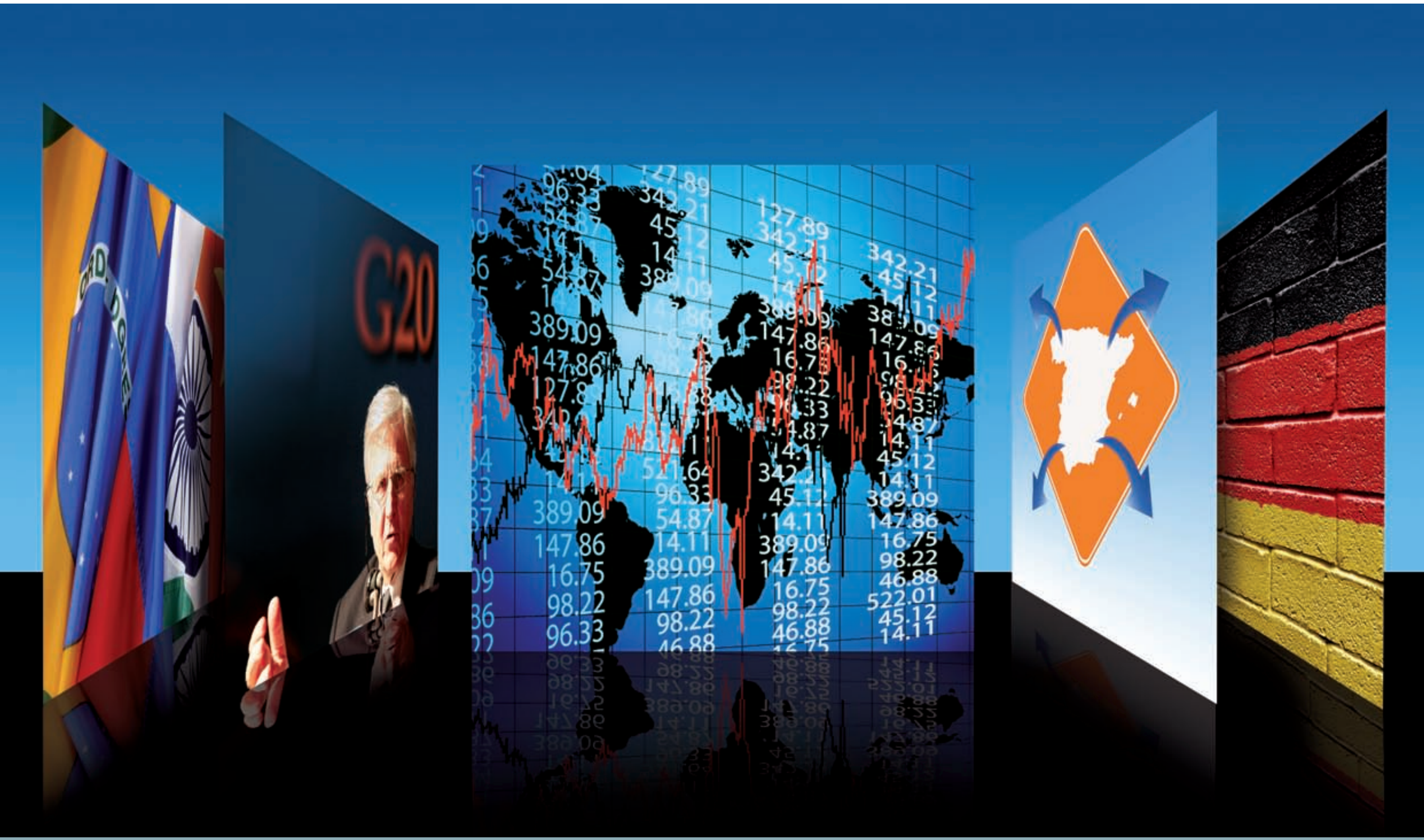
NUMBER 341 • DECEMBER 2010

THE SPANISH ECONOMY

Monthly Report



OUTLOOK 2011

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2009	2010	2011	2009 3Q	2009 4Q	2010 1Q	2010 2Q	2010 3Q	2010 4Q
INTERNATIONAL ECONOMY		Forecast							Forecast
Gross domestic product									
United States	–2.6	2.8	2.2	–2.7	0.2	2.4	3.0	3.2	2.5
Japan	–5.3	3.6	1.5	–4.9	–1.3	4.7	2.7	4.1	3.1
United Kingdom	–4.9	1.5	2.4	–5.4	–3.0	–0.3	1.7	2.8	2.8
Euro area	–4.0	1.7	1.6	–4.0	–2.0	0.8	1.9	1.9	2.1
Germany	*–4.6*	*3.5*	*2.1*	*–4.4*	*–2.0*	*2.1*	*3.9*	*3.9*	*4.1*
France	*–2.2*	*1.6*	*1.8*	*–0.4*	*0.4*	*1.3*	*1.7*	*1.9*	*1.8*
Consumer prices									
United States	–0.3	1.6	1.3	–1.6	1.5	2.4	1.8	1.2	1.0
Japan	–1.4	–0.9	–0.3	–2.3	–2.0	–1.1	–0.9	–0.8	–0.6
United Kingdom	2.2	3.1	2.5	1.5	2.1	3.3	3.4	3.1	2.9
Euro area	0.3	1.6	1.7	–0.4	0.4	1.1	1.5	1.7	1.9
Germany	*0.3*	*1.1*	*1.5*	*–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	1.2	1.1	–4.2	–2.6	–0.3	2.2	1.4	1.3
Government consumption	3.2	–0.3	–1.5	2.7	0.2	–0.5	0.1	–0.1	–0.6
Gross fixed capital formation	–16.0	–7.2	–1.7	–16.4	–14.0	–10.4	–6.8	–7.0	–4.8
Capital goods	*–24.8*	*2.7*	*6.1*	*–25.5*	*–16.9*	*–4.4*	*8.7*	*2.4*	*4.0*
Construction	*–11.9*	*–10.9*	*–5.5*	*–11.7*	*–11.9*	*–11.4*	*–11.4*	*–11.6*	*–9.1*
Domestic demand (contribution to GDP growth)	–6.4	–1.1	–0.1	–6.5	–5.3	–2.9	–0.3	–0.8	–0.5
Exports of goods and services	–11.6	10.1	7.0	–11.0	–2.1	9.1	11.6	8.7	10.9
Imports of goods and services	–17.8	5.5	3.8	–17.2	–9.2	2.3	9.3	3.9	6.2
Gross domestic product	**–3.7**	**–0.2**	**0.7**	**–3.9**	**–3.0**	**–1.4**	**0.0**	**0.2**	**0.5**
Other variables									
Employment	–6.6	–2.3	–0.3	–7.2	–6.0	–3.8	–2.5	–1.7	–1.3
Unemployment (% labour force)	18.0	20.0	20.2	17.9	18.8	20.0	20.1	19.8	20.1
Consumer price index	–0.3	1.7	1.5	–1.1	0.1	1.1	1.6	1.9	2.3
Unit labour costs	1.0	–1.0	–0.5	0.3	0.0	–0.8	–1.0	–1.4	
Current account balance (% GDP)	–5.5	–4.7	–3.7	–4.0	–4.7	–6.1	–5.0	–3.3	
Net lending or net borrowing rest of the world (% GDP)	–5.1	–4.2	–3.2	–3.7	–4.4	–5.4	–4.3	–2.7	
General government financial balance (% GDP)	–11.1	–9.5	–6.4						
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	2.6
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	1.36	1.43	1.48	1.38	1.27	1.29	1.38

Contents

Outlook 2011

After falling into the hell of the Great Recession of 2008-2009, the year 2010 offered well-grounded hopes of recovery. Unlike the Florentine poet, the world economy did not descend through Dante's nine circles of hell but rather decisive action by national authorities managed to brake this fall and reverse the direction to the paths of salvation. The year that is now ending has set a firm course to exit the crisis. But as we already warned a year ago, the extent of the fall and the bold remedies implemented mean that we must be cautious. We have definitely left the crisis behind us but are still facing a complicated road ahead.

First of all, the risk of a double-dip recession has been ruled out and recovery is progressing reasonably well. But some developed economies have lost steam and progress is weaker than in previous exits. An environment of sustained growth in production and world trade is fundamental to tackle the first of the three great challenges facing the world's economy, namely withdrawing fiscal stimuli and reversing the relaxed monetary policy applied but without harming the recovery in activity.

The good news is that the emerging world, hardly affected by the recession, has reached a cruising speed that seems consolidated and sustainable, and is pulling along the rest. The Organization for Economic Cooperation and Development forecasts more than 4% growth in global production for 2011 and 2012, thanks largely to the emerging economies. However, major doubts are tormenting the world's leading economy, the United States, whose recovery has stalled in the second half of the year, and it has still not completely digested the effects of its real estate bubble and can't create enough jobs to face the immediate future with confidence. In any case, we predict that, in 2011, the US economy will grow somewhat more than 2%, a modest rate compared with other episodes of recovery but reinforcing the progress made in 2010.

Wary of the just how solid the recovery might be, the United States' central bank, the Fed, has launched another round of quantitative easing whose aim is to lower long-term interest rates, boost the stock market and improve consumer confidence. But this new injection of liquidity has led to a fall in the dollar and the revaluation of certain emerging currencies, further complicating a panorama that was already complex and disrupting the second great challenge for next year: the correction of global imbalances. The «currency war» is threatening to turn into an episode of escalating protectionism, which would invariably put paid to the recovery, as might also happen if the extensive balance of payments imbalances continue.

The third great challenge of 2011 will be to push forward with the structural reforms that underpin these two previous challenges and to correctly apply the lessons learned from the crisis. Particularly in the banking system, with the gradual adoption of Basel III, but also in other areas of the economy in order to boost growth potential, improve public sector productivity, remove obstacles to job creation and redirect the private sector's heavy borrowing. These reforms will help to restore macroeconomic stability and confidence, thereby ensuring once and for all that we exit the worst recession in decades.

EXECUTIVE SUMMARY

The sovereign debt crisis worsens once again

Ireland is involved in a new episode of sovereign debt crisis.

After a good start to the year, in which recovery seemed to be on the right track, the world economy is taking its leave of the year with a greater risk of a slowdown in growth, although a double-dip recession has been ruled out. However, all eyes have once again been on the tensions in the euro area's sovereign debt markets, reappearing after everyone had believed the situation to be under control after the episode before the summer. How economic policy responds will once again be crucial, both in terms of providing another boost to the economy as well as handling the tensions in the government bond market.

Its origin lies in the effects of the real estate slump on its banks' balance sheets.

The new chapter in the European sovereign debt crisis is being written by Ireland. Unlike the case of Greece, which was caused by serious problems of competitiveness and a lack of transparency in public sector management, there are fewer doubts concerning the growth potential of the Celtic tiger. Its problem lies in the huge adjustment in its real estate industry and its overlarge banking sector. When the international financial crisis was at its peak, the Irish government promised to guarantee all bank liabilities in order to avoid financial panic in its economy. But the hole created in its banks by the real estate sector has been larger than expected. In fact, after the summer, the Irish government once again had to inject large amounts of capital into its banking system which made the deficit expected for this year shoot up to no less than 32% of gross domestic product (GDP).

Financial aid is set at 85 billion euros, in exchange for a tough adjustment plan.

One of the direct consequences has been the closure of wholesale financing markets for the Irish banking system, forcing it to obtain liquidity via the European Central Bank (ECB). Ireland can meet its public debt payments up to mid-2011, but the situation of the Irish banks and the financial effort required to inject capital on the part of the central government finally convinced the European Union that it was necessary to draw up a bailout plan.

Ultimately, the financial aid offered to Ireland totals 85 billion euros. This is mostly expected to go towards recapitalizing, restructuring and reducing the size of the banking sector. In exchange, the Irish government has undertaken to apply a draconian adjustment plan that includes cutting 25,000 civil service jobs, big cuts in social expenditure, a drop in pensions and the minimum wage and a rise in value added tax (VAT) to 23% in 2014.

However, the action taken to stabilize the Irish economy has barely eased the tension in the markets. Interest rate spreads for the debt of some of the most exposed countries compared with German debt have widened, there are still fears that one or more countries will go the same way as Greece and Ireland, and it has even not been entirely ruled out that some economies might have to leave the euro. It is to be hoped, however, that the gradual clarification of the economic and financial prospects, as well as the decisions taken by the Eurogroup, will help get markets back to normal, as happened in the episode in the middle of the year.

Portugal is one of the countries under scrutiny due to its slowness in applying adjustment policies, the persistence of its foreign deficit and especially because of the zero progress made in terms of reducing its public deficit. Neither has its domestic political situation helped the most decisive measures to be adopted that would relieve the high deficit and growing public debt.

Spain has also been affected by tensions in the current European sovereign debt crisis, although the central government's deficit is falling as planned (down 47% in the first ten months of 2010) and public debt remains below the European average. The risks perceived by the market now lie in the restructuring of its financial system, the transparency of public accounts in regional governments and the application of structural reforms. The Bank of Spain has therefore announced new measures to increase the information provided by financial institutions regarding real estate exposure. It has also set a target to finalize the mergers of savings banks by the end of the year. For its part, the Ministry of the Treasury has announced new regulations to improve the budget information provided by autonomous communities. Moreover, the Spanish cabinet has approved a calendar of legislative initiatives that, among others, includes pension and collective bargaining reforms throughout the first quarter of 2011.

In Europe as a whole, the Union's Finance ministers have reached a draft agreement establishing the broad lines for the new support facility for countries at risk, which will be implemented 2013 when the current European Financial Stability Facility expires. As from the middle of that year, all debt issues by countries in the euro area will include clauses establishing the conditions under which certain aspects can be modified, such as the repayment period, interest rate or even reducing the principal.

Another element that might help to improve market perspectives are the favourable economic results recorded by the euro area. In the third quarter, the growth rate stood at 0.4%, a good figure after the strong growth posted in the second quarter. The driving force behind activity is Germany, with exceptional dynamism that can be seen when we look at, among other indicators, the trend in the IFO index for business activity, which has risen above the maximum reached in 2006. The situation of the different economies that make up the euro area is uneven, with Denmark and Finland at the head, enjoying annual growth of 3.5%-4%, and Greece and Ireland bringing up the rear, still in recession.

In Spain, year-on-year growth was positive in the third quarter at 0.2%, the first positive rate after seven quarters of falls. However, the third quarter saw GDP stall after a perceptible recovery in the first half of the year. This slowdown can particularly be explained by the effect of the tax hike in July (VAT), the withdrawal of direct aid for buying vehicles and restrictive budgetary measures, such as the cuts in civil service wages. Growth is expected to reappear in the last part of the year and especially throughout 2011, when the recovery is expected to take hold firmly.

Portugal and Spain have been infected by the Irish bailout.

Spain considerably reduces its public deficit in 2010 and prioritizes continual reforms and adjustment.

The euro area's economy continues to provide good news on growth, while Spain's GDP stabilizes in the third quarter.

In the United States, the recovery doesn't appear to be fully consolidated and the Fed extends its government bond purchase programme.

European interbank rates are not likely to change over the coming months.

As the debt crisis eases, financial markets will recover their positive perspectives.

In general, in 2011 advanced economies will continue to record sluggish growth while the emerging economies will only slightly lessen the good pace they've enjoyed throughout 2010. These differences can also be seen in inflation. Industrialized countries are therefore very likely to maintain a lax monetary policy, while less developed countries will continue to restrict theirs.

The United States' economy, which has accumulated low production capacity utilization and a moderate inflation rate, is one of the key figures in this disparity. The third quarter's figures continue to point towards a modest recovery, with an economy that grew by 0.5% quarter-on-quarter, and the latest actions by the Federal Reserve are framed within this complex context. At its meeting on 3 November, the Fed took a far-reaching decision: to extend its bond purchase programme to support the reactivation in growth and sustain price stability while preventing deflation.

The strategy that the institution presided over by Ben Bernanke has decided to follow has supporters and critics. The latter argue that the meagre economic benefit does not offset the high risk of inflation incurred. In this respect, important members of the Fed have countered these criticisms by stating that the institution has the necessary instruments to toughen up monetary conditions without the need to reduce the size of its balance sheet.

Within a scenario where the ECB does not foresee any substantial changes and most liquidity has already been drained off, Euribor interbank rates are unlikely to see any big variation over the coming months. In the medium term, and as the central bank drains of liquidity or clearly indicates that it will start to raise interest rates, the European interbank rates are likely to rise gently.

For their part, countries such as China, Brazil, South Korea, India and Chile have recorded strong economic growth and a significant upswing in inflationary risk. The response by national central banks has been to raise official interest rates to keep these pressures under control. Within this complex situation, the main stock markets have performed in a wide range of ways and erratically. In the medium term, the outlook for international mixed equity is still positive, although fluctuations have not been ruled out by analysts.

The greater fall in European stock markets and especially the Spanish stock market has pushed indicators up to attractive levels. Consequently, and in the medium term, as the euro area's public debt crisis abates, the gap should close between its equity prices those of the United States and the emerging countries, meaning that confidence has been restored and the recent debt crisis has been successfully handled.

29 November 2010

CHRONOLOGY

2009

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**.

November
19 The government establishes a **legislative calendar** that includes **pension and collective bargaining reforms**.
24 **Ireland** presents an a**djustment plan** with tough measures to cut its public deficit in order to receive **financial aid** from the EU and the IMF.

AGENDA

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 (November).
29 Retail and consumer goods (November).
30 Balance of payments (October).

January

3 HCPI, a leading indicator (December).
5 Industrial production index (November).
12 EU industrial production index (November).
13 Governing Council of the European Central Bank.
14 CPI (December).
EU inflation (December).
25 Producer prices (December).
Fed Open Market Committee.
27 Retail and consumer goods (December).
28 Labour Force Survey (fourth quarter).
US GDP (fourth quarter).
31 Balance of payments (November).

OECD forecasts: a weak 2011, awaiting a better 2012

The OECD predicts 4.2% world growth for 2011.

In its World Economic Outlook for November, the Organization for Economic Cooperation and Development (OECD) downgraded its forecasts for 2011. Growth in 2011 will be 4.2% thanks to the strength of emerging economies but recovery is uneven, with greater weakness in rich economies.

The OECD believes more balanced growth is required, with smaller trade imbalances and a private sector taking over from government stimuli. With regard to trade imbalances, which are not expected to ease significantly over

OECD ECONOMIC OUTLOOK (1)

	2009	2010	2011	2012
GDP (2)				
World total	–1.0	4.6	4.2	4.6
United States	–2.6	2.7	2.2	3.1
Japan	–5.2	3.7	1.7	1.3
Euro area	–4.1	1.7	1.7	2.0
OECD	–3.4	2.8	2.3	2.8
Inflation (3)				
United States	–0.3	1.6	1.1	1.1
Japan	–1.4	–0.9	–0.8	–0.5
Euro area	0.3	1.5	1.3	1.2
Unemployment (4)				
United States	9.3	9.7	9.5	8.7
Japan	5.1	5.1	4.9	4.5
Euro area	9.3	9.9	9.6	9.2
OECD	8.1	8.3	8.1	7.5
Current Account Balance (5)				
United States	–2.7	–3.4	–3.7	–3.7
Japan	2.8	3.4	3.7	3.7
Euro area	–0.4	–0.2	0.3	0.9
OECD	–0.5	–0.7	–0.7	–0.5
China	6.0	5.8	5.9	5.5

NOTES: (1) The date this publication was finalised and the figures included was 12 November 2010.
(2) Percentage rate of change in real terms.
(3) Percentage rate of change in GDP deflator.
(4) As percentage of labour force.
(5) As percentage of GDP.
SOURCE: Organization for Economic Cooperation and Development.

the next two years, the OECD states that coordinated policies are needed within the G-20 to avoid currency wars and prevent the emergence of protectionism.

As regards replacing public stimuli, the OECD particularly stresses the establishment of credible fiscal consolidation plans to restore economic players' confidence in public accounts and to make debt sustainable. All this would result in greater growth in the medium term. However, the OECD acknowledges that, in the short term, the effects might be restrictive but of limited intensity.

The international organization expects that 2011 will be more difficult than 2010 with growth that, for OECD countries as a whole, will drop from 2.8% to 2.3%, picking up again in 2012. Compared with July's report, the forecasts have particularly been lowered for the United States, with expected growth of 2.7%

International cooperation and fiscal consolidation are required to underpin growth.

OECD ECONOMIC OUTLOOK (1)

	2009	2010	2011	2012
Public administration balance (2)				
United States	–11.3	–10.5	–8.8	–6.8
Japan	–7.1	–7.7	–7.5	–7.3
Germany	–3.0	–4.0	–2.9	–2.1
France	–7.6	–7.4	–6.1	–4.8
Italy	–5.2	–5.0	–3.9	–3.1
United Kingdom	–11.0	–9.6	–8.1	–6.5
Spain	–11.1	–9.2	–6.3	–4.4
Euro area	–6.2	–6.3	–4.6	–3.5
OECD	–7.9	–7.6	–6.1	–4.7
Short-term interest rates (3)				
United States	0.9	0.5	0.7	1.8
Japan	0.3	0.2	0.2	0.2
United Kingdom	1.2	0.7	0.9	1.8
Euro area	1.2	0.8	1.1	1.8
Long-term interest rates (4)				
United States	3.3	3.1	3.3	4.5
Japan	1.3	1.1	1.2	1.7
Germany	3.2	2.7	3.0	3.8
France	3.6	3.0	3.3	4.1
Italy	4.3	3.8	3.7	4.5
United Kingdom	3.6	3.5	3.6	4.5
Spain	4.0	4.1	4.0	4.2
Euro area	3.8	3.4	3.6	4.3

NOTES: (1) The date this publication was finalised and the figures included was 12 November 2010.
(2) As percentage of GDP.
(3) 3-month interest rates in national money markets.
(4) Public debt rates of the most representative issuances of each country.
SOURCE: Organization for Economic Cooperation and Development.

Growth in the United States for 2011 remains at 2.2%, while 1.7% is expected for the euro area.

for 2010 and 2.2% for 2011, in line with our own forecasts. The OECD is more optimistic about 2012, putting US growth at 3.1%, which would lead to a fall in unemployment for the period. In contrast, the euro area has improved its prospects for 2010 with 1.7% growth, slightly better than we forecast. This growth, however, won't improve in 2011, repeating the same figure of 1.7%, also coinciding with our forecasts, while, unlike the American case, there will be no appreciable improvement in 2012.

The United States expects its economy to grow by 2.8% in 2010 and 2.2% in 2011.

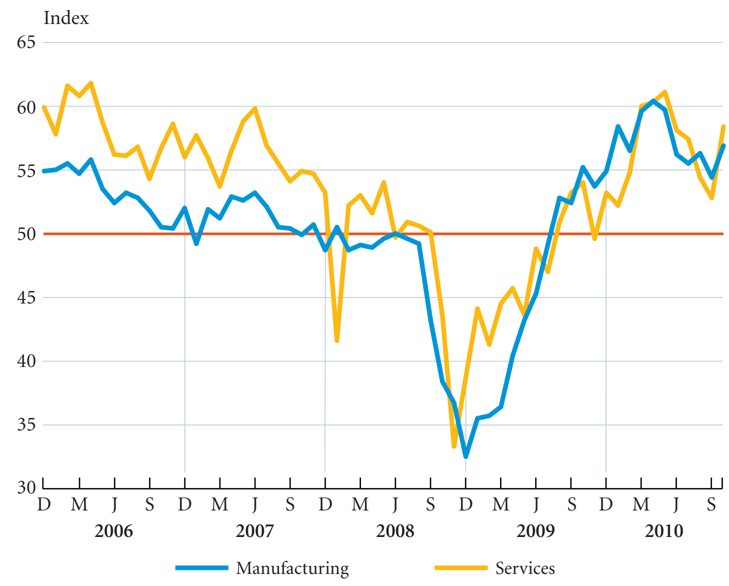
For Spain, the OECD predicts a slight decline in 2010 followed by 0.9% growth in 2011 and speeding up slightly in 2012 to a rate of 1.8%, slightly above the forecasts of "la Caixa".

The United States: growth burdened by employment

We predict the US economy will grow by around 2.2% for the whole of 2011, lower than the 2.8% expected for 2010. The continued weak labour and housing markets, which have a mutual effect on each other, as well as household debt, which has reached 118.4% of gross disposable income, limit growth in private consumption while capital goods investment has lost some of its strength from the first half of the year and exports are still sluggish. In the coming year, neither fiscal stimuli nor the inventory cycle will contribute as much to growth as they did in 2010.

THE UNITED STATES: ENTREPRENEURS IMPROVE THEIR EXPECTATIONS

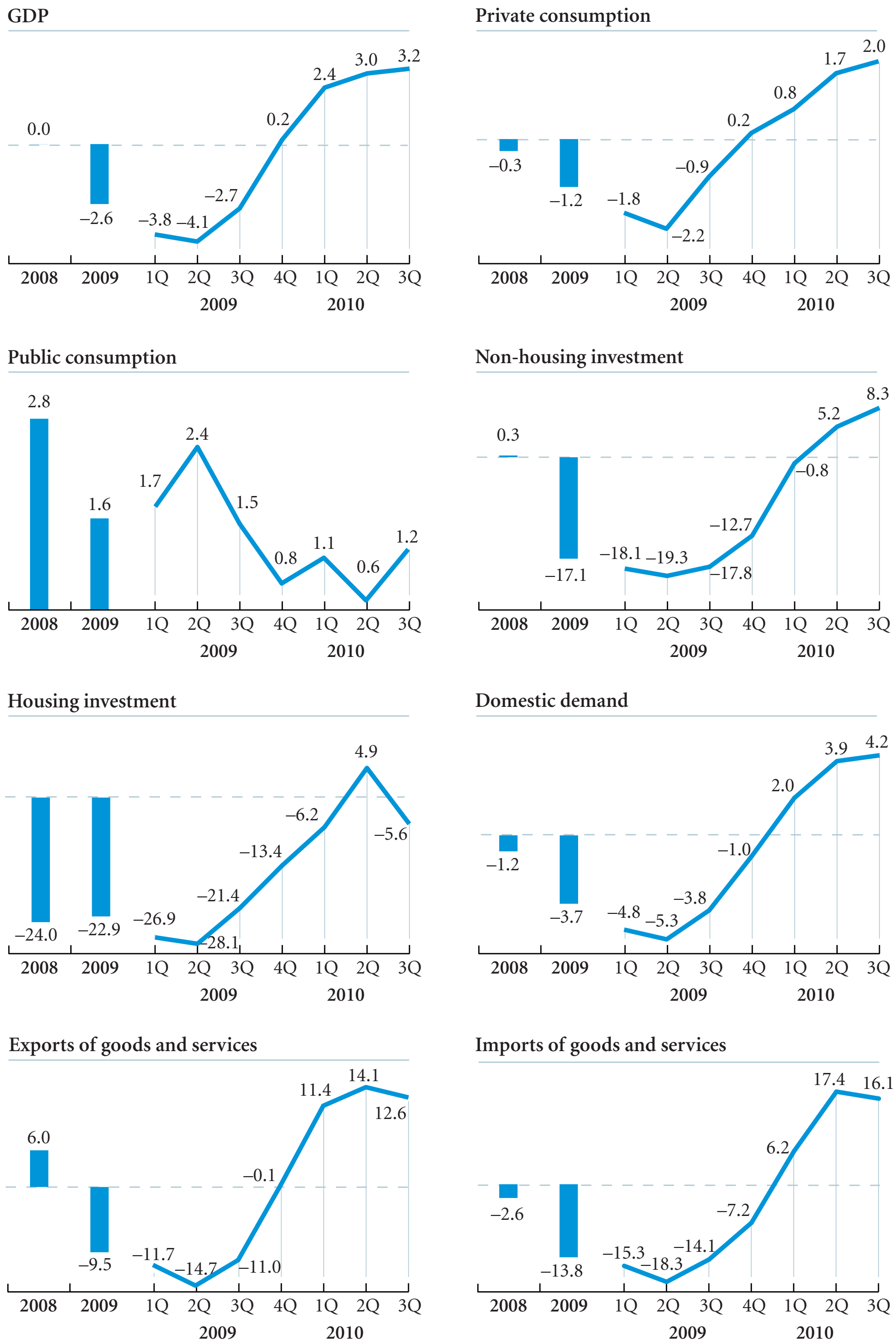
ISM index levels (*)



NOTE: (*) A level of 50 means that there are as many optimistic answers as pessimistic.
SOURCES: Institute for Supply Management and own calculations.

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Bureau of Economic Analysis and own calculations.

The United States grows by 0.6% in the third quarter thanks to the resistance of consumption and restocking.

The data for the third quarter continue to point towards a modest recovery, with the economy growing by 0.6% quarter-on-quarter. In spite of the relatively good performance of private consumption, the growth in this period owes a considerable amount to the accumulation of stocks, while capital goods investment and exports continued to slow up compared with the second quarter. Consequently, the risk of anaemic growth, but not of a double-dip recession, exceeds the inflationary risk, with core inflation at record lows, and justifies keeping expansionary fiscal and monetary policies, although it's still necessary to draw up a credible fiscal consolidation plan for the US economy in the medium term.

Retail sales perform well in October but confidence is low.

Retail sales are a good example of this underlying resistance that private consumption appears to have found. The component that excludes volatile cars and petrol consumption grew by an appreciable 5.3% year-on-year in October, to which we should add the good performance by automobile sales. We must remember, however, that, discounting the effect of price variations, retail trade is still slightly below the level of December 2007, representative of the situation before the crisis.

Entrepreneurs stop the decline in their expectations but industry stagnates.

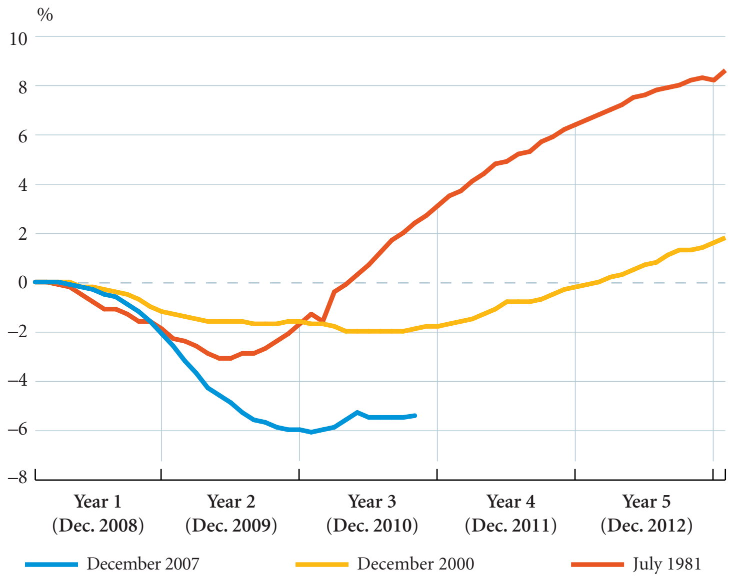
This underlying resistance of consumers can also be seen, in a sense, in the business perspective. After five months of falling expectations, the business sentiment index of the Institute for Supply Management picked up strongly in October, with the manufacturing index rising to 56.9 points and the services index, which accounts for four fifths of private employment, reaching an even better level of 58.4 points. In both indices we have gone from a situation befitting anaemic growth to another consistent with growth in the economy as a whole of more than 3.0%.

But the main weak factor in the US economy is still the labour market which, in order to recover, needs this robust growth noted in the business sentiment indices to be a reality. Most forecasts for 2011 do not include this optimistic scenario, however, so that, without vigorous demand, the unemployment rate is unlikely to improve substantially and is still anchored at 9.6% in October. The problem here is that a delay in recovery actually means the situation will get worse because, among other reasons, it pushes up the proportion of long-term unemployed, who are more difficult to relocate. The people who have been unemployed for more than six months account for more than 44.0% of the total unemployed, doubling the maximum reached in 1982. To all this we must also add the large number of discouraged workers and others who, although they want to work full-time, can only find part-time jobs and who will absorb a considerable portion of any demand for work that might be created over the coming months. It's therefore difficult to see any substantial improvement in employment before the end of 2011.

This persistent unemployment can be largely blamed on construction slumping again in the third quarter. The real estate problem is closely linked to the weakness in the labour market. In the boom years, construction had grown far above its relative weight in the overall economy, supported by household debt. With the end of easy credit, the sector has lost two million jobs which, given their nature, are difficult to reconvert. This job destruction has had a boomerang effect on the sector as a continually high unemployment rate results in mortgage foreclosures. These, in turn, swell the already excessive supply of housing, practically paralyzing residential investment. Another result of this

THE UNITED STATES: THE RECOVERY IN EMPLOYMENT WILL HAVE TO WAIT

Job losses as percentage of total employed at the start of the decline (*)



NOTE: (*) The dates in brackets correspond to the last recession (December 2007).
SOURCES: Department of Labor and own calculations.

excess supply is the stagnation in the precarious recovery in house prices and the volume of property sales hasn't managed to improve consistently after the end of state aid.

Weak demand has left inflation at a record low. Although the general consumer price index (CPI) for October increased by 1.2% year-on-year, the low utilization of production capacity has meant that core inflation grew by just 0.6% year-on-year, the lowest rise since this concept started in 1958. Within a context of extensive leveraging, as in the present, continuously stagnated prices mean that households in debt lose the benefit provided previously by inflation, which reduced the amount of the debt in real terms. Hence the Fed is going to undertake a second round of quantitative easing to push inflation more towards the non-explicit target level of 2%, as well as distancing prices from any hypothetical drop.

For its part, the foreign sector doesn't look like it's going to be the catalyst required by the recovery in 2011. Firstly, given the size of the US economy, exports have less relative weight than in other countries. Secondly, it still hasn't achieved robust growth, in spite of the relatively weak dollar. Although September's trade balance brought some respite by reducing the trade deficit for goods and services by 5.3% compared with the previous month, this was mainly due to fewer imports, which are still getting back to normal after the sharp increases of the second quarter. However, exports continue to slow up. Within this context, the dollar will probably remain relatively weak, influenced both by the continued trade deficit and also by the Fed's expansionary policy.

Construction falls and is still at a record low, while house prices continue rock bottom.

The CPI rises 1.2% and core inflation is up 0.6%, a record minimum.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010			
			4Q	1Q	2Q	3Q	October
Real GDP	0.0	–2.6	0.2	2.4	3.0	3.2	–
Retail sales	–1.0	–6.3	1.8	5.7	6.9	5.7	7.3
Consumer confidence (1)	58.0	45.2	51.0	51.7	58.2	50.9	50.2
Industrial production	–3.3	–9.3	–3.8	2.7	7.4	6.6	5.3
Manufacturing (ISM) (1)	45.5	46.2	54.6	58.2	58.8	55.4	56.9
Housing construction	–32.9	–38.4	–14.8	16.5	12.2	0.6	–1.9
Unemployment rate (2)	5.8	9.3	10.0	9.7	9.7	9.6	9.6
Consumer prices	3.8	–0.4	1.4	2.4	1.8	1.2	1.2
Trade balance (3)	–698.8	–374.9	–374.9	–398.9	–450.1	–483.8	...
3-month interbank interest rate (1)	2.8	0.7	0.3	0.3	0.5	0.3	0.3
Nominal effective exchange rate (4)	74.5	77.7	72.8	74.8	77.6	75.9	72.4

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.

An escalating currency war

Currency wars are the latest threat to global recovery. The Fed's announcement of a second round of quantitative easing, known by the abbreviation QE2 (Quantitative Easing, part 2), together with China's reluctance to allow its currency to appreciate further against the dollar, has sparked a reaction by numerous countries that don't want to lose their competitive edge.

When it announced the QE2, the intentions declared by the Fed were to fight against deflationary pressures and support the recovery and create jobs by reducing interest rates in the long term. However, the dollar's weakness is an inevitable consequence of quantitative easing. The more dollars are available, the more its value is forced down. It's difficult to know whether this was also one of the Fed's aims but it's clear that the United States would benefit from a weaker dollar that boosts US exports. Consequently, from the beginning of September, when another round of expansionary measures started to be ruled out, up to mid-November, the dollar has depreciated by 5% on average (in effective nominal terms) and close to 7% compared with the euro.

Given this situation, several countries have resisted being a counterpart in the greenback's depreciation. China's refusal to allow its currency to appreciate substantially (it's hardly gone up by 3% against the dollar since mid-June) has a lot to do with this reaction. In order to stop their currencies from appreciating too much, several emerging countries have imposed obstacles to capital inflows. Brazil, for example, raised the tax on foreign investment in fixed-income securities to 6% in October. In the last few weeks, Thailand, Indonesia and South Korea have also taken measures to slow up foreign capital inflows. Japan stands out among the advanced economies for its intervention in the currency markets to stop its currency from appreciating, while the euro has borne a large part of the dollar's depreciation. In fact, the euro area has turned out to be one of the few regions willing not to intervene against a weak dollar.

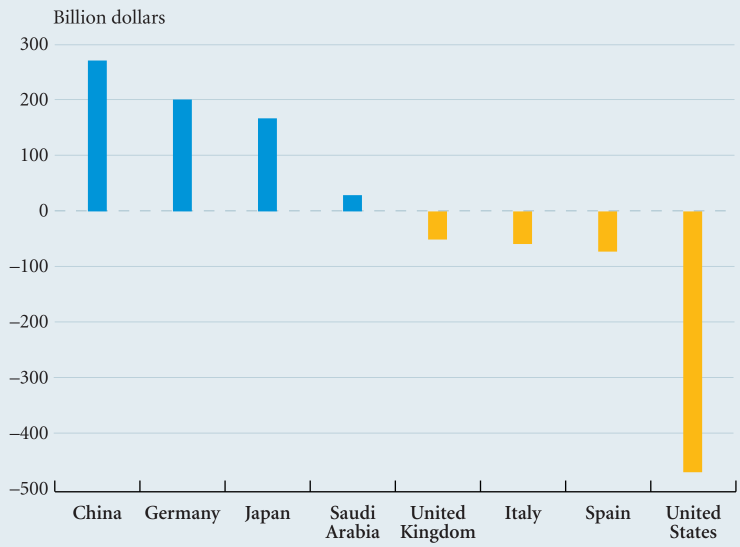
China's reluctance to allow its currency to appreciate has spread to other countries that are fearful of losing competitiveness, both against the Asian giant and against other countries that are also stopping their currencies from appreciating. This would have various consequences: firstly, a possible loss of share in markets where they compete directly with China; secondly, larger imports of «cheap» products from China that might harm their domestic industry; and, lastly, a loss of capacity to compete in the Chinese market.

Without doubt, foreign exchange pressures are also related to the so-called global imbalances. In this respect, the United States' new round of quantitative easing could be considered merely as a catalyst for a process that's inevitable in the long term: the realignment of exchange rates at a global level to reduce the United States' foreign deficit and the large surpluses of China and other economies (see the graph below). In this debate, those countries with a surplus, with China at their head, claim that any adjustments in exchange rates must occur very gradually so as not to hinder economic growth. The United States, however, is demanding greater exchange flexibility to boost growth in its exports. The disagreement between countries became evident in the last G-20 meeting in Korea, where this debate took centre stage.

Nonetheless, trying to stop their currencies from appreciating also involves certain risks for the emerging countries. Intervention in the foreign exchange market requires a considerable accumulation of reserves and therefore higher liquidity. In turn, interest rates remain low so as not to attract capital flows seeking to take advantage of any appreciation in the future. All this aggravates the already existing risk of overheating and creates

LARGE GLOBAL IMBALANCES

Current Account Balance (forecasts for 2010)



SOURCE: IMF (WEO October 2010).

the perfect environment for bubbles to form, in the stock market or in the real estate sector. Some analysts believe that the opposition of big savers to allow their currencies to appreciate might even go against them where they least expect it, namely in their external sector. In particular, they argue that, given the need for an adjustment in external imbalances, a lack of adjustment in nominal exchange rates will push up prices in the emerging economies and lead to deflationary pressure in the United States, if the dollar doesn't become weak enough. This might hinder the recovery of the world's leading economy, whose demand is fundamental for the growth of the emerging economies.

In short, numerous countries are trapped between the US's expansionary measures and China's firm exchange rate intervention. In spite of fearing a loss of competitiveness abroad, countries must realise the pros and cons of starting a currency war, one of these being the possibility of a trade war, whose spectre is hovering over the current scenario. Considering the problem together would lead to a gradual and particularly a coordinated readjustment, whereas unilateral action can only aggravate the recovery for some and reduce the future growth of others.

This box was prepared by Clàudia Canals
International Unit, Research Department, "la Caixa"

Japan: weaker than it seems

Japan is slowing up and grows by 0.4% because of weak domestic consumption.

The Japanese economy will probably have grown by 3.6% in 2010, boosted by exports picking up in the first half of the year and by public stimuli for consumption. But after the end of these temporary factors, growth for 2011 as a whole is unlikely to be higher than 1.5%, with an exit from deflation that will have to wait until early 2012. The upswing in GDP growth in the third quarter, up by 1.0% quarter-on-quarter, shows a better situation than is actually the case.

The greatest contribution to growth came this time from private consumption, boosted by temporary factors such as the end of fiscal stimuli for buying durables and due to the effects of a particularly hot summer, leading to massive purchases of air conditioning and cooling equipment. But the worst news was confirmation of the slowdown in exports, which have been consistently at the forefront of growth for the last decade. Capital goods investment also seemed more sluggish while, in assets, construction seems to have bottomed out, with a real estate market that, in August and September, showed a very timid recovery after the record lows of July.

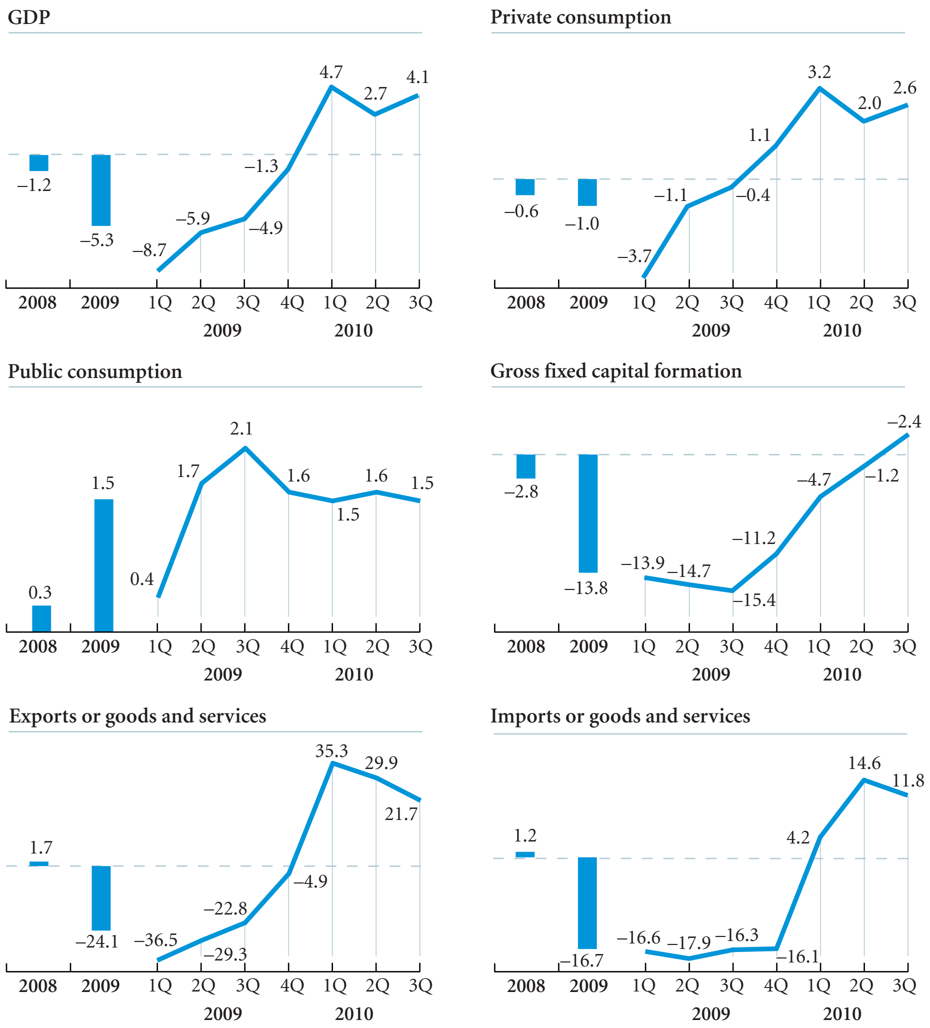
Demand still needs to be stimulated while industrial production stagnates.

Weak domestic demand could be seen again in October's car sales, sliding back now that aid has ended. Looking at these weaknesses, industry, a traditional bastion of Japan's economy, is still stagnant in the best of cases, with an industrial production index that, in September, accumulated its fourth consecutive drop and is now at 15.4% below the level of May 2008, at the start of the crisis.

There was a slight improvement in the labour market in the third quarter, with September's unemployment rate falling to

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Institute of Economic and Social Investigation and own calculations.

5.0%. Prices slowed up their fall in October and the CPI was down 0.6% year-on-year but core inflation, the general index without energy or foods, once again lost a substantial 1.5% year-on-year.

In the foreign sector, the trade surplus increased in September but this was due more to the drop in imports than any improvement in exports. In this respect, although sales to the rest of Asia had been the main motor of growth in exports in the first half of the year, in September exports to China are still clearly below the maximum level of March.

The trade surplus is supported by falling imports.

JAPAN: A TOUGH END TO STIMULI FOR AUTOMOBILES

Automobile sales. Year-on-year change

SOURCES: Japanese Ministry of Communications, National Statistics Office and own calculations.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010			
			4Q	1Q	2Q	3Q	October
Real GDP	–1.2	–5.3	–1.3	4.7	2.7	4.1	–
Retail sales	0.3	–2.3	–0.7	3.8	3.7	3.2	...
Industrial production	–3.4	–21.8	–5.1	27.1	21.1	12.9	...
Tankan company Index (1)	–2.8	–40.8	–24.0	–14.0	1.0	8.0	–
Housing construction	2.5	–27.6	–20.7	–6.7	–1.1	13.9	...
Unemployment rate (2)	4.0	5.1	5.2	4.9	5.2	5.1	...
Consumer prices	1.4	–1.4	–2.0	–1.1	–0.9	–0.8	...
Trade balance (3)	4.2	4.0	4.0	6.7	7.4	8.2	...
3-month interbank interest rate (4)	0.8	0.6	0.5	0.4	0.4	0.4	0.3
Nominal effective exchange rate (5)	86.6	98.6	99.6	101.1	102.8	109.1	111.2

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.

China: good prospects with the danger of overheating

The vigour of Chinese growth so far this year has been surprising and we expect GDP to grow by 10.1% in 2010. The growth prospects for 2011 and 2012 are around 9%, a slight moderation that should help to mitigate the increasing risk of overheating that's hovering over the economy.

This economic recovery, together with a strong upswing in inflation (at 4.4% year-on-year in October, the highest of the last two years) will speed up the removal of expansionary monetary measures. In particular, and for the second time in just a few weeks, China's central bank has raised the cash reserve ratio (to 18.5% for large banks and between 16% and 16.5% for small institutions) and has accumulated a total rise of 250 basis points since the start of the year.

Other restrictive measures have been put in place recently: the unexpected rise in the reference rate (from 5.31% to 5.56%) and the relaxation of controls that kept the exchange rate practically fixed against the dollar. The tightening up of monetary conditions will continue throughout 2011. For the next year, we expect new actions on the cash reserve ratio, in the order of 150 basis points in total, as well as a couple of rises in the interest rate. With regard to exchange rate policy, we expect the renminbi to appreciate very gradually, around 4% annually and in line with its current performance. According to China, any sharp appreciation in its currency might harm the country's economic growth, which is strongly dependent on investment (a large part in the export sector) and on the foreign sector itself.

Given the persistent risk of bubbles in the real estate sector, the monetary authority has also promoted policies aimed at cooling this sector down, from limitations to granting credit to raising the minimum deposit required to acquire housing, including raising mortgage interest rates. As a result, house prices rose by 8.6% year-on-year in October, below the annual average of 10.6%.

On the other hand, fiscal policy will continue to be active throughout 2011, focusing on improving social benefits and supporting domestic consumption, and somewhat less on infrastructure

We expect China to grow by 10.1% in 2010 and in the order of 9% in 2011 and 2012.

The Chinese central bank speeds up its withdrawal of expansionary measures.

Active fiscal policy focusing on supporting domestic demand.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2008	2009	2009	2010			
			4Q	1Q	2Q	3Q	October
Real GDP	9.6	9.1	11.3	11.9	10.3	9.6	–
Industrial production	12.6	12.5	17.9	19.8	16.0	14.5	13.1
Electrical power generation	6.7	6.7	24.3	22.6	17.8	11.8	6.7
Consumer prices (*)	5.9	–0.7	0.6	2.2	2.9	3.5	4.4
Trade balance (**)	298	196	196	148	156	183	186
Reference rate (***)	5.31	5.31	5.31	5.31	5.31	5.56	5.56
Renminbi to dollar (*)	6.9	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.

The risk of protectionist action is increasing.

investment. All this with the aim of rebalancing the country's sources of growth towards a greater emphasis on domestic consumption and private investment.

Lastly, once again China's trade balance posted a robust surplus in October totalling more than 27 billion dollars, higher than the figures for September and August. This is largely due to the lower growth in imports, which were below consensus forecast. This strong trade figure, together with strong capital in-flows, has been reflected in a marked rise in foreign reserves in the third quarter.

Once again, the size of the Chinese trade surplus and the moderate appreciation of the renminbi (hardly 3% since it announced its flexibilization in mid-June) have increased the risk of protectionist action from its main trading partners, particularly the United States, which has the largest bilateral deficit with China. These protectionist measures, the recent inflationary tension and the danger of bubbles in house prices constitute China's three major short term risks.

Brazil takes its leave of a great year and readies itself to inaugurate 2011 with Dilma Roussef at the helm.

Brazil: and, after a good 2010, *Bem-vindo* 2011!

After a fleeting recession, Brazil undertook solid recovery which allowed it to achieve annual GDP growth in 2010 of around 7.2%, the highest figure for the last three decades. Domestic expenditure, with investment at its head, took over as the main engine, so much so that foreign demand continues to deduct from growth due to the continuing strength of the real and the determined recovery in imports.

Leading indicators point towards moderation in activity over the coming months, stabilizing at growth levels more in line with its potential, around 5%, for 2011. Nonetheless, the current situation places the new government of Dilma Roussef, the first female president in Brazil's history, in a very good position, with notable economic growth, record low unemployment and domestic confidence at a record high.

Among the main risks facing the Brazilian economy in the short term

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010			
			4Q	1Q	2Q	3Q	October
Real GDP	5.1	–0.2	4.4	9.0	8.7	...	–
Industrial production	2.9	–7.2	6.3	17.3	14.2	8.0	...
Consumer confidence (*)	140.4	138.3	154.2	158.1	154.6	159.5	154.5
Unemployment rate São Paulo (**)	13.0	12.8	11.8	12.3	13.2	12.6	...
Consumer prices	5.7	4.9	4.2	4.9	5.1	4.6	5.2
Trade balance (***)	24.8	25.3	25.3	23.2	19.3	16.9	17.4
Interest rate SELIC (%)	11.25	11.25	8.75	8.75	10.25	10.75	10.75
Reales to dollar (*)	1.8	2.3	1.7	1.8	1.8	1.7	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.

are particularly the fast deterioration in the current account balance and the continuing appreciation of the real. Intervention in the foreign exchange market has intensified in the last month and a half but neither these actions nor the higher duty levied on bond capital in-flows to 6% in October have been able to stop the advance of the real (2% since January and 7% since June). Only the relative recovery in the dollar has recently led to a lull. However, we don't expect any definitive change in trend while there are still differences in growth and profitability between Brazil and other, more mature economies. This will continue to reduce the competitiveness of the manufacturing sector and therefore the country's export potential.

Inflation and the real continue to pose risks.

In spite of a growth rate above its potential and industrial capacity utilization around 85% of the total installed capacity, macroeconomic policy has preserved the expansionary tone adopted when the crisis started, so that there's still a latent risk of overheating. Inflation picked up again in October, exceeding 5% and therefore the target of 4.5%, so that we expect the series of interest rate rises that stopped in August to start again in 2011, sooner rather than later if exchange rate trends allow.

Resorting to monetary measures appears to be even more likely as little movement is expected in the fiscal area. In the medium term, the main risk will lie precisely in this area. The continuation of quasi-fiscal stimuli for growth and the high investment in infrastructures required by the football World Cup in 2014 and the 2016 Olympics might result in excessive public debt. Nonetheless, there's no doubt that the new cabinet will do its utmost to keep its commitment to macroeconomic stability acquired by the last few governments and that stood them in such good stead when the crisis hit. This commitment continues to be of vital importance to maintain credibility and to promote balanced growth in the long term.

In any case, and at least from a macroeconomic point of view, Brazil is undoubtedly a privileged place to welcome in 2011.

Mexico: consolidating its recovery

The recovery in economic activity in the first two quarters of the year will help the Mexican economy to grow by around 5% in 2010, thanks to the good performance by foreign demand (especially from the United States) and a significant base effect. The data for the third quarter, with growth of 5.3% year-on-year and 0.7% between June and September, confirm the moderation in the pace of growth, also confirming, without doubt, the continuation of the Aztec recovery, which is still benefiting from the resistance of a foreign sector that, little by little, is being supported by domestic spending.

The Mexican economy bolsters its recovery with another rise of 5.3% in the third quarter.

The measured reaction of investment and consumption and the gradual recovery in domestic confidence suggest that the recovery will continue in the coming months. Nonetheless, we can still see a slowdown in the pace of activity, in line with the moderation in the rate of growth of the world's economy, the inventory cycle getting back to normal and by domestic expenditure not taking over sufficiently as a driving force in the economy, affected as it is by the slow recovery in credit and confidence. In 2011 we therefore expect a lower GDP growth than that for this year, around 3.7%.

The Fed's new quantitative easing programme might delay any rise in interest rates until 2012.

The recovery in oil prices has slowed up the decline in the fiscal balance, so we

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010			
			4Q	1Q	2Q	3Q	October
Real GDP	1.5	–6.6	–2.2	5.1	7.3	5.3	–
Industrial production	–0.4	–7.0	–2.4	5.4	7.5	6.4	...
Consumer confidence (*)	92.2	80.5	78.4	81.5	84.9	89.2	89.2
Leading business index	118.2	110.9	113.9	115.1	116.7	117.6	...
General unemployment rate (**)	4.0	5.5	5.3	5.4	5.2	5.6	...
Consumer prices	–11.8	0.0	4.0	4.8	4.0	3.7	4.0
Trade balance (***)	–17.3	–4.6	–4.6	–1.9	–2.4	–2.0	–3.0
Official Banxico rate (%)	7.50	6.75	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	10.6	14.2	13.1	12.3	12.8	12.6	12.3

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

Retail sales, investment and confidence on the up.

expect the deficit to be around 2.2% of GDP at the end of 2010. Nonetheless, reducing fiscal revenue's dependence on oil must still be tackled in the medium term. Without far-reaching fiscal reforms that manage to reduce revenue's oil dependence, the deterioration in the public accounts might become a significant burden and some rating agencies could downgrade their sovereign debt rating for Mexico, affecting the peso and complicating price containment.

For the moment, restrained domestic demand, the absence of any notable exchange rate pressures and the low utilization of production capacity have all relieved pressure on prices. In spite of the recent upswing due to more expensive farm products, we don't expect inflation to exceed 4% by the end of 2010. Given this situation, and a scenario of gentle recovery in domestic expenditure and the gradual weakening of the foreign sector, we don't predict any changes in monetary policy until the end of 2011. Moreover, the recent decision by the Federal Reserve to start a new quantitative easing programme might even delay these rises until early 2012.

Another of the challenges facing the Mexican economy obviously comes from the huge dependence of its export and manufacturing sectors on the economic situation of the United States. In the first ten months of the year, the US market absorbed 69% of Mexico's vehicle exports. That's why the Aztec recovery runs the risk of coming to a greater halt than expected if its northerly neighbour's economy slows down too much. If this happens, we should remember that Mexico has little fiscal margin to implement additional stimuli.

In any case, the Mexican economy has got back on the track of sufficiently robust growth so that, providing there are no surprises, it should be able to close its output gap by mid-2011.

Stability to hold on to what has been gained

Oil continues to rise moderately, coming close to 85 dollars per barrel.

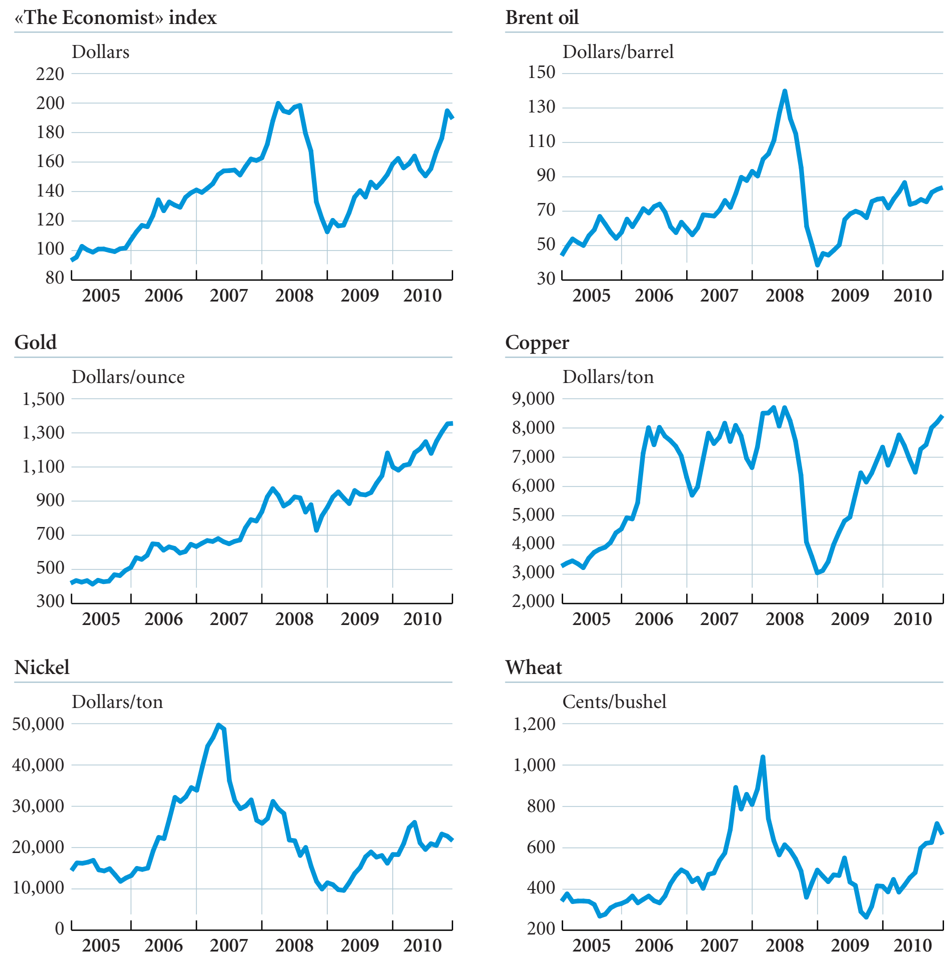
Oil prices remained stable, once again staying below the 85-dollar benchmark after having clearly passed this in the last few weeks. Between 20 October and 19 November, the price of crude rose inappreciably by 1.6%, standing at 84.22 dollars per barrel (Brent quality, for one-month deliveries), an increase of 8.3% for the year so far.

The expansion of emerging economies will continue to support oil prices in the first half of 2011. However, the difficulties of advanced economies will keep these rises moderate and we expect 2011 will end with crude not much above 85 dollars per barrel.

Stability also dominated commodities after having achieved huge gains the previous month, with The Economist index remaining practically the same for the month but accumulating a gain of 19.0% for the year so far. Foods performed unevenly while, among metals, of note was the 22.2% rise for palladium, in clear contrast to the slight drop in the price of platinum. Both precious metals are used in automobile catalysers, the former in petrol engines and the latter in diesel, which are more popular in Europe. This trend is consistent with the slight upswing in US consumption and the certain cooling off in Europe's growth prospects over the last month.

Gains remain within a generally stable situation.

TREND IN VARIOUS COMMODITIES (*)



NOTE: (*) Figures for last day of month (last date November 19).
SOURCES: «The Economist», Thomson Reuters Datastream and own calculations.

EUROPEAN UNION

Euro area: Ireland takes over from Greece

The euro area's GDP grows by 0.4% in the third quarter of 2010...

Europe's sovereign debt crisis is writing a new chapter in the month of November. On this occasion, the protagonist is Ireland but once again the rest of the so-called periphery countries have played an important part. The recovery of the euro area is once again out of the limelight, although the latest figures have been relatively good. In the third quarter, gross domestic product (GDP) grew by 0.4% quarter-on-quarter, which will probably push growth for the whole year above our forecast of 1.5%.

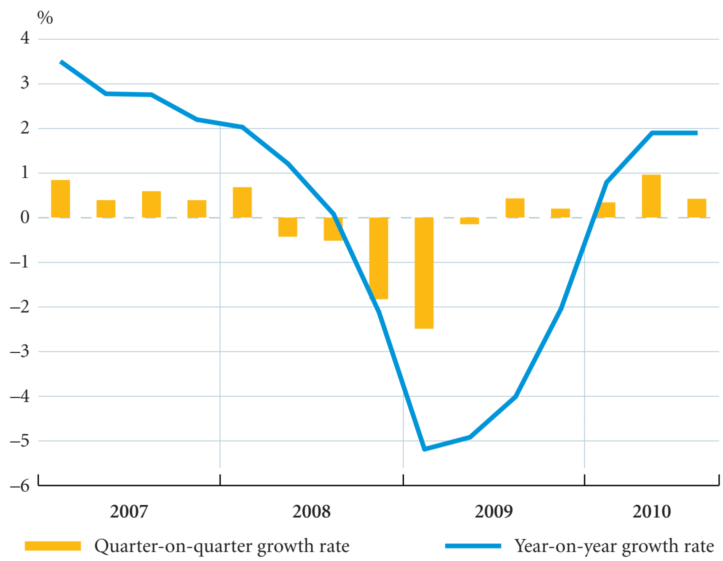
...but the Irish crisis pushes it out of the limelight.

Returning to the main issue, the origin of the Irish crisis lies in its banking system. While Greece's problem is particularly its competitiveness and the lack of transparency in public sector management, there are much fewer doubts regarding the Irish economy's growth potential. The Celtic tiger's problem is the significant adjustment in its housing sector and its overlarge banking sector. In 2009, when the international financial crisis was at its peak, the Irish government promised to guarantee all bank assets to avoid financial panic in its economy.

But the hole created by the real estate sector in its banks has been larger than expected. In fact, after the summer the Irish government had to inject even larger amounts of capital into its banking

THE EURO AREA'S GROWTH CONTINUES APACE

Change in GDP in the euro area



SOURCES: Eurostat and own calculations.

system, pushing the deficit expected for this year up to 32%. This set all the warning bells ringing and the international community quickly picked out Ireland as the main candidate to succeed Greece in the sad tale of developed countries that have needed bailing out.

One of the direct consequences was the total closure of international financing markets for the Irish banking system, forcing it to obtain liquidity from the European Central Bank. However, what actually sent risk premia soaring were statements made by the German chancellor, Angela Merkel, suggesting that any bailout through the Financial Stability Facility would have to be accompanied by a restructuring of debt, which would lead to losses for those holding the country's debt.

The size of the bailout, 85 billion euros, is expected to be aimed mostly at strengthening the banking sector's capital but new fiscal adjustment measures will also have to be taken. This should be enough to calm down the markets. However, they will probably redirect their attention towards the rest of the periphery countries and particularly Portugal, which will have to prove that its fiscal austerity plans are being applied to the letter and also that this isn't harming the economy's ability to grow, something that looks difficult to achieve.

In spite of doubts regarding the sustainability of periphery countries' public debt, the fact is that the GDP flash estimate for the euro area is quite robust. After strong growth in the second quarter, namely 1.0% quarter-on-quarter, the pace of growth has remained relatively strong and we have therefore had to improve our growth forecasts slightly for this year, up to 1.7%. Once again, Germany has been the driving force behind the European recovery for

Ireland's bailout is essentially aimed at the banking sector.

Portugal is the next country in the markets' firing line.

Demand is showing timid signs of improvement.

EURO AREA: MAIN ECONOMIC INDICATORS

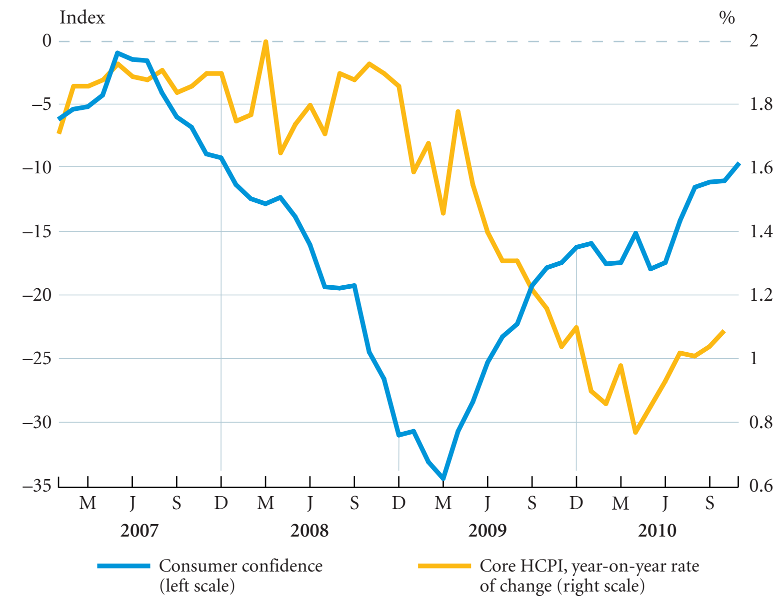
Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010			
			4Q	1Q	2Q	3Q	October
GDP	0.3	–4.0	–2.0	0.8	1.9	1.9	–
Retail sales	–0.7	–2.3	–1.0	0.6	0.6	1.4	...
Consumer confidence (1)	–18.1	–24.7	–17.0	–16.8	–16.7	–12.1	–10.9
Industrial production	–1.7	...	–7.4	4.7	9.1	6.8	...
Economic sentiment indicator (1)	93.5	80.8	91.9	96.6	99.3	102.2	104.1
Unemployment rate (2)	7.5	9.4	9.9	9.9	10.0	10.0	...
Consumer prices	3.3	0.3	0.4	1.1	1.5	1.7	1.9
Trade balance (3)	–1.2	–13.6	16.1	28.1	23.4	10.6	...
3-month Euribor interest rate	4.6	1.2	0.7	0.7	0.7	0.9	0.9
Nominal effective euro exchange rate (4)	110.6	111.7	113.8	108.8	103.2	102.3	106.1

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.

SIGNS OF IMPROVEMENT IN DEMAND

Indicators for demand and prices



SOURCES: Thomson Reuters Datastream and own calculations.

The foreign sector resists exchange rate tensions.

yet another quarter. However, we still expect growth to remain at moderate levels in the coming quarters and it might even fall slightly.

This is suggested by the different supply indicators. Industrial production, for example, which grew strongly in the second quarter, lost its impetus in the month of September after a drop of 0.9% compared with the previous month. It's still too soon to determine whether the pace of growth we have become used to of late will slow up, but the risk has decreased slightly. It's important to note that this change in trend, if it occurs, will be slight, as the purchasing managers' index (PMI) was still showing signs of strength in November.

The evidence provided by the different demand indicators is also mixed, so that consumption will have probably remained at a relatively weak rate of growth in the third quarter, as in the last few quarters. Retail sales are still very flat and show no sign of picking up.

The other side of the coin is consumer confidence and inflation. Regarding confidence, November saw renewed improvement and this continues to rise. The variation in prices also points to a slight change in trend in demand's mood. This can be seen in the rising year-on-year rate of change for the core harmonized consumer price index, up 1.1% in the month of October after four months stuck at 1%. However, until the labour market shows clear signs of improvement, consumption won't return to faster growth rates. Something that's not expected to happen until the end of the coming year.

Lastly, it's worth noting the trends in the foreign sector. During the third quarter, both exports and imports kept to a year-on-year pace of growth of between 20% and 30%, so that the feared effect of the dollar's depreciation has been very limited so far. In fact, the euro depreciated rapidly in November as the Irish debt crisis gained strength. However, we expect the euro to make up the ground it lost against the dollar once the measures to support Ireland have been determined.

In short, the euro area's economy is certainly going through a delicate time. It's very important for Ireland's bailout plan to be approved quickly and very transparently to avoid uncertainty from spreading to other countries. It's equally important for the different countries in the euro area to study the situation of Portugal and, if necessary, anticipate the markets by approving an aid package should the country really need it. The euro area's recovery is on the right track but a small political fault in handling the bailout may have highly negative consequences.

Good prospects for Germany in 2011

German GDP grows by 0.7% quarter-on-quarter in the third quarter.

The German economy reduced its pace of recovery between July and September, with a 0.7% rise quarter-on-quarter. An increase that nonetheless shows «solid growth» according to the annual report drawn up by the panel of economic experts that advises the German government. In this report, «the five wise men» raised their forecasts for GDP growth to 3.7% for this year and to 2.2% in 2011. Should these forecasts be right, the German economy would reach the peak it achieved in 2008 by mid-2011.

Industrial activity shrinks in September.

A breakdown of the growth in the third quarter into its different components shows the German economy to be more balanced, continuing the trend

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010			
			4Q	1Q	2Q	3Q	October
GDP	0.7	–4.7	–2.0	2.1	3.9	3.9	–
Retail sales	0.0	–2.5	–2.0	0.9	0.5	2.1	...
Industrial production	–0.1	–15.5	–8.0	6.1	12.2	10.0	...
Industrial activity index (IFO) (*)	96.8	87.7	93.5	96.5	101.7	106.6	107.6
Unemployment rate (**)	7.8	8.2	8.2	8.1	7.7	7.6	7.5
Consumer prices	2.6	0.4	0.4	0.7	1.0	1.2	1.3
Trade balance (***)	195.2	142.8	133.2	143.2	149.6	149.0	...

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.

But consumers and entrepreneurs are optimistic.

established since it exited the last recession.

In this respect, domestic and foreign demand have made very similar contributions to growth of 0.4 and 0.3 percentage points respectively. Of note is the recovery in public consumption, up 1.1% compared with the previous quarter and contributing two tenths of a percentage point to GDP growth. With regard to the foreign component, trade flows have dipped, reducing their pace of growth by around six percentage points compared with the previous quarter.

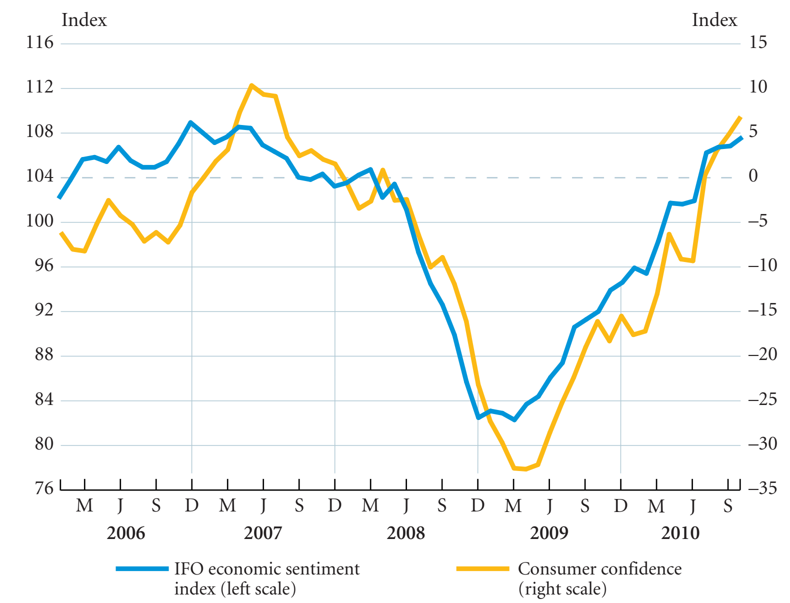
Domestic demand is expected to continue to drive the economy.

Although growth was still healthy in the third quarter, the intense correction of the most frequent indicators in September raises renewed doubts regarding future trends. Industrial production for September fell by 0.8% compared with August, neutralizing a large part of the growth recorded during the previous month. Moreover, the strong shrinkage in industrial orders in September, down 3.5% month-on-month, suggests that industrial activity will grow at a slower pace in the last quarter of the year. This has been confirmed by the slowdown in the growth of industrial capacity utilization in November, a slight moderation being predicted in the rise in investment in this period.

As regards demand, retail sales fell again in September for the second consecutive month, down 1.7% month-on-month. Consequently, retail trade was practically at the same level as that reached a year ago. Only exports grew in September, up 3.0% month-on-month, boosted by trade with non-EU countries. This, and the fall in imports in the same period, down 1.5%, boosted the balance of trade in September by 46.6% year-on-year.

CONFIDENCE INDICATORS COME CLOSE TO RECORD HIGHS

Trends in confidence indices



SOURCES: German Statistics Institute and IFO.

Does this dip mean that domestic demand will come to a standstill in the next few quarters? The upward trend in confidence indicators in October suggests that this won't happen and point to renewed growth in the economy, although perhaps at a slower rate. This can be seen in the graph above, where both the IFO economic sentiment index and the consumer confidence index are approaching levels very close to the records achieved in 2007. The last case is due to the solidity of the labour market, with the unemployment rate remaining at 7.5% in October, the lowest since 1992. A figure that, according to the five wise men, will continue to fall in 2011, although far from full employment, the German chancellor's goal for the coming years.

Germany will therefore start 2011 with very good economic prospects, both in terms of its stronger domestic demand and the gradual recovery in its exports. Given this scenario, the German government believes its priority is to consolidate its public accounts and get its deficit below 3% of GDP as soon as possible. That's why no-one is expecting taxes to be lowered next year. An austerity policy it wants to share with

The German government prioritizes the consolidation of its public accounts.

Germany: towards a path of balanced growth

When December comes, it's customary to weigh up the achievements of the year, as well as to propose new goals for the future. In 2010, the German economy has strengthened its path of growth at a rate that, in some quarters, seemed more typical of a developing country, leaving behind the biggest recession since the Second World War. Furthermore, the strength of its labour market and the correction of its public deficit have also placed the economy in a privileged position in terms of its future.

However, certain questions are appearing on the German horizon for the coming years, particularly regarding its pattern of growth, strongly biased towards the foreign sector. Its strong competitiveness and weak domestic demand place Germany among those economies with the highest current account surplus, together with China and the oil-exporting countries. This position has recently been questioned in the leading economic forums at a global level, where debate regarding the need to control excessively high imbalances has gained momentum.

In any case, the German recovery is having a positive effect on the economy of the euro area. The strong upswing in Germany's gross domestic product (GDP), which leading economic institutions place at over 3% year-on-year, has turned the country into the main engine of the euro area, contributing more than 50% to its growth since the second quarter of 2009. A leadership that is in marked contrast to the first five years of the last decade, when Germany's contribution to European growth stood at 15%, lower than the joint contribution of Spain and Ireland.

In addition to this direct effect on the euro area's growth, its recovery has also pulled along most European countries thanks to foreign trade. The upswing in German imports during 2010, encouraged by greater demand for intermediate goods to supply its industry, has boosted the exports of the rest of the European economies. Consequently, as can be seen in the graph below, most countries' trade balance with Germany has improved between December 2008 and June 2010, particularly among its main trading partners in Eastern Europe.

All this means that the performance of the leading European economy will be a key factor in the development of GDP in the euro area over the coming quarters. According to the forecasts of supranational institutions, Germany will grow by at least 2% in each of the next two years, above the average recorded for the period from 2000 to 2007. This figure, although moderate when compared with the world's economic growth, will exceed the expected growth for Europe over the same period (1.5% and 1.8% year-on-year in 2011 and 2012 respectively). Germany will therefore continue to boost Europe's economy in the medium term.

However, of equal or even more importance than the size of growth is knowing which components will take over the reins of the German economy in the near future. A breakdown of growth in GDP shows that foreign demand has been the main factor to generate value added during the recovery. This pattern of growth coincides with that recorded since the start of the current decade, when a series of structural reforms to the labour market improved the country's competitiveness.(1) Thanks to these, the German economy became the world's leading exporter, a title it has recently lost to China.

GERMAN GROWTH BOOSTS THE EUROPEAN ECONOMIES

Change in trade balance with Germany between 2008 and 2010 (*) in percentage of GDP

NOTE: (*) From the third quarter of 2009 to the second of 2010.
SOURCES: IMF and National Statistics Institutes.

(1) For more details see R. Sabbatini and F. Zollino, *Macroeconomic Trends and Reforms in Germany*, PSL Quarterly Review, vol. 63.

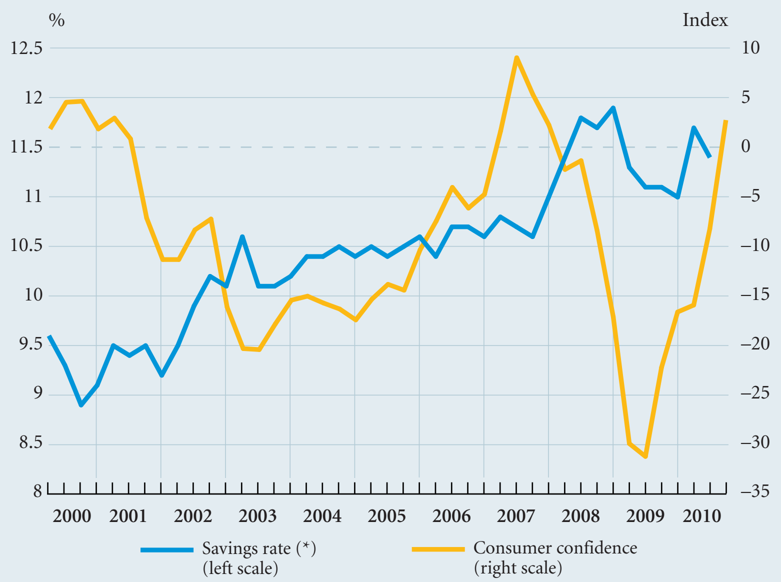
Will the foreign sector hold on to its predominance or might domestic demand modify this growth pattern? Given the tensions recently appearing in financial markets due to the heavy borrowing of some European central governments, in mid-2010 the German government announced austerity measures to sort out its public accounts, which will slow up consumption and public investment. However, there are signs that private consumption will become more important in the economy's future development, leaving behind a decade of almost inconsequential contribution to growth.

While investment and exports collapsed in 2009, private consumption managed to remain stable during the last recession. This solidity is due partly to the plans to boost consumption put in place by the German government, especially tax incentives for buying vehicles. However, it was particularly the labour market's robustness that helped private consumption to perform so well.

Unlike in previous recessive cycles and in other developed countries, the shrinking of the economy had a very limited effect on Germany's unemployment rate, and this only rose by seven tenths of a percentage point between September 2009 and the same month in 2010, peaking at 8.3%. In the same period, the number of jobs fell by 275 thousand. This meagre deterioration is mostly because of a short-time working scheme (*Kurzarbeit*), which allowed German employers to adapt their workforce to the fluctuations in demand without the need to destroy jobs. The widespread use of this scheme, which according to data from the Employment Office was applied to more than a million workers (over 2% of the labour force), led to lower labour costs and productivity in Germany. However, in exchange it allowed firms to maintain a relationship with their specialised workers for when activity picked up again. This greater flexibility explains the almost simultaneous improvement in indicators for the labour market and the German economy, with unemployment down to 7.5% in October.

IMPROVED CONFIDENCE REDUCES THE HOUSEHOLD SAVINGS RATE

Savings rate and consumer confidence



NOTE: (*) As percentage of households' gross disposable income.
SOURCE: German Statistics Institute.

Recent favourable economic data and the upward swing in business confidence mean that we continue to expect good news regarding employment over the coming quarters. An improvement that will lead to further increases in gross disposable income for households. At the same time, a gradual fall is expected in households' savings rate, returning to levels similar to those recorded between 2002 and 2007 (10.4%). As can be seen in the previous graph, household savings rose sharply at the start of the crisis, when consumer confidence fell markedly. A rise that, although it was temporarily corrected by the measures to stimulate consumption implemented by the government, has only started to fall again now that consumer optimism has increased and the job market is performing well.

In short, the German economy has recovered strongly in 2010. There are also signs of more balanced growth, with less drive from the foreign sector and a greater contribution by private consumption, which would also help to moderate the current surplus and to quieten some critical voices.

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French GDP grows by 0.4% in the third quarter of 2010.

the rest of the euro area's members, especially within the current context of high tension in the sovereign debt markets.

The French economy continues to feed on domestic consumption

The recovery in the French economy continued apace in the third quarter of 2010, with GDP up 0.4% quarter-on-quarter and the year-on-year change up to 1.8%. This means that France has enjoyed quarter-on-quarter growth for the last six quarters, practically ruling out the possibility of a double-dip recession.

Breaking down French GDP's trends into its main components we can see that domestic demand continued to drive the economy, up 0.6% during the third quarter. The figures also confirm that investment is playing its part in the recovery as this was up 0.5% in the third quarter compared with the previous quarter, after the 0.9% rise posted in the second quarter. There have therefore been two quarters of positive figures, contrasting with the decline in investment recorded in the previous two years. For its part, private consumption continued to be the engine of growth for the French economy with a 0.6% rise quarter-on-quarter, while public expenditure grew by 0.4%.

The OECD forecasts 1.6% growth in French GDP for 2011.

Looking at foreign demand, imports remained dynamic, up 4.1%, greater than the 2.5% rise in exports and therefore deteriorating the trade balance. However, the negative contribution of foreign demand to GDP was partially offset by corporate restocking, adding 0.3% to growth.

Leading indicators point towards the growth in economic activity remaining strong but with relatively moderate rates, in line with the French recovery. From the point of view of supply, an analysis of the figures shows that industrial production was up 5.1% year-on-year in the third quarter of 2010, although this was still more than 10% below the pre-

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010			
			4Q	1Q	2Q	3Q	October
GDP	0.1	–2.5	–0.5	1.1	1.6	1.8	–
Domestic consumption	–0.3	0.8	4.2	1.8	0.4	1.5	...
Industrial production	–2.7	–12.3	–4.9	5.2	7.5	5.1	...
Unemployment rate (*)	7.8	9.5	9.9	9.9	9.9	10.0	...
Consumer prices	2.8	0.1	0.4	1.3	1.6	1.5	1.6
Trade balance (**)	–50.3	–49.1	–42.0	–42.8	–44.9	–49.7	...

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

crisis peak. This suggests that the French production fabric will continue to improve with positive month-on-month rates, albeit probably with some ups and downs.

In fact, the outlook is favourable according to the business confidence indicator in the Bank of France's report on the French economy from 9 November. Based on this variable, the Bank predicts 0.5% growth in the fourth quarter compared with the previous quarter. This figure is in line with the OECD's growth prospects for the French economy in 2011, predicting year-on-year growth of 1.6%, very similar to the growth expected for this year.

The data point also toward demand continuing to grow, mainly thanks to household consumption, which is expected to remain strong over the coming months, while public expenditure is expected to fall with the implementation of austerity measures. 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 on the economy, this variable fell by four tenths of a percentage point in October to 76.4 points, so it is expected to contribute a little less to growth in the last quarter.

The engines of growth for 2011 will be private consumption and investment.

In short, French activity is likely to continue recovering slowly but surely in 2011, thanks to private consumption performing well and more dynamic investment. All this within a context of a change in government, after the extensive cabinet reshuffle carried out by president Sarkozy on 14 November.

The Italian economy is showing some gaps after its recovery

Italian GDP only grows by 0.2% quarter-on-quarter between July and September.

The pace of growth for Italian GDP fell in the third quarter of 2010, up 0.2% quarter-on-quarter, the lowest level for the year. This slowdown highlights the Italian economy's structural weakness as, after a short period of recovery, it is once again facing the same problems as before the crisis started. Consequently, after an expected upswing in 2010 of around 1%, growth is not expected to be any faster in the coming year.

Private consumption stands still during this period.

In spite of not having the breakdown of GDP by component, the stagnation in private consumption and the lower

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010			
			4Q	1Q	2Q	3Q	October
GDP	–1.3	–5.1	–2.8	0.5	1.3	1.0	–
Retail sales	–0.3	–1.6	–0.6	–0.3	–0.2	...	...
Industrial production	–3.8	–18.2	–9.1	3.2	7.8	6.3	...
Unemployment rate (*)	6.7	7.8	8.3	8.4	8.5	...	–
Consumer prices	3.3	0.8	0.7	1.3	1.5	1.6	1.7
Trade balance (**)	–10.0	–10.2	–6.6	–7.7	–12.7	–18.5	...

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

Italian growth in 2011 will be lower than the euro area's growth.

investment, due to the end of tax incentives in July, slowed up their growth in the third quarter. In the case of consumption, the rise in the unemployment rate and slow progress for wages damaged household confidence. This resulted in almost zero growth in retail sales for July and August 2010 and the consumer pessimism recorded in October suggests that this trend will continue in the fourth quarter.

Moreover, the foreign sector's contribution, which played a leading role in the second quarter's recovery, is also showing signs of running out of steam. The trade deficit therefore tripled in September compared with the same month last year, due to imports rising more strongly. The decline in industrial production in September consequently comes as no surprise, namely 2.1% month-on-month.

The economic outlook for the coming year isn't much more encouraging for Italy. The expected lower contribution of foreign demand in 2011 and weak consumption, both public and private, will keep Italian growth below the average for Europe. A scenario that would require the implementation of structural measures to boost Italian competitiveness. Something that is not feasible in the short term due to the country's political instability, which might lead to early elections.

The British economy is picking up faster than expected

British GDP is up 0.8% quarter-on-quarter.

The British government is currently implementing a drastic austerity plan that aims to reduce the deficit from 10% of GDP this year to 1.1% by 2015-2016. One of the risks of these cuts is that they might put a stop to any economic recovery. However, the more consolidated this reactivation process, the greater the probability of withstanding the cuts carried out next year. In this way, the fact that the GDP flash estimate for the UK in the third quarter was 0.8%, double the figure expected by the consensus, came as a pleasant surprise. This raised the year-on-year change to 2.8%, the highest increase since 2007. Another encouraging aspect is the fact that GDP growth for this quarter was largely due to the private sector.

The good performance of the British economy in the third quarter coincides with the favourable trend in the labour market. During July-September, 167,000 jobs were created, helping to reduce the unemployment rate by one tenth of a percentage point to 7.7%. Nonetheless, the fiscal consolidation efforts being made might still slow up the recovery. This will largely depend on business confidence and the boost that could be provided for exports by a depreciated pound sterling.

In effect, an analysis of the most frequent figures suggests that British industry will continue to recover, albeit more gently. Supply indicators point to entrepreneurs' confidence in October being below the level recorded in previous months. Within this context, the National Institute of Economic and Social Research estimates that the British economy grew by 0.5% in the three months up to October, denoting a certain slowdown in the pace of growth.

On the other hand, the outlook for demand partly depends on whether households and companies wish to save. As regards household consumption, the bulk of the evidence available suggests that this will rise moderately. Although the consumer confidence index improved in October, its behaviour is somewhat erratic. Moreover, some households are still very much in debt. Regarding investment, surveys point towards some improvement. According to the Bank of England's Inflation Report for November, a larger number of entrepreneurs plan to increase their savings over the next twelve months.

The recovery might slow up a little in the last quarter of the year.

Looking at the trends in inflation, this increased by one tenth of a percentage point in October to 3.2%, once again higher than the expected level. Inflation is therefore still at a level that is significantly higher than the Bank of England's target for price stability, namely 2%. Although inflation is not expected to fall below 2% before 2013, for the moment the Bank of England is resisting any rise in interest rates as this would harm the recovery in economic activity.

Inflation surprises again, rising to 3.2%.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010			
			4Q	1Q	2Q	3Q	October
GDP	–0.1	–5.0	–3.0	–0.3	1.7	2.8	–
Retail sales	1.7	1.0	2.6	0.0	0.8	0.7	–0.1
Industrial production	–3.1	–10.1	–5.9	0.3	1.7	3.3	...
Unemployment rate (1)	2.8	4.7	5.0	4.9	4.6	4.5	4.5
Consumer prices	3.6	2.2	2.1	3.3	3.4	3.1	3.2
Trade balance (2)	–93.6	–86.8	–82.4	–82.8	–85.0	–90.2	...
3-month Libor interest rate (3)	5.5	1.2	0.6	0.6	0.7	0.7	0.7
Nominal effective pound exchange rate (4)	97.6	73.9	79.1	80.4	78.2	81.5	79.3

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.

In emerging Europe, 2010 has been a year of recovery, although at different rates.

In short, the United Kingdom's economy is expected to continue to recover, although less strongly, partly due to the significant readjustment planned by the government. However, the fact that British GDP has seen solid growth in the last two quarters practically rules out the possibility of a double-dip recession.

Emerging Europe, 2011: momentum, cycle and financial risk

What can we expect from emerging Europe in economic terms? Perhaps the best way to present our forecasts is to compare this year, 2010, with what we expect for the coming year. First of all, 2010 will have been the year in which the incipient recovery started in the second half of 2009 became consolidated. Nonetheless, this is a strongly uneven recovery. In spite of all the economies we usually mention in this section enjoying improved activity in 2010, namely Poland, Slovakia, the Czech Republic, Hungary and Romania, there will be notable differences between them.

We expect the expansionary drive to continue in 2011.

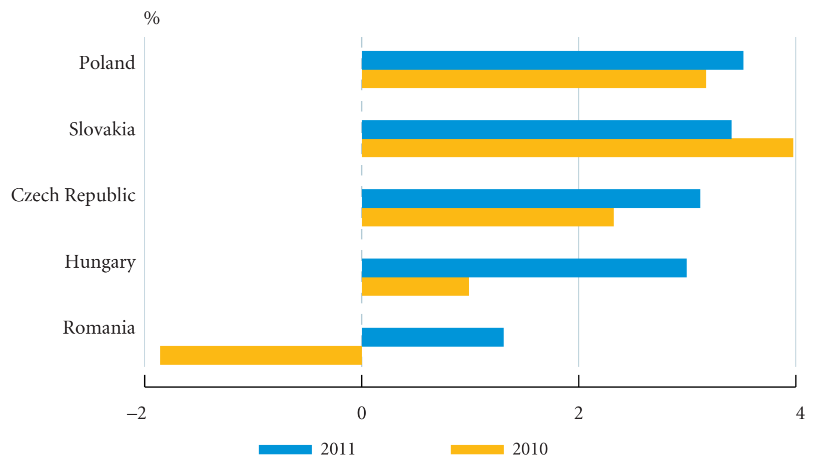
Romania will not have avoided another drop in GDP due to the need for tough adjustments in its public accounts. A similar process, albeit less intense, to that carried out in Hungary, leading to positive but low growth in 2010. The other three economies will have ended 2010 with average annual growth of around 2%-4%.

Expansion in the region will have been mainly due to the pull from exports and, to a lesser extent, restocking. In other words, because of improvements in the euro area. The main exception will be Poland, whose domestic demand has been stronger. Lastly, 2010 will also be remembered as only partly reflecting the strong pressure on country risk that other economies on the periphery of the European Union have suffered from appreciably.

What path will the region's economy take in 2011? The four previous trends, and their expected evolution, could be given four different labels. The first, momentum continues. In other words,

2011, YEAR OF GROWTH IN EMERGING EUROPE

Real growth forecast



SOURCES: National statistics offices, Eurostat and own calculations.

the resurgence looks like continuing. Growth figures for the third quarter have been a pleasant surprise. Except for Romania, a country immersed in heavily reducing its public expenditure, GDP grew in the remaining countries in quarter-on-quarter terms during this period.

Confidence indicators, after weakening a little at the end of this third quarter, have also picked up again at the beginning of the last quarter of 2010. This trend, which points to a positive start for 2011, is backed by the growth scenario we forecast for the euro area, which should grow around 1.6% in the coming year.

Second label: less cyclical disparity. The region's economies will see more similar trends in 2011. First of all, the five countries mentioned will record positive GDP growth, Romania around 1.0% and the other four between 2% and 3.5%. Or, in other words, while the difference between the country that grew the most (Slovakia) in 2010 and the one that grew the least (Romania) will have been close to six percentage points, in 2011 this gap (the two extremes being, once again, Romania and, this time, Poland) will be around two percentage points.

A third summary could be «recomposing growth». Under this somewhat enigmatic label we're simply pointing out that, in 2010, exports and stocks were the main engines behind growth, while in 2011 this is expected to be exports and investment. Domestic demand will therefore gradually start to play a more important role, a situation that will improve the sustainability of the recovery, making it less dependent on the state of the euro area's economy.

The last of these labels for the future could be «limited political and financial volatility». To date, international investors have been precise when differentiating between sources of country risk. The current risk premia (estimated by the so-called Credit Default Swaps, better known by their abbreviation CDS) point towards three categories of countries. Romania and Hungary are in a high country risk zone (in the order of 300 basis points but lower than Portugal's rate, for example). Poland, whose fiscal situation is less pressing than that of the countries we have just mentioned but far from being completely satisfactory, remains in the zone of 125 points. Lastly, the Czech Republic and Slovakia are at low levels, in the zone of 70-80 points.

The recent tension in debt markets resulting from Ireland's problems has hardly been felt by the CDS of Hungary and Poland and has had zero impact on the rest of the countries. This picture has been repeated throughout the different moments of crisis in investor confidence in Europe, and we believe it's likely to follow the same pattern in the coming months. The main sources of financial volatility should therefore be notably idiosyncratic, i.e. resulting from domestic economic policy and limited to the national sphere. This means that the odd point of tension cannot be ruled out for Hungary and Romania throughout the year, two countries whose efforts to cut their public deficit might lead to domestic problems. None of this, however, is sufficient reason to believe it will affect the recent trend of international financial flows picking up and moving towards the region's countries.

The countries will grow at more similar rates than in 2010.

Domestic demand will start to pick up.

There might be the odd rise in country risk in Hungary and Romania.

Monetary and capital markets

Economic and monetary divergence

Divergent economic activity is reflected in monetary policy.

As we reach the end of 2010, the different points at which advanced and emerging economies find themselves in the cycle is becoming more marked. Moreover, the outlook for 2011 is that developed countries will continue to see sluggish growth while emerging countries will only slightly slow up the good pace they've enjoyed throughout 2010. Notable differences can also be seen in inflation. Within this context, industrialized countries are very likely to maintain a lax monetary policy while less developed countries will continue restricting theirs.

The economy of the United States, which has accumulated a high negative output gap (the difference between effective and potential GDP) and low inflation, is one of the key players within this scenario of contrasts. The latest actions to be taken by the Federal Reserve (Fed) are framed

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2009									
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	1.00	1.03	1.52	0.25	0.29	0.20	0.50	0.74	0.23
November (1)	1.00	1.04	1.54	0.25	0.28	0.20	0.50	0.74	0.36

NOTES: (1) November 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.

within this complex situation. At its meeting on 3 November, the Fed took a far-reaching decision: to extend its quantitative easing (QE2), announcing a lower amount than for 2009 with a flexible monthly calendar and dependent on how economic activity develops. In fact, the reserve bank stated that the QE2 has a dual priority: to support the revival in growth and sustain price stability, preventing the economy from falling into deflation.

The strategy that the institution presided over by Ben Bernanke has decided to follow has both supporters and critics. The latter argue that the meagre economic benefit does not offset the high risk of inflation incurred. In this respect, important members of the Fed have countered these criticisms by reminding detractors that the institution has the necessary instruments (such as the capacity to remunerate surplus reserves, reverse repos and term deposits) to toughen up monetary conditions without the need to reduce the size of its balance.

The greater liquidity provided by the QE2, together with additional regulatory and supervisory measures (for example, the Fed's guidelines to banks regarding the payment of dividends and share buybacks) help to contain and consolidate counterparty risk premia in the interbank market. This supports the stable behaviour seen in the Libor dollar interest rate, expected to continue in the short and medium term.

The case of the euro area is different to that of the United States, as although the region is growing below its potential, it does not face any serious deflationary risk. For this reason, statements by the members of the European Central Bank (ECB) have kept on the same lines and arguments of the last few months. The monetary authority has hinted that it will continue to gradually remove exceptional stimuli to provide liquidity and support for credit during the first quarter of 2011. Given that, apparently, the financial problems facing Ireland will be resolved through the European Financial Stability Fund (governmental bailout fund), the ECB will have more margin to remain on its course. In any case, several spokespeople for the reserve bank have repeated that the reference rate could be raised before the financial schemes have been completely withdrawn, although the market does not think this option very likely.

Within a scenario where the ECB is not hinting at any substantial changes and in which most of the surplus liquidity has already been drained off (October's LTRO), the Euribor interbank interest rates are unlikely to vary significantly over the coming months. In the medium term, European interbank rates will probably rise gently as the central bank carries out additional adjustments to liquidity or clearly indicates that it will start to raise the official rates.

Lastly, this panorama of global divergence is completed with several emerging economies. Countries such as China, Brazil, South Korea, India and Chile have recorded strong economic growth and a significant upswing in inflationary risks. The response of their national central banks has been to raise official interest rates to keep these pressures under control.

China particularly stands out due to how much effect its monetary policy might have globally. Once China's annual inflation rate was found to be 4.4%, the central bank increased the ratio for

The Fed opts for greater quantitative easing and the ECB states it will keep to its action plan.

The ECB might withdraw its exceptional stimuli to provide liquidity in the first quarter of 2011.

Inflationary pressures in the emerging countries lie behind their restrictive monetary policies.

mandatory reserves by 100 basis points in the first half of November. One latent risk would be the reserve bank toughening up its monetary policy too much, thereby increasing the risk of a bumpy economic landing.

The Irish sovereign debt crisis is resolved

The sovereign debt crisis reappears in the euro area, now focusing on Ireland.

During the months of September and October, the financial sovereign debt crisis in the euro area seemed to have slackened, only to reappear with twice the virulence in November. The epicentre of this earthquake was in Ireland. Two factors led to this storm in the financial markets. Firstly, the London Clearing House (LCH), with Clearnet asking for greater guarantees in repo operations involving Irish public debt. A clearing house acts as the counterparty for the parties to a contract and determines, on a daily basis, the guarantee deposits for open positions, finally settling contracts at maturity. When it increased the guarantee requirements, several Irish banks found it difficult to meet these conditions. Given this situation, they were forced to sell part of the Irish sovereign bonds in their portfolios and therefore pushed up yields.

The second element that led to sales of Irish bonds was the uncertainty regarding possible reductions for public debt holders from the euro area in the case of a bailout. The result was a fall in the price of bonds and a rise in yields, with Irish 10-year bonds having a yield of 8.9%.

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								
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	2.52	2.91	4.21	3.94	2.60	0.94	3.08	1.49
November (*)	2.72	3.10	4.67	4.19	2.88	1.14	3.38	1.55

NOTE: (*) November 22.
SOURCE: Bloomberg.

To calm down investors, Finance Ministers from the euro area issued a memo denying that, in the case of the bailout mechanism being activated for a member of the European Union, the private sector would lose on any sovereign debt already issued. This managed to pacify the markets for a few days but it didn't stop fears from ultimately spreading to the sovereign debt of other countries in the euro area, such as Portugal and, to a lesser extent, Spain.

Although Ireland has enough liquidity to meet its public debt payments up to mid-2011, its financial system is in a difficult situation. In fact, the extensive bad debt suffered by Irish banks and the government's financial effort to inject capital convinced the European Union that it was necessary to draw up a bailout plan for the country. In mid-November, experts from the International Monetary Fund, in combination with those from the European Union and the European Central Bank, went to Ireland in person to design the bailout plan. Finally Ireland, after Greece, is the second country in the euro area to officially ask for aid from the European Union. The Irish Finance Minister, Brian Lenihan, confirmed that part of the money will be channelled towards the financial system through a contingent capital fund.

Yields also rose slightly on United States debt. For example, the interest rate for 10-year Treasury bonds rose from 2.6% at the end of October to a maximum of 2.96% on 16 November. This increase is not due to greater sovereign credit risk or to a rapid deterioration in the inflation expectations of economic players, which are still reasonably anchored. There are two elements that explain this movement. The first relates to mere profit-taking after the announcement that the Fed would extend its monetary policy. The second relates to the encouraging improvement in the situation of US consumers, confirmed by retail sale figures for October. Both factors helped to raise debt interest rates to levels more in line with the economic situation.

These reasons mean that we can rule out any change in trend in sovereign debt interest rates for the United States. What is most likely is that, over the next few months, the current rates will fluctuate although they're unlikely to return to the low levels reached this year. In the medium term, and depending on the economic expansion, there should be a slight upward trend. Lastly, it should be noted that, in the long term, insufficient fiscal adjustment in the United States might push its sovereign debt interest rates up more quickly.

In the case of the euro area's public debt, and after the strong signal from the European Union that it will do everything required to bail out those member countries that need it, over the coming months the tensions in the region's debt should decrease, although there may be some specific disturbances. In the long term, the outlook is a gentle upward trend in sovereign debt yields for the region as a whole.

Much ado about nothing in the currency markets

Since the start of the year, there have been many official statements by managers of economic policy around the world on the level of exchange rates.

Ireland is the second country, after Greece, to officially ask for financial aid from the European Union.

The rise in debt yields for the United States is due to profit-taking and good retail sale figures.

The currency war is more a war of words whose impact on the real economy is not significant.

THE HANDLING OF THE IRISH CRISIS STOPPED THE EURO FROM DEPRECIATING AGAINST THE DOLLAR

Trend in the euro-dollar exchange rate

SOURCE: Bloomberg.

EXCHANGE RATES OF MAIN CURRENCIES

November 22, 2010

	Exchange rate	% change (*)		
		Monthly	Over December 2009	Annual
Against US dollar				
Japanese yen	83.5	2.5	–11.4	–6.6
Pound sterling	0.622	2.4	–0.6	–3.3
Swiss franc	0.989	1.2	–4.7	–2.2
Canadian dollar	1.013	–1.2	–3.9	–4.2
Mexican peso	12.234	–0.8	–7.0	–6.0
Against euro				
US dollar	1.374	1.5	4.0	8.1
Japanese yen	114.7	1.0	–16.1	–16.0
Swiss franc	1.359	–0.3	–9.2	–11.2
Pound sterling	0.855	–4.0	–3.8	–5.4
Swedish krona	9.360	1.3	–9.6	–10.1
Danish krone	7.455	0.0	0.2	0.2
Polish zloty	3.924	–1.0	–4.5	–5.1
Czech crown	24.69	0.5	–7.1	–4.8
Hungarian forint	272.8	–0.9	0.9	1.8

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

During the last few months, the press has even called this situation a «currency war», although volatility has hardly increased in the currency market, in spite of this media scenario. Certainly, the «war» has been perceived in the press's headlines but the impact on the markets and the economy has been small, as shown by the latest growth figures for international trade published by the World Trade Organization.

Even the absence of any specific agreement at the G-20 summit, held in South Korea on 11 and 12 November, regarding exchange rate coordination has not led to any sharp movements in the main exchange rates, beyond the ranges considered normal by economic players.

This does not mean that exchange rates have been stationary. Although, after the Fed announced its QE2 policy, the dollar lost value against the euro, the Irish crisis then had the opposite effect. The graph below shows this to-ing and fro-ing. Whereas, at the end of October, one euro was worth 1.39 dollars, it started to rise in value until reaching 1.42 dollars (4 November), later returning to the level of 1.35 dollars by mid-November.

Over the next 12 months, the approach taken by Asian countries and particularly China will be decisive. We expect their currencies to appreciate steadily, which will allow the euro-dollar exchange rate to be determined essentially by the relative economic and monetary fundamentals of both regions. Taking these factors into account, the euro is likely to stay around its current value over the next few months.

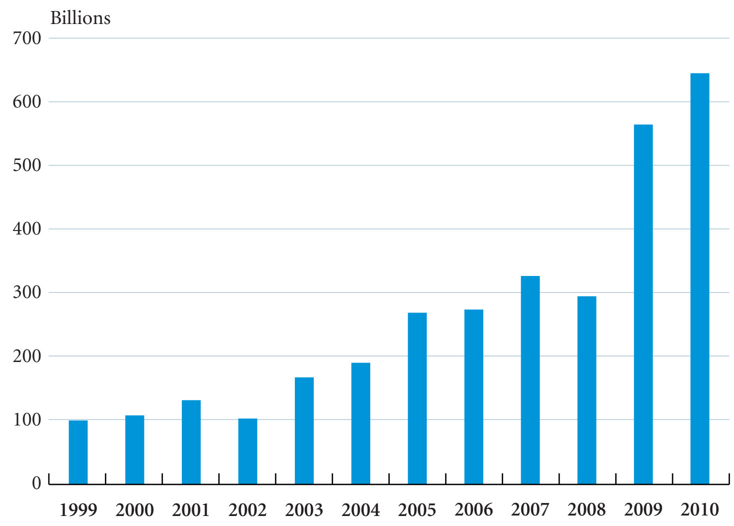
Corporate bonds with and without bubbles

The euphoria in corporate bonds is spreading across all sectors and many analysts are wondering if a bubble is forming.

Within a context of global economic recovery and expansionary monetary policies in developed countries, corporate

THE STRONG DEMAND FOR EMERGING ASSETS BOOSTS ISSUES

Corporate bond issuance of emerging countries



NOTE: From the start of the year to 15 November.
SOURCE: Bloomberg.

Europe's sovereign debt crisis drives investors towards corporate bonds.

bonds continue to perform well, i.e. recording price increases and reductions in yields. This cycle is singular because the rapid drop recorded in yields in the emerging countries has been similar to or greater than the one in developed economies, as the latter are affected by large fiscal deficits or foreign debt.

Recently, the Fed's QE2 announcement has boosted the appetite for higher risk assets and, more specifically, corporate bonds. These measures are pushing flows from monetary assets towards corporate bond assets and have led to an additional reduction in credit spreads and a drop in yields to record lows in various sectors, as a consequence of strong buyer pressure among investors.

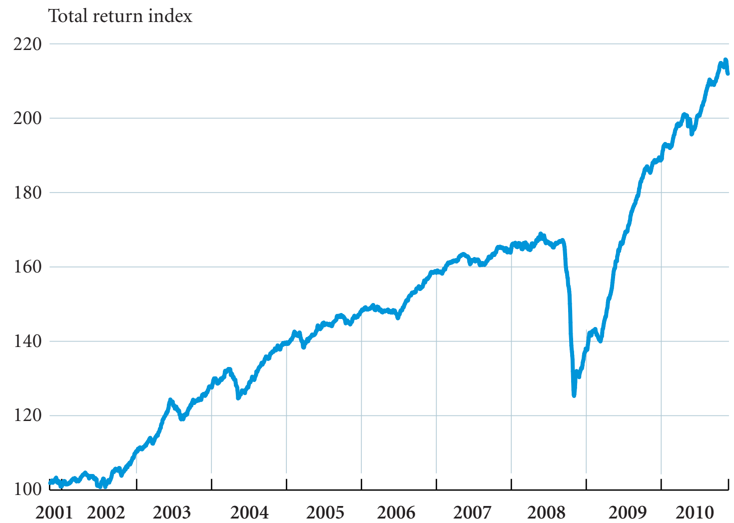
Large firms with access to debt markets have refinanced their debt at low interest rates.

Within this scenario of high liquidity and fund availability in the world's capital markets, together with low interest rates in money markets, managers are diversifying their strategy and making room in their portfolios for securities from new issuers with lower credit quality but higher yields. Surprisingly, the sovereign debt crisis in the euro area is hardly altering the continual flow of funds towards corporate bonds. Rather it seems as if the opposite is happening, as investors believe that corporate bonds are safer, given the uncertain developments in public debt.

Due to the scarcity of public debt from emerging countries, their corporate bond markets also offer an attractive risk-return ratio. Consequently, institutional investors have gradually improved their perception of these economies' capital markets, considering them to be more stable and safer, as opposed to unstable sovereign debt of some developed countries.

EMERGING CORPORATE BONDS CONTINUE TO PERFORM WELL

Corporate bond index. Emerging countries



SOURCES: Bloomberg and Credit Suisse.

Given the consolidating pattern of economic recovery, the outlook for corporate bonds is favourable. On the one hand, future expectations of profit are positive; on the other, the result of the restructuring and financial deleveraging of firms is also helping to reduce credit risk. For these reasons, large firms with access to corporate bond markets have managed to refinance their debt at very low interest rates, while this fall in financial cost should also boost company accounts.

Although risk premia will probably continue to fall, which would strongly support this family of financial assets, two reservations should be made. Firstly, there are signs of overheating in some corporate bond segments and we can't rule out possible declines at times of uncertainty, be it global or local. Secondly, the conditions suggest that the good performance of corporate bonds compared with the stock markets will not be repeated in 2011.

Profits soar for corporate bond investors, leaving little margin for greater gains.

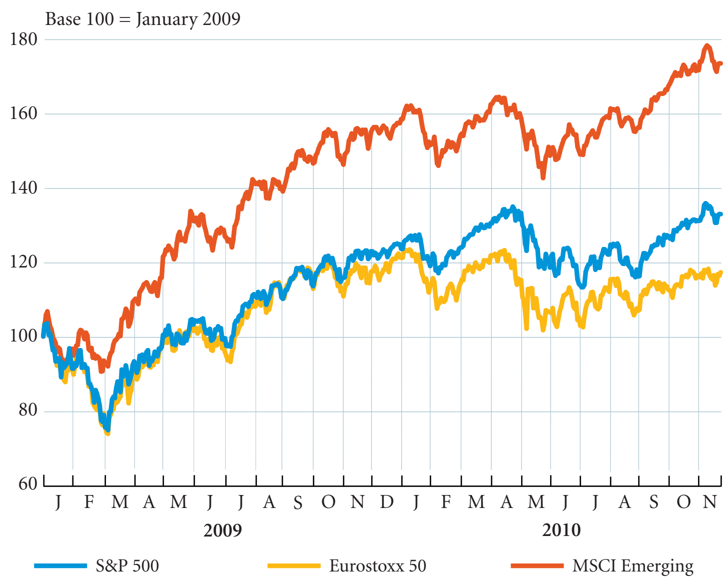
Stock markets: good prospects in spite of the risks

In November, the major stock markets were characterized by divergences and erratic movements, as seems to have been the predominant tone since the start of the year. Strong upward trends have been the name of the game in the indices of the United States and emerging economies, as a result of expectations of economic growth and monetary policy measures. However, European markets have been caught up in another rise in uncertainty given the delicate financial situation of Ireland and Portugal, although the euro area's economic forecasts have not worsened.

The equity of emerging economies accumulates the greatest gains of the year.

TRENDS IN THE MAJOR INTERNATIONAL STOCK MARKETS

Stock market indices



SOURCE: Bloomberg.

Without ruling out short-term corrections, the world's stock markets are likely to continue to rise in the medium and long term.

In the medium term, the outlook for international equity is still positive, although analysts don't rule out further reductions in the short term due to factors such as a more restrictive monetary policy in China or the sovereign debt crisis in the euro area. The expected improvement in economic activity, rising profits and acceleration in announcements of mergers and acquisitions, as well as less defensive strategies on the part of large listed firms, point towards equity performing well in the future.

The greater fall in European stock markets, and especially the Spanish stock market, has pushed indicators to more attractive levels. Consequently, and in the medium term as the sovereign debt crisis abates in the euro area, the gap should narrow between European equity prices and those in the United States and emerging countries.

INDICES OF MAIN WORLD STOCK EXCHANGES

November 22, 2010

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*11,203.6*	*0.6*	*7.4*	*8.6*
Standard & Poor's	*1,199.7*	*1.4*	*7.6*	*9.9*
Nasdaq	*2,518.1*	*1.6*	*11.0*	*17.3*
Tokyo	10,115.2	7.3	–4.1	6.5
London	5,758.0	0.3	6.4	9.6
Euro area	2,860.5	–0.5	–3.5	1.0
Frankfurt	*6,884.2*	*4.2*	*15.6*	*21.6*
Paris	*3,882.9*	*0.4*	*–1.4*	*4.1*
Amsterdam	*346.2*	*1.5*	*3.2*	*11.7*
Milan	*20,761.4*	*–3.6*	*–10.7*	*–7.8*
Madrid	*10,287.3*	*–5.8*	*–13.8*	*–12.2*
Zurich	6,597.7	1.9	0.8	5.1
Hong Kong	23,524.0	0.0	7.6	4.8
Buenos Aires	3,260.8	14.3	40.5	46.1
São Paulo	70,897.9	2.0	3.4	6.9

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.

Basel III, third time lucky?

The financial sector has changed extensively since the start of the crisis, both internationally and in Spain, but the transformation currently underway is only half-finished. During the last two years, several countries have been forced to intervene directly in some institutions in order to stop the crisis from spreading, something that was unthinkable until very recently but vital to stabilize the international financial system. At the same time, the financial industry has started a fast process of consolidation worldwide.

In Spain, the strict supervision carried out by the Bank of Spain during the years of strong growth and the relatively prudent management, especially by leading financial institutions, have resulted in a much lower need to inject public capital than in other developed countries. The financial sector is fundamentally being adjusted via the fast consolidation of the sector. However, although the storms affecting the financial system have notably abated, there are different factors in play that mean the process of transformation is still not over.

Firstly, weak demand and continued high risk keep the speed of the adjustment of the sector as a whole at low levels. The growth rate for credit posted a decline of 0.1% in September 2010 and this downward slide will continue next year, although some segments, such as consumer credit, are likely to show a positive trend. On top of the low levels of activity there is an additional pressure: narrowing brokerage margins and therefore lower profits. The low ECB reference rate limits the size of the brokerage margin and very likely the ECB is not going to change its monetary policy in the medium term.

Although it will put Spain's financial system under pressure, this adverse economic environment should not endanger the sector if it continues to look for solutions to improve its efficiency. The stress tests on the financial sector carried out in the month of July in all countries of the European Union (EU) analyzed their capacity to withstand more adverse conditions than those described above and most Spanish banks passed them. Similarly, in an exercise of transparency, the stress tests in Spain were applied to almost all banks in the system, specifically 95%, while the average for the rest of the countries was 65%.

In addition to this complex scenario, the financial sector will also have to adapt to far-reaching changes in its regulatory framework. The international financial crisis highlighted some significant gaps in the regulation for the banking sector, known as Basel II, and this has led regulators, supervisors, academics and the finance industry itself working against the clock over the last two years to redesign this framework. By the end of this year, the Bank for International Settlements (BIS) is expected to publish the definitive version of what is already known as Basel III, but the key features it's most likely to contain have already been disclosed.

Broadly speaking, two fundamental changes stand out regarding the current regulatory framework. Firstly, there will be a significant increase in the quality and quantity of capital that must be held by financial institutions.[(1)] This will strengthen the sector's solvency and should make it able to successfully handle periods of deep economic recession. Moreover, the capital requirements will be relatively flexible throughout the economic cycle to incentivize the accumulation of capital during economic booms that can be used during recessions. Given the considerable changes in the capital required, the BIS has proposed that this rise should be implemented gradually, between 2013 and 2019.

(1) For a more detailed discussion of the new regulatory framework, see Aspachs-Bracons, Bulach, Gual and Jódar-Rosell (2010), «Hacia una nueva arquitectura financiera». *Documentos de Economía*, no. 18, "la Caixa".

Secondly, the new minimum liquidity requirements for financial institutions also stand out. The aim is to ensure that institutions can handle periods when it's more difficult to obtain liquidity from international capital markets. The need to introduce this kind of requirement has become evident over the last few years. Some institutions had abused short-term wholesale financing to fund the rapid growth of their business. However, this strategy has shown itself to be devastating in periods of economic uncertainty, not only because it has made these institutions bankrupt but also because it has increased the instability of the system as a whole.

The BIS has already published a study that attempts to quantify the benefits that might be provided by the new regulatory framework. In the long term, it notes, the likelihood of a financial crisis is significantly lowered and would change from one every 20 years to one every 200 years, approximately. Given that the costs associated with such episodes have been very high in the past, 60% of GDP on average, this would be of significant benefit. However, the study presented by the BIS is not free from controversy. The BIS believes that a crisis is less likely because institutions will have a higher level of capital, but it has not taken into account the strategies that the financial sector will probably use to adapt to this new regulatory environment.

On the one hand, the risks taken by institutions might increase, as happened with Basel II. Greater capital requirements will probably increase the banking sector's financing costs and, in an attempt to maintain profitability, some institutions might take on higher risks. Moreover, part of this higher financing cost could be passed on to interest rates for loans. However, this might also have the opposite effect to the one intended by the regulator. Small firms would find it more difficult to access credit and the economy's potential growth might therefore decrease. Large firms, with more resources, are likely to reduce their bank financing and resort increasingly to financing themselves through the capital markets which, as has been seen over the last few years, are much more volatile at times of uncertainty. Consequently, the final outcome of Basel III might be the opposite to what is intended since, although the banking system will appear more solvent, the financial system as a whole might be weaker. In fact, in the BIS's own report, its authors acknowledge the limitations of the techniques used and conclude that the final effect is highly uncertain.

The strategy adopted by institutions while changing over to the new regulatory framework is also fundamental. The BIS believes that they will recapitalize partly by generating profits and partly by issuing more capital. But we have already seen that the financial system's profits will be quite limited over the coming years, so many institutions will have to resort extensively to the capital market to meet the new requirements. In Spain, the application of the new savings bank act will be fundamental in this respect. However, it's very important to remember what these markets' conditions will be like in the coming years. Although an institution can normally recapitalize without difficulty, we must bear in mind that the need to recapitalize will be widespread in most developed countries and, moreover, that the market will most likely put pressure to ensure the new capital and liquidity requirements are complied with more quickly than stipulated by Basel III. In fact, several institutions have already started recapitalizing to secure access to the market, and increasingly more institutions will follow suit in the coming year.

Given these circumstances, it's not clear whether the market will be able to absorb all the financial sector's recapitalization needs and this might greatly harm the economy as a whole. A study by "la Caixa" suggests that each percentage point of increase in capital requirements will reduce Spain's GDP by between 0.7 and 2.2 percentage points. The effect on credit growth might also be significant.(2) Estimates by the Institute of International

(2) See «The impact for Spain of the new banking regulations proposed by the Basel Committee», *Working Paper 01/2010,* Research Department, "la Caixa".

Finance (IIF) for the United States, the euro area and Japan aren't very encouraging either. According to the IIF, introducing Basel III in its design before the summer will deduct 4.4 percentage points from the GDP of the euro area in the coming years and the effect on credit will also be notable.(3)

If the challenges facing the financial system weren't enough, the introduction of Basel III will test the sector's capacity to transform itself. But before applying the new regulations, regulators must make sure that the consequences will be those intended: a more stable banking and financial sector that can contribute to the growth of the economy as a whole. The need to repair the current regulatory framework must not make us rush into anything too hasty - lest it's not a case of third time lucky.

(3) See «Interim report on the cumulative impact on the global economy of proposed changes in the banking regulatory framework», Institute of International Finance, June 2010.

This box was prepared by Oriol Aspachs Bracons
European Unit, Research Department, "la Caixa"

Economic activity

GDP comes to a halt in the third quarter

July's VAT hike and the withdrawal of economic stimuli result in economic activity slowing up in the third quarter...

After an initial six months with economic activity speeding up its growth to a certain extent, in the third quarter gross domestic product (GDP) ground to a halt, according to data from the National Accounts system published by the National Institute of Statistics. In fact, GDP increased by 0.0% in the period July-September compared to the previous quarter, a slowdown compared with the 0.3% quarter-on-quarter rise seen in the second quarter. This is particularly due to the hike in value added tax (VAT) in July, the withdrawal of direct aid for buying a vehicle and restrictive budgetary measures, such as civil service wage cuts.

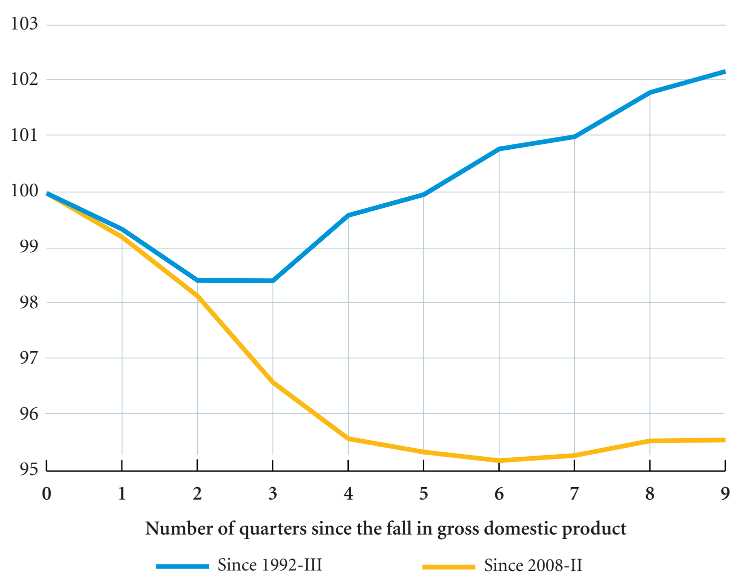
...but GDP posts its first year-on-year growth after seven quarters of falls.

However, in year-on-year terms GDP recorded a growth rate of 0.2%, its first positive figure after seven quarters of falls. This improvement was due to the foreign sector, which increased its contribution by 7 tenths of a percentage point, up to one point, whereas domestic demand intensified its subtraction by half a point to 0.8 points.

Nonetheless, the level of GDP in the third quarter of 2010 was 4.5% below that of the second quarter of 2008, at the

SLOW EXIT FROM THE GREAT RECESSION

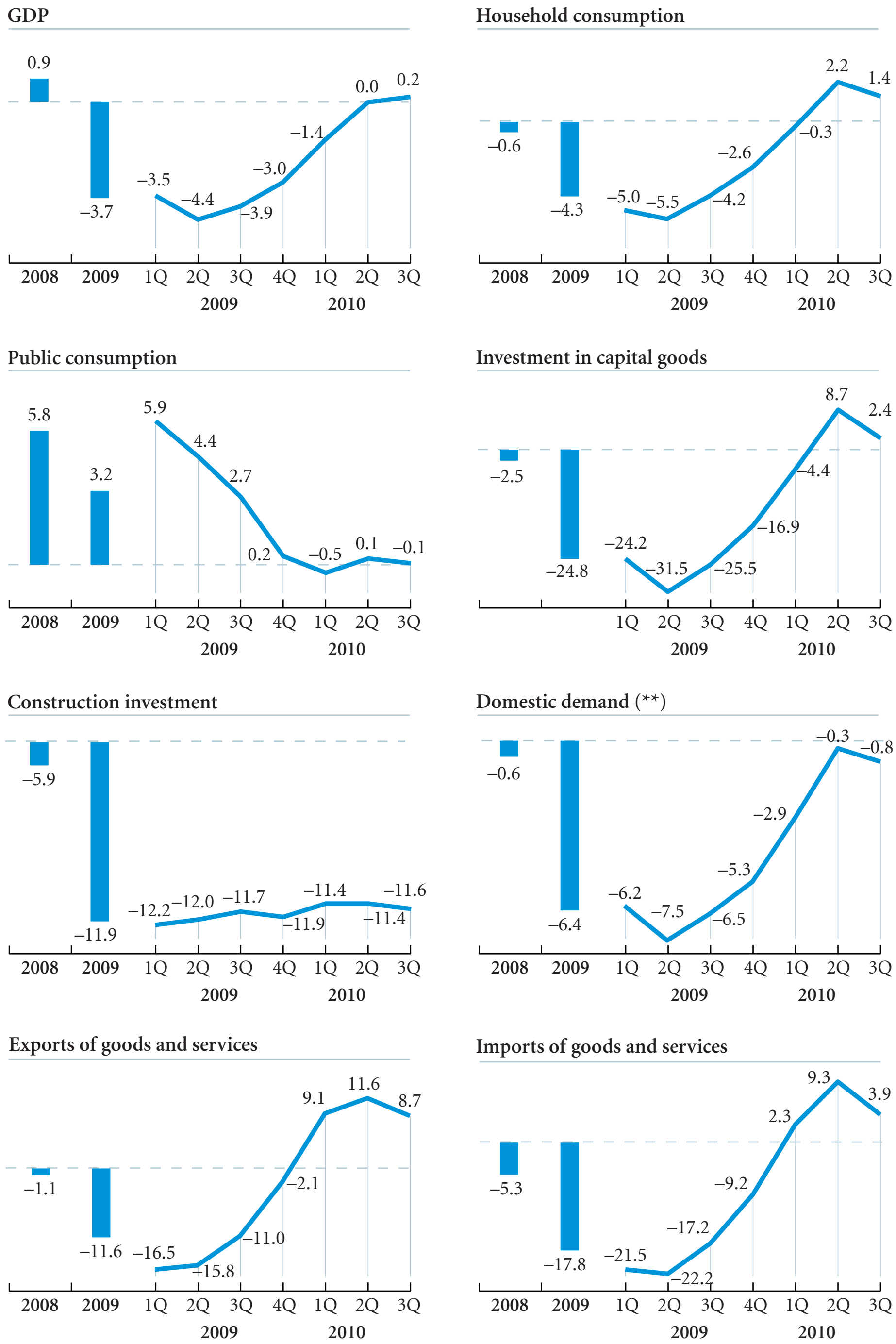
Gross domestic product indices by volume (*)



NOTE: (*) Series seasonally adjusted and corrected for calendar differences.
SOURCES: National Institute of Statistics and own calculations.

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



NOTES: (*) Data adjusted for seasonal and calendar effects.
(**) Contribution to GDP growth.
SOURCE: National Institute of Statistics.

Public consumption falls in the third quarter, in line with the restrictive budget policy.

Housing transactions fall in September but are likely to pick up again given the partial withdrawal of the tax deduction in 2011.

Upswing in electricity consumption at the start of the fourth quarter.

start of the great recession. However, in the previous recession of 1992-1993, GDP was 2.2% above its initial level nine quarters after the crisis started. This illustrates the depth, duration and slow exit from the great recession of 2008-2009.

Looking at demand, household consumption was down 1.1% compared with the second quarter, affected by purchases being brought forward to the second quarter to avoid the VAT hike, as well as the end of some fiscal stimuli, lower incomes and falling property prices. However, household consumption was 1.4% above the third quarter of 2009. The few data available for the fourth quarter show consumption to be ailing, as consumer confidence weakens slightly and car sales continue to plummet, in October posting a year-on-year drop of 37.6%, down to 1995's levels.

With regard to public consumption, this fell by 0.1% in the third quarter compared with the same period a year ago, particularly due to the cut in wages of government employees.

Investment interrupted its upward trend in the third quarter, also affected by the VAT hike and falling 3.0% compared with the previous quarter. This shrinkage was due to its main components: capital goods and construction.

Purchases of capital goods were down 5.2% compared to the previous quarter, affecting both machinery and especially transport equipment. However, truck registrations stopped falling in October and a gradual improvement is expected for capital goods investment, albeit limited, as industrial capacity utilization has dropped slightly in the fourth quarter.

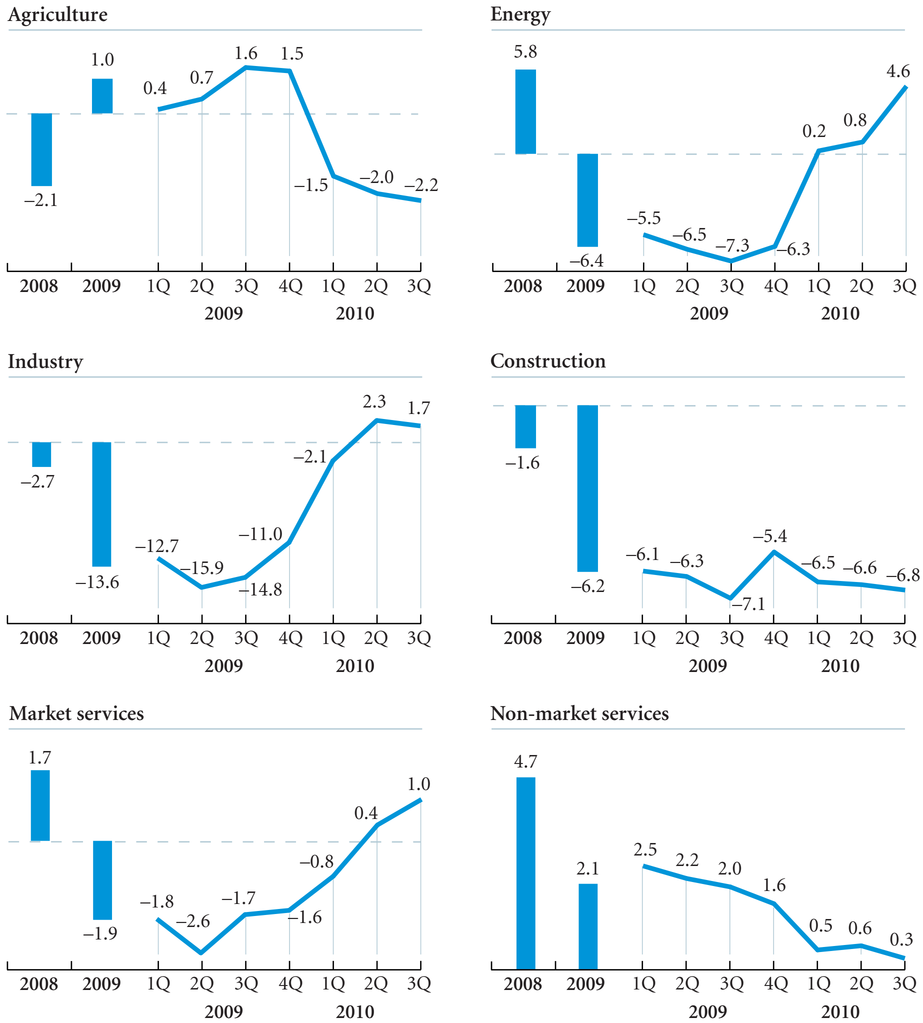
Investment in construction fell by 11.6% year-on-year, 2 tenths of a percentage point more than in the previous quarter. This slightly faster drop was due to non-residential construction and infrastructures, affected by budget cuts and down 8.5% compared with the third quarter a year ago. However, investment in housing eased up its decline from 19.3% to 16.4%. It should be noted that housing transactions fell in September due to the VAT hike in July. However, they will probably pick up again over the coming months given the partial withdrawal of the tax deduction for house purchases as from 2011.

With regard to the foreign sector, both exports and imports slowed up, in line with the moderation in demand, but imports did so to a greater degree. Foreign sales of goods rose by 10.4% compared with the same quarter the year before, while those of non-tourist services were up 5.4%. The tourism expenditure of non-residents also grew by 5.4% in the last year, speeding up slightly and reflecting a notable summer tourist season.

Looking at supply, trends varied across the different sectors. The branches of energy and market services livened up the rate of growth in their value added and industry posted increases of 1.7% compared with the same period a year ago, although this was lower than the figure recorded in the second quarter. On the other hand, both construction and the primary sector recorded higher year-on-year declines in their value added.

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)



NOTE: (*) Data adjusted for seasonal and calendar effects.
SOURCE: National Institute of Statistics.

Industrial confidence improved and electricity consumption picked up at the beginning of the fourth quarter. This points to the secondary market becoming more dynamic, albeit gradually, given the trend in demand.

From the point of view of incomes, the wages of salaried workers stabilized their year-on-year decline at 0.9%, as the 0.5% slowdown in average wages totally offset the moderation in the drop of the number of wage earners, standing at 1.3%. Meanwhile, both gross operating surplus and mixed income moderated their decline to 1.5% year-on-year.

Worker productivity reduced its annual growth to 1.9%. Manufacturing was the sector with the greatest growth in productivity in the last year, namely 5.5%, followed by the branches of energy, 3.1%, construction, 3.0%, and market services, 1.8%. However, the fall in unit

The acceleration in the fall in unit labour costs helps to improve competitiveness.

We have upped our GDP growth forecast for 2010 by one tenth of a percentage point to –0.2%.

labour costs sharpened to –1.4%, helping to improve competitiveness.

The indicator of economic sentiment for the Spanish economy improved slightly in October over September. Our forecasts also indicate a slight improvement in the fourth quarter, consolidating the exit from the recession. However, GDP for 2010 as a whole will probably record a slightly negative annual change, which we place at –0.2%.

The government announces a new package of measures to combat unemployment and change the production model.

Consumption will continue to improve in 2011, although not very strongly, in line with private sector deleveraging. The push from the foreign sector and the gradual improvement in the situation of firms will also boost investment, although investment in construction will continue to record negative year-on-year changes. GDP will therefore return to annual growth in 2011 after two negative years. Nonetheless, because of the correction in the imbalances accumulated and restrictive fiscal policy, economic expansion will probably be moderate, which we place at 0.7% annually.

Within this context, in mid-November the President of the Spanish government, José Luis Rodríguez Zapatero, announced an action plan to combat unemployment and change the production model. This broad set of measures will gradually be defined up to the end of the legislature but the package will contain measures to reform the labour market, such as modifying the collective bargaining system.

Also included are measures to boost business, such as reinforcing credit lines from the Official Credit Institute for innovation, extending the liberalisation of the rules on the amortization of business investments until 2015 and tax exemptions for capital increases in the property transfer and stamp duty tax, as well as a Comprehensive Plan for Industrial Policy and reforms of the energy sector. Moreover, the plan to rationalize state-owned companies will get rid of 14 public corporations and merge a further 24. Pension reform will also be carried out.

Labour market

Less deterioration in the labour market

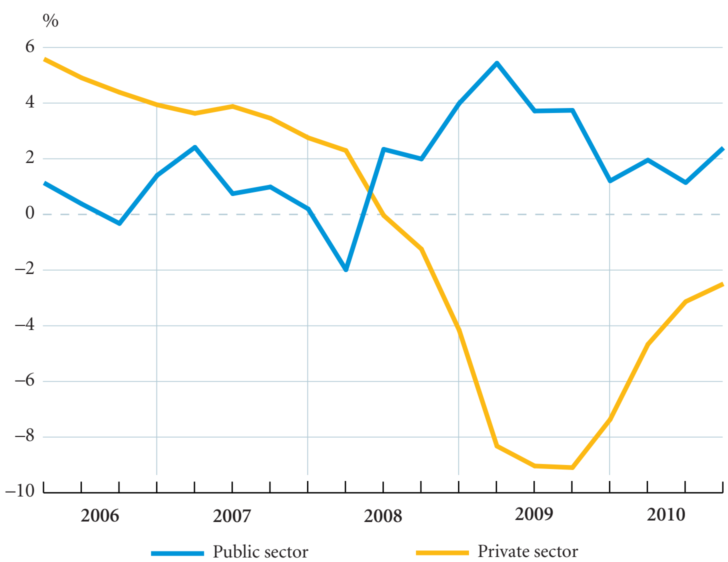
The slow recovery in economic activity is not heralding any change in job creation in the short term. In spite of the labour force survey (LFS) showing that the number of employed increased by 69,900 people in the third quarter, placing the total at 18,546,800, this figure is strongly affected by seasonal factors, as the summer months tend to be when most jobs are created. The fact that this rise was due to the public sector is no cause for optimism either. In fact, during the third quarter, 90,300 jobs were created in public administration and corporations but 20,400 jobs were lost in the private sector.

Nonetheless, the year-on-year drop in employment eased back to 1.7% (2.5% in the private sector), representing almost 325,000 jobs. On the other hand, in the last twelve months the total number of workers in public administration and corporations grew by 2.4%, mostly in the local bodies of Andalusia, Madrid and the Basque Country. This rise in public employment in the third quarter is partly due to contracts to replace public employees on holiday and temporary teaching posts, typical in the month of September. This trend, however, contrasts with the desire to reduce the public sector workforce expressed in the Public Function Agreement for the period 2010-2012 between the government and the unions.

Close to 325,000 jobs lost in the last 12 months.

ONLY THE PUBLIC SECTOR IS CREATING JOBS

Year-on-year change in estimated employment



SOURCES: National Institute of Statistics and own calculations.

The recovery in the number of people registered as employed with Social Security levels off.

Given these trends, the seasonal component leads us to suspect that employment will fall again in the fourth quarter, as suggested by the average monthly number of people registered as employed with Social Security for October. According to the Ministry of Labour and Social Affairs, the total number of people registered as employed in this month fell by 5,531 to 17,666,149 (around 18,000, seasonally adjusted), a higher drop in employment than expected. These data confirm that the employment situation is still deteriorating, albeit not so quickly.

Returning to the LFS, in the third quarter this shows that roughly the same number of jobs were created for men and women, with a year-on-year drop of 2.2% and 1.0%, respectively. By age, the number of employed increased among those under 25, boosted by summer jobs, and those over 44, also with positive year-on-year job creation rates. By sector, construction continued to lose the most

ESTIMATED EMPLOYMENT

Third quarter 2010

	No. of employees (thousands)	Quarterly change		Accumulated change		Annual change		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	754.0	–24.2	–3.1	–28.6	–3.7	16.8	2.3	4.1
Non-farm	17,792.8	94.1	0.5	–70.5	–0.4	–340.2	–1.9	95.9
Industry	*2,600.6*	*–18.3*	*–0.7*	*–80.3*	*–3.0*	*–119.0*	*–4.4*	*14.0*
Construction	*1,668.1*	*–31.6*	*–1.9*	*–134.6*	*–7.5*	*–182.2*	*–9.8*	*9.0*
Services	*13,524.1*	*144.0*	*1.1*	*144.4*	*1.1*	*–39.0*	*–0.3*	*72.9*
By type of employer								
Private sector	15,370.9	–20.4	–0.1	–209.3	–1.3	–397.4	–2.5	82.9
Public sector	3,175.9	90.3	2.9	110.2	3.6	74.0	2.4	17.1
By work situation								
Wage-earners	15,456.4	93.0	0.6	–36.2	–0.2	–193.7	–1.2	83.3
Permanent contract	*11,506.5*	*–34.8*	*–0.3*	*–99.9*	*–0.9*	*–97.6*	*–0.8*	*62.0*
Temporary contract	*3,949.9*	*127.8*	*3.3*	*63.7*	*1.6*	*–96.1*	*–2.4*	*21.3*
Non-wage-earners	3,085.4	–18.5	–0.6	–55.2	–1.8	–124.2	–3.9	16.6
Entrepreneurs with employees	*1,008.0*	*–28.7*	*–2.8*	*–43.0*	*–4.1*	*–53.7*	*–5.1*	*5.4*
Entrepreneurs without employees	*1,927.6*	*12.6*	*0.7*	*–3.1*	*–0.2*	*–40.3*	*–2.0*	*10.4*
Family help	*149.8*	*–2.4*	*–1.6*	*–9.1*	*–5.7*	*–30.2*	*–16.8*	*0.8*
Other	5.0	–4.6	–47.9	–7.7	–60.6	–5.5	–52.4	0.0
By time worked								
Full-time	16,174.8	196.6	1.2	–0.4	0.0	–379.2	–2.3	87.2
Part-time	2,371.9	–126.7	–5.1	–98.8	–4.0	55.8	2.4	12.8
By sex								
Males	10,376.2	42.3	0.4	–64.4	–0.6	–237.1	–2.2	55.9
Females	8,170.6	27.7	0.3	–34.7	–0.4	–86.3	–1.0	44.1
TOTAL	**18,546.8**	**69.9**	**0.4**	**–99.1**	**–0.5**	**–323.4**	**–1.7**	**100.0**

SOURCE: National Institute of Statistics and own calculations.

jobs, with an annual decrease of 9.8%. Also significant was the drop in industry over the last year, namely 4.4%, affected by weak demand. On the other hand, jobs were created in services in the last quarter, so that job losses were much fewer in this sector, 0.3% year-on-year.

On the other hand, total salaried employment fell by 1.2% year-on-year, the biggest readjustment being for workers with temporary contracts, down 2.4%, higher than the negative rate of 0.8% recorded for salaried workers with permanent contracts. But the economic crisis has affected non-salaried workers even more, with their jobs falling by 3.9% in the last twelve months. The number of employers therefore decreased by 5.1% year-on-year, a higher rate than the 2.0% drop for the self-employed.

Looking at the type of work day, figures show that the decline in employment is concentrated mostly in full-time jobs. While this group saw a 2.3% decrease compared with the previous year, the more flexible part-time employment increased 2.4% year-on-year. However, it should be noted that this trend came to a halt during the third quarter, as there were only job losses, 5.1% among part-time jobs. So the ratio of part-time employees fell by 7 tenths of a percentage point in the third quarter to 12.8%.

The labour force remains stable in the third quarter.

The labour force estimated by the LFS remained practically unchanged this quarter, standing at 23,121,500 people and with 0.6% year-on-year growth, higher than expected. This is due to the expansion in the foreign population. Given this expansion, the average annual growth in the labour force is likely to be higher than expected a few months ago.

Unemployment rate reaches 19.8%.

The trend in unemployment is the result of trends in the labour force and employment. In the third quarter, the total number of unemployed fell by 70,800 to a total of 4,574,700, this trend in supply and demand for work helping the unemployment rate to fall by three tenths of a percentage point to 19.8%. The expected rises in the labour force also point towards unemployment

ESTIMATED UNEMPLOYMENT

Third quarter 2010

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	2,480.2	–57.8	–2.3	189.3	8.3	54.2	19.3
Females	2,094.6	–12.9	–0.6	262.1	14.3	45.8	20.4
By age							
Under 25 years	860.8	–10.2	–1.2	–25.0	–2.8	18.8	40.7
Other	3,714.0	–60.5	–1.6	476.4	14.7	81.2	17.7
By personal situation							
Long-term unemployment	1,970.3	2.0	0.1	753.0	61.9	43.1	–
Seeking first job	378.4	16.6	4.6	64.0	20.4	8.3	–
Other	2,226.0	–89.3	–3.9	–365.6	–14.1	48.7	–
TOTAL	**4,574.7**	**–70.8**	**–1.5**	**451.4**	**10.9**	**100.0**	**19.8**

SOURCE: National Institute of Statistics and own calculations.

The number of unemployed falls in October in seasonally adjusted terms.

being somewhat higher in the coming quarter than expected, once again exceeding the figure of 20%.

The rise in registered unemployment is showing signs of stabilizing

In the month of October, registered unemployment increased again by 68,213 to a total of 4,085,976 people, a year-on-year increase of 7.3%. Nonetheless, once the series is seasonally adjusted, unemployment falls (by around 10,000) and its pace of growth continues to reduce.

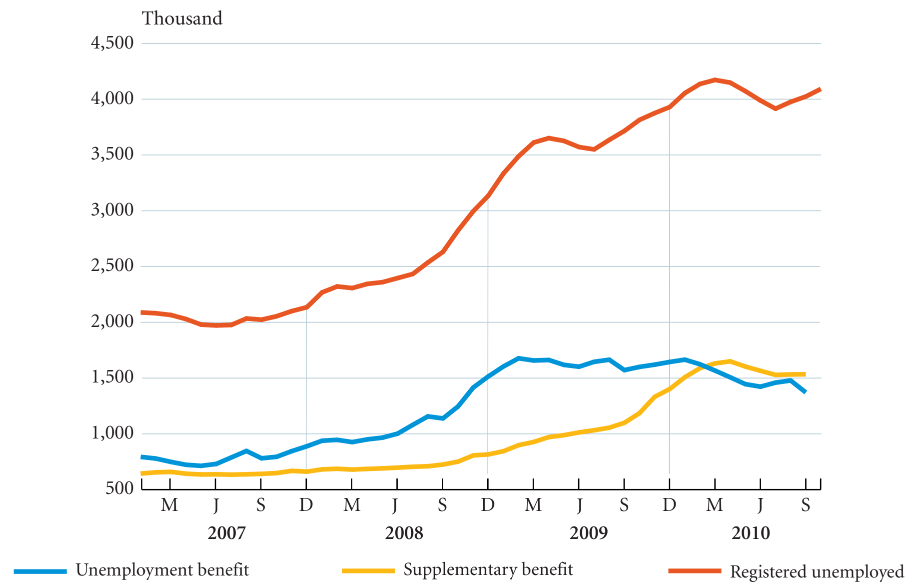
The number of claimants is growing more slowly than the number of unemployed.

In the last twelve months, the increase in newly registered unemployed of more than 275,000 people has led to a rise in unemployment benefits. At the end of August, the total number of claimants was therefore up to almost 3 million, a growth of 8.8% compared with the same month last year. However, it should be noted that the total number of claimants has levelled off in the last few months, largely due to the relative rise in the long-term unemployed, who have run out of entitlement. As the number of unemployed is not expected to fall before the second quarter of 2011, the larger number of people not receiving benefit or aid is likely to increase and this might harm consumption in the short term.

In short, the outlook for the labour market over the coming months is still not very optimistic as GDP is not expected to grow fast enough to create jobs. As the labour force is unlikely to shrink, unemployment will very probably be above 20% in 2011. However, the prospects for the second half of the coming year look more promising.

TOTAL CLAIMANTS LEVEL OFF WHILE UNEMPLOYMENT CONTINUES TO RISE

People receiving employment-related benefit or aid



SOURCES: Public Employment Offices and own calculations.

Prices

Electricity and fresh foods push up inflation in October

The year-on-year rate of change in the consumer price index (CPI) stood at 2.3% in October, 2 tenths of a percentage point more than in the previous month and back at the level of November 2008. Given the overall situation, this upswing in inflation over the last few months could be disconcerting but it can be explained by various factors that are, in principle, temporary.

Firstly, the upswing in inflation in consumer prices from the record low of –1.4% in July 2009 was particularly due to the rise in energy prices, especially fuels and oils as a result of the increase in crude. In October, almost 0.15 of the 0.2 percentage point rise in the year-on-year rate can be attributed to higher electricity prices.

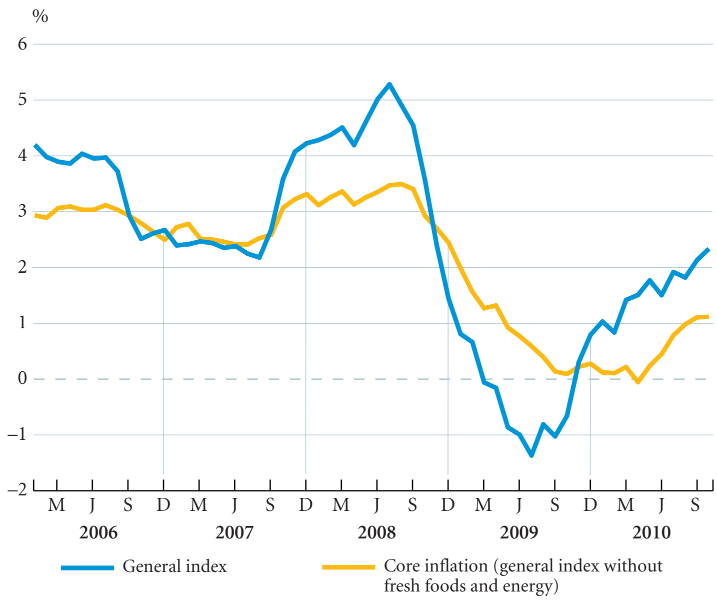
Fresh foods have also contributed to higher year-on-year inflation in the last few months, reflecting higher agricultural and livestock prices. In October, fresh foods contributed almost 0.05 points to the rise in the CPI's year-on-year rate, due to price rises for chicken and fresh fish.

Another factor that has pushed inflation up over the last few months has been the hike in the general value added tax (VAT) rate from 16% to 18%, and in the reduced rate from 7% to 8% as from July. This rise in VAT added about half

The year-on-year rate of change in consumer prices rises to 2.3% in October, returning to the level of November 2008.

CORE INFLATION SLOWS UP ONCE VAT'S IMPACT HAS BEEN ABSORBED

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	0.9	1.8	2.3
November	0.5	0.8	0.3			
December	0.0	0.8	0.8			

SOURCE: National Institute of Statistics.

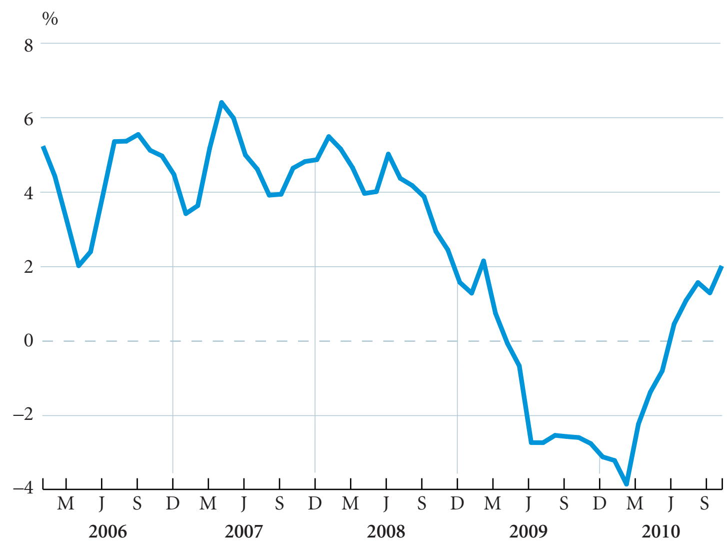
Business margins absorb close to half the theoretical impact of 1.2 points of inflation due to the VAT hike.

a point to inflation, approximately half the theoretical impact of 1.2 points if this hike had been passed on entirely to consumer prices, as deduced from the trends in the consumer price index at constant tax rates, published by the National Institute of Statistics. The rest was absorbed by business margins, given the weak consumer demand.

The most stable core of inflation, also known as underlying inflation, which

UPSWING IN FRESH FOOD PRICES

Year-on-year change in the price index for unprocessed foods



SOURCE: National Institute of Statistics.

excludes the most volatile elements, namely energy products and unprocessed foods, held steady in October at 1.1%. This therefore stopped the run of five consecutive rises, once the impact of the VAT hike had ended.

Core inflation's main components were quite stable in October, although non-energy industrial products increased their year-on-year rate of change by 2 tenths of a percentage point, up to 0.6%. Both clothing and footwear, as well as household articles contributed to this rise.

The harmonized consumer price index also posted a 2.3% rate of change year-on-year, leaving inflation's differential with the euro area at 0.35 percentage points, essentially due to energy products. On the other hand, the core inflation differential was –0.08 points.

Regarding the outlook for inflation, in November this might drop slightly but

CONSUMER PRICE INDEX BY COMPONENT GROUP

October

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2009	2010	2009	2010	2009	2010
By type of spending							
Food and non-alcoholic beverages	108.2	–0.2	0.1	–2.6	0.1	–2.4	0.4
Alcoholic beverages and tobacco	136.8	0.0	0.0	12.8	8.6	12.9	8.5
Clothing and footwear	104.9	9.6	9.8	–3.9	–2.8	–1.9	0.3
Housing	118.2	0.2	1.4	0.4	5.0	–0.3	5.4
Furnishings and household equipment	108.1	0.3	0.5	0.5	0.6	1.0	0.9
Health	96.5	0.0	–0.4	–1.4	–1.1	–1.3	–1.0
Transport	109.8	0.0	0.2	3.2	6.3	–4.4	6.9
Communications	98.6	0.0	–0.2	–0.3	–0.7	–0.9	–0.8
Recreation and culture	97.2	–0.7	–0.8	–1.8	–1.4	–1.3	–0.8
Education	116.9	1.6	1.4	2.5	2.1	2.2	2.3
Restaurants and hotels	113.7	–0.2	–0.2	1.5	1.7	1.2	1.5
Other goods and services	112.6	0.1	0.3	1.9	2.5	2.1	2.7
By group							
Processed food, beverages and tobacco	112.9	0.0	0.1	0.5	0.9	0.4	1.1
Unprocessed food	108.7	–0.5	0.3	–3.3	1.9	–2.6	2.1
Non-food products	109.0	0.9	1.1	0.5	2.0	–0.7	2.6
Industrial goods	105.8	2.0	2.5	–0.4	2.6	–3.0	3.7
Energy products	*119.2*	*0.0*	*1.3*	*6.1*	*11.1*	*–6.6*	*12.6*
Fuels and oils	*114.9*	*0.0*	*0.3*	*6.0*	*12.3*	*–11.0*	*14.3*
Industrial goods excluding energy products	*101.1*	*2.7*	*2.9*	*–2.6*	*–0.4*	*–2.1*	*0.6*
Services	112.3	–0.1	–0.2	1.5	1.3	1.6	1.5
Underlying inflation (**)	108.4	0.9	0.9	–0.2	0.7	0.1	1.1
GENERAL INDEX	**109.7**	**0.7**	**0.9**	**0.3**	**1.8**	**–0.7**	**2.3**

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

Inflation might dip in November but will probably pick up again in December and ease off in 2011.

it will probably pick up again in December and end the year around 2.4%, mainly because of oil prices. However, in 2011 weak consumer demand and the base effect of VAT as from July will tend to reduce inflation. Nonetheless, there is the risk of sharp rises in commodity prices.

Wholesale prices push inflation up

Energy and intermediate goods push up wholesale prices.

Industrial prices picked up again in September, particularly pushed by energy and intermediate goods. The year-on-year rate of change for industrial prices therefore rose to 3.4%, 7 tenths of a percentage point more than in August. The branches with the highest year-on-year increases were coking plants and oil refinement, with 24.4%, and metallurgy, with 16.1%, reflecting the rises in crude and metals in the last period.

The year-on-year increase in industrial import prices over the last twelve months up to September was higher, namely 9.1%, due to the euro's depreciation, although the highest year-on-year increases in import prices corresponded to energy (24%) and intermediate goods (10.6%), consumer goods rose by 6.6%.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflator (*)
		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	0.2	0.2	–
February	1.0	1.1	–0.6	0.0	–0.4	6.8	4.8	–0.5	0.3	1.5	0.7
March	5.6	2.3	–0.1	0.0	0.4	10.1	7.4	1.2	0.5	4.3	–
April	2.8	3.7	0.1	–0.1	2.4	13.1	8.5	2.1	0.7	6.7	–
May	13.7	3.8	0.2	–0.1	3.5	12.0	10.2	4.2	1.6	9.9	0.6
June	8.6	3.2	0.3	0.1	3.7	8.7	10.1	5.3	2.0	10.9	–
July	...	3.3	0.2	0.2	3.2	9.8	9.3	4.9	2.0	10.5	–
August	...	2.7	0.0	0.5	3.4	7.0	8.6	5.7	1.8	10.2	1.4
September	...	3.4	0.2	0.5	4.0	9.1	9.1	6.6	1.8	10.6	–

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

Foreign sector

New boost for the reduction in the current deficit

The foreign sector became the main engine of the Spanish economy in the third quarter of 2010, counteracting the weak performance of domestic demand in the same period. As illustrated by foreign trade figures, this is due to the slower pace of growth in imports resulting from the end to stimuli for consumption and the hike in value added tax (VAT). According to data from the National Accounts system, imports grew by 8.9% year-on-year in the third quarter, less than the 12.4% growth in exports over the same period. This situation represents a change in trend in the balance of goods deficit between July and September, down to 4.2% of Spain's gross domestic product (GDP).

Will the balance of trade continue to adjust in the medium term? The Spanish economy's sluggishness compared with its European partners in 2011 and the

The foreign sector becomes the main engine of the Spanish economy in the third quarter.

BALANCE OF PAYMENTS

August 2010

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change: Absolute	Annual change: %
Current account balance					
Trade balance	–31,000	8.8	–47,626	6,286	–11.7
Services					
Tourism	*18,792*	*2.4*	*26,476*	*–232*	*–0.9*
Other services	*260*	*–*	*–36*	*1,108*	*–96.8*
Total	19,052	6.2	26,440	875	3.4
Income	–15,241	–31.7	–23,473	11,506	–32.9
Transfers	–7,431	12.1	–8,783	–443	5.3
Total	**–34,620**	**–12.3**	**–53,443**	**18,224**	**–25.4**
Capital account	**4,742**	**68.9**	**5,992**	**2,150**	**56.0**
Financial balance					
Direct investment	–438	–	–2,539	4,942	–66.1
Portfolio investment	3,166	–78.2	33,550	35,321	–
Other investment	–20,044	–	–23,949	–69,034	–
Total	**–17,316**	**–**	**7,061**	**–28,770**	**–80.3**
Errors and omissions	–3,783	266.5	–5,761	–6,051	–
Change in assets of Bank of Spain	50,978	227.0	45,853	15,127	49.2

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 income balance deficit increases after a year of reductions.

significant improvement in exports to other, non-EU countries suggest that this will be the case, providing exchange rates are not too turbulent. In addition to this favourable trend in the balance of goods is the growing surplus in the balance of services, particularly boosted by tourism which, in August, came close to its record high of 2008. Given the good performance of these two main components of the current balance, the current deficit is expected to decrease in the medium term, leaving behind the stagnation of the second quarter.

However, not all sections of the current balance are facing the last part of the year with the same prospect of improving their balance. For example, the deficit in the income balance for August suffered its first decline after a year of adjustment. Taking into account the fact that employment income is not very significant, the increase in this deficit essentially reflects the behaviour of income from investment.

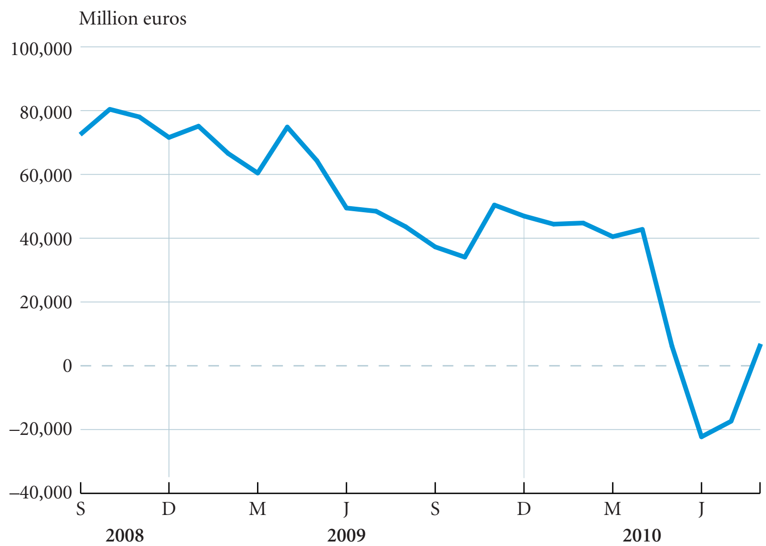
Of note is August's improved portfolio and short-term investment.

In short, the current deficit is expected to shrink again in the coming quarters thanks to the balances of goods and services, although the Spanish current imbalance will continue to be very high in 2011, more than 4% of GDP. Moreover, trouble with public debt interest rates might weaken this correction. A burden that, due to the Spanish economy's extensive leveraging, might get worse if interest rates are raised earlier than expected.

With regard to financial flows, August saw a reduction in foreign capital inflows, with portfolio investments and short-term financing being the main sources of funding. This can be seen in the following graph, which shows a recovery in the most customary financing channels (portfolio investment, direct investment and short-term financing). These figures contrast with the data for June and July, when the sovereign debt crisis meant that the Eurosystem became the main lender to cover Spain's net borrowing.

THE MOST CUSTOMARY FINANCING CHANNELS ARE BACK

Accumulated balance over the last twelve months of the financial balance (excluding the Bank of Spain)



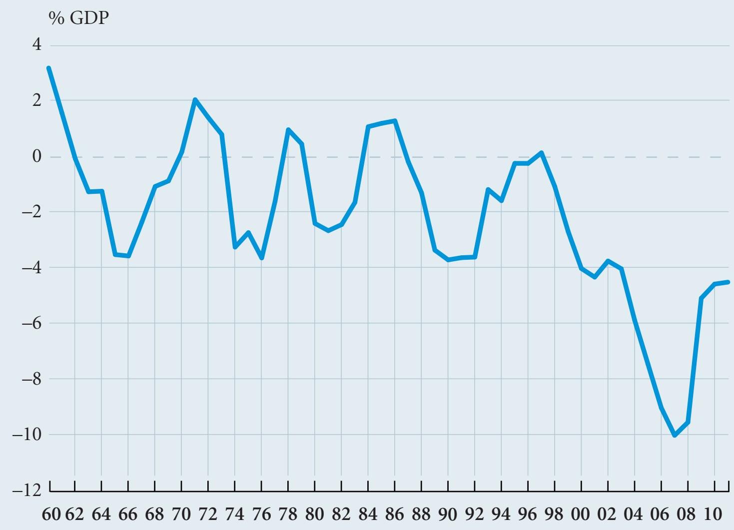
SOURCES: Bank of Spain and own calculations.

Correcting the Spanish economy's foreign deficit

Foreign imbalances took pride of place at the last G-20 meeting in the third week of November. Finally, the proposal made by Tim Geithner, the US Secretary of the Treasury, to put a limit on current account imbalances (both deficits and surpluses) of 4% of GDP did not come about. But ministers were given the task of establishing indicators to warn of any excessive deviations in their current accounts related to other countries. Spain does not form part of the G-20, although it has taken part in the last few meetings, but its representatives certainly felt they were being picked out: the Spanish economy has incurred deficits higher than 4% of GDP since the year 2000 (with the exception of 2002: 3.8%). Up to this year, it had never reached 4%, not even at the worst moments of the first oil crisis in the mid-1970s, or in the recession of the early 1990s, which led to three almost consecutive devaluations in the peseta.

BEYOND 4%, UNTIL WHEN?

Current account balance



SOURCES: AMECO and own calculations.

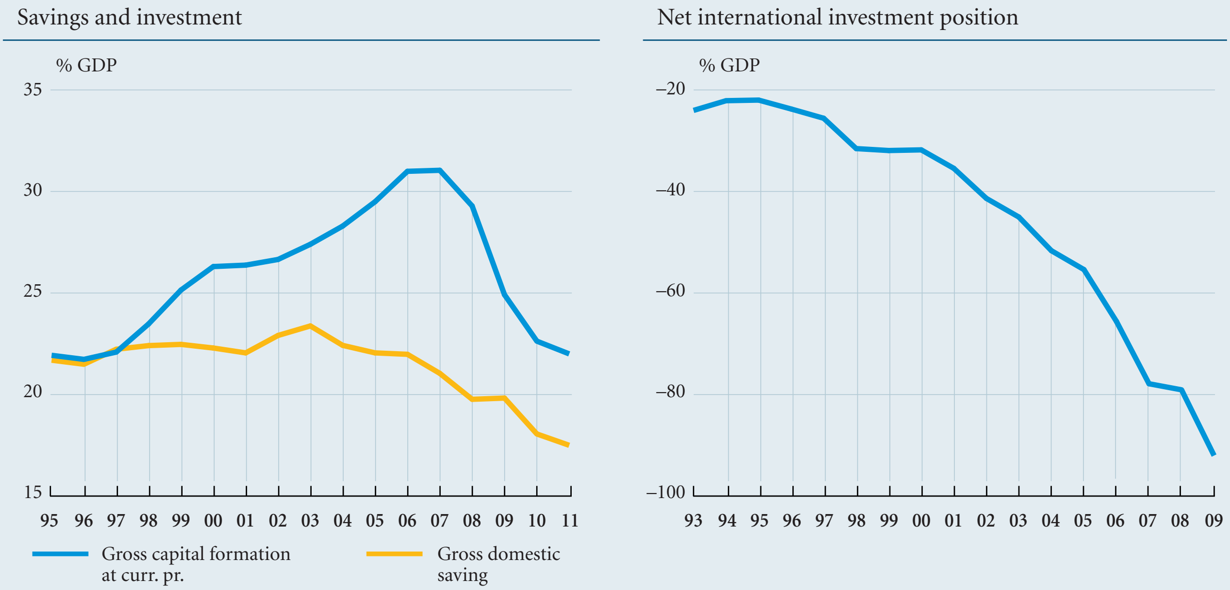
In 2010, and in spite of the slump in activity due to the recession that started in 2008, the current account deficit will once again be above 4%, a situation that's only matched by a few countries in our environment (Greece, Portugal, Turkey, Romania, Cyprus and Malta). If the Spanish economy enters a phase of recovery or expansion, periods in which foreign imbalances often get worse, there's every chance the deficit will widen even further. But what's the reason for this trend? Is it sustainable? How can it be rebalanced? For a greater understanding of how Spanish foreign imbalances have developed, we should look at the situation from three different perspectives: the balance of payments per se, the difference between savings and investment and, lastly, the Spanish economy's net international investment position.

From the perspective of the balance of payments current account, the main culprit is the trade deficit, which in the last decade has not been offset by the surplus in services and has been made worse by the increase in investment income payments and the change in trend of current transfers. Longstanding red numbers in the balance of imports and exports of goods suggest there's a problem with competitiveness abroad, even more so when we compare Spain's level and trends in productivity compared with its rivals, as well as the tendency of Spanish domestic costs to grow faster than most of its trading partners. However, when we look at the share of Spain's exports of goods in the world market, although we can see a slight dip in the last few years this is no worse than the decline suffered by countries such as France, Italy or the United Kingdom. In fact, this dip is due to trade within the EU, presumably because of competition from the economies of Central and Eastern Europe after they joined the European Union. However, in the case of the share in non-EU countries, this has remained stable, albeit at a very low level. A large part of the foreign imbalance can therefore be attributed directly to the strong pull of domestic demand, which grew dramatically in the last expansionary cycle. Another big influence has been the growing share of imported products in the final demand of consumption and investment, which must be attributed, in addition to the problems of competitiveness in Spanish industry, to the composition of growth. For example, the growing weight of construction, which imports quite a lot and exports nothing, is one of the elements that has had such an influence.

The strength of the last expansionary cycle leads us to the second perspective from which the current imbalance can be viewed: namely the difference between savings and investment. The difference between domestic savings (what remains of income after consumption) and investment is the same, on a national accounts basis, as the current balance compared with the foreign balance, which together with capital transfers constitutes the country's net borrowing (or lending) and its foreign exposure. In this respect, and as can be seen in the graph below, investment is almost singly responsible for the deviation. Over the last few years, until the crisis started, domestic savings had remained close to their historical average, namely 22% of GDP, while investment was above its historical average of 25% of GDP every year, even exceeding 30% of GDP in two years. Normally, expenditure on capital formation is valued more positively than that on consumption, but in the last expansionary cycle it seems clear that there was too much investment, or investment was aimed at activities that weren't very productive, given the slight change in the factors' overall productivity. In this trend, pride of place went to the private sector (the public sector's net savings were positive at the start of the recession). Excessive private investment compared with its savings required very high financial resources that have led to record high levels of debt. Consequently, household debt compared with its available income has gone from 70% at the beginning of 2000 to 130% at the start of 2008, when the crisis began, whereas in the case of firms, their debt has gone from 400% to 800% of their gross operating surplus in the same period.

The boom in debt in the private sector would not have been possible without the introduction of the euro in 1999, which opened the door to large amounts of cheap financing from abroad... until the global crisis erupted in 2007. During that period, financial restrictions were extraordinarily lax for households and firms, hence the growing debt channelled from abroad, the third dimension in which the current deficit is reflected. The accumulation, year after year, of current account deficits has led to a notable increase in the Spanish economy's net debt position compared with the rest of the world, this totalling almost one billion euros and going from 30% of GDP in 1995 to more than 90% in 2009. This is one of the highest levels among the countries in our environment and is a highly sensitive point given the current conditions, as a part of this debt must be refinanced every year, funds that add to the resources required to cover the new deficit generated each period. The worldwide economic crisis altered the placid nature of the international financial panorama and brought to light Spain's foreign deficit problem in all its harsh glory. The tensions created by the sovereign debt crisis this year have affected the stock markets and wholesale financing, creating serious problems of liquidity. Under these conditions, a high foreign deficit, such as the one held by the Spanish economy, is difficult to sustain.

THE OTHER FACES OF THE SPANISH FOREIGN DEFICIT



SOURCES: AMECO and own calculations.

Is it possible to go on growing without incurring a higher current deficit and greater foreign exposure? Can the private sector deleverage without depressing domestic demand? Can the necessary confidence be generated to continue to attract capital within a restrictive financial scenario like the present? The answer is yes, provided a serious effort is made regarding improvements to productivity and competitiveness, control of production costs, steering the productive economy towards the foreign sector, increasing public savings and carrying out the structural reforms required to facilitate all this. This is one of the biggest challenges to face the Spanish economy in the last few decades.

This box was prepared by Joan Elias
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Public sector

The discretional measures to correct the public deficit are having an effect.

Noticeable shrinkage in the central government's deficit

The slight improvement in the economic situation and particularly the discretional measures adopted to correct the public deficit, including some withdrawals of the economic stimuli put in place to tackle the recession, are having an effect on the central government's deficit. However, this adjustment is being noticed more in income than expenditure.

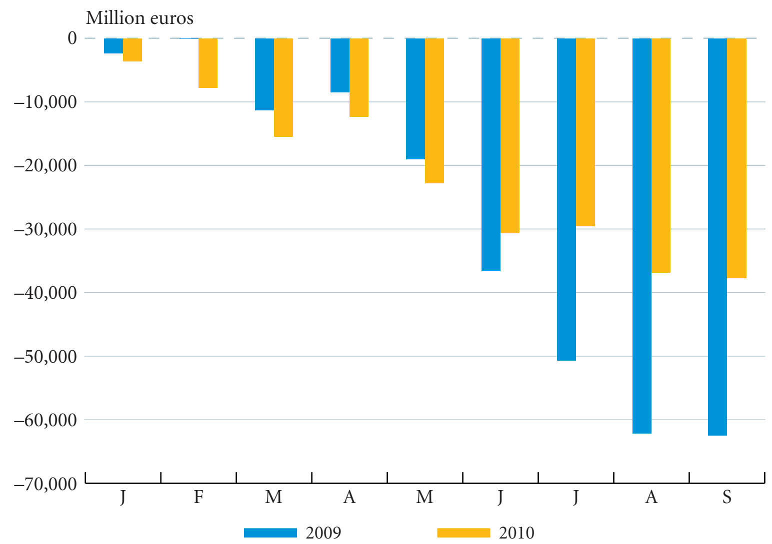
The central government's non-financial income rises 10% up to September, driven particularly by VAT.

The central government's non-financial income in Treasury terms, i.e. considering the monetary flows recorded, rose by 9.9% in January-September compared with the same period the previous year, before transfers to regional governments in line with the current financing system. This increase was particularly due to indirect tax, as the accumulated revenue from direct taxation fell by 0.4%.

Within direct taxation, the main item, personal income tax (IRPF), rose by 5.6% in the first nine months of the year compared with the same period a year ago, up to nearly 49.5 billion euros. This trend was largely due to the 5.0% rise in employment withholdings, the 8.2% fall in capital withholdings and the 6.8% fall in returns. The partial elimination of the 400-euro deduction contributed almost 2.9 billion euros and the rise in the capital withholding rate a further 210 million euros. Meanwhile, revenue from corporate taxation fell by 21.3% compared with the same period in 2009,

THE CORRECTION IN THE CENTRAL GOVERNMENT'S DEFICIT COMES TO A HALT IN SEPTEMBER

Data accumulated for the year



SOURCE: Ministry of the Treasury.

down to 11.3 billion euros. Regulatory changes contributed 555 million euros to this drop.

However, revenue from indirect taxation grew by 35.7% thanks mostly to value added tax (VAT), up by 57.1%. This trend in VAT revenue can particularly be explained by the drop in returns, the rise in tax rates and improved final expenditure by families and firms. Specifically, the rise in tax rates contributed 630 million euros.

Special taxes, on the other hand, rose by 4.2% up to 14.9 billion euros. This increase can be put down to the hike in the rates levied on hydrocarbons and tobacco in June 2009. However, the highest year-on-year increase was recorded by the special tax on electricity, up by 9.2%, of which 3.0 points are due to higher consumption and 6.2 to the average rise in the rate.

On the other side of the balance sheet, accumulated non-financial expenditure was down 2.2% year-on-year and current payments fell back by 0.3%. Among these, personnel costs rose by 2.7%, although the wages and salaries of active personnel rose less, namely 0.8%. Expenditure on goods and services dropped by 2.2% and current transfers by 2.9%. On the other hand, financial costs rose by 9.1% due to the expanding debt, basically bonds and commercial paper.

Capital costs fell by 13.0% year-on-year up to September. Real estate investment particularly suffered from the budget cuts and shrank by 11.0%, while capital transfers were down 14.1%.

Given these trends in revenue and expenditure, the central government had a non-financial cash deficit of 37.9 billion euros, an annual drop of 39.6%. On a national accounts basis, i.e. according to the rights and obligations recognised following accounting criteria, the accumulated net borrowing of the central government was 36.4 billion euros, an annual drop of 42.1%, leaving financing needs up to September at 3.45% of the gross domestic product, slightly less than the 5.96% recorded in the first nine months of 2009.

On the other hand, the EU's Council of Economic and Finance and Ministers asked for more reforms regarding the public pension scheme, as its long-term sustainability was called into question given the dramatic ageing of the population. The government stated that it would promote reforms in this area.

Spain's non-financial expenditure drops by 2%, due particularly to cuts in capital payments.

Financing needs fall by 42% year-on-year.

Savings and financing

Company deleveraging eases

Drops in credit to firms, while corporate bond issues rise.

The supply of loans to the private sector stabilized in the third quarter, in accordance with the findings of the Bank Loan Survey of October 2010 carried out by the Bank of Spain and in contrast to the tougher conditions observed three months earlier. According to this report, demand for credit shrank a little more than in the previous quarter, unlike the stability seen three months before, although applications for funds look likely to increase in the fourth quarter, except for consumption.

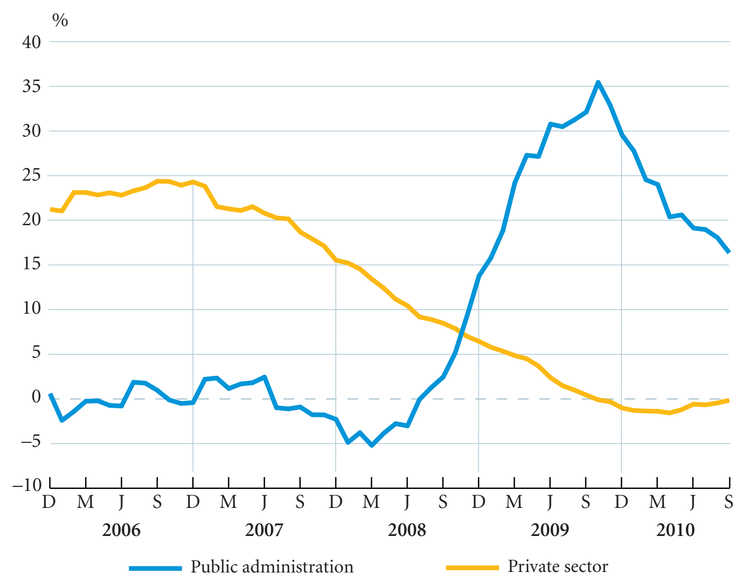
In fact, financing to non-financial firms continued to slow up its decline in September, recording a year-on-year decrease of –0.5%, aided by a lower real interest rate, discounting inflation. This year-on-year decrease was due to loans, both domestic and foreign, with drops of 1.5% and 2.1%, respectively. However, bond issuance picked up and posted 28.1% growth compared with the same month last year.

Slight slowdown in the fall in trade credit.

On the other hand, trade credit, which is aimed at financing firms' working capital, arrested its fall slightly and

PUBLIC SECTOR FINANCING SLOWS UP WHILE PRIVATE STABILIZES

Year-on-year change in financing



SOURCE: Bank of Spain.

FINANCING OF NON-FINANCIAL SECTORS (1)

September 2010

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,215,709	2,752	–0.1	78.4
Non-financial corporations	1,314.238	5,037	–0.5	46.5
Resident credit institution loans (3)	*903,873*	*–12,488*	*–1.5*	*32.0*
Securities other than shares	*63,139*	*6,940*	*28.1*	*2.2*
External loans	*347,226*	*10,585*	*–2.1*	*12.3*
Households (4)	901,472	–2,285	0.4	31.9
Housing loans (3)	*676,406*	*–2,146*	*0.4*	*23.9*
Other (3)	*221,572*	*–252*	*0.3*	*7.8*
External loans	*3,493*	*113*	*2.5*	*0.1*
General government (5)	611,445	50,857	16.3	21.6
TOTAL	**2,827,154**	**53,609**	**3.0**	**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.

recorded a year-on-year drop of 3.5%, whereas financial leases, linked to the funding of investment, saw a year-on-year decrease of 15.4%, similar to the previous months' figures.

Credit to households slowed up in September, recording a year-on-year growth of 0.4%, 2 tenths of a percentage point less than the previous month. This slowdown came particularly from housing, with a 0.4% rise year-on-year, 5 tenths of a percentage point less than in August and due to a certain reversal in mortgage applications after the VAT hike at the beginning of July. However, demand will probably pick up again over the coming months, as the deduction for the purchase of primary residences will be partially withdrawn in 2011. The rest of domestic loans, however, accelerated slightly up to a year-on-year change rate of 0.3%. For their part, foreign loans continued to moderate a little, with a year-on-year rise of 2.5%.

The bad debt ratio fell in September, with savings banks having a lower rate than banks.

With regard to non-performing loans, in September these took a break in their upward movement for financial institutions as a whole and fell by one tenth of a percentage point to 5.5%, although still 0.6 points above the rate of twelve months ago. For the first time, the bad debt rate for savings banks was lower than that of banks. In any case, both savings banks and banks are generally increasing their reserves as part of the process to adapt to the new regulations.

The risk premium for Spain's sovereign debt reaches a record high due to the Irish crisis.

With regard to general government financing, in September this continued to slow up, down to 16.3% for both short-term and long-term loans. As regards the risk premium, the spread for Spanish ten-year bonds compared with German in the first few weeks of November grew substantially in the light of the Irish debt crisis, in the fourth week of the month reaching its highest level since the euro was launched, namely 253 basis points.

Upswing in term deposits due to higher returns.

In September, the growth in overall financing to resident sectors therefore remained stable at 3.0% year-on-year for the fourth month in a row. This trend is the result of the slowdown in public sector financing and the brake on private sector deleveraging.

Slight growth in bank deposits

Returns on deposits have tended to pick up slightly in the last few months, in line with the Euribor, and the average return on household term deposits was 2.73% in September, 23 basis points more than in August and 60 more than twelve months before. This contributed to the expansion in private sector deposits, growing by 1.1% compared with September 2009. The gap between credits and deposits has therefore been narrowing, albeit very slightly, forming part of the adjustment currently underway.

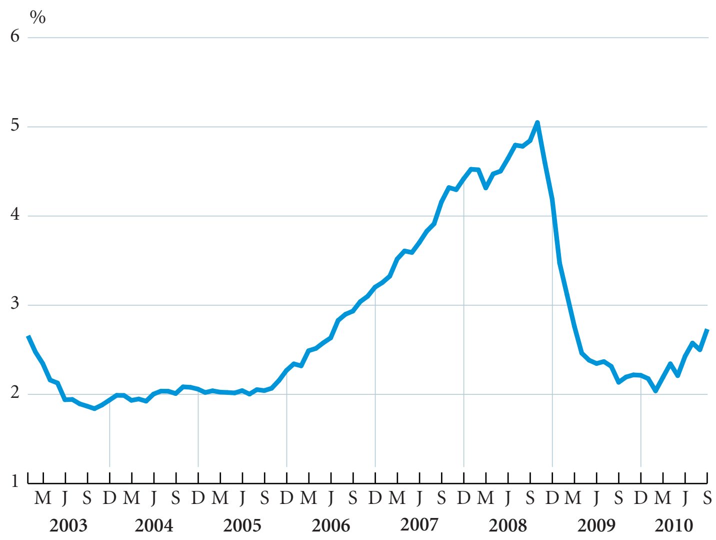
Within this context, term deposits took pride of place and posted positive year-on-year growth for the first time since October 2009, while on-demand and savings deposits continued to slow up.

Mutual funds were still affected by competition from deposits and the volatile financial markets. In October, net withdrawals totalled 2.1 billion euros, concentrated in short-term bonds and principal protected products.

However, mutual funds posted a positive average yield of 0.55% in the month, giving an annual average return of 1.7% and all categories recorded gains except for domestic equity and partially protected products. The largest gains went to international equity from the emerging markets, followed by other international equity funds.

UPSWING IN RETURNS FOR TERM DEPOSITS

Interest rate for new operations in credit institutions for household term deposits



SOURCE: Bank of Spain.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

September 2010

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	256,340	–6,395	–2.4	561	0.2	18.0
Savings deposits	208,518	727	0.3	10,554	5.3	14.6
Term deposits	733,342	13,331	1.9	5,436	0.7	51.4
Deposits in foreign currency	18,763	–3,252	–14.8	–3,672	–16.4	1.3
Total deposits	**1,216,964**	**4,411**	**0.4**	**12,880**	**1.1**	**85.3**
Other liabilities (*)	**209,807**	**–3,323**	**–1.6**	**–6,696**	**–3.1**	**14.7**
TOTAL	**1,426,771**	**1,088**	**0.1**	**6,184**	**0.4**	**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.

For their part, pension fund assets grew to 84.6 billion euros in the third quarter, a 3% year-on-year increase compared to September 2009. Gross accumulated contributions for 2010 as a whole, namely 2.9 billion euros, were greater than the figure for the first nine months of 2009, which was 2.8 billion euros. By system, the highest year-on-year increase in asset volume was the 3.6% rise recorded for the employment system, which is carried out by firms, followed by the individual system with a rise of 2.8%.

The average yield for the last twelve months was 1.3%. At fifteen and twenty years, the most appropriate periods for this kind of product, average annual returns were 4.2% and 5.2%, much higher than inflation for the same periods.

Pension fund assets rise 3% year-on-year.

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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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