAN THE OECD AVERAGE

Life expectancy and healthcare spending (*)



NOTE: (*) Data refer to 2007 or the most recent data available.
SOURCES: «Health at a glance 2009, OECD Indicator» and own calculations.

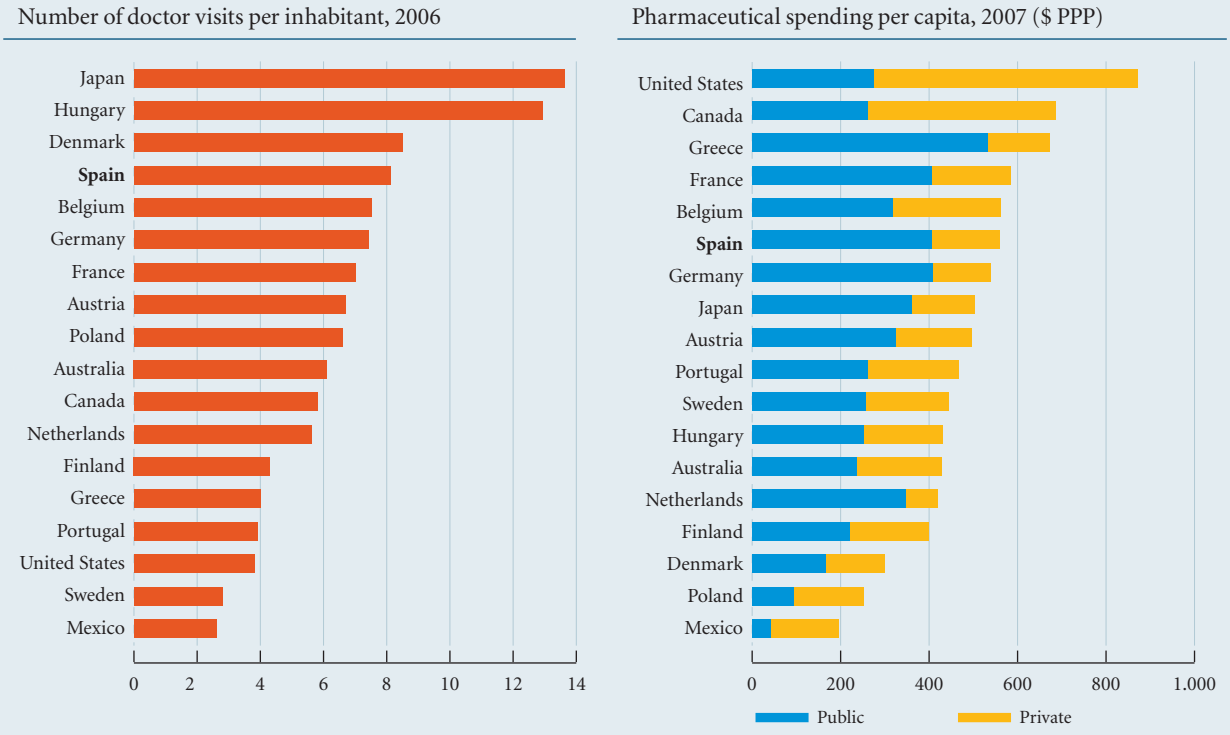
On the other hand, demand for healthcare services will substantially increase over the coming decade both for demographic reasons (a higher proportion of people aged over 65, whose healthcare cost is around four times higher) and technological reasons (new operations and treatments). Both factors will exert greater pressure on healthcare spending (see the box «What determines healthcare spending...»).

Within this context, not only will it be necessary to increase the public and private resources allocated to healthcare but formulas will also have to be designed to ensure these resources are used effectively by agents (patients, professionals and managers) with the least impact on the population's health. There are two ways of doing this: by acting on demand, or on supply.

From the demand point of view, most instruments focus on a more rational use of healthcare services, with co-payment being the main mechanism. Some data show the importance of increasing patient responsibility, be it in how they use the system or in their awareness of their own health. By way of example, the graph below shows that the frequency of doctor visits is relatively high in Spain, partly denoting a possible over-use of healthcare services. Similarly, pharmaceutical cost per capita is higher than in other advanced countries and accounted for almost 20% of the 2008 total healthcare budget. Spain does not do too well either when it comes to looking after one's own health, considering the figures for the number of smokers or those who are overweight.

Part of this inefficiency in healthcare spending is the result of users not being aware of the cost of healthcare. One possible way to reverse this tendency would be by introducing co-payment formulas or producing programmes aimed at raising the population's awareness of the real cost of services.

DOCTOR VISIT FREQUENCY AND PHARMACEUTICAL COSTS IN SPAIN ARE AMONG THE HIGHEST IN THE OECD



SOURCES: OECD health data 2010 and own calculations.

Although co-payment might increase users' co-responsibility in the healthcare system, there's a dilemma regarding its implementation, particularly in how to design it so that services are used effectively but without them becoming a tax on sick people. To this end, the following questions must be asked: Firstly, for which services (hospitalisation, emergency, primary healthcare) and which drugs? Secondly, for whom? (Excluding, for example, the chronically ill, pensioners or those in the lowest income bracket). Thirdly, how should the payment be made: with fixed fees or percentages, with or without a ceiling, linked to income or with selective tax rebates?

International experiences can help us decide how co-payment should be applied.[2] Most studies highlight the fact that, on average, higher co-payment does not lead to worse health among the population except for high-risk patients (with high blood pressure, heart problems, etc.) and the poorest. Another important factor is the risk of patients reducing their healthcare consumption, both in treatments that are important for their health and others that are not. The only exception are emergency services, as there's no evidence that patients reduce their consumption when they pay part of the cost in truly urgent situations. From these findings we can see that, should co-payment be introduced, it should take into account patients' income and state of health.

From the point of view of the supply of healthcare services, costs might also fall if the use of resources by professionals were optimised. Regional differences, for example, in diagnostic tests (CAT scans, NMR, mammograms) or in the average number of surgical operations per bed show that practices can become more efficient. This is achieved by making the work of healthcare service providers more transparent, so that managers

(2) Mas, N. «The healthcare crisis». Comentarios de Coyuntura. IESE Business School. November (2009).

can reform those procedures that operate most inefficiently. With this aim in mind, the Institute of Healthcare Information in Spain gathered together a series of Key Indicators for the National Healthcare System, although the total number of variables and their frequency are still quite limited.

Other countries' experiences also suggest that an organisational model that allows professionals greater autonomy in managerial terms encourages their involvement because they become more responsible for the results. Of note is the British case, where hospitals are now foundations responsible for the risks involved in their management and they must meet quality targets that affect how they are paid.

On the other hand, it is also important to implement an incentive scheme that rewards the merits of professionals. The high number of workers in the sector with temporary contracts points to job instability that is not very motivating. The payment system needs to be improved and, to this end, it is once again useful to observe the changes made in other countries. In France, for example, the position of hospital director has been strengthened, gaining in management responsibility and with a stable team.

Lastly, the constant emergence of new treatments and technologies may improve our quality of life but generally involves higher costs and this means it is essential to design a system that guarantees these new techniques will be analysed in cost-benefit terms. Internationally there are examples of organizations in charge of calculating the cost-effectiveness of a new treatment before it is implemented, such as the NICE in the United Kingdom, IQWIG in Germany and HAS in France. The British NICE, for example, is an independent body that makes recommendations in the area of health on whether to incorporate new treatments within the portfolio of state-funded provisions. Although there are some such organizations in Spain, such as the Drugs Agency, which assesses the quality of healthcare drugs and products, their functions are more limited and the mechanisms they use to assess cost-effectiveness are less methodical.

In short, although Spain's healthcare system is working relatively well, the current model can be made more efficient. It is therefore vital to look for new formulas to increase responsibility for the use of resources, both among the patients demanding services as well as among the professionals and managers providing them.

This box was prepared by Maria Gutiérrez-Domènech
European Unit, Research Department, "la Caixa"

Savings and financing

In the fourth week of October, the one-year Euribor passes the rate of 1.5%, a level not reached since June 2009.

Financing to non-financial firms down 1.7% in the last twelve months up to August, but the rate of decline is slowing.

Private sector financing: falls in firms and rises in households

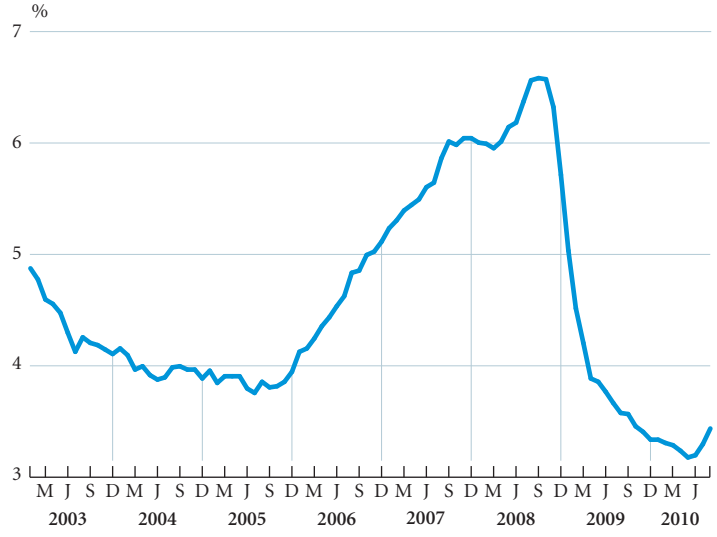
The approach taken by the European Central Bank of gradually withdrawing extraordinary monetary stimuli once the serious crisis of the last few years has been overcome has meant that the one-year Euribor, used as the reference rate for numerous credit operations, has tended to increase slightly over the last few months in the interbank market. It went above 1.5% in the fourth week of October after having stood at a monthly average of 1.42% in September, posting its highest rate since June 2009. Within this context, asset interest rates also tended to pick up in the summer, the average interest rate for credit operations with the private sector standing at 3.41% in August, 25 basis points above May's level but 15 basis points below that of a year ago.

However, the real interest rate, i.e. discounting inflation, fell in the last few months. This might have had something to do with the slight slowdown in private sector deleveraging, in parallel with the moderation in public sector debt. The year-on-year rate of change for resident sector financing therefore held steady at 2.7% in August.

Financing to non-financial firms stood at –1.7% in August compared with the same figure month a year ago, revealing

SLIGHT UPSWING IN NOMINAL INTEREST RATES

Overall interest rate for loans and credit to the private sector (*)



NOTE: (*) Average of interest rates for new operations for financial institutions as a whole, adjusted by the amounts in euros.
SOURCE: Bank of Spain.

FINANCING OF NON-FINANCIAL SECTORS (1)

August 2010

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,208,337	–7,025	–0.7	78.7
Non-financial corporations	1,304,768	–7,581	–1.7	46.5
Resident credit institution loans (3)	*900,351*	*–16,009*	*–2.2*	*32.1*
Securities other than shares	*62,570*	*6,311*	*26.7*	*2.2*
External loans	*341,847*	*2,118*	*–4.7*	*12.2*
Households (4)	903,569	557	0.7	32.2
Housing loans (3)	*679,862*	*1,310*	*0.9*	*24.2*
Other (3)	*220,981*	*–844*	*0.0*	*7.9*
External loans	*2,727*	*90*	*4.5*	*0.1*
General government (5)	599,787	39,200	17.9	21.4
TOTAL	**2,805,412**	**31,808**	**2.7**	**100.0**

NOTES: (1) Resident in Spain.
(2) Year-on-year rates of change calculated as effective flow/stock at beginning of period.
(3) Include bank off-balance-sheet securitized loans.
(4) Include those non-profit institutions serving households.
(5) Total liabilities (consolidated). Liabilities among public administrations are deducted.
SOURCES: Bank of Spain and own calculations.

a slowdown in deleveraging, given that the year-on-year drop in April was 3.1%. This has also been affected by the improvement in the overall economic situation and in financial markets. Bonds rose by 26.7% in the last twelve months up to August, 0.8 points more than in the previous month. However, foreign loans fell by 1.2% compared with a year earlier.

With regard to resident bank credit, this was 2.2% below the level of August 2009. Within this figure, commercial credit, aimed at financing firms' working capital, was down 9.1% compared with a year earlier but falling at a slower rate than at the start of the year. For their part, financial leases reported a year-on-year decrease of 14.2%, less than in the previous period but indicative of weak investment.

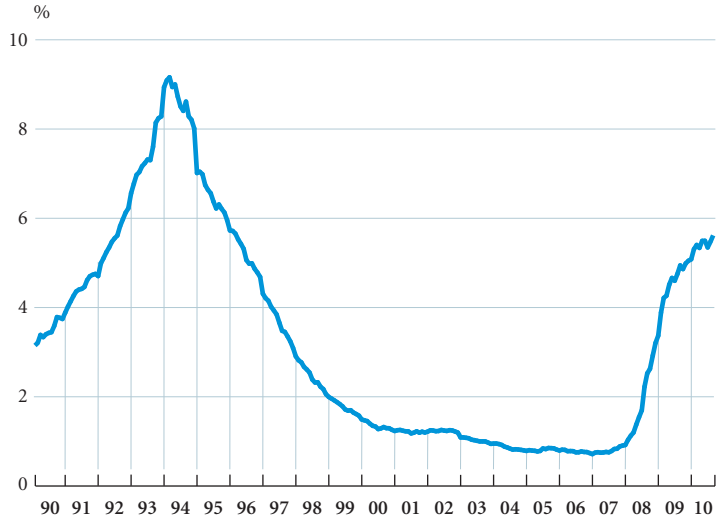
With regard to households, their financing has remained practically stable over the last few months, with a year-on-year growth of 0.7% in the last twelve months up to August. In fact, this slight rise is due entirely to housing loans, which have livened up over the last few months given that the theoretical effort required to buy a property has decreased, thanks to lower prices and with the impending partial removal of the tax rebate as from January 2011, encouraging people to buy before this change comes into effect.

With regard to non-performing loans, these continued to rise slightly in August in line with the high levels of unemployment. The default rate therefore reached 5.6%, 0.1 percentage points higher than in July and 0.7 more than twelve months ago. However, the level of non-performing loans is slightly below the maximum level recorded in the previous recession of 1992-1993.

Loans to households rise slightly due to renewed interest in mortgages for homes.

NON-PERFORMING LOANS CONTINUE TO RISE BUT ARE BELOW THE LEVELS OF THE PREVIOUS RECESSION

Default rate in the private sector for financial institutions as a whole (*)



NOTE: (*) Due to some changes in accounting and legislation, the rate is not strictly homogeneous throughout the period.
SOURCES: Bank of Spain and own calculations.

The risk premium for sovereign bonds falls.

For its part, public debt continued to slow up, in line with the government's aims for fiscal consolidation. It therefore posted a year-on-year change rate of 17.9%, 8 tenths of a percentage point less than July and 17.4 points below the rate for October 2009. On the other hand, in the first few weeks of October, the risk premium for Spanish sovereign debt fell, measured by the difference between the return on Spanish ten-year government bonds and similar German bonds, which went from 196 basis points at the end of September to 164 basis points in the middle of the last week in October. The fact that the rating agency, Moody's, downgraded Spanish sovereign debt on 30 September by one notch from Aaa, the maximum, to Aa1 with a stable outlook did not have a negative effect, as some agents in the market had already ruled out a downgrade of two notches.

Slight expansion in bank deposits

The rise in consumption in the second quarter led to a marked downward swing in household savings, which stood at 16.2% of available income calculated over the last four quarters. This rate was 1.5 points lower than in the preceding moving period. Nonetheless, this is still a relatively high level, caused by precaution given the high unemployment and persistence of some economic uncertainty, standing at 5 points above the pre-crisis level. Savings generated by households, together with net transfers received, financed investment totalling almost 15 billion euros and net lending of 18.3 billion euros, 6.7% of quarterly GDP.

Most of these net financial savings took the form of bank deposits and the balance for private sector deposits with

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

August 2010

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	257,946	–4,789	–1.8	3,087	1.2	18.3
Savings deposits	211,500	3,709	1.8	14,049	7.1	15.0
Term deposits	727,163	7,151	1.0	–8,094	–1.1	51.5
Deposits in foreign currency	19,561	–2,454	–11.1	–4,939	–20.2	1.4
Total deposits	**1,216,171**	**3,618**	**0.3**	**4,102**	**0.3**	**86.2**
Other liabilities (*)	**195,336**	**–17,794**	**–8.3**	**–13,263**	**–6.4**	**13.8**
TOTAL	**1,411,507**	**–14,176**	**–1.0**	**–9,160**	**–0.6**	**100.0**

NOTE: (*) Aggregate balance according to supervision statements. Includes asset transfers, hybrid financial liabilities, repos and subordinated deposits.
SOURCES: Bank of Spain and own calculations.

banks therefore rose by 0.3% in August compared with twelve months before. On demand deposits and savings accounts lost their appeal compared with term deposits, whose returns have tended to rise over the last few months. However, over the last year the highest relative increase has been in savings deposits, reflecting the precaution of households.

The competition between bank deposits and the erratic nature of international financial markets affected another favourite product of savers, namely mutual funds. In September, negative net withdrawals totalled 1,847 million euros, higher than the volume of monthly gains, so that assets fell by 0.9% to 145,885 million euros. However, notable net subscriptions were recorded in mixed international bonds and international equity. The annual average return was 0.9%, although with a wide spread. While international mixed equity for emerging markets enjoyed 24.0%, domestic equity stood at –7.2%.

On the other hand, and due to G20 commitments, the European Union's Economic and Financial Affairs Council reached agreement on a draft directive to harmonise the supervision of hedge funds. To date, these funds had not been supervised or regulated specifically at a European level. Once approved by the European Parliament, this new legislation will improve transparency in risk management for these funds, as well as other alternative investment funds, and particularly concerning leveraging. Investor protection will also be enhanced, while it's also planned for funds based outside the European Union to be able to operate throughout the community provided they have obtained permission from an EU member state authority.

Term deposits become more attractive with a rise in their returns.

The regulation of hedge funds is defined for the first time at a European level.

"la Caixa" Research Department

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As of December 31, 2009

FINANCIAL ACTIVITY	Million euros
Total customer funds	237,799
Receivable from customers	178,026
Profit attributable to Group	1,510

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	27,505
Branches	5,326
Self-service terminals	7,951
Cards (million)	10.3

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2010	Million euros
Social	356
Science and environmental	62
Cultural	55
Educational and research	27
TOTAL BUDGET	**500**

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