

THE SPANISH  
ECONOMY

# Monthly Report



## THE CURRENCY CONFLICT

*Currency wars: prelude to a trade war?* [Page 10](#)

The relationship between exchange rates and international trade

*Which exchange rates are far from their equilibrium?* [Page 32](#)

Asia has the largest number of substantially undervalued currencies

*Alternatives for the small investor given the currency war* [Page 43](#)

The market has a wide range of investment products and strategies on offer

*Capital controls - why not?* [Page 62](#)

Those countries applying such measures have been the least affected by the worldwide financial crisis

# Forecast

% change over same period year before unless otherwise noted

	2009	2010	2011	2009		2010			
				3Q	4Q	1Q	2Q	3Q	4Q
INTERNATIONAL ECONOMY	Forecast								
Gross domestic product									
United States	-2.6	2.8	2.9	-2.7	0.2	2.4	3.0	3.2	2.6
Japan	-6.3	4.4	1.7	-6.2	-1.8	5.5	3.5	5.0	3.8
United Kingdom	-4.9	1.8	2.1	-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	-0.6	0.6	-2.3	-2.0	-1.1	-0.9	-0.8	0.4
United Kingdom	2.2	3.2	2.5	1.5	2.1	3.3	3.4	3.1	3.1
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								
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	1.8	2.3	-1.1	0.1	1.1	1.6	1.9	2.5
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								
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	3.2	3.3	3.5	3.4	3.7	3.2	2.6	3.2
10-year German bonds	3.3	2.7	2.9	3.3	3.2	3.1	2.6	2.3	3.0
Exchange rate									
\$/Euro	1.39	1.33	1.36	1.43	1.48	1.38	1.27	1.29	1.36

## Contents

<b>1 Editorial</b>
<b>2 Executive summary</b>
<b>6 International review</b>
6 United States
<b>10 <i>Currency wars: prelude to a trade war?</i></b>
12 Japan
15 China
16 Brazil
18 Mexico
19 Raw materials
<b>21 European Union</b>
21 Euro area
25 Germany
27 France
28 Italy
29 United Kingdom
30 Emerging Europe
<b>32 <i>Which exchange rates are far from their equilibrium?</i></b>
<b>35 Financial markets</b>
35 Monetary and capital markets
<b>43 <i>Alternatives for the small investor given the currency war</i></b>
<b>47 Spain: overall analysis</b>
47 Economic activity
51 Labour market
55 Prices
59 Foreign sector
<b>62 <i>Capital controls - why not?</i></b>
65 Public sector
67 Savings and financing

## The currency conflict

After the Second World War, the victors designed a monetary and global trade system that would help nations to progress based on stable exchange rates and the elimination of barriers to international trade. The authors of this system were very aware of the turbulences that started after the Great Depression of the 1930s, when countries attempted to export their unemployment by achieving trade surpluses with other countries, forced by devaluing their currency and implementing protectionist measures. After the Great Recession of 2008-2009, and given the tensions sparked in the exchange markets, we are once again hearing of «currency wars». Do we run the risk of repeating the turbulent thirties, with all the negative consequences this entails? Can we achieve internationally accepted standards of behaviour?

The Bretton Woods monetary system collapsed at the beginning of the 1970s because it was impossible to maintain fixed exchange rates within a context of increasingly mobile capital. Nothing replaced it and a multitude of exchange rate mechanisms were adopted on the whim of countries. Until the 1990s, the main concern regarding the absence of an international monetary system was the volatility of exchange rates and the extent or duration of fluctuations. Particularly in small or financially weak countries, as well as in developing countries.

As from the last decade of the last century, a new group of countries came on the international scene. Emerging economies, mostly Asian, prioritized exports as a means of growth, relegating progress in domestic demand to second place. This also led to a large amount of foreign reserves being accumulated, considered necessary to protect them against any possible crisis and to gain independence from advanced economies. Many of these countries adopted a fixed exchange rate system so that, over time, and given the accumulated gains in productivity, the undervaluation of their currencies has become much more evident. China is the clearest example of this policy, raising angry protests especially from the United States, which is suffering from a large trade deficit compared with the Asian giant.

Given this situation, the Great Recession has further turned the screw in the complicated international monetary network. First of all, it makes it very tough for advanced economies to maintain high current deficits due to the growing difficulty in financing these deficits. Moreover, it has given rise to the application, in some economies, of extraordinarily expansionary monetary policies which, as in the case of the United States, can potentially weaken the currency. The fluctuations in exchange rates and alterations in capital flows resulting from such policies have led to angry protests by countries that, like Brazil, have suffered from their currency appreciating extensively.

For the moment, the protectionist reflex has been very moderate, given that one of the pillars of the structure created after the Second World War, today known as the World Trade Organization, continues to set the rules of international trade. But monetary disarray is patent. The solution is not easy. But international authorities should make an effort to agree some rules that avoid the inconsistency of «each man for himself». Meanwhile, we will continue at the mercy of the intrinsic risks of currency wars.

# EXECUTIVE SUMMARY

**The modest growth of advanced economies contrasts with the dynamism of emerging countries.**

**The United States' new fiscal stimulus plan improves 2011's economic outlook.**

**In the EU, the northern economies are enjoying vigorous growth while some peripheral countries remain in recession.**

## Improved economic outlook for 2011

The outlook for the world economy in 2011 is positive. However, a marked contrast can be seen between advanced economies, generally with modest growth and high unemployment, with the dynamism being shown by emerging economies, which are even at risk of overheating. The exit from the recession seems assured, although the differing approaches on each side of the Atlantic stand out: expansionary fiscal policy and extremely lax monetary policy in the United States compared with the withdrawal of fiscal stimuli in Europe. Meanwhile, financial markets are slowly getting back to normal, at the same time as commodity prices are clearly on the rise.

Forecasts have improved noticeably in the United States. In addition to the good indicators of the last few weeks (business confidence, exports, etc.) and to another round of quantitative easing planned by the Federal Reserve, is a new fiscal stimulus plan that extends the tax cuts from the Bush era and reduces social security payments. President Obama, abandoning his electoral promise, has given in to the opposition on agreeing to maintain tax cuts for medium and high income brackets. Together with other measures, this stimulus package totals more than 850 billion dollars, to be distributed over 2011 and 2012.

For this reason, we have revised our growth forecast for the United States' gross domestic product (GDP) in 2011

from 2.2% to 2.9%, with the second half of the year possibly seeing rates above 3%, which is the growth threshold as from which unemployment tends to fall. The main risk lies in a possible relapse in house prices. We still think that the low inflation rate and high unemployment, which will not fall significantly in 2011, will make the Federal Reserve wait until 2012 to embark upon any increases in interest rates. Nonetheless, of note is the appreciable rise in yield for long-term US public debt over the last few weeks. Taking into account the fact that inflation expectations are still anchored and that the economy's solvency risk has not increased, which affects financial market ratings, this increase should be put down to a rise in the real interest rate, reflecting the improved economic outlook for the coming quarters.

The situation is more complex in Europe. The euro area's economy has continued to show signs of strength in the last part of the year and, in spite of the good figures for both the second and third quarter, there are no symptoms of growth wearing out – quite the opposite, in fact. The publication of GDP figures by component for the third quarter actually points to a more robust recovery than expected. Nonetheless, the cold arrival of winter, with the subsequent chaos in transport and interruption of construction projects in a large number of the countries of the European Union (EU) will suck some of the energy from growth in the final part of the year.

However, differences come to the fore when we look at individual countries,

with the strong growth rates of the north (Germany, Sweden, Poland, Slovakia and even the United Kingdom) contrasting markedly with the muted results of the south (France, Italy, Spain) and the recession of some peripheral countries (Ireland, Greece, Romania).

Beyond macroeconomic development, throughout December attention has focused once again on how to tackle sovereign debt crises, both current and future. The recurrence of turbulences as from October has been particularly intense and, on this occasion, has forced Ireland to accept a bailout plan given the severe deterioration in its banking system and the far-reaching imbalances in its public accounts. But pressure on sovereign bonds has also extended to Greece (whose economy was already bailed out in May), Portugal, Spain and even Belgium and Italy. These countries' spread with German debt, which has become the anchor for the system, has shot up to the highest levels since the euro came into being.

Paradoxically, the search for solutions to the crisis has helped to make this worse. The disclosure, mid-October, of the proposal that governments investing in public debt in the future should accept losses if the corresponding government can't meet its payments merely widened the spreads, while the announcement on 21 November that Ireland would receive financial aid in exchange for stabilization measures did not manage to calm the markets either. Speculation in the financial press and markets singled out Portugal as the next country for intervention, as well as Spain and even Belgium and Italy.

At the beginning of December, the European Central Bank (ECB) announced

that it would maintain its exceptional injections of liquidity via 3-month financing, which relieved tension to some extent. Moreover, the realization that the ECB's purchase of sovereign bonds was continuing at a good rate helped spreads to narrow. In any case, the decision of several international ratings agencies to downgrade and even negatively rate the public debt of Greece, Portugal, Spain and Ireland reflects the fact that the debt problem will not be resolved in the short term.

Acknowledging this, in December the European Council greenlit the creation of a European Stability Mechanism which, as from 2013, will turn the current European Financial Stability Facility into a permanent mechanism, created last May to provide financial support for those countries experiencing serious economic or financial disturbances and allocated 440 billion euros. Among other provisions, it was established to introduce standardized, identical conditions for collective action regarding new issues of public debt in the euro area as from June 2013 so that, when a country appears insolvent, it will be required to draw up a comprehensive restructuring plan with its private creditors. The European Council also agreed that the ECB should double its capital stock to underpin its efforts to buy up sovereign debt. However, certain proposals were not taken into account, such as the enlargement of provisions for the bailout fund, the possibility that this might buy up public debt or that the EU could issue euro bonds.

In Spain, the public debt spread with German bonds reached a record of almost 300 basis points by the end of November, easing as from then but remaining in the area of 250 points. As in the case of Greece, Ireland and Portugal, we expect

**New tension in the sovereign debt markets leads to Ireland's bailout.**

**The ECB acts to redress the situation but the ratings of affected economies are still falling.**

**The European Council agrees to make the current bailout fund permanent and to enlarge the ECB's capital.**

**The high spreads for Spanish public debt mean that a great effort needs to be made to control the deficit.**

**The government implements new economic policy measures, such as pension reform...**

**...and announces the reform of collective bargaining, key to regaining competitiveness.**

this spread to narrow as it becomes clear that the economic policies implemented are helping to consolidate fiscal development. Further increases in spreads cannot be ruled out, however. This, combined with the higher yields for German debt, means that the cost of issuing debt for the Spanish Treasury is the highest it has been for the last decade, forcing it to redouble its efforts to meet its budget targets.

So far, the results have been satisfactory. In the first eleven months of the year, the government deficit rose to 3.7% of GDP, a 46% drop compared with the same period a year ago and with the target figure of 6.7% of GDP for the whole year. With regard to the budget for autonomous communities, the aggregate deficit at the end of the third quarter reached 1.2% of GDP, so we expect the 2.4% target for 2010 will be achieved. Given that the Social Security budget is also on target, the figure of 9.3% of GDP, which was planned for 2010, is likely to be achieved (11.1% deficit in 2009).

For 2011, the target for fiscal consolidation is 6% of GDP, so that government wages and most pensions will be frozen, only one tenth of vacant posts will be filled and investment will be drastically cut back. In the last few weeks, the government has adopted further measures that affect the budget, such as a hike in tax on tobacco and the reduction in corporate tax applied to a certain segment of small and medium-sized enterprises. It has also announced the privatization of the airport management organization, AENA, and the organization that manages the state lotteries, measures that help to substantially reduce Spain's debt. Lastly,

the reform of the pension system, which will be specified in January 2011, will clarify the solvency of the public accounts in the medium or long term.

With regard to developments in the non-financial private sector, i.e. households and firms, the key lies in how activity is recovering. GDP growth forecasts for 2011 made by the OECD, the European Commission and the consensus of analysts agree with our figure of 0.7%. This is a lower rate of expansion than surrounding countries but we believe it's compatible with an improved economic-financial balance for these sectors. With regard to the financial sector, the consolidation of the savings bank sector and the Bank of Spain's announcement that it will provide more information on the risk of banks will help to reduce uncertainty and combat the mistrust generated in this respect.

Fiscal adjustment and improved confidence must be combined with steady progress in the area of foreign competitiveness, a key element to bolster the recovery and reduce the high unemployment rate that is hindering the Spanish economy. In this respect, the reform of collective bargaining, which will be specified in the first quarter of 2011, will be decisive in altering companies' ability to compete. It should be noted that, during the recession, labour costs continued to rise up to high rates in spite of sales plummeting, unemployment soaring and firms encountering problems of liquidity. Improved competitiveness will undoubtedly be the crux around which the economic recovery will revolve over the coming years.

27 December 2010



## CHRONOLOGY

### 2010

<b>January</b>	<b>29</b>	The government passes a package of <b>budget austerity measures</b> and proposes to raise <b>the retirement age</b> to 67.
<b>February</b>	<b>9</b>	Agreement for employment and <b>collective bargaining 2010, 2011 and 2012</b> between representatives of employers and trade unions.
<b>April</b>	<b>7</b>	The government presents its <b>extraordinary Infrastructure Plan</b> , which will involve 17 billion euros in the coming two years.
	<b>9</b>	The government passes a <b>new package of measures to boost economic activity</b> .
	<b>10</b>	The Finance Ministers of the euro area announce the <b>conditions for helping Greece</b> .
	<b>12</b>	The government proposes a <b>new plan to reform the labour market</b> , to be discussed within the context of social dialogue.
<b>May</b>	<b>2</b>	Countries in the euro area <b>approve financial aid for Greece</b> , totalling 110 billion euros.
	<b>10</b>	The European Union adopts a <b>European Stabilization Mechanism</b> , provided with 750 billion euros, with the involvement of the International Monetary Fund.
	<b>20</b>	The government approves a Decree-Law to adopt <b>extraordinary measures to speed up the planned reduction in its public deficit</b> .
<b>June</b>	<b>17</b>	The European Council decides to publish the <b>stress tests</b> for the main European banks, to levy a <b>new tax on banks</b> and improve the <b>budget discipline and macroeconomic standards</b> .
	<b>22</b>	The Spanish parliament <b>approves a Decree-Law with urgent measures to reform the labour market</b> , proposed by the government.
	<b>26</b>	One year after the Fund for Orderly Bank Restructuring (FROB) was set up, the Bank of Spain considers the <b>process of restructuring savings banks</b> in Spain to be almost complete.
	<b>27</b>	The <b>G-20</b> summit decides to halve the deficits of advanced economies by 2013.
<b>July</b>	<b>1</b>	<b>Rise in the general VAT</b> rate from 16% to 18%, and the reduced rate from 7% to 8%.
	<b>9</b>	The government approves the <b>reforms of the Savings Bank Governing Body Act</b> .
	<b>22</b>	The Ministry of Public Works specifies its <b>cuts in public works spending</b> .
	<b>23</b>	The Committee of European Banking Supervisors publishes the results of the <b>stress tests</b> on European banks.
<b>September</b>	<b>9</b>	The Spanish lower house passes the <b>labour reforms</b> .
	<b>24</b>	The government passes the bill for the <b>2011 General State Budget</b> , involving strong adjustments aimed at reducing the public deficit.
	<b>29</b>	<b>General strike</b> , called against the labour reforms.
<b>October</b>	<b>20</b>	Extensive reshuffle in the <b>Spanish government</b> .
<b>November</b>	<b>19</b>	The government establishes a <b>legislative calendar</b> that includes <b>pension and collective bargaining reforms</b> .
	<b>24</b>	<b>Ireland</b> presents an <b>adjustment plan</b> with tough measures to cut its public deficit in order to receive <b>financial aid</b> from the EU and the IMF.
<b>December</b>	<b>3</b>	The government approves a package of <b>economic policy measures</b> that includes, among others, the partial privatization of the state lotteries management body and the public corporation AENA, as well as raising taxes on tobacco.
	<b>16</b>	The European Council agrees to create a <b>European Stability Mechanism</b> in 2013, which will replace the current bailout fund, as well as to enlarge the capital of the European Central Bank.

## AGENDA

### January

- 4** Registration with Social Security and registered unemployment (December).
- 5** Industrial production index (November).
- 13** Governing Council of the European Central Bank.
- 14** CPI (December).  
EU HCPI (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).  
HCPI flash estimate (January).

### February

- 2** Registration with Social Security and registered unemployment (January).
- 3** Governing Council of the European Central Bank.
- 4** Industrial production index (December).
- 11** Quarterly GDP flash estimate (fourth quarter).
- 15** CPI (January).  
EU GDP (fourth quarter).
- 16** Quarterly National Accounts (fourth quarter).
- 17** Fed Open Market Committee.
- 25** Producer prices (January).
- 28** HCPI flash estimate (February).  
EU HCPI (January).

## INTERNATIONAL REVIEW

**The United States improves its growth prospects for 2011 and is expected to advance by 2.9%.**

**This improvement is due to state stimuli and private consumption's good performance, but the recovery will still be modest.**

### **The United States: the government and the Fed boost growth**

The outlook for the US economy in 2011 is improving, although high unemployment and debt levels will continue to ensure its recovery is modest. There are two reasons for this improvement. Firstly, the latest indicators for consumption and investment have been better than expected, reflecting a slowdown in household deleveraging, and fiscal and monetary policies have also taken a more expansionary direction than initially predicted at the end of the summer. So while the Fed continues with its second quantitative easing, at the beginning of December

the House of Representatives and the Senate agreed to extend unemployment benefit, maintain the tax cuts from the Bush era and reduce taxation on wages. A whole package of stimuli that totals 858 billion dollars, to be distributed mostly during 2011 and 2012.

This improvement in private indicators and particularly the larger amount of state aid have pushed up our growth forecast for gross domestic product (GDP) for 2011 from 2.2% to 2.9%, with the second half of the year possibly seeing growth rates higher than 3%, the growth threshold from which point unemployment begins to fall. However, in spite of this improved outlook,

### UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010				
			4Q	1Q	2Q	3Q	October	November
Real GDP	0.0	-2.6	0.2	2.4	3.0	3.2	-	...
Retail sales	-1.0	-6.3	1.6	5.7	6.9	5.8	8.0	7.7
Consumer confidence (1)	58.0	45.2	51.0	51.7	58.2	50.9	49.9	54.1
Industrial production	-3.3	-9.3	-3.8	2.7	7.4	6.8	5.5	5.4
Manufacturing (ISM) (1)	45.5	46.2	54.6	58.2	58.8	55.4	56.9	56.6
Housing construction	-32.9	-38.4	-14.8	16.5	12.2	0.4	0.9	-5.8
Unemployment rate (2)	5.8	9.3	10.0	9.7	9.7	9.6	9.6	9.8
Consumer prices	3.8	-0.4	1.4	2.4	1.8	1.2	1.2	1.1
Trade balance (3)	-698.8	-374.9	-374.9	-398.9	-451.6	-486.6	-493.0	...
3-month interbank interest rate (1)	2.8	0.7	0.3	0.3	0.5	0.3	0.3	0.3
Nominal effective exchange rate (4)	74.5	77.7	72.8	74.8	77.6	75.9	72.3	72.8

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.



recovery will still be precarious, as the private sector has yet to take over the baton from state stimuli and also the economy is still weighed down by certain problems. For example, household debt remains at a high 117.6% of disposable personal income, while the surplus supply of housing and unemployment will continue to feed off each other and push down real estate prices in the first half of 2011. Lastly, the extension of expansionary policies will delay the fiscal consolidation required, with a fiscal deficit that is expected to continue above 10% of GDP for the whole of 2011.

One of the most positive indicators for the last few months is for private consumption. Households saved 5.7% of their disposable income in October, a percentage that has fallen steadily since the peak of 6.3% last June. The effect of this relatively lower savings rate, together with lower interest repayments by households, can be seen in the good

performance of retail sales that grew by 6.8% year-on-year in November, excluding automobiles and petrol. In fact, consumers reached a milestone in November as, discounting the effect of price variations, retail trade managed to get back to its level of December 2007, before the credit crisis began.

This improvement in private consumption was in addition to the moderate optimism reigning among entrepreneurs. The business sentiment index of the Institute for Supply Management for November took a break after its upswing in October, with a manufacturing index that fell slightly to 56.9 points, while the services index fell to 57.0 points. Nevertheless, in both cases business sentiment continues to be in line with an expanding economy, although the drop in new orders reminds us of just how precarious this recovery is.

**Retail sales reach the levels of December 2007 thanks to lower savings.**

**Entrepreneurs continue to see signs of moderate expansion but the drop-off in orders raises some doubts.**

## THE UNITED STATES: THE RECOVERY IN PRIVATE CONSUMPTION PROGRESSES

Real retail sales without vehicles or petrol (\*)

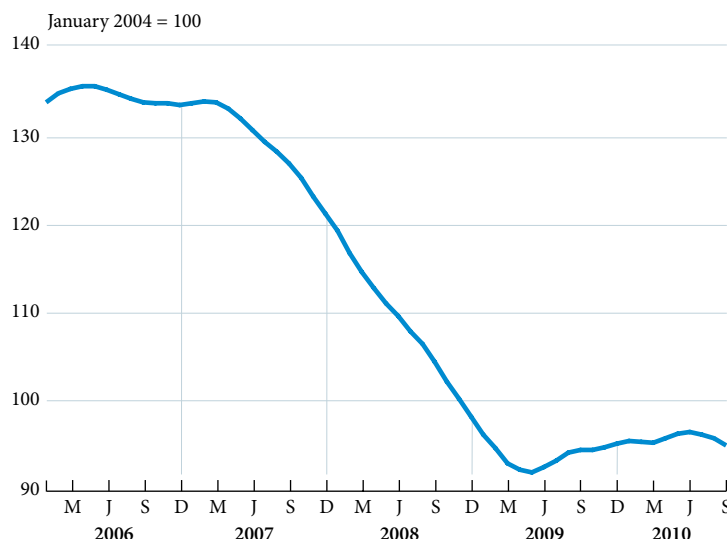


NOTE: (\*) Data deflated by the consumer price index without energy or foods.

SOURCES: Department of Trade and own calculations.

## THE UNITED STATES: THE RECOVERY IN HOUSING HAS FADED AWAY

Case-Shiller housing price index (\*)



NOTE: (\*) Series seasonally adjusted for the 20 most significant areas as a whole.

SOURCES: Standard & Poor's and own calculations.

**Construction still fails to recover while housing declines for the third consecutive month.**

In the area of housing, afflicted by problems of surplus supply, the sector will clearly continue to lag behind entrepreneurs and consumers throughout 2011. New homes started in November did not show any great improvement, still submerged at levels that are a third of the historical average prior to the recent real estate boom. Although sales are partly picking up from the slump after the end of state aid, this is due more to falling prices than any real revival in demand. The Case-Shiller index for second hand housing in September therefore saw its third consecutive month of decline. Prices should continue to fall during the first half of 2011 and, although the main scenario suggests these decreases will be moderate, should the decline in real estate wealth get any worse, this might put a squeeze on private consumption.

**The continuing high unemployment rate, now up to 9.8%, is the greatest burden on recovery.**

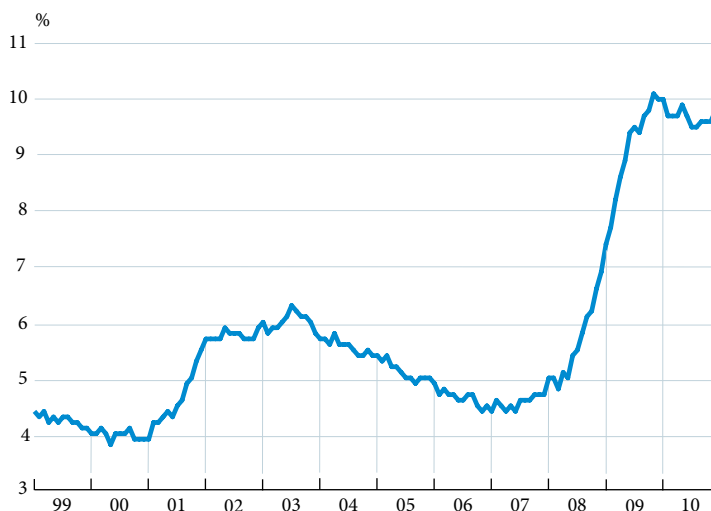
The main burden on the US economy is the labour market as weak labour increases

mortgage foreclosures which, in turn, continue feeding the surplus supply in the housing market. The unemployment rate increased in November from 9.6% to 9.8% due to discouraged workers joining the labour market, while the creation of jobs in the private sector is still feeble. Although the improved growth prospects point towards falls in the unemployment rate, this is unlikely to go below 8.5% in 2011. The slowness of the recovery means that the share of long-term unemployed, namely 41.9%, is double the previous record reached in 1982. In this respect, if the period of entitlement for unemployment benefit had not been extended, more than two million households would lose this subsidy in the first quarter of 2011, consequently pushing down aggregate demand.

For its part, inflation is still extremely moderate, with a general consumer price index (CPI) that continued to grow

## THE UNITED STATES: HIGH, PERSISTENT UNEMPLOYMENT

Unemployment rate compared with the labour force



SOURCES: Department of Labor and own calculations.

by 1.1% year-on-year in November. Core inflation, which excludes energy and food prices, rose by 0.8% year-on-year, more than October's rate of 0.6% and also higher than analysts predicted. Core inflation is being pushed down by the further fall in the price of durables, accumulating a drop of 1.1% over the last three months, while real estate rents are pushing in the opposite direction. More specifically, the improved growth prospects and quantitative easing being carried out by the Federal Reserve should gradual distance us from this deflationary scenario without, however, leading us into any appreciable tension in prices. As indicated by the debt markets, prices are unlikely to rise by much more than 2% in 2011 and 2012, given the US economy's persistently low production capacity utilization.

The foreign sector also joined the group of positive indicators in October. The trade deficit for goods and services was 38.7 billion dollars, its lowest level since last January, when the effects of the crisis in international trade were still being felt. The most significant figure was the good performance by exports, picking up after several months of slowdowns. But the upswing was more centred on the sale of commodities, subject to greater fluctuations, than on exports of manufacturing and capital goods, so we'll have to wait and see if this trend is confirmed to decide whether the foreign sector can make a positive contribution to growth in 2011. On the other hand, the continuing trade deficit and the Fed's expansionary policy should keep the dollar relatively weak.

**The CPI rises by 1.1% and the core CPI is up 0.8%, leaving behind its record low.**

**The trade deficit improves markedly thanks to exports.**

## Currency wars: prelude to a trade war?

At the end of September, Brazil's Finance Minister warned of an apparent «currency war». Since then, the tension resulting from the manipulation of some exchange rates has gradually increased, aggravated by the Federal Reserve's decision to implement a second round of quantitative easing. In addition to the volatility generated and its possible repercussions beyond the foreign exchange market, there is also the worrying possibility of these exchange rate squabbles leading to a full-blown trade war.

Exchange rate uncertainty is not insubstantial in economic terms, as it affects any decision that depends on this value, either directly or indirectly. Nonetheless, if there's one sector that's particularly affected by variations in foreign exchange markets it's undoubtedly import-export. When the exchange rate fluctuates, those involved in exchanging goods and services abroad are usually forced to act, either by adjusting the volume and/or price of their products or by reallocating their production resources. On the other hand, firms initially prepared to embark upon commercial operations abroad might become discouraged given this exchange rate risk, or the resulting adjustment costs should such fluctuations occur.

Since the flexible exchange rate system was widely adopted in 1973, the relationship between currency market volatility and the volume of international trade has aroused huge interest. However, neither theoretical analysis nor the efforts made to quantify the extent of this impact have achieved consensus. Regarding the theory, the assumed negative impact of exchange rate volatility on trade depends on specific events that cannot be generalized, so there's no certain relation between both variables. In fact, scenarios have been proposed where greater volatility can even widen a firm's range of opportunities, boosting its commercial activity abroad.

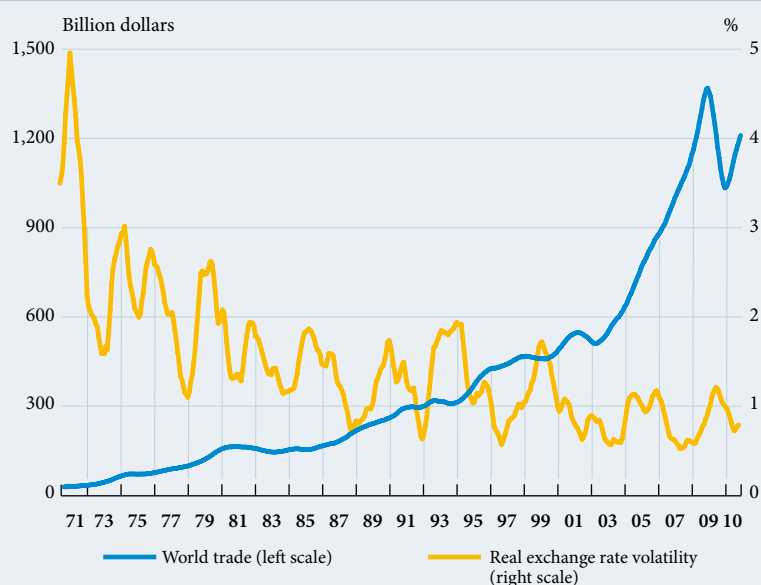
The ambiguous nature of theoretical predictions has given an additional boost to empirical analysis but, unfortunately, the results aren't irrefutable in this case either and are even sometimes contradictory. Although no conclusive decision has been reached, most estimates point to greater volatility inhibiting trade's progress and, if consensus can be glimpsed on any point, it's in the smallness of this impact. One of the most widely cited studies, by Broda and Romalis (2003), estimates that eliminating exchange rate volatility would increase international trade in manufactured goods by around 5% and total trade by 3%.

So, from the point of view of trade, exchange rate volatility is of no great concern. Moreover, not only has such volatility decreased dramatically in the last three decades (see the graph below) but its impact on the volume of trade should have fallen as the instruments to hedge exchange rate risk have proliferated. What is of concern, however, is the possibility of international fights in foreign exchange markets sparking off a trade war.

And this fear is not ungrounded, as events in the 1930s suggest that exchange rate disputes having the potential to be very dangerous given their capacity to provoke protectionist pressures. During the Great Depression, those countries tied to the gold standard and therefore less able to control their exchange rate responded to their currencies' growing loss of competitiveness with a wave of protectionist measures. This led to spiralling reprisals that ended up plunging international trade into its deepest crisis and the world economy into the depths of depression.

## EXCHANGE RATE VOLATILITY HAS EASED IN THE LAST FEW DECADES

World trade and exchange rate volatility (\*)



NOTE: (\*) Trade calculated as the average global exports and imports and exchange rate volatility as the standard deviation of the first difference of the natural logarithm of the exchange rate in the 5 preceding years, in 12-month moving averages and as a percentage.

SOURCES: IMF (International Financial Statistics and Direction of Trade Statistics) and own calculations.

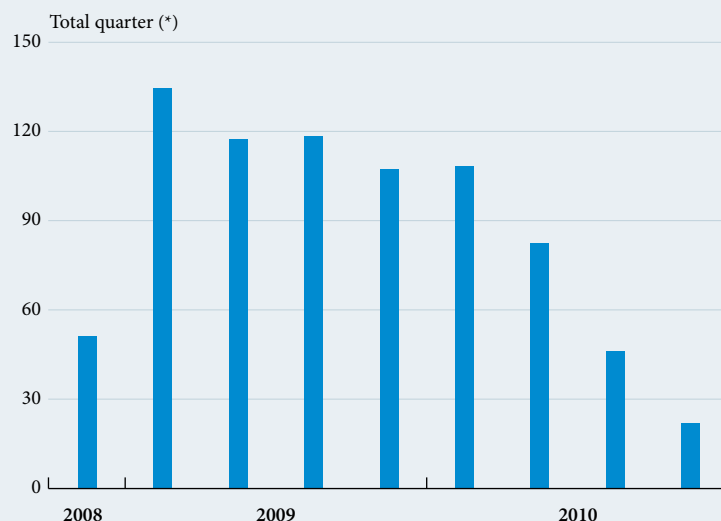
The bulk of the evidence suggests that, in the recent crisis, a potential protectionist upswing had little effect on how international trade performed. As shown by the graph below, after a relatively quiet 2008, there was a sudden outbreak of openly protectionist measures in 2009 but this outbreak was not only tardy but also moderate and without any notable consequences. According to the World Bank, less than 2% of the collapse in trade during the crisis can be attributed to protectionist measures. In the 1930s, however, such measures have been blamed for almost half the slump in trade.

Although, for the moment, disagreements in foreign exchange markets have had a limited effect on the use of discriminatory measures, tension still exists on three fronts: China's reticence to revalue the renminbi; the monetary policy of the most advanced economies and particularly of the United States, promoting capital flows towards other destinations, mostly emerging economies; and, lastly, the reaction of these countries given the massive inflow of foreign capital and the consequent appreciation of their currencies. If the recovery does not improve the economic conditions of large advanced countries quickly enough, these protectionist pressures, which have been contained so far, might increase and, if they come about, could lead to incalculable economic damage.

Protectionism might safeguard domestic production capacity in the short term but has a very harmful effect both on trade and growth in the long term. The impact of formal barriers to international trade is considered to

## THE PROTECTIONIST UPSWING DURING THE CRISIS WAS TARDY AND MODERATE

Number of protectionist measures implemented



NOTE: (\*) Data only up to November for the 4th quarter of 2010.  
SOURCE: GTA Report, November 2010.

be much more negative than that of exchange rate volatility: several studies estimate that a 1% rise in customs duties could result in a drop in trade of around 10%.<sup>(1)</sup> The best solution to the existing tension is therefore a gradual, coordinated readjustment of global imbalances, avoiding protectionism at all costs. History has taught us that acting unilaterally in this area is very dangerous and that a protectionist spiral such as the one in the last century could plunge us into the depths or, in other words, another Great Depression.

As the celebrated British economist Joan Robinson once said, «If your trading partner throws rocks into his harbour, that is no reason to throw rocks into your own». Although some may feel that responding to a protectionist affront with more protectionism is only fair, it doesn't actually get you anywhere; like a ship that's run aground in a harbour full of rocks.

(1) See, for example, Head and Ries (2001). American Economic Review.

*This box was prepared by Marta Noguer  
International Unit, Research Department, "la Caixa"*

**Japan might grow more than 4% in 2010 but 2011 will be a year of slowdown.**

### Japan: a highly doubtful upgrade

The Japanese economy revised its growth forecast upwards and will probably progress by 4.4% for the whole of 2010. This revision for the first three quarters

of the year focused equally on private consumption, public consumption and capital goods investment. However, our growth forecast for 2011 is still below 2.0%. This revision underlines the importance of government stimuli



## JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010				
			4Q	1Q	2Q	3Q	October	November
Real GDP	-1.2	-6.3	-1.8	5.5	3.5	5.0	-	...
Retail sales	0.3	-2.3	-0.7	3.8	3.7	3.2	-0.2	...
Industrial production	-3.4	-21.8	-5.1	27.1	21.1	12.9	5.8	...
Tankan company Index (1)	-2.8	-40.8	-24.0	-14.0	1.0	8.0	-	5.0
Housing construction	2.5	-27.6	-20.7	-6.7	-1.1	13.9	6.6	...
Unemployment rate (2)	4.0	5.1	5.2	4.9	5.2	5.1	5.1	...
Consumer prices	1.4	-1.4	-2.0	-1.1	-0.9	-0.8	0.2	...
Trade balance (3)	4.2	4.0	4.0	6.7	7.4	8.2	8.0	...
3-month interbank interest rate (4)	0.8	0.6	0.5	0.4	0.4	0.4	0.3	0.3
Nominal effective exchange rate (5)	86.6	98.6	99.6	101.1	102.8	109.1	111.2	110.7

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.

during 2010 but, in 2011, the Japanese economy will be without the upswing provided by exports during the first half of 2010 and with governmental

stimuli having to be cut back, in an economy whose public coffers have accumulated a debt greater than 200% of GDP.

## JAPAN: A RELAPSE FOR INDUSTRY

Industrial production index



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

## Automobile sales. Year-on-year change



In the labour market, October's unemployment rate rose slightly to 5.1% while the same month's prices provided a positive note, suggesting that deflation

THE SPANISH ECONOMY MONTHLY REPORT  "la Caixa"

might come to an end more quickly than expected. The general CPI was up 0.2% year-on-year, the first positive change since December 2008. Core inflation, the general index without energy or food, also seems to have joined this positive trend with a year-on-year fall of 0.8%, clearly less intense than the 1.5% fall in September. However, we'll have to wait and see if this trend continues to confirm this statement, as Tokyo's prices in November, which are a leading indicator for Japan's CPI, came to a standstill after picking up in October.

### China: overheating and intense activity

The further rise in inflation (which in November rose to 5.1%), together with the strength of macroeconomic indicators are increasing the risk of the Chinese economy overheating and highlight the need to continue restricting monetary policy.

Given the country's inflationary tensions and vigorous momentum, the central bank once again raised the cash reserve

ratio, now at 19% for large banks. This increase, the seventh in 2010 and the third in little over a month, follows the tightening of monetary conditions stressed by the government during its annual Central Economic Work Conference held in December. This is also in addition to October's rise in interest rates (from 5.31% to 5.56%), as well as the announcement in mid-June of greater exchange rate flexibility against the dollar and several other measures aimed at cooling down the real estate sector, particularly credit restrictions.

In spite of these corrective measures, inflation is still setting records, exceeding both the consensus forecasts and also the target set by the government for 2010, namely 3%. Although, once again, the trend in food lies behind a large part of the price index's behaviour, the component without food has also speeded up, forcing the country's authorities to raise their 2011 target to 4%.

The most recent data on activity, for the month of November, don't show any sign of moderation either. Industrial production grew by 13.3% year-on-year

**Prices rise by 0.2%, the first increase since December 2008.**

**In November, China's inflation rises to 5.1% and reaches a new record high.**

## CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2008	2009	2009			2010		
			4Q	1Q	2Q	3Q	October	November
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	13.3
Electrical power generation	6.7	6.8	24.3	22.6	17.8	11.8	6.7	6.8
Consumer prices (*)	5.9	–0.7	0.6	2.2	2.9	3.5	4.4	5.1
Trade balance (**)	298	196	196	148	156	183	186	190
Reference rate (***)	5.31	5.31	5.31	5.31	5.31	5.56	5.56	5.56
Renminbi to dollar (*)	6.9	6.8	6.8	6.8	6.8	6.8	6.7	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.

## Tension grows between monetary and exchange policy.

in real terms, compared with 13.5% in the third quarter. Retail sales grew by 18.7% in nominal terms, also in line with the average for the last quarter. Meanwhile, investment in fixed assets rose by a resounding 24.9%, still not showing the slowdown predicted in spite of the measures to cool off the housing sector, mentioned above.

Neither has the growth in credit shown any sign of the adjustment intended by the monetary authorities. New bank lending in November approached 564 billion renminbi, placing the total for the year at 7.4 trillion and practically guaranteeing that the annual figure of 7.5 trillion set by the central bank for 2010 will be exceeded.

Given this scenario, more aggressive monetary measures are required. For this reason, many were surprised by the lack of movement in the interest rate at the meeting of 13 December. This decision illustrates the interrelationship between monetary policy and exchange policy and the tension that is growing between both. Raising the interest rate means attracting

more flows of capital towards China, which tends to push up the renminbi. This upward pressure goes against the gradual appreciation desired for the exchange rate.

A more flexible currency would not only make it possible to implement independent monetary policy but would also help to correct external imbalances. In particular, and in spite of a slight decrease in November, the trade balance surplus has been recovering its energy. While the accumulated figure up to August was 15% below the value of 2009, in November this was only 3.7% less than the figure recorded a year earlier.

## After growing 6.8% in the third quarter, Brazil will end 2010 with around 7.5% growth.

### Brazil: a box full of surprises

In the third quarter, Brazil's GDP surprised again with 6.8% growth year-on-year and 0.5% compared with the previous quarter, practically guaranteeing annual growth of around 7.5% at the end of 2010. Although, as we expected, the pace of growth eased compared with the two previous quarters, the robustness

### BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010				
			4Q	1Q	2Q	3Q	October	November
Real GDP	5.2	-0.7	4.9	9.3	9.1	6.8	-	-
Industrial production	2.9	-7.2	6.3	17.3	14.2	8.1	3.8	...
Consumer confidence (*)	140.4	138.3	154.2	158.1	154.6	159.5	154.5	159.3
Unemployment rate São Paulo (**)	13.0	12.8	11.8	12.4	13.2	12.1	10.9	...
Consumer prices	5.7	4.9	4.2	4.9	5.1	4.6	5.2	5.6
Trade balance (***)	24.8	25.3	25.3	23.2	19.3	16.9	17.4	17.1
Interest rate SELIC (%)	11.25	11.25	8.75	8.75	10.25	10.75	10.75	10.75
Reales to dollar (*)	1.8	2.3	1.7	1.8	1.8	1.7	1.7	1.7

NOTES: (\*) Value.

(\*\*) Percentage of labour force.

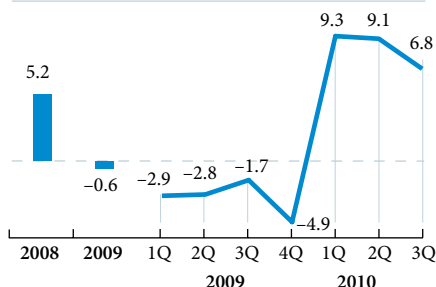
(\*\*\*) Cumulative balance for 12 months. Billion dollars.

SOURCES: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

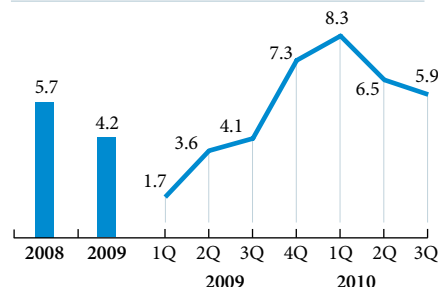
## TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms

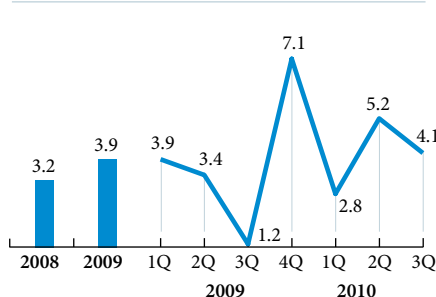
GDP



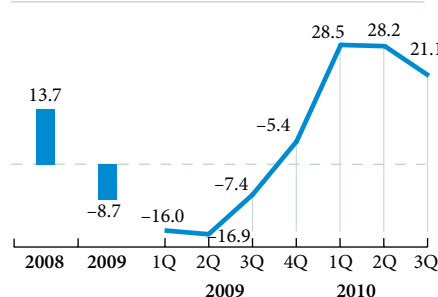
Private consumption



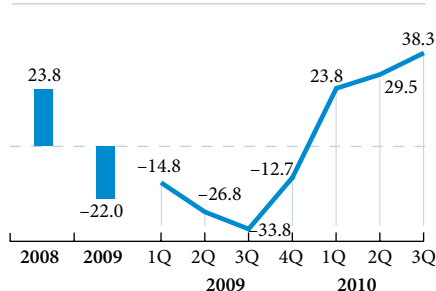
Public consumption



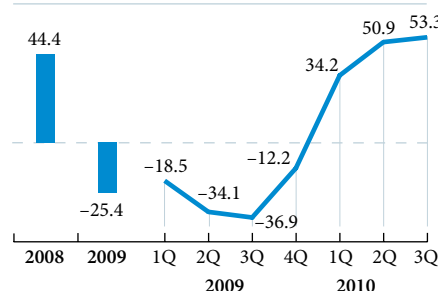
Gross fixed capital formation



Exports or goods and services



Imports or goods and services



SOURCES: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

of the Brazilian recovery has been confirmed, as well as the domestic nature of its engines.

In fact, in the third quarter of 2010 domestic expenditure once again confirmed its position at the forefront of Brazil's growth: investment leads this driving force with 21.1% year-on-year growth, followed by consumption, both private and public, advancing 5.9% and 4.1%, respectively. In spite of the renewed

thrust from exports, up by 38.3%, the foreign flank continues to detract from growth, affected by a strong real and persistent growth in imports (53.3% in the third quarter).

In spite of some slowdown, leading indicators continue to point towards strong progress. To start with, Brazilian consumer confidence picked up again in November and remains at historically high levels. Retail sales also

**Domestic expenditure is still the driving force and the current account balance continues to get worse.**

**There's still the risk of the economy overheating but, for now, Brazil's not raising its interest rate.**

grew by 8.8% year-on-year in October, supported by strong credit and job market, with a historically low unemployment rate (10.9%).

On the supply side, industrial production slowed up its progress in October but still rose, up 3.8% compared with the same period a year ago. For its part, the purchasing managers' index (PMI) reached its highest value in five months and continues at levels indicative of expansion, boosted by the services sector and the upswing in the manufacturing indicator.

Given this scenario, there are still signs of the Brazilian economy overheating. Although food prices are expected to contain their growth in December and this should lead to lower inflation compared with the previous month, the final figure for 2010 will undoubtedly be higher than the target set by Brazil's central bank, namely 4.5% ( $\pm 1\%$ ). Consequently, although it opted not to raise the Selic rate at its last monetary policy meeting, and after having

increased the reserve and capital requirements a week earlier, the bulk of the evidence suggests that interest rates will soon be raised again.

Meanwhile, the most popular president in Brazil's history is preparing to leave his presidential seat. However, just a few days before handing over to his successor, Dilma Rousseff, Lula decided to surprise his fellow Brazilians once more: he might run for president again in four years' time.

### **Mexico: good for you, good for me**

The prospect of economic growth in Mexico is improving slightly given the situation developing in the United States over the last few weeks. To the north of the Río Grande, trend indicators are evolving favourably, the Federal Reserve has decided to implement a second quantitative easing and is unlikely to change interest rates until 2012, and Congress has approved a new package of fiscal stimuli.

**The United State's improved prospects are passed on to Mexico.**

## **MEXICO: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			4Q	1Q	2Q	3Q	October	November
Real GDP	1.5	-6.1	-2.2	5.1	7.3	5.3	-	-
Industrial production	-0.4	-7.0	-2.4	5.4	7.5	6.5	4.6	...
Consumer confidence (*)	92.2	80.5	78.4	81.5	84.9	89.2	89.2	88.5
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	5.7	...
Consumer prices	-11.8	0.0	4.0	4.8	4.0	3.7	4.0	4.3
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	4.50
Mexican pesos to dollar (*)	10.6	14.2	13.1	12.3	12.8	12.6	12.3	12.5

NOTES: (\*) Value.

(\*\*) Percentage of labour force.

(\*\*\*) Cumulative balance for 12 months. Billion dollars.

SOURCES: Banco de México and own calculations.



Given the strong link between manufacturing in the United States and Mexico's economic cycle, and taking into account the retrospectively revised figures for GDP growth, we have upped our forecasts for the Aztec economy both this year and for 2011. At the end of 2010, we expect growth to be around 5.2% while, for the coming year, we place the GDP estimate at 3.8%.

Given the progressive moderation in exports over the last few months and the consequent deterioration in the balance of trade, the favourable winds from the north have been highly opportune. Nonetheless, the Aztec economy's growth will balance itself out thanks to the growing energy of its tertiary and primary sectors, up to now eclipsed by the push from industry. This reflects the gradual reaction of domestic expenditure that is recovering, bit by bit, from the effects of the crisis. The latest data for retail and consumer goods also point in this direction, with solid growth of 0.67% in October compared with September and 4.4% compared with the same month a year ago.

Over the coming months, we expect this trend to consolidate, with a growing contribution by domestic expenditure and less weight on the part of exports. On the other hand, the abundant liquidity worldwide and the relatively favourable macroeconomic environment might push up the peso, accelerating the rebalancing and giving Banxico extra margin to keep its reference rate intact,

even up to 2012, although inflation will be over target in 2010.

### **Oil and food on the up**

Oil prices started moving upwards again, passing the 90 dollar benchmark. Between 19 November and 20 December, the price of crude rose by a substantial 9.0% and reached 91.81 dollars per barrel (Brent quality, for one-month deliveries), an 18.0% rise this year so far.

The arrival of harsh winters and the scarcity of stocks in the United States lie behind December's rise. However, the current price is above the comfortable limit for OPEC and it's unlikely to go on rising in the coming months. Saudi Arabia, the world's main oil producer, has enough with prices above 74 dollars a barrel to maintain revenue for its public accounts.

Rises also predominate among commodities as a whole, with The Economist index up 4.8% in the month and accumulating gains of 31.7% for the year to date. Among metals, which maintained their past gains and continued to rise, of note was the 9.0% increase for copper, affected by serious supply problems, while gold was still at a record high. But food saw the highest gains, led by sugar, which rose by a resounding 24.4%, as well as wheat, up by 14.9%. This rise in food prices puts additional pressure on the inflationary tensions of some emerging economies.

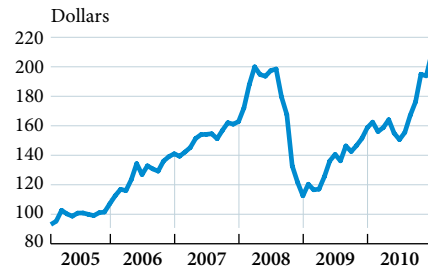
**In Mexico, domestic expenditure and services are on the up.**

**Oil starts to rise again and goes above 90 dollars per barrel.**

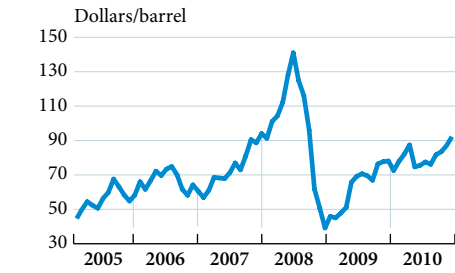
**Food and copper lead the gains in the rest of commodities.**

## TREND IN VARIOUS COMMODITIES (\*)

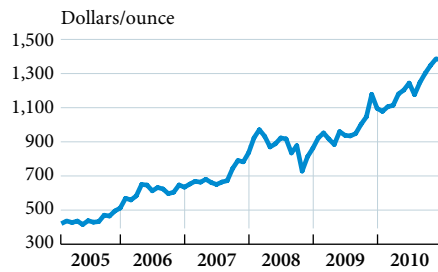
«The Economist» index



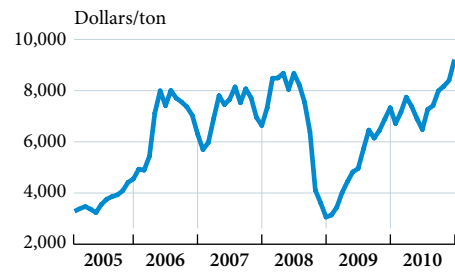
Brent oil



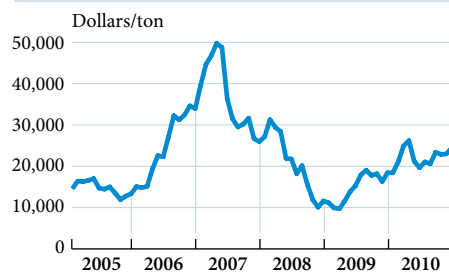
Gold



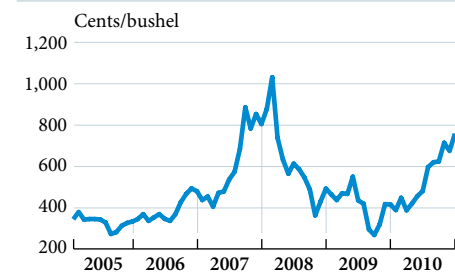
Copper



Nickel



Wheat



NOTE: (\*) Figures for last day of month (last date December 20).

SOURCES: «The Economist», Thomson Reuters Datastream and own calculations.

## EUROPEAN UNION

### **The euro area: growth becomes more robust**

The euro area's economy continued to show signs of strength in the last part of the year and, in spite of good growth figures in the second and third quarter, there are no symptoms of growth wearing out – quite the opposite, in fact. However, various factors still exist that might cause the recovery to run out of steam in the short term. In this respect, the main questions for 2011 are the outcome of the sovereign debt crisis of the countries on the periphery and the effect of fiscal containment plans.

For the moment, all this means that uncertainty remains high, but this hasn't affected the pace of growth. In fact, the publication of the disaggregated gross domestic product (GDP) for the third quarter points to a more robust line of recovery than expected. Behind the moderate growth in GDP, up 0.4% in quarter-on-quarter terms, we find growth in public and private consumption. Both were surprisingly positive. Public consumption, which grew by 0.4%, should start to feel the effects of budget cuts, so we don't expect it to keep up this pace of growth over the coming quarters. However, private consumption, which was up 0.3% on the previous quarter, is showing a highly positive trend: the average rate of growth for the last 4 quarters is 0.3%, only one tenth of a percentage point below its historical average.

This is very good news, as one of the main doubts hovering over the recovery was the route taken by private consumption within a context of widespread deleveraging. Moreover, leading indicators for the fourth quarter allow us to be relatively optimistic. Retail sales, for example, grew by 0.5% in October in month-on-month terms. Similarly, the figures for previous months were raised substantially, so that the series has gone from a situation of stagnation to a notably upward trend. Consumer confidence has also performed positively in the fourth quarter as a whole, although it dropped back slightly in December.

Consumption is managing to withstand an adverse labour context. The unemployment rate remains stuck at 10.1% and still shows no sign of improving. The reason why consumption for the euro area as a whole is achieving good figures in spite of this labour situation is largely because of the strong recovery being experienced by the German economy. Germany seems to be finally taking the leading role it has claimed for itself for so many years. Moreover, this country's unemployment rate, which hardly rose at all during the years of recession, is now falling and has reached its lowest level since reunification.

Unlike private consumption, investment interrupted its upward trend and hardly advanced in quarter-on-quarter terms.

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

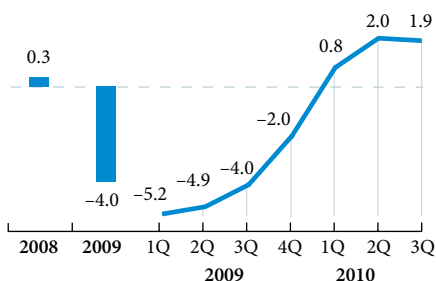
**...boosted by private and public consumption.**

**Private consumption continues to grow in spite of the adverse labour situation.**

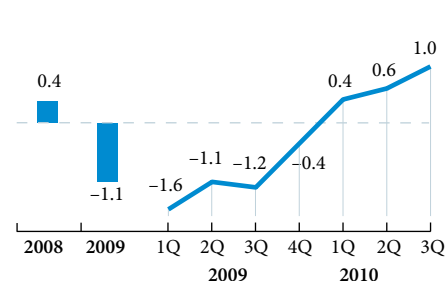
## TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change

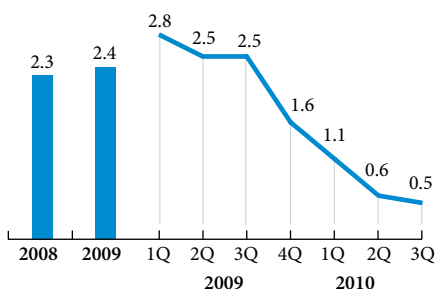
GDP



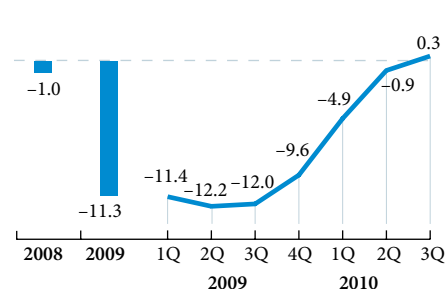
Private consumption



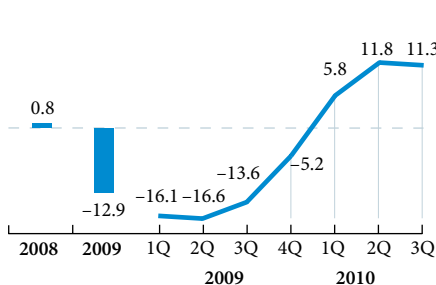
Public consumption



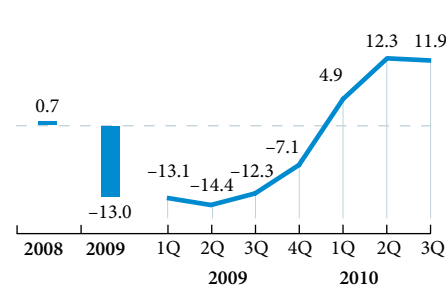
Gross fixed capital formation



Exports of goods and services



Imports of goods and services



SOURCES: Eurostat and own calculations.

**Investment maintains its positive trend in the fourth quarter.**

But given the nature of this series, which has always been more erratic, we need to interpret the figures for the third quarter together with those for the second, where it did progress very strongly, namely by 1.7%. Moreover, the bulk of the evidence suggests that investment will pick up again in the last few months of 2010.

One sign of this is the trend in the purchasing managers' index (PMI) which, after dipping slightly in the third quarter, returned to an upward trend. The industrial production index also performed well, although in this case we can see a certain slowdown in the pace of growth.

## EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010				
			4Q	1Q	2Q	3Q	October	November
GDP	0.3	-4.0	-2.0	0.8	2.0	1.9	-	...
Retail sales	-0.7	-2.4	-1.1	0.6	0.6	1.6	1.4	...
Consumer confidence (1)	-18.1	-24.7	-17.0	-16.8	-16.7	-12.1	-10.9	-9.4
Industrial production	-1.8	-14.9	-7.4	4.7	9.0	6.9	6.9	...
Economic sentiment indicator (1)	93.5	80.8	91.9	96.6	99.4	102.2	103.8	105.3
Unemployment rate (2)	7.5	9.4	9.9	9.9	10.0	10.0	10.1	...
Consumer prices	3.3	0.3	0.4	1.1	1.5	1.7	1.9	1.9
Trade balance (3)	-1.2	-13.6	16.1	28.1	22.9	9.6	9.7	...
3-month Euribor interest rate	4.6	1.2	0.7	0.7	0.7	0.9	0.9	1.0
Nominal effective euro exchange rate (4)	110.6	111.7	113.8	108.8	103.2	102.3	106.1	104.8

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.

Trends in the foreign sector provided fewer surprises. Both exports and imports continued to post notable growth and the recovery in world trade and the prospect of a gradual recovery in consumption and investment will ensure that this pace of growth will continue over the coming quarters for both series. We therefore think that the foreign sector is unlikely to make any huge contribution to growth for the economy as a whole.

What will very probably continue to attract all the attention over the coming months is how the so-called periphery countries perform. After approving the bailout fund for Ireland, close attention will be paid to the effect of the additional measures taken by this country to sort out its banking sector and public accounts. Portugal and Spain will also be closely monitored, countries from which investors still demand high premiums in public debt issues. In fact, these

premiums will probably remain high until the countries concerned show a somewhat more robust rate of growth and convincing signs of their ability to reduce their public deficit.

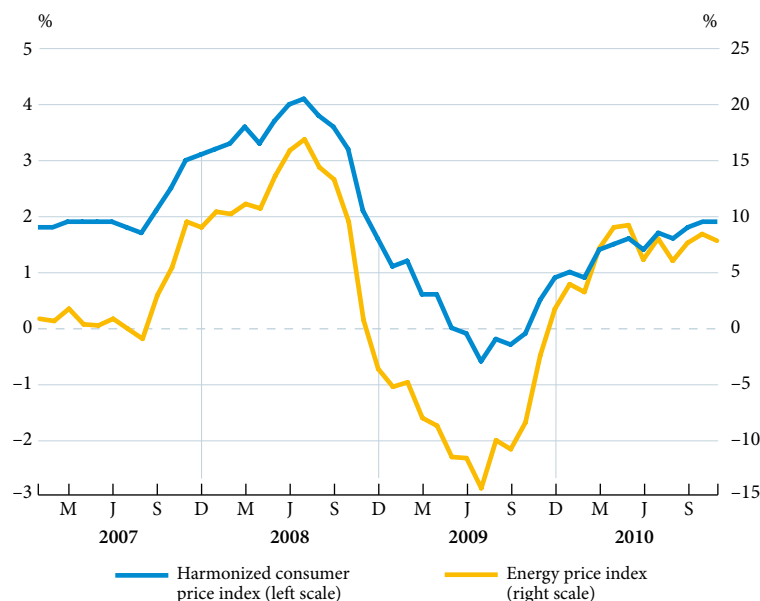
Given this scenario, the European Union heads of state are still taking steps to better define the framework for bailouts. In December, they reached an agreement to approve a permanent bailout mechanism for European Union countries and signed a firm declaration supporting the euro. This step was essential as the mechanism currently in place, the European Financial Stability Facility, will expire in 2013. The details have yet to be defined. For the present, in order to implement this new facility it will be necessary to amend the Lisbon Treaty and, over the coming months, the role to be played by private capital in any bailout operations will be specified, as well as the conditions for such aid.

**Resolving the sovereign debt crisis takes priority.**

**The European Union heads of state approve a permanent bailout mechanism.**

## ENERGY UNDERPINS INFLATION

Year-on-year percentage change



SOURCES: Eurostat and own calculations.

**The rate of increase in consumer prices, close to 2%.**

The European Central Bank (ECB) has always stressed the importance of carrying out these steps as it has seen how the banks of economies with the most problems become highly dependent on the different liquidity facilities put in place. According to the ECB, this situation was counterproductive as these measures were designed to help the financial system overcome temporary disturbances that might affect price stability but not to resolve structural problems. In this respect, of note is the recourse being sought by the banks of Ireland, Portugal and Greece to the ECB's resources, although this is likely to ease with the measures taken.

Inflation doesn't look like calling the ECB's policy into question over the next few months. In the month of November, the year-on-year change in the harmonized consumer price index stood

at 1.9%, now three months close to 2%. Although these values might continue in the short term, the bulk of the evidence available suggests that it will approach 1.5% throughout 2011. However, we must keep a close eye on the trends in commodity and food prices. The upswing seen over the last few months is partly due to the strong pace of growth in emerging countries. Given that this is expected to continue in the coming years, pressure on prices might increase.

In short, the euro area is starting 2011 well on the way to recovery and, in general, activity and demand indicators allow us to be relatively optimistic. However, it's very important to bear in mind the different risks that are still hovering over the recovery. If these are overcome, we might be back up to cruising speed by 2012.



## Germany advances towards more balanced growth

According to the European Commission, the German economy grew by more than 3.5% last year, becoming the main economic engine in the euro area during 2010. This intense recovery, and its capacity to keep its public deficit at a moderate level, has reinforced the German economy's leading role in the European Union, a huge responsibility at this time of strong tensions in European sovereign debt markets.

All the evidence points towards growth in gross domestic product (GDP) dropping off in the coming years. However, year-on-year growth close to 2% is expected for 2011 and 2012, above its potential level. Nevertheless, unlike what happened during the last few quarters of 2009, economic growth is expected to be less dependent on the foreign sector. This greater equilibrium comes from the dynamism in private consumption and investment, two areas that seem likely to be the main factors of growth in the medium term.

The upswing in private consumption is thanks to the good state of the German labour market, whose unemployment rate held steady in November at 7.5%, very close to the minimum reached in 1992. Moreover, the good prospects for future employment pushed consumer confidence up to a new record high in December. Consequently, retail sales are expected to grow at a good rate over the next few months, reaching similar levels to those recorded before the recession. The gradual recovery in credit will also play an important role in how consumption develops.

This greater household consumption will help imports reach high growth levels. The latest data available for October show a 23.0% growth in imports year-on-year, two tenths of a percentage point higher than that of exports. Moreover, the slower than expected recovery in some European countries, in particular those on the periphery, might reduce the rate of growth for German exports in 2011. Consequently, foreign demand's contribution to growth will be close to zero, reducing the current account

**The European Commission forecasts 3.5% growth quarter-on-quarter for German GDP in 2010.**

**The improved job market strengthens private consumption.**

**The contribution of Germany's foreign sector will be very low in 2011.**

### GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010				
			4Q	1Q	2Q	3Q	October	November
GDP	0.7	-4.7	-2.0	2.1	3.9	3.9	-	...
Retail sales	0.0	-2.9	-2.4	1.0	0.5	2.8	1.3	...
Industrial production	-0.1	-15.5	-8.0	6.1	12.2	9.9	11.7	...
Industrial activity index (IFO) (*)	96.8	87.7	93.4	96.5	101.8	106.6	107.7	109.3
Unemployment rate (**)	7.8	8.2	8.2	8.1	7.7	7.6	7.5	7.5
Consumer prices	2.6	0.4	0.4	0.7	1.0	1.2	1.3	1.5
Trade balance (***)	195.2	142.8	133.1	143.1	149.7	149.1	154.8	...

NOTES: (\*) Value.

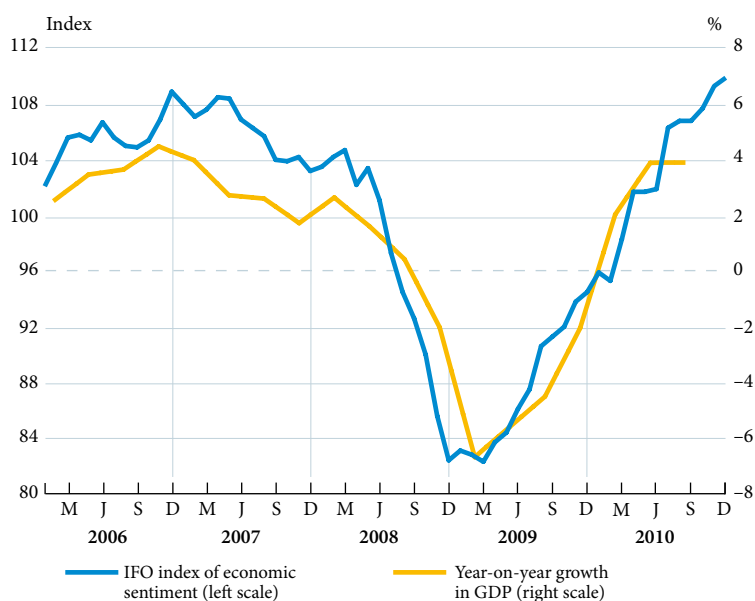
(\*\*) Percentage of labour force.

(\*\*\*) Cumulative balance for 12 months. Billion euros.

SOURCES: Eurostat, European Central Bank, European Commission, national statistical bodies and own calculations.

## BUSINESS CONFIDENCE ANTICIPATES AN UPSWING IN GDP AT THE END OF 2010

IFO index (monthly) and year-on-year change in GDP (quarterly figures)



SOURCES: German Statistics Institute and IFO.

### Industrial capacity utilization returns to pre-crisis levels.

surplus to 4.6% of GDP in 2011 according to the European Commission, three percentage points below the maximum of 2007.

On the supply side, an analysis of business indicators reveals another rise in industrial production in October, namely 2.9% month-on-month. In turn, higher domestic demand and demand by non-EU countries boosted industrial orders, which grew by 1.6% in the same period. This greater activity will lead to further increases in investment over the next few months due to the high production capacity utilization, which reached levels close to its historical average in December.

Given this situation, the IFO business climate index reached a new record high in the month of December. The upswing in this indicator, which as can be seen in the graph reflects the country's overall economic performance, augurs a further

rise in GDP growth in the fourth quarter, in line with estimates by the main international organizations.

This improvement of the German economy throughout 2010 and the containment of costs helped the German government to keep its public deficit at a moderate level, 3.7% of GDP according to estimates by the European Commission, while this same organization places the deficits of 2011 and 2012 at 2.7% and 1.8% of GDP respectively.

In spite of these good economic prospects for the coming years, polls show that the two parties that make up the German coalition government would not be able to repeat their majority. This is significant if we remember that 2011 will see elections in six of the sixteen states the country is divided into, as bad election results would weaken the leadership of Chancellor Angela Merkel, both beyond and within Germany's borders.

### The public deficit will fall below 3% in 2011.

## France's economic growth remains in good shape

The French economy continues to feed off household consumption and, thanks to this, is expected to advance at a good pace during the last quarter of 2010. Household consumption was up 2.8% in November, reaching a historically high level, while other variables such as the improved consumer confidence and the rise in vehicle registrations in November also point to domestic demand strongly supporting the growth in France's GDP. The rise in the total number of salaried workers, 0.4% year-on-year in the third quarter of 2010, will also make it easier for consumption to remain strong.

Looking at the other components of domestic demand, public expenditure is expected to play a lesser role over the coming months given the government's intention to cut its budget. With regard to investment, figures indicate that this will make a positive contribution to the economy's recovery as the index of production capacity utilization continued to rise in November, although still below its long-term average. Moreover, it should also be noted that some of the reforms carried out by the French government

since the start of the crisis are aimed precisely at boosting investment, such as reforms to the tax on local activity (*taxe professionnelle*) and the creation of *Fonds Stratégique d'Investissement*. These measures should become more effective in a few months' time.

Also of note within this context of structural reforms to boost economic activity is the creation of a special *auto-entrepreneur* scheme which came into effect as from January 2009. This aims to help new start-ups, as social security payments do not have to be made while the new firm has no turnover. The data suggest this scheme has been successful as a record number of firms were set up in the period January-September 2010, namely 470,000.

Looking at exports, sales abroad are not expected to play a large part in reactivating the French economy, at least not in the short term. However, the fact that some international indicators show a certain increase in French competitiveness, such as the World Bank Doing Business and the World Economic Forum Global Competitiveness Index, allows us to be moderately optimistic.

**Sharp rise in French household consumption in November.**

**The Bank of France forecasts 0.6% growth during the last quarter of 2010.**

### FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			4Q	1Q	2Q	3Q	October	November
GDP	0.1	-2.5	-0.5	1.1	1.6	1.8	-	...
Domestic consumption	-0.3	0.8	4.1	1.8	0.4	1.6	-0.3	1.5
Industrial production	-2.7	-12.3	-4.9	5.3	7.5	5.3	4.7	...
Unemployment rate (*)	7.8	9.5	9.9	9.9	9.8	9.9	9.8	...
Consumer prices	2.8	0.1	0.4	1.3	1.6	1.5	1.6	1.6
Trade balance (**)	-50.3	-49.0	-41.9	-42.9	-45.1	-49.7	-50.8	...

NOTES: (\*) Percentage of labour force.

(\*\*) Cumulative balance for 12 months. Billion euros.

SOURCES: OECD, Eurostat, INSEE, European Commission and own calculations.

**The European Commission predicts 1.1% growth in GDP year-on-year for 2011 in Italy.**

The outlook is favourable on the supply side, as highlighted by the positive business surveys published in Bank of France's Annual Report on 8 December. Based on various supply indicators, the central bank predicts 0.6% growth in the fourth quarter compared with the previous quarter. This rate is one tenth of a percentage point higher than the estimate for the previous month's report and points to France's growth remaining in good shape.

**The new year imposes some significant challenges for the Italian economy**

The Italian economy is starting the new year with the significant challenge of strengthening the growth initiated the previous year. However, the European Commission predicts a 1.1% rise in GDP year-on-year in 2011, the same as the estimate for the previous year, a lower rate than the one forecast for the euro area as a whole. In fact, this slowdown in growth could already be seen in the third quarter, when the negative contribution of the foreign sector and public consumption reduced quarter-on-quarter growth by two tenths of a percentage point to 0.3%.

The most frequent indicators also point towards the Italian economy being less dynamic in the fourth quarter. On the supply side, industrial production remained almost the same in October, with a drop of 0.1% month-on-month. The slow recovery in industrial confidence and industrial capacity utilization suggests lower growth in investment in the coming quarters than last summer, namely 0.9% quarter-on-quarter. Moreover, unlike the first half of the year, the foreign sector will stop contributing to growth. The trade deficit therefore increased again in October compared with the same month in 2009, keeping up the trend started a few months earlier.

However, private consumption is expected to continue contributing positively to growth in the coming quarters. The gradual rise in consumer confidence, boosted by improved employment prospects, will more than likely lead to an increase in retail sales over the next few months. This greater consumption, together with rising oil prices, will keep inflation going up, in November standing at 1.7%, its highest level since 2008.

**Private consumption will continue to contribute positively to growth.**

**ITALY: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010			
			4Q	1Q	2Q	3Q	October	November
GDP	-1.3	-5.1	-2.8	0.5	1.3	1.1	-	...
Retail sales	-0.3	-1.6	-0.6	-0.3	-0.2	0.7	...	...
Industrial production	-3.8	-18.2	-9.0	3.5	7.9	6.3	3.3	...
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	1.7
Trade balance (**)	-10.0	-10.2	-6.6	-7.7	-13.2	-19.1	-22.3	...

NOTES: (\*) Percentage of labour force.

(\*\*) Cumulative balance for 12 months. Billion euros.

SOURCES: OECD, national statistical bodies and own calculations.

But, undoubtedly, one of the main challenges that must be faced by the Italian economy in the new year is sorting out its public accounts. In spite of maintaining its public deficit at around 5% of GDP for the last two years, according to estimates by the European Commission Italy's public debt is equivalent to 118.9% of GDP in 2010. Given this heavy borrowing, in December the Italian government passed its austerity plan, announced last summer, to reduce the deficit by 25 billion euros over the next two years. These measures will help to keep the cost of financing the public debt at a sustainable level, easing the possible adverse effects caused by the government's instability.

### **The United Kingdom starts the new year immersed in a tough austerity plan**

The British economy's rate of growth in the second and third quarter of 2010 was better than expected. However, the economy of the United Kingdom is expected to continue its recovery at a slower pace, due to the tough fiscal adjustment planned by the government and to the fact that a large part of the growth in the last six months probably resulted from stock adjustments being brought forward by firms.

In fact, on 29 November the Office for Budget Responsibility, an independent body in charge of providing the economic forecasts that form the basis of the budgets, announced 1.8% year-on-year growth in 2010 and 2.1% in 2011. This is a better rate for this year compared with June's estimate but it has reduced the figure forecast for the next period by two tenths of a percentage point.

However, other organizations believe these growth prospects to be too optimistic as they place a lot of importance on foreign trade and investment.

The main indicators over the last few months suggest that there will be a very slight slowdown in the progress of economic activity in the United Kingdom during the last quarter of the year. Looking at supply, industrial production fell by 0.2% in October, so that the year-on-year growth rate fell by five tenths of a percentage point to 3.3%. Meanwhile, industrial and service confidence indices were quite erratic. Based on these indicators, the National Institute of Economic and Social Research estimates that the British economy grew by 0.6% in the three months up to November, denoting a growth rate very close to the 0.7% recorded in the third quarter, just one tenth of a percentage point lower.

On the other hand, demand variables are also quite favourable for the last quarter of the year as household consumption was up 0.3% in November, placing the year-on-year rate at 1.1%. December's sales are also likely to increase if families bring their purchases forward due to the VAT hike from 17.5% to 20%, which comes into effect in January 2011.

Regarding investment, this slumped by almost 20% during the recession because of more expensive and tougher credit, as well as business uncertainty. According to surveys, the outlook for this heading is more favourable as figures show that firms are now in a relatively healthy position and credit conditions are improving. However, production capacity is still underused and this might act as a brake on investment.

**Reducing Italy's public debt becomes a priority.**

**The Office for Budget Responsibility predicts 2.1% growth for 2011 for the British economy.**

**Growth prospects for the last quarter of 2010 are good...**

## UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010				
			4Q	1Q	2Q	3Q	October	November
GDP	-0.1	-4.9	-2.8	-0.3	1.6	2.7	-	...
Retail sales	1.7	1.0	2.5	-0.1	0.8	0.8	0.4	1.1
Industrial production	-3.1	-10.1	-5.9	0.2	1.5	3.2	3.3	...
Unemployment rate (1)	2.8	4.7	5.0	4.9	4.6	4.5	4.5	4.5
Consumer prices	3.6	2.1	2.1	3.2	3.4	3.1	3.2	3.3
Trade balance (2)	-93.6	-86.8	-82.4	-83.0	-85.0	-90.3	-93.3	...
3-month Libor interest rate (3)	5.5	1.2	0.6	0.6	0.7	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	79.9

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.

**...but there will be a slowdown in 2011.**

**In emerging Europe, the notable push from activity in the third quarter...**

**...and the good shape of the euro area justify upping the growth forecast for 2011.**

With regard to the foreign sector's contribution to the recovery, this has been disappointing so far, in spite of the pound losing more than a quarter of its value since August 2007. This depreciation in the currency should make exports more attractive and boost competition compared with imported products. For example, the United Kingdom's unit labour costs are now more than 25% lower than at the start of the recession. The foreign sector should therefore pick up over the coming months. In fact, although the data show exports performing weakly in financial services, surveys point towards a notable increase in orders for exports of manufactured goods.

In short, after the pleasant surprise provided by the good GDP estimate for the last half of 2010, next year's growth might be somewhat weaker than expected if the implementation of budget cuts smothers domestic consumption.

### Emerging Europe: consolidating expansion

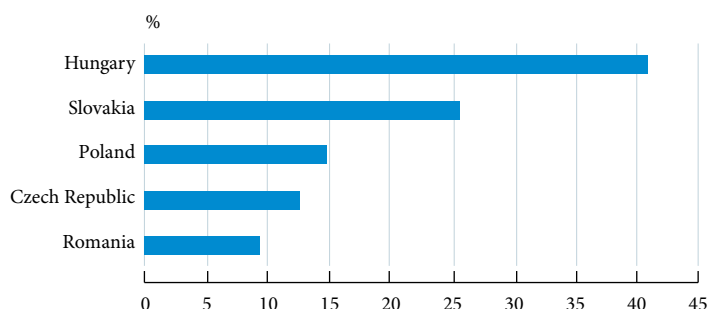
With the publication of data for the third quarter from Poland's National Accounts system, a round of generally excellent results has been completed in terms of growth. Of the economies we normally highlight in these pages, only Romania has seen a 0.7% drop in its quarter-on-quarter rate, while the others (Poland, Hungary, the Czech Republic and Slovakia) have all recorded rises in the order of 1% quarter-on-quarter. These figures are above the forecasts given for these four economies. This fact, together with the macroeconomic indicators available for the fourth quarter, points to the growing push from activity.

In addition to its dynamism, the composition of growth is also encouraging. Without forgetting that exports continue to be key to the recovery, domestic demand is also starting to pick up in these countries.



## CONSUMERS REGAIN THEIR OPTIMISM

Difference between the current and minimum value of the consumer confidence index



SOURCES: European Commission and own calculations.

Consequently, more positive data than expected in the area of investment (and in some cases also in consumption) in the third quarter are in addition to the equally rising trends in consumption indicators in the fourth quarter. It therefore seems as if the expansion is consolidating more quickly than forecast and with a more appreciable contribution by the domestic sector than expected.

All this, together with the signs of Germany and other fundamental markets in the euro area recording a good rate of activity, justifies a moderate increase in our growth forecasts for 2011. Although not a substantial change when we look at the region as a whole, this does become quite important in the case of the zone's main economy, Poland, for which we forecast GDP growth of 3.9% in 2011, compared with our previous forecast of 3.4%.

What is the main threat to these positive growth prospects coming to fruition in 2011? The budget situation. Although the fiscal squall affecting the periphery economies of the euro area has scarcely caused a ripple in emerging Europe, this is an issue that requires continued attention, given the sensitivity of

international investors to this area. To date, the trends in country risk indicators point towards financial attention focusing on Hungary and Poland and nothing suggests this source of risk will completely disappear in 2011.

In the first case, that of the Hungarian economy, the fundamental concern relates to the unorthodox measures being undertaken by this country to control its public deficit, based on increasing fiscal revenue by taxing specific sectors (banking, commercial chains and energy and telecommunications, essentially) and on gradually eliminating the private pillar from the pension system. This concern has been explicitly expressed both internally and internationally.

Internally, the country's central bank decided to raise its reference rate on two occasions, in November and December, which has gone from 5.25% to 5.75%. This decision, which surprised analysts and investors as they did not expect rates to rise until well into 2011, was defended by the central bank as a measure to prevent inflation, given the insufficient containment of fiscal policy. Shortly afterwards, the agency Moody's decreased its credit rating of Hungary's

**Budget developments - the focus of attention in the case of Hungary and, to a lesser extent, Poland.**

### Hungary's sovereign debt rating falls and its interest rate rises.

sovereign debt by two levels. Although this level is still above investment grade, this is a serious warning regarding how fiscal consolidation is being carried out.

The second country that has been affected in some way by the Irish debt crisis is Poland. Although not too intense, this is a reminder of that the country's budget management could be slightly better. To date, Poland has relied on good cyclical trends in income and expenditure for fiscal containment. However, even in the case of the only economy in the European Union that never fell into recession during the recent crisis, public debt has not stopped rising over the last few years.

The forecasts for 2011 contained in Poland's Stability and Growth

Programme give a figure for public debt equivalent to 55.6% of GDP. It should be remembered that, if this figure goes above the threshold of 55% of GDP, the government must constitutionally carry out spending cuts. In an attempt to control its growing debt, Poland has negotiated and has attained the agreement of the European Commission for the cost to reform its pension system be taken into account when calculating its excessive public deficit and debt. This will somewhat help to keep in check the tendency of public imbalances to grow. Nonetheless, there is still the feeling that Poland is merely delaying a task that will have to be carried out sooner or later, leaving itself open to financial risk; a risk that may be lower but is still not negligible.

## Which exchange rates are far from their equilibrium?

The last few months have been full of recriminations due to some countries' intervention in the foreign exchange markets. Most accuse the Chinese authorities of manipulating the renminbi's exchange rate and keeping it artificially low. China has responded by saying that any possible undervaluation is not excessive and is actually being corrected. Moreover, it claims that other countries, such as Brazil, are also intervening in the foreign exchange markets to slow up the appreciation of their currencies. Brazil, for its part, has defended its actions to stop the real from increasing in value, stating that they believe it's already overvalued. So who's right? Unfortunately, it's not easy to decide whether a currency is under or overvalued and to what extent. There are several different methods and they don't always come up with the same answer.

We cannot directly observe a currency's equilibrium exchange rate, i.e. its right price. This is a theoretical concept. In principle, it's the exchange rate that allows an economy to achieve both internal and external equilibrium within a reasonable period of time (e.g. within four years). Internal equilibrium can be defined as when the level of activity coincides with the potential of the economy in question, and when the unemployment rate stabilizes at a level that does not lead to inflationary pressures. An equilibrium exchange rate therefore helps to ensure an economy doesn't overheat but doesn't remain too cold either – it must help it achieve the right temperature.

External equilibrium is achieved when the balance of trade (or, strictly speaking, the current account balance) is consistent with the underlying demographic and economic features of the economy in question. This equilibrium must obviously ensure that the trend in the country's external debt can be sustained. The equilibrium exchange rate must help an economy to be sufficiently competitive in international markets but not excessively so. If an

## COMPARISON BETWEEN EQUILIBRIUM EXCHANGE RATES AGAINST THE DOLLAR AND THE ACTUAL RATES IN DECEMBER 2010 (\*)

Country	Currencies against the dollar, unless otherwise stated		Overvalued (-) / Undervalued (+)
	Equilibrium exchange rate	Exchange rate December 2010	
Australia (**)	0.81	0.98	-17.5
Brazil	1.85	1.70	-8.3
Canada	1.03	1.01	-2.1
China	5.57	6.66	19.6
Czech Republic	19.80	18.93	-4.4
Euro area (**)	1.31	1.33	-1.2
Hong Kong	6.36	7.77	22.2
Hungary	214	209	-2.2
India	44.10	48.26	9.4
Indonesia	8,178	9,022	10.3
Japan	84.00	83.68	-0.4
Korea	1,077	1,145	6.3
Malaysia	2.54	3.14	23.7
Mexico	12.80	12.41	-3.0
Poland	3.14	3.02	-3.8
Singapore	0.98	1.31	33.6
South Africa	8.55	6.88	-19.5
Switzerland	0.97	0.98	1.0
Taiwan	26.40	30.13	14.1
Thailand	29.40	30.02	2.1
Turkey	1.70	1.50	-12.0
United Kingdom (**)	1.52	1.57	-3.2

NOTES: (\*) The equilibrium exchange rates come from Cline and Williamson (2010).

December's exchange rates are the average between the 1 and 20 December.

(\*\*) Exchange rate expressed in dollars per currency.

SOURCES: Cline and Williamson (see reference in the text) and own calculations.

exchange rate gives a competitive edge to a country, by definition it puts others at a disadvantage. This exchange rate would not be an equilibrium exchange rate.

These requirements suggest that defining equilibrium exchange rates is highly complex as they depend on a multitude of factors, both internal and external, which also vary over time. In practice, the most widely used methodology to analyze the under- or overvaluation of exchange rates stresses the concept of external equilibrium. This focus requires three steps: firstly, medium-term current account projections in a baseline target scenario that keeps the exchange rate constant; secondly, an estimate of the equilibrium current account balance for the economy in question, given its underlying factors; lastly, a calculation of what would be the variation required in the exchange rate to eliminate the difference between the target current account and the equilibrium current account. The first and last steps are relatively standard. The first is routinely carried out by analysts when making their economic forecasts. The last step requires knowing the sensitivity of the current account, essentially of

exports and imports, to the exchange rate (a calculation that analysts are also relatively familiar with). The most complicated step is the second.

How can we estimate the equilibrium current account balance? There are basically two approaches used to answer this question.

The first uses statistical models to empirically relate the current account balance with a series of fundamental economic and demographic variables.<sup>(1)</sup> Most estimates detect that the current balance tends to vary with the fiscal balance (a larger public deficit reduces the external balance, as public savings decrease); the share of the retired population (a larger inactive population also reduces the external balance, as private savings decrease); the level of external debt (the higher the debt, the lower the external balance due to interest payments); the degree of development and pace of economic growth (less developed countries tend to have a lower external balance, as do those that grow the most, since in both cases the demand for imports tends to grow more quickly than for exports); and the oil balance (those countries that depend more on oil imports have a lower external balance). These typical relations determine the equilibrium current account balance for each economy.

A second approach simply defines the equilibrium current account balance as the one that stabilizes external debt at a level that's considered reasonable in a more or less arbitrary way. In practice, this approach complements the first. Given the uncertainty surrounding any of these estimates, analysts regularly use both techniques to reach a final conclusion.

A recent study by the Peterson Institute for International Economics, which has been widely covered, has combined these two methods to estimate the extent of over- or undervaluation of the main currencies against the dollar.<sup>(2)</sup> According to these estimates (see the previous table), we can differentiate three broad groups of currencies: those with little significant difference to their equilibrium level, such as the euro; those that appear to be overvalued, such as the Australian dollar, the Brazilian real, the South African rand and the Turkish lira; and, lastly, those showing significant undervaluation. Several Asian currencies particularly stand out in this last group: the Chinese renminbi, the Singapore dollar, the Hong Kong dollar and the Malaysian ringgit. The renminbi, in particular, would be 19.6% undervalued against the dollar. On average, the US dollar would be slightly overvalued (by 2.5%).

In spite of the uncertainty that might surround the estimates of equilibrium exchange rates, there are conclusions that leave little room for doubt. That the renminbi is too cheap and should appreciate is one of these conclusions. Another is that it should appreciate a lot more than the 2.5% gain made since June, when the Chinese authorities once again allowed the exchange rate to float against the dollar.

(1) As the current account balance is, in accounting terms, the same as the difference between national savings and domestic investment, anything that determines savings and investment can be considered as a determining factor of the external balance.

(2) William Cline and John Williamson (2010). «Currency Wars?», Peterson Institute for International Economics, Policy Brief 10-26, November.

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# FINANCIAL MARKETS

## Monetary and capital markets

### More light than dark at the end of 2010

2010 has left us with some aspects that are positive and others not quite so positive. One of the favourable aspects we can point to is the change in growth prospects at a global level. The economic activity in the United States and in the euro area (particularly Germany) suggests that both regions are establishing a reasonable rate of progress. The main negative aspect can be found in the tensions affecting the

sovereign debt of the so-called peripheral countries in the euro area: Greece, Ireland, Portugal and Spain.

In order to stop this sovereign debt unrest from becoming a systemic problem, the European Central Bank (ECB) announced that it will maintain its full allotment liquidity provision until at least the end of the first quarter of 2011 and, for the moment, is not planning on holding competitive auctions. This indicates that, should it be necessary, the monetary

**The reappearance of sovereign debt tension mars the end of an encouraging year.**

### SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
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	1.00	1.03	1.53	0.25	0.30	0.19	0.50	0.74	0.20
December (1)	1.00	1.02	1.53	0.25	0.30	0.19	0.50	0.75	0.20

NOTES: (1) December 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.

**ECB extends its full allotment liquidity provision but maintains its course.**

authority will keep to its policy of selectively supporting countries with problems.

In any case, the ECB President, Jean-Claude Trichet, has made it clear that the institution's main aim remains in place, namely to safeguard monetary and price stability, and that it is in no way pursuing a policy of quantitative easing. Proof of this is that, on the one hand, all the bonds purchased through its programme continue to be sterilized. On the other hand, the decision has been taken to return almost completely to the collateral system in place before the worldwide economic crisis began. This shows that the reserve bank still wishes to gradually remove the non-standard components of credit and liquidity facilities as the markets get back to normal. It's important to remember that, from a technical point of view, these adjustments in the central bank's line of action in no way impede the appropriate handling of official interest rates.

These actions by the monetary authority have helped stop the sovereign debt crisis from harming the euro area's interbank market. In fact, interbank interest rates have not recorded any significant variation, although this does not mean that everything is back to normal, as the banks in the most severely affected countries are being penalized by demands for a higher interest rate to obtain financing in this market. In the medium and long term, the trend in the euro area's interbank rates will be slightly upward, starting as the time approaches for the ECB to announce to investors that it will begin to raise official rates.

In the case of the Federal Reserve (Fed), presided over by Ben Bernanke, the end of

the year has become a period of transition. At December's meeting, and given November's decision to hold a second round of quantitative easing (QE2), the institution limited itself to confirming that it's still committed to supporting growth, reducing unemployment and stopping inflation from remaining at excessively low levels.

Taking into account the actions already carried out by the Fed, the extension of fiscal stimuli approved by the government and the improvement being seen in activity, economic observers note that the institution is unlikely to consider taking additional measures in 2011.

Within this context, the US interbank market is characterized by its stability and the lack of tension, fundamentally thanks to two factors. The first is abundant liquidity, still increasing due to the Fed's bond purchases. The second is related to the increasingly healthier position of banks, a process that encourages lower counterparty risk premia. It should be noted that the crisis in the countries on the periphery of Europe has led to some tension in the region's financial institutions accessing the dollar interbank market. However, given that the Fed and the ECB have extended their currency swap lines, these frictions are moderate in nature and will gradually ease.

### **The public debt of the United States and the euro area diverges**

During the summer months, the yield for US public debt fell due to doubts regarding the economy's speed of recovery and the expected announcement of bond purchases by the Fed. This downward slide stopped after the minimums recorded in

**The Fed's QE2 and the extension of fiscal stimuli aim to support activity and reduce unemployment.**

**The interest rate for US public debt picks up...**

August. Since the end of October, the yield of US public debt has quickly recovered, creating some concern among analysts and investors.

Two key factors have put a brake on the downward slide of bond yields. Firstly, the US Treasury's announcement of a new fiscal plan to further boost economic growth via investment and domestic consumption. Secondly, the publication of macroeconomic data that show a slight improvement in the US economic cycle.

Taking into account the fact that inflation expectations are still anchored and that sovereign solvency risk (which determines CDS market prices) has not increased, the demanded rise in interest rates for US public debt is due to a rise in the real interest rate, reflecting the improved

economic outlook for the coming quarters. The table below shows how, since the end of October, the yield for 10-year Treasury bonds has increased by 72 basis points (100 basis points are 1%), from 2.60% to the 3.32% quoted on 21 December.

The situation in the euro area is more complex, however. It's true that the economic data published also point towards the region tending to improve as a whole, but this recovery is being affected by tensions in peripheral sovereign debt. Although the European Union has approved a new facility to handle future sovereign debt crises, the spreads between German debt and that of the affected countries continue to be very high.

For example, the spread between 10-year Spanish and German bonds is 257 basis

**...reflecting the improved growth prospects.**

**High spreads continue between peripheral and German debt.**

## 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
<b>2009</b>								
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
<b>2010</b>								
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	2.67	3.15	5.50	4.67	2.80	1.19	3.23	1.56
December (*)	2.97	3.32	5.54	4.65	3.32	1.18	3.48	1.78

NOTE: (\*) December 21.

SOURCE: Bloomberg.



**In the medium term, the absence of higher official interest rates and inflation should lead to a slight upward trend in interest rates.**

points. This is lower than for Ireland or Portugal but, in all three cases, it is too high to be able to say that the sovereign debt crisis has finally turned the corner.

Neither has the decision taken by several international ratings agencies to lower or negatively rate the sovereign debt of various countries affected helped to calm the markets. The most significant changes in this respect are those of Greece, Portugal, Spain and Ireland. The most concerned investors closely inspect when these countries' sovereign debt is due to mature order to identify the fullest months, when it might be difficult to renew maturing debt. At the same time, more long-term investors seem to be waiting for economic data to confirm the end of these countries' fiscal deterioration.

**Emerging countries try to stop their currencies from appreciating against the dollar.**

In the medium term, we expect a slightly rising trend both for US and German bonds and there are two reasons why this movement is unlikely to be very fast. Firstly, due to the lack of rises in official rates for quite a few months to come, since central banks have indicated the need to support the economic recovery. Secondly, the expected absence of price tensions in both regions. The spreads between German debt and that of the peripheral countries in the euro area (Greece, Ireland, Portugal and Spain) will narrow as it's confirmed that the economic policies implemented in these countries are helping to consolidate their fiscal situation.

### **Currency management becomes a challenge for emerging countries**

The expansionary monetary policy in the United States has helped to push up the

value of currencies in the emerging countries compared with dollar. For Latin America and Asia, the strength of their currencies is also due to their economies' high growth prospects and rising commodity prices, as some of these countries are strong exporters of these products and benefit from such price rises.

In order to prevent the economy from overheating and to avoid the risk of prices going too high, some countries feel they have to implement more restrictive policies. But, in order to avoid raising official interest rates, they have opted to apply administrative measures (raising reserve ratios, tax hikes on foreign capital invested in financial assets, etc.). The aim is obviously to stop their currencies from appreciating, as far as this is possible. In this respect, although China allowed the renminbi to appreciate slightly in the period prior to the last G-20 meeting, this movement has been frozen in December.

On the other hand, the currencies of some countries in Eastern Europe have been an exception, such as the Hungarian forint or the Polish zloty, with these currencies being pushed down in value. The reason for this situation lies in the domino effect of the euro area's sovereign debt crisis. In fact, sovereign debt turbulences in the euro area continue to affect not only the aforementioned currencies but also, logically, the euro. The exchange rate between the euro and the dollar has fluctuated within a narrow range of 1.30 and 1.35 during December, with the European currency looking weak. More significant was the movement between the Swiss franc and the euro. On 22 December, the single currency was worth 1.24 Swiss francs, its lowest value since the euro was

**The Swiss franc appreciates against the euro, acting as a safe haven.**

## EXCHANGE RATES OF MAIN CURRENCIES

December 21, 2010

	Exchange rate	% change (*)		
		Monthly	Over December 2009	Annual
<b>Against US dollar</b>				
Japanese yen	83.7	0.4	-11.1	-8.9
Pound sterling	0.645	-3.0	-4.3	-3.5
Swiss franc	0.960	-3.1	-7.9	-9.0
Canadian dollar	1.017	-0.1	-3.5	-4.4
Mexican peso	12.411	0.9	-5.5	-4.2
<b>Against euro</b>				
US dollar	1.315	3.5	8.2	7.9
Japanese yen	110.1	-3.2	-21.0	-18.3
Swiss franc	1.262	-6.8	-17.5	-18.3
Pound sterling	0.849	-0.6	-4.5	-4.9
Swedish krona	8.984	-4.4	-14.1	-16.1
Danish krone	7.451	-0.1	0.2	0.1
Polish zloty	3.996	1.2	-2.6	-5.0
Czech crown	25.24	2.0	-4.8	-3.8
Hungarian forint	276.2	0.5	2.1	0.4

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

SOURCE: Bloomberg.

launched. There can be no doubt that the Swiss currency continues to act as a safe haven at times of uncertainty.

In 2011, the euro-dollar exchange rate does not look like moving to any great extent from its current position (around 1.35 dollars). The risk would be asymmetric, with the dollar increasing in value if one or more of the following three factors occurred: increased turbulence in the euro area, growth speeding up in the United States or greater appreciation of the renminbi.

### Consolidation and divergence in corporate bond markets

Corporate bonds are still positive in tone, although also prudential, taking in their

stride the volatility produced by the various risks that have rattled other financial markets. Within this context, significant divergences have been noted among corporate bonds in the last few weeks. In order to be able to understand these differences, it's important to classify corporate bonds according to their risk segment, where they were issued geographically and their economic sector.

The economic measures implemented in the United States (expansionary monetary and fiscal policies) and in the euro area (a new permanent facility to handle potential sovereign debt crises) have been positive for corporate bonds with a low credit rating. However, they have harmed high quality corporate bonds due to the narrow margins already reached and the rise in government interest rates in many

**The performance of corporate bonds depends on where they're from geographically, their economic sector and degree of seniority.**

**The bonds from emerging countries have successfully withstood the recent financial turmoil.**

countries. Geographically, Europe's corporate bonds have tended to perform worse than US bonds, affected by the euro area's sovereign debt crisis. According to the segmentation by economic sector, bonds issued by the European financial sector have suffered the most, especially those issued with a lower seniority as they are more likely to involve losses. Technically, this is called subordinated debt or junior securities and, should the issuer become insolvent, creditors with this kind of debt wouldn't get paid out until after the senior debtholders were paid in full, and then only if there were enough funds left over.

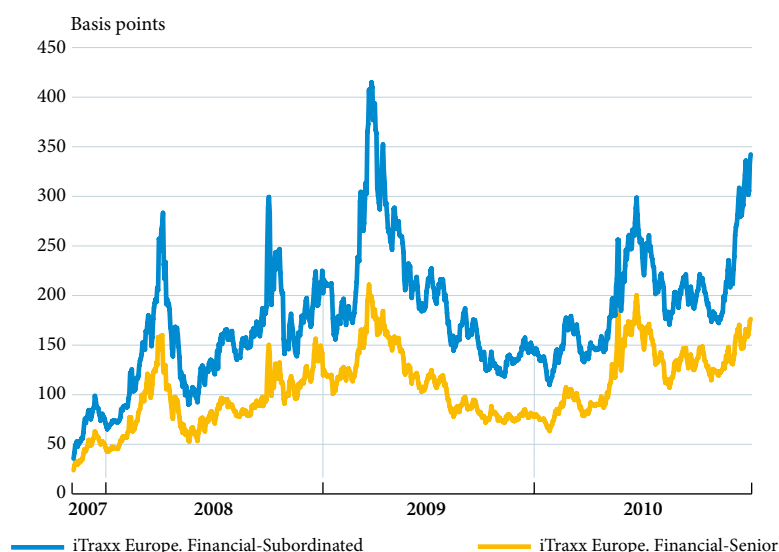
The news that some banks need to enlarge their capital to strengthen their equity and the comments and reflections regarding the regulatory changes emanating from what has been called Basel III have also harmed the prices of bonds issued by some banks.

However, corporate bonds from emerging countries have shown great stability given the sovereign debt troubles in peripheral countries of the euro area and the upward pressure on interest rates exerted by the West's public debt curves. There are several variables underpinning this good performance. On the one hand, a highly positive economic outlook and, on the other, very solid financial foundations. Generally speaking, emerging countries' high risk (or high yield) corporate bonds continue to offer relatively high spreads and yields.

We can therefore conclude that the corporate bond market is reaching an advanced state of maturity in which, nonetheless, some sectors still offer opportunities for investors to decide according to their risk tolerance, such as corporate bonds from emerging countries, lower credit rating or high risk (high yield) bonds and the subordinated debt of some

#### THE FINANCIAL SECTOR'S SPREADS SUFFER THE MOST

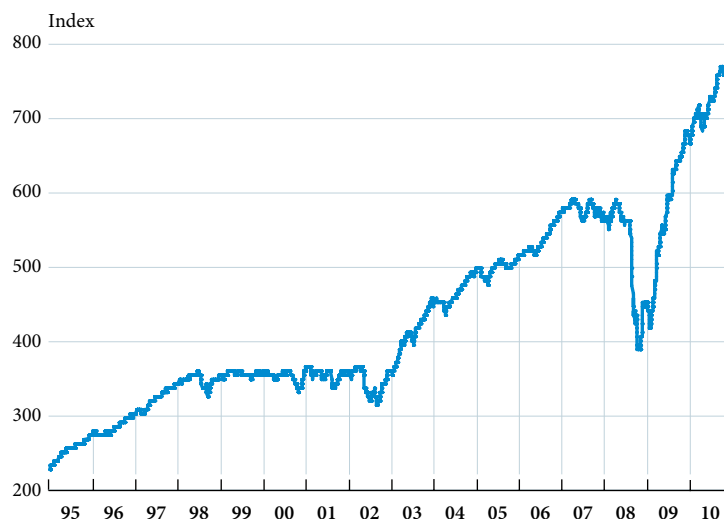
Trend in corporate bond risk premia for iTraxx 5 years. Euro area



SOURCE: Bloomberg.

## HIGH RISK CORPORATE BONDS BECOME MORE ATTRACTIVE

Index of total yields for high yield bonds



SOURCE: Merrill Lynch.

European banks, which offer abnormally high yields due to particular factors.

### After the storm, now's the time for equity

Looking at the last part of the year and weighing up the last few months, we can state that the world's stock markets have been characterized by geographical divergence and erratic behaviour in Europe. Divergence has been caused by the fast growth rates in emerging economies and the expectations of recovery in the United States. On the other hand, the movements, without any definite trend, of the European markets reflect the uncertainty that has taken over the region and specifically those countries directly affected by the sovereign debt crisis.

One area in which this divergence can be noted between the different markets is in the in- and outflows of mutual funds.

Although public debt, at a global level, acted as a safe haven for investors after the financial crisis got worse in September 2008, the subsequent and persistent uncertainty caused by the delicate situation of economies on the periphery of Europe is causing funds from the sovereign debt of these countries to flee towards other assets with a more attractive risk/return ratio in the eyes of investors, such as corporate bonds and, to a lesser extent, equity. In fact, the latest figures gathered on capital markets point towards an intensification in investment flows – both institutional and private – towards stock markets, attracted by factors such as improved corporate profits.

In addition, over the last two months, the improvement in the flow of macroeconomic indicators has been reinforced by the implementation of some economic policy measures that are highly favourable for the development of equity as a whole over the coming year. For example, in the United States, in addition

**The sovereign debt crisis and the growth of emerging economies lead to differences in the stock markets.**

## TRENDS IN THE MAIN INTERNATIONAL STOCK MARKETS

Stock market indices



SOURCE: Bloomberg.

**The European sovereign debt crisis is encouraging greater investment flows towards equity.**

**The medium and long term outlook for stock markets is positive, although specific corrections cannot be ruled out.**

to the Federal Reserve's quantitative easing measures (QE2), the government has also approved the extension of significant fiscal stimuli up to 2012. Another important event that will surely bolster stock markets over the coming quarters is the agreement reached among the countries of the European Union to create a permanent bailout mechanism as part of greater fiscal and political integration. All these measures should boost company margins due to the increase in aggregate demand via the rise in private expenditure, as well as reducing financing costs for firms. These factors support the estimates made by the consensus of analysts for 2011 concerning the trends in earnings per share of listed firms.

In short, and in spite of some of the differences between stock markets being repeated next year, a wide range of indicators (sentiment, value and economic) point towards equity once again embarking on a cycle of moderate expansion, marked by the improved economic activity, the increase in company margins and the adoption of more equity-based investment strategies on the part of private investors. Risks such as the euro area's sovereign debt crisis or those resulting from the possible overheating of some emerging economies, such as China, should be no more than a minor setback to stock market gains throughout the coming year.

## INDICES OF MAIN WORLD STOCK EXCHANGES

December 20, 2010

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
<i>Dow Jones</i>	11,451.6	2.2	9.8	10.9
<i>Standard &amp; Poor's</i>	1,243.5	3.7	11.5	12.8
<i>Nasdaq</i>	2,642.0	4.9	16.4	19.5
Tokyo	10,216.4	1.9	-3.1	0.7
London	5,890.5	2.8	8.8	13.3
Euro area	2,840.0	-0.2	-4.2	-1.1
<i>Frankfurt</i>	7,020.2	2.6	17.8	20.4
<i>Paris</i>	3,887.5	0.7	-1.2	2.5
<i>Amsterdam</i>	353.4	2.5	5.4	8.8
<i>Milan</i>	20,369.9	-1.9	-12.4	-9.4
<i>Madrid</i>	9,980.3	-2.8	-16.4	-14.3
Zurich	6,534.0	-0.9	-0.2	1.1
Hong Kong	22,639.1	-4.1	3.5	6.9
Buenos Aires	3,420.2	4.9	47.4	54.4
São Paulo	67,620.3	-4.6	-1.4	1.2

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.

## Alternatives for the small investor given the currency war

With the backdrop of the crisis that all countries are longing to leave behind them once and for all, over the last few months the expression «currency war» has spread, especially among the press, to refer to the occasionally conflictive situation in foreign exchange markets due to the economic policies of various governments and central banks. The nature of the economic forces in play could indeed result in far-reaching movements among currencies in terms of both size and duration,<sup>(1)</sup> dotted with episodes of high volatility, which have actually become quite customary over the last few decades. So what actions and strategies might be of use to private investors within this context? In principle, the term «war» suggests the notion of risk and therefore tempts us to search for a safe haven or at least apply caution. But it also offers opportunities that some might think are worth taking advantage of.

Generally speaking, investors should be prepared to hold positions in foreign assets (stocks, bonds, etc.). The benefits of international diversification can be seen in an improved ratio between a portfolio's expected return and its risk; i.e. a higher return for a certain risk or less risk for a certain target return.<sup>(2)</sup> However, in practice

(1) See the box «Which exchange rates are far from their equilibrium?» in this issue.

(2) For example see: R. De Santis and L. Sarno, *Assessing The Benefits Of International Portfolio Diversification In Bonds And Stocks*, ECB Working Paper, no. 883 (2008).

portfolios don't tend to diversify much internationally, not only those of private investors but also institutional. For decades now, this phenomenon has been identified and studied extensively in a range of countries and has been called the «home bias puzzle».<sup>(3)</sup> Many different explanations have been offered for this phenomenon, with some referring to the irrational performance of investors while others uphold the paradigm of rationality but stress institutional factors, such as transaction costs, asymmetries or barriers to information, etc.

The hypothesis that the home bias puzzle can be attributable to a greater perception of risk in foreign assets is directly related to the issue of the currency war, i.e. to the added risk incurred when the asset in question is in a foreign currency. But is this unavoidable? Not conceptually, insofar as exposure to the currency can be hedged,<sup>(4)</sup> with the only remaining risk being that of the underlying asset acquired (e.g. shares in Microsoft for a European investor). However, we must remember that, in the case of small investors, hedging can involve high transaction and operational costs and is often technical unworkable (due to the lack of or insufficient flexibility in hedging instruments for certain currencies).

In any case, and assuming hedging is feasible, the key question that investors must ask themselves is whether it's better to leave the portfolio exposed (do nothing), hedge it completely (passive hedging) or partially hedge it (active hedging). As you can imagine, there is no definitive or universal answer to this question. It depends on factors such as the correlation between underlying assets and currencies, the expected performance of both (i.e. the forecast of exchange rates, if the investor knows them), as well as investor preferences. Quantitative exercises to determine the optimum hedge consider each currency as an asset with its own identity and separate from the underlying assets. Consequently, these usually result in recommended portfolio compositions where hedging is partial (or alternatively in overhedging), asymmetric between currencies and variable over time.<sup>(5)</sup>

The fact that, in general, the optimum way to handle exposure to foreign currency is by applying partial hedges that change over time has given rise to a heterogeneous family of financial strategies, products and services known as currency overlay. These approaches aim to separate, but not to disconnect, the decision regarding the underlying assets that will make up the portfolio from the decision regarding currency exposure, to the extent that these two aspects are often assigned to different management teams.<sup>(6)</sup> Logically, this is easier to implement in large portfolios, such as those held by insurance companies or pension funds, but small investors also have access to some investment products that are managed in this way. The drawback is that control is lost over the inputs that determine the final currency exposure, as this is delegated to the manager. One special case, however, does not suffer from this problem: when the currency risk is totally and permanently hedged, i.e. through passive hedging. For example, a European can invest in ETFs<sup>(7)</sup> that replicate the performance of the S&P500 (US stock market) with hedging for the risk of the dollar fluctuating against the euro. In other cases, the currency exposure implemented by the manager results from a strategy and criteria that are explicit, transparent and known beforehand by the investor.

(3) There is an up-to-date review of research in this area in G. Bekaert and X. Wang, *Home Bias Revisited*, Columbia Business School working papers, (2009).

(4) Exchange derivatives are financial products conceived for this purpose: futures, swaps, options, warrants, etc.

(5) See, for example: J. Campbell, K. Serfaty-De Medeiros and L. Viceira, *Global Currency Hedging*, The Journal of Finance, Vol. LXV, no. 1, (2010). Also: J. Schmittmann, *Currency Hedging for International Portfolios*, IMF Working Paper 10/151, (2010).

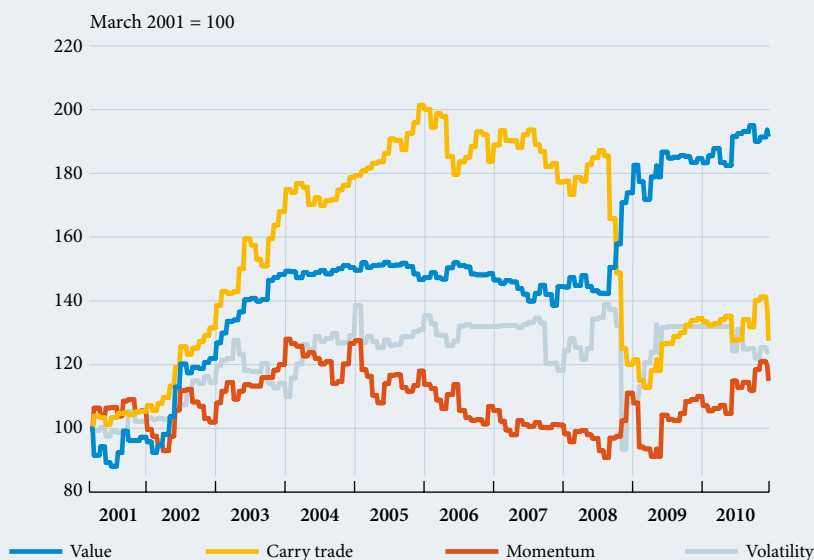
(6) One stage beyond currency overlay is what is known as pure alpha currency strategies and products, which are focused exclusively on exchange rates, taking currency positions without any prior underlying assets.

(7) ETFs: *Exchange Traded Funds*. These are mutual funds quoted on the stock market, so that they are bought and sold in the same way as buying and selling the shares of any company.



## RETURN OF SOME CURRENCY INVESTMENT STRATEGIES

Accumulated yield indices



SOURCE: RBS.

In this respect, over the last few years some currency investment strategies have been achieving the status of a standard, in two respects. Firstly, because they limit themselves to reflecting, objectively, mechanically and without hardly any room for discretion on the part of the manager, certain regularities of the foreign exchange markets that have provided positive returns in the past. Secondly, because they are available to small investors in the form of ETFs, mutual funds and structured bonds that replicate publicly known and transparent indices. The main strategies of this kind are: value, carry trade, momentum and volatility. The graph shows how they have performed over the last few years.<sup>(8)</sup>

The «value» strategy is based on the purchasing power parity theorem, according to which exchange rates eventually tend to even out the price of the same good in different countries. The «carry trade» strategy consists of buying (long position) currencies that offer a high rate and selling (short position) others with low rates. This is difficult to justify theoretically, since orthodox approaches assert that it should not provide positive results. Nonetheless, it can be provided with a theoretical base if we take into account elements that do not follow the efficient market hypothesis. The «momentum» strategy is also justified by phenomena that question the full efficiency of the market, specifically those related to transmitting and processing information. Based on the idea that prices (exchange rates) adjust very slowly to new information, this strategy consists of buying currencies that appreciated during the previous period and selling those that depreciated. The «volatility» strategy does not aim to take advantage of regularity in the direction of exchange rates but in the extent of their fluctuations. The actual mechanism can become highly sophisticated but, ultimately, the idea is to buy products that are cheap when volatility is low (e.g. options) and sell them when the price goes up because of rising volatility.

(8) The Royal Bank of Scotland's family of indices has been used. Various organizations have developed similar indices.

In summary, complementing the more traditional instruments such as derivatives, the existence of ready packaged and easy to access products that replicate these strategies, and other similar strategies, significantly broadens the possibilities of small investors to become involved in foreign exchange markets. With the attendant risks and opportunities.

*This box was prepared by the Financial Markets Unit,  
Research Department, "la Caixa"*

# SPAIN: OVERALL ANALYSIS

## Economic activity

### Gentle economic reactivation

After the slowdown in the economy recorded in the third quarter, indicators available for the fourth quarter of 2010 point towards a recovery, albeit a slight one. In particular, the index of economic sentiment, which condenses the consumer and business confidence indicators, posted an upswing in November after a slight dip in October. In November, the indicator for the economic climate reached its highest level since the month of June 2010.

Looking at demand, some improvement can be seen in consumption after the

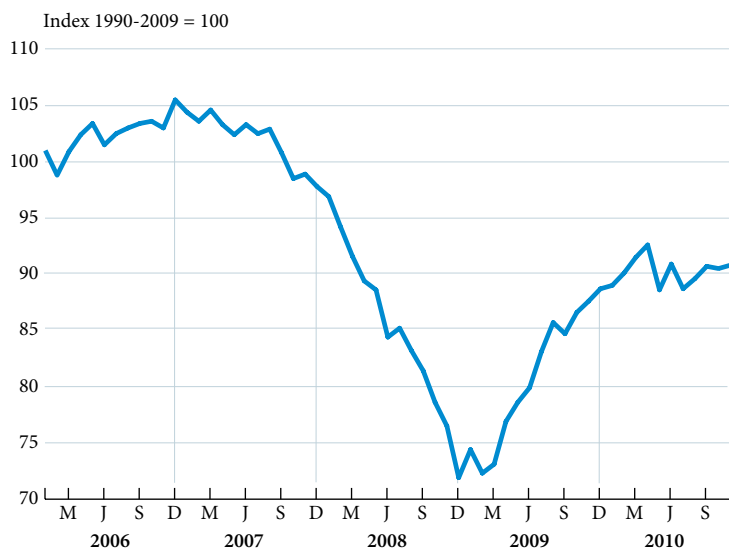
drop in the third quarter. Retail sales excluding cars were down 0.6% in October compared to the same month in 2009, indicating that the decline is easing, compared with the 2.5% fall in the second quarter. Passenger car registrations were down 25.5% in November compared with the same month the year before but were up compared with the third quarter. For its part, the consumer confidence indicator dipped slightly in November after a rise in October, standing at the same level as twelve months before, quite a long way below the historical average and pointing to little energy in consumption's recovery.

**Slight improvement in economic activity after the slowdown in the third quarter.**

**Registrations of load-bearing vehicles up 7% year-on-year in November, the first positive figure since June 2010.**

### SLIGHT IMPROVEMENT IN ECONOMIC SENTIMENT IN NOVEMBER

Index of economic sentiment (\*)



NOTE: (\*) Made up of confidence indicators for industry (40%), services (30%), consumers (20%), construction (5%) and retail trade (5%).

As from May 2010, there is a break in the series as a new classification for economic activity is implemented.

SOURCE: European Commission.

**Industrial confidence significantly higher than a year ago.**

Investment in capital goods has shown limited progress. Imports were up 14.5% in October compared with the same month last year but domestic production was down 7.5% year-on-year in the same month. Registrations of load-bearing vehicles rose by 7.0% in November compared with twelve months before, recording the first positive year-on-year rate of change since June 2010.

With regard to investment in construction, leading indicators such as cement consumption and confidence in the sector are not very encouraging. In particular, the latter dropped significantly in November due to the budget cuts for infrastructures. Looking at the residential sector, this was affected by a sluggish real estate market, with housing transactions down 17.7% in October compared with a year earlier, due to acquisitions being brought

forward to avoid the hike in value added tax (VAT) in July.

Industry was also sluggish from the point of view of supply, with the industrial production index falling by 1.9% year-on-year in October. Imports of non-energy intermediate goods slowed up, although these were 16.0% higher in October than in the same month last year. However, electricity consumption picked up its pace of growth in October and November and industrial confidence is significantly higher than a year ago, thanks especially to foreign demand.

With regard to services, in October the turnover in calendar-adjusted terms fell by 1.2% compared with the same month in 2009, almost one percentage point less than in September. Weak demand affected most branches, with the exception of transport and storage,

**Weak demand affects most branches of services in October.**

## DEMAND INDICATORS

Percentage change over same period year before

	2008	2009	2009	2010				
			4Q	1Q	2Q	3Q	October	November
<b>Consumption</b>								
Production of consumer goods (*)	-4.7	-8.2	-1.7	0.4	2.5	0.4	-1.5	...
Imports of consumer goods (**)	-7.7	-6.1	3.7	-10.8	2.8	-16.2	-20.4	...
Car registrations	-28.1	-17.9	29.3	44.5	35.3	-25.0	-37.6	-25.5
Credit for consumer durables	3.6	-11.5	-9.1	-5.6	-9.8	-19.2	-	...
Consumer confidence index (***)	-33.8	-28.3	-20.0	-18.2	-22.9	-21.7	-20.0	-21.0
<b>Investment</b>								
Capital goods production (*)	-8.8	-22.1	-10.3	-2.4	-1.7	-6.3	-7.5	...
Imports of capital goods (**)	-19.6	-27.0	-16.9	-1.2	13.0	5.8	14.5	...
Commercial vehicle registrations	-43.6	-40.0	-7.8	8.5	24.2	-9.3	-4.0	7.0
<b>Foreign trade (**)</b>								
Non-energy imports	-4.9	-17.5	-0.7	10.4	18.1	5.1	2.8	...
Exports	1.9	-9.8	4.3	17.4	14.9	11.7	11.0	...

NOTES: (\*) Adjusted for public holidays.

(\*\*) By volume.

(\*\*\*) European Commission survey: difference between percentage of positive and negative replies.

SOURCES: ANFAC, National Institute of Statistics, Bank of Spain, Ministry of the Treasury, European Commission and own calculations.

and those subsectors recording the highest year-on-year falls were information and communications and professional, scientific and technical activity.

In fact, thanks to the foreign sector's contribution, the quarter-on-quarter growth in gross domestic product (GDP) in the fourth quarter will probably be slightly positive again, after stagnating in the third quarter. We are therefore maintaining our forecast of a 0.2% drop in gross domestic product for 2010 as a whole. The recovery will continue

in 2011, although the correction of accumulated imbalances will ensure its rate is moderate, namely 0.7%.

On the other hand, several economic policy measures were announced in December in order to lay the foundations for solid economic recovery.

Administrative charges have been eliminated for firms, the corporate tax burden for SMEs will be reduced and the special tax on tobacco has been raised. The airport management organization (AENA) will also be partly privatized, as well as the state lottery. The end of

**We expect the economy's recovery to continue in 2011 with 0.7% growth in GDP.**

**New economic policy measures to lay the foundations for a solid recovery.**

## SUPPLY INDICATORS

Percentage change over same period year before

	2008	2009	2009	2010				
			4Q	1Q	2Q	3Q	October	November
Industry								
Electricity consumption (1)	0.5	-4.3	-1.4	3.3	4.7	1.9	3.0	3.3
Industrial production index (2)	-7.3	-15.8	-5.6	0.3	2.9	-0.2	-1.9	...
Confidence indicator for industry (3)	-18.0	-31.2	-24.1	-20.1	-14.4	-13.7	-10.0	-10.0
Utilization of production capacity (4)	80.1	71.2	70.6	69.5	71.8	73.9	72.9	-
Imports of non-energy intermediate goods (5)	-0.7	-21.6	0.1	26.9	28.4	18.8	16.0	...
Construction								
Cement consumption	-23.8	-32.3	-17.4	-18.9	-12.2	-13.6	-15.4	-20.9
Confidence indicator for construction (3)	-22.6	-30.6	-24.5	-24.9	-24.3	-28.0	-32.0	-43.0
Housing (new construction approvals)	-59.4	-58.1	-45.5	-24.4	-10.3	-13.2	...	...
Government tendering	3.0	-8.2	-17.0	-50.5	-11.0	-36.6	...	...
Services								
Retail sales (6)	-6.0	-5.4	-2.7	0.7	-0.2	-2.5	-0.6	...
Foreign tourists	-2.5	-8.8	-3.5	0.3	-3.1	4.2	4.2	2.7
Tourist revenue inflows	-0.4	-9.0	-5.5	0.2	0.4	7.0	...	...
Goods carried by rail (ton-km)	-7.7	-28.4	-7.7	4.5	20.9	5.9	-10.0	...
Air passenger traffic	-3.0	-7.9	-0.7	3.5	-0.6	4.2	8.6	5.1
Motor vehicle diesel fuel consumption	-3.8	-5.1	-2.0	-0.5	-0.5	-2.2	...	...

NOTES: (1) Adjusted for number of working days and temperature.

(2) Adjusted for public holidays.

(3) European Commission survey: difference between percentage of positive and negative replies.

(4) Business survey: percentage of utilization inferred from replies.

(5) By volume.

(6) Index (without petrol stations) deflated and corrected for calendar effects.

SOURCES: Red Eléctrica Española, OFICEMEN, AENA, National Institute of Statistics, Bank of Spain, European Commission, Ministry of Public Works, Ministry of Industry, Commerce and Tourism, Ministry of the Treasury and own calculations.

**Corporate profits and performance improve but not enough to create net employment.**

January has also been set as the deadline for specifying the reforms to the pension system and March for modifying the collective bargaining system.

compared with a year earlier, a result of the fall in employment and the slowdown in average wage rises per employee to 0.8% year-on-year.

**Improvement in corporate performance**

It's important to monitor company accounts as the creation of net employment depends on these, and the data from the Quarterly Composite Balance Sheet of the Bank of Spain throw light on the corporate situation. During the first three quarters of 2010 we can see a recovery in activity for the companies in the quarterly sample, with a 4.4% year-on-year increase in nominal gross value added, in contrast to the drop of 11.8% recorded for the same period of 2009, indicating that the worst of the crisis has passed. Personnel costs fell by 1.5% in the period January-September 2010

Gross operating profit rose by 9.7%, which contrasts with the 19.5% drop in 2009. The fall in financial income, slight increase in financial costs and higher amortization and provisions meant that growth in the ordinary net profit was less than 6.9%. Taking non-trading income and tax on profits into account, profits for the year were up 5.2% on the same period last year, comparing favourably with the drop of 7.7% in 2009.

Regarding returns, both net assets and equity improved slightly in 2010, standing at 5.5% and 7.6%, respectively. In short, firms continue to strengthen their situation with improved profits and performance, although net employment is still not being generated.

**INCOME STATEMENT OF NON-FINANCIAL FIRMS**

Annual rates of change

	2009	Quarters: 1-3	
		2009	2010
Value of output	-13.5	-17.9	10.9
Intermediate consumption	-16.1	-21.1	14.8
<b>Gross value added (GVA)</b>	<b>-8.3</b>	<b>-11.8</b>	<b>4.4</b>
Personnel costs	-2.0	-1.8	-1.5
<b>EBITDA</b>	<b>-13.5</b>	<b>-19.5</b>	<b>9.7</b>
Financial income	-11.6	-15.8	-11.3
Financial costs	-31.6	-30.4	0.8
Depreciation and provisions	-1.2	-0.0	2.7
<b>Ordinary net profit or loss</b>	<b>-6.6</b>	<b>-20.4</b>	<b>6.9</b>
Divestment and deterioration	-	-16.1	-41.9
Changes in fair value and rest of earnings	-29.1	78.3	-37.5
Corporate income tax	-	-23.4	42.0
<b>Profit or loss from the year</b>	<b>55.4</b>	<b>-7.7</b>	<b>5.2</b>

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

## Labour market

### Slow reversal in the decline in the labour market

The weak recovery in economic activity continues to be insufficient to generate employment, as seen in the number of people registered as employed with Social Security for November. According to the Ministry of Labour and Social Affairs, the total number of registrations this month fell by 53,440 people to 17,612,709 (around 16,000 seasonally adjusted), worse figures than expected. Nonetheless, the rate of decline over the last year slowed up slightly, reaching 1.3% year-on-year. These figures therefore suggest that the employment situation is continuing to get worse, albeit at a slower rate.

By sector, although job losses were widespread in November, they were particularly severe in services with a loss of close to 30,000 people. Consequently, although the services sector was the only one to generate employment in the first half of 2010, it's now looking at six months with no jobs created. Once seasonally adjusted, the data confirm that the recovery in the labour market has come to a standstill across all sectors.

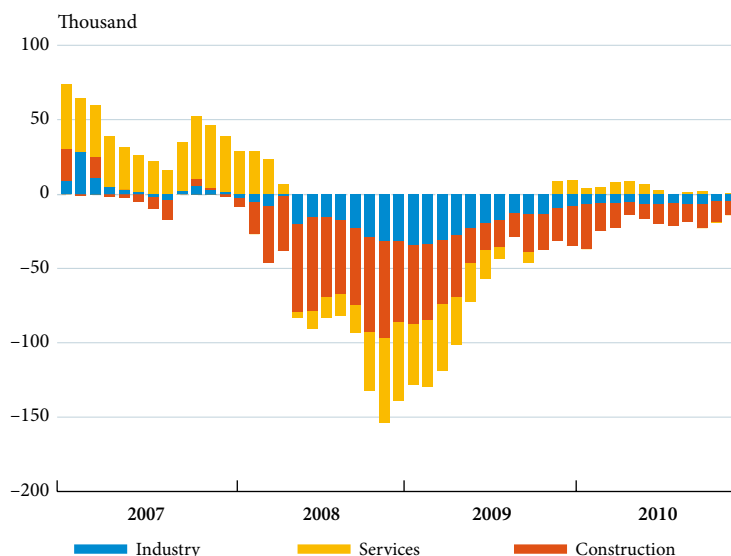
The labour outlook for the last month of the year is more optimistic, as employment contracts saw a year-on-year increase of 4.4% in the month of November. However, this increase in employment contracts probably contains a significant seasonal factor, so that there

**The destruction of employment continues.**

**Jobs are lost in all sectors in November.**

### THE RECOVERY IN EMPLOYMENT COMES TO A STANDSTILL IN ALL SECTORS

Monthly change in the number of employed people registered with Social Security (\*)



NOTE: (\*) Series corrected for seasonal factors.

SOURCES: Ministry of Labour and Social Affairs and own calculations.



## EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2008	2009	2009	2010				
			4Q	1Q	2Q	3Q	October	November
Persons registered with Social Security (1)								
Sectors of activity								
Industry	-2.1	-10.6	-10.0	-7.2	-4.9	-3.8	-3.3	-3.2
Construction	-10.3	-23.1	-18.9	-16.4	-13.1	-12.5	-11.8	-11.3
Services	1.7	-2.6	-2.1	-0.8	0.1	0.4	0.4	0.4
Job situation								
Wage-earners	-0.7	-6.0	-4.6	-2.8	-1.8	-1.4	-1.2	-1.2
Non-wage-earners	0.4	-4.8	-4.9	-4.0	-3.0	-2.4	-2.1	-1.9
Total	-0.5	-5.8	-4.6	-3.0	-1.9	-1.6	-1.4	-1.3
Persons employed (2)	-0.5	-6.8	-6.1	-3.6	-2.5	-1.7	-	-
Jobs (3)	-0.5	-6.6	-6.0	-3.8	-2.5	-1.7	-	-
Hiring contracts registered (4)								
Permanent	-14.3	-31.0	-22.5	-11.9	-5.6	-7.6	-6.4	0.7
Temporary	-10.4	-13.5	-2.1	3.7	5.2	3.5	-0.3	4.8
Total	-10.9	-15.5	-4.3	2.0	4.2	2.6	-0.9	4.4

NOTES: (1) Average monthly figures.

(2) Estimate by Labour Force Survey.

(3) Equivalent to full-time work. National Accounting estimate; data adjusted for seasons and public holidays.

(4) At the Public State Employment Service.

SOURCES: National Institute of Statistics, Ministry of Labour and Social Services, Public State Employment Service and own calculations.

### Registered unemployment rises by 6.2% in one year.

might be another fall in employment at the beginning of 2011, as suggested by the fact that more than 90% of the contracts signed were temporary.

Employment registration fell both for men and women in the month of November but more sharply among the former, as they are more present in those sectors hardest hit by the economic crisis. This same reason was also behind the number of foreigners registered as employed falling more sharply in annual terms than for Spanish registrations, down by 1.9% and 1.2% respectively.

### Less registered unemployment than expected in November

Registered unemployment at the state employment offices increased by 24,318

people in November up to a total of 4,110,294, placing the year-on-year growth rate at 6.2%, one percentage point lower than the previous month. However, when this series is seasonally adjusted, there is a drop in unemployment (of around 22,000 people), the first fall in November since the crisis started.

The fact that the recovery in the labour market has come to a standstill but the seasonally adjusted total of unemployed is falling suggests that a number of the total unemployed are becoming inactive in employment terms. This might result in a decline in the labour force in the last quarter of the year, thereby slowing up the rise in the unemployment rate.

## REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

November 2010

	No. of unemployed	Change over December 2009		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	133,696	27,563	26.0	23,629	21.5	3.3
Industry	485,441	-23,361	-4.6	-11,884	-2.4	11.8
Construction	724,091	-57,633	-7.4	-2,697	-0.4	17.6
Services	2,402,348	161,283	7.2	161,485	7.2	58.4
First job	364,718	78,839	27.6	70,815	24.1	8.9
By sex						
Males	2,027,565	15,029	0.7	87,164	4.5	49.3
Females	2,082,729	171,662	9.0	154,184	8.0	50.7
By age						
Under 25 years	461,409	14,640	3.3	-2,930	-0.6	11.2
All other ages	3,648,885	172,051	4.9	244,278	7.2	88.8
TOTAL	4,110,294	186,691	4.8	241,348	6.2	100.0

SOURCES: Public State Employment Service and own calculations.

### The first fall in labour costs for the last decade

According to the quarterly labour cost survey carried out by the Statistics Institute, total labour costs for firms by worker and month fell by 0.3% in the third quarter of 2010 compared with the same period a year ago. This is the first fall in the year-on-year rate since this statistic started in 2000.

The sharp drop in labour costs is essentially due to the slowdown in wage rises, its main component, as these increased by just 0.1% in the last twelve months. The non-wage component also contributed, down 1.5%, thanks to the fall in redundancy payments.

With regard to hourly labour costs, according to Eurostat figures these fell by 0.8% in the third quarter of 2010. This drop is significantly lower than the average for the euro area, whose year-on-year rate was up 0.8%, and

might help to relieve Spain's competitiveness problem.

These figures therefore confirm that the job losses caused by the crisis have had a strong, albeit delayed effect on moderating wages. It should also be pointed out that the 0.1% year-on-year rise in average earnings per worker and month was much lower than inflation for the same period, namely 1.9%. There was therefore a drop recorded in purchasing power for salaried workers in this quarter, breaking the trend of the last four years. This loss in purchasing power might harm consumption and slow up the recovery in economic activity.

In short, the outlook for the labour market over the next six months is of very gradual improvement. Although the decline in labour costs will provide significant support, employment probably won't grow until the gross domestic product posts significant increases.

**Labour costs down by 0.3% year-on-year in the third quarter.**

## WAGE INDICATORS

Percentage rate of change over same period year before

	2008	2009	2009		2010		
			3Q	4Q	1Q	2Q	3Q
<b>Increase under general wage agreements (*)</b>	<b>3.6</b>	<b>2.5</b>	<b>2.6</b>	<b>2.5</b>	<b>1.4</b>	<b>1.3</b>	<b>1.3</b>
<b>Wage per job equivalent to full-time work (**)</b>	<b>6.4</b>	<b>4.1</b>	<b>3.9</b>	<b>3.2</b>	<b>1.8</b>	<b>1.4</b>	<b>0.5</b>
<b>Quarterly labour cost survey</b>							
Wage costs							
Total	5.1	3.2	3.1	2.7	1.9	1.8	0.1
Industry	4.8	2.1	2.0	2.5	2.8	3.0	2.9
Construction	6.3	5.2	4.9	5.3	1.9	1.4	-0.9
Services	5.0	3.2	3.2	2.5	1.6	1.6	-0.4
Average wages per hour worked	4.9	5.3	3.9	5.3	2.9	1.4	-0.9
Other labour costs	4.1	4.3	3.9	1.9	-1.1	-0.6	-1.5
Work day (***)	0.2	-2.1	-0.9	-2.4	-1.0	0.3	1.1
<b>Farm wages</b>	<b>5.1</b>	<b>2.6</b>	<b>0.3</b>	<b>2.8</b>	<b>3.3</b>	<b>3.2</b>	<b>-</b>
<b>Labour cost in construction</b>	<b>5.7</b>	<b>4.7</b>	<b>3.7</b>	<b>3.6</b>	<b>3.1</b>	<b>0.7</b>	<b>0.1</b>

NOTES: (\*) Does not include wage revision clauses. Cumulative figures.

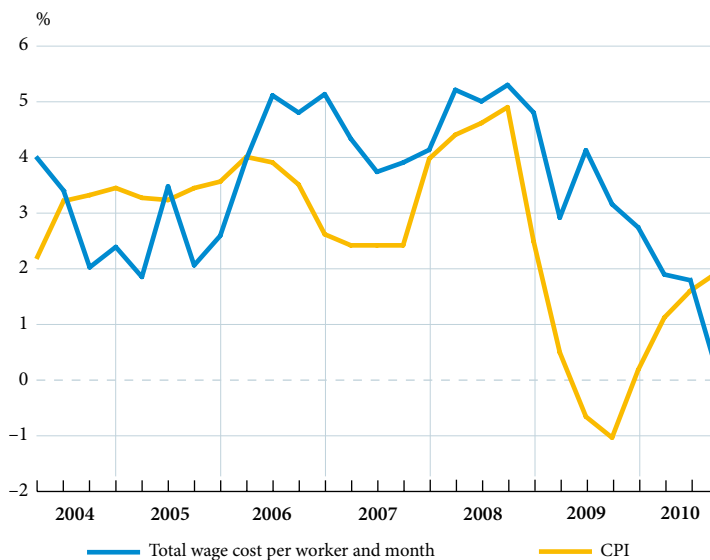
(\*\*) Quarterly National Accounts: data adjusted for seasons and public holidays.

(\*\*\*) Effective hours worked per worker per month.

SOURCES: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fisheries and Food, Ministry of Public Works and own calculations.

## AFTER MORE THAN TWO YEARS OF CRISIS, INFLATION EXCEEDS WAGE RISES FOR THE FIRST TIME

Year-on-year change



SOURCES: National Institute of Statistics and own calculations.

## Prices

### Inflation remains at 2.3% in November

The year-on-year rate of change in consumer prices (CPI) stood at 2.3% in November, the same rate as the previous month and the highest for the last two years. During this period, the factors that have influenced inflation the most have been weak consumption, which has pushed prices down, and the trend in oil prices. Since July, the hike in value added tax (VAT) has also been significant, adding around half a point to inflation.

However, the contribution of fuels and oils was negative in November by half a percentage point, as they rose this month

by less than they did twelve months ago, while the contribution by the other large, volatile component of the CPI, namely unprocessed food, was slightly positive. It's worth noting the rise in pulses and fresh vegetables, as well as poultry.

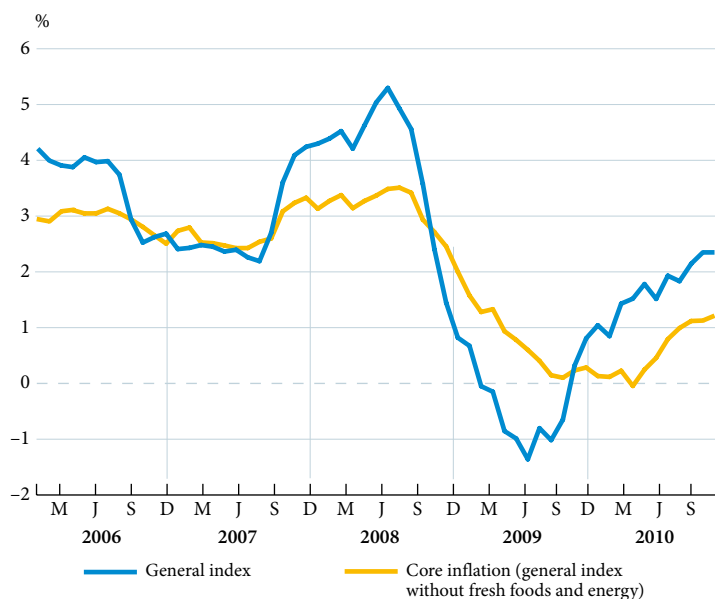
For its part, the most stable core of inflation, also known as underlying inflation, increased by one tenth of a percentage point in November to 1.2%, therefore offsetting the effect of energy products. The three large components of core inflation posted positive contributions to the month's annual inflation, although the greatest was by industrial products. In this heading, of note are the rises in clothing and

**In November, the negative contribution to annual inflation by fuels and oils...**

**...is offset by the rise in core inflation.**

### SLIGHT INCREASE IN CORE INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

## CONSUMER PRICE INDEX

	2009			2010		
	% monthly change	% change over December 2008	% annual change	% monthly change	% change over December 2009	% annual change
January	-1.2	-1.2	0.8	-1.0	-1.0	1.0
February	0.0	-1.2	0.7	-0.2	-1.2	0.8
March	0.2	-1.1	-0.1	0.7	-0.5	1.4
April	1.0	-0.1	-0.2	1.1	0.6	1.5
May	0.0	-0.1	-0.9	0.2	0.8	1.8
June	0.4	0.3	-1.0	0.2	1.0	1.5
July	-0.9	-0.5	-1.4	-0.4	0.6	1.9
August	0.3	-0.2	-0.8	0.3	0.8	1.8
September	-0.2	-0.4	-1.0	0.1	0.9	2.1
October	0.7	0.3	-0.7	0.9	1.8	2.3
November	0.5	0.8	0.3	0.5	2.4	2.3
December	0.0	0.8	0.8			

SOURCE: National Institute of Statistics.

footwear, higher than in November 2009, and also automobiles.

Affected by the rise in food commodities over the last few months, processed foods were up 1.3% on last year, 0.1 percentage

points more than in September, with a particularly notable increase in dairy products.

The prices for services remained stable overall in November with a 1.5% change

## UPSWING IN FOOD PRICES

Year-on-year change in the price index for food and non-alcoholic beverages



SOURCE: National Institute of Statistics.

rate year-on-year, this stability resulting from the opposing movements of their components: while organized travel was down, hotels and restaurants were up.

The harmonized consumer price index posted a 2.2% year-on-year change rate, one tenth of a percentage point less than the previous month and the CPI. The inflation differential with the euro area

therefore remained at 0.3 percentage points. For its part, the differential for core inflation was slightly favourable to Spain.

We have revised our forecast for December given the sharp rises in oil prices over the last few weeks and especially because of the hike in the special tax on tobacco as from December. The year-on-year rate

**We are upping our inflation forecast for December 2010 because of oil and the tax on tobacco.**

## CONSUMER PRICE INDEX BY COMPONENT GROUP

November

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2009	2010	2009	2010	2009	2010
By type of spending							
Food and non-alcoholic beverages	108.4	0.0	0.2	-2.6	0.3	-2.4	0.5
Alcoholic beverages and tobacco	136.8	0.0	0.1	12.8	8.6	12.8	8.5
Clothing and footwear	109.9	4.5	4.8	0.4	1.8	-0.9	0.6
Housing	118.6	0.3	0.4	0.8	5.4	0.3	5.4
Furnishings and household equipment	108.3	0.2	0.2	0.7	0.8	0.9	0.9
Health	96.3	0.0	-0.2	-1.3	-1.3	-1.4	-1.2
Transport	110.8	1.1	0.9	4.4	7.2	0.9	6.7
Communications	98.6	0.0	0.0	-0.3	-0.7	-0.8	-0.7
Recreation and culture	96.3	-0.7	-0.9	-2.5	-2.4	-1.1	-1.0
Education	117.0	0.1	0.1	2.6	2.2	2.7	2.3
Restaurants and hotels	113.5	-0.3	-0.2	1.2	1.5	1.2	1.5
Other goods and services	112.7	0.1	0.1	2.0	2.6	2.1	2.7
By group							
Processed food, beverages and tobacco	113.2	0.1	0.2	0.6	1.2	0.5	1.3
Unprocessed food	108.9	-0.1	0.1	-3.3	2.0	-2.7	2.2
Non-food products	109.7	0.7	0.6	1.2	2.6	0.5	2.5
Industrial goods	107.4	1.5	1.4	1.1	4.1	-0.6	3.6
Energy products	120.6	1.9	1.2	8.2	12.4	1.9	11.7
Fuels and oils	116.7	2.6	1.6	8.8	14.1	0.1	13.2
Industrial goods excluding energy products	102.6	1.4	1.5	-1.3	1.2	-1.7	0.8
Services	112.1	-0.2	-0.2	1.3	1.2	1.6	1.5
Underlying inflation (**)	108.9	0.4	0.5	0.2	1.2	0.2	1.2
GENERAL INDEX	110.3	0.5	0.5	0.8	2.4	0.3	2.3

NOTES: (\*) Base 2006 = 100.

(\*\*) General index excluding energy products and unprocessed food.

SOURCE: National Institute of Statistics.

of inflation could therefore end 2010 at around 2.8%. Inflation is likely to continue to rise in January due to the increase in electricity and other state-regulated services. However, after that inflation is likely to fall as a result of weak consumption and the reversal of the VAT effect in the second half of 2011, except for any abrupt rises in commodities.

### Industrial prices go on rising

Industrial prices continued to increase in October, particularly driven by energy, consumer perishables and intermediate goods. The year-on-year rate of change for industrial prices therefore increased

to 4.1%, 7 tenths of a percentage point more than in September. The branches with the highest rises year-on-year were coking plants and oil refineries, up 20.4%, as well as metallurgy, up 14.3%, reflecting the increases in crude and metals in the last period.

Industrial import prices increased more in the last twelve months up to October, namely by 8.5%, but less than in the previous month due to the euro's appreciation. The highest increases year-on-year for import prices went to energy (21.3%) and intermediate goods (10.4%), but there was also a notable 6.5% rise in consumer goods, whereas farm prices dropped in July to 4.5% year-on-year, 4.1 points less than the month before.

**The euro's appreciation slows up the rise in industrial import prices.**

## 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											
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	4.5	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	8.7	6.0	1.8	10.2	1.4
September	...	3.4	0.2	0.5	4.0	9.1	9.2	6.8	1.8	10.6	-
October	...	4.1	0.6	0.5	4.4	10.4	8.5	6.5	1.7	10.4	-

NOTES: (\*) Seasonal and calendar effects adjusted data.

(\*\*) Except energy.

SOURCES: National Institute of Statistics, Ministry of the Treasury and own calculations.



## Foreign sector

### The non-energy component sustains the reduction in the trade balance

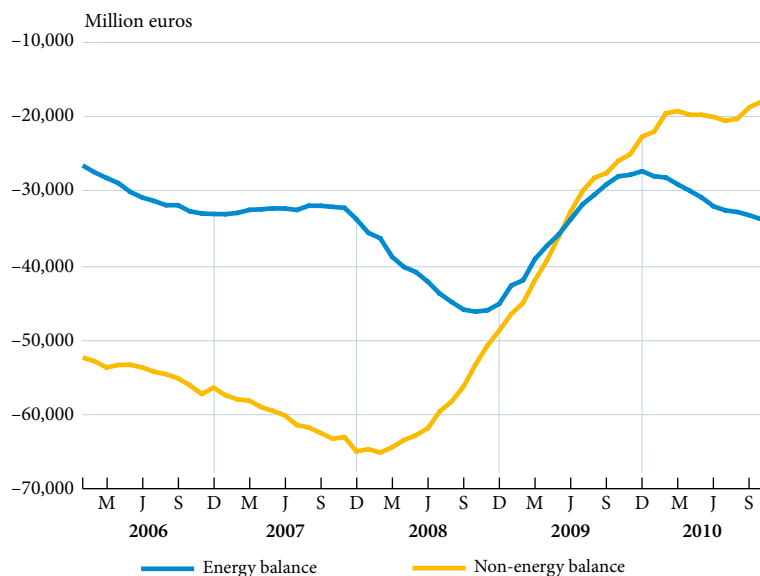
The trade deficit totalled 3.7 billion euros in October, 5.3% less than the figure for the same month a year ago. This improvement in the trade imbalance, the third one in a row, is due to the higher year-on-year growth in exports than in imports, namely 16.6% and 12.0%, respectively. A difference that widens to 8.2 percentage points when we compare the volume of trade flows, due to the sharp increase in the price of imports over this period.

An analysis of the balances accumulated over the last twelve months, which provides a better view of the medium-term trends, reveals a change in trend of the trade balance after its deterioration in the first half of last year. However, this new adjustment in the trade imbalance has lost steam compared with the one recorded in 2009. As can be seen in the graph, the slower rate of decrease is due to the rise in the energy deficit, which accounted for 65% of the total in October. The dramatic upswing in the value of energy imports, boosted by rising oil prices, caused this larger deficit.

**The trade deficit shrinks again in October...**

### THE GOOD PERFORMANCE BY THE NON-ENERGY COMPONENT LIES BEHIND THE IMPROVED TRADE DEFICIT

Data accumulated over the last twelve months



SOURCES: Ministry of the Economy and own calculations.

## FOREIGN TRADE

January-October 2010

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	36,128	28.2	18.5	7,156	25.9	4.7	-28,973	19.8
Consumer goods	48,775	-9.8	25.0	51,169	-1.4	33.6	2,394	104.9
Food	12,691	5.2	6.5	19,132	10.4	12.6	6,441	150.7
Non-foods	36,083	-14.1	18.5	32,037	-7.4	21.0	-4,046	88.8
Capital goods	14,651	8.3	7.5	12,945	19.0	8.5	-1,706	88.4
Non-energy intermediate goods	95,801	26.1	49.0	81,047	30.6	53.2	-14,753	84.6
By geographical area								
European Union	107,280	6.9	54.9	103,287	14.4	67.8	-3,993	96.3
Euro area	86,390	4.4	44.2	84,844	14.0	55.7	-1,546	98.2
Other countries	88,075	23.2	45.1	49,030	21.9	32.2	-39,045	55.7
Russia	4,866	26.7	2.5	1,617	36.1	1.1	-3,249	33.2
United States	7,588	6.5	3.9	5,361	10.5	3.5	-2,228	70.6
Japan	2,887	13.4	1.5	1,170	17.1	0.8	-1,718	40.5
Latin America	11,572	30.7	5.9	8,202	29.3	5.4	-3,369	70.9
OPEC	18,807	33.9	9.6	5,517	4.5	3.6	-13,290	29.3
Rest	42,354	20.8	21.7	27,164	25.9	17.8	-15,190	64.1
TOTAL	195,355	13.7	100.0	152,318	16.7	100.0	-43,038	78.0

SOURCES: Ministry of the Economy and own calculations.

### ...due to the good performance of the non-energy component.

On the other hand, the non-energy balance fell in October after remaining at around 20 billion euros for half a year. The boost to private consumption in the second quarter due to the impending end of subsidies for buying vehicles and July's hike in value added tax (VAT) lies behind the trend in this component of the deficit.

The trade imbalance is likely to continue adjusting over the coming quarters, although there are still some risks that might slow down this correction in the short term. Further increases in oil prices in 2011 and a strong euro would negatively affect the deficit's performance. This might, however, be neutralized by the upswing in private consumption in

countries such as France and Germany, two of the main destinations for Spanish exports.

### Goods and services drive the reduction in the current deficit

The latest figures for the current account balance in September place the deficit at 3.7 billion euros, 20.4% lower than the figure for the same month a year ago. This adjustment was due to the correction in the deficit of the balance of goods, with a fall of 21.3% year-on-year, and the improved surplus in services, up by 27.4%. On the other hand, the deficits in the transfer and income balances grew over the same period.

An analysis of the data accumulated over the last twelve months shows a 22.6% fall in the current deficit compared with the same period a year ago, now standing at 52.5 billion euros, equivalent to 5.0% of GDP. Although far from the maximum reached in June 2008, this figure clearly shows stagnation as it's no different from the levels recorded in the first quarter of this year. However, the further contraction in the trade deficit and the upswing in services in the third quarter are expected to reduce the current deficit to 4.7% of GDP.

With regard to financial flows, September's lower net borrowing

led to a drop in foreign capital inflows. The data show portfolio investment and short-term investment to be the main sources of financing during this month. Direct investment gave rise to net outflows of 5.65 billion euros due to the upswing in Spanish investment abroad, while the Bank of Spain's use of Eurosystem funds was negative for the third consecutive month, with an outflow of almost 25 billion euros. This figure contrasts with the inflows of almost 70 billion euros which, under the same heading, financed the Spanish economy during the summer months, due to the outbreak of tension regarding sovereign debt.

**Portfolio and short-term investment are the main sources of financing**

## BALANCE OF PAYMENTS

September 2010

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
<b>Current account balance</b>					
Trade balance	-34,921	4.3	-46,566	5,144	-9.9
Services					
<i>Tourism</i>	21,741	2.9	26,641	298	1.1
<i>Other services</i>	481	-	480	1,311	-
Total	22,222	8.8	27,122	1,609	6.3
Income	-17,095	-28.1	-23,855	9,607	-28.7
Transfers	-8,546	16.5	-9,191	-1,030	12.6
<b>Total</b>	<b>-38,339</b>	<b>-13.2</b>	<b>-52,491</b>	<b>15,329</b>	<b>-22.6</b>
<b>Capital account</b>	<b>5,299</b>	<b>84.3</b>	<b>6,481</b>	<b>2,944</b>	<b>83.2</b>
<b>Financial balance</b>					
Direct investment	-6,086	-	-9,566	-5,515	136.2
Portfolio investment	12,005	-32.7	39,085	41,714	-
Other investment	5,346	-8.1	2,829	-33,353	-92.2
<b>Total</b>	<b>11,265</b>	<b>-56.7</b>	<b>32,348</b>	<b>2,846</b>	<b>9.6</b>
Errors and omissions	-4,341	214.3	-5,970	-5,375	-
Change in assets of Bank of Spain	26,116	51.4	19,334	-15,064	-43.8

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.

## Capital controls - why not?

In October 2008, the collapse of the krona and of the country's three largest banks forced Iceland to adopt draconian adjustment measures and put itself in the hands of the International Monetary Fund (IMF) in order to save an economy that had become one of the richest in the world. Among the instruments implemented to stabilize the economy were exchange rate controls (restrictions on currency exchange) and capital controls (limits to capital inflows and outflows).

At about the same time, Brazil was pondering a very different dilemma. The worldwide economic crisis, which had hit advanced economies as a kind of cyclone, had passed through the emerging countries as a slight and short-lived drizzle. The economy soon picked up again and, although flows of global foreign investment were down, those aimed at Brazil continued to rise. Consequently, the real appreciated even more sharply against the dollar and demands were raised to slow up this rise in the exchange rate, as it was harming the economy's competitiveness. The government's solution has been to levy a tax on foreign capital inflows, complemented by another tax to make foreign transactions with Brazilian shares more expensive. In this case the in- and outflows of capital are not restricted but have become less attractive due to their higher taxes.

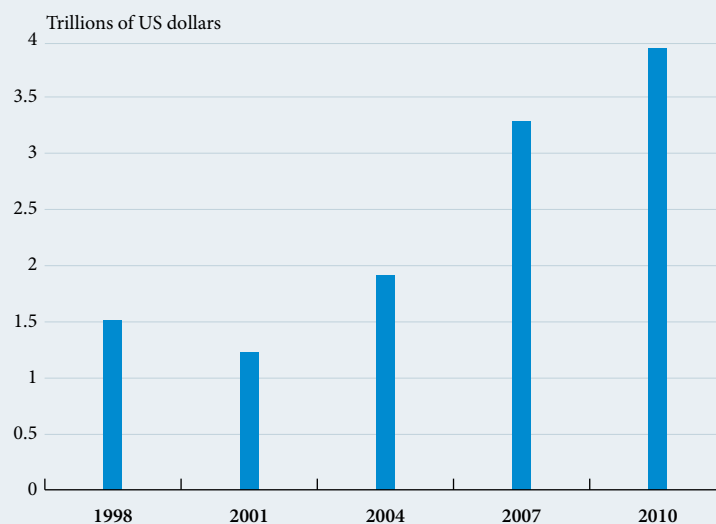
The example of Iceland and Brazil has caught on, with countries such as Indonesia, Taiwan, Singapore and South Korea all introducing various forms of capital controls, added to the already traditional forms employed by countries such as India or, of course, China. In fact, there has clearly been a change of focus regarding these controls. Limiting the capacity of capital to move freely from one national market to another was normal in developed countries as from the Second World War, with few exceptions (United States, Switzerland and Canada). The international monetary system, based on fixed exchange rates, saw limits to international financial transactions, at that time small in number, as a way to protect their domestic monetary policy's capacity to act and to support exchange rate stability. The measures most frequently employed were limits on non-residents investing in the domestic financial market or on the ownership of domestic firms; tough limits were also imposed on the outflow of resident capital. The panorama changed radically in the 1980s and 1990s, when advanced economies gradually but resolutely eliminated all traces of capital controls within the framework of the post-Bretton Woods exchange rate systems. In the European Union, any limitation is strictly prohibited among member states, while there is almost complete freedom regarding non-EU countries. This change was brought about by the growing flow of international capital as part of the globalization of financial transactions; due to the realization that domestic limitations were increasingly ineffective; and to the belief that liberalization was positive. In fact, numerous academic studies supported the favourable effect of eliminating limitations to moving capital on economies' real capacity for growth. The free circulation of capital became almost a doctrine. At the end of the 1990s, the IMF even considered modifying its statute to prohibit restrictions at a global level.

However, even at that time, at the end of the 1990s, the crisis among the «Asian tigers» highlighted the destabilizing potential of short-term capital movements or «hot money», when this decides to hurriedly enter or leave a country. Given this experience some countries, such as Thailand, decided to impose different measures to control capital, particularly aimed at slowing up capital outflows. But what has led to a change in how capital controls are perceived was the realisation that those countries with controls have been the least affected by the worldwide

financial crisis. The IMF itself has acknowledged, in a document published in February 2010,<sup>(1)</sup> that restrictions on the free movement of capital can be a useful complement in prudential regulations, avoiding credit bubbles and limiting foreign debt on the part of sectors that don't normally protect themselves against any sudden changes in currency parity (e.g. households). On the other hand, the total absence of controls in emerging economies with little developed financial systems might have a very negative effect. The mass inflow of capital might lead to the exchange rate being overvalued, swelling asset bubbles, amplifying the financial fragility of the system and rapidly increasing the risk of crisis.

### GROWING LIQUIDITY

Volumes traded daily in foreign exchange markets



SOURCE: Bank for International Settlements.

For the IMF, the question is how to channel capital inflows that might be a risk to prudential and macroeconomic policy. Imposing restrictions on the movement of capital should be a last resort. There are other instruments available to economic authorities, such as accumulating foreign reserves (sterilizing them, i.e. stopping them from becoming a growth in domestic credit) or modifying monetary or fiscal policy. However capital controls can be acceptable if these measures do not manage to contain the flows, although it's not clear which are the most effective (or cause the fewest distortions), those that apply administrative restrictions to flows or those based on taxation. In any case, what is worrying is that, although it might be useful for a country to implement capital controls, their widespread use could have a detrimental effect due to the distortion they might cause in the efficient assignment of international investment. That's why any such controls should be temporary in nature.

(1) Ostry, Ghosh, Habermeier, Chamon, Qureshi & Reinhardt (2010), «Capital Inflows: The Role of Controls», IMF Staff Position Note, February 19.

Given this change in stance, more countries will probably decide to apply capital controls, given the scenario of little growth, high liquidity and low interest rates in developed economies, on the one hand, and high growth and interest rates in emerging economies, on the other. If anything was brought to light by the last G-20 summit in November, it was the fact that not only was there no world government but that there wasn't even a hint of international coordination. Within this context, many might think that «throwing sand in the wheels», as advocated by Tobin in his proposal in the 1970s to tax the foreign exchange markets, namely the «Tobin tax», might be a way to improve how the mechanism works. Resorting to controlling capital is understandable, although it will always be preferable to have a solid, well developed financial system, together with suitable macroeconomic policies, than to artificially distort the free flow of capital.

*This box was prepared by Joan Elias  
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## Public sector

### New fiscal and budgetary measures

Measures affecting the budget and taxation have been announced over the last few weeks. The duty levied on tobacco products was raised at the beginning of December as part of a number of actions to encourage investment and create jobs. Although the main aim of this measure is to reduce consumption to protect citizens' health, the additional revenue obtained from this tax will also help to consolidate public accounts. This increase will raise the specific rate on cigarettes from 10.2 to 12.7 euros per 1,000 cigarettes and the minimum tax up to 116.9 euros per 1,000 cigarettes, from the previous figure of 91.3 euros.

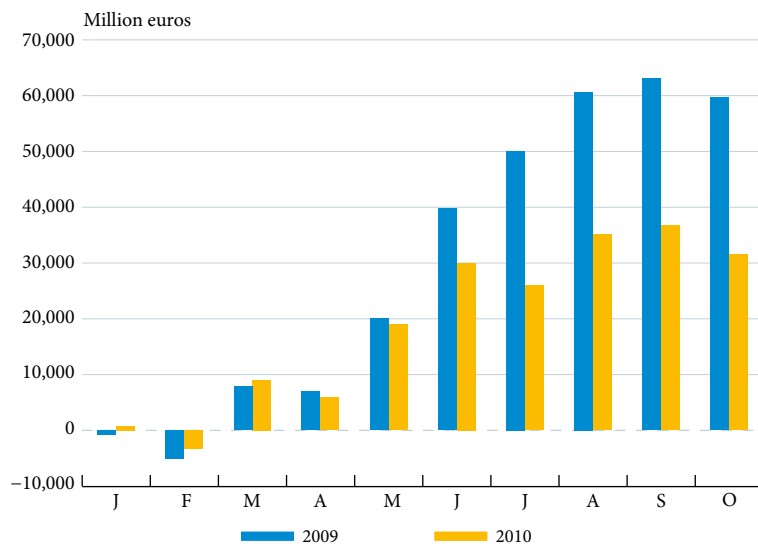
There have also been modifications to corporate tax. The maximum net turnover for companies to come under the special tax rate for smaller businesses has been raised from 8 to 10 million euros, whereby they pay 25% corporate tax instead of the general rate of 30%. Moreover, the threshold taxable base has been raised for small businesses to fall within the 25% corporate tax bracket, or 20% in the case of microfirms.

With regard to central government accounts, the stabilization of the economy overall and the discretionary measures adopted have led to improvements. In the first ten months of the year, accumulated revenue totalled 151,658 million euros

**Higher special tax on tobacco as from December 2010.**

### SHARP FALL IN CENTRAL GOVERNMENT DEFICIT

Accumulated net borrowing for the year



SOURCE: Ministry of the Treasury.



**Revenue from value added tax is up 45% year-on-year in the first ten months of 2010 but slows up in October.**

before transfers to regional governments according to the current financing system and in Treasury terms, i.e. in accordance with the monetary flows recorded. This is an increase of 8.0% on the same period the previous year.

This rise was particularly due to indirect taxation, as direct tax revenue fell by 0.8% year-on-year. The main figure, personal income tax, totalled 57,301 million euros in January-October, a rise of 5.4% compared with the same period of 2009, thanks to the 5% increase in employment withholdings, helped by the partial withdrawal of the 400 euro rebate and the 7.1% fall in tax returned. However, revenue from corporate tax fell by 19.5% compared with the first ten months of the previous year, although this figure shows a slowdown in the decline, thanks to company profits tending to improve.

Indirect taxation accumulated up to October rose by 29.3% year-on-year to 63.4 billion euros thanks mostly to the push from value added tax (VAT), up by 44.8% because of the recovery in consumption, lower tax returns and tax hikes as from July, resulting in an additional 1.4 billion euros. However, in the month of October VAT revenue was only up by 1.7% year-on-year because of the 2.5% drop in domestic operations, a result of consumption shrinking after purchases had been brought forward to avoid the tax hike in July. Special taxes rose by 2.6% up to October compared with the same period the previous year.

On the other side of the balance sheet, accumulated expenditure was down 0.3% year-on-year, compared with an 18.4%

rise in the same period of 2009. Current payments were up 1.7% year-on-year, particularly because of the 25.1% rise in financial costs due to debt expanding. Capital payments fell by 12.3% year-on-year, reflecting the restrictive budgetary position.

Given these trends in revenue and expenditure, net borrowing totalled 31.3 billion euros on a national accounts basis, in accordance with accrual accounting criteria, a year-on-year drop of 47.3%. As a percentage of gross domestic product (GDP), financing needs were 2.96%, which compares favourably with the 5.63% for the same period in 2009. It should be noted that the central government's target for 2010 is 6.7% of GDP, so that there is significant margin. Moreover, the Minister for the Economy and Taxation, Elena Salgado, recently repeated that the government will take additional measures should there be any deviation from the planned course of budget consolidation.

With regard to the autonomous communities, these ended the first half the year with a budget deficit of 1% of GDP and, according to the evaluation by the Fiscal and Financial Policy Council, the bulk of the evidence suggests that the 2.4% target for the whole of 2010 will be achieved, thanks to decisions taken both by the regional bodies and also by the central government insofar as they are affected by these measures, such as reducing personnel and pharmaceutical costs. The Fiscal and Financial Policy Council also reached an agreement to improve transparency regarding the economic and financial information provided by autonomous communities.

**State net borrowing stood at 3.0% of GDP up to October, compared with a central government target of 6.7% for the whole year.**

**The autonomous communities will also meet their budget targets for 2010 and will improve the transparency of their information.**

## Savings and financing

### Small increase in private sector financing

Credit interest rates continued to rise slightly in the month of October and the average interest rate on new loan operations for the private sector was 3.57%, 19 basis points higher than the month before, although only 13 higher than a year earlier. This therefore reflected the slight upward trend of interbank interest rates and also the rise in risk premium for Spanish debt. However, real interest rates, i.e. discounting inflation, continued to fall slightly. This meant that private sector financing, although affected by weak demand, recorded a slight year-on-year

rise for the first time since September 2009.

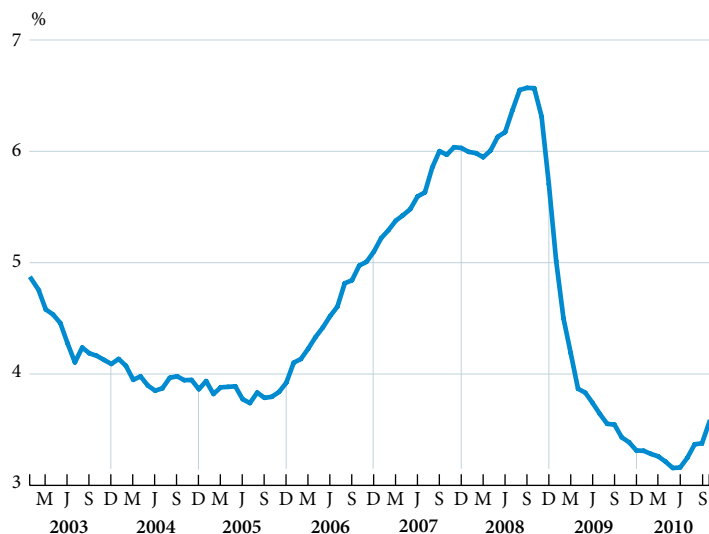
This small acceleration was due to the financing of firms, whose year-on-year rate of change rose by 2 tenths of a percentage point to -0.1%. Specifically, this improvement can be put down to bank loans, both domestic and foreign, which moderated their year-on-year drop. On the other hand, the issuance of fixed-income securities slowed up its expansion to 26.4%, 1.7 points less than in September, within a context of tense financial markets due to the Irish crisis.

Trade credit, aimed at financing the working capital of firms, continued

**Private sector financing posts a slight year-on-year rise for the first time since September 2009.**

### UPSWING IN CREDIT INTEREST RATES

Interest rates for financial institutions' new loan operations to the private sector



SOURCE: Bank of Spain.

## FINANCING OF NON-FINANCIAL SECTORS <sup>(1)</sup>

October 2010

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,218,775	5,817	0.1	78.0
Non-financial corporations	1,318,165	8,964	-0.1	46.3
<i>Resident credit institution loans (3)</i>	903,999	-12,362	-1.3	31.8
<i>Securities other than shares</i>	64,111	7,912	26.4	2.3
<i>External loans</i>	350,055	13,414	-0.9	12.3
Households (4)	900,610	-3,147	0.3	31.7
<i>Housing loans (3)</i>	678,095	-457	0.6	23.8
<i>Other (3)</i>	219,024	-2,800	-0.6	7.7
<i>External loans</i>	3,491	111	2.1	0.1
General government (5)	626,152	65,530	16.4	22.0
<b>TOTAL</b>	<b>2,844,927</b>	<b>71,347</b>	<b>3.2</b>	<b>100.0</b>

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.

### The fall in credit for construction and property development speeds up.

to slow up its decline, recording a year-on-year dip of just 0.9% thanks to the more stable economic situation, while financial leases, aimed at investment, hardly slowed up their fall, dropping by 15.3% in annual terms.

By sector, based on figures up to September, a generalized improvement can be seen compared with the second quarter except in construction, which increased its year-on-year drop to 9.3%. In all, the only large sector with a positive year-on-year change rate was services, up 1.2%, while credit to finance real estate activities sharpened its year-on-year fall to 1.3%, industry reduced its year-on-year decline to 0.7% and the primary sector fell by a similar extent, namely 0.5%.

Financing to households stabilized its rate of growth in October at 0.3% year-on-year. This trend came from a very

slight slowdown in loans for housing, posting a 0.6% year-on-year rise, as well as the decline in the rest of financing easing slightly, to -0.6%. However, the latest data available for credit to purchase consumer durables showed a sharp 19.2% drop at the end of September compared with twelve months before, much larger than that posted in June 2010, reflecting the decline in consumption of this kind of goods after the hike in value added tax in July 2010.

After an interlude in September, the default rate for private sector credit for financial institutions as a whole rose slightly to 5.7% in October, standing at 0.7 points above the level of twelve months before, whereas the default rate for real estate activities stood at 11.8% in September, half a point more than at the end of June 2010. The default rate for mortgages to purchase housing also

### Sharp fall in credit to purchase consumer durables after July's VAT hike.

rose very slightly in September to 2.6% but was still 4 tenths of a percentage point below that of a year earlier, while the default rate for consumer durables fell by 7 tenths of a percentage point in September compared with the previous quarter, although still considerably higher than the average, namely 7.2%.

Looking at financing channelled to public administrations, the figure for October 2010 was 16.4% higher than for the same month in 2009, one tenth of a percentage point more than the difference between September 2009 and 2010 but half the corresponding rate for October 2008 to 2009. Public sector financing has become more costly over the last few months due to the rise in the risk premium because of the Irish crisis and the spread in yields compared with German 10-year bonds reached its highest level since the euro

was launched, namely 291 basis points at the end of November. However, it then relaxed after the announcement of new fiscal and liberalizing measures, as well as the support of the European Central Bank, with this spread standing at 258 basis points at the end of the autumn.

Consequently, financing for non-financial sectors resident in Spain as a whole slightly speeded up its pace of growth to 3.2% year-on-year, although still 2.1 points lower than a year earlier.

On the other hand, the Bank of Spain announced that it will demand greater transparency from financial institutions and credit institutions will therefore provide more details on their financing and liquidity.

**The Bank of Spain will demand greater transparency from financial institutions.**

## CREDIT TO PRIVATE SECTOR BY PURPOSE

Third quarter of 2010

	Balance (*)	Change this year		Change over 12 months	
	Million euros	Million euros	%	Million euros	%
<b>Financing of production activities</b>					
Agriculture, livestock raising and fishing	23,456	333	1.4	-120	-0.5
Industry	152,031	-168	-0.1	-1,039	-0.7
Construction	121,514	-8,925	-6.8	-12,531	-9.3
Services	694,373	8,771	1.3	8,414	1.2
<b>Total</b>	<b>991,373</b>	<b>11</b>	<b>0.0</b>	<b>-5,277</b>	<b>-0.5</b>
<b>Financing to individuals</b>					
Acquisition and renovation of own home	658,552	3,986	0.6	6,118	0.9
Acquisition of consumer durables	40,259	-9,013	-18.3	-9,581	-19.2
Other financing	111,225	1,124	1.0	3,350	3.1
<b>Total</b>	<b>810,037</b>	<b>-3,903</b>	<b>-0.5</b>	<b>-112</b>	<b>0.0</b>
<b>Other</b>	<b>39,410</b>	<b>7,674</b>	<b>24.2</b>	<b>199</b>	<b>0.5</b>
<b>TOTAL</b>	<b>1,840,820</b>	<b>3,782</b>	<b>0.2</b>	<b>-5,190</b>	<b>-0.3</b>
<i>Acquisition of housing and real estate activities</i>	<i>948,105</i>	<i>366</i>	<i>0.0</i>	<i>1,543</i>	<i>0.2</i>

NOTE: (\*) By credit institutions as a whole: banking system, loan finance establishments and official credit.

SOURCES: Bank of Spain and own calculations.

### Term deposits expand as their returns rise.

### The expansion in bank deposits livens up

The interest shown by financial institutions in attracting customers' deposits has boosted the return on term accounts, reaching 2.75% on average in October in the case of private individuals, 56 basis points higher than twelve months ago. This also boosted term deposits, up by 3.2% in October compared with a year earlier. As a whole, deposits rose by 1.9% year-on-year, 8 tenths of a percentage point more than in September, given the continued downturn in sight and savings accounts.

The volatility of financial markets and competition for deposits had a significant effect on shares in mutual funds, another popular product among savers. November saw net withdrawals totalling nearly 3 billion euros, the third largest

of 2010. Consequently, assets stood at nearly 139 billion euros, a year-on-year drop of 14.8%. The average annual yield was -0.22% but with a wide range: while emerging markets' equity was up 24.3%, domestic equity lost 15.2%.

This competition for bank deposits is also affecting insurance products, with the volume of premiums for direct insurance accumulated up to September totalling almost 42 billion euros, a year-on-year drop of 5.3%. Life insurance was down 10.9% although the funds managed by life insurance branches rose by 2.1% year-on-year, while there was a notable rise in dependency insurance funds, up 23.0% year-on-year. The total premiums for non-life branches were 23.7 billion euros up to September, a 0.5% drop compared with a year earlier, with vehicle insurance falling by 1.1%, while health and multi-risk insurance rose by 4.2% and 2.7%, respectively.

### Year-on-year drop in the volume of insurance premiums up to September.

## BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

October 2010

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	252,414	-10,320	-3.9	-3,931	-1.5	17.7
Savings deposits	207,170	-622	-0.3	7,027	3.5	14.5
Term deposits	737,499	17,488	2.4	22,673	3.2	51.7
Deposits in foreign currency	20,381	-1,634	-7.4	-3,303	-13.9	1.4
<b>Total deposits</b>	<b>1,217,465</b>	<b>4,912</b>	<b>0.4</b>	<b>22,466</b>	<b>1.9</b>	<b>85.3</b>
<b>Other liabilities (*)</b>	<b>209,431</b>	<b>-3,699</b>	<b>-1.7</b>	<b>3,194</b>	<b>1.5</b>	<b>14.7</b>
<b>TOTAL</b>	<b>1,426,896</b>	<b>1,213</b>	<b>0.1</b>	<b>25,660</b>	<b>1.8</b>	<b>100.0</b>

NOTE: (\*) Aggregate balance according to supervision statements. Includes asset transfers, hybrid financial liabilities, repos and subordinated deposits.

SOURCES: Bank of Spain and own calculations.



# "la Caixa" Research Department

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As of December 31, 2009

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

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	27,505
Branches	5,326
Self-service terminals	7,951
Cards (million)	10,3

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



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