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THE SPANISH ECONOMY

Monthly Report

INUNDATED WITH LIQUIDITY

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2009	2010	2011	2009 3Q	2009 4Q	2010 1Q	2010 2Q	2010 3Q	2010 4Q
INTERNATIONAL ECONOMY		Forecast							Forecast
Gross domestic product									
United States	–2.6	2.9	3.0	–2.7	0.2	2.4	3.0	3.2	2.8
Japan	–6.3	4.4	1.7	–6.2	–1.8	5.5	3.5	5.0	3.8
United Kingdom	–4.9	1.7	2.1	–5.4	–3.0	–0.3	1.6	2.7	1.7
Euro area	–4.0	1.7	1.6	–4.0	–2.0	0.8	2.0	1.9	2.1
Germany	*–4.7*	*3.6*	*2.3*	*–4.4*	*–2.0*	*2.1*	*3.9*	*3.9*	*4.6*
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	1.8	–1.6	1.5	2.4	1.8	1.2	1.2
Japan	–1.4	–0.6	0.6	–2.3	–2.0	–1.1	–0.9	–0.8	0.4
United Kingdom	2.2	3.3	2.5	1.5	2.1	3.3	3.4	3.1	3.4
Euro area	0.3	1.6	1.9	–0.4	0.4	1.1	1.5	1.7	2.0
Germany	*0.3*	*1.1*	*1.8*	*–0.2*	*0.4*	*0.8*	*1.1*	*1.2*	*1.5*
France	*0.1*	*1.5*	*1.9*	*–0.4*	*0.4*	*1.4*	*1.6*	*1.5*	*1.7*
SPANISH ECONOMY		Forecast							Forecast
Macroeconomic figures									
Household consumption	–4.3	1.2	1.1	–4.2	–2.6	–0.3	2.2	1.4	1.3
Government consumption	3.2	–0.3	–1.5	2.7	0.2	–0.5	0.1	–0.1	–0.6
Gross fixed capital formation	–16.0	–7.2	–1.7	–16.4	–14.0	–10.4	–6.8	–7.0	–4.8
Capital goods	*–24.8*	*2.7*	*6.1*	*–25.5*	*–16.9*	*–4.4*	*8.7*	*2.4*	*4.0*
Construction	*–11.9*	*–10.9*	*–5.5*	*–11.7*	*–11.9*	*–11.4*	*–11.4*	*–11.6*	*–9.1*
Domestic demand (contribution to GDP growth)	–6.4	–1.1	–0.1	–6.5	–5.3	–2.9	–0.3	–0.8	–0.5
Exports of goods and services	–11.6	10.1	7.0	–11.0	–2.1	9.1	11.6	8.7	10.9
Imports of goods and services	–17.8	5.5	3.8	–17.2	–9.2	2.3	9.3	3.9	6.2
Gross domestic product	**–3.7**	**–0.2**	**0.7**	**–3.9**	**–3.0**	**–1.4**	**0.0**	**0.2**	**0.5**
Other variables									
Employment	–6.6	–2.3	–0.3	–7.2	–6.0	–3.8	–2.5	–1.7	–1.3
Unemployment (% labour force)	18.0	20.1	20.2	17.9	18.8	20.0	20.1	19.8	20.3
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						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	3.5	3.5	3.4	3.7	3.5	2.8	2.8
10-year German bonds	3.3	2.8	3.0	3.3	3.2	3.2	2.8	2.4	2.6
Exchange rate									
$/Euro	1.39	1.33	1.35	1.43	1.48	1.38	1.27	1.29	1.36

Inundated with liquidity

Contents

Milton Friedman used to say that monetary theory is like a Japanese garden: an apparent simplicity that conceals a sophisticated reality; a surface view that dissolves in ever deeper perspectives... Recently, designers of monetary policy have faced the challenge of a great recession and have gone into unknown territory, attempting to stop economies from collapsing. Only time will tell if they were right or wrong.

The most daring design, without doubt, has been that of the Federal Reserve. Its Chairman, Ben Bernanke, is an expert, not of Japanese gardens but of the monetary policy followed by Japan after its asset bubble burst at the end of the 1980s, a clear precedent for today's situation. The Fed has embarked on an extremely lax monetary policy, more aggressive than the one pursued by Japan's central bank in the 1990s. First, it cut its official interest rate for Federal funds down to a minimum (ranging from 0% to 0.25%). Having exhausted the interest rate option, it then chose quantitative easing, i.e. broadening the monetary base by buying up government and corporate bonds, injecting as much liquidity as possible and mobilizing collapsed markets, such as the mortgage or commercial paper markets.

Resorting to non-standard policies, combined with an expansionary fiscal policy, helped to contain the worst recession in the last few decades. The Bank of England also did not hesitate to expand its monetary base. Even the European Central Bank, less inclined to move away from standard monetary orthodoxy, has adopted exceptional measures, such as injecting all the liquidity required by financial institutions and buying up the public debt of some states in the Eurosystem.

However, these actions by monetary authorities arouse controversy. For example, it's not clear whether a lax monetary policy is any use in resolving a recession caused by excessive debt; i.e. no matter how long interest rates are kept at zero and no matter how much the central bank monetizes debt, what concerns the private sector (households, firms, banks) is still their excessive debt and how to reduce it, leading the economy into deflation and/or contraction. In this respect, Japan's experience is highly illustrative.

Another problem lies in the fact that, by inundating the economy with liquidity, we run the risk of stirring up inflationary tensions once activity picks up. A risk that, at first glance, may seem remote when the main concern, until very recently, was precisely the opposite; namely deflation. Some even claim that it is good, under the current circumstances, to generate inflation expectations in order to mobilize spending. When all is said and done, we assume that central banks are capable of draining excess liquidity from the system in time, before inflation runs riot. Whatever the case, the relaxed monetary policy has had a direct effect on the value of the dollar, the world's leading and main reserve currency, distorting the currency markets and causing concern among those countries holding most US debt, with China at their head. There are also suspicions that this excessive liquidity is being diverted towards destinations other than the one planned by the central bank, as might now be the case with commodities. Recent experience suggests that excessively lax monetary policy probably lay behind bubbles of the past, such as the dot.com and real estate booms.

Will central banks be able to withdraw the huge monetary stimulus in time?

EXECUTIVE SUMMARY

A two-speed recovery, with inflation behind it

The world economy recovers and will keep up its rate of growth in 2011.

Although the relevant indicators for 2011 are still not available, there can be few doubts that it's going to be a year of recovery. Nonetheless, this will be at two different speeds, as confirmed by Olivier Blanchard, Chief Economist at the International Monetary Fund (IMF): slow growth in the large economies compared with the risk of overheating in some emerging economies. One new issue is the rise in commodity prices over the last few weeks, much greater than expected, which is already being passed on to consumer price indices. A reduction in uncertainty and in risk aversion among investors can be seen in the financial markets.

China continues to grow at rates of 10% while advanced economies record very discreet results.

In its January review of the world economic outlook, the IMF is now somewhat more optimistic and predicts global growth of 4.4% in 2011, after advancing 5.0% in 2010 and a long way from the recession of 2009. High rates that can be put down mainly to the emerging and developing economies, which in 2011 will grow by 6.5% after their 7.1% growth in 2010. This group is benefiting from the fast recovery in international trade, after its collapse in 2008-2009, as well as from growing world demand for commodities and sustained improvement in domestic demand.

China warrants a mention apart. Its 9.8% year-on-year growth in the fourth quarter of 2010 places its annual figure at a strong 10.3%, taking over from Japan as the second world economy behind the United States. The most recent indicators for activity, corresponding to December, merely confirm China's vitality. With regard to capital formation, investment in fixed assets grew by 24.5% year-on-year, far from any correction in spite of the numerous measures aimed at cooling down the real estate sector.

Conversely, advanced economies will grow by 2.5% in 2011, half a point less than in 2010. Nonetheless, this forecast is a little better than the one being used a few months ago, thanks to the push from emerging economies and firmer private consumption than expected.

Forecasts improve for the United States and Japan provides a pleasant surprise in 2010.

In particular, the United States faces a 2011 with higher growth prospects than the 2.9% of 2010, thanks to the rise in private consumption and capital goods investment. Nevertheless, this growth will not be enough to reduce unemployment significantly. That's why its fiscal and monetary policies still have a clearly expansionary bias. The priority is to reduce unemployment via demand. The fiscal consolidation required has been left for later, so its public deficit in 2011 will not be far below 10% of gross domestic product (GDP).

The Japanese economy has surprised analysts by growing more than 4% in 2010, thanks to an upswing in exports. But in 2011 the export motor will lose steam and domestic demand is not giving much cause for celebration, so Japan is expected to grow less than 2% in 2011.

In the euro area, the latest economic activity figures confirm that the region still has divergent growth rates, with

Germany and some of its neighbours posting high growth and the rest of the countries showing much more reserved progress and sometimes even negative figures. We expect this divergence in growth to decrease slightly during 2011 and this will help tensions in the sovereign debt market to calm down gradually. The uncertainty generated by this crisis is still high and, in January, tension was focused on Portugal, whose intervention was discussed at certain points. Although it's true that the latest measures undertaken by the European Union have contained this uncertainty, there are still doubts regarding the direction taken by fiscal consolidation in several member states.

These issues are expected to be dealt with in detail at the next European Union summit on 24 and 25 March. At their meeting in January, Finance Ministers studied the possibility of increasing the resources of the bail-out fund used to tackle the sovereign debt crisis in the euro area. They also discussed how to achieve stricter fiscal discipline, how to implement the necessary structural reforms and coordinate more closely the economic policies of the different member states. The Ministers also agreed to carry out stress tests on the region's banks, whose results will be published in July.

Attention has also focused on rising inflation. The main culprit seems to be commodities, which rose considerably in 2010, mainly due to the strength of demand. But the expansionary monetary policies applied by developed economies may have also played their part, expansion which is largely passed on to emerging economies through various means. In any case, the result is a notable upswing in the inflation rates of emerging countries, where food prices form a significant part of the shopping basket.

In China, December's rate of inflation fell to 4.6% year-on-year compared with 5.1% in November, but this did not stop the central bank from once again toughening up monetary conditions.

In developed economies, the impact of inflation is most visible in Europe. Mervyn King, Governor of the Bank of England, has said that British inflation may reach 5% over the coming months. The start of 2011 isn't going to be very easy for Jean-Claude Trichet either, the President of the European Central Bank (ECB), as in December the euro area's inflation stood at 2.2%, the highest in two years, surpassing the target set by the euro's monetary authority. At his last press conference, the ECB President warned of inflationary risk and of a possible response to this through monetary policy.

In any case, the rising prices in Europe have hardly affected inflation expectations and the markets are moving according to other parameters. Both appeals to the ECB and also the banks' surplus reserves continue to decrease, encouraging the monetary market to gradually get back to normal. With regard to the euro/dollar exchange rate, it's worth noting the high volatility between the end of 2010 and the start of this year, caused by the crisis on the edge of the euro area, which is expected to ease over time. The yield on debt, both US and German, might post a slightly upward trend if the expansionary macroeconomic scenario is confirmed and the central banks manage to neutralize the inflationary threats.

In Spain, available indicators point towards the gradual reactivation of the economy continuing in the fourth quarter of 2010. This trend will continue in 2011, partly thanks to the support provided by the foreign sector, but the limited progress seen by domestic demand will

The tensions of Europe's public debt crisis recur in January.

Inflation reappears due to rising commodity prices within a situation of abundant liquidity.

For the moment, the belief is that inflationary threats can be neutralized.

The Spanish economy grows slightly in the fourth quarter...

keep the rate of growth below its potential. In the fourth quarter, private consumption made only fragile progress, combined with a drop in consumer confidence. Confidence for the construction sector also fell, while some indicators of capital goods investment were more positive in tone. Some of the main components for the industrial production index also pointed towards a certain upswing in November. For their part, exports remain dynamic, particularly sales to the rest of the countries in the euro area.

...but can't avoid a further increase in unemployment, as well as inflation rising to 3%.

The weak progress made by economic activity makes it difficult for the trend in job creation to change, so that, in the first quarter of 2011, the number of employed is expected to fall further. Nonetheless, after months of stagnation in employment's recovery, the drop in the number of new employment registrations with Social Security was lower in December. In 2010 as a whole, employment registrations with Social Security were down by almost 220,000, a lower drop than the one recorded in 2009, when more than 700,000 jobs were lost. The Labour Force Survey also shows job losses slowing up in the fourth quarter, although this still meant that, in 2010 as a whole, more than 370,000 people lost their jobs. The unemployment rate ended the year at 20.3%, compared with 18.8% at the end of 2009.

Meeting the public deficit targets helps to ease tension in the debt markets.

One obstacle on the road to recovery could be rising inflation which, in Spain, has been encouraged by a hike in indirect taxes as well as by rising commodity prices. In December, the consumer price index reached 3.0% year-on-year, in contrast to the negative rates recorded in 2009. Higher prices reduce the purchasing power of households, whose available income shrank slightly in 2010, which does not help private consumption to recover. This situation might also indicate a loss in competitiveness, insofar as the inflation differential with the euro area has widened to 0.7 percentage points, compared with the negative figure of 2009.

However, the tax hike has at least helped to comfortably meet the government deficit target for 2010. According to the most recent data, and in terms of GDP, the government deficit was 5.1% compared with an initial forecast of 5.9%. This improvement will help to relieve the diversion in the opposite direction of the deficit of regional administrations, so that the deficit for the public sector as a whole will be 9.2%, one tenth of a percentage point less than forecast. This adjustment in the public accounts is particularly important at a time of tension in the debt markets, a time of unease regarding sustainability and demands for high risk premia.

Moreover, the government has agreed the basic outline of the reforms for public pensions with business owners and trade unions, with their sights set on future viability. Lastly, also of note are the new regulations aimed at accelerating the work being carried out by savings banks to sort out and capitalize their finances, as these banks represent half of Spain's financial system.

28 January 2011

CHRONOLOGY

2010

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

2011

January	1	Estonia joins the **euro area**, which grows to seventeen member states.

AGENDA

February

2 Registration with Social Security and registered unemployment (January).
3 Governing Council of the European Central Bank.
4 Industrial production index (December).
11 GDP quarterly flash estimate (fourth quarter).
15 CPI (January).
EU GDP (fourth quarter).
16 Quarterly National Accounts (fourth quarter).
22 International trade (December).
25 Producer prices (January).
28 HCPI flash estimate (February). EU HCPI (January).
Balance of payments (December).
Government revenue and expenditure (December 2010 and January 2011).

March

2 Registration with Social Security and registered unemployment (February).
3 Governing Council of the European Central Bank.
4 Industrial production index (January).
10 Retail and consumer goods (January).
11 CPI (February).
15 Fed Open Market Committee.
16 EU HCPI (February). Labour costs (fourth quarter).
22 International trade (January).
Government revenue and expenditure (February).
25 Producer prices (February).
30 Retail and consumer goods (February).
HCPI flash estimate (March).
31 Balance of payments (January).

The United States: growing in search of employment

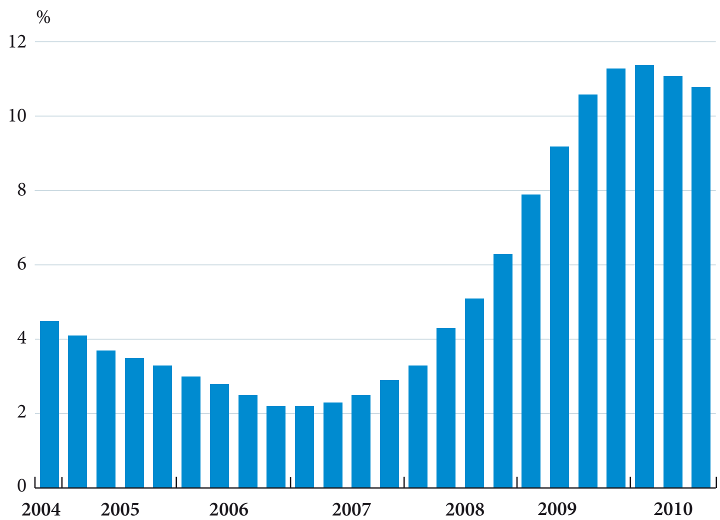
The United States grows by 2.8% and improves its outlook for 2011 at the cost of a high public deficit.

At the time of closing this report, the publication of the gross domestic product figures for the fourth quarter of 2010 showed growth of 2.8% year-on-year, boosted by private consumption. This confirms that growth in 2011 should be higher than the 2.9% for the whole of 2010. This progress, however, might not be enough to significantly lower the unemployment rate that, according to the Federal Reserve, is four points above a level consistent with full employment. Regarding prices, core inflation will clearly continue below 2% in 2011. This lack of inflation, and of the benefit it brings to those in debt by eroding the principal, means that households will find it a little harder to reduce their debt, which in gross terms exceeds 117.7% of their available income.

Because of this, the risk of insufficient growth continues to be greater than the risk represented by possible inflationary tensions. That's why the fiscal and monetary policies remain clearly expansionary in nature, with a second round of quantitative easing announced by the Fed in November, the extension of unemployment benefit and lower taxes. The priority is to reduce unemployment through demand, while the necessary fiscal consolidation will have to wait, with a public deficit for 2011 as a whole that's barely below 10% of gross domestic product (GDP).

THE UNITED STATES: STIMULI ENTAIL DEFICIT

Public deficit as a percentage of gross domestic product



NOTE: Average of the last 12 months (including federal and local government).
SOURCES: Bureau of Economic Analysis, Thomson Datastream and own calculations.

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	December
Real GDP	0.0	–2.6	0.2	2.4	3.0	3.2	–	2.8	–
Retail sales	–1.0	–6.4	1.6	5.7	6.9	5.8	7.9	7.5	7.9
Consumer confidence (1)	58.0	45.2	51.0	51.7	58.2	50.9	49.9	54.3	52.5
Industrial production	–3.3	–9.3	–3.8	2.7	7.4	6.9	5.9	5.6	5.9
Manufacturing (ISM) (1)	45.5	46.2	54.6	58.2	58.8	55.4	56.9	56.6	57.0
Housing construction	–32.9	–38.4	–14.8	16.5	12.2	0.4	0.8	–6.1	–8.2
Unemployment rate (2)	5.8	9.3	10.0	9.7	9.6	9.6	9.7	9.8	9.4
Consumer prices	3.8	–0.4	1.4	2.4	1.8	1.2	1.2	1.1	1.5
Trade balance (3)	–698.8	–374.9	–374.9	–398.9	–451.6	–486.6	–492.8	–495.8	...
3-month interbank interest rate (1)	2.8	0.7	0.3	0.3	0.5	0.3	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	73.8

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.

Consumption consolidates its improvement although retail sales slow up after a good period.

One of the US economy's strong points is the energy shown by private consumption that, boosted by expansionary policies and a slight moderation in the household savings rate, has now got back to its pre-crisis level. Private consumption ended the year up 1.1% quarter-on-quarter (2.7% year-on-year), the end of a vigorous year that should help towards a fall in the unemployment rate in 2011.

Another strong point is the healthy expenditure on capital goods investment, in spite of the slowdown in the fourth quarter. Investment will still rely on improved corporate profits, which should continue throughout 2011 thanks to the greater growth in demand and cost cutting measures, leading to idle capacity. In line with this, business perception has reaffirmed its optimism. The business sentiment index of the Institute for Supply Management for December picked up again and climbed to 57.0 points, in the case of manufacturing, and to 63.5 in that of services; figures that correspond to a situation of vigorous expansion. However, this optimistic view is marred by the employment component of the services index, which accounts for 80% of all private employment and fell to 50.5 points, showing that, for the moment, most firms' strategies are focusing more on investment and improving processes than hiring personnel.

The 9.4% unemployment rate will fall little in 2011.

This merely confirms that the job market is still the US economy's main area to fix. Slight improvement is expected for 2011 but the situation is unlikely to get completely back to normal until three years' time, unless growth far exceeds the threshold of 3%. But it looks like being a tough ride. Although December's unemployment rate fell from 9.8% to 9.4%, this improvement might be due to seasonal factors. 1,124,000 jobs were created in 2010 as a whole, very few

THE UNITED STATES: GROWTH WITHOUT MUCH EMPLOYMENT

ISM services index

SOURCES: ISM, Thomson Reuters Datastream and own calculations.

Housing's still in the dumps due to mortgage foreclosures.

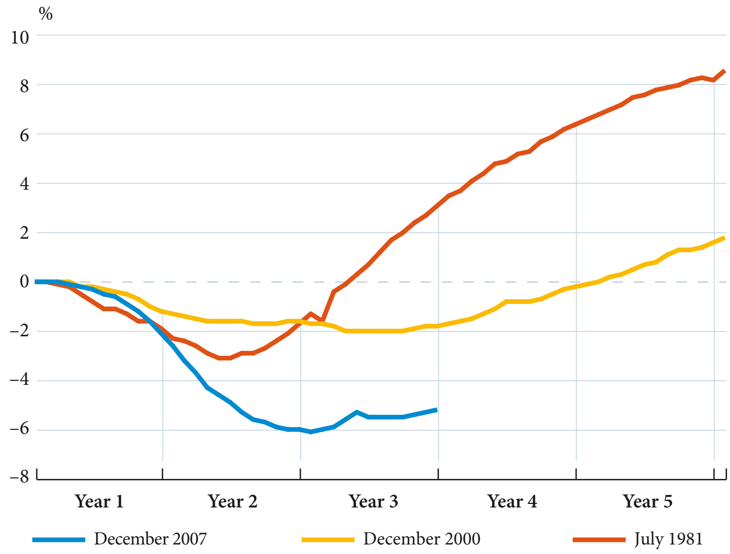
compared with the 8.5 million lost during the crisis. The reduction in the number of unemployment benefit applications and economic growth suggest that job creation for 2011 as a whole might be around the 2 million mark, but the number of discouraged workers and those involuntarily working part-time should absorb a significant proportion of these jobs. And another complication is still the high proportion of long-term unemployed which, higher than 40%, doubles the rate of previous recessions.

Unemployment is one of the main reasons for the high number of mortgage foreclosures due to non-payment which, together with high household debt, mean that the housing market continues to be dominated by excessive supply. Although the effort required to buy a home is now at a favourable level and the ratio between house prices and household income has got back to normal, marking the end of the bubble, the market has yet to react. In October, the Case-Shiller price index for second-hand homes saw its fourth consecutive month of decline, accumulating a loss of 2.9% over these four months. Housing sales picked up in December but largely thanks to a very low starting point. On the supply side, new homes started for the same month fell again, completing a second year stuck at levels scarcely higher than half a million units, 1.1 million fewer than what would be considered normal. Building permits, a leading indicator of construction, rose sharply in December but this was due to builders trying to register building work before 2011, when more restrictive building regulations came into force.

Looking at prices, inflation is still very moderate. The general consumer price index (CPI) rose by 1.5% year-on-year in December, a little above the previous months due to the upswing in oil prices. However core inflation, which excludes energy and food prices and more accurately reflects the underlying trend,

THE UNITED STATES: EMPLOYMENT IS TAKING ITS TIME TO RECOVER

Job losses as percentage of total employed at the start of the declines



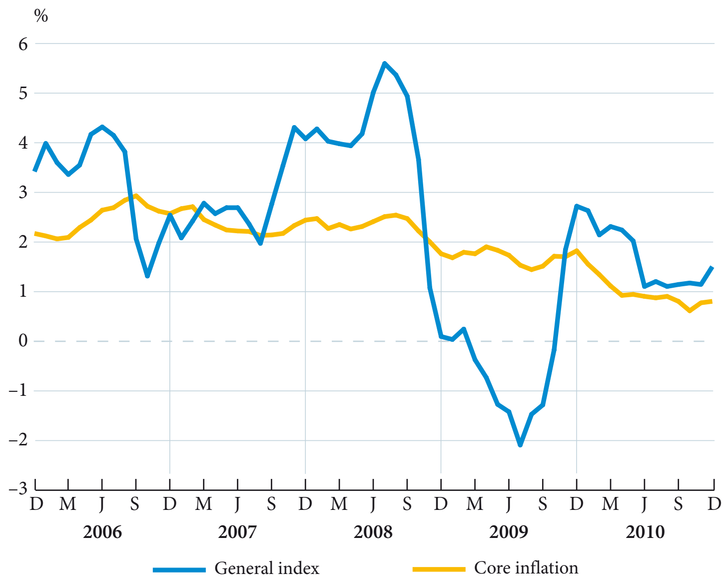
SOURCES: Department of Labor and own calculations.

rose by 0.8% year-on-year, very close to the record low of October. The Fed has shown little concern about the possible inflationary tensions on core inflation resulting from rising commodity prices. Within a context of surplus production

Inflationary tensions are remote, with the CPI rising by 1.5% and core inflation up 0.8%.

THE UNITED STATES: UNDERLYING PRICES IMPERTURBABLY MODERATE

Year-on-year change in general and core consumer price index components (*)



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

The foreign sector maintains its improvement in October and once again contributes to growth.

capacity, higher energy or food prices are unlikely to be passed on to the basket of purchases.

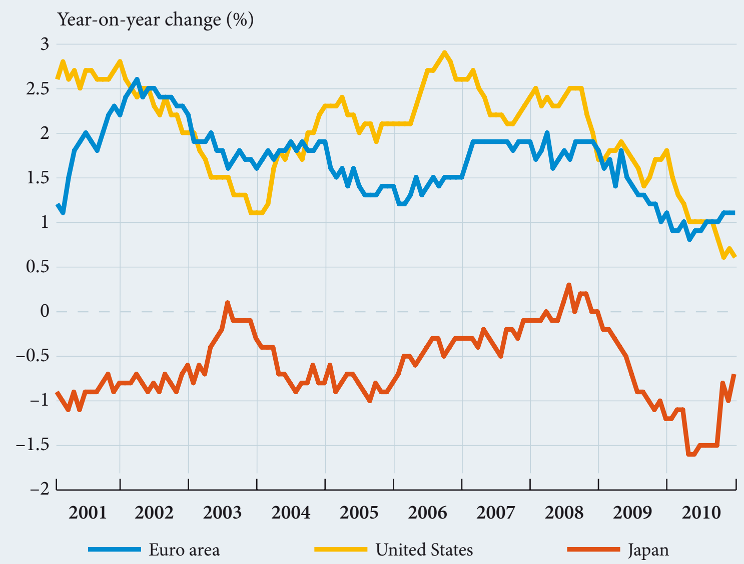
The foreign sector, for its part, continues to be the bearer of good news. November's trade deficit for goods and services maintained the improvement made in October and fell to 38,309 million dollars thanks to rising exports. The trade imbalance of the last three months was 3.3% of GDP, clearly lower than the 5.0% of 2008. This improvement should result in the foreign sector contributing positively to the economy's growth after nine months of it being a burden. This factor, together with private consumption and capital goods investment, will help to improve the US economy's health over the coming months.

Deflation, zero interest rates... and other traps

Throughout 2010, the low levels of inflation and the modest start to the recovery in advanced economies revived the spectre of deflation. The recent upswing in commodities has assuaged fears of a widespread drop in prices in Germany and the euro area (see the box «Inflationary pressures reappear. Will interest rates go up?»), but the restrained progress being made by activity and the persistent lethargy of core inflation on the other side of the Atlantic (see the graph below) have prevented the spectre from disappearing altogether. The Federal Reserve Chairman himself, in his recent Testimony to the Senate Budget Committee, warned of the risks resulting from a deflationary episode that, if it takes hold, can be as or more terrible than many forms of inflation. At present, such

CORE INFLATION FAILS TO RECOVER IN THE THREE LARGEST ADVANCED ECONOMIES

Core inflation



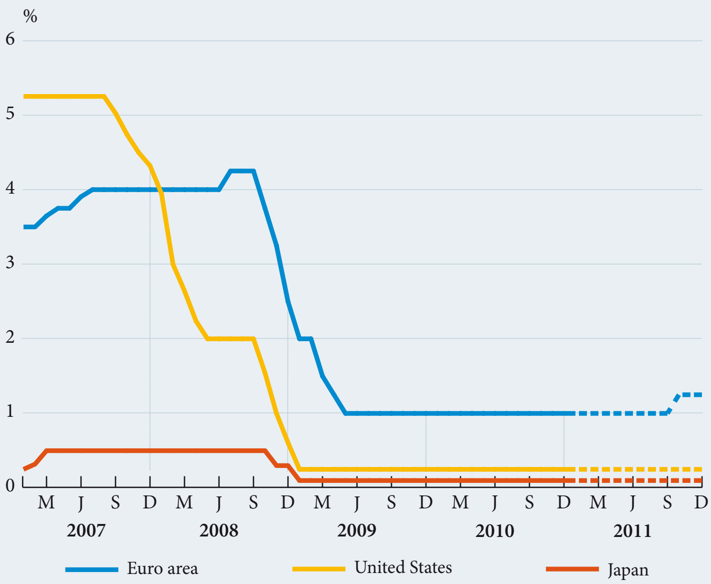
SOURCES: Thomson Reuters Datastream and own calculations.

an episode does not appear very likely but the seriousness of such risks warrants a close eye being kept on the situation.

Responsibility for controlling the price level falls to the monetary authority and its usual reaction to a situation of persistent unemployment and unusually low core inflation would be to lower the official interest rate. In principle, this would boost aggregate demand and push up prices. However, the current situation is somewhat more complex: as can be seen in the following graph, the official nominal interest rate of the large advanced economies has been approaching zero since the end of 2008 so that, as a negative nominal rate cannot be set, there's little room for further reductions. According to some, the three largest advanced economies in the world might be in the dreaded «liquidity trap», a state of affairs in which conventional monetary policy loses its capacity to affect the economic cycle. In such a case, what are the options? What alternatives are available to avoid deflation and stimulate an economy caught in the liquidity trap?

INTEREST RATES AT THE LIMIT

Official interest rate



SOURCES: Thomson Reuters Datastream and own calculations.

Although there's some consensus as to how to avoid a liquidity trap, agreement is more diluted concerning the most appropriate measure to boost the aggregate demand of an economy «trapped» in such a way. Nonetheless, in one of the most cited articles, Lars E.O. Svensson discusses and evaluates different proposals based on the following thesis:[1] the interest rate that really matters when taking consumption or investment decisions is the real interest rate, i.e. the difference between the nominal interest rate and inflation expectations. Consequently, although the

(1) Svensson, Lars E.O. 2003. «Escaping from a Liquidity Trap and Deflation: The Foolproof Way and Others.» Journal of Economic Perspectives, 17(4): 145-166.

nominal interest rate may be close to zero, the monetary authority can affect aggregate demand via the real interest rate providing it manages to alter inflation expectations, i.e. if it can convince the private sector that inflation will be higher in the future, the real interest rate will fall, stimulating expenditure and helping the economy to exit the recession and the trough of deflation.

According to Svensson's approach, the optimum strategy for raising inflation expectations would require the central bank to deliberately embark upon a markedly expansionary monetary policy that would unquestionably result in higher inflation in the future. Similarly, it should keep the nominal interest rate at zero for a prolonged period of time, even once out of recession and deflation. Paraphrasing Paul Krugman, the central bank should credibly commit to acting irresponsibly.

In practice, this «markedly expansionary» behaviour might consist of announcing a sufficiently high inflation target (above the usual level) and of keeping it high for a prolonged period of time (a few years) to almost certify higher inflation in the future. Another option would be to announce a medium-term price level target. The advantages of this strategy lie in that, in the short term, if recorded inflation is low, the medium-term inflation expectation will go up, as the price level target will require higher inflation to make up for the initial gap. If, however, the target is one of inflation, although this may not be as high as the target at the beginning, the target for the subsequent periods remains the same, so that long-term inflation expectations will be lower. Unlike an inflation target, a price level target therefore means that inflation expectations can be controlled to a greater extent in the long term (the expectations that matter in order to boost expenditure).

The Achilles heel of both strategies is credibility: although the «trapped» central bank may promise higher inflation in the future, the private sector might doubt its desire or ability to keep this promise once it gets out of the trap. The greater the doubt, the greater the likelihood of inflation expectations not increasing and of this strategy failing. To counter uncertainty, the monetary authority could strengthen its «inflationary commitment» with specific, communicable, transparent measures that in some way force it to keep its promise in the future.

One possibility is to resort to extensive quantitative easing. This means expanding the monetary base through open market operations, buying up bonds or debt, as carried out by the Japanese monetary authority in the 1990s and, more recently, by the Federal Reserve. However, this option is also controversial. Its greatest critics claim that there's a high risk of it going out of control, leading to an excessive upswing in inflation when activity picks up. They also warn of the possible repercussions of this kind of action on other economies that become receivers of part of this greater liquidity, pushing up the value of their currencies and increasing the risk of a currency war.

Another proposal suggests lowering long-term interest rates. Although the short-term nominal rate may be zero, the long-term rates don't have to be and it's the latter that influence expenditure decisions. In 2002, Bernanke himself proposed that the central bank might announce an interest rate ceiling for public bonds of a specific maturity, undertaking to buy up an unlimited amount to reach this target. This undertaking is easy to verify and, in fact, in 2010 the Fed already made it clear that it was prepared to intervene in the 10-year bond market to keep the interest rate below 3.5%. In a recent article, Ricardo Caballero proposes the alternative of using the creation of money to finance fiscal stimuli but, as with the rest of the measures proposed, this needs to be easily reversible.[(2)]

(2) Caballero, R. «A helicopter drop for the U.S. Treasury», VoxEU (August, 2010).

In short, although putting it into practice is not without difficulty and involves risks, the plan to successfully get out of a liquidity trap needs to contain three elements: the monetary authority's commitment to reach a higher price level in the future; a specific action that substantiates this commitment and leads to a change in expectations in the private sector; and, lastly, an exit strategy that specifies when and how things will get back to normal in order to boost the strategy's credibility. Without doubt, Ben Bernanke is well aware of this plan and this very conviction is already boosting the credibility of the steps he's taking.

This box was prepared by Marta Noguer
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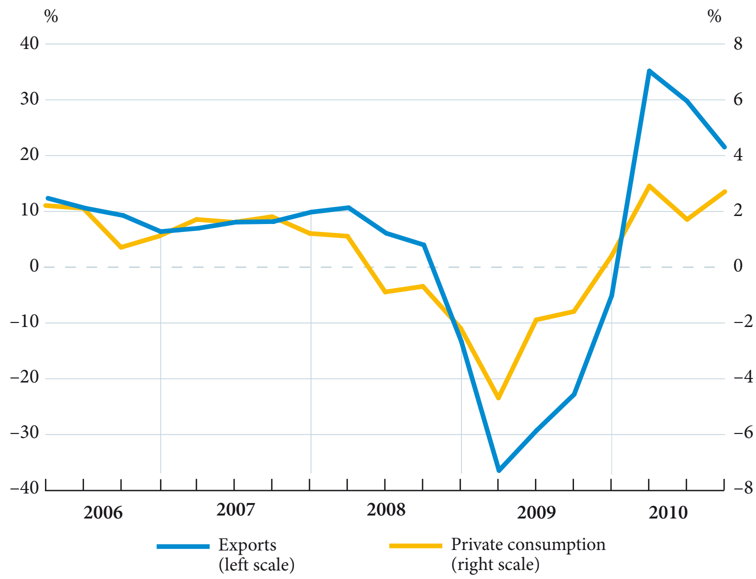
Japan: compensating for the slowdown in exports

Japan has grown during most of 2010 thanks to the upswing in exports, after these had slumped in 2009. For 2010 we expect growth in excess of 4% but things will be different in 2011 as the export motor is losing steam. November's trade balance confirms this trend with a surplus that continued to fall due to exports growing much less than imports. The government of Naoto Kan is following a policy of boosting private consumption to offset this slowdown but this is unlikely to be enough, so that Japan is expected to grow less than 2% in 2011.

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

JAPAN: WILL CONSUMPTION MAKE UP FOR THE SLOWDOWN IN EXPORTS?

Year-on-year change in private consumption and exports



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

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010					
			4Q	1Q	2Q	3Q	October	November	December
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	1.5	...
Industrial production	–3.4	–21.8	–5.1	27.1	21.1	12.9	5.8	4.2	...
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	6.9	...
Unemployment rate (2)	4.0	5.1	5.2	4.9	5.2	5.1	5.1	5.1	...
Consumer prices	1.4	–1.4	–2.0	–1.1	–0.9	–0.8	0.2	0.1	...
Trade balance (3)	4.2	4.0	4.0	6.7	7.4	8.1	8.0	7.8	...
3-month interbank interest rate (4)	0.8	0.6	0.5	0.4	0.4	0.4	0.3	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	110.9

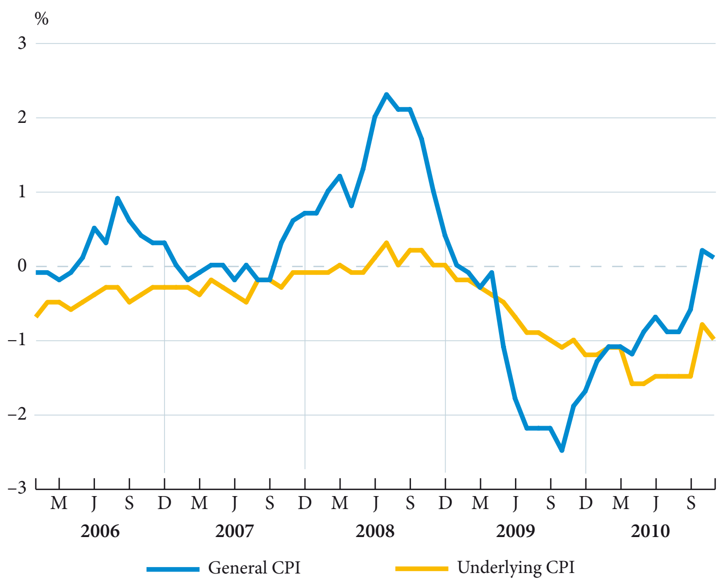
NOTES: (1) Index value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Trillion yen.
(4) Percentage.
(5) Index weighted for foreign trade movements. Higher values imply currency appreciation. Average in 2000 = 100.
SOURCES: OECD, national statistical bodies and own calculations.

Industrial production continues to look weak in general.

Looking closer at this slowing trend, industrial production, which is closely linked to the economy's health in Japan, has reversed the course of its recovery although November's figures partly repaired the weakness shown in October.

JAPAN: DEFLATION'S STILL AFFECTING CORE INFLATION

Year-on-year change in the consumer price index



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

The indicator continues to be 16.0% below that of May 2008, marking the start of the crisis. November wasn't a good month for the prospects for capital goods investment either, with a sharp fall in machinery orders aimed at export.

According to the latest indicators, consumption is unlikely to repeat the strong figures seen in the third quarter. Automobile sales which, in the third quarter, grew by 26.7% quarter-on-quarter thanks to state aid, fell by 40.5% in the fourth quarter. In the area of housing, new homes started seem to have bottomed out while sales in Tokyo look like they are recovering slightly, although we must bear in mind the low starting point and 17.9% accumulated depreciation of land compared with the first quarter of 2008.

November's unemployment rate repeated October's figure of 5.1%, while prices fell again after the previous month's mirage, proving that deflation's shadow is long. The general CPI rose by 0.1% year-on-year but core inflation, the general index without energy or food, intensified its decline by falling 1.0% year-on-year. Tokyo's prices, a leading indicator which, last month, already pointed to this reversal in prices, fell again in December, making it clear that deflation might continue for several more months.

Private consumption shows signs of fizzling out after stimuli have ended.

The CPI rises 0.1% but core inflation falls by 1.0%.

China: second in the world ranking

Once again, China's growth is surprising and, with a 9.8% rise year-on-year in the fourth quarter of 2010, the figure for the year now stands at a sturdy 10.3%, taking over from Japan as the world's second economy behind the United States.

Given this energy, the risk of overheating has intensified. In spite of the slight drop in inflation, 4.6% year-on-year in December compared with 5.1% in November (the highest in somewhat more than two years), inflationary tensions haven't ceased. The upward trend in the component without food adds to the pressure being exercised by food prices, which rose 7.2% in 2010, on the country's price index. For their part, house prices were up 6.4% year-on-year and sales rose again.

China accumulates 10.3% growth in 2010 and becomes the world's second power.

The most recent business indicators, corresponding to December, merely

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2008	2009	2010				
			1Q	2Q	3Q	4Q	December
Real GDP	9.6	9.2	11.9	10.3	9.6	9.8	–
Industrial production	12.6	12.5	19.8	16.0	13.5	13.3	13.5
Electrical power generation	6.7	6.8	22.6	17.8	11.8	6.2	5.2
Consumer prices	5.9	–0.7	2.2	2.9	3.5	4.7	4.6
Trade balance (*)	298	197	149	156	183	185	185
Reference rate (**)	5.31	5.31	5.31	5.31	5.31	5.81	5.81
Renminbi to dollar	6.9	6.8	6.8	6.8	6.8	6.7	6.6

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

Business indicators continue firm, at the same time as the risk of overheating increases.

confirm China's vitality, with industrial production growing by a resounding 13.5% in real terms. Regarding demand, retail sales advanced 19.1% in nominal terms, higher than consensus forecasts and than the 18.4% of the third quarter, reflecting a certain rise in private consumption, whereas in capital formation, investment in fixed assets increased by 24.5% year-on-year, far from correcting itself in spite of the numerous measures aimed at cooling down the real estate sector.

Similarly, credit limitations, one of the leading measures in this cooling down, have not had the desired effect. New bank lending came close to 8 trillion renminbi for 2010 as a whole, 0.5 trillion above the target set by the authorities.

Monetary conditions tighten: a rise in interest rates and the cash reserve ratio.

Within this context of dynamism and inflation, monetary conditions have been tightened again. Just before the end of the year, the central bank raised the official interest rate by 0.25 basis points to 5.81%, calming down those people who were surprised that the rate wasn't raised at the meeting on 13 December. This is in addition to the new rise in the cash reserve ratio, the fourth in two months, up to 18.5% on average and above 19% for larger institutions, announced in mid-January.

Looking at foreign trade, the strength of imports in December and the weakness of exports moderated the commercial recovery of the last few months and placed the total surplus for the year at 184.5 billion dollars, 6% lower than the figure for 2009. In terms of percentage of GDP, the surplus shrank considerably, from 3.9% of GDP in 2009 to 3% in 2010.

In spite of the slowdown in foreign trade, the abundant capital inflows, partly due to the expected appreciation of the renminbi, made China's international reserves rocket. These grew by 448 billion dollars in 2010 up to 2.85 trillion. Enough dollars to acquire 20% of US GDP.

Brazil: inflation rising

Given the ever-rising prices and with inflation approaching 6% at the end of 2010 (the target is 4.5% ± 2%), Brazil's Monetary Policy Committee surprised no-one when it unanimously decided to raise the Selic rate by 50 basis points after its meeting in January. The official interest rate has therefore returned to 11.25%, a high level even compared with that of other emerging economies. Also noted was the intention to continue with monetary adjustment, so the next rise in interest rates is not expected to be long in coming.

This decision is not without its risks. The most significant is undoubtedly the effect this will have on an already strong real and consequently on the competitiveness of local manufacturers. With the real interest rate at around 5%, Brazil's authorities will not find it easy to slow up the inflows of foreign capital and the upward pressure on its currency. In the last few weeks, efforts have multiplied to calm down these pressures. Of note among the new measures is the rise in the reserve requirements for foreign currency deposits and a reverse currency swaps auction, i.e. action being taken by the government in the futures markets to depreciate the real and counteract pressure.

Brazil's central bank is taking over in the battle against overheating.

On the other hand, this direction of monetary adjustment is supported in the fiscal area. There's no doubt that the greater lassitude of public expenditure

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2010				
			1Q	2Q	3Q	4Q	December
Real GDP	5.2	–0.7	9.3	9.1	6.8	...	–
Industrial production	2.9	–7.2	17.3	14.2	8.1	3.9	...
Consumer confidence (*)	140.4	138.3	158.1	154.6	159.5	157.7	...
Unemployment rate São Paulo (**)	13.0	12.8	12.4	13.2	12.1	10.9	...
Consumer prices	5.7	4.9	4.9	5.1	4.6	5.6	5.9
Trade balance (***)	24.8	25.3	23.2	19.3	16.9	20.3	20.3
Interest rate SELIC (%)	11.25	11.25	8.75	10.25	10.75	10.75	10.75
Reales to dollar (*)	1.8	2.3	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.

due to the crisis, which continued during the electoral year, has played a significant part in the recent inflationary upswing. Dilma Rousseff and her cabinet know only too well that, if they want to meet their target of reducing the real interest rate, they have no choice but to reduce the government's budget. To this end, their intention is to announce their plan for public spending cuts at the end of January.

Most of the evidence suggests that Rousseff's government won't delay its fiscal adjustment plan.

All this should help to ease the obvious overheating of Brazil's economy. Leading business indicators suggest that activity probably gained impetus in the last quarter of 2010 and domestic demand continues to show no sign of weakness. The bulk of the evidence suggests that inflation will continue to cause concern during the first few months of the year, also being affected by significant rises in public tariffs and pressure on the food markets. Brazil's central bank has already made it clear that it will not take its eye off the ball and its firm stance increases pressure on the fiscal flank to play its part. Now Dilma must take over the reins.

Mexico: treading firmly, without letting up

As expected, the International Monetary Fund approved the application by the Mexican authority to extend the amount and duration of the Fund's line of credit up to 72 billion dollars and for two years. This line replaces and extends the one renewed in March 2010 worth 47 billion dollars. In any case, Mexico is not expected to resort to the new line of credit and it must be interpreted as a precautionary measure whose aim is merely to maintain external confidence in the Mexican economy.

Mexico extends its line of credit with the IMF.

If there are no surprises, it won't be necessary even to restore this confidence. The economy's performance continues to show signs of solid fundamentals and a strict safeguarding of macroeconomic discipline. The IMF itself has stressed that the recent renewal of the line of credit is a vote of confidence by the Fund in the Mexican economy and has praised both the reaction of public policies to the crisis as well as the progress made in putting right weaknesses of a more

Domestic demand is gradually picking up after the crisis, while foreign demand holds steady.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2010				
			1Q	2Q	3Q	4Q	December
Real GDP	1.5	–6.1	5.1	7.3	5.3	...	–
Industrial production	–0.4	–7.0	5.4	7.5	6.5	3.9	...
Consumer confidence (*)	92.2	80.5	81.5	84.9	89.2	89.6	91.2
Leading business index (*)	118.2	110.9	114.9	116.8	117.8	...	...
General unemployment rate (**)	4.0	5.5	5.4	5.2	5.6	5.3	4.9
Consumer prices	–11.8	0.0	4.8	4.0	3.7	4.2	4.4
Trade balance (***)	–17.3	–4.6	–1.9	–2.4	–2.0	–2.9	...
Official Banxico rate (%)	7.50	6.75	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	10.6	14.2	12.3	12.8	12.6	12.3	12.3

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

Inflation continues to rise but the output gap and the strength of the peso are keeping core inflation under control.

structural nature, such as the public coffers' dependence on oil.

Recent indicators for activity show a domestic demand that is gradually regaining its vigour, boosted by renewed confidence of Mexicans in their economy, the steady improvement in the job market and the gradual recovery in credit. With regard to foreign demand, although it has probably eased back slightly, it still looks healthy. These trends are reflected in the development of activity by sector, with an industry whose recovery continues to surprise, a construction sector that's building up speed and services that are starting to make a significant contribution to economic growth.

In any case, the output gap is still negative, which has meant that, together with a relatively strong peso, underlying inflation has been kept more or less under control. General inflation, however, continues to rise and has passed the official target of 3% ± 1%. Nonetheless, we don't expect any changes in Banxico's monetary policy, at least not until the end of 2011.

Have oil and gold peaked?

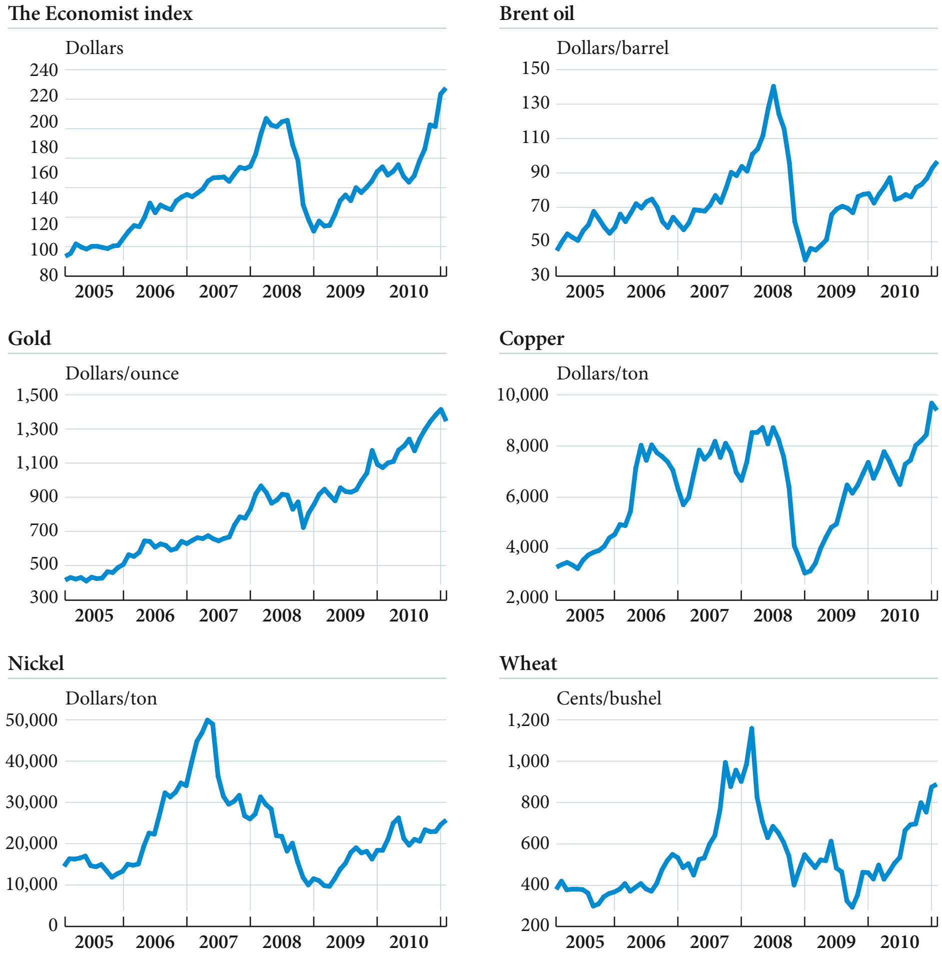
Oil corrects its price after coming close to 100 dollars per barrel.

Oil prices momentarily stopped their rise, remaining close to the benchmark of 100 dollars. Between 20 December and 20 January, the price of crude rose by 5.2% to 97.34 dollars per barrel (Brent quality, for one-month deliveries), resulting in a 24.1% increase since the start of 2010.

Oil should fall away from 100 dollars with the end of the harsh winter.

The cold winter helped to shoot up the price of Brent at the start of the year. OPEC also decided recently to increase production in order to stabilize prices. Both factors should encourage some profit-taking February and March at a price that has also been affected by speculation. Over the coming months, crude should continue to grow slightly but we don't think it will cross the barrier of 100 dollars in 2011.

TREND IN VARIOUS COMMODITIES (*)



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

Rises continued to predominate in commodities as a whole, with The Economist index up by 7.1% compared with last month and accumulating gains of 41.0% since the start of 2010. Among metals, iron and the precious metals of palladium and platinum appreciated the most, while copper paused in its upward trend, although still in short supply due to the obsolete nature of some mining operations. For foods, wheat and coffee prices continued to rise, sugar took a breather and rice continued to see the lowest increase. Regarding gold, current demand is mainly investment-based and boosted by the risk aversion to other assets.

Iron, platinum and palladium rise the most among metals, and wheat in foods.

Inflationary pressures reappear. Will interest rates go up?

Few press conferences receive as much attention as the one given regularly by those in charge of monetary policy. Typically, behind what appears to be a description of the macroeconomic conditions lie key indications regarding the future movement of the official interest rate. In this respect, the press conference held in January by the President of the European Central Bank (ECB), Jean-Claude Trichet, after the meeting of the Monetary Policy Committee, could represent a turning point. After months of discourse in which the great uncertainty surrounding the recovery took pride of place, the tone of his message underwent a slight but significant change. The head of European monetary policy indicated that inflationary pressures had increased more than expected and that they would probably continue during the first half of the year. He also reminded those present that he had never promised not to raise the interest rate and added that we should all remember the episode of the summer of 2008 when, within a highly adverse economic climate, the ECB raised the official interest rate in order to slow up rising inflation.

The current situation certainly has some parallels with the one experienced in 2008. At that time, inflationary pressures were also due to rising commodity prices. Oil had risen by 143% between January 2007 and June 2008 and the index for agricultural products by 85%. The trend recorded by these indices since January 2010 has been similar although the levels reached are not the same. The index for agricultural products has grown by 63% since January 2010 and oil by 34%. Moreover, the price of industrial metals is rising strongly this time, accumulating a 32% increase since January 2010. The same thing is happening with the price of precious metals.

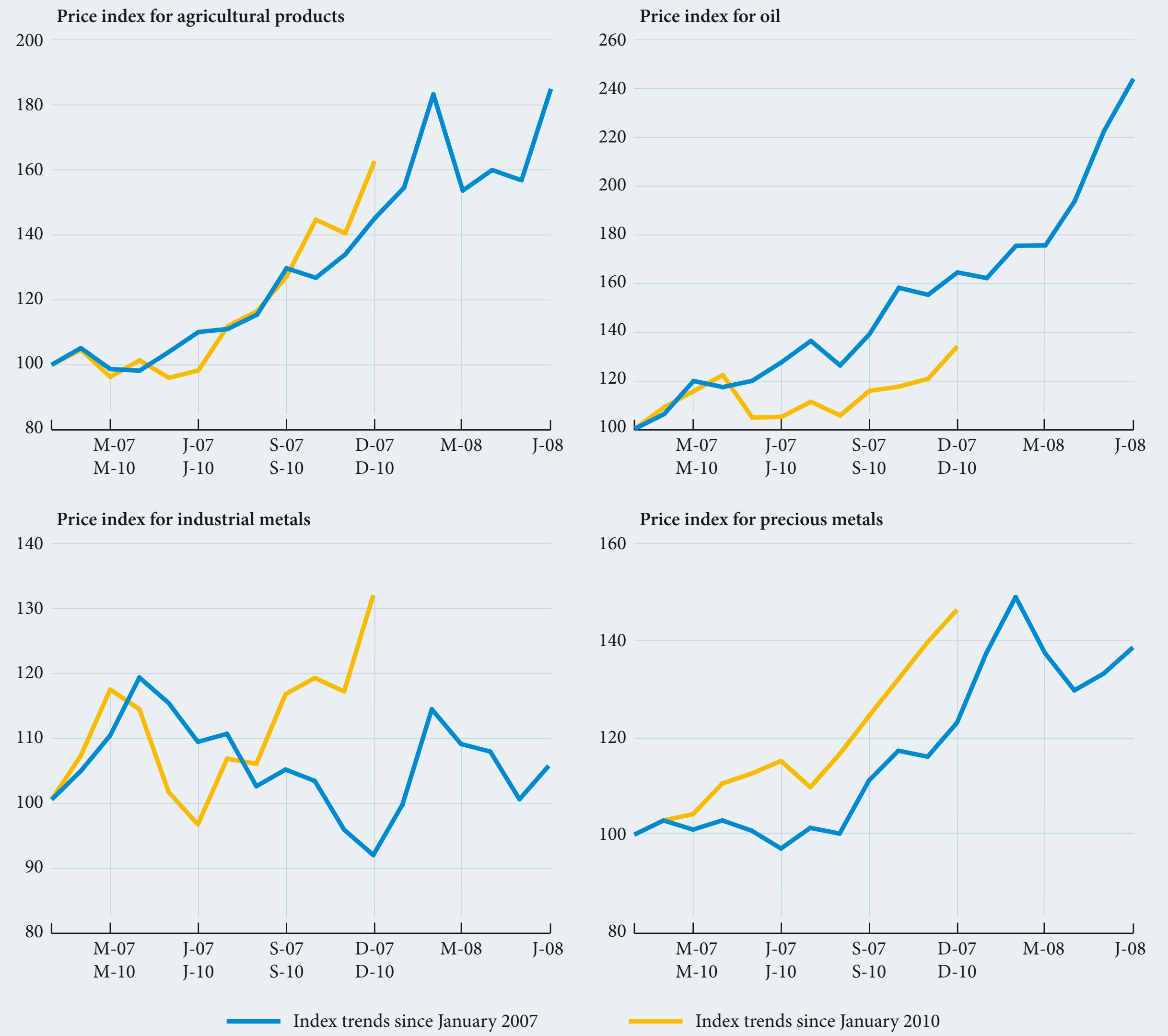
But not everything is similar. One of the ways in which the current situation differs from that of 2008 is the capacity of central banks to combat inflation. At that time, the official interest rate of the ECB and the Fed was around 4%, giving them room to raise or lower it in order to stabilize prices. Now interest rates are at record lows, so raising them is no problem. But, since the start of the crisis, both institutions have implemented unconventional measures to inject liquidity that might complicate the management of monetary policy within a context of inflationary pressure.

As is widely known, the main central banks of developed countries have injected a huge amount of liquidity into their economies to ensure the international financial system works well. These measures have been criticized by some economists due to the inflationary risk they entail. Greater liquidity in the financial system could ultimately overstimulate demand via a rise in credit and this would eventually push up prices (see the box «Deflation, zero interest rates... and other traps»). Nevertheless, this scenario does not seem at all likely given the state in which demand finds itself. But there is another channel, less visible but equally dangerous, through which liquidity could lead to inflationary pressures. This liquidity could have been directed towards assets with a high growth potential, thereby boosting speculation. In this respect, commodities are a good candidate, as the strong growth being experienced by emerging countries means that their prices will probably enjoy sustained growth in the medium term. The problem is that, as explained in the box «Bubbles: a complex phenomenon that's difficult to identify», it's very difficult to determine whether the price of an asset is higher because of speculation or if it is due to a structural change in the economy.

Within this context, the ECB and the Fed will face a huge dilemma if commodity prices continue to rise. The question of whether to raise the interest rate in this kind of scenario has no obvious answer; just think back to 2008, when the strategies employed by the Fed and the ECB were completely opposed. While, in the euro area, the official interest rate was raised by 25 basis points and stood at 4.25%, in the United States the Fed lowered it from

COMMODITY PRICES BOOST INFLATIONARY PRESSURES

Indices January 07 = 100, January 10 = 100



SOURCES: Bloomberg and own calculations.

4% to 2%. In addition, both institutions will have to analyze the prospect of starting to drain liquidity from financial markets before they have stabilized.

The fact that it's impossible to prove whether quantitative easing is behind these rising prices could lead to wide-ranging debate regarding the best strategy to combat inflation. This alone might increase the volatility of interbank interest rates, as it will be more difficult for markets to predict the strategy to be employed by the central banks. Moreover, if they finally opt to drain off liquidity, volatility may increase even further. It's true, as noted repeatedly by Jean-Claude Trichet and Ben Bernanke, that draining injected liquidity is a technically simple task. They just need to encourage financial institutions to return liquidity to the central bank. A simple way of doing this, for example, is by raising the interest rate for deposits held by institutions with the ECB or Fed. But the huge amount of liquidity injected and their lack of experience, as this would be the first time such a mechanism has been put into practice on a large scale, make it difficult to ascertain the effects of this strategy.

Another way monetary authorities can drain the liquidity injected is by selling the debt initially bought to financial institutions. This, however, might increase the pressure on interest rates. Within a situation where central governments are already issuing a large amount of public debt, if the supply is increased further by the monetary authority, interest rates might have to rise quickly to satisfy the demand. Should this situation arise, it would be very harmful for the economy as a whole and might slow up the recovery.

In conclusion, it's to be hoped that inflationary pressures end up being moderate and temporary. The central banks of developing countries with high inflationary pressures, such as China and Brazil, have already started to raise their interest rates. This should moderate the growth of their economies and therefore take some pressure off commodity prices. If this doesn't happen, then the pressure on developing countries' central banks will once again be high.

This box was prepared by Oriol Aspachs Bracons
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Euro area: divergent growth

The latest data on economic activity confirm that growth is still divergent between the countries that make up the euro area. While Germany is still going full speed ahead, other countries such as France, Italy and Spain continue at a slower pace. This divergence in growth will decrease slightly during 2011, helping tensions to gradually ease in the sovereign debt market.

Pending the publication of data on the gross domestic product (GDP) for the fourth quarter, the revised GDP figure for the third quarter has come as some surprise. Although year-on-year growth remained unchanged at 1.9%, the growth in private consumption altered, going from a prior estimate of 0.3% to 0.1% quarter-on-quarter, and especially investment, revised downwards by three tenths of a percentage point to –0.3% quarter-on-quarter.

Divergent growth remains in the euro area.

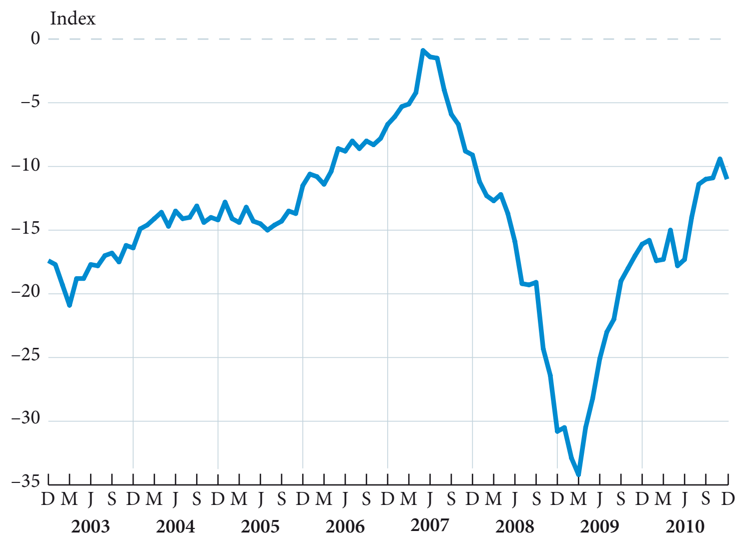
In spite of these modifications in the composition of growth, leading economic indicators point towards a slight acceleration over the next two quarters. In fact, the latest figures for European consumer confidence in January worsened slightly compared with December but, seen in perspective (see the graph below), this remains above the historical average.

The data for retail and consumer goods also show a slight decline, although the trend is still positive. In November these

Leading indicators for consumption and investment are positive...

CONSUMER CONFIDENCE REMAINS HIGH

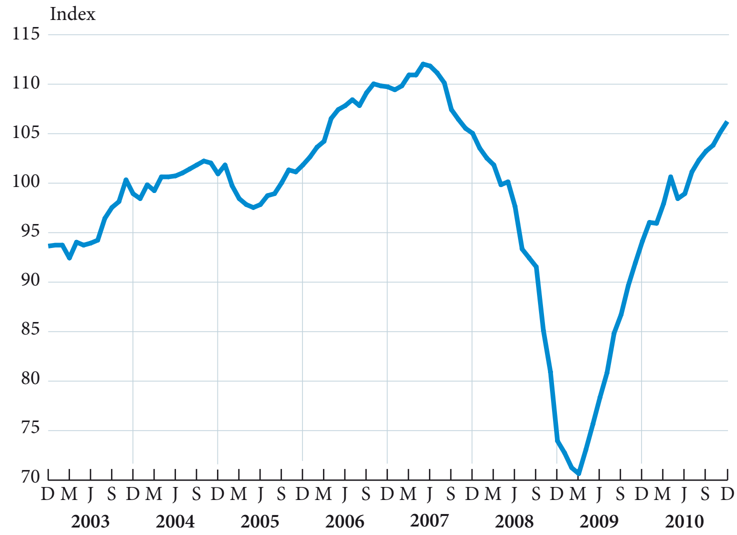
Trend in the confidence index



SOURCES: Eurostat and own calculations.

BUSINESS CONFIDENCE CONTINUES TO RISE

Economic business sentiment



SOURCES: Eurostat and own calculations.

...auguring solid growth in the first quarter.

grew to 0.1% in year-on-year terms, while the figure for the previous month was 1.2%. But the expected improvement in the labour market, which should begin over the coming months, as well as the rise in credit granted to acquire housing for the euro area as a whole, and consumer confidence remaining high, should all help to improve the consumption component from the 0.4% recorded for the first quarter of this year.

The consolidation of the improvement in activity will help the job market situation...

In particular, the unemployment rate for October reached 10.1% although the series has actually been stuck at around 10% since October 2009. Over the coming months, business prospects, the improved tone of consumption and contained labour costs should result in greater job creation capacity in the euro area which will help to lower the unemployment rate.

...although restrictive fiscal policies and the sovereign debt crisis are negative factors.

On the other hand, although the revised figure for investment in the third quarter was more negative than expected, the data for industrial production (7.5% year-on-year for November) and the portfolio of orders, especially from outside the euro area, have pushed up the different indices measuring business confidence. In any case, this growth in investment will not be sustainable until domestic demand picks up more forcefully.

With regard to the foreign sector, exports continue to grow apace, although rising oil prices have further boosted imports. This has led to a deficit in the balance of payments for November in the euro area of 11.2 billion euros. In principle, the recent rise in the euro against the dollar should not harm foreign trade because this movement has been very limited.

But it's not all good news as there are two factors that go against the positive trend in activity in the euro area. Firstly, the implementation of restrictive fiscal policies in various countries, which will prevent the contribution made by public expenditure to economic growth from remaining at its current level.

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	December
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	1.2	0.1	...
Consumer confidence (1)	–18.1	–24.7	–17.0	–16.8	–16.7	–12.1	–10.9	–9.4	–11.0
Industrial production	–1.9	–14.7	–7.4	4.7	9.0	7.0	7.1	7.5	...
Economic sentiment indicator (1)	93.5	80.8	91.9	96.6	99.3	102.2	103.8	105.1	106.2
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	2.2
Trade balance (3)	–1.2	–13.6	15.9	27.8	22.7	9.3	8.8	5.3	...
3-month Euribor interest rate	4.6	1.2	0.7	0.7	0.7	0.9	0.9	1.0	1.0
Nominal effective euro exchange rate (4)	110.6	111.7	113.8	108.8	103.2	102.3	106.1	104.8	102.6

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.

Secondly, the uncertainty caused by the sovereign debt crisis in the euro area continues to be high and, should it remain at this level, might slow up the recovery in investment. Although it's true that the latest measures undertaken by the European Union have somewhat contained this uncertainty, there are still doubts regarding the direction being taken by fiscal consolidation in several member states.

It is planned to tackle these issues in depth at the next European Union summit on 24 and 25 March. At January's meeting, the Finance Ministers of the euro area (ECOFIN) explored different ways of boosting the effective capacity to grant credit through the European Financial Stability Fund (EFSF). This was created last year as a temporary facility to tackle the sovereign debt crisis in the euro area.

The Dutch Finance Minister, Jan Kees de Jager, confirmed that the possibility to enlarge the EFSF from its current figure of 440 billion euros had been rejected. However, the German Finance Minister, Wolfgang Schaeuble, accepted the possibility of the amount available from the Fund being higher provided other conditions were included, namely stricter fiscal discipline, structural reforms and greater coordination of economic policy in the euro area.

The European Union is studying how to reform the European Financial Stability Fund and approves new stress tests for banks.

The European Union also agreed to carry out new stress tests on the region's banks, whose results will be published in July according to sources from the Hungarian presidency of the European Union. The EU Commissioner for Internal Market and Services, Michel Barnier, acknowledged that the new tests on the euro area's banks need to be more robust and credible, although details concerning the methodology to be applied are still being negotiated.

Inflation increases to 2.2% due to rising energy prices.

On the other hand, inflation in the euro area for December was 2.2% year-on-year, compared with 1.9% in November and 0.9% a year ago, according to the data

The ECB President wishes to keep inflation expectations anchored.

published by Eurostat. The reason for this increase was rising energy prices. Moreover, the food component, which was deflationary a year ago, is no longer negative and, although only growing at a rate of 1.8% year-on-year, is expected to continue increasing due to the future impact of rising agricultural commodity prices. However, core inflation, excluding the most volatile components such as energy prices and food, remained contained at 1.1% year-on-year.

The President of the European Central Bank, Jean-Claude Trichet, announced that these data highlighted the pressures forcing up prices in the short term. Although he believes that inflation will ease in the long term, he stressed that the situation requires close monitoring and added that «we are never pre-committed not to move interest rates», in spite of the fragility of the euro area's financial situation. However, according to the consensus of analysts, the reserve bank's words were aimed at keeping inflation expectations anchored (having risen slightly in the surveys).

Axel Weber himself, President of the Bundesbank and ECB board member, has indicated that he expects inflation in the euro area to reach 2.4% by March, although recognising that this temporary situation does not endanger price stability in the medium term.

In summary, the new year has started with good prospects for consolidating economic activity and, although divergence will remain between different countries' rate of growth, this will be less than in 2010. To this end, it is vital for the rise in inflation to be temporary and for the reforms of the European Financial Stability Fund and bank stress tests to manage to reduce the sovereign debt crisis.

Record level of employment in Germany in 2010

The German economy's gross domestic product grows by 3.6% in 2010 after plummeting the previous year.

After having suffered the largest annual fall in GDP in 2009 since the Second World War, namely –4.7%, the euro area's largest economy relaunced itself strongly in 2010 and grew by 3.6%, according to provisional data from Germany's Federal Statistics Institute. This rate is the highest recorded since the reunification of Germany in 1990. However, once growth in GDP has been adjusted by the number of working days, this falls to 3.5% in 2010, the highest since 2006.

The strong growth posted in 2010 was higher than expected by analysts in general at the end of 2009, namely 1.7%. However, the level of GDP in 2010 was still 1.3% below the figure reached in 2008 and, logically, the output gap (the difference between real and potential GDP) will continue to be negative for the second consecutive year.

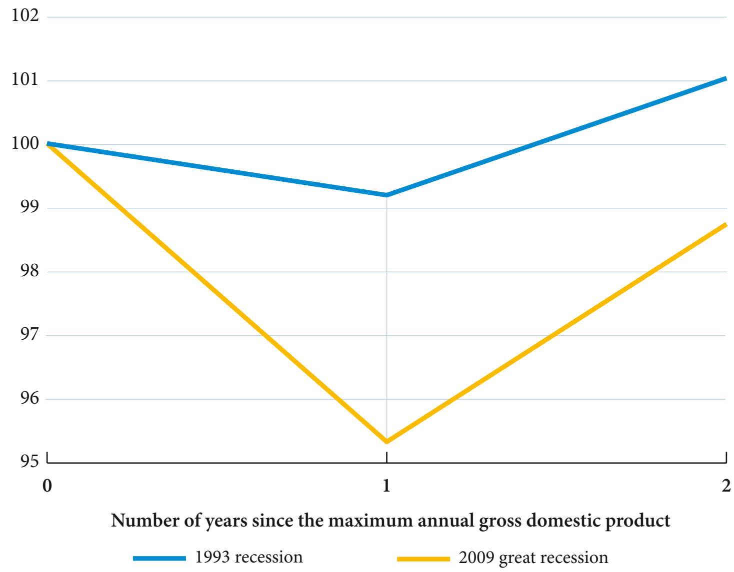
Domestic demand boosts Germany's economic recovery, as well as its foreign sector.

The rise in GDP was boosted by exports, contributing 1.1 percentage points to annual growth although domestic demand provided more than two thirds of the increase. Of note is the 9.4% rise in investment in capital goods after the slump of 22.6% recorded in 2009. Investment in construction also picked up, although rising less steeply by 2.8% after falling 1.5% the previous year. For its part, changes in stock contributed 0.8 percentage points to the economic increase.

Household consumption also picked up, albeit to a lesser degree, rising by 0.5%. The highest rise was in clothing and footwear, up 3.2%. On the other hand, public consumption moderated its growth and rose by 2.2%, as costs fell due to labour market measures.

STRONG RECOVERY IN THE GERMAN ECONOMY IN 2010, ALBEIT STILL PARTIAL

Indices of gross domestic product by volume



SOURCES: Statistisches Bundesamt Deutschland and own calculations.

In fact, the higher household consumption was due to higher employment, 40.5 million people as an annual average, an all-time record, up 0.5% on 2009. The improvement in economic activity made it possible to withdraw most of the measures to shorten the working day that had been implemented to tackle the economic crisis in 2009, the so-called *Kurzarbeit* or short-time working scheme. In this way, the number of hours worked per employee rose 2.0% year-on-year. However, there was a rise in the number of temporary employment contracts. Higher incomes also boosted consumption, although the

The *Kurzarbeit* scheme is withdrawn but temporary contracts increase.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010					
			4Q	1Q	2Q	3Q	October	November	December
GDP	0.7	–4.7	–2.0	2.1	3.9	3.9	–	...	–
Retail sales	0.0	–3.1	–2.6	1.0	0.6	2.8	1.1	–0.4	...
Industrial production	–0.1	–15.5	–8.0	6.1	12.2	10.3	12.3	11.1	...
Industrial activity index (IFO) (*)	96.8	87.7	93.4	96.6	101.8	106.7	107.7	109.3	109.8
Unemployment rate (**)	7.8	8.2	8.2	8.1	7.7	7.6	7.5	7.5	7.5
Consumer prices	2.6	0.4	0.4	0.7	1.0	1.2	1.3	1.5	1.7
Trade balance (***)	195.2	142.8	133.1	143.1	149.7	149.1	154.8	151.5	...

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

Germany's public deficit exceeds the Stability and Growth Pact limit for the first time in five years and the process of fiscal consolidation starts up.

household savings rate remained at relatively high levels and even rose slightly.

Exports were the launch pad for the German economy's recovery, up 14.2% after having fallen 14.3% the previous year. Imports of goods and services also grew notably after the squeeze of 2009 and rose by 13.0%, spurred on by domestic demand picking up. The euro's depreciation in 2010 helped to boost the foreign sector, which had accounted for –2.9 percentage points of the change in GDP in 2009.

From the point of view of supply, of note was the recovery in industry, although the number of employed continued its downward secular trend as companies were relocated. Construction grew for the first time in more than ten years and services expanded slightly.

The economic upswing did not pressurize prices too much. The consumer price index (CPI) rose by 1.1% as an annual average, thanks partly to improved productivity. However, the CPI accelerated in the last few months of the year, mostly due to rising prices for oil and other commodities, and rose by 1.7% in the last twelve months up to December 2010.

As a negative figure, we should note that the public deficit, for the first time in five years, exceeded the limit of 3% of GDP established in the EU Stability and Growth Pact, standing at 3.5%. This means that a restrictive budget policy must be implemented in 2011 within the fiscal consolidation plan, once the recovery has been confirmed. However, this will have a negative effect on the economy's expansion.

In fact, most of 2010's economic growth took place in the first half of the year, while a 0.5% quarter-on-quarter increase is expected for the fourth quarter. The moderation in activity was affected by the harsh winter coming early, leading to an insignificant rise in unemployment in seasonally adjusted terms in December. However, most leading indicators point to the German economy continuing to improve and GDP is expected to regain its pre-crisis level in 2011. Within this context, the German government raised its GDP growth forecast for 2011 to 2.3% in real terms.

The French economy is coping

French economic expansion speeds up in the fourth quarter of 2010.

After posting 0.3% quarter-on-quarter growth in the third quarter of 2010, French GDP will record an acceleration in economic expansion in the period October-December, according to available indicators. The economic recovery will have therefore been confirmed after the 2.5% annual fall in 2009, although the euro area's second economy has still not reached its pre-crisis level of activity.

Passenger car registrations rocketed in December before the end of aid for purchases, the so-called *prime à la casse*, in January 2011, rising to 9.9% compared with November in seasonally and calendar adjusted terms, although falling 0.9% compared with the same month of 2009. However, retail sales in general fell in December in line with household confidence. Concerns for unemployment and inflation lie behind this drop. In fact, according to Eurostat's standardized data, France's unemployment rate increased slightly in November 2010 to 9.8%, standing a little above the European Union's average although below the

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010					
			4Q	1Q	2Q	3Q	October	November	December
GDP	0.1	–2.5	–0.5	1.2	1.6	1.7	–	...	–
Domestic consumption	–0.3	0.8	4.1	1.8	0.4	1.6	–0.4	1.5	0.4
Industrial production	–2.7	–12.3	–5.0	5.1	7.7	5.3	4.5	6.0	...
Unemployment rate (*)	7.8	9.5	9.9	9.8	9.8	9.7	9.7	9.8	...
Consumer prices	2.8	0.1	0.4	1.3	1.6	1.5	1.6	1.6	1.8
Trade balance (**)	–50.6	–49.1	–42.1	–42.9	–45.1	–49.6	–50.7	–49.9	...

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

average for the euro area. However, the trend in goods consumption remains on the up.

On the supply side, industrial production was up 2.2% in November compared with the previous month in homogeneous terms. In the period September-November, this rose by 4.9% compared with twelve months before. However, the level of production was slightly below the maximum prior to the recession of 2008/2009. In December, the business climate indicator for industry showed another rise and order entries continued to improve, pointing to good short-term prospects for the secondary sector. Services also continued to increase in activity in December, except for transport, and the number of people employed by the tertiary sector continued to rise.

Prices remained at moderate levels in 2010. The consumer price index rose by 1.5% as an annual average, although the year ended at 1.8%, 2.0% harmonized with the European Union. The increase of the last few months was essentially due to oil products, and core inflation was 0.7%. Although inflation might still rise in January, it will subsequently tend to fall, except for some abrupt increases in commodities.

Moderately optimistic prospects for the French economy in 2011.

The outlook for 2011 is one of consolidation of an economic recovery that is turning out to be quite irregular. Certainly the budgetary policy will not boost growth, as the public deficit will have to be cut to 6.0% of GDP, according to the readjustment plan that must lower it to 3.0% by 2013 and balance it out by 2016-2017. However, the panorama is moderately optimistic and, in the economic field, President Sarkozy has prioritized employment, competitiveness and preserving the social model for 2011.

Italy: *piano, piano*

Slow and steady wins the race, says the proverb. This could be applied to the Italian economy if, in this year and the next, the structural reforms are put in place to extend its medium-term growth potential and allow it to take better advantage of the global recovery, as has been suggested by international organizations and the Italian central bank itself.

After slow growth in Italy's economy in the fourth quarter of 2010, the Banca d'Italia forecasts meagre rises over the next two years.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009	2010					
			4Q	1Q	2Q	3Q	October	November	December
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	0.5	0.6	–0.1	...
Industrial production	–3.8	–18.2	–9.0	3.5	7.7	6.3	3.3	4.2	...
Unemployment rate (*)	6.8	7.8	8.3	8.4	8.4	8.3	–	...	–
Consumer prices	3.3	0.8	0.7	1.3	1.5	1.6	1.7	1.7	1.9
Trade balance (**)	–10.0	–10.2	–6.6	–7.7	–13.2	–19.1	–22.3	–24.7	...

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

Italy's medium-term growth potential might be increased via structural reforms.

In fact, the recent revision of its growth forecasts by the Banca d'Italia places the rise in gross domestic product for 2011 at 0.9%, one tenth of a percentage point less than the estimate for 2010, and only 1.1% in 2012. Consequently, at the end of 2012 GDP will have only recovered half what it lost in the recent recession. Moreover, these meagre growth rates would only enable a tiny rise in employment, when Eurostat's harmonized unemployment rate for November 2010 stood at 8.7%, four tenths of a percentage point more than a year earlier and the highest rate in recent years.

These projections are influenced by the effect of the planned restrictive budgetary policy. In 2010, pending the definitive figures, the public deficit target of 5.0% of GDP will have probably been achieved, via adjustments based particularly on expenditure. For the next period, the government seems clearly determined to get the deficit down to 3.9% in 2011 and 2.7% in 2012, below Maastricht's limit. The remaining structural reforms will not be easy, especially given that Italian politics seems to have returned to a typically fragile situation.

However, if foreign demand was stronger than expected, growth rates of 1% could be exceeded. On the other hand, there's also a negative risk as, if the sovereign debt crisis of the peripheral countries of the euro area got worse, interest rates for private sector financing and the sluggish recovery could be affected. For the moment, after a slow rise in activity in the fourth quarter of 2010 (there are still no official figures), in January 2011 pressure has eased on Italian bonds and confidence indicators show some improvement. There is still hope that this and next year will not be lost.

The United Kingdom starts the year with huge challenges

Good figures for the manufacturing sector but the lethargy of services shows worrying signs.

The activity figures for the British economy at the end of 2010 were mixed, so no change in trend is expected, for the moment, in Britain's rate of economic growth. Foreign orders were a great help to the manufacturing sector. For example, the manufacturing PMI (purchasing managers' index) reached 58.3 points in December, the highest level of the last ten years.

This indicator of economic activity implies a situation of economic expansion when it goes above 50 and shrinkage in the opposite case.

But the same index for the services sector stood at 49.7 points at the end of December. A worrying sign, as the services sector is more important in a developed economy such as the British one. However, it's true this drop in activity in services was affected by the bad weather at the end of last year (with heavy snowfalls), which hit the retail distribution sector.

Unfortunately, retail distribution will have an additional problem as from the beginning of 2011: a permanent rise in VAT from 17.5% to 20%. Within a context of lethargic growth in consumption and without being able to set higher prices, we will have to see to what extent this tax hike will lead to a fall in company margins.

The situation of consumption isn't very encouraging either. In addition to the VAT hike there is the drop in disposable income due to the sharp rise in inflation within an environment of wage containment. Moreover, the labour situation is still adverse and jobs are still being lost. A situation that will get slightly worse with the cuts in public employment contained in the restrictive fiscal plan presented by the government.

In fact, harmonized inflation for December rose to 3.7% year-on-year while core inflation reached 2.9% year-on-year. Given this sharp increase, several economists criticized the credibility of the Bank of England's Monetary Policy Committee due to its inability to predict this rise and the potential risk of inflation continuing on the up. At the beginning of last year, the reserve bank forecast that inflation would be around 1% in December. The central bank's difficulty lies in the risk represented by raising the official interest rate within a context of an economic recovery that still has serious doubts hanging over it.

But there are also encouraging figures. On the one hand, the consensus of economists believes the government is very likely to succeed in its attempt to implement its fiscal austerity plan without affecting economic recovery. Moreover, the containment of labour costs is helping to boost corporate results. In particular, the corporate earnings presented by the financial sector have been strong, which is good news as this is the economic sector that had to be partly nationalized at the start of the recent financial crisis.

In addition, the sharp depreciation in the pound sterling should boost British exports and their contribution to economic growth. A situation that is occurring within a context of intense growth in the rest of the world and, in particular, in those countries that receive its exports, particularly: the United States, Germany, France and Holland.

In summary, the expected growth in the United Kingdom's GDP this year, which analysts place at around 2%, is subject to significant uncertainty. The leading economic data will therefore have to be monitored closely to make out its definitive course. The recovery in the services and real estate sectors will be particularly important as the consolidation of the recovery started in the second quarter of 2010 largely depends on this.

Wages grow at a slower rate than inflation, reducing consumers' disposable income...

...but the containment of labour costs, good corporate results and the initial success of the fiscal austerity plan are positive factors.

Two key sectors need to be monitored, namely services and the real estate market, to discern the economic future of the United Kingdom.

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	December
GDP	–0.1	–4.9	–2.8	–0.3	1.6	2.7	–	...	–
Retail sales	1.7	1.0	2.6	–0.1	0.8	0.7	0.3	0.9	0.0
Industrial production	–3.1	–10.1	–5.9	0.2	1.5	3.2	3.5	3.3	...
Unemployment rate (1)	2.8	4.7	5.0	4.9	4.6	4.5	4.5	4.5	4.5
Consumer prices	3.6	2.1	2.1	3.2	3.4	3.1	3.1	3.2	3.7
Trade balance (2)	–93.6	–86.8	–82.4	–83.0	–85.0	–90.3	–93.4	–95.2	...
3-month Libor interest rate (3)	5.5	1.2	0.6	0.6	0.7	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	80.6

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.

Emerging Europe: a new phase in monetary policy

In emerging Europe, the central banks of Hungary and Poland have started to raise their official interest rates.

Hungary unexpectedly started the dance. In November 2010, when few people expected it, the Hungarian central bank raised its official interest rate by 25 basis points, repeating this decision in December and January. In three months, the rate had gone from 5.25% to 6%. The reason given was that the government's fiscal policy was not being sufficiently restrictive to reduce the risk of inflation. Also in January, and in a movement pre-announced by the members of its central bank, Poland raised its reference rate from 3.5% to 3.75%. As in the case of its Hungarian peer, the central bank justified this raise with the medium-term risk of inflation.

The acceleration of growth and rising energy and food prices are putting pressure on inflation expectations in the region.

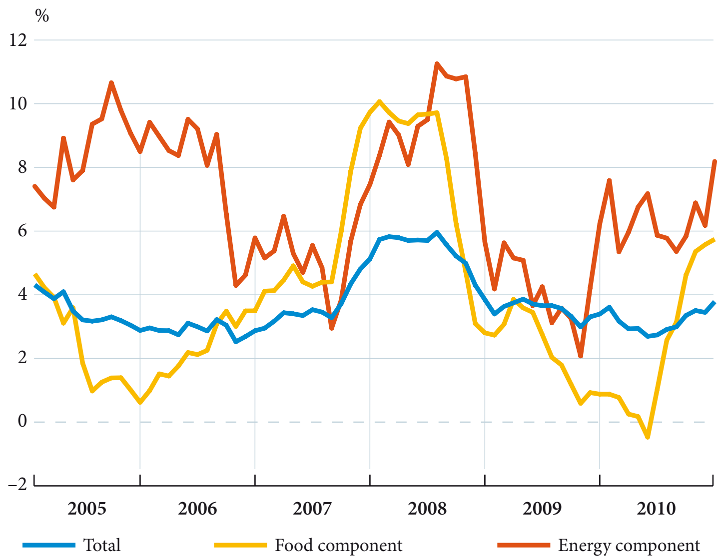
This conclusion might seem over-enthusiastic, given that even today's inflation levels can hardly be considered as exceptionally alarming. On average, the five economies we usually cover in this section (Poland, Hungary, the Czech Republic, Slovakia and Romania) posted a harmonized inflation rate of 3.8% year-on-year last December. Nonetheless, there are other elements to the discussion that must be taken into account.

First of all, in some of the region's countries the current levels of inflation are higher than the targets set by their respective central banks. For example, Hungary's inflation in December stood at 4.7%, when the official target by the central bank is 3% and the maximum limit 4%. Over-target inflation isn't a temporary situation either, as this has been the case since 2009. In addition, if the inflation forecasts for 2011 are correct, over-target inflation may become widespread throughout the different countries in the region.

Moreover, the nature of this rising inflation is of some concern. As is already known, the sharp rise in commodity prices at source is having a great effect on consumer prices in the different economies. In the case of emerging Europe, while the general index is at the aforementioned 3.8%

SIZEABLE INFLATIONARY PRESSURE FROM FOOD AND ENERGY

Year-on-year change in the harmonized consumer price index, weighted average for Poland, the Czech Republic, Slovakia, Hungary and Romania



SOURCES: Eurostat and own calculations.

year-on-year, the food component has risen to 5.8% and energy to 8.2%. Worrying figures if these levels become consolidated, as they might affect consumers' inflation expectations in these countries within a context of increasing growth.

If we add to this upswing in prices the fact that official interest rates tend to be at very low levels, a situation that limits monetary policy's room to manoeuvre against a hypothetical negative economic shock, we need to ask not so much why the central banks of emerging Europe are changing their monetary policy but rather why they have taken so longer to start this shift to a more restrictive policy. To understand the reluctance of the central bankers we need to review the different factors that have affected their decisions.

The first of these, the fundamental one, lies in doubts concerning the consolidation of the economic expansion and the possibility that an over-hasty toughening up of monetary policy would weaken it. Although, as from the second half of 2010, any doubts concerning the intensity of the recovery might have seemed resolved, since then there has been great uncertainty as to whether this rising trend in activity would continue. Of particular concern is whether the cycle of replacing industrial stock, at a world level, might run its course. This development has notably benefited the greatly exporting and industrial economies of emerging Europe, particularly through their trade with Germany and other central economies in the euro area.

Even though it seems highly improbable that the German economy will repeat its excellent economic growth figures of 2010 (3.6%), the forecasts for 2011 now being used, around 2%, should be enough to provide emerging Europe with a comfortable contribution to their foreign sector. Available indicators for industrial

The doubts regarding expansion and the fear of their currencies appreciating too much delay tougher monetary policies.

With a firm recovery and less pressure on currencies, from the end of 2010 a door has been opened for monetary normalization.

During the year, the Czech Republic and Romania will join the process of getting monetary policy back to normal.

production, exports of goods and industrial orders referring to the end of 2010 point to activity clearly continuing to accelerate, at least in the first part of 2011. All this reaffirms the scenario of increasing growth in these five economies in 2011, coming close to their growth potential by the end of the year.

A second element that explains the containment carried out by some of the region's central banks, and related to the previous factor, was the fear of encouraging their currencies to appreciate too much, reducing external competitiveness at a time of strong international competition. This is the clear case of Poland and the Czech Republic. Although 2010 has ended with their currencies at similar levels to those recorded at the start of the year, between June and November the Polish zloty and the Czech krona appreciated by 6% and 7% respectively, in nominal effective exchange rate terms. However, the respite of the last few months of 2010, when this rising trend was reversed, has undoubtedly tempered the risks in this area.

In summary, the process led by Hungary and Poland represents the first steps in getting monetary policy back to normal. Both countries are expected to gradually move along these lines and other central banks will probably join this movement of raising national official interest rates. In particular, the Czech central bank may also raise its rate in the second quarter of 2011 and the Romanian in the third. For the moment Slovakia, as it's a member of the euro area, will remain outside this schedule of imminent interest rate hikes.

Bubbles: a complex phenomenon that's difficult to identify

In January 1637, the price of tulips reached such great heights in Holland that the annual wages of ten Dutch craftsmen was required just to buy a single bulb. A few weeks later, the price of this article plummeted, ruining those who had placed their wealth in such a curious investment.

Many economists consider this event to be the first documented case of an asset price bubble:(1) the situation when something's price or value goes way above its intrinsic or fundamental value and then falls abruptly afterwards. But not all economists share this view. In fact, the sharp ups and downs experienced from time to time in asset prices have led to a long, controversial debate between economic schools of thought regarding the nature of this phenomenon. For some, these may be speculative bubbles in the sense already mentioned, while others believe we should not talk of bubbles but rather of fluctuations linked to the fundamental (or perceived) value within the context of efficient markets. Although by no means settled, this debate appears to lean towards the first current of thought, especially after the traumatic evidence provided by two big episodes in recent years: the rise and fall of dot.coms between 1997 and 2002, as well as the boom and subsequent crash in house prices in many countries between 2003 and 2010. Assuming that bubbles are a possibility, some important questions arise: what effects do they have on the economy, what factors encourage them to appear and how can they be detected. The answers to these questions are of great importance for economic authorities and private investors.

(1) See Peter M. Garber, «Famous First Bubbles». Journal of Economic Perspectives (1990).

One conclusion that seems to be gaining consensus is that bubbles, at the end of the process, harm the development of the real economy.(2) On the one hand, when they form, they distort the investment decisions of economic agents in detriment of efficient resource allocation. On the other, when they burst, they reduce the wealth of some investors and can undermine the stability of the financial system, damaging economic growth. From the viewpoint of economic policymakers, this means that it's very important to study how bubbles form and what measures can be used to act on them.

Some economists attribute the development of bubbles to not entirely rational behaviour on the part of investors.(3) They argue that the birth of bubbles is generally linked to events or new developments that improve the prospect of future profit associated with an asset. Phenomena such as internet use becoming widespread, growing flows of immigrants and the economic upsurge of developing countries would explain, respectively, the initial rise in the price of technology shares, housing or commodities over the last few years. However, it is after this initial price increase that investors' expectations may become too optimistic, in turn leading to further increases. This enthusiasm is usually attributed to factors intrinsic to human behaviour. The short-sighted belief that recent price increases will be repeated in the future, the tendency to underestimate the chance of making a loss and constant references in the media all boost optimism regarding how prices will behave. Consequently, the assets in vogue are increasingly more attractive for investors, in turn raising their value.

In any case, irrational behaviour is not the only factor that can lead to the formation of bubbles.(4) Numerous studies have shown that, even with the presence of rational agents capable of identifying deviations in asset prices (compared with the underlying fundamentals), the existence of «limits to arbitrage» in the markets may not only sustain but also increase these deviations for a certain period of time. Some of these restrictions are due to the lack of arbitrage instruments, leaving the performance of asset prices in the hands of more uninformed and optimistic investors. But even if such instruments exist, the risk of prolonged price deviations harming the solvency of informed, rational investors might stop them from taking any corrective action. This happens when, due to the size of the market, it's impossible for a single agent to reverse the price of an asset, forcing rational investors to act in a coordinated way, something that's easier said than done. Given these limitations, the best strategy for these agents might be to «ride the bubble», attempting to sell just before it bursts. Far from correcting price deviations, this intensifies their fluctuations even further.

Apart from these elements associated with the microstructure of markets, i.e. concerning how information flows and is processed by the different agents, other economists have identified factors of a macroeconomic nature related to the excessive increase in asset prices. In fact, several recent studies agree that most of the severe episodes have been preceded by periods of abundant liquidity and excessive credit.(5) The argument is that an environment of low interest rates and easy credit access encourages bubbles to form through various channels (for example, encouraging risk-taking to secure a higher return).

Except in cases as extreme as the tulips in Holland, identifying the existence of a bubble in real time is a very complicated task. The main reason lies with the doubts regarding the fundamental value of each asset at any

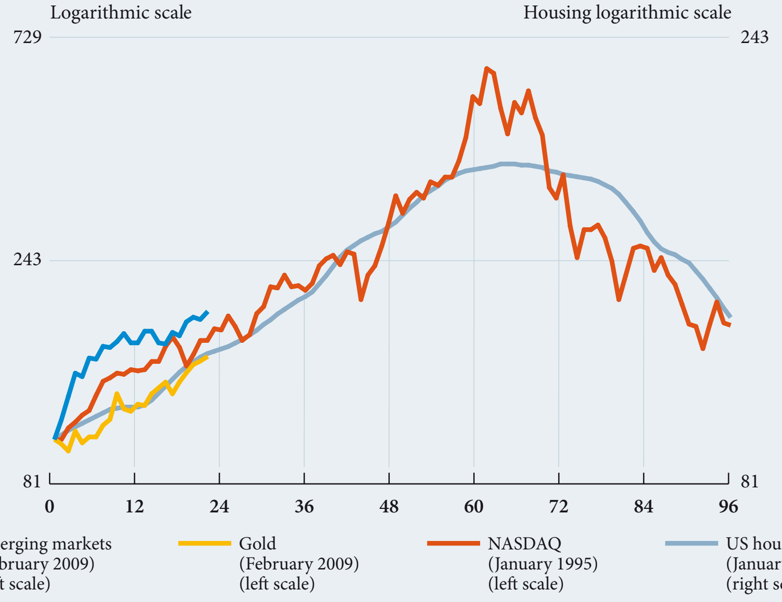
(2) One exception to this point of view is presented in A. Martín and J. Ventura, «Economic Growth with Bubbles», NBER Working Paper no. W15870 (2010).
(3) R. Shiller, «Irrational Exuberance» (2000).
(4) M. K. Brunnermeier, 2008. «Bubbles» in The New Palgrave Dictionary of Economics.
(5) See R. Adalid and C. Detken. «Liquidity Shocks and Asset Price Boom/Bust Cycles». ECB Working Paper no. 732 (2007).

particular time, something that usually results in significant discrepancies between economists.[6] Given this circumstance, analysts usually base their judgements on phenomenon-related indicators in the hope that these will provide information on each particular case. The following would therefore be warning signs: high levels of liquidity and leveraging in the economy, signs of investor confidence reaching levels of euphoria or mania, little market transparency, a lack of active arbitrageurs, etc. In retrospect, it seems clear that these kinds of factors could be observed during the dot.com and housing bubbles. However, it's also true that the difficulty in measuring such factors prevents any irrefutable diagnosis concerning the size of a bubble to be made. Another example of this inconvenient ambiguity can be seen, at present, in assets such as the stock markets of some emerging countries and numerous commodities: their rapid price rise (see the graph below) and the observation of suspicious signs are leading some analysts to warn that the phenomenon is happening again.

In short, the uncertainty surrounding the identification of speculative bubbles represents a huge challenge for all those interested in, or affected by, their development. Specifically, central banks continue to investigate their options for action, taking careful note of the most recent episodes. For their part, the best strategies of private investors vary depending on their risk profile: for the most conservative, remaining on the sidelines; for others, «riding the bubble» and attempting to sell before it bursts, and for the rest, taking positions that lead to profit should the bubble go down. This last option, even realising that a bubble exists, is not easy.

SOME ASSETS ARE EXPERIENCING SIMILAR GROWTH PATTERNS TO THE LAST BUBBLES

Index (100 = start of growth)



SOURCES: Bloomberg and own calculations.

(6) K. Gerardi and C. Foote. «Reasonable people did disagree: optimism and pessimism about the U.S. housing market before the crash.» Federal Reserve Bank of Boston Public Policy. Discussion Paper no. 10-5 (2010).

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FINANCIAL MARKETS

Monetary and capital markets

Dodging obstacles

The recent performance of the global financial markets is following patterns that have been in place for some months now and should continue throughout 2011. Added to the development of a favourable macroeconomic environment, characterized by improved world growth, reasonable levels of inflation and record low interest rates, is the gradual reduction in uncertainty and risk aversion.

However, there are still signs of vulnerability in various areas and risks still loom that should not be underestimated as they could threaten financial stability, such as the slow correction in global and some local imbalances, the aggressive nature of economic policy in the United States and the possible formation of bubbles (principally in emerging countries).

With regard to how the debt crisis is progressing on the periphery of Europe, investors have started to rate more positively the efforts and progress made by the countries in question, as well as by the institutions of the European Union and the European Central Bank. These have led to modest but encouraging falls in sovereign risk premia. This respite suggests that, over the coming months, the tensions resulting from this long crisis might be finally contained, providing discipline and cohesion continue along the same lines. But unfortunately another obstacle is emerging on the world scene: rising commodity prices. Their potential effect on inflation and the debate regarding whether monetary policies need to be tougher is starting to grab the attention of investors.

In 2011, the markets will be boosted by a favourable macroeconomic environment and less uncertainty.

Central banks: adapting to the cycle's dynamics in each region

The actions taken by central banks have continued to vary considerably depending on the region. While restrictive monetary policy measures are spreading in emerging economies, in developed countries the authorities are still committed to keeping interest rates exceptionally low in order to boost economic recovery.

Investors appreciate the efforts made by authorities to resolve the debt crisis in Europe's peripheral countries.

Looking at recently publicized figures, it seems likely that the US economy will have once again performed better than expected in the last quarter of 2010. Should this be confirmed, the Federal Reserve is likely to up its estimates for gross domestic product (GDP) in 2011 (currently in the range of 3.5%-4.2%), coinciding with the next Monetary Policy Committee meeting. However, in his latest public appearances Governor Ben Bernanke has stressed that there's still one vital variable in the economic recovery that is performing below par: namely job creation. For this reason, most observers believe the institution will continue with its current position of monetary policy, justifying this based on the large negative output gap and high unemployment. Similarly, given that the recent rise in commodity prices has

The diverging actions taken by central banks at a global level are related to the different cyclical positions.

The Fed and the ECB keep on course and, through the tone of their messages, indicate they are getting ready for a change in direction in economic conditions.

The large emerging countries are already immersed in a gradual process of monetary restriction.

Interbank markets are starting to wonder about future rises in official interest rates.

scarcely raised inflationary expectations in the United States, the time does not seem to have come for the Fed to announce an alteration in its diagnosis and prognosis for the economy. In summary, at present no change is likely in the official interest rates or in the quantitative easing programme (QE2), which should be completed as announced last November.

In Europe, the ECB is at a crossroads consisting of the solid pace of growth of Germany and the countries in northern Europe and the sovereign debt crisis of the peripheral economies. This dichotomy seems to have raised some questions in the central bank regarding the right path to be taken by monetary policy in the coming quarters. So far, and supported by the central bank's firm commitment to safeguard price stability, after the last meeting of the Governing Council Trichet stated that there is no pre-commitment to keeping interest rates low and that they will be keeping an eye on a possible increase in inflationary risks. Similarly, and in line with its recent action in the sovereign debt markets, he acknowledged the appropriateness of continuing to act selectively on those areas of the market showing unfounded and/or unwelcome tension (through non-conventional programmes and measures, such as those it has already been applying), but Trichet repeated that the ECB would like to gradually give up this role and leave it to private agents and governments to underpin stability. This suggests that, both in terms of conventional and non-conventional policy, the ECB is considering adapting its position to the changing circumstances. In this respect, what is most likely is that any reorientation will be very gradual, starting with slight changes in the content of messages and telegraphing, as far in advance as possible, any intention to tighten up monetary conditions, something that does not seem likely during the first half of the year in any case.

The situation is very different in the case of the emerging countries. The intense pace of growth of their economies and the rise in their inflation rates are leading to a more restrictive response by their monetary policies. In general, their action strategies are gradual and everything suggests they will continue over the next few months. This has been the case, for example, of the central banks of Poland and Brazil, where official interest rates have risen by 25 and 50 basis points, respectively. The particular process undertaken by the Chinese authorities stands out for its complex instrumentation as, in addition to the latest rise in official interest rates in December, various administrative measures have also been applied, aimed at controlling the private sector's monetary and credit volumes in order to take some heat out of the economy.

Within this context, the interbank markets have performed differently depending on each market's economic scenario. On the one hand, recent developments in the US market have been characterized by stability and a lack of friction. There are three reasons for these circumstances. The first is the persistence of abundant liquidity (thanks to the Fed's bond purchases) and the consequent accumulation of commercial banks' surplus reserves. The second relates to the stability of counterparty risk premia for banking institutions, the result of these institutions gradually putting their house in order. The third concerns the stability in consensus expectations

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
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	1.00	1.01	1.51	0.25	0.30	0.19	0.50	0.76	0.20
2011									
January (1)	1.00	1.03	1.59	0.25	0.30	0.19	0.50	0.78	0.33

NOTES: (1) January 24.
(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.

regarding the Fed's future actions. In principle, this third factor will result in the most significant movements in dollar monetary markets in the future, but this is more likely in the second half of the year.

On the other hand, in the euro area the interbank market is performing without any alterations of a systemic scope, in spite of the sovereign debt crisis. Any effects, which are sometimes severe, are local in nature, logically centred on the peripheral countries. In aggregate terms, both appeals to the ECB and banks' surplus reserves are tending to decrease, helping the monetary market to gradually get back to normal. Over the coming months, Euribor interest rates are likely to fluctuate more widely as economic growth in the area consolidates and the ECB's language becomes more belligerent concerning inflationary risks.

US interbank rates show no friction while tensions are localized in the euro area.

The currencies of the emerging countries: in investors' sights

Recent developments in the currency markets are being determined by cyclic and structural differences between the different regions and by the different spots of financial instability arising in the euro area. The intense pace of growth and

Intense growth and gains in productivity have boosted the appreciation of the emerging countries' currencies.

notable gains in productivity of emerging economies mean that their currencies are tending to appreciate against the dollar and the euro. The authorities of numerous countries are trying, with more or less effort, to have an effect on this situation via measures of different types, including exchange controls. Over the last few weeks, there have been further examples of this but, overall, it seems that events are happening in a relatively orderly fashion, suggesting that the dreaded «currency war» and its commercial diversions should be avoided. In this respect, the case of the Chinese yuan is particularly significant. Coinciding with an emblematic visit by the Asian country's top leaders to the United States, in January the yuan continued its slow but sustained appreciation against the dollar. Since China decided to let its currency gain in value again last June, it has appreciated close to 4% against the greenback and all the evidence points to this process continuing throughout 2011.

Regarding the euro/dollar exchange rate, of note is the period of high volatility seen at the end of 2010 and the beginning of this year, with fluctuations of up to 5%, caused by the crisis on the edge of the euro area. The intensity of this kind of tension is likely to ease gradually over the coming months, giving way to a more stable exchange phase in which the underlying economic and financial fundamentals of both regions will essentially determine currency movements. In this respect, the current euro/dollar exchange rate seems to be reasonably in line with these

EXCHANGE RATES OF MAIN CURRENCIES

January 25, 2011

	Exchange rate	% change (*)		
		Monthly	Over December 2010	Annual
Against US dollar				
Japanese yen	82.4	–0.5	1.6	–9.6
Pound sterling	0.633	2.4	1.2	–2.8
Swiss franc	0.946	–1.5	1.1	–9.9
Canadian dollar	0.999	–0.8	0.1	–5.9
Mexican peso	12.085	–2.3	–2.1	–6.4
Against euro				
US dollar	1.364	–3.6	–1.9	3.6
Japanese yen	112.4	3.0	3.5	–13.7
Swiss franc	1.290	2.0	3.0	–14.1
Pound sterling	0.863	1.0	0.6	–1.0
Swedish krona	8.935	–0.4	–0.6	–14.5
Danish krone	7.454	0.0	0.0	0.1
Polish zloty	3.874	–2.8	–2.3	–5.1
Czech crown	24.21	–4.8	–3.3	–7.4
Hungarian forint	275.3	–1.4	–1.2	1.1

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

fundamentals, so that few variations are expected in the accumulated over the next few months, with a slight bias towards the appreciation of the dollar once the Fed's latest round of quantitative easing is over.

Government bond markets try to get back to normal

Having seen the end of doubts regarding the US economy's capacity to recover, and after the Fed started up its second round of quantitative easing (QE2), the yield of US public debt rose quickly during the last two months of 2010. This movement consolidated in January, an example being the 10-year bond rate fluctuating within a narrower range around 3.40%. The reasons for this stability can be partly found in the absence of any surprises in the macroeconomic figures and partly in the credibility that the US economy and its managers seem to continue to enjoy among the international investment community, in evidence in the very low risk premium for insolvency.

In contrast, the European market has other, more complex characteristics due to the region's heterogeneous nature and the impact of the sovereign crisis affecting its peripheral countries. Firstly, confirmation of the spectacular recovery of the German economy in 2010 has led to the rise in German bond yields spreading to all maturities; in the case of the 10-year bund, up to levels close to those at the start of 2010. Secondly, although tensions regarding the risk premia of peripheral countries have eased (thanks to the strictness perceived by investors in the fiscal and structural measures adopted by these economies), the spreads between their 10-year bonds and German bonds are still very high.

The yield from US 10-year debt consolidates in January around 3.40%.

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
2010								
January	3.20	3.46	4.12	4.12	3.58	1.33	3.91	2.00
February	3.10	3.40	3.86	4.00	3.61	1.31	4.03	1.90
March	3.09	3.42	3.82	3.98	3.83	1.40	3.94	1.88
April	3.02	3.29	4.03	4.02	3.65	1.29	3.85	1.78
May	2.66	2.92	4.26	4.14	3.28	1.27	3.58	1.54
June	2.58	3.05	4.56	4.09	2.93	1.09	3.36	1.48
July	2.67	2.95	4.21	3.95	2.91	1.07	3.33	1.46
August	2.12	2.47	4.05	3.83	2.47	0.97	2.83	1.13
September	2.28	2.66	4.12	3.88	2.51	0.94	2.95	1.40
October	2.52	2.91	4.21	3.94	2.60	0.94	3.08	1.49
November	2.67	3.15	5.50	4.67	2.80	1.19	3.23	1.56
December	2.96	3.36	5.45	4.82	3.29	1.13	3.40	1.72
2011								
January (*)	3.15	3.48	5.24	4.67	3.40	1.24	3.67	1.87

NOTE: (*) January 24.
SOURCE: Bloomberg.

In Europe, fiscal and structural measures help to reduce tension in the risk premia of peripheral countries.

Corporate bond markets start the year with marked differences between sector and regional indices.

The US market has hardly been affected by the European sovereign debt crisis; quite the opposite.

With regard to the latest news concerning the resolution of the sovereign debt crisis, of note is the debate raging in the European Union regarding the possible enlargement of the size of the EFSF (European Financial Stability Fund), as well as its facility to buy up the public debt of countries in difficulty in the secondary market. The reasonable success of the latest sovereign debt issuances in Portugal, Spain and Greece is also remarkable.

With a view to the coming quarters, it's reasonable to expect the yield for US and German debt to remain slightly on the up, within an expansionary macroeconomic scenario where one crucial element will be the central banks managing, by means of their credibility and good communication policy, to neutralize the inflationary threat from the recent rises in commodity prices. But in both cases further figures will be required to confirm the consolidation of economic growth for the rise in interest rates to come about. Meanwhile, we cannot rule out that the main troubles will still be related to resolving the European sovereign debt crisis, which is bound to provide us with more excitement before it ends.

Looking at the public debt of emerging economies, the most outstanding fact is that sovereign bond spreads are continuing to narrow compared with US bonds. This trend has been steady since the beginning of 2009 and is due to the good tone shown by these economies, as well as the abundant liquidity at a global level. However, this trend might not be as agreeable throughout 2011, given that tougher monetary policies and the application of capital controls in many of these countries will probably result in greater macroeconomic and financial volatility.

High Yield, the fashionable segment in corporate bonds

Corporate bond markets have started the year with marked differences between the different sector and regional indices, attributable to various factors.

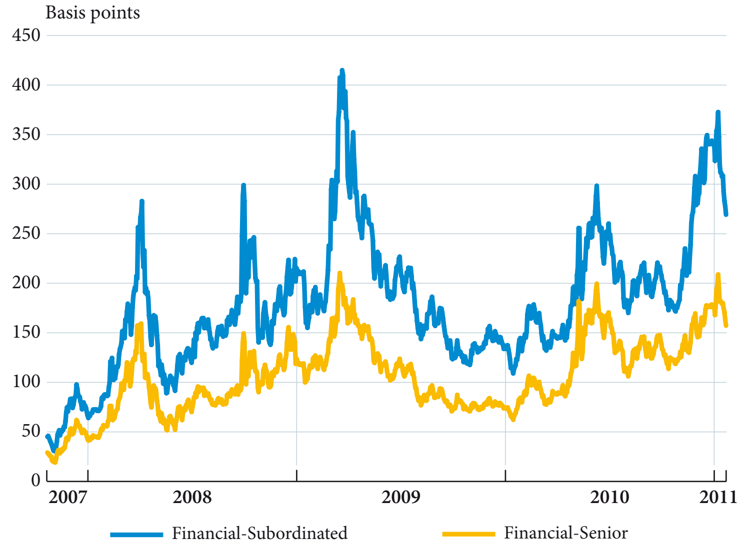
On the one hand, the sovereign debt crisis in the euro area's peripheral countries has mainly affected the financial sectors, raising the risk premia of bank institutions up to record highs, in some cases even reaching levels close to those seen in the High Yield bond tranche. Similarly, on days of maximum tension, this has also affected the debt of investment grade firms. On the other hand, in the United States and emerging countries (principally in the BRIC), corporate debt spreads have fallen to record lows.

The US market has hardly been affected by the European sovereign debt crisis, in fact quite the opposite, so that investment grade firms have taken advantage of the circumstances to issue bonds at very low interest rates. There are various reasons for issuing these bonds: those aimed at financing production-related investment are beginning to be the most frequent but there are still others aimed at financing M&A operations, to buy back shares or pay out dividends. Similarly, firms from the very low credit rating segment (High Yield), boosted by investors' huge appetites, have started to issue bonds at more attractive rates for them.

Two trends can be seen in the recent development of private investor flows.

ANOTHER TENSE EPISODE IN EUROPEAN BANK DEBT

iTraxx indices Financial sector



SOURCE: Bloomberg.

Firstly, flows have reached maximum volumes in the US bond markets, both high yield and investment grade. Secondly, the rate of inflows towards the emerging markets has slowed up, due to factors such as the fall in credit spreads and tougher monetary policies in these countries, seriously threatening the expected returns in these markets.

Meanwhile, rating agencies are making increasingly optimistic revisions of their ratings, particularly in the segment of high risk firms. In turn, this enhances the favourable scenario for this segment: good growth prospects for profits and the strength of balance sheets within an environment of exceptionally low interest rates, meaning that debt can be issued with very low returns at competitive prices.

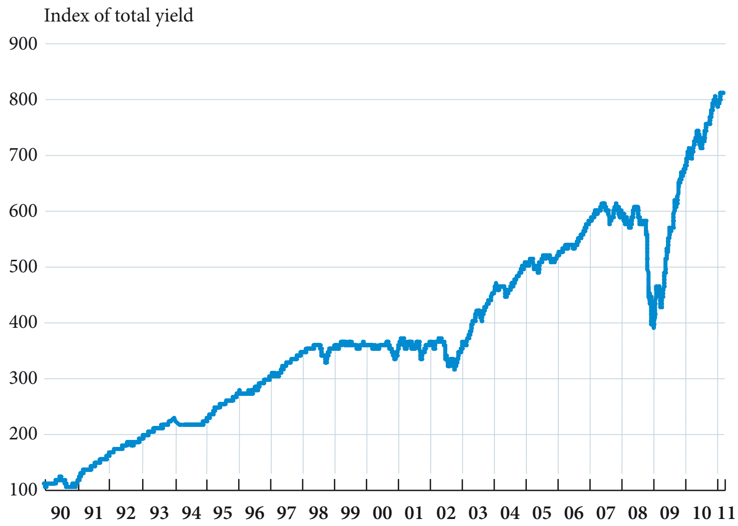
On the whole, this context (where a lot of firms have taken advantage of the situation to issue debt at low interest rates, private investor flows are reaching maximum levels and ratings are somewhat more optimistic) defines a market that requires a certain dose of calm and caution. The justification for advising caution is based on the fact that, in the area of corporate debt of both developed and emerging countries, there are signs of consolidation which occasionally approach exuberance. This means that the relation between the risk assumed and the potential return has lost appeal when compared with other assets. If this situation increases, it will therefore be no surprise to see investors (private and institutional) changing the composition of their portfolios with their attention focused on other financial markets that offer more attractive opportunities in the medium term, such as equity.

Rating agencies are making increasingly optimistic revisions of their ratings.

Investors turn their attention towards other financial markets with greater opportunities in the medium term, such as equity.

THE BONDS OF HIGH YIELD FIRMS ACCELERATE THEIR GAINS

Merrill Lynch high yield bond index



SOURCE: EcoWin.

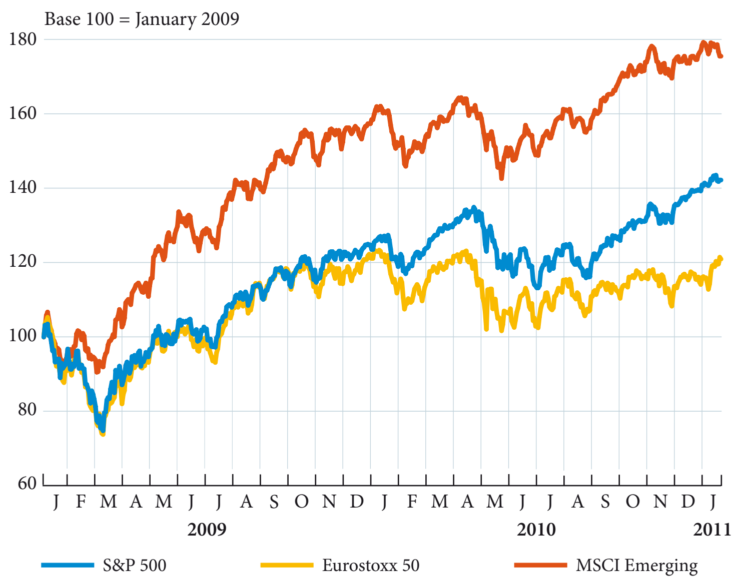
The first stock market trading for the year is taking place within a more favourable financial environment.

New year, new stock market opportunities

The first stock market sessions for the year are taking place within an environment that is increasingly looking more favourable for global stock markets. We can observe a reduction in uncertainty and risk aversion among investors, who have

THE YEAR STARTS POSITIVELY IN THE STOCK MARKETS

Stock market indices



SOURCE: Bloomberg.

been realizing for the last few months that the macroeconomic and corporate dynamics currently in play are making equity more attractive.

Among the positive factors, of note is the improved flow of economic indicators. This process has been reinforced by the application of reasonable economic measures in different regions, aimed at sustaining economic recovery. The fear of a double-dip recession, which hit the stock markets so hard mid-2010, seems to have faded completely, while stock markets are dealing calmly with the debate regarding the impact of rising commodity prices, possibly putting their faith in economic policy responding correctly.

Secondly, another key element for equity is currently the widespread improvement in corporate earnings. This circumstance can be observed throughout January, at the start of the earnings season for the fourth quarter of US and European firms, confirming that margins are continuing to pick up for a second year in a row. For example, in the case of the S&P 500, the results of 16% of the companies have been published to date and 70% of these have exceeded the expectations of the consensus of analysts. In addition, the boom scenario generated by low interest rates is stimulating corporate mergers and acquisitions, getting back to the levels of 2008, as well as companies buying back shares, an activity that is boosting the US stock markets even further.

The consolidation of the trend described above is starting to be supported by small

Improved corporate earnings are a key element in the stock markets recovering.

The medium-term outlook for stock markets is positive, although the odd correction cannot be ruled out.

INDICES OF MAIN WORLD STOCK EXCHANGES

January 25, 2011

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*11,871.8*	*2.6*	*2.5*	*16.7*
Standard & Poor's	*1,283.4*	*2.1*	*2.0*	*17.5*
Nasdaq	*2,689.5*	*0.9*	*1.4*	*22.0*
Tokyo	10,345.1	0.6	1.1	–2.3
London	5,906.9	–1.7	0.1	11.4
Euro area	2,957.8	3.3	5.9	4.3
Frankfurt	*7,019.2*	*–0.5*	*1.5*	*23.2*
Paris	*4,006.6*	*2.7*	*5.3*	*4.9*
Amsterdam	*358.4*	*0.7*	*1.1*	*8.8*
Milan	*21,994.0*	*5.9*	*9.0*	*–2.5*
Madrid	*10,722.0*	*6.1*	*8.8*	*–5.7*
Zurich	6,563.3	–0.5	2.0	1.1
Hong Kong	23,801.8	4.2	3.3	14.8
Buenos Aires	3,648.3	4.9	3.5	56.5
São Paulo	69,133.1	0.9	–0.2	4.4

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.

investors, attracted by improved potential returns from equity compared to other assets with less potential, such as public debt. After years in which private investors had turned their backs on stock markets in their attempt to reduce risk and preserve their assets, the current configuration of their portfolios is defensive, leaving lots of room for taking up positions in equity.

With regard to the short-term conditions, various indicators for sentiment and flows continue to suggest a relatively large probability of one-off corrections that would nonetheless be limited in scope. Rising commodity prices and/or a hasty toughening up of monetary policy have now been added to those factors that might lead to this corrective movement. In any case, in the medium term we can say that the outlook for the stock markets remains positive, based on a satisfactory economic scenario and an expansionary phase in the corporate cycle, with falling volatility and credit risk.

Why are (risk-free) long-term interest rates so low?

While the countries on the periphery of Europe are battling to contain the cost of their public debt, other sovereign states are enjoying record low interest rates. The yield on ten-year bonds for the United States and Germany, two countries with practically zero default risk, was around 2.5% in the second half of 2010. For Germany, this was the lowest level since such records began, and for the United States it was a yield that, in fifty years, had only been seen briefly at the end of 2008, after the Lehman Brothers crisis. In spite of having gone up slightly in the last few weeks, interest rates are still very low. Will this situation continue for very long? Or have interest rates started to get back to their more normal, higher levels?

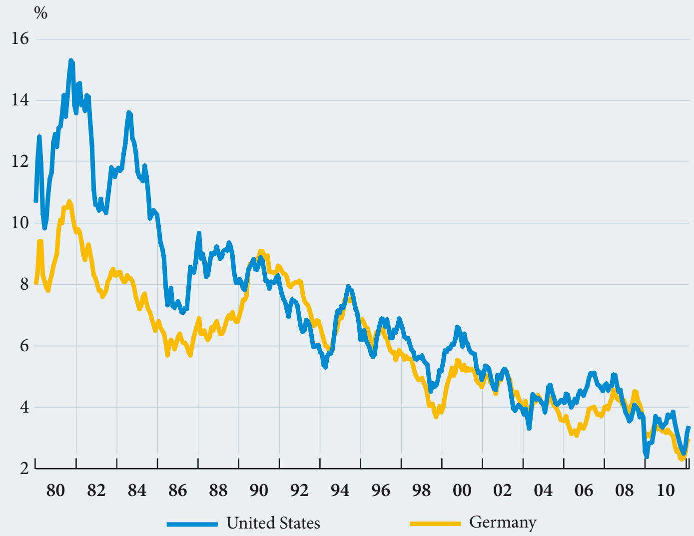
The variation in interest rates during the last economic cycle took place within a clearly downward trend over the last three decades (see the graph below). This trend can mainly be explained by falling rates of inflation and their volatility. In the United States, average annual inflation reached 5.5% in the 1980s, fluctuating between a low of 1.9% and a high of 13.5%. However, the first decade of the new millennium saw a lower average (2.6%) and much less variability (between –0.9% and 3.8%). It was the same situation in Germany, although the extent of the changes was not so great.

In addition to falling inflation, other factors also pushed interest rates down during the noughties. On the one hand, the global economy had a greater propensity towards saving due to the growing importance of the frugal Asian economies (particularly China) and to the very high savings rate generated in the oil exporting countries after crude prices rocketed mid-decade. Part of these savings went to long-term American or German debt, which tended to reduce their yield. Another factor often mentioned is the abundant liquidity generated by relatively lax monetary policies. Although this liquidity would not have led to higher inflation thanks to the global pressure on costs exercised by the emerging countries, it would have contributed to raising the price of certain financial assets, including long-term debt (and more expensive debt means lower yields).

Just before the subprime crisis hit, 10-year interest rates were at a level that could be considered close to normal or to the long-term equilibrium, around 4.5%. In particular, American bonds were offering an average yield of 4.8% in the first half of 2007. Thanks to the existence of inflation-linked bonds in the United States, this yield can be broken down into the real interest rate (the rate paid by an indexed bond) and implicit inflation (which would

30 YEARS OF FALLING INTEREST RATES

Monthly average yield for 10-year public debt of the United States and Germany



SOURCE: Thomson Reuters Datastream.

equalize the yields of indexed and nominal bonds and can be interpreted as a measure for expected inflation).(1) This breakdown indicates that the 4.8% nominal yield reflected a real interest rate of 2.4% and implicit inflation, coincidentally, also of 2.4% (see the graph below). As from this point, the nominal interest rate began to fall, mainly reflecting a drop in the real rate, affected by the worsening economic growth prospects and the weakness of private investment. The lowest real interest rate was reached in October 2010, after analysts started to fear the possibility of a double-dip recession in the American economy and a deflationary scenario.

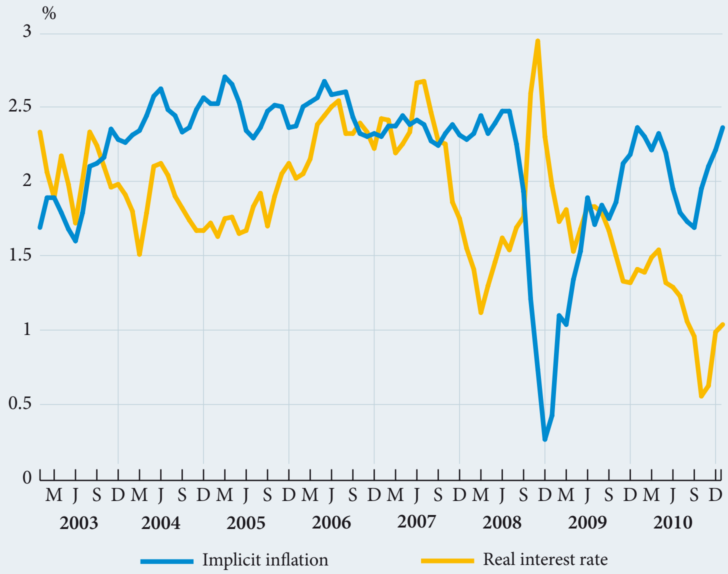
It's worth noting that the real interest rate was no lower at the end of 2008 or during 2009, at the times of the greatest economic weakness, but this can be explained by some financial market anomalies that also affected the sovereign debt markets. During these months, investors fled from instruments that were not very liquid, such as inflation-linked bonds, leading to an exaggerated rise in the interest rate for these bonds, the real rate.

For the same reason, since implicit inflation in indexed bonds is calculated as the spread between the nominal and indexed bonds, this was excessively low at the end of 2008 (due to the combination of very low nominal rates because of the great liquidity offered by nominal bonds and abnormally high real rates). Although it's true that inflation expectations fell at that time, implicit inflation in indexed bonds significantly underestimated these. As liquidity premiums normalized throughout 2009, implicit inflation got back to its level of around 2%, somewhat below what was usual in 2004-2007 but not by much. This suggests that long-term inflation expectations have remained firmly anchored close to the Fed's target levels. And when, last summer, these expectations threatened

(1) Ignoring some technical complexities, essentially an inflation-linked bond undertakes to pay a fixed interest rate known at the time of buying the bond (which is considered to be the real interest rate) plus the inflation accumulated between the date of issue and its maturity. Breaking down a bond's nominal yield into the real interest rate (that of the indexed bond) and an implicit inflation rate (which would equalize the yields of nominal and indexed bonds) is a simplification, as this spread may also be due to factors such as the inflation risk premium or liquidity premium.

INFLATION EXPECTATIONS HAVE NORMALIZED BUT THE REAL INTEREST RATE IS STILL VERY LOW

Monthly averages for the real interest rate and implicit inflation for US 10-year inflation-linked bonds



NOTE: Implicit inflation is calculated as the average rate of inflation over the next ten years that would equalize the yields of nominal and inflation-linked bonds.
SOURCE: Thomson Reuters Datastream.

to fall, the Fed announced another round of quantitative easing (known as the QE2). Since then, implicit inflation has gone back up to around 2.4%.

The improvement in growth prospects since the announcement of the QE2 and the approval of a new package of fiscal stimuli has also pushed up the real interest rate for American bonds to a little more than 1% at the beginning of 2011. The nominal yield for 10-year bonds is therefore around 3.4%. Over the coming months, the implementation of the QE2, which involves the Fed purchasing long-term debt, is likely to stop the interest rate from rising much further. However, in the second half of the year, once the QE2 is over and if the positive outlook for economic growth consolidates, as we expect to happen, the real interest rate should start to rise again. At that time, one of the focuses of attention for investors will be the North American fiscal deficit and the adjustment plan designed by the Administration to reduce it. The lack of any ambitious, credible plan would push up interest rates further.

In the case of Germany, where inflation-linked bonds have only existed since 2009, the fluctuation in interest rates and implicit inflation has been similar to that experienced by the United States. The lowest real interest rate (0.7%) was reached in October 2010, a time when inflation expectations were around 1.6%, also lower than usual. Since then, both indicators have picked up to 1% and 2%, respectively. They are also expected to continue rising over the coming months.

We are therefore witnessing a timid start to long-term interest rates getting back to normal. This change will probably be gradual and certainly dotted with ups and downs but, in the medium term, we will once again see risk-free long-term interest rates of between 4% and 5%. Neither can we rule out the possibility that the greater weight of emerging economies and their investment needs, combined with the ageing population in advanced economies, which reduces their savings rate, might push interest rates above the usual levels in the noughties. In any case, we should all prepare ourselves for an inevitable journey towards more normal interest rates, and this journey has just one direction: upwards.

This box was prepared by Enric Fernández
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SPAIN: OVERALL ANALYSIS

Economic activity

Sluggish recovery in economic activity

The economy will advance at quite a moderate rate at the beginning of 2011...

The Spanish economy gradually consolidated its progress during the second half of 2010. Although the rate of growth for gross domestic product (GDP) is still at a moderate level, standing at 0.2% in year-on-year terms in the third quarter, available indicators suggest that the economy's gradual revival continued in the fourth quarter. This trend will continue in 2011, partly thanks to support from the foreign sector, but the limited progress that will be seen by domestic demand will keep the growth rate below its potential. Until private consumption and investment liven up, something that will happen gradually throughout the year, the pace of progress will be quite restrained.

...due to weak domestic demand.

In fact, according to the latest data available on demand, the recovery experienced by private consumption was quite fragile, although its performance in the last part of the year was somewhat more favourable. The retail sales index reduced its decline by five tenths of a percentage point, with a drop of 1.6% year-on-year in the month of November. For their part, vehicle registrations fell in December by 23.9% year-on-year, although this rate continues

DEMAND INDICATORS

Percentage change over same period year before

	2008	2009	2009	2010					
			4Q	1Q	2Q	3Q	October	November	December
Consumption									
Production of consumer goods (*)	–4.7	–8.2	–1.7	0.4	2.5	0.4	–1.2	–1.3	...
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	–23.9
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	–23.0
Investment									
Capital goods production (*)	–8.8	–22.1	–10.3	–2.4	–1.7	–6.3	–6.9	1.4	...
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	1.3
Foreign trade (**)									
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.

to be affected by the end of the Plan 2000E. More qualitative indicators also point to consumption's recovery continuing to be weak. Consumer confidence worsened in the fourth quarter compared with the previous period, standing at a level somewhat lower than that recorded twelve months earlier. Given that this indicator is still below its historical average, a fast recovery in consumption is unlikely in the short term.

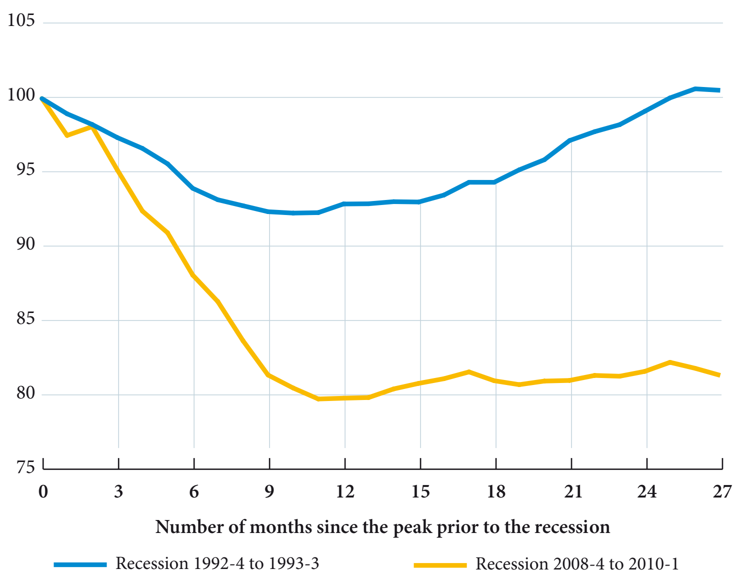
Neither does investment as a whole seem to be on the road to recovery. In this case, however, this is due to the poor performance of the construction industry. For example, the confidence indicator for construction intensified its year-on-year drop in December by four percentage points, so that we can't be very optimistic about this sector reviving over the coming months. Neither will it be helped by the withdrawal of tax deductions for first-home buyers, coming into force as from January 2011. The rest of the indicators, however, offer a somewhat more positive outlook. For example, imports of capital equipment were up 14.5% year-on-year in October. Similarly, in the fourth quarter registrations of load-bearing industrial vehicles got back to positive year-on-year rates after several consecutive months of decline. This indicates that there is some dynamism in sectors not directly linked to construction and allows us to be relatively optimistic regarding the future performance of the economy as a whole.

An analysis of the trend in the industrial production index also provides a good picture of the current situation. Since the peak previous to the recession, activity has picked up very slowly, only recovering two points from the maximum level lost, namely 20%. This contrasts with the trend in the index after the 1992-1993 recession, when recovery was somewhat faster.

Investment continues to worsen in the construction sector but improves in the rest.

SLOW RECOVERY IN INDUSTRIAL PRODUCTION AFTER THE RECENT CRISIS

Industrial production index



NOTE: Adjusted for seasonal factors and six-month moving averages.
SOURCES: National Institute of Statistics and own calculations.

Surprising rise in the industrial production index in November.

However, November's figures for the industrial production index point to a possible change in trend in some of its main components. This has led to the calendar-adjusted indicator increasing its rate of growth by more than four percentage points in year-on-year terms, standing at 2.3%. However, the volatility of this series requires us to be cautious and we must wait for the figures from the coming months in order to confirm any change in trend.

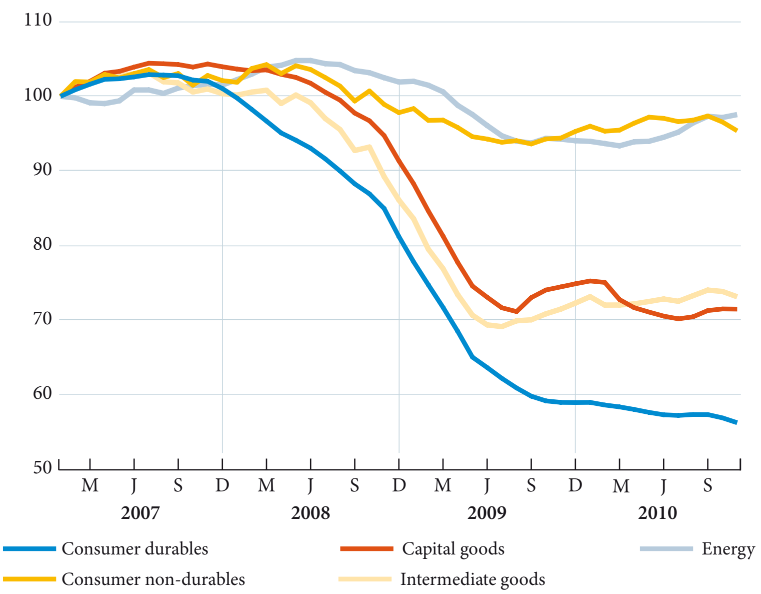
As can be seen in the graph, consumer durables appear to have the most negative basic trend. Not only have they not touched bottom, their decline got worse during the second half of 2010 after the hike in value added tax (VAT).

The rest of the components, which have not yet managed to define any clear trend, were surprisingly positive in the month of November. Of particular note is the dynamism shown by capital goods, boosting their year-on-year growth rate by more than eight percentage points, up to 1.4%. Progress in the production of capital goods is important in measuring the advance being made in activity, as it accounts for more than 20% of the total. Moreover, if this item does not increase, this might mean that companies have enough production capacity to meet demand and do not therefore need to renew their machinery. The fact that capital goods production has risen so much is therefore encouraging, especially after the slight stagnation in production over the last few months.

The progress made by the industrial production of intermediate goods, which account for more than a third of the total, is also more favourable, as its year-on-year rate rose by five percentage points to 4%.

CONSUMER DURABLES LEAD THE FALL IN INDUSTRIAL PRODUCTION

Industrial production index



NOTE: Seasonally adjusted and six-month moving averages.
SOURCES: National Institute of Statistics and own calculations.

SUPPLY INDICATORS

Percentage change over same period year before

	2008	2009	2009	2010					
			4Q	1Q	2Q	3Q	October	November	December
Industry									
Electricity consumption (1)	0.5	–4.3	–1.4	2.7	4.6	1.8	2.0	3.3	2.9
Industrial production index (2)	–7.3	–15.8	–5.6	0.3	2.9	–0.2	–1.9	2.3	...
Confidence indicator for industry (3)	–18.0	–31.2	–24.1	–20.1	–14.4	–13.7	–10.0	–10.0	–8.0
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	–9.6
Confidence indicator for construction (3)	–22.6	–30.6	–24.5	–24.9	–24.3	–28.0	–32.0	–43.0	–49.0
Housing (new construction approvals)	–59.4	–58.1	–45.5	–24.4	–10.3	–13.2	–37.1	...	...
Government tendering	3.0	–8.2	–17.0	–50.5	–11.1	–36.4	0.1	...	...
Services									
Retail sales (6)	–6.0	–5.4	–2.7	0.7	–0.2	–2.5	–0.8	–1.2	...
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	7.4	...	...
Goods carried by rail (ton-km)	–7.7	–28.4	–7.7	4.5	20.9	5.9	–10.0	–0.7	...
Air passenger traffic	–3.0	–7.9	–0.5	3.5	–0.6	4.2	8.6	5.1	–2.3
Motor vehicle diesel fuel consumption	–3.8	–5.1	–2.0	–0.5	–0.6	–2.1	–4.9	...	...

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

For their part, the production of consumer non-durables and of energy show a slightly positive trend, thereby offering some respite to supply.

For the moment, the foreign sector continues to be the great reference point for the Spanish economy in its gradual recovery and of particular note is the good performance by exports, up by 24% in November. Domestic demand will also gradually pick up speed throughout the year, helping the growth rate for the economy as a whole to improve in 2011. Indicators for sectors not related to construction are already offering a more positive outlook and this is fundamental for consumption to gradually win back confidence.

Strong upswing in the industrial production of capital goods.

Labour market

Slight improvement in the labour market's performance

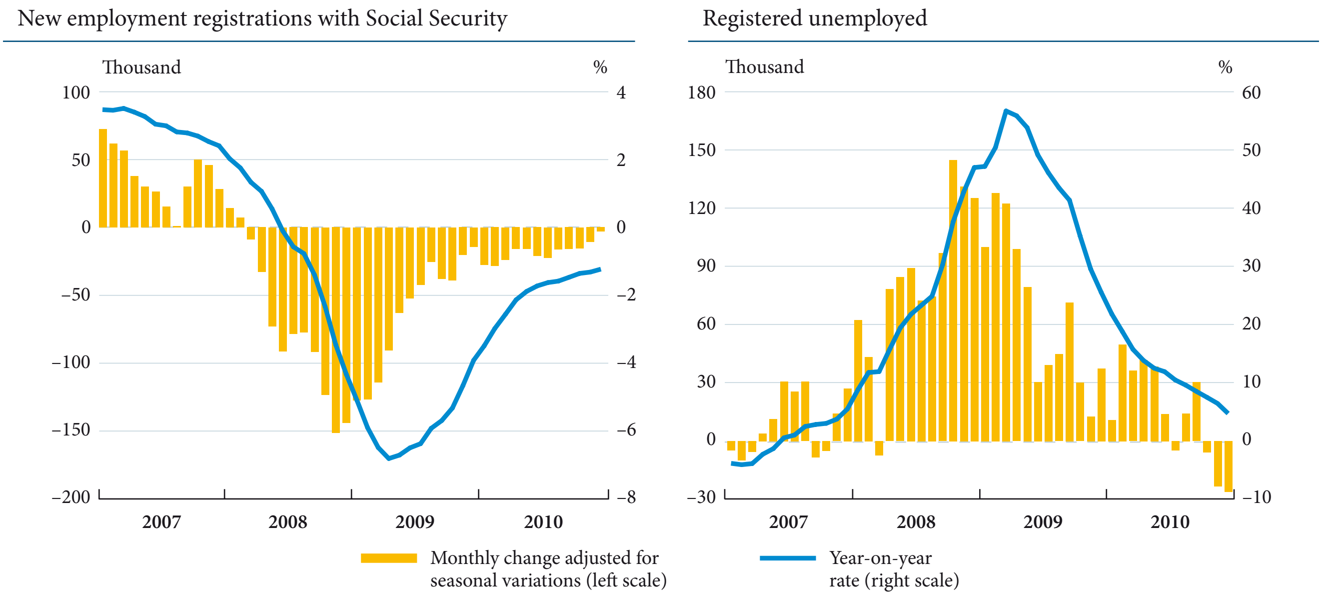
Close to 220,000 jobs lost in the last year.

The weak progress made by economic activity is hindering a change in trend in job creation so that, in the first quarter of 2011, the number of employed is expected to fall further. Nonetheless, after months of stagnation in employment's recovery, in December the fall in the number of people registered as employed with Social Security was lower. In this month, the total number of employed fell by 27,728 people compared with the previous month (3,000 seasonally adjusted), bringing the year-on-year rate down by one tenth of a percentage point to 1.2%. In 2010 as a whole, registrations were down by almost 220,000, a smaller decrease than the one recorded during 2009, in which more than 700,000 jobs were lost. These figures therefore show that the employment situation is continuing to deteriorate, albeit not so intensively.

The services sector creates jobs in December, helped by the Christmas campaign.

An example of how the labour market is still failing to reactivate with any energy becomes clear when we look at the trend in the sector with the highest volume of labour, namely services. In fact, although this was the only sector to generate employment in December, with a rise of 20,000 people and therefore maintaining its job creation rate at 0.4% year-on-year, seasonally adjusted, the figures reveal a highly marginal increase in employment. The other sectors of activity, construction and industry, continued to lose jobs, albeit

AFTER MONTHS OF STAGNATION, EMPLOYMENT STARTS TO PICK UP AGAIN



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

EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2008	2009	2009	2010					
			4Q	1Q	2Q	3Q	October	November	December
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*	*–3.1*
Construction	*–10.3*	*–23.1*	*–18.9*	*–16.4*	*–13.1*	*–12.5*	*–11.8*	*–11.3*	*–10.9*
Services	*1.7*	*–2.6*	*–2.1*	*–0.8*	*0.1*	*0.4*	*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*	*–1.1*
Non-wage-earners	*0.4*	*–4.8*	*–4.9*	*–4.0*	*–3.0*	*–2.4*	*–2.1*	*–1.9*	*–1.8*
Total	**–0.5**	**–5.8**	**–4.6**	**–3.0**	**–1.9**	**–1.6**	**–1.4**	**–1.3**	**–1.2**
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	8.6
Temporary	–10.4	–13.5	–2.1	3.7	5.2	3.5	–0.3	4.8	4.3
Total	**–10.9**	**–15.5**	**–4.3**	**2.0**	**4.2**	**2.6**	**–0.9**	**4.4**	**4.6**

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

somewhat more moderately, placing their year-on-year drop at 10.9% and 3.1%, respectively.

This disparate progress between sectors also marks the difference between employment trends in terms of gender and nationality, as both men and immigrants are more widely present in those sectors hardest hit by the economic crisis. Consequently, while registrations among women ended the year with a slightly positive balance, rising 0.1% year-on-year in December, among men the year closed with a drop of 2.3% year-on-year. As a result, the ratio of female workers compared with the total workforce continued to grow, reaching 45.2%. The figures also show that, in 2010, the fall in the number of registered workers was sharper among those of foreign nationality that among Spaniards, namely 1.8% and 1.2% year-on-year, respectively.

A more optimistic view is provided by the data from employment contracts, as their year-on-year rate was positive last year, at 2.8%. This contrasts with the drops in the total number of contracts of 10.9% and 15.5% in 2008 and 2009, respectively, and therefore suggests that the labour market has now left the worst of the crisis behind it. Moreover, for the first time since mid-2007, permanent contracts stopped falling compared with the previous year in the last quarter of 2010. However, around 92% of the contracts signed in December were temporary.

After two years of decline, the total number of contracts grows in 2010.

Unemployment stands at around four million

Registered unemployment rises by 4.5% in one year.

Registered unemployment at the public employment offices fell by 10,221 people in December to a total of 4,100,073, a larger decrease than expected, with the consequent moderation in the year-on-year growth of close to two points, down to 4.5%. Moreover, seasonally adjusted, unemployment fell by around 25,000 people, the first drop in December since the crisis started. However, part of this brake on the rise in total registered unemployed is probably due to some unemployed leaving the job market completely, as it is not generating jobs at present.

The number of unemployed without benefit entitlement increases.

On the other hand, in the last few months the total number of people receiving benefit saw a slight drop due to the relative rise in long-term unemployed, who are no longer entitled to contribution-based benefits. If this trend continues, the number of people who are not receiving any benefit or aid is therefore likely to increase in the short term, as the overall number of unemployed is not expected to fall before the second quarter of 2011. This fact, together with the reduction in purchasing power of workers' salaries, might have a negative effect on consumption in the short term and thereby slow up the recovery in economic activity. Given this situation, we should note the reorientation of aid programmes for the unemployed that will restrict benefit to those who commit to some kind of training. This new system replaces the so-called Prodi plan, which gave 426 euros to those unemployed that had used up all their benefit entitlement.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

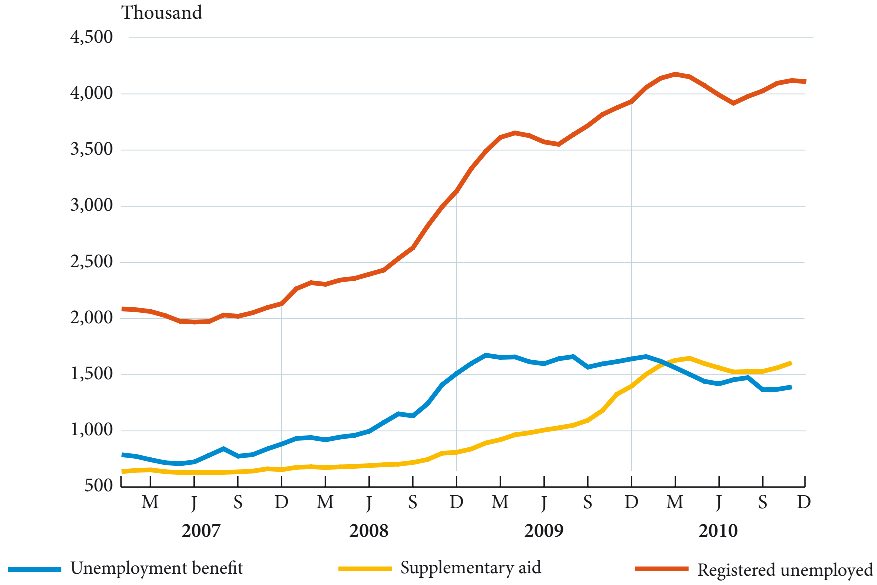
December 2010

	No. of unemployed	Change over same period year before		% share
		Absolute	%	
By sector				
Agriculture	126,829	20,696	19.5	3.1
Industry	491,638	–17,164	–3.4	12.0
Construction	753,067	–28,657	–3.7	18.4
Services	2,371,939	130,874	5.8	57.9
First job	356,600	70,721	24.7	8.7
By sex				
Males	2,053,188	40,652	2.0	50.1
Females	2,046,885	135,818	7.1	49.9
By age				
Under 25 years	433,774	–12,995	–2.9	10.6
All other ages	3,666,299	189,465	5.4	89.4
TOTAL	**4,100,073**	**176,470**	**4.5**	**100.0**

SOURCES: Public State Employment Service and own calculations.

THE END OF THE RISE IN REGISTERED UNEMPLOYMENT CONSOLIDATES

Those receiving unemployment-related benefit and aid



SOURCES: Public Employment Offices and own calculations.

Prices

In 2010, inflation rises by 1.8% on average as a result of higher oil and commodity prices and the hike in indirect taxes.

Inflation ends 2010 at 3.0%, a higher figure than forecast

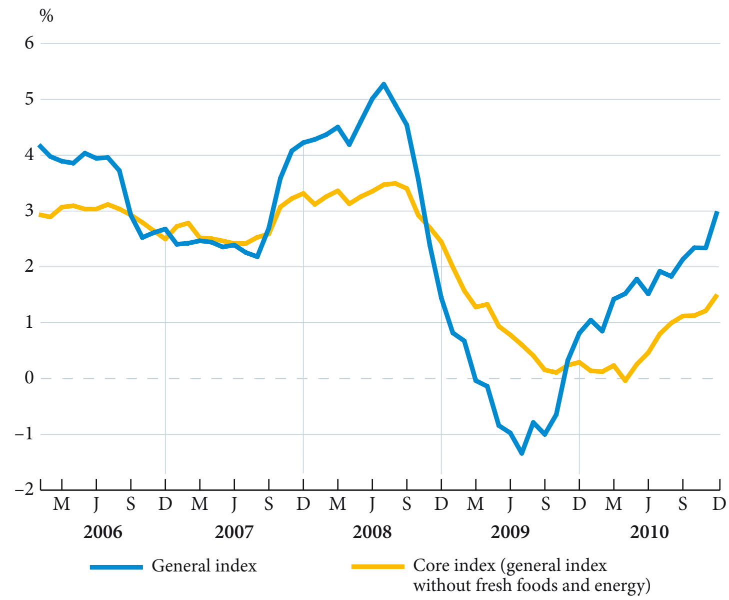
The year-on-year change in the consumer price index (CPI) went up by seven tenths of a percentage point in December to 3.0%, the highest rate since October 2008 when it reached 3.6%. This strong upswing was a consequence of rising commodity prices, especially oil, and of the tax hike on tobacco, and is at a considerably higher rate than the 0.8% recorded for the same month a year ago. Consequently, after a 2009 affected by the uncertainty of possible deflation, 2010 has ended dogged by quite a different concern, namely stagflation: stagnant growth and high prices.

Naturally, the effects of rising prices on economic activity are very different if they result from a more dynamic economy than if they are attributable to higher prices for oil, commodities, higher indirect taxes or rises in other officially regulated prices, such as electricity. In this second case, families' purchasing power decreases and this can intensify cutbacks in domestic consumption and worsen the economic situation.

One indication that the recent price rises might hinder the economy's recovery becomes clear when we look at the variation in core inflation, which

INFLATION SHOOTS UP DUE TO COMMODITIES AND TOBACCO TAX

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	0.6	3.0	3.0

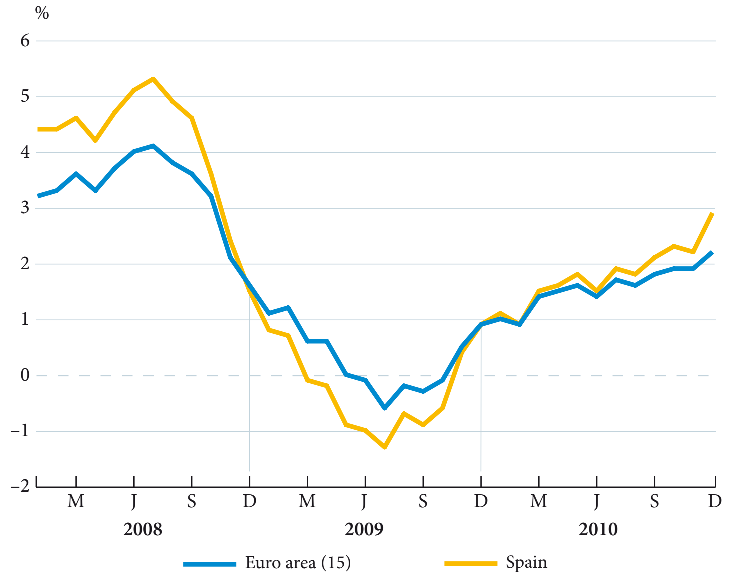
SOURCE: National Institute of Statistics.

excludes energy and fresh foods and therefore better reflects the dynamism of domestic demand than the general index.

Within this context, it should be noted that it was the change in the tobacco tax in December and not stronger consumption that boosted core inflation

STRONG UPSWING IN THE INFLATION DIFFERENTIAL COMPARED WITH THE EURO AREA

Year-on-year change in HCPI



SOURCES: National Institute of Statistics, Eurostat and own calculations.

The tax hike on tobacco raises inflation by almost two tenths of a percentage point in December.

by three tenths of a percentage point to 1.5%, as the rest of the components helped to contain rising prices. In particular, the rise in the special tax on tobacco, a product that accounts for 2% of the total basket used to calculate the general CPI, accentuated its price rise in December by 21% year-on-year, leading the general CPI to go up by more than four tenths of a percentage point that month. This trend in the main components of inflation therefore points towards household expenditure still being weak in spite of the upswing in inflation, so that most firms probably tended to hold down their prices to boost sales.

Another negative result of this upswing in inflation is the loss of competitiveness. This can be seen when we compare the trend in prices in Spain with the trend in the rest of the euro area countries. Consequently, according to data from Eurostat, the harmonized inflation rate for December for the euro area stood

CONSUMER PRICE INDEX BY COMPONENT GROUP

December

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2009	2010	2009	2010	2009	2010
By type of spending							
Food and non-alcoholic beverages	108.8	0.2	0.4	–2.4	0.7	–2.4	0.7
Alcoholic beverages and tobacco	145.1	–0.1	6.1	12.7	15.2	12.7	15.2
Clothing and footwear	108.6	–1.2	–1.2	–0.8	0.6	–0.8	0.6
Housing	119.0	0.0	0.3	0.8	5.7	0.8	5.7
Furnishings and household equipment	108.5	0.1	0.2	0.8	1.0	0.8	1.0
Health	96.3	0.0	0.0	–1.3	–1.2	–1.3	–1.2
Transport	112.9	–0.5	1.9	3.9	9.2	3.9	9.2
Communications	98.6	0.0	0.0	–0.3	–0.7	–0.3	–0.7
Recreation and culture	97.5	1.4	1.3	–1.1	–1.1	–1.1	–1.1
Education	117.1	0.0	0.0	2.7	2.3	2.7	2.3
Restaurants and hotels	113.7	0.0	0.2	1.2	1.7	1.2	1.7
Other goods and services	112.9	0.1	0.2	2.1	2.8	2.1	2.8
By group							
Processed food, beverages and tobacco	114.7	0.1	1.4	0.7	2.6	0.7	2.6
Unprocessed food	109.5	0.2	0.6	–3.1	2.6	–3.1	2.6
Non-food products	110.2	–0.1	0.5	1.1	3.1	1.1	3.1
Industrial goods	108.0	–0.5	0.6	0.7	4.7	0.7	4.7
Energy products	*124.0*	*–0.6*	*2.8*	*7.5*	*15.6*	*7.5*	*15.6*
Fuels and oils	*121.1*	*–0.8*	*3.8*	*7.9*	*18.4*	*7.9*	*18.4*
Industrial goods excluding energy products	*102.3*	*–0.4*	*–0.3*	*–1.7*	*0.9*	*–1.7*	*0.9*
Services	112.5	0.3	0.4	1.6	1.6	1.6	1.6
Underlying inflation (**)	109.3	0.0	0.3	0.3	1.5	0.3	1.5
GENERAL INDEX	**111.0**	**0.0**	**0.6**	**0.8**	**3.0**	**0.8**	**3.0**

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

at 2.2%, while Spain's index was 2.9%. The inflation differential with the euro area therefore went up to 0.7 percentage points.

Inflation is expected to continue rising slightly in January due to price rises in electricity and other officially regulated services. However, subsequently, inflation will tend to ease due to weak consumption, the reversal of the VAT effect in the second half of 2011 and particularly because we expect the pressure from commodity prices to weaken over the coming months.

Lastly, producer prices continued their upward trend in the month of November, increasing by three tenths of a percentage point to 4.4% year-on-year, driven particularly by consumer and intermediate goods. This was partly affected by the increase in raw materials. On the other hand, the energy sector slowed up its rise, although it continued to be the most important part of the rise in producer prices. Regarding import producer prices, these saw bigger increases, namely 9.2% in the last twelve months up to November, a higher rate than that of the previous month, partly due to the euro's depreciation.

Spain loses competitiveness as its price differential with the euro area increases.

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											
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	5.1	2.7	0.0	0.5	3.4	7.0	8.7	6.0	1.8	10.2	1.4
September	8.0	3.4	0.2	0.5	4.0	9.1	9.2	6.0	1.8	10.6	–
October	...	4.1	0.6	0.5	4.3	10.5	8.6	6.4	1.7	10.5	–
November	...	4.4	0.9	0.6	5.1	10.6	9.2	7.7	2.2	10.9	...

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

Foreign sector

The trade deficit improves in spite of the price of crude

The trade deficit falls by 20% in November.

In November, the trade deficit posted its fourth consecutive reduction, namely 20.1% year-on-year, reaching 3.88 billion euros. This improvement in the trade imbalance is due to a strong upswing in exports, which increased by 24.6% in the same period, approximately double the growth in imports. However, the situations for both series are quite different. The rise in exports was due to greater demand for Spanish goods abroad, while the increase in import prices in November, especially oil, lay behind more than three quarters of imports' rise. In fact, the trend in the price of crude will be a key factor for the trade deficit in the medium term.

Rising oil prices might hinder the correction in the deficit.

In particular, the correction in the non-energy balance, 57.1% compared with the same month in 2009, brought the accumulated deficit for the last twelve months down to the levels of 1998.

FOREIGN TRADE

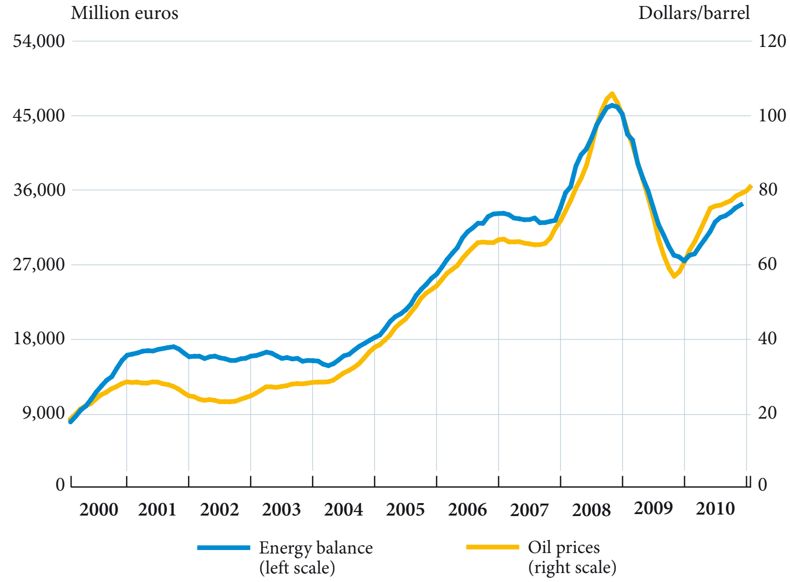
January-November 2010

	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	39,943	27.8	18.4	8,094	30.2	4.8	–31,849	20.3
Consumer goods	54,082	–9.1	25.0	57,267	–0.7	33.7	3,185	105.9
Food	*14,117*	*5.8*	*6.5*	*21,520*	*11.5*	*12.7*	*7,404*	*152.4*
Non-foods	*39,965*	*–13.4*	*18.4*	*35,747*	*–6.8*	*21.0*	*–4,219*	*89.4*
Capital goods	16,527	9.4	7.6	14,351	19.6	8.4	–2,176	86.8
Non-energy intermediate goods	106,207	25.2	49.0	90,130	31.1	53.1	–16,077	84.9
By geographical area								
European Union	118,793	6.7	54.8	115,114	14.9	67.8	–3,679	96.9
Euro area	*95,609*	*4.2*	*44.1*	*94,541*	*14.6*	*55.7*	*–1,068*	*98.9*
Other countries	97,968	23.5	45.2	54,729	23.1	32.2	–43,238	55.9
Russia	*5,560*	*31.6*	*2.6*	*1,824*	*33.3*	*1.1*	*–3,736*	*32.8*
United States	*8,454*	*7.5*	*3.9*	*5,965*	*12.6*	*3.5*	*–2,489*	*70.6*
Japan	*3,195*	*11.8*	*1.5*	*1,296*	*18.2*	*0.8*	*–1,898*	*40.6*
Latin America	*13,037*	*32.6*	*6.0*	*9,296*	*31.8*	*5.5*	*–3,740*	*71.3*
OPEC	*20,709*	*32.6*	*9.6*	*6,245*	*8.6*	*3.7*	*–14,465*	*30.2*
Rest	*47,013*	*20.7*	*21.7*	*30,103*	*26.0*	*17.7*	*–16,910*	*64.0*
TOTAL	**216,760**	**13.7**	**100.0**	**169,843**	**17.5**	**100.0**	**–46,917**	**78.4**

SOURCES: Ministry of the Economy and own calculations.

RISING OIL PRICES PREVENT LARGER REDUCTIONS IN THE TRADE DEFICIT

Data accumulated over the last twelve months and 12-month moving average



SOURCES: Ministry of the Economy and own calculations.

Improved trade balance with the euro area.

However, this improvement was partially offset by the energy deficit which, after November's 14.2% rise, reached more than 34 billion euros between December 2009 and November 2010, close to two thirds of the total. The bulk of the evidence suggests that this trend will continue in the short and medium term. As can be seen in the graph, the inelasticity of energy demand means that the energy balance is closely tied to the trend in oil prices, which are expected to approach 94 dollars per barrel over the next few years. If this relationship continues between both series in the future, this might push the energy deficit up to nearly 40 billion euros, more than 3% of Spanish GDP, becoming a clear obstacle to reducing Spain's trade deficit.

November's figures show some trends that, should they continue, might lead to further improvements in the trade balance in the future. In fact, growth in exports to the euro area (which account for more than half the total) is intensifying. Spain's trade balance with the rest of the countries in the monetary union was therefore positive in November, a situation not seen since 1996. The upswing in exports to France, Italy and Portugal are the main reason behind this improvement. However, the tensions appearing in the European Union due to sovereign debt and the economic consequences for some countries might put a stop to this trend.

Widespread improvement in all current account components

The current deficit falls by 45% in October.

The latest figures for the current account balance for October place the deficit at 2.7 billion euros, 44.9% lower than the figure recorded for the same month a year ago. This adjustment is due to the improvement in all components that make up the current balance, something that has not occurred since May 2009.

BALANCE OF PAYMENTS

October 2010

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change: Absolute	Annual change: %
Current account balance					
Trade balance	–37,980	2.7	–46,126	1,255	–2.6
Services					
Tourism	24,393	3.3	26,829	575	2.2
Other services	340	–	501	1,382	–
Total	24,734	8.8	27,331	1,957	7.7
Income	–18,655	–27.6	–23,409	8,424	–26.5
Transfers	–9,182	1.4	–8,108	682	–7.8
Total	**–41,083**	**–16.3**	**–50,312**	**12,318**	**–19.7**
Capital account	**5,096**	**77.4**	**6,282**	**2,960**	**89.1**
Financial balance					
Direct investment	–1,053	–	–4,936	–1,289	35.3
Portfolio investment	36,211	21.7	51,375	42,088	453.2
Other investment	533	–91.3	–2,272	–38,741	–
Total	**35,690**	**–7.6**	**44,167**	**2,058**	**4.9**
Errors and omissions	–8,813	178.2	–8,655	–6,275	263.6
Change in assets of Bank of Spain	9,109	–17.6	8,519	–19,688	–69.8

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.

The services surplus peaks in October.

The components with the largest contribution to this correction were services and current transfers, with 29.1% and 31.9%, respectively.

Moreover, the further rise in the services surplus pushed the accumulated figure for this balance for the last twelve months over 27 billion euros, a record amount. This meant that the current deficit accumulated over the same period fell to 50.3 billion euros, a figure that would be below 5% of GDP, in line with our forecasts of 4.7% for 2010 as a whole. The good performance of the capital balance surplus once again reduced the Spanish economy's financing needs.

Portfolio investment is the main source of financing in October.

With regard to financial flows, this lower net borrowing in October led to a fall in foreign capital inflows. The data point to portfolio investment as the main source of financing in this month, with net inflows of 23 billion euros, the highest since June 2006. These inflows are due both to higher portfolio investment in Spain by foreigners as well as the withdrawal of Spanish investment (divestment) abroad. On the other hand, the take-up of Eurosystem funds on the part of the Bank of Spain was negative for the fourth consecutive month, with an outflow of 16 billion euros. This figure contrasts with the inflow of almost 70 billion euros which, under this same heading, financed the Spanish economy during the summer months, when sovereign debt tensions erupted.

Public sector

The month of January brings a small hiatus for public accounts

The intensification of the sovereign debt crisis over the last few months of 2010 led to some doubts regarding the sustainability of Spain's public accounts and raised the cost of financing sovereign debt. With the arrival of the new year, the messages of support sent from Brussels and the efforts made to reduce the public deficit helped to ease these tensions slightly. This meant that the central government was able to issue new debt in January at a lower financing cost than for the last issue several months ago. However, there's still a long way to go until public accounts become consolidated again, forcing the executive to maintain its austerity policy.

Tension concerning the public accounts eases in January.

The efforts made to stabilize public accounts can be seen in the reduction of the central government's cash deficit. This fell to 43 billion euros over the first eleven months of 2010, 37.2% less than the same period a year ago. A figure that, according to estimates by the Ministry of the Treasury, is equal to 4.1% of gross domestic product (GDP) in 2010 and 2.4 percentage points less than the figure recorded in November 2009.

In November, the accumulated cash deficit falls to 4.1% of GDP...

This correction is thanks to the economic situation stabilizing and to the measures adopted last year that, as can be seen in the graph, began to impact strongly as from the second half of the year. Among these measures, of note are those boosting non-financial revenue, contributing almost entirely to the improvement in the public accounts during this period. Particularly significant was the rise in value added tax (VAT) as from July 2010, resulting in a 29.2% increase in indirect tax year-on-year during the first eleven months of the year. Although to a lesser extent, direct taxation also rose as a result of withdrawing the 400-euro rebate in income tax and higher withholdings for capital gains.

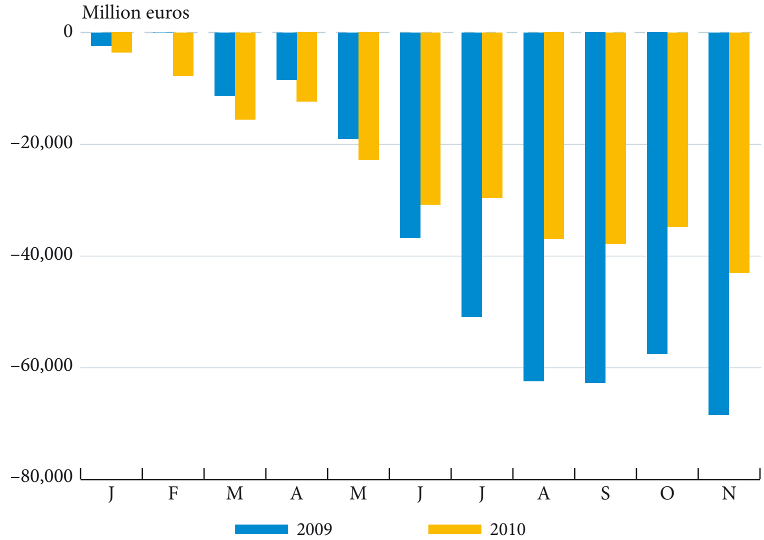
Looking at expenditure, accumulated costs recorded a much smaller variation, shrinking by 0.8% year-on-year. The reductions in investment and capital transfers were particularly significant, down by 17.4% and 10.0% respectively and the lower expenditure on personnel salaries also helped towards this improvement, down by 1.6%. However, financial costs rose by 12.5% up to 19.5 billion euros, a result of the higher interest payments for issuing commercial paper and bonds. As a consequence of these trends in revenue and expenditure, the central government's net borrowing, on a national accounts basis, fell by 45.8% year-on-year to 3.7% of GDP. This figure is more than two percentage points below Spain's target for the year 2010, a goal that looks feasible, although the figures for December are still pending.

This satisfactory correction in its finances helped the Treasury to successfully place 14.5 billion euros of new debt, with varying maturities, during the month of January. The market's good acceptance of these issues, with demand vastly exceeding supply, highlights the credibility of the stabilizing trend in the deficit

...due to higher revenue and cost cutting.

SIGNIFICANT IMPROVEMENT IN THE CASH DEFICIT IN THE SECOND HALF OF THE YEAR

Spain's accumulated cash deficit for the year



SOURCE: Ministry of the Treasury.

The Treasury places 14.5 billion euros of new debt.

set by the executive. Of note is the high proportion of foreign subscriptions, reaching almost three quarters of the total.

But this slight hiatus in sovereign debt tensions in January, extendable to other peripheral countries in Europe, must not make us forget the still fragile public accounts of some member states in the European Union. Because of this, the President of the European Commission, José Manuel Durão Barroso, declared his intention to increase the European Union's bail-out fund to strengthen the euro. Words that have received the support of both the European Central Bank and the International Monetary Fund. However, Germany does not accept this extension unless it is subject to an effective programme of reforms to improve the financial stability and competitiveness of countries in the euro area.

2011 will be accompanied by new measures to guarantee public account stability.

Reforms that, in the case of Spain, are expected to continue to set the agenda for the government over the coming months. Of particular importance is the aid to the banking system through the Fund for Orderly Bank Restructuring (FROB) and the negotiations to raise the retirement age to 67. All without losing sight of recent debate concerning the adjustment of the deficit of the autonomous communities. A deficit that looks more than likely to exceed the target set for 2010, namely 3.1% of GDP.

Savings and financing

Private sector financing advances hesitantly

The savings and financing of the Spanish resident sector are mostly determined by the state of the country's economic cycle and its banking system and both these variables showed signs of weakness throughout 2010. The Spanish economy remained practically stagnant with an unemployment rate above 20%. For its part, the banking system saw how, in the midst of its reconstruction process, the wholesale financing channels shrivelled due to tension in the sovereign debt markets. Nonetheless, at the end of last year some indications of a recovery in credit started to emerge.

Taking into account the gradual improvement of the Spanish economy, whether this trend will continue in 2011 will depend on the ability of the Spanish financial system to overcome the challenges facing it throughout the year.

Specifically, private sector financing grew in November for the third consecutive month, up 0.4% year-on-year. This tentative acceleration is particularly due to the financing of non-financial firms, which increased by 0.7% year-on-year. Loans from abroad and securities other than shares were the main sources of finance last year. However, a certain stagnation can be observed in bond issues over the last few

Economic stagnation and difficulties in wholesale markets have determined savings and financing flows in 2010.

FINANCING OF NON-FINANCIAL SECTORS (1)

November 2010

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,222,076	9,119	0.4	77.8
Non-financial corporations	1,320,019	10,818	0.7	46.2
Resident credit institution loans (3)	*905,797*	*–10,564*	*–0.6*	*31.7*
Securities other than shares	*64,808*	*8,609*	*17.8*	*2.3*
External loans	*349,415*	*12,773*	*1.3*	*12.2*
Households (4)	902,057	–1,699	–0.1	31.6
Housing loans (3)	*675,838*	*–2,714*	*0.1*	*23.7*
Other (3)	*222,632*	*808*	*–0.8*	*7.8*
External loans	*3,587*	*207*	*4.6*	*0.1*
General government (5)	632,306	71,684	14.2	22.2
TOTAL	**2,854,450**	**80,870**	**3.1**	**100.0**

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

Credit grows for the first time in fourteen months and non-performing loans stand still.

The rate of growth in public debt falls.

months due to tensions in the financial markets. This trend contrasts with the recent improvement in loans from resident financial institutions, which continued to pick up after falling to their lowest level last August. Meanwhile households experienced practically no change in their level of financing over the same period, housing loans being the only ones to grow year-on-year.

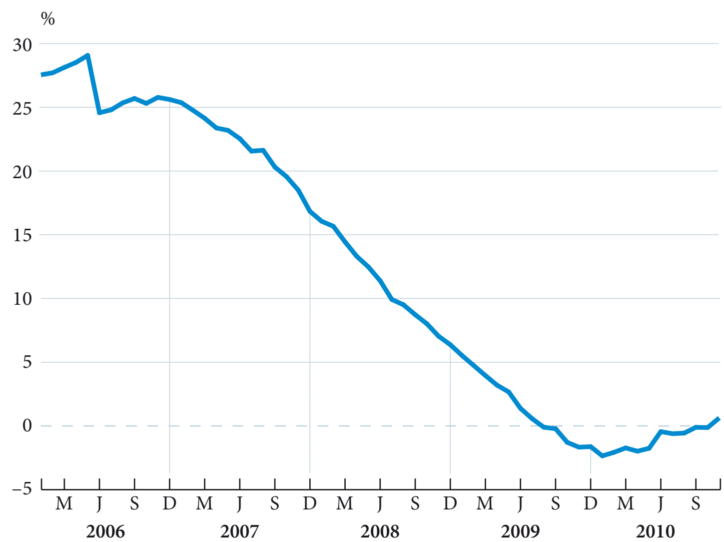
As a consequence of this rise in private financing, total credit granted by financial institutions in November grew by 0.5% year-on-year. As can be seen in the graph below, this was the first rise since July 2009. In spite of a breakdown still not being available, everything points to an improvement in credit to households aimed at buying housing and to industry and services being the main reasons for this increase. Another piece of good news is that the doubtful debt rate stood still in November, at 5.68%.

All this took place in a month when the interest rates for financing new credit operations to resident sectors halted their own rise, standing at 3.53%, four basis points below the previous month. Nevertheless, further increases are expected in the short term resulting from the upward trend in interbank interest rates and the expectation of interest rate hikes by the European Central Bank in the medium term.

Regarding general government financing, this continued to grow at a fast rate, namely 14.2% year-on-year in November, boosted by medium and long-term issues. However, a significant slowdown can be observed in this rise, as it is now eighteen percentage points below the peak recorded one year ago. This is due to the recent austerity measures adopted by the government and the rising cost of financing, which reached record highs in November.

CREDIT TO OTHER RESIDENT SECTORS GROWS IN NOVEMBER

Year-on-year percentage change



SOURCE: Bank of Spain.

Mutual funds still fail to pick themselves up

Bank deposits continue to grow in November...

In 2010, the strong tensions regarding sovereign debt in the European Union made it difficult for Spanish banks to access the wholesale markets. The banks and savings banks therefore continued to increase their private deposits (the savings of households and non-financial firms). This need for resources to finance banking business led to a steady rise in the interest rate for deposits. Consequently, in November, the rate for term deposits for households reached 2.82% on average, 60 basis points higher than the rate being offered a year ago. This boosted term deposits, which rose by 3.4% in the same period. Meanwhile, deposits in general increased by 2.2% compared with the same month in 2009, two tenths of a percentage point more than in October.

...to the detriment of mutual funds.

But this competition to attract bank deposits, together with the economy's need for liquidity, had a clear casualty throughout last year: mutual funds. At 31 December 2010, the assets for these funds had fallen to 138 billion euros, 15% lower than a year ago. This figure represents almost half the accumulated assets in 2007, the year in which they peaked. Another factor also prompting these withdrawals was the low return during the year, on average 0.1%, with only international equity funds providing returns above inflation. For the year as a whole, the largest outflows corresponded to short-term bonds and monetary funds.

What are the prospects for savings and financing in Spain in the medium term? As mentioned at the beginning, the keys to the future that will determine how these perform lie in the Spanish economy's performance and the robustness of its banking system. For the former, the economy is expected to recover progressively and the lower unemployment rate is expected to gradually reactivate the demand for credit. Regarding the short and medium-term future for the banking system, this will be determined by the gradual improvement in international finance markets and the results of the stress tests. The bulk of the evidence available suggests that these tests, which will be carried out in spring, will introduce stricter measures regarding institutions' sovereign debt exposure and liquidity. The reason for these tougher measures

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

November 2010

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	252,046	–10,689	–4.1	–3,752	–1.5	17.4
Savings deposits	206,240	–1,551	–0.7	5,080	2.5	14.3
Term deposits	737,772	17,761	2.5	24,505	3.4	51.1
Deposits in foreign currency	21,783	–232	–1.1	–138	–0.6	1.5
Total deposits	**1,217,842**	**5,289**	**0.4**	**25,694**	**2.2**	**84.3**
Other liabilities (*)	**226,550**	**13,420**	**6.3**	**23,666**	**11.7**	**15.7**
TOTAL	**1,444,392**	**18,709**	**1.3**	**49,360**	**3.5**	**100.0**

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

New stress tests for banking in July.

is to prevent a repetition in Europe of a situation such as the one that affected the Irish financial system, which after passing the tests last summer found itself immersed in an intensive restructuring process that ended up nationalizing some banks.

Given this scenario, the Spanish government has decided to undertake new measures to ensure its banking sector passes these stress tests, renewing the confidence of the financial markets. To this end, new debt issues are being prepared by the Fund for Orderly Bank Restructuring (FROB) in order to facilitate the recapitalization of the savings bank sector. A sector that is facing the challenge of meeting the new demands made by the government, including a rise in minimum capital requirements to 8% of the risk-weighted assets.

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As of December 31, 2009

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

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

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

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