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THE SPANISH ECONOMY

Monthly Report

REFORMING THE FINANCIAL SYSTEM

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2009	2010	2011	2010				2011	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast					Forecast	
Gross domestic product									
United States	–2.6	2.9	3.0	2.4	3.0	3.2	2.8	2.7	3.1
Japan	–6.3	4.0	0.6	5.4	3.3	4.7	2.6	1.4	–0.1
United Kingdom	–4.9	1.8	2.1	–0.3	1.7	2.8	2.8	2.7	1.9
Euro area	–4.0	1.7	1.5	0.8	2.0	1.9	2.0	2.1	1.4
Germany	*–4.7*	*3.5*	*2.4*	*2.1*	*3.9*	*3.9*	*4.0*	*4.1*	*2.2*
France	*–2.5*	*1.5*	*1.6*	*1.2*	*1.6*	*1.7*	*1.5*	*1.9*	*1.5*
Consumer prices									
United States	–0.3	1.6	2.7	2.4	1.8	1.2	1.2	2.1	3.0
Japan	–1.4	–0.7	1.0	–1.1	–0.9	–0.8	0.1	0.1	0.9
United Kingdom	2.2	3.3	4.0	3.3	3.4	3.1	3.4	4.1	4.2
Euro area	0.3	1.6	2.3	1.1	1.5	1.7	2.0	2.4	2.5
Germany	*0.4*	*1.1*	*2.1*	*0.7*	*1.0*	*1.2*	*1.5*	*2.1*	*2.1*
France	*0.1*	*1.5*	*1.9*	*1.3*	*1.6*	*1.5*	*1.7*	*2.1*	*2.0*
SPANISH ECONOMY			Forecast					Forecast	
Macroeconomic figures									
Household consumption	–4.3	1.3	0.9	–0.3	2.2	1.5	1.7	1.0	–0.1
Government consumption	3.2	–0.7	–1.7	–1.1	–0.1	–0.7	–0.9	–0.9	–2.4
Gross fixed capital formation	–16.0	–7.5	–3.6	–10.5	–6.7	–6.7	–6.1	–5.1	–5.2
Capital goods	*–24.8*	*1.9*	*3.0*	*–4.6*	*8.7*	*2.4*	*1.2*	*1.7*	*–1.3*
Construction	*–11.9*	*–11.1*	*–7.5*	*–11.3*	*–11.3*	*–11.2*	*–10.6*	*–9.4*	*–8.7*
Domestic demand (contribution to GDP growth)	–6.4	–1.2	–0.6	–3.0	–0.3	–0.7	–0.6	–0.7	–1.7
Exports of goods and services	–11.6	10.3	9.4	9.4	11.9	9.4	10.5	8.5	9.5
Imports of goods and services	–17.8	5.5	4.7	2.0	9.6	5.0	5.3	3.1	1.0
Gross domestic product	**–3.7**	**–0.1**	**0.5**	**–1.4**	**0.0**	**0.2**	**0.6**	**0.6**	**0.5**
Other variables									
Employment	–6.6	–2.3	–0.5	–3.8	–2.5	–1.7	–1.4	–0.6	–0.6
Unemployment (% labour force)	18.0	20.1	20.4	20.0	20.1	19.8	20.3	20.6	20.4
Consumer price index	–0.3	1.8	2.9	1.1	1.6	1.9	2.5	3.5	3.1
Unit labour costs	1.0	–1.5	–0.5	–0.9	–0.9	–1.9	–2.3		
Current account balance (% GDP)	–5.5	–4.5	–3.7	–6.0	–5.1	–3.7	–3.2	–4.4	–3.6
Net lending or net borrowing rest of the world (% GDP)	–5.1	–4.2	–3.2	–5.3	–4.4	–3.1	–2.6	–3.9	–3.1
General government financial balance (% GDP)	–11.1	–9.2	–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	1.2	1.0	1.0	1.0	1.0	1.0	1.2
10-year US bonds	3.2	3.2	3.6	3.7	3.5	2.8	2.8	3.4	3.6
10-year German bonds	3.3	2.8	3.5	3.2	2.8	2.4	2.6	3.2	3.4
Exchange rate									
$/Euro	1.39	1.33	1.39	1.38	1.27	1.29	1.36	1.37	1.39

Contents

Reforming the financial system

The worldwide economic crisis that erupted in 2007 highlighted the excessive risk accumulated by the financial system as a whole. In previous years, economic expansion had been exceptionally strong and, moreover, took place within a context of low inflation, rock bottom interest rates and ample liquidity. This cocktail explains why the financial system's expansion was more pronounced than in a normal expansionary cycle and also why the degree of leveraging went beyond what was reasonable, without the regulatory authorities becoming aware of the excessive risk-taking.

Can suitable regulation anticipate and prevent imbalances in the financial system? Probably not, given the difficulty of anticipating all the possible behaviours, developments and innovations. Neither would this be desirable since rigid, narrow regulations would hinder credit flows and would prevent the sector from fulfilling its role as an intermediary. But it is possible to learn from the experience of the crisis and to attempt to repair the current mechanisms with a view to detecting, early enough, excessive risk-taking in the financial system.

In this Report we present various articles that examine some aspects of the current reforms being carried out on the financial system. Proposals are explored that aim to stop institutions that believe themselves to be «too big to fail», given that their bankruptcy would lead to great economic collapse, from taking excessive risks. For these «systemically important» financial institutions, regulatory proposals attempt to raise capital and liquidity requirements above those recently set by Basel III, to introduce taxes and duties that reflect the social cost of systemic risk, tax «excessive» income in the financial sector or establish mechanisms to intervene in institutions in order to make a potential bail-out easier.

Another focus of interest lies in proposals aimed at offsetting or eliminating the procyclical nature of the financial system, i.e. the fact that it does not dampen economic cycles but rather accentuates them. Basel III introduces two key elements to cushion the procyclical effect: capital «buffers» and calculating credit provisions according to the losses expected. The aim is for institutions to set up reserves or provisions during the good times that can be used up during a recession.

Deficiencies in mechanisms to supervise the financial system come to light in adverse scenarios so that, to be on the safe side, one initiative has been to subject institutions to the so-called stress tests. This exercise consists of defining highly negative scenarios and calculating their effect on banks. The United States led the way in carrying these out and the tests helped to restore investor confidence. These tests were also carried out in Europe last year but, in spite of their good effect initially, their inability to predict the collapse of the Irish banking system seriously damaged their credibility. There will be a second round of tests during the next few months, revising the methodology employed in 2010.

Lastly, the Report also looks at derivatives, given their important role in the crisis, and in particular at credit derivatives, proposing various measures in order to avoid their destabilizing potential. However, reform does not stop here as there are many other issues under review, such as the role of rating agencies or the structure of macroprudential supervision. It is to be hoped that these reforms achieve their aims but without hindering the flow of credit, for the good of economic recovery, both in terms of its extent and sturdiness.

EXECUTIVE SUMMARY

The catastrophe in Japan and the war in North Africa; gate-crashing the economies' recovery.

Japan will manage to get over its misfortunes relatively quickly, given its tried and tested ability to recover from adversity.

The involvement of international forces in the Libyan conflict is not helping to ease the price of a barrel of oil.

Confidence in the recovery continues, in spite of everything

2011 is turning out to be anything except boring in terms of the economic situation. It started with good prospects of recovery, thanks to the push from emerging countries and to advanced economies exiting the crisis, although the sudden rise in commodity prices in the last part of 2010 and the persistence of sovereign debt problems in Europe were still of some concern. In the first quarter of 2011, business indicators confirmed the positive signs. But rising commodity prices have been complicated by conflict in the countries of North Africa, Europe's sovereign debt storm has yet to blow away completely and the catastrophe that hit Japan in mid-March raises questions as to its effect on the world's recovery.

We don't think the earthquake and subsequent tsunami that hit northern Japan will alter the course of the global economy, although Japan is the third largest economy in the world after the United States and China. Given the experience of previous natural disasters (particularly the Kobe earthquake in 1995) and assuming that the situation of the Fukushima nuclear plant will soon stabilize, we must conclude that Japan will manage to overcome its misfortunes within a relatively short period of time, given the country's tried and tested ability to recover from adversity. We have reduced our growth forecast for 2011 from 1.3% to 0.7% but have raised our forecast for 2012. We must remember that gross domestic product (GDP) measures the goods and services produced within a certain period, so that this is not a measure of wealth or physical capital. Initial estimates suggest a loss of capital equivalent to at least 4%, but the need to replace these losses will be precisely what will boost GDP in the coming quarters.

Reconstruction costs will be a heavy burden on the Japanese public coffers, already holding the record for the highest debt. Last year its public debt was over 200% of GDP, a worrying situation if it weren't for the fact that most of the debt is held by domestic investors and its financing does not raise doubts for other countries. For its part, the Bank of Japan has reacted quickly by injecting a huge amount of liquidity into the monetary and financial system. It has also intervened in the foreign exchange market to contain the yen's tendency to appreciate, pushed up by the repatriation of capital. This task has received the extraordinary support of the central banks of the G-7 countries, which agreed to intervene jointly in the foreign exchange market, the first time in ten years.

The balance of risks for 2011 has been upset by the escalating conflict in Libya, with the intervention of international forces in a war of uncertain consequences. Although Libya's oil production is relatively limited and the Organization of the Petroleum Exporting Countries has decided to keep up supply, the price of a barrel of crude has remained high. The doubts arising regarding the nuclear accident at Fukushima haven't helped to calm the markets either. It's already starting to be generally accepted that,

this year, the average price per barrel will be above 100 dollars (80 dollars in 2010) and this means less growth for importing economies, due to the consequent reduction in income.

Rising oil prices are currently the biggest risk to growth. In the United States, however, we don't think the economy will deviate from our growth forecast of 3% for 2011. Household consumption is consolidating its recovery and prices remain under control (core inflation was at 1.1% in February). Moreover, business sentiment is still very confident. We are now starting to see this optimism in plans for new contracts. Following this pattern, the labour market showed signs of improvement in February, with 192,000 jobs created and an unemployment rate that once again fell slightly to 8.9%, a figure not seen since April 2009.

In China, both industrial production and investment continue to show marked vitality. Moreover, inflation is remaining above the official target of 4%, so that the central bank has decided to raise the cash reserve ratio, for the third time this year, to 20% for larger institutions. For its part, the Brazilian economy closed 2010 with spectacular growth of 7.6%. The figure for the fourth quarter was also better than expected, with year-on-year growth of 5.0%. The solidity of the Brazilian recovery has therefore been reaffirmed, whose only dark spot comes from growing inflationary tensions that might take the shine off 2011.

In the euro area, developments during the first few months of 2011 have forced us to revise our forecasts for GDP growth, which we have reduced by one tenth of a percentage point to 1.5% for the whole of the year. We have also raised our inflation forecast from 2.1% to 2.3%. This has nothing to do with a change in scenario but it does recognize that rising commodity prices and the risk of somewhat higher interest rates might reduce economic activity. Regarding interest rates, the President of the European Central Bank surprised the markets at the press conference after the meeting of the Governing Council on 3 March by suggesting the institution might raise the reference rate in the near future. The main reason is to keep medium and long-term inflation expectations firmly anchored, at a time when the euro area's harmonized consumer price index has clearly exceeded the threshold of 2%. These statements have led to a radical change in investors' expectations, now assuming the central bank will start to raise interest rates this spring.

Growth seems guaranteed in the United States, while the vitality of emerging countries is pushing up their inflation.

At present, a higher interest rate is not exactly what would be most useful for those European economies that are lagging behind. Neither does it help to calm the tensions related to the sovereign debt crisis of the European periphery. A crisis that is now at a key stage in its resolution. Specifically, on 24 and 25 March the European Council greenlit a package of measures to guarantee financial stability in the euro area, including the European Stability Mechanism, a permanent fund that, in 2013, will replace the current bail-out fund to support those countries in the euro area with serious economic difficulties. It also approved the Euro Plus Pact, which aims to strengthen economic coordination in order to improve competitiveness.

In the euro area, the ECB announces an impending hike in interest rates...

The EU's decisions, together with the application of an extensive programme of reforms, has helped Spain's risk premium to ease over the last few weeks. The cost of financing 10-year bonds compared with German bonds gradually fell in March, standing at below 200 basis points by the end of the month, 15 points lower than its average in February. Within this context,

...while the European Council strives to adopt measures to help contain the peripheral debt crisis.

Spanish debt risk premium falls below 200 basis points.

the Treasury has placed new debt issues on the market at lower interest rates than those paid at the end of last year. These issues have managed to practically cover all maturities until July. The improved market confidence regarding Spanish debt contrasts with the rise in differentials for the rest of the peripheral countries and with the delicate situation in Portugal, on the point of bail-out.

The improvement in Spain's assessment by the financial markets results from the country achieving its public deficit targets and the structural reforms undertaken (employment contracts, pensions, collective bargaining and financial system). At the Brussels summit, the President of the Spanish government also announced the reform of the Budget Stability Act in order to link the rise in public spending to expenditure in the economy as a whole. The aim is to improve the sustainability of public finances, in line with the requirements of Europe's new competitiveness strategy.

Rising prices, the decline in jobs and higher interest rates; all obstacles to improving domestic expenditure.

Meanwhile, the recovery continues, albeit at a very moderate pace. Private consumption expenditure shows a certain weakness, although the confidence index improved in February. Rising prices, the job losses that are still being recorded and the gradual increase in reference interest rates for mortgages are not helping to stabilize household budgets. Public expenditure is not going to help to boost growth either, given the need for austerity in its most important items, such as healthcare and education.

Modest growth forecasts for 2011 in spite of the foreign sector's contribution.

As regards investment, of note is the good performance by capital goods production in January, which rose significantly, placing the year-on-year growth rate at 4.6%, while indicators continue unfavourable for investment in construction. Most of these sharpened their decline, such as the confidence of entrepreneurs in the construction business and permits for new builds, although demand for cement did show signs of a change in trend.

Although domestic demand has yet to pick up, the foreign sector continues to provide pleasant surprises. Goods exports are still progressing apace and, according to the data accumulated over twelve months up to January, the trade balance with the euro area was practically zero, something that has not happened since the Single Market was created. The trend in service exports is still very positive as well, thanks to foreign tourism, which has been partly benefited by the instability of destinations in North Africa.

In short, higher oil prices and the hike in interest rates mean that forecasts for growth and inflation in 2011 must be revised. The greater difficulties faced by the recovery in domestic demand have reduced expected growth from 0.7% to 0.5%. Part of the oil burden will be offset by a greater contribution from tourism due to North Africa's loss of appeal, so that most of the growth will come from foreign demand. We also expect a higher rate of inflation, around 2.9% on average for 2011, compared with the 1.8% recorded in 2010. Within this context, unemployment will still remain high but the targets for reducing the deficit are considered to be feasible, within a situation of private sector deleveraging.

29 March 2011

CHRONOLOGY

2010

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**.
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.
	14	Ben Ali's regime in Tunisia falls, the first in a chain of **political changes** in North Africa and the Middle East, with repercussions for oil prices.
February	2	Signing of the **Social and Economic Agreement** by the government, trade unions and employers, including pension reform.
	18	The government passes a Decree-Law to reinforce the solvency of **financial institutions**.
March	25	The **Euro Plus Pact** is approved and the foundations are laid to set up the **European Stability Mechanism** in the European Council.

AGENDA

April

- **4** Registration with Social Security and registered unemployment (March).
- **6** Industrial production index (February).
- **7** Governing Council of the European Central Bank.
- **12** CPI (March).
- **15** EU HCPI (March).
- **20** International trade (February).
- **25** Producer prices (March).
- **26** Government revenue and expenditure (March).
- **27** Fed Open Market Committee.
- **29** Labour Force Survey (first quarter).
  Retail and consumer goods (March).
  HCPI flash estimate (April).
  Balance of payments (February).

May

- **4** Registration with Social Security and registered unemployment (April).
- **5** Governing Council of the European Central Bank.
- **6** Industrial production index (March).
- **12** CPI (April).
- **13** GDP flash estimate (first quarter).
  EU GDP flash estimate (first quarter).
- **16** EU HCPI (April).
- **18** Quarterly national accounts (first quarter).
- **19** International trade (March).
- **25** Producer prices (April).
- **27** Retail sales (April).
- **30** HCPI flash estimate (May).
- **31** Balance of payments (March). Government revenue and expenditure (April).

INTERNATIONAL REVIEW

The United States consolidates its recovery but oil and public debt are a risk.

The United States: oil threatens growth

At the same time as the US economy is consolidating its recovery, risks are taking a downward turn. Gross domestic product (GDP) grew by 2.9% in 2010 and, for 2011, we expect it to rise by around 3%. Demand is still being supported by the public sector and the Fed's quantitative easing continues, but there is an appreciably strong base in the private sector. Although consumption is moving away from its upswing in the second half of 2010, it is still advancing, while manufacturing appears strong and the labour market is starting to show slight signs of improvement.

Rising oil prices constitute the greatest risk to growth but, unlike what happened in the 1970s and 1980s, they should have a limited effect on non-energy prices. In December 2010, a Brent barrel cost slightly below 92 dollars, while the average for February was 104.6 dollars. This appreciation of black gold is a spanner in the works for the recovery as, for example, given the current levels of demand, a 10-dollar rise in the cost of a barrel increases the energy bill by 0.5% of the United States' GDP.

The second risk is the heavy borrowing incurred by the public sector to sustain aggregate demand. Gross debt has gone from 62.1% of GDP in 2007 to 92.7%

UNITED STATES: MAIN ECONOMIC INDICATORS

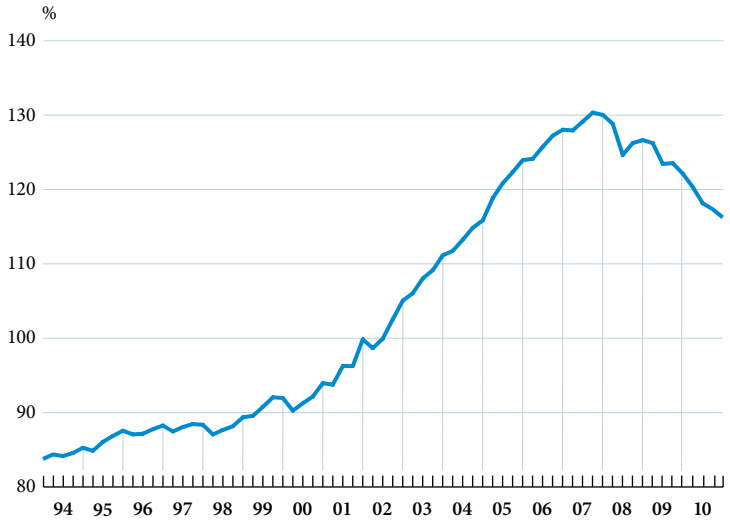
Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
Real GDP	–2.6	2.8	2.4	3.0	3.2	2.8	–	...
Retail sales	–6.4	6.5	5.5	6.9	5.8	7.7	8.1	8.9
Consumer confidence (1)	45.2	54.5	51.7	58.2	50.9	57.0	64.8	70.4
Industrial production	–9.3	5.7	2.7	7.4	6.9	5.9	5.6	5.6
Manufacturing (ISM) (1)	46.3	57.3	58.6	57.6	55.2	57.9	60.8	61.4
Housing construction	–38.4	5.6	16.5	12.2	0.4	–5.4	1.0	–20.8
Unemployment rate (2)	9.3	9.6	9.7	9.6	9.6	9.6	9.0	8.9
Consumer prices	–0.4	1.6	2.4	1.8	1.2	1.3	1.6	2.1
Trade balance (3)	–375	–496	–398	–450	–484	–496	–507	...
3-month interbank interest rate (1)	0.7	0.3	0.3	0.5	0.3	0.3	0.3	0.3
Nominal effective exchange rate (4)	77.7	75.3	74.8	77.6	75.9	73.0	73.0	72.0

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

THE UNITED STATES: DEBT THAT MUST GO ON FALLING

Gross household debt as percentage of disposable income



SOURCES: BEA, Federal Reserve and own calculations.

in 2010, and the expansionary budgets for 2011 might take it to 100% of GDP. Another factor to be added to the mix is household debt, standing at 116.1% of disposable income in the fourth quarter of 2010, as well as the surplus supply of housing and continuing high unemployment. The outcome for 2011 will depend on how strongly private demand can take over from public stimuli and how this is translated into an improved labour market.

Greater consumer caution can be seen in January's national accounts. Lowering taxes helped households' disposable income to increase in January at a faster pace than the average for 2010, but this increase was mostly aimed at savings, which in January reached 5.8% of disposable income, when in the last quarter of 2010 they had stood at 5.4%. A welcome prudence that, nonetheless, does not stop private consumption from being considerably vigorous. February's retail trade therefore advanced 5.3% year-on-year, excluding volatile cars and petrol, while the Conference Board Consumer Confidence index improved in February, going from 64.8 to 70.4 points.

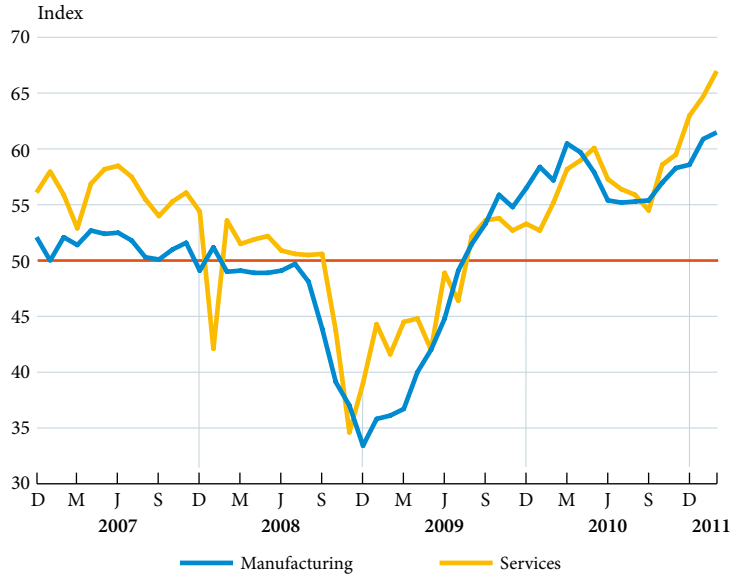
Public debt reaches 93% of GDP in 2010.

This good tone for private consumption is added to the confidence that continues to predominate business sentiment, based on non-financial firms that are clearly less in debt than banks, households and the public sector, and on expectations of higher profits, encouraged by rising demand that should not pressurize costs too much, thanks to the low utilization of production capacity. In this respect, the business sentiment index of the Institute for Supply Management continued to pick up in February until reaching the level of 61.4 points in manufacturing and 66.9 in services. In the case of manufacturing, this figure equals the maximum of May 2004 and we would have to go back to 1983 to find higher levels, when the economy was recovering from a double recession, which gives an idea of the optimism reigning among the business class. This optimism is also starting to be seen, albeit more

Optimism continues to increase among entrepreneurs.

THE UNITED STATES: INCREASINGLY OPTIMISTIC ENTREPRENEURS

ISM index levels (*)



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

The unemployment rate falls to 8.9% but the improvement in employment will continue to be slow.

moderately, in the plans of new contracts, showing a somewhat clearer upward trend than in previous months.

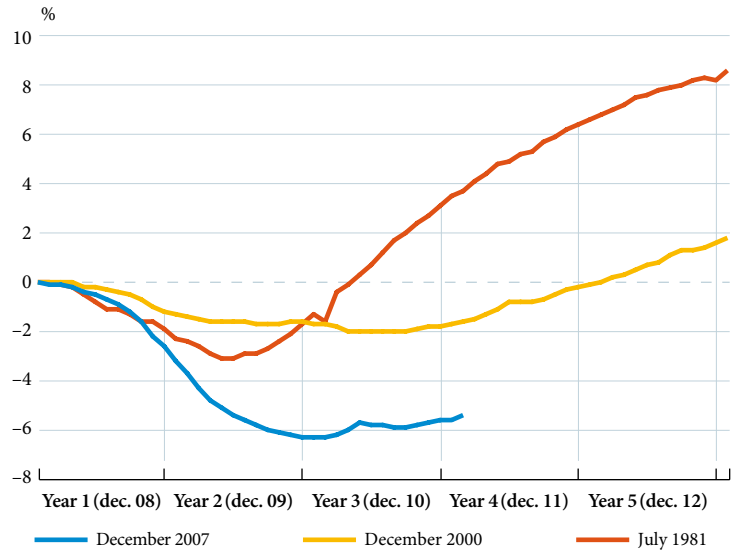
Following this pattern, the labour market showed signs of improvement in February, with 192,000 jobs created and an unemployment rate that fell again slightly to 8.9%, a figure that has not been seen since April 2009. But caution is required here. Firstly, we should take into account the fact that, in a year of recovery, the labour market has only created 1,269,000 jobs, still far from the 8,750,000 lost during the crisis. Secondly, the high proportion of long-term unemployed and the large number of discouraged workers, or those who are working less than they would like, will mean that the unemployment rate won't fall much below its current level, given the forecast for economic growth in 2011.

Construction disappoints because of continued excess supply in housing.

This persistently high unemployment hits the middle classes particularly hard, resulting in higher doubtful debt that ends up in mortgage foreclosures, swelling the excess supply that has dominated the sector since 2007. The number of foreclosed mortgages is falling in the subprime sector, of low credit quality, but is still rising in the prime sector, which accounts for 73.1% of the total number of mortgages. Excess supply makes prices fall, with the Case-Shiller index for second-hand house prices down in December for the sixth consecutive month, accumulating a drop of 3.8% in the second half of 2010. Should this continue, this new phase of loss in value for real estate could have a negative effect on private consumption through the wealth effect. Within such a scenario, construction is still at rock bottom. The 479,000 homes started in February, in annual terms, are very close to a record low.

THE UNITED STATES: THE RECOVERY IN EMPLOYMENT IS SLOW

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



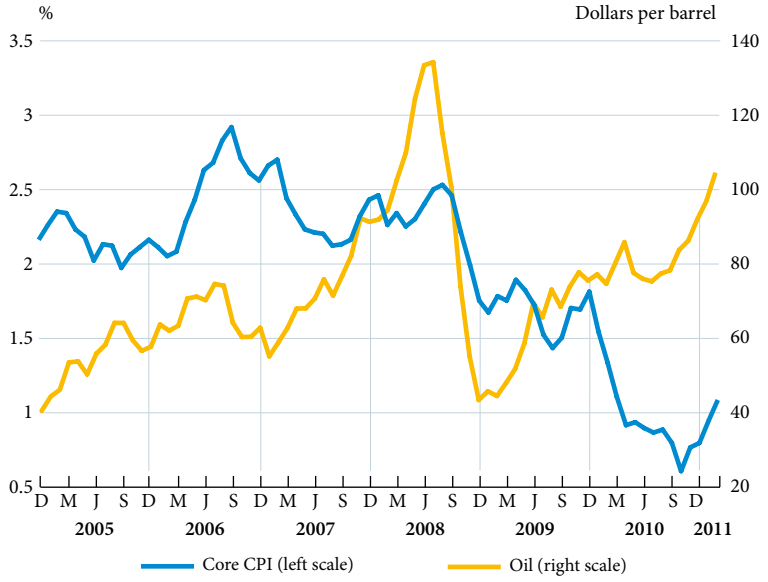
NOTE: (*) The dates in brackets correspond to the last recession (December 2007).
SOURCES: Department of Labor and own calculations.

Inflation picked up in February, with a general consumer price index (CPI) that rose to 2.1% year-on-year and that, throughout 2011, might increase further due to rising oil prices. However, the Fed takes the core CPI as its reference which,

The CPI picks up to 2.1% but core inflation continues at a moderate 1.1%.

THE UNITED STATES: NOT A VERY UNDERLYING INFLUENCE

Oil prices and year-on-year change in the core consumer price index (*)



NOTE: (*) Core inflation excludes food and energy. Oil prices are the future in one month's time for a Brent barrel.
SOURCES: Department of Labor, Datastream and own calculations.

The trade deficit disappoints because of the recovery in imports.

since it excludes energy and food prices, is a more accurate reflection of the underlying trend. The core CPI also picked up in February, with a 1.1% rise year-on-year. Production prices and business sentiment are pushing up prices at the beginning of 2011 due to the general rise in commodity prices, but this upward trend is being limited by high unemployment and idle capacity, which are pulling wages down and are thereby offsetting the effect of commodities. In this respect, we should remember that the record low recorded for core inflation in October 2010 is very close, both in time and level.

In the foreign sector, January's trade balance wiped out the improvements of the last two months. Imports woke up from their lethargy and pushed up the trade deficit, which reached 46.34 billion dollars. The trade deficit without oil also rose, reaching 19.68 billion, the worst figure in the last four months. Although exports kept some of their vigour of the previous months, with a gradual recovery in domestic demand, the foreign sector's contribution to growth in 2011 will be limited.

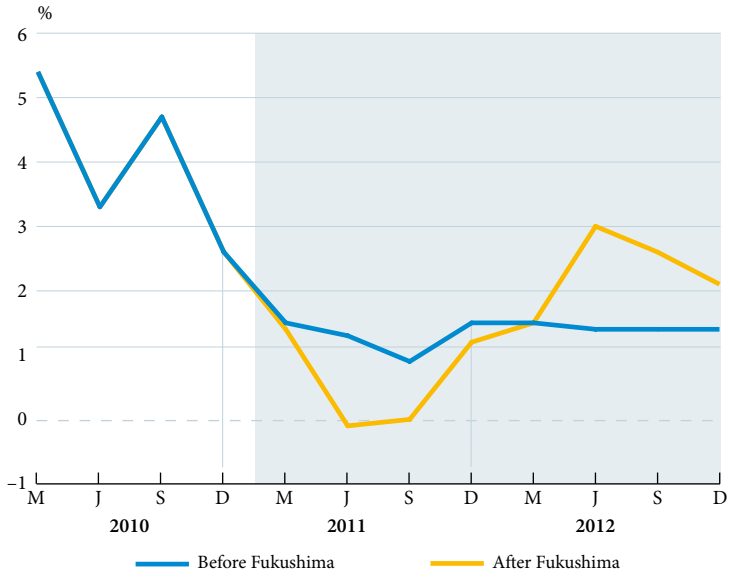
The Fukushima tragedy entails great human cost but its effect on GDP should be limited.

Japan: rising out of the ashes

The Fukushima tragedy entails huge human cost and a loss of wealth that, according to initial estimates, might exceed 4% of GDP, 1.6 times what had been lost in the Kobe earthquake of 1995. However, the effects on GDP, which is a measure of activity and not of wealth, should be limited in an economy such as Japan's, with a stronger supply than demand, stock levels that, in previous months, had recovered from their minimum levels and a population with a notable ability to recover from adversity.

JAPAN: THE RECOVERY OF THE PHOENIX

Year-on-year change in GDP (*)



NOTE: (*) The data for 2011 and 2012 are forecasts (shaded).
SOURCES: Japanese Ministry of Communications, Datastream and own calculations.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
Real GDP	–6.3	4.0	5.4	3.3	4.7	2.5	–	...
Retail sales	–2.3	2.5	3.8	3.7	3.2	–0.4	0.1	...
Industrial production	–21.8	16.0	27.1	21.1	12.9	5.0	1.8	...
Tankan company Index (1)	–40.8	0.0	–14.0	1.0	8.0	5.0	–	...
Housing construction	–27.7	2.7	–7.0	–0.8	13.7	6.8	2.3	...
Unemployment rate (2)	5.1	5.1	5.1	5.1	5.0	5.0	4.9	...
Consumer prices	–1.3	–0.7	–1.2	–1.0	–0.8	0.1	0.0	...
Trade balance (3)	4.0	8.0	6.7	7.4	8.1	8.0	7.3	...
3-month interbank interest rate (4)	0.6	0.4	0.4	0.4	0.4	0.3	0.3	0.3
Nominal effective exchange rate (5)	98.6	106.0	101.1	102.8	109.1	111.0	111.1	110.3

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.

For 2011, we expect a growth of 0.7%, lower than the previous 1.3% due to the expected decline in the second quarter, with the second half of year and 2012 showing robust growth. The greatest risk for this scenario is a nuclear crisis at the Fukushima plant. The main hypothesis is that this situation will stabilize, but we cannot rule out the possibility of it getting worse and, as this would lead to a more prolonged interruption in energy supply, it might push GDP down in 2011.

The nuclear industry supplies 29% of Japan's electricity, a further 66% comes from fuel and the rest is of hydroelectric origin. The damaged Fukushima I plant meets 7.2% of the electricity demand of eastern Honshu, the island that includes the conurbation of Tokyo. It's not viable to compensate the power lost with the western zone's grid, thereby forcing intermittent blackouts that should reach their peak in April. Industrial production, which in January maintained its upswing, will be directly affected in the short term. However, with the utilization of manufacturing capacity 9.0% below its historical average, we might witness a strong upswing in the second half of the year, a pattern that should also be reflected in exports, the true engine of the Japanese economy.

The growth forecast for 2011 remains at 0.7%.

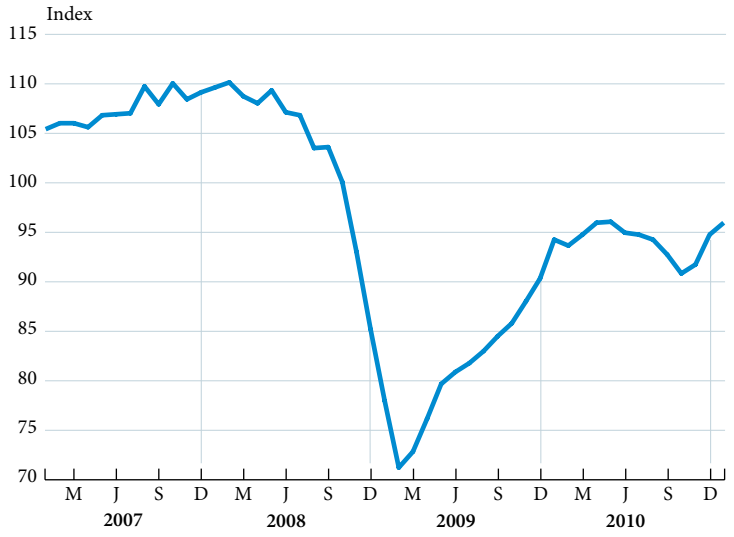
Reconstruction costs will pressurize the already battered public coffers. The Bank of Japan, which intervened to guarantee liquidity in the system and stop the yen from appreciating, pushed up by the repatriation of assets by insurers and speculation, hesitates to monetize debt but the fact that the government's main creditors are Japanese should relieve pressure in the short term.

January's CPI remained the same in year-on-year terms, while core CPI, which excludes energy and foods, fell by 0.6% year-on-year. Although Tokyo's prices fell in February, the inflationary

If the nuclear risk stabilizes, the economy will pick up again in the second half of 2011.

JAPAN: AN INDUSTRIAL UPSWING THAT STILL HAS A LONG WAY TO GO

Industrial production index



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

Inflation in China stands at 4.9% in February, underlining the risk of overheating.

panorama seems uncertain with upward pressure resulting from energy and food problems.

China: overheating?

With 4.9% inflation in February, above the consensus forecasts and the government's 4% target, the risk of overheating is becoming confirmed for the Asian giant. Although once again we must mention the sharp rise in food prices, 11% in February compared with an average of 7.2% in 2010, the component without food continues to pick up pace, highlighting the importance of demand's pressure on price rises.

Monetary tightening continues: third rise in the cash reserve ratio.

Given these inflationary tensions, the central bank has decided to raise the cash reserve ratio for the third time this year, with the rate already at 20% for the largest institutions. This monetary tightening is in addition to various provisions to slow up the strong credit flows, which might have started to have an effect. In particular, new bank lending for February stood at 540.6 billion renminbi, representing 17.7% growth year-on-year, clearly below the average of 21% last year. Monetary supply also slowed up its growth.

Within this context, and with the interpretive caution required regarding February's figures for activity due to the seasonal effects of the Chinese New Year, which changes its dates every year, both industrial production and investment continue to be noticeably vigorous. Industrial production for January and February combined grew by a strong 14.1%. Far from moderating, fixed capital investment grew by 24.9% year-on-year in February, above the 24.5% of December. On the other hand, the purchasing managers' index (PMI) fell for the third consecutive month, down to 52.2 points, although still within the expansionary zone. Similarly, retail sales for the whole of January and February

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
Real GDP	9.2	10.3	11.9	10.3	9.6	9.8	–	...
Industrial production	12.5	15.7	19.8	16.0	13.5	13.3	13.3	14.9
Electrical power generation	6.8	14.0	22.6	17.8	11.8	6.2	8.2	15.0
Consumer prices	–0.7	3.3	2.2	2.9	3.5	4.7	4.9	4.9
Trade balance (*)	196	184	148	155	182	184	177	162
Reference rate (**)	5.31	5.81	5.31	5.31	5.31	5.81	5.81	6.06
Renminbi to dollar	6.8	6.8	6.8	6.8	6.8	6.7	6.6	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.

grew by 15.8% in nominal terms, clearly below the 19.1% of December.

For its part, and as announced at the last National Popular Assembly, fiscal policy will continue to be active. Unlike what's happening in other emerging economies with symptoms of overheating, China is not considering carrying out any great fiscal consolidation, as its deficit is modest (around 1.6% in 2010) and its level of debt low (around 18% of GDP). Moreover, it is committed to reinforcing the social benefit system. All this puts more pressure on monetary and exchange policies as instruments to slow up the risk of overheating.

Lastly, the foreign trade figures for February showed a deficit of 7.3 billion dollars, the largest monthly deficit in seven years, although very close to the deficit observed in March 2010. Once again, it's difficult to draw conclusions concerning this deficit, as it is mainly due to the drop in exports because of the holiday period for the lunar New Year. Nonetheless, we expect some correction in the country's external imbalances for 2011, in line with a pattern of growth that is less dependent on exports.

Brazil: target - moderation

The Brazilian economy came out of 2010 as a whole with spectacular growth of 7.6%. The figure for the fourth quarter was also better than expected, with a year-on-year growth of 5.0%. The robustness of Brazil's recovery has therefore been reaffirmed, whose only dark spot comes from growing inflationary tensions that might take the shine off 2011.

In the last few months, the marked rise in inflation, now at 6.0% and increasingly further away from Brazil's central bank's target of 4.5% ±1 pp, has intensified the restriction of stimuli in all areas: interest rates have been raised again and more hikes are expected this year; the lines of credit set up because of the crisis are gradually being reduced and the new government has already embarked upon fiscal consolidation. This relative acceleration in the adjustment has led us to slightly downgrade our growth forecast for Brazil in 2011, placing it closer to 5% than the 5.5% previously. However, we view the restrictive tone of Brazil's economic policies positively, vital to ensure macroeconomic stability and

Seasonal effects might lie behind the entire large trade deficit in February.

Brazil's economy comes out of 2010 with spectacular growth of 7.6%.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
Real GDP	–0.7	7.5	9.4	9.1	6.8	5.0	–	...
Industrial production	–7.3	10.5	17.4	14.2	8.1	3.5	1.9	...
Consumer confidence (*)	138.3	157.9	158.1	154.6	159.5	159.3	159.9	162.2
Unemployment rate São Paulo (**)	12.8	12.1	12.4	13.2	12.1	10.9	...	...
Consumer prices	4.9	5.0	4.9	5.1	4.6	5.6	6.0	6.0
Trade balance (***)	25.3	20.3	23.2	19.3	16.9	20.3	20.9	21.7
Interest rate SELIC (%)	9.92	10.00	8.75	10.25	10.75	10.75	11.25	11.25
Reales to dollar (*)	2.3	1.8	1.8	1.8	1.7	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.

Domestic demand confirms its driving force but foreign demand also starts to make itself felt.

reduce the risk of a crash landing for an economy that had previously suffered the ravages of inflation out of control.

An analysis by component of the latest growth figures, for the fourth quarter of 2010, leaves no room for doubt: Brazil's domestic demand no longer needs public support and must return to levels compatible with price stability. With 7.5% growth year-on-year, private consumption has shown that it doesn't appreciate base effects, posting an improvement as splendid as the one in the same quarter of 2009. For its part, investment, although easing back its rate of advance, continued to post year-on-year growth in double figures, namely 12.2%. With regard to public expenditure, this slowed up after the boom of the pre-electoral period in the third quarter, but it remained positive, up 1.3% compared with the same period a year ago. Lastly, although exports slowed down their growth, imports did so to a much greater extent so that, for once, exports overtook imports and helped towards GDP growth. Nonetheless, for the year as a whole, the external balance was still negative and positive for the rest of the components, of note being investment with annual growth of 22.5% (see the graph on the next page).

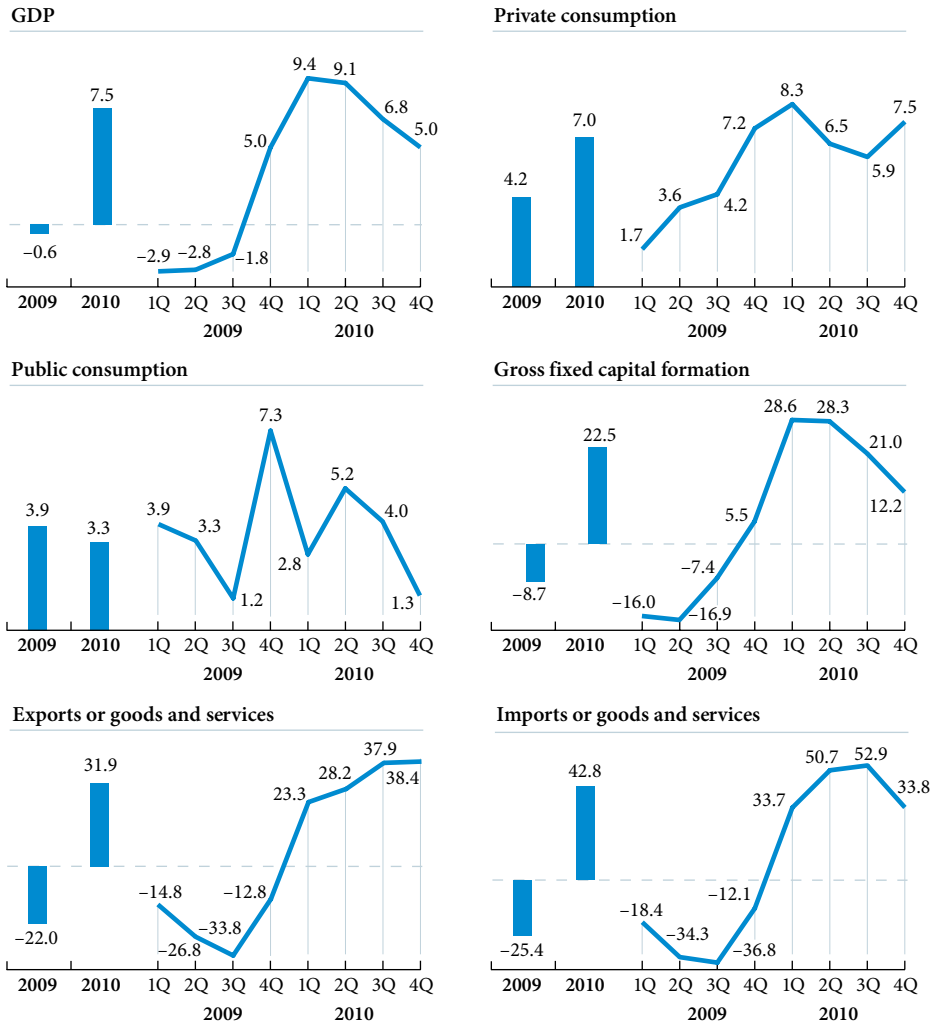
Inflation continues strong and is still a risk but adjustment is already underway.

In short, Brazil's macroeconomic scenario is made up of vigorous growth with clear signs of overheating. In this respect, the monetary policy's restrictive tone is sure to continue throughout 2011. On the fiscal flank, we believe that the measures promoted by the government to date will not be enough, so that greater adjustments should be introduced to reduce the growing pressure on prices. Even more so if we remember that the investment required by the 2014 World Cup and the 2016 Olympics adds yet another risk to the already high pressure of demand.

In this respect, and with another great carnival having just ended, Brazil must aim for moderation. Only then will it be able to continue enjoying the party, albeit not to a Samba beat.

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms



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

Mexico: a balanced cocktail

While many other countries, emerging and advanced, are battling against growing inflationary tensions and trying not to put at risk, as a consequence, the continuity of their recovery, the Mexican economy is advancing at cruising speed with a historically low rate of inflation (3.6% in February). This delicious Mexican cocktail, which has managed to combine a surprisingly vigorous recovery with a price scenario free from inflationary risk, is worthy of admiration. Even more so if we take into account the fact that the Mexican basket of purchases is highly sensitive to trends in food prices and that these have been rising for several months now.

We need to look back in time to work out the recipe for such a delicious mixture. To start with, we must remember that Mexico started the crisis with relative

Mexico manages to consolidate its recovery without awaking the phantom of inflation.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
Real GDP	–6.1	5.5	5.0	7.4	5.3	4.4	–	...
Industrial production	–7.0	6.0	5.4	7.6	6.5	4.7	6.6	...
Consumer confidence (*)	80.5	86.3	81.5	84.9	89.2	89.6	92.3	92.3
Leading business index (*)	110.9	117.2	115.3	116.9	117.7	118.6	...	...
General unemployment rate (**)	5.5	5.4	5.4	5.2	5.6	5.3	5.4	5.4
Consumer prices	5.3	4.2	4.8	4.0	3.7	4.2	3.8	3.6
Trade balance (***)	–4.6	–3.1	–1.9	–2.4	–2.0	–3.1	–2.6	–2.8
Official Banxico rate (%)	6.75	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	14.2	12.3	12.3	12.8	12.6	12.3	12.2	12.1

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

The United States' economic improvement and a renewed push from domestic expenditure improve the outlook for growth in 2011.

macroeconomic stability, achieved at the cost of comparatively restrained economic growth which attempted to avoid, above all, the exaggerated fluctuations of other eras. This stability allowed it to resort, this time, to using countercyclical economic policies to alleviate the impact of the recessionary cycle. However, it could not stop the worst recession in years from damaging the Mexican middle classes. This frightened domestic expenditure to a great extent, needing long months and the support of stimuli to recover, very gradually, the tone it had lost and confidence in its economy.

The persistent weakness of domestic expenditure and the drastic fall in GDP in 2009 set Mexico apart from other nearby countries, such as Brazil, where the recession was brief and domestic demand hardly affected but which, now, given the too-late withdrawal of stimuli, are facing growing risks of overheating.

Mexico is also characterized by its huge dependency on US foreign demand, and the recovery on the other side of the Río Grande is advancing at a moderate pace, so the pull by exports in Mexico was neither sudden nor exaggerated. Lastly, we should also remember that Mexico is a net exporter of crude so that, in principle, it is benefited by the high prices internationally.

All this has not only contributed to Mexico's success in 2010 but paints a relatively comfortable macroeconomic picture for 2011. Moreover, the recent improvement in the United States' economic prospects and the strength of the latest leading indicators for activity in Mexico have led us to slightly upgrade our forecasts for Mexican GDP growth in 2011, to 4.2%. For the moment, however, we have not revised the scenario for interest rates, seeing as, given the apparent calm of prices, we still do not think Banxico will make a move until early in 2012. Nonetheless, if food prices soar and the recovery in domestic expenditure picks up, we might consider the likelihood of an initial rise in the reference rate in the last quarter of 2011.

Increasingly more expensive oil

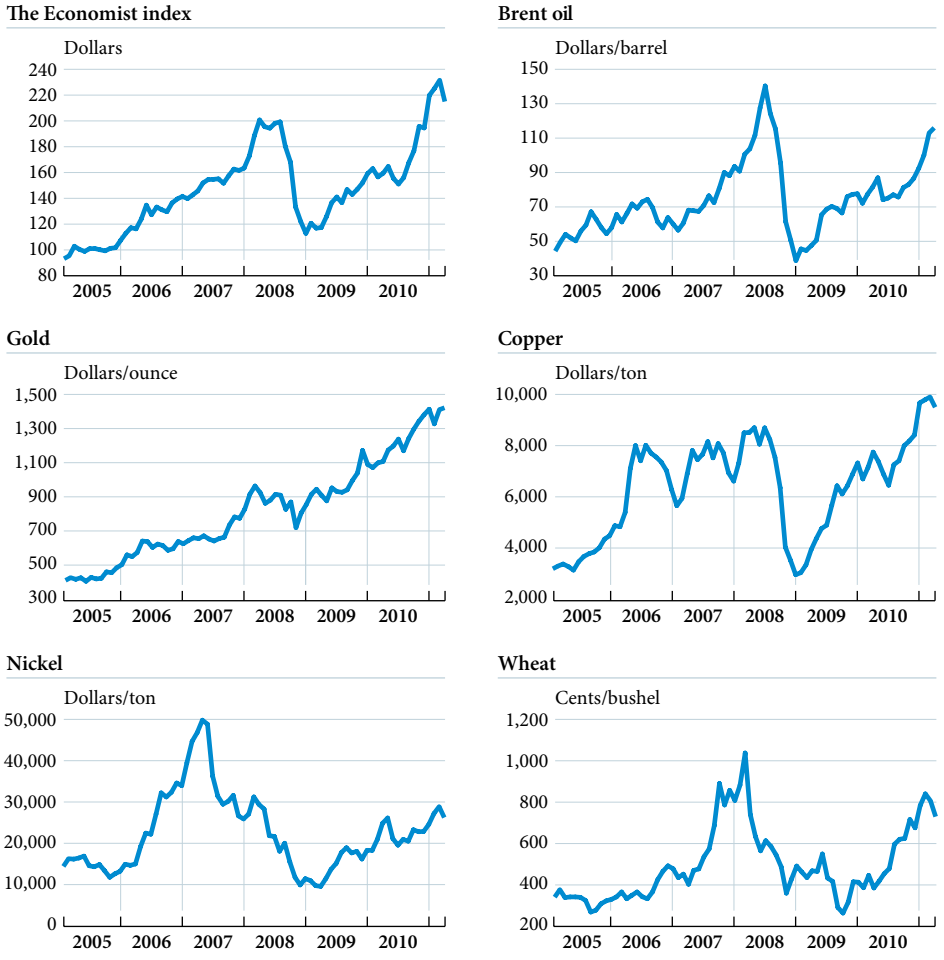
Oil prices are resolutely on the up again. Between 20 February and 22 March, the price of crude continued to rise, up 10.4% and reaching 115.99 dollars per barrel (Brent quality, for one-month deliveries), placing the increase since the start of the year at 25.2% and 49.1% since the start of 2010.

The escalating Libyan crisis, with an uncertain outcome whose end does not seem to be in sight, together with the already familiar upward pressure exerted by expectations of higher global demand, including the consolidation of US growth, will create bottlenecks in oil producing countries, especially those that do not belong to the Organization of the Petroleum Exporting Countries, which have a deficit in investment in oil extraction infrastructure. With this new situation, oil is unlikely to return to under 100 dollars per barrel during 2011, which constitutes a risk for the precarious growth of advanced economies and inflationary pressures in emerging economies.

Oil reaches 115 dollars per barrel.

Uncertainty and greater demand will keep oil above 100 dollars in 2011.

TREND IN VARIOUS COMMODITIES (*)



NOTE: (*) Figures for last day of month (last date March 22).
SOURCES: The Economist, Thomson Reuters Datastream and own calculations.

Commodities adopt a downward direction except for gold and aluminium.

Previous rises and the risks to global demand affected the prices of the rest of commodities. The Economist index fell by 9.1% between 21 February and 22 March. There were widespread losses among metals apart from aluminium, which might be pulled upwards by rising oil prices, as its production is energy-intensive. For its part, gold remained at the same level due to its status as a safe haven. Falls also predominated among foods, of note being the decrease in tea and sugar due to profit-taking from previous rises.

Guaranteed bail-out: a risky perception for the system

Until the fall of the Lehman Brothers in September 2008, there had been an unwritten law in the financial sector that some institutions were «too big to fail». Institutions whose bankruptcy would lead to such an economic collapse in their home country that the government would prefer to bail them out. Far from disproving this belief, the fall of the Lehman Brothers endorsed its validity, revealing the size of the collapse and with the G-7 adopting an action plan whose first point ensured that it would «take decisive action and use all available tools to support systemically important financial institutions and prevent their failure». This decision is highly controversial, as it encourages institutions to take even greater risks. Against this, regulators are trying to find the correct regulatory focus to lessen such incentives.

Statements such as that by the G-7 helped to reduce the perception of institutions regarding the cost involved in risky investments going wrong. This perceived cost is, in itself, lower than the true cost for society, which also includes the effect of such investments on the proper functioning of the financial system as a whole and therefore on the channelling of the economy's resources. As a consequence of this lower perceived cost of risk, institutions tend to finance riskier projects than would normally be desirable. To correct this perception, the existing regulation required institutions to maintain minimum capital requirements which rose in line with the risk of their assets. However, what the present crisis has revealed is that this risk cannot be correctly measured given the incomplete information available. Consequently, while maintaining similar minimum requirements, institutions could opt to finance projects with high expected returns whose real risk levels were higher than those foreseen by the regulator.

It is therefore vital to amend the regulation in order to correct these incentives, and several more or less advanced proposals have already been made to this effect. Many of them focus on institutions that are key to the proper functioning of the financial system, as they have greater incentives to take excessive risk given the impossibility of governments to credibly commit not to eventually bail them out. Others are of wider scope. However, all have significant complications in their design that affect their ultimate effectiveness.

The first of the proposals aims to reduce the probability and severity of bankruptcies among systemically important financial institutions (or SIFIs) by raising their capital and liquidity requirements higher than the levels recently set by Basel III. By way of example, Switzerland, the only jurisdiction in which these levels have been specified, requires its SIFIs to have a total minimum regulatory capital of 19% given their disproportionate size in relation to GDP. Such a level more than doubles that required by Basel III. This option has two problems. The first is how to determine whether an institution is a SIFI: its size, its interconnexion with other institutions or the latter's inability to substitute the services provided by the institution might become key aspects. The second problem is that this proposal still relies on the same measurement of asset risk that has shown itself to be defective. Consequently, although the cost for institutions increases, the mechanism that led to excess risk in the present crisis is still in place.

IDENTIFYING KEY INSTITUTIONS: SIZE IS NOT THE ONLY VARIABLE THAT DEFINES A SIFI

Index of interconnectedness(*) and size in a selection of financial institutions

Index of interconnectedness	Assets in 2008 (% of GDP of the home country)				
	< 20%	20% < x < 50%	50% < x < 100%	100% < x < 200%	> 200%
Very high	Lehman Brothers Safeco Chubb Morgan Stanley AIG	Dresdner Bank	BNP Paribas		UBS
High	Goldman Sachs Bank of America Bear Stearns(**) Met Life HVB	Commerzbank	Barclays	RBS	
Moderate	Fannie Mae Freddie Mac Merrill Lynch American Express Standard Chartered B. Monte dei Paschi Abbey National	Lloyds TSB AXA Allianz	HBOS HSBC Crédit Agricole Société Générale UniCredit Banco Santander Banco Comercial Português		Credit Suisse
Low	Citigroup JP Morgan Hartford	ABN Amro(**)	Deustche Bank Rabobank	ING	

In red, institutions that have received injections of public capital

NOTES: (*) Importance index in terms of interconnectedness. A high value indicates that signs of financial distress in the institution materially raise the likelihood of financial distress in other institutions. See Yang, J. and Y. Zhou (2010), «Finding systemically important financial institutions around the global credit crisis: Evidence from credit default swaps», article presented at the 13th *ECB-CFS Research Network conference: Macro-prudential Regulation as an Approach to Contain Systemic Risk: Economic Foundations, Diagnostic Tools and Policy Instruments.*

(**) Data from 2007.

SOURCES: The Banker 2008, OECD, Yang, J. and Y. Zhou (2010) and own calculations.

A second group of proposals aims to modify the incentives for institutions to take risks by introducing levies or taxes that reflect the social cost of the built-in systemic risk. To this end, the IMF has proposed a tax whose rate will grow according to the institution's risk and its contribution to systemic risk. The basic rate would be calculated using financial institutions' external financing (excluding deposits), as this would be roughly equal to the volume of resources the state would need to provide to support the institutions' liabilities. If defined in a sufficiently broad manner and applicable to all kinds of financial institutions, it would avoid possible distortions and arbitrage in financing decisions. However, once again the question remains of which criteria would be used in defining the tax rate so as to measure the contribution to systemic risk in a way that improves the current method.

The effectiveness of other tax-related proposals with the same objective is more questionable. For example, one suggestion has been to tax excessive returns in the financial sector, with the idea that these are the result of excessive risk and of the implicit guarantee provided by the state. However, these taxes face the difficulty of defining an appropriate level of return for the financial sector so as not to tax profits that actually result from greater efficiency.

One last group of proposals, which appears to be more effective, also aims to modify incentives but by acting on the institutions' perceived likelihood of a future bail-out. This entails reducing the public costs associated with

bank failure so that it becomes more plausible to bear such failures. This might be achieved by a resolution scheme, designed in various stages, that prevents the paralysis of the financial system should the time come. Initial signs of problems would trigger an early intervention phase, in which the supervisor would be able to constrain the institution behaviour, both in terms of profit distribution and in terms of lines of business. The scope of the intervention would increase as the situation worsened, until the institution failed to meet the regulatory ratios. The institution would then be wound down in an orderly manner, possibly by transferring the essential activity of deposits or other functions considered crucial to a bridge bank until the business can be sold to interested rivals. The public cost of this process could be financed by creating a resolution fund with the proceeds of a tax such as the one proposed by the IMF. The United States, European Union and United Kingdom are currently working along these lines.

In short, there are many proposals and most authorities are tempted to apply them all quickly, without taking into account the effect of their interaction. However, care should be taken not to adopt generic measures that have little relation with the risk of each institution. Otherwise, we would merely be encouraging the accumulation of more risk in the system and paving the way for history to repeat itself once again.

This box was prepared by Sandra Jódar Rosell
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EUROPEAN UNION

The euro area: oil and interest rates threaten economic activity

After the victory of the allied troops in Egypt, Winston Churchill, in his speech of November 1942, pronounced these famous words: «Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning». His aim was to rouse his fellow citizens and, at the same time, celebrate the first remarkable victory in the war that might indicate a change in direction.

A change in direction that has also come about in the European Union (EU) after the summits held in March. For weeks, the EU's political leaders had promised to reach a big agreement on economic reform. And, at the extraordinary meeting held in Brussels on 11 March, they surprised us with a series of very important decisions. Four of these stand out in particular. The first measure agreed is to increase the lending capacity of the European Financial Stability Facility (EFSF) from its previous level of 250 to 440 billion euros. Moreover, the EFSF may buy up the public debt of member countries in primary markets provided the country in question commits itself to a fiscal austerity plan.

The second decision consists of creating a permanent stability mechanism, as

The European Union reaches a big agreement about economic reforms.

EURO AREA: MAIN ECONOMIC INDICATORS

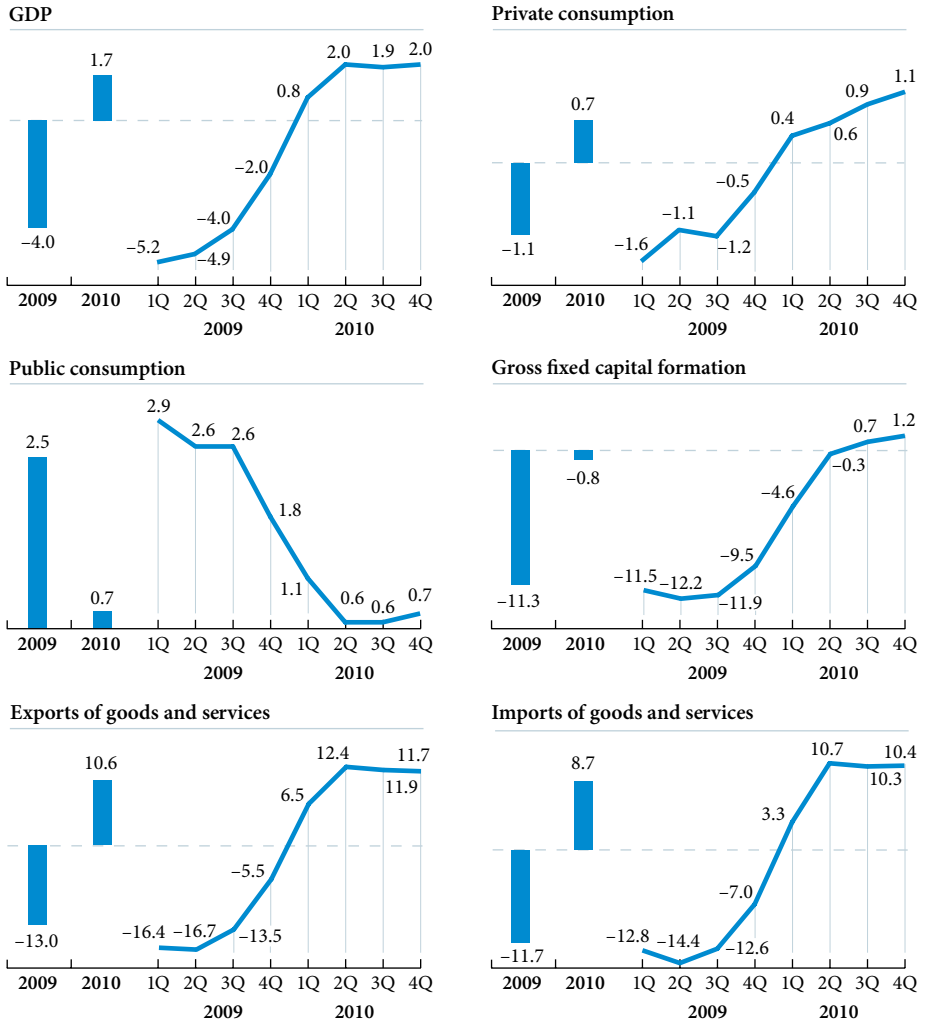
Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
GDP	–4.1	1.7	0.8	2.0	1.9	2.0	–	...
Retail sales	–2.5	0.8	0.5	0.6	1.4	0.5	0.7	...
Consumer confidence (1)	–24.8	–14.0	–16.8	–16.7	–12.1	–10.4	–11.2	–10.0
Industrial production	–14.7	7.5	4.7	9.1	7.0	7.9	5.9	...
Economic sentiment indicator (1)	80.7	100.8	96.4	99.1	102.2	105.6	106.8	107.8
Unemployment rate (2)	9.4	10.0	9.9	10.0	10.0	10.0	9.9	...
Consumer prices	0.3	1.6	1.1	1.6	1.7	2.0	2.3	2.4
Trade balance (3)	–16.7	14.1	23.5	20.0	8.2	4.6	–4.5	...
3-month Euribor interest rate	1.2	0.8	0.7	0.7	0.9	1.0	1.0	1.1
Nominal effective euro exchange rate (4)	111.7	104.7	108.7	103.2	102.3	104.4	102.4	103.4

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.

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCES: Eurostat and own calculations.

The loan to Greece is extended and its interest rate lowered.

from 2013, namely the European Stability Mechanism, which will be provided with 500 billion euros to contain any potential crises that may arise in the future.

Another measure, which will help Greece in particular, is the review of the interest rate applied to the portion of aid it received from the EU (110 billion euros), which has fallen by 1% to 4%. Moreover, the loan originally granted for a period of 4.5 years has been extended to 7.5 years. In exchange, the Greek central government has undertaken to sell off assets totalling 50 billion euros.

Lastly, European leaders also agreed a pact to increase economic coordination, a new series of fiscal cuts and the monitoring of public pension plans in the different member countries. In summary, the EU has shown itself to be strong in defending the euro.

This protection is useful within a macroeconomic context that is being threatened by two factors: rising oil prices and higher interest rates. Impacts on economic activity that had yet to be seen in the fourth quarter of last year. A breakdown of the gross domestic product (GDP) shows a correction in investment due to the adverse weather.

However, these two risks have forced us to revise our forecasts for GDP growth in the euro area, down one tenth of a percentage point to 1.5% for the whole of 2011 and, at the same time, to increase our estimate for inflation for the whole of the year, from 2.1% to 2.3%. In no case does this indicate a change in scenario but it does recognize that the developments in the energy market and the risk of somewhat higher interest rates might result in less economic activity.

That's why it's useful to review the different components of GDP to estimate the possible impact on each of them. Regarding consumption, purchases that could not be made due to heavy snowfalls in the months of November and December are being carried out during the first quarter, as shown by the recovery in retail sales in January, up by 0.7% month-on-month. Moreover, consumer confidence levels remain high, although rising energy prices will reduce families' net disposable income and therefore slightly reduce consumption, an effect that will be noticed more clearly as from the second quarter.

Because of households' lower disposable income due to rising energy prices, the good household consumption figures for the first quarter might be followed by slightly lower growth in the next few quarters.

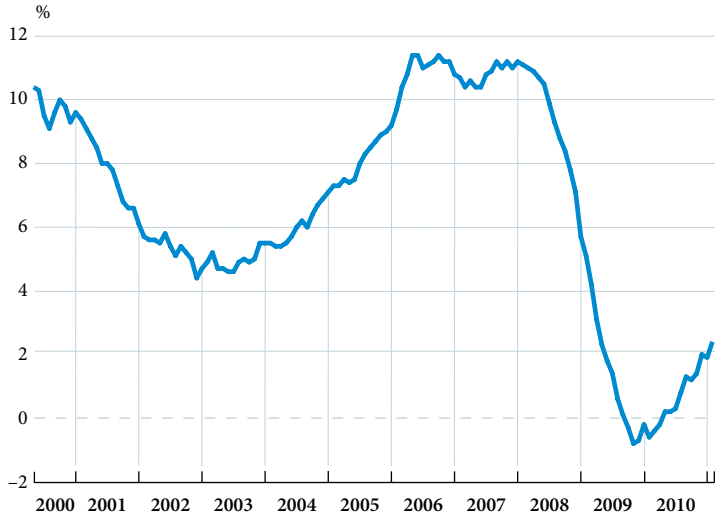
This impact would be softened by two factors: the first, the improvement in lending in the euro area and, the second, the fall in the unemployment rate, down by one tenth of a percentage point in January to 9.9%. This trend should continue thanks to contained labour

Rising oil prices and higher interest rates are likely to reduce growth in the euro area.

Households' net disposable income could be hit by higher inflation.

DELEVERAGING IS NO LONGER SLOWING UP ECONOMIC RECOVERY

Year-on-year change in credit in the euro area



SOURCES: European Central Bank and own calculations.

The portfolio of industrial orders points to good performance on the part of business investment.

costs and the good prospects for entrepreneurs.

Regarding private investment, this fell by 0.6% quarter-on-quarter in the last quarter last year but this was due to the collapse of the construction industry because of the snowfalls at the end of the year. The normal reactivation of this sector and the high level of industrial production, which in the month of January in the euro area advanced by 6.6% in year-on-year terms, together with the high confidence of entrepreneurs, who express an optimistic view in the surveys based on the portfolio of orders they have for the coming quarters, suggest that this component will contribute positively to growth during this year.

The European Union shows a strong desire to defend the euro.

The component of public expenditure should fall at a rate of one tenth of a percentage point during the coming quarters due to the different fiscal adjustments in members of the euro area. In any case, the risk would be that lower growth would require some countries to implement additional measures to reinforce the programmes.

But one of the factors that have forced us to lower our growth forecasts for 2011 has been the trend in the euro area's trade balance. The initial estimate for January has a deficit of 14.8 billion euros. The greatest impact was from the sharp rise in oil prices, raising the import bill. Should current prices remain the same, this will lead to the foreign sector deducting slightly from growth in the euro area in the coming quarters.

Dynamic German consumption in the early part of the year.

Rising energy commodity prices are also having an effect on the CPI, whose latest figures for February rose at a rate of 2.4% year-on-year. Rising prices can result in higher interest rates, entailing a reduction in economic activity. In our new growth estimates, we have taken into account the expected path of the main interest rates, both for public debt and the interbank market.

In summary, we can state that the risk of rising prices due to the sharp increase in energy commodity prices and their impact on interest rates might slightly reduce growth. But the biggest risk facing the euro area was the sovereign debt crisis, which has been contained thanks to the decisions taken by the European Union, showing a political will to defend the single currency that is unprecedented in its short history. Paraphrasing Churchill, we can say that perhaps it's not the end of the sovereign debt crisis but the instruments have been readied to redirect it, although it's true that the road ahead may still be long.

Good times for the German economy

After the slowdown in economic activity in the fourth quarter of 2010, mostly due to the bad weather, a robust recovery could be observed in the early part of 2011. Both domestic and foreign demand seem to have contributed to the current expansion.

Expectations of higher employment and wage rises are boosting consumption. Retail sales rose by 2.6% in real terms in January compared with the same month the year before. Moreover, passenger car registrations are showing notable energy in spite of the rise in fuel prices. In the first two months, automobile sales posted a year-on-year increase of 15.8%. The outlook for consumption is favourable, although its growth will probably moderate, as seems to be indicated by a slight decline in consumer confidence in the last three months up to February, affected by inflation picking up.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
GDP	–4.7	3.5	2.1	3.9	3.9	4.0	–	...
Retail sales	–3.2	1.4	1.0	0.5	2.7	1.0	2.6	...
Industrial production	–15.4	10.0	6.2	12.2	10.3	11.5	12.4	...
Industrial activity index (IFO) (*)	87.7	103.5	96.5	101.8	106.7	108.9	110.3	111.2
Unemployment rate (**)	8.2	7.7	8.1	7.7	7.6	7.5	7.4	7.3
Consumer prices	0.4	1.1	0.7	1.0	1.2	1.5	2.0	2.1
Trade balance (***)	142.8	149.2	143.3	150.2	149.9	153.4	153.8	...

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

Similarly, investment looks strong, given the good tone of demand and the increase in industrial capacity utilization. In fact, use of this investment in the production of capital equipment is above its long-term average.

The future also looks brighter for foreign trade. January's figures show an upward trend for exports and expectations are good, although there is likely to be some slowdown compared with the strong growth of 2010, although not so much because of the situation in Japan after the earthquake in March, given that Japan's share of the country's exports is relatively small. With regard to imports, these rose appreciably in January but especially due to rising prices.

The situation is also favourable on the supply side. Industrial production continued to progress in January, recording a year-on-year increase of 12.4%. The rise in industrial orders reinforces the position of the secondary sector. However, what is most surprising is the spectacular recovery by the construction industry, which grew by 36.3% in January compared with the previous month, after a decline at the end of 2010 because of bad weather conditions. Moreover, services are also included in the general improvement and the hotel sector recorded a notable rise in its turnover in the month of January.

These good macroeconomic figures are reflected in the labour market. The level of employment rose by 0.1% in January, seasonally adjusted, compared with December and by 1.2% compared with the same month last year. In February, the BA-X employment demand index reached a peak, as can be seen in the graph below, indicating the favourable perspectives for the labour market. The unemployment rate therefore continued to fall to 7.3% in February, its lowest level for several years.

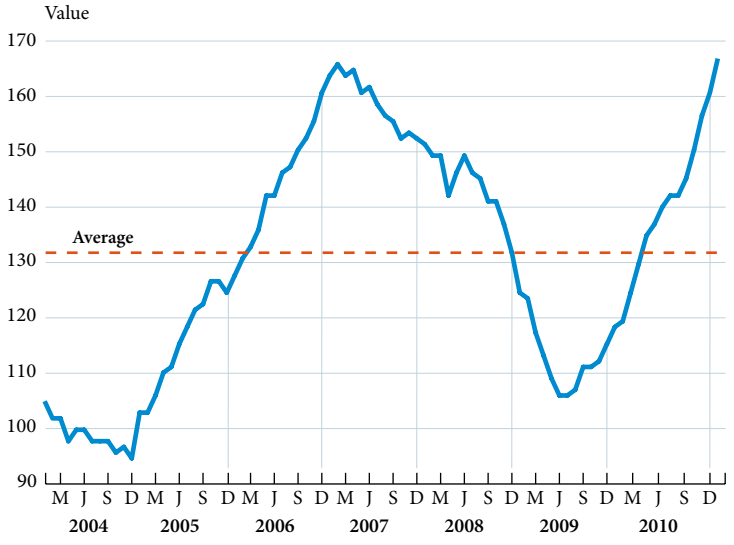
In contrast, demands for wage increases have intensified. However, it looks like unit labour costs will be contained due to higher productivity. On the other hand, the rate of inflation continued to rise in February, for the fourth consecutive month, up to 2.1%, passing the level of 2% for the first time since October 2008. This

The catastrophe in Japan should only affect German exports to a very slight degree.

Spectacular recovery by the construction industry after its decline at the end of 2010.

DEMAND FOR EMPLOYMENT REACHES A PEAK

BA-X employment index (*)



NOTE: (*) Data seasonally adjusted.
SOURCES: Bundesagentur für Arbeit and own calculations.

German GDP will speed up in the first quarter.

upswing was basically due to energy prices as core inflation, which excludes the most volatile components, remained at 1% in February. Nonetheless, we have raised our forecast for average annual inflation by 2 tenths of a percentage point to 2.1%.

In summary, GDP will speed up in the first quarter of 2011, after having posted 0.4% quarter-on-quarter growth in the fourth quarter of 2010. However, we then expect it to ease off and, for 2011 as a whole, post an annual rise below 2010's rate of 3.5%, which we place at 2.4%. This slowdown is particularly due to the rebound effect after the Great Recession of 2008-2009 wearing off, as well as to the repercussions of a restrictive budgetary policy in 2011. The impending hike in the official interest rate by the European Central Bank should not appreciably affect the German economy if real interest rates remain low.

New employment boosting measures in France to reduce a relatively high unemployment rate.

The French economy speeds up in the first quarter

Consumption livened up to some extent in February. Retail sales grew by 0.5% in real terms, seasonally adjusted, compared with the previous month. Of note is the 12.5% monthly rise in footwear and 4.5% in clothing, while passenger car registrations were up by 13.3% compared with February 2010. However, consumption will probably slow down in the next quarter, judging by the drop in consumer confidence in February for the third consecutive month. The unfavourable outlook for the labour market is weighing heavily on French people's spirits.

In fact, in spite of registered unemployment falling by 0.7% in January compared with December 2010 and the unemployment rate falling slightly to 9.6%, this is a relatively high level and the bulk of the evidence available suggests

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
GDP	–2.5	1.5	1.2	1.6	1.7	1.5	–	...
Domestic consumption	0.8	1.0	1.8	0.4	1.5	0.4	2.4	...
Industrial production	–12.4	5.9	4.8	7.5	5.1	5.9	5.4	...
Unemployment rate (*)	9.5	9.8	9.8	9.8	9.7	9.7	9.6	...
Consumer prices	0.1	1.5	1.3	1.6	1.5	1.7	1.8	1.7
Trade balance (**)	–49.3	–47.1	–43.0	–45.1	–49.6	–50.7	–53.4	...

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

that it will only fall very gradually. New measures were therefore presented to boost employment, totalling 500 billion euros, focusing on the young and the long-term unemployed and with an emphasis on training.

On the supply side, industrial production advanced in January compared with the previous month. The outlook is positive, partly due to demand from Germany. Services are also looking healthy. Quarter-on-quarter growth in GDP in the first quarter of 2011 was therefore able to go above the 0.4% recorded in the fourth quarter of 2010.

However, the economic expansion will probably moderate over the next few quarters, as suggested by some leading indicators and due to the effect of a restrictive fiscal policy. In this respect, the government passed a bill to introduce provisions in the Constitution to ensure the public accounts are balanced, following in the footsteps of Germany and in line with the recent guidelines provided by the European Union regarding economic governance. As we already know, the public deficit must fall to 6% in 2011, 4.6% in 2012 and 3% in 2013. Because of all this, and taking rising oil prices into account, we have lowered our forecast for the annual rise in GDP by 2 tenths of a percentage point to 1.6%.

The Libyan crisis is not helping the Italian economy

As the European neighbour closest to Libya and a notable trade partner, Italy might be hit by the crisis in this country. Although it might also benefit due to the diversion of a part of international tourism from North Africa, the overall balance seems to be negative, although economic indicators have yet to be noticeably affected.

In February, there was an upswing in inflation to 2.4% year-on-year, 0.3 percentage points more than in January. This is the third rise in a row for the consumer price inflation rate, mainly due to rising commodity prices and especially oil, also reflecting the tension in Libya. Core inflation also rose by 0.3 percentage points in February to 1.7%, due especially to increases in transport. On the other hand, the figures for wages in large firms showed a modest year-on-year increase of 0.9% per employee in

The French government also wants to introduce provisions in the Constitution to ensure the public accounts are balanced.

Job losses in January and the upswing in inflation discourage Italian consumers.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
GDP	–5.2	1.2	0.6	1.5	1.4	1.5	–	...
Retail sales	–1.7	0.0	–0.1	–0.3	0.6	0.1	0.1	...
Industrial production	–18.2	5.4	3.5	7.9	6.2	4.2	0.9	...
Unemployment rate (*)	7.8	...	8.4	8.4	8.3	...	–	...
Consumer prices	0.8	1.5	1.2	1.4	1.6	1.7	2.1	2.4
Trade balance (**)	–10.2	–16.2	–7.7	–13.2	–19.1	–24.8	–29.9	...

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

Modest rate of growth for the Italian economy.

December, supporting the thesis of excluding, for the moment, any second-round effects.

If we add to this the 0.4% increase in job losses in January compared to the previous month, it's no surprise that consumption is looking weak in the first few months of the year. Industrial production didn't get off to a good start in 2011 either, down 1.5% compared with December. However, orders rose year-on-year by 17.5% and confidence in the secondary sector is above its long-term average, so that the outlook is moderately optimistic. The panorama for investment is also favourable.

On the other hand, foreign demand might help economic expansion. In fact, in January exports rose more than imports compared with the previous month. For the whole of 2011, and given that the need for budgetary consolidation will moderate domestic demand, we expect an annual increase in GDP of around 1%, a little below the rise in 2010, which was revised to 1.2%. The Italian economy will therefore continue to grow a little less than the average for the euro area as a whole. On the other hand, we have increased our forecast for average inflation in 2011 to 2.3%, due to the rising trend in commodity prices.

Inflation rises to 4.4% year-on-year.

The United Kingdom: more inflation and more uncertainty regarding growth

In mathematics, an equation is an equal sum that contains one or more unknowns. However, not all equations can be solved. This seems to be the current situation of the United Kingdom, where the two unknowns are consumption and public spending, which form part of the gross domestic product equation. Even the Governor of the Bank of England, Mervin King, admitted to the press that uncertainty had significantly increased regarding the future path to be taken by inflation and growth.

However, we can restrict this level of uncertainty by selecting key variables on which economic activity will depend in the United Kingdom during 2011. These are: inflation, interest rates, the new fiscal budget and foreign trade. The importance of these variables lies in their impact on the net disposable income of households.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
GDP	–4.9	1.3	–0.3	1.5	2.5	1.5	–	...
Retail sales	1.0	0.4	–0.1	0.9	0.7	0.1	5.3	...
Industrial production	–10.1	2.1	0.1	1.5	3.0	3.3	4.5	...
Unemployment rate (1)	4.7	4.6	4.9	4.6	4.5	4.5	4.5	4.5
Consumer prices	2.1	3.3	3.2	3.4	3.1	3.4	4.0	4.4
Trade balance (2)	–86.8	–88.7	–83.3	–85.4	–90.6	–95.5	–96.5	...
3-month Libor interest rate (3)	1.2	0.7	0.6	0.7	0.7	0.7	0.8	0.8
Nominal effective pound exchange rate (4)	73.9	80.4	80.4	78.2	81.5	79.3	79.2	80.5

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.

Regarding inflation, the latest figures for the CPI in February showed a 4.4% rise year-on-year, the highest since October 2008, while core inflation was up 3.4%. Our forecast for inflation, which remains the same for 2011, is 4.0%.

Which components push up inflation? There are several factors but two stand out. The first is the two and a half point rise in VAT from 17.5% to 20%, which took place in January. Secondly, the United Kingdom is not immune to price rises in oil and other commodities. So we cannot rule out inflation approaching 5% over the coming months. But it is very important to consider whether these impacts are permanent or temporary, and in both cases it is the latter. This is important because we expect British inflation to end the year close to 3.6% and that, in 2012, the base effect will help inflation to fall sharply, although this higher inflation will undoubtedly erode households' disposable income during 2011.

Another key variable will be how the central bank reacts to the rise in inflation. The minutes published for one of its latest meetings shows a split in the Monetary Policy Committee. At the moment, the official interest rate is at 0.5%, and one member proposed a rise of 0.5%, another two voted in favour of a rise of just 0.25%, while another member preferred to increase liquidity through buying up assets and the rest decided that the best thing was to keep the official interest rate as it was.

This situation reflects the uncertainty regarding growth in the United Kingdom. Given the bad growth figures for the fourth quarter, we believe the reserve bank will prefer to see the figures for the first quarter before taking any decision. However, it is likely that, around summer time, the United Kingdom will have a somewhat higher official interest rate. It's clear that this situation would lead, once again, to a reduction in consumers' disposable income, although this possibility has already been included in the price of money, as can be seen in

Higher taxes and interest rates will reduce households' disposable income.

The risk for the United Kingdom is a downgrade in its economic growth.

the different curves for interest rates (public debt and interbank market) that have risen recently, incorporating this information.

The other two most important factors are the new fiscal budget presented by the Chancellor of the Exchequer at the end of March and the trend in foreign trade. Regarding the former, it's important to know what the tax hikes will be to help the government achieve its goal of fiscal consolidation, as this will allow us to calculate the impact on families' reduced net income. On the other hand, the depreciation of the pound sterling, together with greater global growth, was expected to boost exports. Although the latest figures do not point towards an improved trade balance, higher prices for foreign products compared with domestic ones will encourage consumers to spend their money on the latter, helping this component to contribute positively to growth in the United Kingdom.

Fortunately, over the next few months a large number of these unknowns will be revealed, so that we'll be able to determine the direction taken by economic activity this year and the next with more certainty. But we can already state that the risk is asymmetrical, insofar as it's more likely that we will have to lower our growth forecast for 2011 from 2.1%.

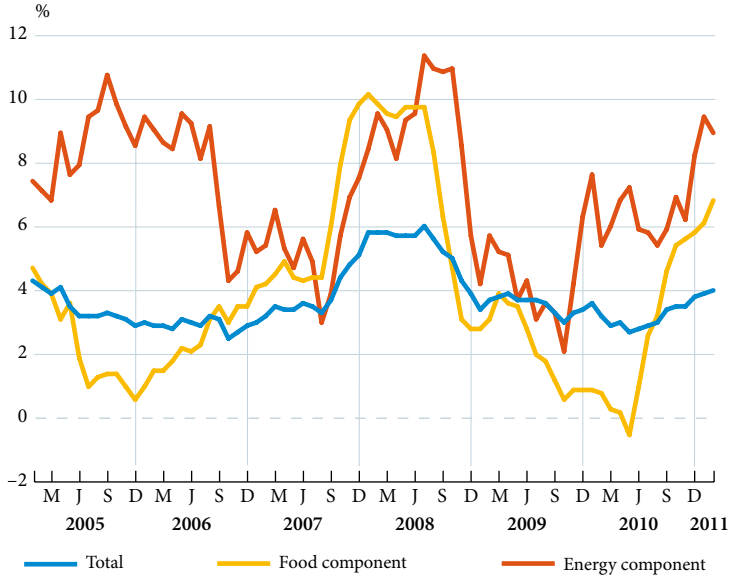
Emerging Europe: inflation, a paper tiger?

Emerging Europe is concerned about inflation.

The sharp rise in commodity prices and particularly oil has led to doubts regarding the impact this process will have on inflation and growth in emerging Europe. In order to determine whether this concern is well grounded or lacks any factual basis, we can ask three questions: have these pressures on prices at source already been passed on to consumer prices in the region?; have

NOTABLE INFLATIONARY PRESSURE BY FOODS 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.

the inflation expectations of economic agents altered and, consequently, the basic premises that have guided the development of monetary policy to date?; and, lastly, is this upswing in prices occurring within a context of dynamic recovery or within another that points to a loss in economic pace?

The first of these questions can be answered in the affirmative: inflation is already reflecting the upswing in commodity prices. Taking as our regional reference the average of the figures for Poland, the Czech Republic, Slovakia, Hungary and Romania, the energy and, to a lesser extent, food components have posted notable increases since the last part of 2010 (see the graph above). The latest figures available, referring to February, place the first of these aggregate flash estimates close to 9% year-on-year, and more than 7% year-on-year in the case of foods. Nonetheless, there has been less tension on the general index as, since mid-2010, inflation has gone from 3% year-on-year to 4%.

Although today's figures cannot be seen as historically high, neither can we be complacent about them. First of all, rather than the level of inflation reached, of concern is the fact that this upward trend has occurred in relatively few months. Moreover, and this is related to the second question, the one regarding the alteration of monetary policy, the figures being reached in the region's main economies are at the top end of the inflation targets for their respective central banks (which, depending on the country, are usually between 3% and 4%). This fact alone does not require an immediate reaction on the part of the monetary authority, as it might be temporary, but it does become more crucial if the shock of prices has more permanently altered inflation expectations.

If we assume that the inflation forecasts for 2011 and 2012 being used by analysts are a reasonable estimate for these expectations, then we must admit that both the levels forecast for inflation as well as the upward revisions carried out over the last few months do not suggest the situation will get particularly worse.

Certainly, consumer prices have picked up...

Nonetheless, for the coming quarters, consumer prices will grow too close to the upper limits of inflation targets to conclude that this situation is without any risk.

All this suggests that the central banks will continue with their current plan for 2011 and 2012, starting the process of getting reference interest rates back to normal. Should this plan be followed, Hungary and Poland, which have already started toughening up their monetary policy, will be followed before the summer by the Czech Republic and, in the second half of the year, by Romania. In all cases, the rise in interest rates will be gradual and should continue in 2012.

...although, for now, there seems to be no deterioration in inflation expectations.

In short, the answer to the second question we asked initially is that it seems that inflation expectations have hardly degraded and the premises supporting the planned developments for monetary normalization do not differ too greatly from those employed months ago.

We still have to answer the last of the questions asked, the one regarding the context of economic activity in which the inflationary upswing is occurring. Any definitive assessment of the economic damage produced by the upswing in prices certainly depends on whether this occurs during a dynamic or hesitant recovery. Fortunately, emerging Europe is positioned within the first of these. Available indicators suggest that the economy is recovering its dynamism

No changes are expected in the plan for monetary policy: gradual normalization in 2011 and 2012.

Fortunately, the upswing in inflation is occurring within a context of solid expansion.

after a slight slowdown in activity in the fourth quarter of 2010. This is therefore a clear consolidation of a recovery that had already built up strength throughout 2010 and that, via inertia, should remain notably vigorous at least during the first half of 2011. Within such a context, the drain on growth represented by higher prices is likely to be offset by activity expanding faster than expected a few months ago.

Implicitly, all the previous assessment, widely shared in the region, depends critically on how the upswing in inflation is interpreted in emerging Europe. To date, the most popular interpretation is that this is a temporary setback and its effect is therefore relatively moderate in scope and concentrated in terms of time (particularly because it is occurring within a context of solid recovery, as mentioned above). Should the reality differ from this hypothesis, the scenario will be different and certainly less benign in a region where commitment to macroeconomic stability is a relatively recent feat.

The procyclicality of the new regulation: will we rest any easier with the new buffers?

One of the main causes of the recent financial and economic crisis, and one often mentioned, is the procyclical nature of the financial system. In other words, the fact that the financial system does not dampen economic cycles but actually accentuates them.[1]

This Box analyses one of the main reasons for this procyclical nature - the lack of cyclical adjustment in regulatory capital - and evaluates to what extent the new regulatory proposals solve the problems detected.

The proposal made by Basel III[2] introduces two key elements to dampen the procyclical effect: the establishment of **capital buffers** and the calculation of credit provisions based on expected losses **(countercyclical provisions)**. The idea is for institutions to build up buffers in good times that can be drawn upon, and thereby offset credit losses, in recessionary periods. The aim is to prevent institutions from reducing the availability of credit during recessionary periods in order to be able to comply with the regulatory capital requirements.

Regarding **capital buffers**, two have been established above the new minimum core capital requirement of 4.5% of risk-weighted assets (RWAs): a «capital conservation» buffer (2.5% of RWAs, at the discretion of the financial institution)[3] and another «countercyclical» buffer (up to 2.5% of RWAs, at the discretion of the national regulator). The idea is that, once Basel III comes fully into force in 2019, institutions will be able to vary their core capital ratio between 9.5% during boom periods and 4.5% at times of crisis, using up to 5 percentage points of capital to mitigate the effect of a crisis. As a reference, in the case of Spain this would increase the capacity to take on gross losses by up to 140 billion euros.

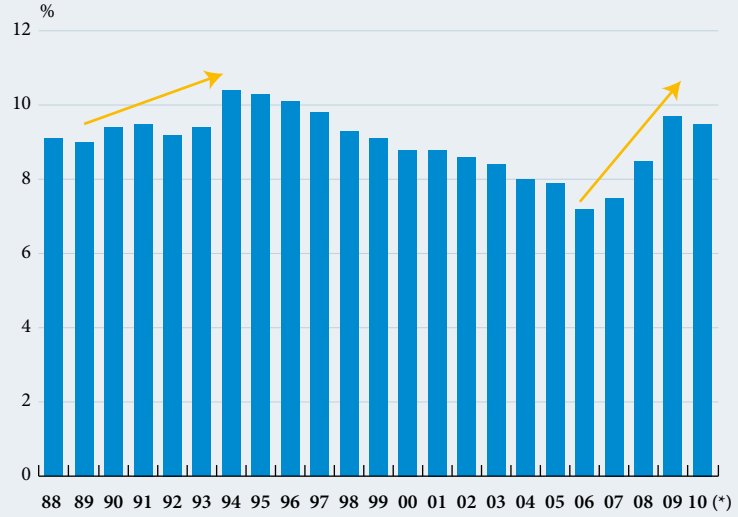
(1) For an exhaustive discussion of this issue, see Gual, J. (2009) «El carácter procíclico del sistema financiero», *Documento de Economía "la Caixa"*, no. 14.
(2) Basel Committee on Banking Supervision (2010), «Basel II: A global regulatory framework for more resilient banks and banking systems».
(3) Non-compliance leads to restrictions on the payment of dividends, among others.

However, **capital buffers are not used up automatically** but at the discretion of the national supervisor and the financial institution. It is therefore necessary for supervisors, governments and also the markets to really allow institutions to use these buffers and reduce their capital levels during years of crisis. But would these agents agree to buffers being used up and the consequent deterioration in capital? It seems more likely that the negative signal emitted when the level of capitalization falls would be too strong and would substantially limit the capacity of institutions to access capital markets. The graph below shows how, in the last expansionary phase, Spanish financial institutions preserved large buffers in spite of gradually reducing their Tier 1 capital base,[4] as they always remained a long way above the regulatory level required (4% under Basel II for Tier 1 capital). However, since the start of the crisis in 2007, and as happened in the crisis of the 1990s, they weren't able to make use of these buffers. Moreover, they were forced to increase their capital base to limit the damage to their image of solvency. In the latest crisis, it is clear that many international analysts mistrust not only the regulatory models used to estimate risk (the basis for calculating capital requirements) but also the stress tests carried out by supervisors at a European level. In fact, in their own analyses they use even more severe and therefore even less likely scenarios. They also require that, right now, institutions should keep enough capital to be able to maintain levels that are much higher than the regulatory ones, even under these extreme scenarios. They ignore the fact that these regulatory minimums were designed precisely for the worst moment in the cycle, once the buffers established had been used up. In short, in a future crisis it doesn't seem very likely that the markets would react more rationally and allow capital levels to fall by making use of the buffers built up in the good times.

One type of buffer that seems to have been used better during the last crisis is the Bank of Spain's **countercyclical provisions**. As can be seen in the graph on the next page, Spanish financial institutions built up provisions during the upward phase of the cycle and started to use them up to soften the impact of the crisis on profits and solvency as from 2007. This way of using buffers seems to be more readily accepted by the market. These are buffers that

TIER 1 CAPITAL OF THE SPANISH GROUPS

As a percentage of risk-weighted assets



NOTE: (*) Flash estimate by the Bank of Spain in a presentation by its governor in February 2011.
SOURCE: Bank of Spain Supervisory Report.

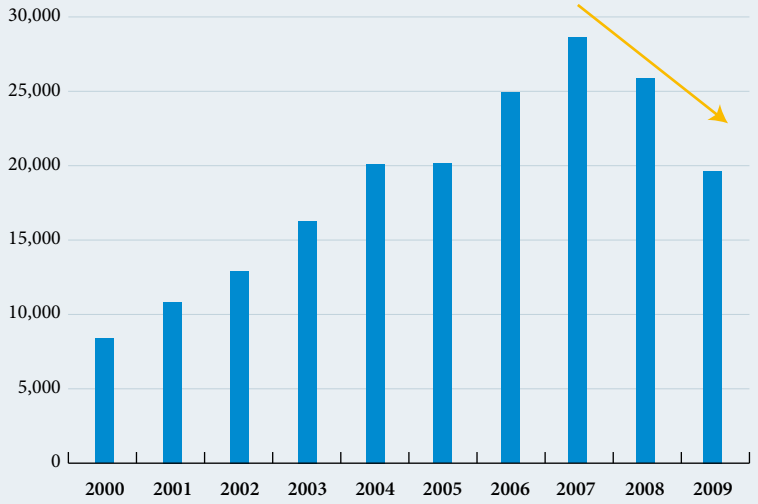
(4) A broader definition of capital than core capital, as it also includes preferred shares.

do not form part of the core capital and, as they are used up, become capital as greater falls in profits are avoided. Moreover, this is a tool that – correctly calibrated - not only softens the effect of a crisis *ex post*, like capital buffers, but also discourages excessive credit growth by institutions because it discriminates between institutions according to the growth in their portfolio. The new Basel III regulation supports the production of a system of countercyclical provisions but leaves this task to the accounting standard boards (IASB and FASB). The last joint proposal by these two organizations[5] represents a correct step in this direction but still leaves some important loose ends. On the one hand, different concepts are used from those of the regulator. On the other hand, the fund of provisions to be set up has, as a minimum limit, an estimate of the expected loss of the credit portfolio for the coming years (and not a fixed estimate of the cycle average, as in the case of the Spanish countercyclical provisions). Consequently, requirements increase when the cycle's downward phase starts and provisions continue to be built up at a time when they should be used to soften the effect of an economic slowdown. As a consequence, using up the buffer of provisions accumulated is delayed until the recovery phase begins, invalidating a large part of its countercyclical function.

In conclusion, to really be able to rest easy with the new buffers, it seems necessary to make a significant effort to convince the markets of the usefulness of these mechanisms and to refine even further the proposal of countercyclical provisions by the IASB and FASB.

COUNTERCYCLICAL PROVISIONS (*)

In millions of euros



NOTE: (*) Estimate based on Bank of Spain data. It underestimates the real consumption as, in addition to generic provisions, it also includes specific provisions for public administration, non-resident sectors and contingent risks. In a recent publication (February 2011), the Bank of Spain calculated the consumption of the generic provision between December 2007 and September 2010 at around 16 billion euros.
SOURCE: Chapter 4.07 of the Statistical Bulletin of the Bank of Spain.

(5) IASB, IFRS (2011), «Financial Instruments: Impairment - Supplement to ED/2009/12 – Financial Instruments: Amortised Cost and Impairment», January 2011.

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FINANCIAL MARKETS

Monetary and capital markets

Calm in spite of the shocks

While, in February, the financial markets were disturbed by the socio-political conflict of the countries in North Africa and the Middle East, unfortunately in March the natural catastrophe suffered in Japan was added to the mix. Internationally, the effect of these factors has been passed on via two fundamental channels. Firstly, by rising commodity prices (mainly crude), significant due to the related risks of inflation and global growth. Secondly, the fact that both events are subject to a large amount of doubt, given that they are difficult to quantify, constitutes a threat to investor confidence and financial stability.

However, the financial markets' performance observed during the first quarter of 2011 has been reasonably satisfactory compared with the same period a year ago. This is due to the positive trend in the macroeconomic variables of each region, as well as to coordinated action between monetary authorities and governments. Everything suggests that agents, when making their investments, are assuming that world economic growth will continue to consolidate, with contained levels of inflation and relatively comfortable liquidity levels. In the medium term, the bulk of the evidence available suggests that the progressive consolidation of this economic scenario should be accompanied by a normalization of monetary policy, which should not undermine the rises in stock market indices.

However, once again we must highlight the nuances generated by cyclical and structural differences between the different economic regions, given that unequal growth rates entail different monetary policy decisions, with a range of reactions in the foreign exchange, bond and equity markets.

The outbreak of conflict in Arab countries and the earthquake in Japan grab the attention of global investors.

With regard to the euro area, we cannot ignore the fact that the development of the sovereign debt crisis in the periphery zone is now in at a key stage in its resolution, after the different summits held by top political leaders. Specifically, the progress made in the functions and operations of the European Financial Stability Fund, as well as the approval of the Euro Plus Pact, together with fiscal discipline, are managing to restore investor confidence in Spanish assets.

Greater prospects for economic growth boost investor confidence.

The Fed focuses on growth while the ECB is concerned about inflation

The world economy continues to advance apace, led by the emerging countries and supported by the progressive recovery both in the United States and Europe. However, recent politico-military and natural events negatively distort the balance of risk, a situation that makes it difficult to take economic decisions, particularly those regarding monetary policy. On the one hand is the growing geopolitical risk in the Middle East and North Africa, which has a direct impact on oil prices and, by extension, inflation and the economic activity of the different

The development of the sovereign debt crisis in the periphery of Europe enters a key stage in its resolution.

The Fed continues to commit to lax monetary policy and quantitative easing but without forgetting inflation.

countries, of an uncertain and varying extent. Since mid-2010, oil prices have risen by almost 40%. The consensus of economic analysts estimates that this rise could deduct between 0.2% and 0.4% from the GDP of developed countries (the G-7) for the coming quarters, but we will have to wait and see how long and to what extent tension grows in the crude market. On the other hand is the negative impact that might result from the tsunami that shook Japan and the subsequent nuclear accident at Fukushima. In principle, most analysts limit any significant effects to Japan. However, and although it may be difficult to measure, we must not underestimate the impact of these events on investor confidence.

On the other hand, the ECB announces possible hikes in official interest rates in order to stabilize prices.

Within this global environment, the Federal Reserve (Fed) is starting to present a slightly more optimistic view regarding the relevant variables that would determine the time to start changing its conventional and unconventional monetary policy. Regarding activity, the institution has pointed out that the recovery «is on a firmer footing», at the same time stressing that conditions in the labour market «seem to be improving gradually». We must remember that, in January this year, the reserve bank classified activity as «insufficient» to boost job creation in any sustained way. Regarding general inflation, the Fed believes that second-round effects will not occur after the rise in energy commodity prices over the last few months, but that a close eye will have to be kept on this factor. Given this scenario, the Fed announced that it is keeping its quantitative easing scheme in place in order to consolidate and boost the improvement. Most economists support the view that the institution presided over by Ben Bernanke will maintain its status quo in terms of official interest rates and balance management for a few more months, and will continue to resort to communication policy as a key tool to guide the markets. We will have to wait and see, in the coming summer, whether the institution sets out the lines of action it will adopt once the recovery is consolidated, which should include a route map for the gradual withdrawal of the stimuli currently in place.

In the euro area, the European Central Bank (ECB), by means of its President, Jean-Claude Trichet, surprised the markets at the press conference after the meeting of the Governing Council on 3 March. Trichet explicitly commented on the institution's unease regarding the low level of official interest rates and the need to get them back to normal. The main reason for the ECB's resounding change in tone is to keep inflation expectations firmly anchored at a suitable level in the medium and long term. These statements led to a radical change in investor forecasts, which now expect the central bank to start raising official interest rates in the spring. Moreover, Trichet, supporting himself with the «separation principle» between the mandate of maintaining price stability (whose instrument is interest rates) and the need to ensure financial markets work appropriately (by providing liquidity), confirmed that the full allotment policy will be maintained for another quarter in the seven-day, one-month and three-month loan auctions.

Given the upswing in inflation, the emerging economies' central banks toughen up their economic policies.

In general, the situation in the emerging countries has not varied substantially and economic authorities are focusing their efforts on containing short-term inflationary pressures resulting from the sharp rise in energy and food commodity

prices, and on anchoring medium and long-term inflation expectations. Along these lines, the central banks continue to restrict monetary policy and accept a gradual appreciation of their currencies. In the case of China, the monetary authority has opted to increase the mandatory reserve ratio for commercial banks to 20%, whereas the central banks of India, South Korea, Brazil and Chile, among others, have decided to raise their official rate. Although monetary policy is tightening up gradually, the dominant opinion in the markets is that the strategy adopted by the central banks will manage to contain the second-round effects threatening economic stability. The main underlying risk, especially for China, is the rate of restriction being too moderate and not enough to stop the economy from overheating, not a very desirable situation as it might result in a sharp slowdown in growth.

Within this global context, characterized by upward inflationary pressures, the interbank markets in dollars and euros continue to perform disparately. In the case of the Libor dollar interest rate, market expectations indicate that the current stability will continue being the predominant tone in the coming months. The Fed's decision to keep official interest rates very low and the

Europe's interbank market reflects the greater expectation of interest rate hikes.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2010									
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	1.00	1.07	1.64	0.25	0.30	0.19	0.50	0.78	0.26
February	1.00	1.09	1.77	0.25	0.31	0.19	0.50	0.80	0.10
March (1)	1.00	1.19	1.95	0.25	0.31	0.20	0.50	0.81	0.29

NOTES: (1) March 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.

Government bond markets have reacted to the conflict in Arab countries and Japan's earthquake with higher volatility.

abundant liquidity injected are helping this situation. On the other hand, and given the decisive nature of Trichet's message, the interbank market rates in euros have risen, principally the 12-month Euribor, up from 1.77% at the end of February to above 1.9% in March. The vast majority of analysts have upped their forecasts for European interbank rates. However, the levels reached in March are likely to consolidate for a few months, picking up again in the second half of the year when the central bank's monetary restrictions are in full swing.

Temporary factors are affecting the government bond markets

In the last few weeks, sovereign debt has suffered from the geopolitical conflict in the Middle East and the events in Japan. Public debt yields at a global level have recorded strong volatility and a downward trend in March, a consequence of these short-term, temporary factors and not so much due to a change in medium or long-term macroeconomic perspectives. In the case of the United States, the fall in two and ten-year yields, to 0.53% and 3.15% respectively, has occurred over two phases. The first was associated with a mere technical correction after the strong upswing in yields during the end of February and early March. The second is the result of a «flight to quality» by investors, due to the terrible earthquake and tsunami that struck Japan and the intervention of western forces in Libya. This last phase also affected German 2 and 10-year bond yields, falling to 1.47% and 3.09% respectively. At the end of March, the geopolitical and nuclear uncertainty

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								
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	3.16	3.53	5.37	4.72	3.37	1.22	3.66	1.87
February	3.17	3.55	5.39	4.84	3.43	1.26	3.60	1.90
March (*)	3.23	3.59	5.18	4.76	3.35	1.22	3.56	1.85

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

started to dissipate, a situation that boosted the confidence and appetite of investors for higher risk assets and, consequently, pushed up yields on the sovereign debt of central countries, reflecting more precisely the perspectives of solid global growth and moderate increase in inflationary risks.

In the United States, we can expect yields to rise again as the end of the Fed's quantitative easing scheme approaches (planned for June) and the new direction of monetary policy is announced. There are principally two risks within this process that might accentuate this movement. The first is inflation, which the Fed has stated it is keeping a close eye on. The second, crucial to ensure no loss of investor confidence, is carrying out the necessary fiscal consolidation to ensure medium to long-term sustainability.

In the case of Europe, specifically the central countries, current conditions point towards a consolidation of levels in the spring which, in the second half of the year, will give way to a moderate rise. This would affect both long-term and short-term rates, in line with the ECB's monetary restriction process. Regarding the risk premia of countries such as Spain and Italy, the gradual fall observed indicates that agents are welcoming the European Union's measures to improve economic and financial governance in the region. This new situation will help to reduce the sovereign risk premia of the peripheral countries, although countries such as Spain will do so to a greater extent than others with high debt ratios, such as Greece, Ireland and Portugal.

International cooperation to slow up the yen's appreciation

As has been typical since the start of the year, the foreign exchange market has continued to show notable stability in general, albeit dotted with some unexpected episodes. At the start of March, the calm was disturbed by statements by the ECB President suggesting impending interest rate hikes, and subsequently by Japan's earthquake. In any case, the dynamic of exchange rates is providing a more balanced reflection of the trends in economic figures among the main economic regions (basically between emerging and developed countries), helping to reduce volatility in these markets.

In the euro area, the progress made in resolving the sovereign debt crisis is helping Spanish public debt yields to stabilize.

In the case of the euro, the change in investor expectations regarding whether the ECB will raise the official interest rates in the near future, fed by repeated statements by important members of the institution, together with the satisfactory developments in the sovereign debt crisis in Europe's periphery, have been the factors behind the euro's appreciation to 1.41 dollars, a rise of more than 2.5% between the ECB's last meeting and the end of the month.

The euro exchange rate appreciates, pushed up by expectations of interest rate hikes.

Regarding the Japanese yen, the country's tragic events led to its currency rising sharply against the dollar, reaching record levels (76.25 yen per dollar). This strong movement was due to increased expectations regarding the repatriation of Japanese savings invested in foreign assets. Given this situation, and as an extraordinary measure, the central banks of the G-7 countries agreed to intervene jointly in the foreign exchange market,

Joint monetary action by the G-7 reduces inflationary pressure on the yen.

EXCHANGE RATES OF MAIN CURRENCIES

March 24, 2010

	Exchange rate	% change (*)		
		Monthly	Over December 2010	Annual
Against US dollar				
Japanese yen	80.9	–1.2	–0.2	–14.1
Pound sterling	0.618	0.3	3.5	8.1
Swiss franc	0.912	–1.6	–2.6	–17.7
Canadian dollar	0.979	–0.4	–2.0	–4.9
Mexican peso	11.995	–1.3	–2.9	–4.9
Against euro				
US dollar	1.410	–2.2	–5.4	–5.9
Japanese yen	114.1	0.9	4.9	–7.7
Swiss franc	1.286	0.6	2.7	–11.1
Pound sterling	0.872	1.9	1.6	–2.8
Swedish krona	8.934	1.4	–0.6	–8.5
Danish krone	7.457	0.0	0.0	0.2
Polish zloty	4.025	1.1	1.5	3.3
Czech crown	24.42	–0.4	–2.4	–4.0
Hungarian forint	268.6	–1.9	–3.8	1.8

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

Credit spreads widen as a result of international instability.

the first time in ten years. The mission was to sell yen in order to relieve the sufferings of the Japanese economy. As a result of this action by the G-7, the yen's exchange rate fell by almost 3%, reaching around 80 yen per dollar at the end of the month.

High yield bonds still shine

The global private bond market performed well in March, although temporarily (and inevitably) subject to unstable episodes due to the tragic events in Africa and Japan. As has already been mentioned, these factors led to a selective fall in top quality sovereign debt yields and, therefore, an increase in credit spreads. This was a hiatus in the narrowing that has been occurring since spring last year. However, once the possible effects of Japan's natural disaster had been assimilated, credit spreads readily started to narrow again, indicating the strength exhibited by corporate bond markets for the last few months.

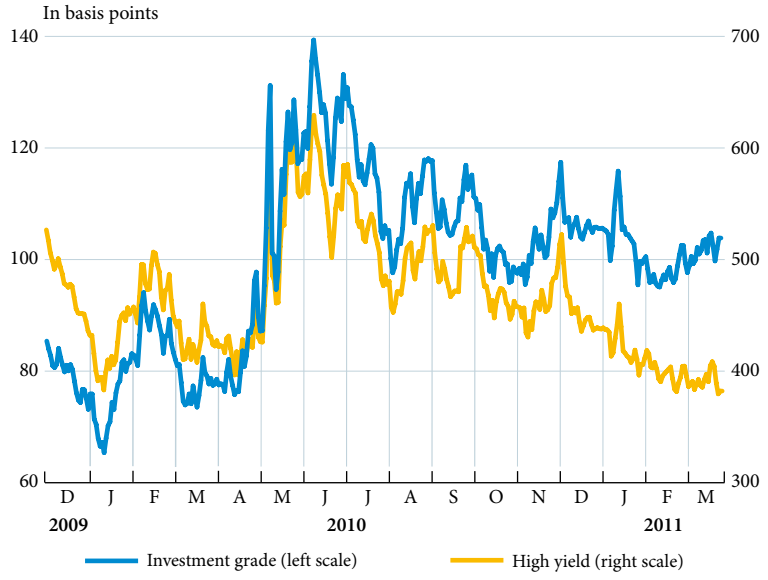
Yields for the high risk bond segment are still immersed in a downward spiral.

In fact, having at least partially overcome the episodes of instability, the fall in firms' credit risk has continued inexorably, both in the United States and in the euro area. Once again, the greatest reduction has been in the high yield segment, to the point that yields for these corporate bonds were close to record lows. Taking advantage of this circumstance, investors have opted to increase the volume of their portfolios for this kind of asset.

From the point of view of issuers, it should be noted that, in the case of the

TRENDS IN CORPORATE RISK PREMIA IN THE EURO AREA

5-year Markit iTraxx indices



SOURCE: Bloomberg.

United States, the lassitude that is still being preached by the Federal Reserve is giving companies an opportunity, and one they are making the most of, to issue bonds with weak guarantees and very low interest rates, given that investors are reducing their demands because of the general context of low interest rates in traditionally alternative products (bank deposits and public debt). Nonetheless, managers can still find interesting opportunities within the wide range of corporate bond assets, albeit by being very selective in terms of geographical area and issuer.

In the case of the euro area, the progress achieved in the last few meetings of central government heads regarding the new economic and financial governance framework has led the sovereign debt crisis of the periphery towards a satisfactory resolution, helping corporate credit risk premia to fall. To this we should also add the improvement in investor confidence, overcoming short-term setbacks such as the events in March, so that capital flows have once again increased towards the corporate bond market. In the current phase, a preference can be seen for banking and insurance sector debt in the euro area, severely hit during the harshest moments of the sovereign debt crisis.

Agreements to resolve the European sovereign debt crisis make banking sector bonds more attractive.

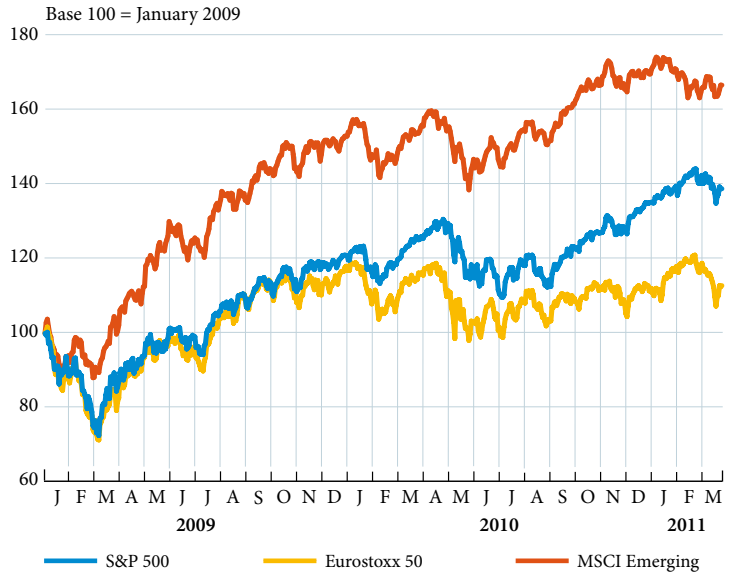
In spite of adversities, the stock market outlook is favourable

The global stock market context has not remained unaffected by March's tumultuous international context. However, losses have been limited thanks to the support provided by the consolidation of global economic growth prospects and the boom of the business cycle. Although there has been the odd upswing in volatility, after having weighed up the effects of the risk mentioned above, investors have

The outlook for economic growth and the business expansionary cycle boost stock markets.

TRENDS IN THE MAIN INTERNATIONAL STOCK MARKETS

Stock market indices



SOURCE: Bloomberg.

Improved expectations for yields from the indices of advanced economies are starting to attract greater investor flows.

gradually returned to equity in detriment of other assets with less attractive expected yields.

March saw a hiatus in the emerging stock markets performing worse than those of developed countries. Given that the economic conditions surrounding the emerging economies have not changed, this seems to be a one-off occurrence related to the month's tragic events that might not be repeated in the future. We must remember that the need to keep inflationary pressures under control suggests that the normalization of monetary policies in emerging economies will continue and this will hinder any rises in their stock market indices. Moreover, the higher yields expected from the indices of industrialized countries (reflecting the improved economic outlook) should lead to flows being transferred from emerging economies, something that will further accentuate this decoupling. It should be noted that the progress made in the area of fiscal discipline in the euro area, focusing on improving the stability and strength of the region's financial system, is being welcome by investors and analysts, becoming an additional support.

In the medium term, economic and business factors are making equity more attractive.

Within this context, the outlook for the world's equity markets looks favourable in the medium term. The forecasts of the vast majority of economists point towards a consolidation in world economic growth, which will restore investor and entrepreneur confidence, help the expansion of the business cycle to continue and lead to a gradual reduction in credit risk. All this should help equity to rise in value. Nonetheless, we must acknowledge the fact that there are short-term risks that might lead to uncertainty and one-off corrections in the direction taken by the main stock markets. Among these elements, of note is the worsening of some of the geopolitical risks, as well as an (unlikely) outbreak of the sovereign debt crisis in the euro area.

INDICES OF MAIN WORLD STOCK EXCHANGES

March 24, 2011

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,086.0*	*0.1*	*4.4*	*11.5*
Standard & Poor's	*1,297.5*	*–0.7*	*3.2*	*11.1*
Nasdaq	*2,698.3*	*–1.4*	*1.7*	*12.5*
Tokyo	9,435.0	–9.7	–7.8	–12.8
London	5,805.9	–1.9	–1.6	2.3
Euro area	2,858.5	–3.1	2.4	–1.6
Frankfurt	*6,811.5*	*–4.5*	*–1.5*	*12.8*
Paris	*3,903.0*	*–2.7*	*2.6*	*–1.2*
Amsterdam	*359.4*	*–1.2*	*1.4*	*5.2*
Milan	*21,687.0*	*–1.2*	*7.5*	*–4.9*
Madrid	*10,569.4*	*–0.7*	*7.2*	*–2.7*
Zurich	6,240.6	–4.2	–3.0	–9.3
Hong Kong	22,915.3	1.4	–0.5	9.1
Buenos Aires	3,348.8	–1.0	–5.0	37.3
São Paulo	67,795.5	1.3	–2.2	–1.6

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.

Regulating CDS markets: looking for a balance between stability and efficiency

The derivate markets, and in particular credit derivatives, have played an important role in various episodes throughout the economic and financial crisis of the last few years. The dominant opinion among authorities is that they helped to destabilize the system and increase tensions so that, during 2010, a number of international and local initiatives were implemented to reform their regulation, which are due to culminate in the coming months. As often happens in the financial area, the conflict between stability and efficiency surrounds the debate regarding the advantages and drawbacks of these new rules.

Credit derivatives are instruments whose value depends (hence the term «derivative») on the credit risk (defaulting on a debt obligation) existing for another asset (called the «underlying asset»), such as a bond or loan. In the last few years, the most important credit derivatives have been Credit Default Swaps (CDS) and Collateralized Debt Obligations (CDOs), notably present both in the 2007 subprime mortgage crisis of the United States as well as in the quasi-collapse of the banking system in Autumn 2008 and, more recently, in the tensions regarding the sovereign debt of the euro area's peripheral countries. While CDOs have practically disappeared due to the stigma

of the subprime fiasco, CDS have become a basic, fundamental instrument for handling credit risk and have attracted the attention of regulators.

In essence, a CDS is a derivative contract under which one party (the buyer) makes a regular payment to another party (the seller) for a certain period of time, in exchange for a payment by the latter should a certain firm or government (the reference entity) default during this period. This contingent payment covers the difference between the nominal value of the underlying asset (the bonds issued by the reference entity) and its market value after possible default. So this instrument can be used to cover the risk of a pre-existing bond portfolio (by buying CDS) or to create credit risk exposure (by selling CDS). But CDS can also be purchased without possessing the underlying asset at the same time, a situation that is called a «naked» position.

Until the crisis, the overwhelming conception among investors, academics and regulators stressed that CDS help to slightly increase the efficiency of the financial market and the economy, since they improve the price discovery mechanism, redistribute risk towards predisposed agents able to bear it and complete the markets by widening the possibilities for portfolio selection. And all this at a very low transaction cost. Given these arguments, the position of authorities was one of *laissez-faire*, keeping themselves at a distance from a market that was growing via private initiative, with practices and customs coming from the participants themselves and hardly any regulation or public supervision.

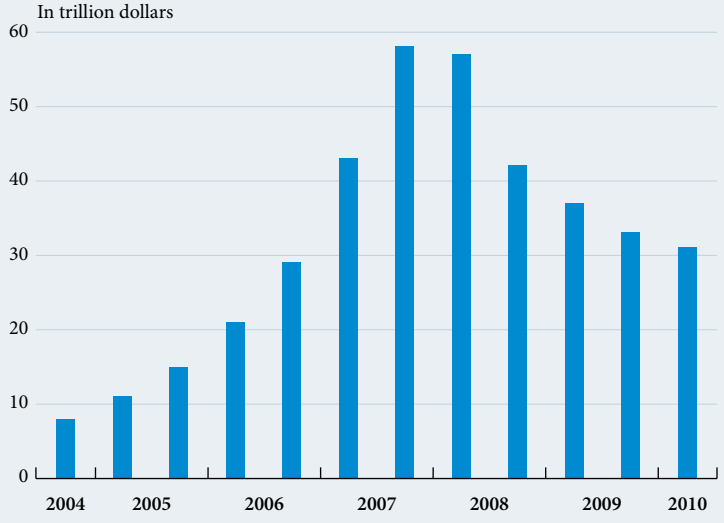
Under these conditions, in the five years prior to the crisis the international CDS markets saw extraordinary growth, literally exponential in some cases. In part, this expansion seemed reasonable given that the starting levels were very low, as this was a new and very useful instrument, just at a time when the economic and credit cycle was clearly on the rise. But it was also partly a consequence of how CDS are traded: by means of bilateral OTC (over-the-counter) agreements, i.e. without the presence of a central clearing house, not for taking out contracts or for settlement. This meant, in most operations a few years ago, that agreements were made verbally between the two parties, confirmation was by fax or a similar channel, records were not very formal and were not available to the public and settlement was left to the judgement and discretion of those involved.

As can be seen in the graph below, this mode of operation led to the gross notional value of CDS contracts rocketing, considering, for example, the way for a certain agent to reverse a position sold in a specific CDS contract was not by buying back this contract (which would only be possible if the original counterparty agreed) but by buying another similar, additional contract with a new counterparty. The consequence was extreme, disordered growth, hugely increasing counterparty and concentration risk. Particularly worrying was the threat of the whole system becoming destabilized (systemic risk), insofar as problems that were initially localized in one entity could easily have a domino effect, as finally happened in the bankruptcy of the Lehman Brothers and the bail-out *in extremis* of the insurer AIG.

In fact, when tensions broke out in 2008 and 2009, the widespread feeling was that the CDS markets were not only out of control but that the authorities were even unaware of what was really going on, overtaken by opacity and vulnerable on several fronts. With the push by the G-20, various reform projects have been launched, of note being those promoted by the regulators of the United States and the European Union. Although there are significant differences between these, the basic lines of action are similar and, for the purposes of presentation, they can be grouped into three broad but closely related areas.

IMPRESSIVE GROWTH IN THE SIZE OF THE CDS MARKET

Outstanding balance of the gross notional value



SOURCE: BIS.

Firstly, the measures to correct infrastructure problems and the lack of transparency, such as encouraging electronic confirmation and electronic records, standardizing contracts (as part of the reinforcement of the legal infrastructure), the creation of databases on outstanding positions (for example, the Trade Information Warehouse project by DTCC), as well as the establishment of obligations to disclose information (disclosure) for the market's participants. In this area, the authorities' initiative has majority support, both from participating entities and academic economists. However, there are still objections. The most notable is the argument that too much detail in the obligation of disclosure is counterproductive, insofar as it might inhibit some actions that, in principle, would help to make the system more efficient. Similarly, rigid standardisation stops the huge variety of credit risk from being able to be hedged or managed with precision.

Secondly, the measures to mitigate counterparty and concentration risk. This is possibly the most important area and, fortunately, it is being tackled with a reasonable degree of consensus among regulators and participants. There are two basic areas of improvement: by setting up of central counterparty houses (CCP) for taking out and settling contracts, and reinforcing collateral requirements. The opinion that CCPs are a preferable alternative to the much-feared bilateral OTC contract system is almost unanimous. However, they are no panacea, given that there are also drawbacks which regulators are attempting to minimize in developing the rules, in particular the systemic risk entailed by the CCP itself. For its part, the increase in collateral requirements has the drawback of reducing the liquidity of CDS contracts for some entities.

Lastly, provisions to neutralize the possibilities for market abuse and manipulation. This front has become particularly relevant due to the sovereign debt crisis in the euro area's peripheral countries. In May 2010, coinciding

with the outbreak of tension in Greece, the German authorities decided to ban the «naked» purchase of CDS. In September, the European Commission included this kind of prohibitive measure in its proposal to regulate CDS and short-selling, recently supported by the European Parliament but still pending final approval. This is because such operations are perceived as undesirable speculative practices, carried out by agents after a quick profit that ignore the underlying fundamentals of the debtor and which are, in some cases, tinged with manipulation. This refers to the incentive that a naked buyer might have to make the market doubt the solvency of the reference entity, as this would increase the value of the buyer's position. The problem is worse insofar as these actions might lead to a self-perpetuating spiral of sales. This is possibly the most controversial regulatory measure and it has met opposition both from private investors and most academic economists, based on a series of arguments. First, the difficulty in distinguishing between speculative operations and genuine hedges. Second, and more importantly, the legitimate, beneficial role played by speculators, in particular regarding the aforementioned price discovery mechanism. It should be noted that the US authorities rejected including restrictions on «naked» CDS purchases in its reform of the regulation approved last year. In fact, the absence of any appropriate international coordination of these rules could put paid to any local, unilateral attempts to ban such operations.

In short, the approval of the CDS market reforms is now in its final stages, with many elements already clearly outlined but others subject to intense debate. Ultimately, its impact on the financial and economic system will depend on the balance achieved between preserving stability and encouraging efficiency.

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SPAIN: OVERALL ANALYSIS

Economic activity

Rising prices will slightly lessen the economy's pace of progress

Economic activity is improving in Spain, although more slowly than in most European countries. The recent rise in commodity prices has led to growth forecasts for 2011 being reduced by two tenths of a percentage point to 0.5%. An interpretation of the indicators offers a mixed picture and points towards risks levelling out, allowing the economy to progress slowly but surely. In fact, over the next few months, although the adjustment may slow up a little if high inflation persists, better performance on the part of tourism might boost the foreign sector and thereby offset lower domestic demand.

From the perspective of demand, the variables are moving in different directions and therefore, on average, point towards private consumption improving slowly throughout the year with quarter-on-quarter rates close to 0.3%, placing the annual rate for the whole of 2011 at 0.9%. An example of this discrepancy in indicators can be seen in the trends for car registration and retail sales, which continued to fall in January, contrasting with the improvement in consumer confidence in February.

Slow but sure growth in GDP is expected for 2011 of 0.5% year-on-year.

DEMAND INDICATORS

Percentage change over same period year before

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
Consumption								
Production of consumer goods (*)	–8.2	0.8	0.4	2.5	0.4	0.1	3.2	...
Imports of consumer goods (**)	–6.1	–10.2	–10.8	2.8	–16.2	–15.1	...	...
Car registrations	–17.9	3.1	44.5	35.3	–25.0	–29.3	–23.5	–27.6
Credit for consumer durables	–11.5	–11.5	–5.6	–9.8	–19.2	–14.6	–	...
Consumer confidence index (***)	–28.3	–21.0	–18.2	–22.9	–21.5	–21.0	–21.0	–15.2
Investment								
Capital goods production (*)	–22.1	–3.4	–2.4	–1.7	–6.3	–3.2	4.6	...
Imports of capital goods (**)	–27.0	6.4	–1.2	13.0	5.8	6.5	...	...
Commercial vehicle registrations	–40.0	6.4	8.5	24.2	–9.3	1.4	–0.7	–2.7
Foreign trade (**)								
Non-energy imports	–17.5	9.4	10.4	18.1	5.1	4.2	11.0	...
Exports	–9.8	14.7	17.4	14.9	11.7	14.1	24.6	...

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.

If high inflation persists, progress in consumption might slow down a little.

Although some factors might impair household spending, these can probably be offset by other, more favourable factors. One of the risks to take into account is the possibility that continued high inflation rates might reduce purchasing power and thereby deter consumption. Another aspect that could slow down consumption's recovery is the sluggish recovery in the labour market, which has a negative effect on the disposable income of households. However, as the savings rate is relatively high (over 14% while, in the decade before the crisis, it was close to 11%), part of the fall in disposable income might be directed towards a drop in savings, without affecting consumption to any great extent. The effect of higher prices and a worsening labour market on consumption will probably be relatively small.

Improved confidence might speed up the adjustment.

Another possible consequence of high inflation is a hike in interest rates by the central bank, which could alter the readiness to consume. However, the ECB's rise in the reference rate is expected to be very moderate and, in any case, its effect on household spending will not be immediate.

On the other hand, we should also note some favourable factors that might help growth to pick up faster than expected, such as the increase in consumer confidence and the reorganization of the financial system. The latter is having a positive effect on market confidence, as shown by the significant drop in Spain's risk premia, in contrast to other peripheral countries of the euro area. This might improve credit flows and thereby stimulate domestic demand.

Capital goods investment holds steady.

With regard to public consumption, the outlook is for negative growth rates until the target reduction in the public deficit is reached. If interest rates rise, the burden of interest payments will become greater and, to offset this, the government could end up cutting back spending even further. But we should note that this scenario is increasingly less likely. Within this context, the government is making a big effort to balance its accounts by introducing some far-reaching reforms.

Investment won't help to boost domestic demand either, as investment in construction is expected to fall significantly again in 2011. Nevertheless, the good performance of capital goods investment is important. Particularly of note is the notable rise in capital goods production in the month of January, placing the year-on-year growth rate at 4.6%. With regard to investment in construction, indicators continue to be unfavourable in general. Although most increased their rate of decline, such as confidence in construction and the permits for new builds, the demand for cement showed some signs of a change in trend.

Due to the trends in its different components, domestic demand is expected to fall by close to six tenths of a percentage point in 2011. Consequently, it will be exports that will help GDP to grow approximately at a rate of 0.5% year-on-year. In fact, the figures available for the foreign sector confirm their good performance. In January, exports rose significantly, largely thanks to Europe's recovery, Spain's main trading partner. Moreover, productivity started to improve as a result of the moderation in labour costs and the fall in employment. Should this situation continue, it will help to improve competitiveness, a key factor to boost exports. For their part, imports also grew significantly, although

to a lesser extent, driven by rising crude prices.

The outlook is favourable for exports and this suggests that their contribution to growth will reach 1.2% this year. However, the positive trend in the foreign sector is not without its risks, as it closely depends on the trends in oil prices. If these continue to rise, imports will become more expensive and the foreign sector's contribution to GDP growth will be less. Higher inflation will also harm the purchasing power of those countries buying Spanish products, which will harm exports. On the other hand, healthy tourism might help the foreign sector to progress at a better pace.

On the supply side, one example of the positive situation of economic activity comes to light when we look at indicators for industrial production. In fact, on average these have been looking healthier in the last few months. In the fourth quarter of 2010, the purchasing managers' index (PMI) was above 50 points, the level that separates expansionary from recessionary periods. This trend has remained during the first few months of 2011 and, in February, the variable stood at 52.1 points.

However, although the economy is expanding once again, Spain is still far from regaining its pre-crisis GDP levels. It will probably take another five quarters to get back to the same level as the beginning of 2007, when the financial crisis started. It may even have to wait until the end of 2013 to reach the peak achieved at the beginning of 2008. This contrasts, for example, with the German case, which has already regained all the GDP lost during the recession. Nonetheless, the recovery process in Spain clearly appears to be more encouraging than in Greece, Portugal, Italy or Ireland.

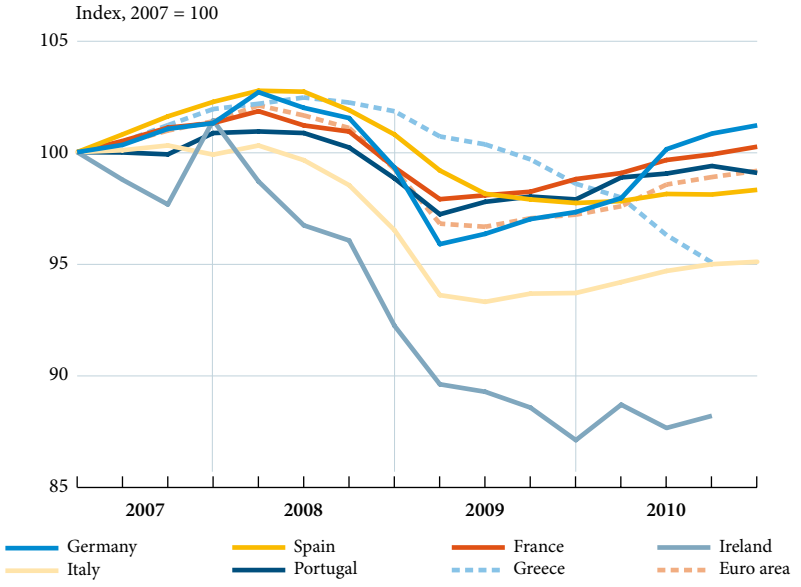
The foreign sector underpins growth in 2011...

...but remains vulnerable to trends in oil prices.

GDP will not get back to its previous peak until the end of 2013.

SPAIN MOVES AWAY FROM THE REST OF THE EURO AREA'S PERIPHERAL COUNTRIES

Gross domestic product by volume



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

SUPPLY INDICATORS

Percentage change over same period year before

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
Industry								
Electricity consumption (1)	–4.8	2.7	2.6	3.7	2.3	2.4	1.2	1.9
Industrial production index (2)	–15.8	0.8	0.3	2.9	–0.2	0.4	3.8	...
Confidence indicator for industry (3)	–31.2	–14.3	–18.4	–13.9	–13.5	–9.2	–8.3	–7.2
Utilization of production capacity (4)	71.2	72.0	69.5	71.8	73.9	72.9	72.6	–
Imports of non-energy intermediate goods (5)	–21.6	22.4	26.9	28.4	18.8	15.8	...	...
Construction								
Cement consumption	–32.4	–15.1	–21.3	–12.3	–13.6	–16.1	0.3	2.7
Confidence indicator for construction (3)	–30.6	–29.6	–25.6	–24.0	–27.8	–41.5	–50.7	–52.1
Housing (new construction approvals)	–58.1	–18.3	–24.4	–10.3	–13.2	–20.3	...	...
Government tendering	–8.2	–35.0	–52.2	–18.1	–36.6	–34.7	...	...
Services								
Retail sales (6)	–5.4	–1.0	0.7	–0.2	–2.5	–1.9	–4.5	...
Foreign tourists	–8.8	1.0	0.3	–3.1	4.2	1.3	4.7	...
Tourist revenue inflows	–9.0	4.0	0.2	0.4	7.0	5.8	...	...
Goods carried by rail (ton-km)	–28.4	6.4	4.5	20.9	5.9	–4.2	1.2	...
Air passenger traffic	–7.9	2.8	3.7	–0.6	4.2	4.3	6.0	4.6
Motor vehicle diesel fuel consumption	–5.1	–1.2	–0.5	–0.5	–2.1	–1.6	...	...

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.

Labour market

The Labour market is still in the doldrums

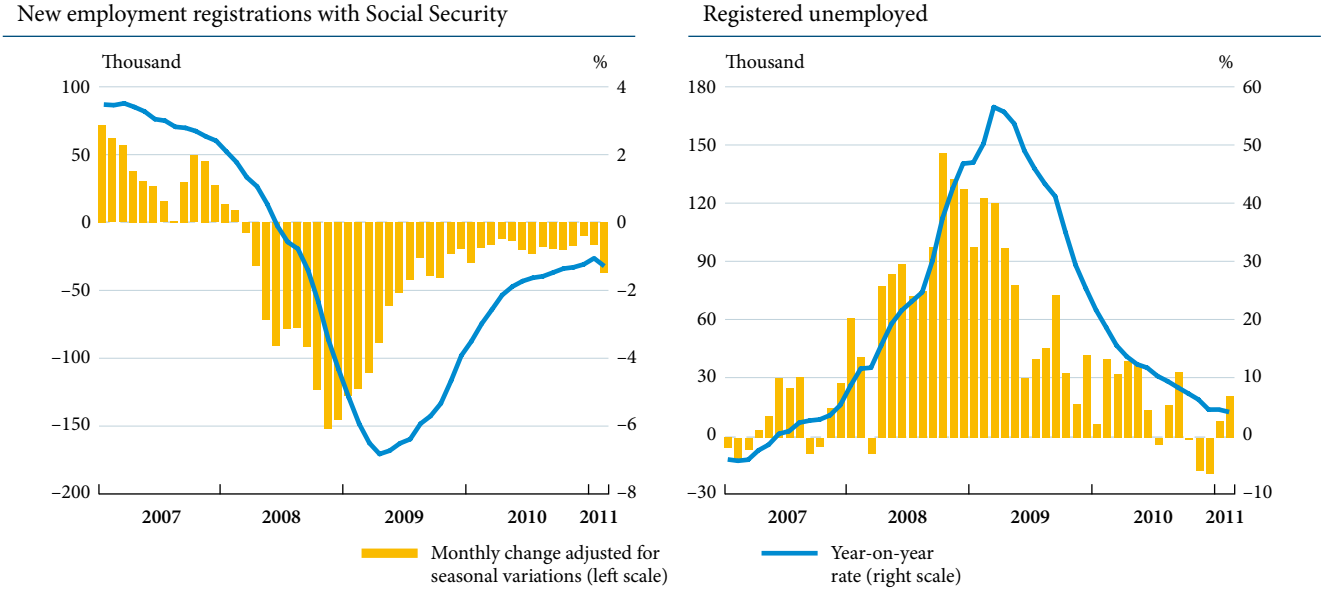
In spite of more dynamic economic activity over the last few months, the labour market has yet to see any improvement. The latest data available for February were worse than expected, causing us to downgrade our forecasts slightly. For 2011, our forecast is therefore higher by two tenths of a percentage point both for unemployment, up to 20.4%, and for the average rate of decline in employment, to 0.5%.

In fact, the economy has yet to recover sufficiently to create jobs, as shown by the decrease in the total number of people registered as employed with Social Security for February, namely 14,745 (almost 38,000 once seasonally adjusted). This led to a decline in the labour market's recovery, as the rate of decline in the year-on-year employment rate accelerated, up two tenths of a percentage point to 1.3%. Moreover, this drop in the total number of employed was a shock because a slight increase was expected in employment for this month.

With regard to registered unemployment, this grew by 68,260 people in the month of January (around 21,000 seasonally adjusted), a higher increase than expected. Registered unemployment therefore rose for the second month in a row, halting the more favourable trend of the last few months of 2010. Nonetheless,

The rate of decline of total employment speeds up by two tenths of a percentage point to 1.3%.

RELAPSE IN THE LABOUR MARKET'S STATE OF HEALTH



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

The weakness in the labour market might result in a slower recovery.

the year-on-year rate of growth fell by four tenths of a percentage point to 4.1%.

One consequence of the rather unfavourable trend in the labour market is that activity might end up recovering more slowly. Within this context, it's important to assess the effect of the recent labour reforms, in force since July 2010, which aim to ensure that the progress made by the economy is translated into new jobs. With this aim in mind, one of the goals of the new legislation is to reduce the dual nature of the labour market, between employees with permanent and those with temporary contracts. Although it's still too early to measure the legislation's effects, as agents have to become familiar with its specifics, the figures show that, for the moment, the proportion of temporary contracts has not changed and is still over 25%.

The dual nature of the labour market continues.

Precisely one of the main measures in the labour reforms was to encourage the use of Contracts to Promote Permanent Employment (CFCI in Spanish), whose severance pay is 33 days per year worked in the firm (instead of the 45 days previously established for permanent contracts). The graph below shows that this kind of contract increased substantially at the end of 2010, motivated by the chance to convert temporary contracts prior to the reform into CFCI contracts before 31 December. However, since January 2011, the number of CFCI has fallen sharply and this, for the time being, prevents us from making any conclusions regarding whether the measures adopted to stimulate this kind of contract are working.

It should also be noted that part of the reform has yet to be implemented, such as the incorporation of the Austrian model, which consists of taking out an insurance policy, chargeable to the firm's Social Security contribution, that covers part of the severance pay and can be accumulated up to retirement. Moreover, other significant reforms, such as collective bargaining, are still being negotiated.

NO CLEAR TREND HAS BEEN OBSERVED IN PERMANENT EMPLOYMENT CONTRACTS

Ratio of Contracts to Promote Permanent Employment out of the total permanent contracts

SOURCES: Ministry of Labour and Immigration and own calculations.

Another factor that might slow up the recovery in the job market is the poor prospect for employment in the construction industry. February's figures continue to show sharp falls in employment in this sector, 9.7% year-on-year, and the pace of job losses is likely to remain high in 2011. This will make it difficult to reduce the unemployment rate. However, at the end of 2012, this process of job losses should finally abate, as activity in the sector is expected to stop declining.

On the other hand, as the months go by, some employees in the construction industry should be able to relocate to other jobs, especially in the services sector. Within this context, of note is the relatively improved tone of employment in the tertiary sector during the second half of 2010. In spite of a slight dip in services employment in the first two months of 2011, moderating its year-on-year growth rate to 0.2%, this sector is expected to absorb some of the jobs lost in construction over the next few months. This might be due to the good outlook for tourism this year, as shown by the figures for the number of nights spent in hotel establishments, up by 4.6% in January compared with the same month last year. Moreover, while the instability continues in the countries of North Africa, Spain could benefit from a redistribution of both national and international tourism.

Another factor that will determine the pace of recovery in the job market over the coming months is how far wages will adjust. In Spain, these tend to react slowly and very moderately to changes in the

The recovery in tourism might help to create jobs over the next few months.

EMPLOYMENT INDICATORS

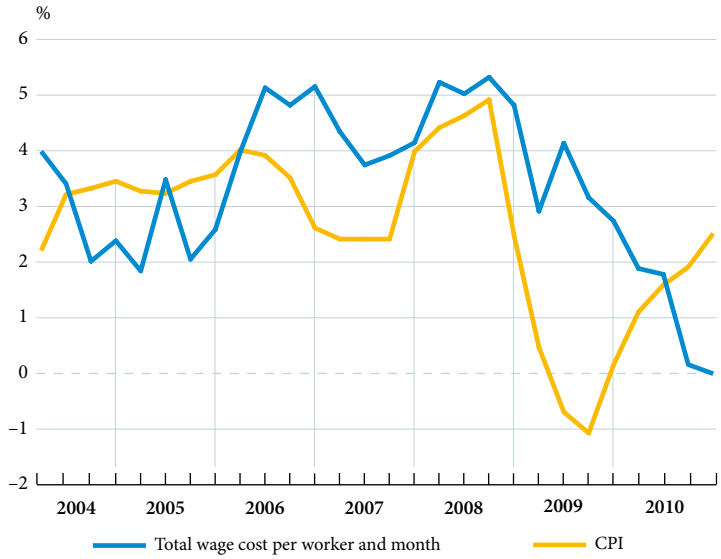
Percentage rate of change over same period year before

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	January	February
Persons registered with Social Security (1)								
Sectors of activity								
Industry	*–10.6*	*–4.8*	*–7.2*	*–4.9*	*–3.8*	*–3.2*	*–2.9*	*–2.9*
Construction	*–23.1*	*–13.4*	*–16.4*	*–13.1*	*–12.5*	*–11.3*	*–9.6*	*–9.7*
Services	*–2.6*	*0.0*	*–0.8*	*0.1*	*0.4*	*0.4*	*0.3*	*0.2*
Job situation								
Wage-earners	*–6.0*	*–1.8*	*–2.8*	*–1.7*	*–1.4*	*–1.2*	*–0.9*	*–1.2*
Non-wage-earners	*–4.8*	*–2.8*	*–4.0*	*–3.0*	*–2.4*	*–1.9*	*–1.7*	*–1.7*
Total	**–5.8**	**–2.0**	**–3.0**	**–1.9**	**–1.6**	**–1.3**	**–1.0**	**–1.3**
Persons employed (2)	**–6.8**	**–2.3**	**–3.6**	**–2.5**	**–1.7**	**–1.3**	**–**	**–**
Jobs (3)	**–6.6**	**–2.4**	**–3.9**	**–2.4**	**–1.6**	**–1.4**	**–**	**–**
Hiring contracts registered (4)								
Permanent	–31.0	–6.4	–11.9	–5.6	–7.6	0.0	8.6	–6.8
Temporary	–13.5	3.8	3.7	5.2	3.5	2.8	6.0	–1.1
Total	**–15.5**	**2.8**	**2.0**	**4.2**	**2.6**	**2.5**	**6.3**	**–1.6**

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.

COMPETITIVENESS IMPROVES AS REAL WAGE COSTS PER WORKER FALL

Year-on-year change



SOURCES: National Institute of Statistics and own calculations.

Real costs per worker fall.

economic cycle. This leads to greater employment volatility in relation to changes in GDP than in other advanced countries, as adjustments are made via job losses rather than wage variations. In fact, as can be seen in the graph above, real wage costs per worker took time to fall and didn't do so until the third quarter of 2010, after two years of economic recession. However, the figures are finally showing significant wage constraint.

Wages are expected to continue moderating, although the extent of the adjustment will depend on the extent of wage indexing. Unlike Spain, in several European countries wages are linked to core inflation. This limits the impact of rising oil prices on wages and helps productivity to improve.

Job creation will continue weak throughout the year.

In short, the labour market is likely to pick up gradually throughout 2011, although jobs will not be created until 2012. There are some factors that might slow up this adjustment. Firstly, if the inflationary trend continues, households' purchasing power could be affected, hindering the recovery in consumption. As a consequence, the improvement in activity, and employment, might slow up. Secondly, a rise in interest rates could reduce the incentive to consume and thereby slow up activity, although this effect is expected to be quite limited. However, not all the risks are unfavourable, as the better performance shown by sovereign debt in the last few weeks might have a positive effect on the adjustment in economic activity and thereby boost job creation.

Prices

The rise in oil prices pushes inflation up to 3.6%

The year-on-year change in the consumer price index (CPI) increased by three tenths of a percentage point in February to 3.6%, following the upward trend of the last few months. This upswing in the CPI's year-on-year rate was largely due to higher fuel prices, responsible for half this increase. The rise in oil prices has actually speeded up over the last few months and is now starting to be reflected in high inflation rates the like of which has not been seen since 2008. This has led to us raising our forecast for average inflation in 2011 by four tenths of a percentage point, up to 2.9% year-on-year. Core inflation, on the other hand, which excludes energy and fresh foods, was quite a lot lower in February, namely 1.8% year-on-year, and its outlook for this year remained unchanged at 1.7% year-on-year.

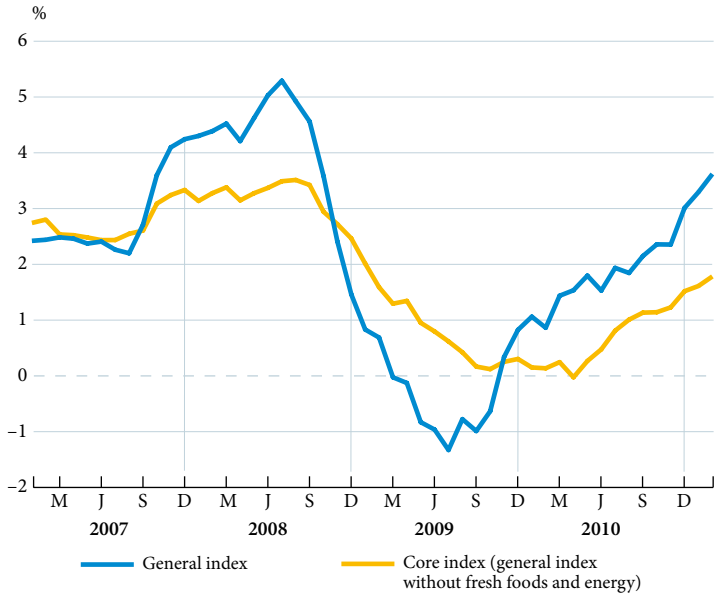
As households have a high expenditure on oil derivates, the trend in the CPI is closely linked to oil prices. Price changes in crude are therefore fundamental to determining inflationary periods. In fact, one of the risks is that this rise in oil prices, which we expect to be temporary, will continue for quite a few months and thereby deduct several tenths of a percentage point from the growth in GDP.

Due to rising oil prices, the average annual increase forecast for the CPI in 2011 is raised by four tenths of a percentage point to 2.9%.

This inflationary trend is expected to be temporary...

THE INFLATIONARY TREND CONTINUES

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

...because the risks that might make it last longer are unlikely to come about.

Although oil prices are not likely to continue on the up for long, this might happen if the conflict in North Africa doesn't stabilize soon. However, should this be the case, the Organization of the Petroleum Exporting Countries might increase their crude production to curb the increase in prices, as they don't want their buyers to fall back into a recession.

Wages might also affect price trends if they are linked to price rises. Within the current context, however, wages are not expected to add to inflationary pressures. Firstly, the belief has been growing that it's important to maintain firms' competitiveness in order to shore up the recovery in activity. On the other hand, the very high unemployment rate is easing wage demands by employees. Consequently, although the

CONSUMER PRICE INDEX BY COMPONENT GROUP

February

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2010	2011	2010	2011	2010	2011
By type of spending							
Food and non-alcoholic beverages	108.8	–0.8	–0.2	–0.8	–0.1	–2.7	1.5
Alcoholic beverages and tobacco	148.5	1.6	0.2	3.0	2.4	12.3	14.5
Clothing and footwear	91.7	–1.5	–1.6	–15.4	–15.6	–1.2	0.3
Housing	122.7	0.1	0.3	0.9	3.1	0.8	8.0
Furnishings and household equipment	107.5	0.0	0.0	–0.9	–0.9	0.5	0.9
Health	96.3	0.1	0.0	0.2	0.0	–1.4	–1.5
Transport	115.5	–0.1	0.8	1.6	2.3	5.8	9.9
Communications	98.5	0.0	0.0	–0.1	–0.1	–0.5	–0.7
Recreation and culture	96.3	–0.3	0.6	–2.2	–1.3	–2.1	–0.2
Education	117.2	0.0	0.0	0.1	0.1	2.6	2.3
Restaurants and hotels	114.0	0.1	0.1	0.2	0.2	1.0	1.7
Other goods and services	114.2	0.3	0.6	0.9	1.2	1.8	3.1
By group							
Processed food, beverages and tobacco	115.6	0.0	0.2	0.0	0.8	0.5	3.4
Unprocessed food	108.6	–1.4	–0.9	–1.2	–0.9	–3.8	2.9
Non-food products	109.2	–0.1	0.2	–1.4	–0.8	1.3	3.7
Industrial goods	105.8	–0.3	0.1	–2.9	–2.0	1.4	5.6
Energy products	*131.2*	*0.0*	*1.2*	*2.8*	*5.8*	*9.9*	*19.0*
Fuels and oils	*127.1*	*0.0*	*1.6*	*3.2*	*4.9*	*11.9*	*20.4*
Industrial goods excluding energy products	*97.3*	*–0.4*	*–0.4*	*–4.8*	*–4.9*	*–1.5*	*0.8*
Services	112.9	0.1	0.3	0.0	0.3	1.1	1.8
Underlying inflation (**)	107.7	–0.1	0.1	–1.7	–1.4	0.1	1.8
GENERAL INDEX	**110.3**	**–0.2**	**0.1**	**–1.2**	**–0.6**	**0.8**	**3.6**

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

agreements signed in January included a 3% average increase in salary scales for 2011, higher than the initial rates agreed in 2010, which rose by 1.3% on average (2.1% taking into account the effect of the severability clause), this trend is not expected to continue.

Another indirect effect of rising commodity prices is the increase in production costs, as these are closely linked to the trend in oil prices. Producer prices rose significantly in the month of January, up 1.5 percentage points to 6.8% year-on-year, the highest rate since September 2008, particularly pushed by energy goods. Rising crude prices also have a significant effect on import producer prices, up by 11.9% in the last twelve months to January, almost two points higher than the previous month's figure. Rising production costs and import producer prices might slow up the recovery process, as firms must either reduce their profit margins or pass on these increases to the product's end price, to the detriment of the consumer.

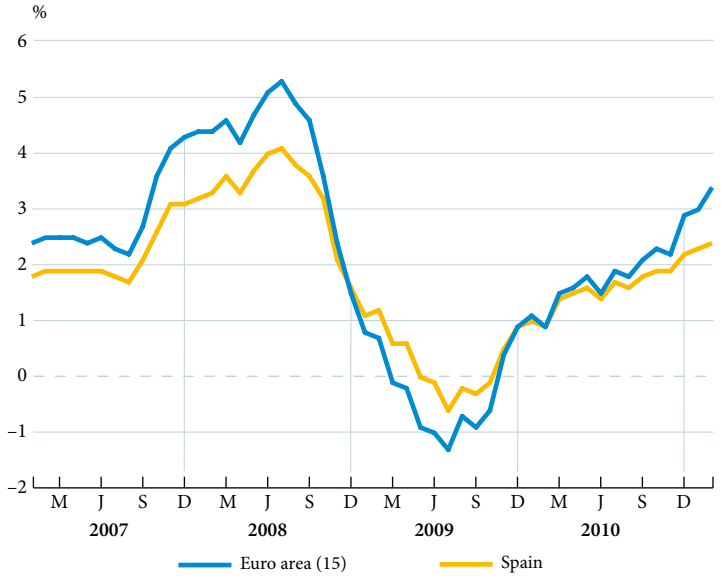
Substantial rise in production costs.

From other perspective, one consequence of high inflation in Spain might be a loss of competitiveness if the price rises in this country exceed the rise recorded in the rest of the countries of the euro area. According to Eurostat figures, the euro area's harmonized inflation rate for February stood at 2.4%, while the index recorded in Spain was 3.4%. The upswing of inflation observed in Spain in the last few months has been sharper than the one recorded in the euro area, so that the inflation differential has gone from zero in December 2009 to one percentage point in February 2011. This figure can be mostly put down to the energy component, as happened in 2008 when the gap reached 1.2 percentage points in July. However, the differential is expected to narrow again once inflation's volatile components disappear, as these have a greater weight in Spain.

The price differential compared with the euro area is at one percentage point due to the energy component.

SPAIN'S INFLATION DIFFERENTIAL WITH THE EURO AREA WIDENS SUBSTANTIALLY

Harmonized year-on-year change in CPI



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

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
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	0.6
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	0.5
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	1.3
September	8.0	3.4	0.2	0.5	4.0	9.1	9.2	6.9	1.8	10.7	–
October	10.2	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	10.7	9.2	7.7	2.2	11.0	1.4
December	...	5.3	1.3	0.7	5.7	13.5	10.3	8.1	2.4	11.8	–
2011											
January	...	6.8	1.5	1.0	6.8	17.3	11.9	7.6	2.0	12.4	–

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

The year-on-year inflation rate will tend to ease by the end of 2011, thanks to the disappearance of base effects due to tax hikes and the price of crude.

Inflation is therefore expected to continue rising slightly due to higher oil prices over the next few months, while the situation in the Middle East remains tense. However, the year-on-year inflation rate should subsequently slow down, once the conflicts are resolved and the base effects associated with past events, such as tax hikes, disappear. We should therefore see a reversal both in the effect of the hike in value added tax in the summer months as well as the effect of higher oil and tobacco prices in the fourth quarter.

Foreign sector

Dependence on energy slows up the correction in the trade deficit

Over the last few months, oil has become the main obstacle to adjusting the trade balance. In fact, the persistent rise in the price of crude since September last year has considerably damaged the energy balance, neutralizing the large correction recorded by the rest of the components. The trend in the price of this commodity, conditioned by the resolution of the political conflicts in North Africa, will be a key factor in adjusting the trade imbalance.

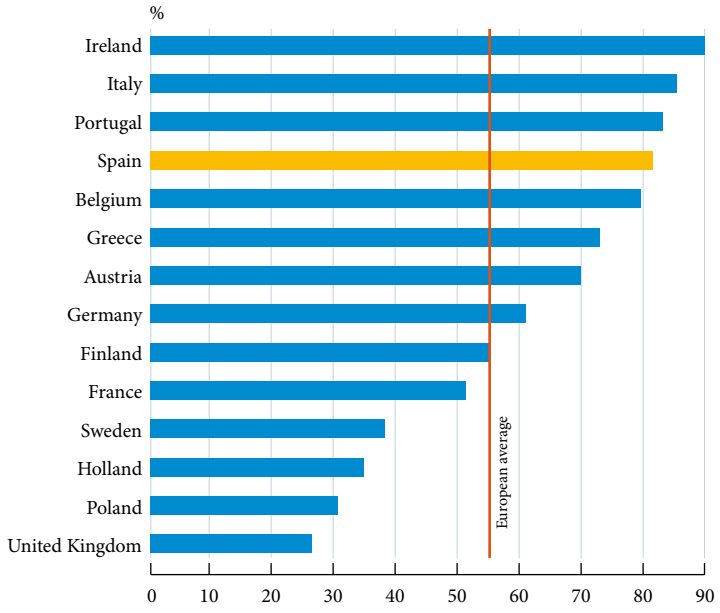
This obstacle to the trade deficit's correction is the result of the Spanish economy's high dependence on energy.

As can be seen in the graph below, Spain imported more than 80% of the energy it consumed in 2008, much higher than the European average. This low level of self-supply has not significantly altered since then. During the first three quarters of 2010, the energy generated in the country, mainly nuclear or renewable, only covered 26.1% of the total energy consumption. This is mainly due to the large relative weight of fossil fuel consumption, accounting for 72% of the total. This high percentage explains the Spanish deficit's sensitivity to commodity price variations. Consequently, pressure on the trade deficit is unlikely to ease until the political situation in North Africa gets back to normal.

Oil prices will set the trend in the trade balance.

SPAIN'S HIGH DEPENDENCE ON ENERGY

Percentage of the energy consumed that's imported from other countries, 2008



SOURCES: Eurostat and own calculations.

The trade balance with the euro area continues to improve.

The expectations regarding the non-energy balance for 2011 are more optimistic. The recovery of the Spanish economy, less than that of its main trading partners, will keep the growth in imports below that of exports. January's figures, with a 32.0% year-on-year growth in exports, more than six points above imports, support this hypothesis. Of note is the trend in the balance for the rest of the countries in the euro area, Spain's main trading partners. The recovery in the main European economies, particularly Germany and France, meant that exports accumulated over the last twelve months practically equalled imports, something that hasn't happened since the single market was created. In the case of France, the trade surplus accumulated since February 2010 reached 8.45 billion euros, the highest since records began. We expect Spain's role as a net exporter in the rest of the euro area to continue over the next year. However, there are some risks that might reduce this tendency for the trade balance to improve compared with the rest of the countries in Europe. These include a greater impact than expected on the part of inflation or rising interest rates on European demand for Spanish products.

The lower deficit of the income balance in 2010 helps to correct the current balance.

Good prospects for tourism

The imbalance of the balance of payments fell by 18.2% in 2010. Even the slight deterioration in the balance of goods, the main factor behind the adjustment in the current imbalance in previous years, was neutralized by the

FOREIGN TRADE

January 2011

	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	4,922	60.0	23.6	943	97.7	5.9	–3,978	19.2
Consumer goods	4,405	4.3	21.1	5,458	16.6	34.2	1,053	123.9
Food	*1,138*	*18.0*	*5.4*	*2,189*	*20.5*	*13.7*	*1,051*	*192.3*
Non-foods	*3,267*	*0.2*	*15.6*	*3,270*	*14.1*	*20.5*	*2*	*100.1*
Capital goods	1,375	11.7	6.6	1,143	51.9	7.2	–232	83.2
Non-energy intermediate goods	10,181	26.2	48.8	8,410	36.1	52.7	–1,770	82.6
By geographical area								
European Union	10,567	15.4	50.6	10,865	25.3	68.1	299	102.8
Euro area	*8,555*	*15.1*	*41.0*	*8,873*	*24.2*	*55.6*	*318*	*103.7*
Other countries	10,316	38.6	49.4	5,090	48.8	31.9	–5,226	49.3
Russia	*808*	*57.0*	*3.9*	*153*	*84.1*	*1.0*	*–655*	*19.0*
United States	*856*	*32.9*	*4.1*	*572*	*62.9*	*3.6*	*–284*	*66.9*
Japan	*278*	*–3.3*	*1.3*	*143*	*42.6*	*0.9*	*–134*	*51.7*
Latin America	*1,182*	*55.8*	*5.7*	*746*	*40.3*	*4.7*	*–436*	*63.1*
OPEC	*2,354*	*49.1*	*11.3*	*453*	*26.3*	*2.8*	*–1,901*	*19.2*
Rest	*4,837*	*32.2*	*23.2*	*3,022*	*51.4*	*18.9*	*–1,816*	*62.5*
TOTAL	**20,882**	**25.8**	**100.0**	**15,955**	**32.0**	**100.0**	**–4,927**	**76.4**

SOURCES: Ministry of the Economy and own calculations.

improvement in the rest of the components over this period. Of note is the correction in the income balance deficit for the second consecutive year. This was mostly due to the decrease in payments of interest on investment. A trend that, nonetheless, could slacken as from the second half of the year.

Given the smaller improvement in the income balance, tourism is expected to take over the reins, contributing positively to the correction in the current imbalance. This recovery started to take place in 2010, when both the number of tourists and the income generated by them increased. This put an end to the huge shrinkage recorded since June 2008. The recovery in the world economy, and in particular in Europe, is expected to lead to a further rise in the number of tourists visiting Spain in 2011. This will undoubtedly be boosted by the flow of visitors who, given the political turbulence in North Africa, decide to holiday in Spain. According to our estimates, these will exceed one million, pushing the total figure above 56 million in 2011, which would represent an annual growth of 6.6%. As a consequence, the services sector is likely to contribute significantly to the Spanish economy's growth this year.

Tourism picks up in 2011.

With regard to financial flows, portfolio investment was the main source of capital inflow in order to meet Spain's financing needs. The expected improvement in country risk means we can expect new inflows of direct investment and also portfolio investment throughout this year.

Portfolio investment was the main source of capital inflow in 2010.

BALANCE OF PAYMENTS

December 2010

	Last 12 months		
		Annual change	
	Balance in million euros	Absolute	%
Current account balance			
Trade balance	–46,361	–1,250	2.8
Services			
Tourism	*26,933*	*894*	*3.4*
Other services	*530*	*1,240*	–
Total	27,462	2,134	8.4
Income	–21,448	9,088	–29.8
Transfers	–7,327	654	–8.2
Total	**–47,674**	**10,625**	**–18.2**
Capital account	**6,492**	**2,434**	**60.0**
Financial balance			
Direct investment	574	1,676	–
Portfolio investment	28,848	–16,073	–35.8
Other investment	603	–2,695	–81.7
Total	**30,024**	**–17,091**	**–36.3**
Errors and omissions	–4,538	–1,529	50.8
Change in assets of Bank of Spain	15,696	5,232	50.0

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.

Public sector

Spain does its homework

European leaders approve the Euro Plus Pact to boost competitiveness and tackle the debt crisis.

«A historic reform of economic governance». That's how Olli Rehn, EU Monetary Affairs Commissioner, defined the agreement between the leaders of the seventeen countries of the euro area to boost competitiveness and successfully tackle the debt crisis. This agreement was subsequently ratified by the European Council, christening it the Euro Plus Pact. Without any doubt, this Pact must be seen as an important step towards common economic policy in the monetary union. In Spain's case, this agreement could become the salutary lesson needed by the economy to finish off the structural reforms undertaken that are aimed at improving its competitiveness. An expectation that seems to be shared by the markets, judging by the improvement in the risk premium associated with Spain's debt. Adopting the necessary measures to comply with the Pact and the tough reduction in the fiscal deficit planned for this year will be two important challenges for the Spanish government in 2011.

Spain has implemented various reforms in line with the Pact's guidelines.

The Pact contains measures aimed at reinforcing budgetary discipline and reducing economic imbalances, commitments that boost competitiveness and employment, contribute towards the sustainability of public finances and reinforce financial stability. The plan is that these results will be assessed every year and any non-compliance could give rise to penalties.

Spain's risk premium improves, unlike the rest of the peripheral countries.

In addition to these decisions, the Council has also decided to guarantee the European Financial Stability Fund (EFSF) an effective loan capacity of 440 billion euros. Moreover, a permanent bail-out fund will be created as from June 2013, namely the European Stability Mechanism, which will replace the current EFSF and will be provided with 500 billion euros.

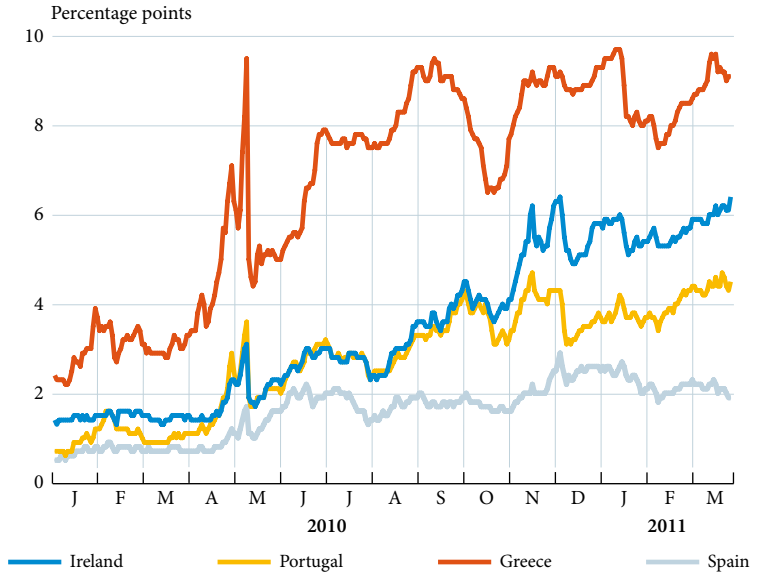
Most notable in the Spanish case has been the effort made by the government over the last few months to adopt new measures in line with the guidelines agreed in the Euro Pact. Among these are those carried out on the financial system, the pension system and the labour market. However, some additional reforms are still required, particularly in the case of the labour market. The proposal to reform collective bargaining is along these lines, aiming partly to link wages with employees' productivity.

The reception given to such measures is reflected in the trends in the government bond market. The cost of financing Spanish ten-year debt compared with German debt (the latter normally being used as the reference yield) gradually fell in March, going below 200 basis points at the end of the month, 15 points below its average for February. Only Moody's rating downgrade temporarily hindered this adjustment process. Within this context, the Spanish Treasury issued new debt onto the market at lower interest rates than those paid at the end of last year. These issues have almost managed to cover all April's maturities until July.

As can be seen in the graph below, the greater market confidence in Spanish

SPANISH RISK PREMIUM PULLS AWAY FROM THE REST OF THE PERIPHERAL COUNTRIES

10-year government bond differentials compared with German bonds



SOURCES: Datastream and own calculations.

debt contrasts with the widening spreads for the rest of the peripheral countries. The case of Portugal particularly stands out in this respect, forced by its low competitiveness, political instability and difficulty in correcting its fiscal deficit, and the country is on the point of bail-out. A fact that, should it occur, is not expected to significantly affect Spanish financing.

This change in trend in the sovereign risk premium can be partly explained by the improvement in the Spanish public deficit in 2010. Cost-cutting and, to a greater extent, the rise in revenue reduced the public sector's financing needs to 9.2% of the gross domestic product (GDP) last year. A figure that is even one tenth of a percentage point higher than the level set in the fiscal adjustment plan, thanks to the extensive correction in the central administration deficit.

The government's forecasts for 2011 are even more ambitious. According to its adjustment plan, the fiscal deficit will fall to 6.0% of GDP this year. It is expected that, of the 3.2 percentage points' reduction compared with 2010's deficit, more than two thirds can be put down to lower public spending. This contrasts with the important role played by greater revenue in the deficit correction of 2010. Should these targets be met, the fiscal adjustment, whose aim is to achieve a 3% deficit by 2013, will be more than halfway towards its goal by the end of this year.

The government expects to reduce the deficit to 6.0% of GDP in 2011.

January's figures do not provide enough information to be able to compare how the public accounts are performing. A deterioration can be seen in January's cash deficit compared with the previous month, namely 7,706 and 3,590 million euros, respectively. However, this increase in the month-on-month deficit, of more than 100%, can be put down to calendar effects, which delayed the maturity payments for debt from the first month of last year. In fact, the primary balance

Autonomous communities will have to extensively reduce their deficit as from 2012.

for January 2011, i.e. excluding the interest charged, was 37.7% less than the figure for the same month a year ago.

Consequently, the 6% target for the fiscal deficit for 2011 is possible if the government maintains the rigidity shown over the last few months. For such an undertaking, however, it will be necessary to control the spending of the autonomous communities. According to the government's forecasts, these administrations' deficit will account for more than half the total in 2011. One of the main challenges for the Spanish government will undoubtedly be ensuring that these communities get back to lower deficit levels in 2012.

Savings and financing

Weak demand might slow up the recovery in credit

In March, attention regarding Spain's financial system was focused primarily on the publication of its recapitalization requirements, estimated by the Bank of Spain. According to this institution, the financial system needs 15.15 billion euros to meet the new capital requirements demanded in the Financial Sector Reinforcement Plan. This figure accounts for 1.4% of Spanish gross domestic product (GDP) and is lower than the estimates by leading international analysts. The greater basic capital required for savings banks compared with banks, 10% and 8% of risk-weighted assets respectively, means that the former have a greater need to recapitalize.

However, the amount published by Spain's banking regulator will be lower as several savings banks that do not meet the minimum capital ratio demanded by the Bank of Spain have announced their intention to go public. In this case their capital requirements will be lowered by two percentage points to 8%, the same level as the one required for banks. In any case, covering the additional capital required by the system is guaranteed, either through private investors or

The banking system needs 15.15 billion euros to comply with the new capital requirements.

CREDIT TO PRIVATE SECTOR BY PURPOSE

Fourth quarter of 2010

	Balance (*)	Change this year	
	Million euros	Million euros	%
Financing of production activities			
Agriculture, livestock raising and fishing	23,127	4	0.0
Industry	152,374	175	0.1
Construction	114,517	–15,921	–12.2
Services	695,133	9,530	1.4
Total	**985,151**	**–6,212**	**–0.6**
Financing to individuals			
Acquisition and renovation of own home	662,797	8,231	1.3
Acquisition of consumer durables	42,069	–7,204	–14.6
Other financing	107,916	–2,185	–2.0
Total	**812,781**	**–1,158**	**–0.1**
Other	**46,017**	**14,281**	**45.0**
TOTAL	**1,843,949**	**6,911**	**0.4**
Acquisition of housing and real estate activities	*948,229*	*490*	*0.1*

NOTE: (*) By credit institutions as a whole: banking system, loan finance establishments and official credit.
SOURCES: Bank of Spain and own calculations.

The strength of the financial sector will open up wholesale financing markets to banks.

through contributions from the Fund for Orderly Bank Restructuring (FROB in Spanish). This recapitalization will undoubtedly strengthen the solvency of Spain's financial institutions. They will therefore find it easier to pass the new stress tests that will be carried out on banks in the spring. In short, this is a step forward in restoring confidence in the Spanish financial system.

What effect will bank recapitalization have on credit trends? On the one hand, the European Central Bank (ECB) believes that adopting this plan might hinder the recovery in credit for households and firms. However, a more solid financial system is expected to encourage wholesale financing markets to open up to banks. As a consequence, Spanish banks' dependency on ECB financing will lessen, continuing the trend that started last August. All this will help to channel credit towards the private sector.

The recovery in industrial activity and services is reflected in an increase in their financing.

There are, however, other factors that might slow up the recovery in credit in 2011. In spite of fewer doubts regarding the financial system's real estate risk, this system performing less well than expected might prevent the wholesale markets from opening up so readily. It will therefore be important to keep a close eye on trends in real estate doubtful debt over the next few months. As we expected, this ratio rose again in December 2010, boosted by the large amount of doubtful assets related to real estate development and construction. The continuation of this trend raised the banking system's doubtful debt rate to 6.06% in January this year.

However, weak demand might reduce the outstanding credit balance in 2011.

But the factors that will hinder credit growth can be mainly found on the side of demand. Of note is the weak recovery in the Spanish economy expected for 2011. Albeit to a lesser extent, the ECB raising interest rates will also have a slight impact on credit demand. In this last case, our forecasts predict two hikes in the reference interest rate, in May and October, placing it at 1.5%. Given such expectations, the interest rate for new credit granted rose by 26 basis points in January. For its part, the interbank market interest rate (Euríbor) has accelerated its growth since the start of year, a trend that is expected to slow up over the next few months. Demand for mortgages to buy housing won't be very dynamic either this year. This is due to the mortgage burden of households because of the rise in interest rates and especially the withdrawal of tax deductions. However, the fall in house prices will keep this effort at stable levels.

Given this scenario, the reduction in private sector financing in January comes as no surprise. But this fall will not become generalized throughout the year. A breakdown of financing by sector shows that industrial activity and principally that of the services sector grew in 2010, a trend that might remain for the whole year. On the other hand, general government debt continued to grow in the first month of the year.

In short, a good result for the Spanish financial system in the stress tests is expected to dissipate doubts regarding the sector, opening up wholesale financing markets to banks. However, the economic situation augers weak credit demand which might lead to a reduction in the outstanding credit balance in 2011.

The balance of bank liabilities compared with households and firms fell by 1.9% month-on-month in January. This

FINANCING OF NON-FINANCIAL SECTORS (1)

January 2011

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,205,809	–6,069	0.7	77.2
Non-financial corporations	1,310,386	–2,686	1.3	45.9
Resident credit institution loans (3)	*892,899*	*–4,573*	*–0.8*	*31.2*
Securities other than shares	*63,976*	*–265*	*11.1*	*2.2*
External loans	*353,511*	*2,152*	*5.1*	*12.4*
Households (4)	895,423	–3,383	0.0	31.3
Housing loans (3)	*676,164*	*–3,703*	*0.2*	*23.7*
Other (3)	*215,654*	*306*	*–0.7*	*7.5*
External loans	*3,605*	*14*	*4.4*	*0.1*
General government (5)	651,771	13,004	13.7	22.8
TOTAL	**2,857,580**	**6,935**	**4.1**	**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.

decrease took place within a context of falling interest rates, down for the second month in a row. The performance of returns on deposits is expected to affect the change in the future balance of bank liabilities. However, there are several factors that will push interest rates in opposite directions over the coming months.

Will the fall in interest rates on bank liabilities continue?

On the one hand, the gradual opening up of financing markets to Spanish banks should reduce the need to attract customer deposits. This will reduce competition between institutions and thereby the interest rates for new deposit operations. This is probably the main reason for the fall in returns on bank deposits in January.

However, this effect might be weakened by the action taken by the main European monetary authority over the next few months. The possibility of the ECB toughening up the conditions for accessing liquidity auctions and the probable rises in the official interest rate will push up deposit returns. This second effect is expected to become more significant over the next few months, leading to a new period of rises in rates for liabilities during the second half of the year.

However, the trend in bank deposits may be affected by the upswing in mutual funds. In fact, February's figures show that net subscriptions for mutual funds increased, this being the first rise since November 2009. The gradual reduction in risk aversion in the markets expected for this year might keep this trend going during 2011.

Fall in deposits and the return on liabilities in January.

In the medium term, interest rates are expected to rise again.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

January 2011

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	254,928	–6,838	–2.6	–5,956	–2.3	18.1
Savings deposits	208,654	–2,633	–1.2	3,162	1.5	14.8
Term deposits	739,348	–4,219	–0.6	27,661	3.9	52.4
Deposits in foreign currency	18,095	–1,287	–6.6	–5,953	–24.8	1.3
Total deposits	**1,221,025**	**–14,978**	**–1.2**	**18,914**	**1.6**	**86.5**
Other liabilities (*)	**190,658**	**–12,353**	**–6.1**	**–9,881**	**–4.9**	**13.5**
TOTAL	**1,411,684**	**–27,331**	**–1.9**	**9,033**	**0.6**	**100.0**

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

Stressing banks at times of stress

The deficiencies in the financial sector's supervisory system came to light during the Great Recession of 2008-2009. After this episode, no-one could doubt that the supervisory mechanisms needed a thorough overhaul and this has meant that, in a very short time, numerous measures have been implemented to ensure that the risk taken by the different institutions is controlled more precisely. And the stars of these initiatives are the so-called stress tests.

The United States led the way in carrying out these tests and, partly thanks to this, managed to restore investor confidence in its financial system. The countries of the European Union (EU) followed suit last year but, in this case, the reaction ended up being the opposite. Although the markets interpreted the tests' results positively in the short term, the failure to predict the collapse of the Irish financial system seriously damaged their credibility. The effectiveness of the stress tests is therefore not guaranteed. In this Box we will review their key aspects.

As is common knowledge, the aim of carrying out stress tests is to analyze the capacity of the different institutions to withstand highly adverse conditions. For example, in the stress tests carried out on European banks over the last few months, a fall in GDP has been assumed for the euro area that, according to the ECB's estimates, has less than a 1% likelihood of occurring, as well as a drop in housing prices greater than expected and that unemployment rates will remain at abnormally high levels (see the table below). This stress scenario also assumes an upswing in risk premia and therefore also in interest rates.

In the Spanish case, for example, the stress scenario assumes a 1.0% fall in GDP in 2011, a 12.3% drop in housing prices and an unemployment rate of 21.3%. These are the key variables that form the basis for each institution to estimate its resistance, in collaboration with a national supervisor and coordinated by the European Banking Authority (EBA). The key, naturally, lies in determining, with some precision, the increase in the default rate and the fall in brokerage margins such scenarios would entail.

MACROECONOMIC SCENARIO ASSUMED IN THE STRESS TESTS

	GDP growth (%)		Unemployment rate (%)		Change in house prices (%)	
	2011	2012	2011	2012	2011	2012
Germany	–0.9	0.6	6.8	6.9	4.3	0.5
Spain	–1.0	–1.1	21.3	22.4	–12.3	–11.0
France	0.4	0.2	9.6	9.8	–3.4	–12.4
Greece	–4.0	–1.2	15.2	16.3	–9.2	–8.5
Ireland	–1.6	0.3	14.9	15.8	–17.4	–18.8
Italy	–0.1	–1.0	8.6	9.2	–1.2	–3.5
Portugal	–3.0	–2.6	11.6	12.9	–2.9	–8.4

SOURCE: European Banking Authority.

The aim is to determine whether any institution has a significant imbalance. Fundamentally, whether it would have enough capital to survive. In this respect, it's vital for each country to have designed a system to recapitalize its institutions, by injecting either public or private capital. This ensures there are the right incentives when the stress tests are carried out and no fear of any institution failing them. While, in the United States, these systems were designed before the stress tests were carried out, in the EU last year not all the countries had done so. This year, however, the EBA wants all countries to have such mechanisms ready before it starts.

The success of the stress test also depends on other factors. A group of economists from New York University, led by the Nobel prize-winner for Economics, Robert Engle, points out the following two aspects.(1) Firstly, very thoroughly justifying the shocks the banks are subjected to. It wouldn't make much sense to assume a scenario that only has a very remote chance of occurring. Scenarios must be improbable but plausible. In this respect, the option chosen by the EBA, to justify the fall in GDP of the euro area by using the probability distribution of the ECB's forecasts, is a step in the right direction. What is not clear, however, is how the EBA has arrived at the scenario for each country. Secondly, they point out the need to make the scenarios' estimated impact as transparent as possible. But this is difficult to carry out as, ultimately, it relies on the assessment made by the supervisors and institutions in each case, based on their internal models. Lastly, they also point out that carrying out these stress tests once a year may not be enough because, if instability unexpectedly increases 2 or 3 quarters after the tests have been carried out, they might not provide much information.

To resolve these aspects, Engle and his collaborators suggest complementing the stress tests carried out in the United States with stress tests that use only publicly available data: stock market prices. In fact, from their website you can download a weekly update of each institution's capacity to withstand stress.(2) For the moment, the results are available for the main institutions of the United States but it has been announced that, in the near future, they will also provide results for Europe and Asia.

(1) Acharya, V., Cooley, T., Engle, R. and Richardson, M., «Overseeing Systemic Risk», Voxeu.org (2011).
(2) http://vlab.stern.nyu.edu/

Specifically, to calculate each institution's potential need for capital given a systemic shock, they estimate how much the value of its stock would fall if the index as a whole fell by 40% over six months. To this end, they use sophisticated econometric models that allow them to take into account the correlation of the share price of each institution with that of the market as a whole, as well as volatility and performance when sharp movements occur. This information is combined with each institution's degree of leverage and they estimate how this would change in the stress scenario. This allows them to infer each institution's potential need for capital to be able to keep its capital ratio at 8%.

Unlike the stress tests carried out in the United States and the EU, this measure can be validated using historical data. The authors have discovered that, in July 2007, the model would have identified Citigroup, Merrill Lynch, Freddie Mac and Lehman Brothers as the institutions with the greatest potential need for capital. Moreover, they also show that their model's findings are very similar to those of the stress tests carried out in the United States in May 2009. This they consider to be a success, since the method used is simple, transparent and can be regularly updated.

But the method presented by Engle and his collaborators is not without controversy. Stock market movements are not always due to structural reasons and this might harm the model's predictive ability. As pointed out by the authors themselves, their proposal must be seen as complementing the stress tests carried out by supervisors. This is the spirit that must continue over the coming years. The process of transforming the supervisory model is merely in its early stages and, given that there is no single, definitive solution to improve it, we must be on the look-out and take on board the new contributions that will very likely be made by the academic, regulatory and business world.

This box was prepared by Oriol Aspachs Bracons
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As of December 31, 2010

FINANCIAL ACTIVITY	Million euros
Total customer funds	247,897
Receivable from customers	189,546
Profit attributable to Group	1,307

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	28,651
Branches	5,409
Self-service terminals	8,181
Cards (million)	10.3

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2011	Million euros
Social	335
Science and environmental	68
Cultural	64
Educational and research	33
TOTAL BUDGET	**500**

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