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THE SPANISH ECONOMY

Monthly Report

COMMODITY PRICES

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Commercial and energy policies add pressure to increasing demand

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2010	2011	2012	2010		2011			
				III	IV	I	II	III	IV
INTERNATIONAL ECONOMY		Forecast						Forecast	
Gross domestic product									
United States	3.0	1.6	2.0	3.5	3.1	2.2	1.6	1.4	1.3
Japan	4.0	–0.5	2.7	4.8	2.5	–0.7	–1.1	–1.1	0.7
United Kingdom	1.3	1.1	1.7	2.5	1.5	1.6	0.7	0.6	1.5
Euro area	1.7	1.6	1.3	2.0	2.0	2.4	1.6	1.3	1.2
Germany	*3.6*	*2.9*	*1.5*	*4.0*	*3.8*	*4.6*	*2.8*	*2.3*	*1.8*
France	*1.4*	*1.7*	*1.4*	*1.6*	*1.4*	*2.2*	*1.7*	*1.4*	*1.5*
Consumer prices									
United States	1.6	3.2	2.4	1.2	1.2	2.2	3.3	3.7	3.8
Japan	–0.7	0.2	0.3	–0.8	0.1	0.0	0.1	0.5	0.1
United Kingdom	3.3	4.3	2.7	3.1	3.4	4.1	4.4	4.4	4.2
Euro area	1.6	2.5	1.7	1.7	2.0	2.5	2.8	2.5	2.3
Germany	*1.1*	*2.2*	*1.8*	*1.2*	*1.5*	*2.1*	*2.3*	*2.5*	*2.2*
France	*1.5*	*2.0*	*1.6*	*1.5*	*1.6*	*1.8*	*2.1*	*2.1*	*2.0*
SPANISH ECONOMY		Forecast						Forecast	
Macroeconomic figures									
Household consumption	1.3	0.7	0.7	1.5	1.7	0.7	–0.2	1.1	1.2
Government consumption	–0.7	–0.3	–2.4	–0.7	–0.9	2.6	–1.0	–1.3	–1.6
Gross fixed capital formation	–7.5	–5.0	0.1	–6.7	–6.1	–6.0	–6.7	–4.2	–3.2
Capital goods	*1.9*	*0.6*	*4.3*	*2.4*	*1.2*	*0.3*	*–3.7*	*3.1*	*2.7*
Construction	*–11.1*	*–8.2*	*–1.9*	*–11.2*	*–10.6*	*–10.4*	*–9.3*	*–7.6*	*–5.6*
Domestic demand (contribution to GDP growth)	–1.2	–0.8	0.0	–0.7	–0.6	–0.4	–1.9	–0.6	–0.3
Exports of goods and services	10.3	9.7	6.4	9.4	10.5	12.1	8.4	10.1	8.1
Imports of goods and services	5.5	3.2	2.3	5.0	5.3	6.3	–1.7	4.2	3.9
Gross domestic product	**–0.1**	**0.8**	**1.1**	**0.2**	**0.6**	**0.9**	**0.7**	**0.9**	**0.8**
Other variables									
Employment	–2.3	–0.9	0.3	–1.6	–1.4	–1.4	–1.0	–0.7	–0.6
Unemployment (% labour force)	20.1	20.8	20.7	19.8	20.3	21.3	20.9	20.4	20.8
Consumer price index	1.8	3.2	1.6	1.9	2.5	3.5	3.5	3.0	2.7
Unit labour costs	–1.5	–1.0	0.1	–1.9	–2.3	–1.5	–1.5		
Current account balance (% GDP)	–4.5	–4.0	–3.5	–3.7	–3.2	–6.4	–2.9	–2.7	–3.8
Net lending or net borrowing rest of the world (% GDP)	–3.9	–3.5	–3.1	–3.1	–2.6	–5.9	–2.4	–3.3	–3.6
General government financial balance (% GDP)	–9.2	–6.4	–4.8						
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	1.0	1.3	1.5	1.0	1.0	1.0	1.3	1.5	1.5
10-year US bonds	3.2	2.8	2.1	2.8	2.8	3.4	3.2	2.4	2.0
10-year German bonds	2.8	2.6	2.7	2.4	2.6	3.2	3.1	2.3	2.0
Exchange rate									
$/Euro	1.33	1.41	1.40	1.29	1.36	1.37	1.44	1.42	1.40

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Commodity prices

At the beginning of July 2008, the CRB index, widely used to monitor world trends in commodity prices, reached its highest peak ever. This was when a barrel of crude oil cost close to 150 dollars. Just seven months later, when the severity of the crisis had become evident, the index had lost more than half its value. Crude had fallen by 40 dollars but, from this moment on, it resumed its upward trend, which continued until just recently, halting in the last few weeks.

In fact, until a short time ago, the historical trend in commodity prices had been downward compared with manufacturing prices. There was talk of the «paradox of plenty» affecting many countries with abundant natural resources that, nevertheless, were incapable of getting a foothold on the development train. This trend has changed in the last few decades, although today's price of a barrel of crude, for example, is still very close to the maximum prices recorded in the mid-1970s, in real terms. But it is undeniable that the appearance of emerging economies, with China at their head, has turned demand for energy, mineral and agricultural resources around. The production of these materials is also expanding but it's often unable to keep up with demand and tensions therefore arise.

The fact that commodity prices are rising is highly significant. These prices have a direct effect on national inflation rates, affect prices related to production process components, disturb balances of payments and complicate monetary policy. Citizens notice their effect directly on their wallets when they fill up their vehicles with fuel or, in developing countries, when they buy rice or corn to survive. Importing countries see their disposable income dwindle when they have to pay more to consume the same amount of the product imported, and vice versa. Those benefitting the most are the regions that produce commodities, such as Latin America, particularly Brazil, Australia and parts of Africa, although they must bear very much in mind the fact that frequent price fluctuations often cause swings between opulence and poverty.

But what possibly arouses the greatest concern is the growing volatility observed in commodity prices. Many blame these sharp changes in trend and even the very rise in prices on financial speculators. According to this interpretation, the growing presence of investors in commodities markets or capital entering commodity funds in recent years are distorting the market and causing bubbles that are destabilizing it. However, empirical studies have not managed to find any direct relationship between financial or speculative activity and price rises and volatility. In any case, it's not easy to clearly identify the influence of each of the many different factors that affect price formation for each commodity on the market at any particular time. For the moment, we can content ourselves with the fact that, if commodity prices go up, this is not entirely bad, as it very probably means that the world is in expansion and international trade is animated. And if they go down, neither is this entirely good, because it might be due to dwindling activity, although this reduction will help towards an eventual recovery.

EXECUTIVE SUMMARY

High tension

The world economy is slowing down, fears are growing of a double dip recession and the sovereign debt crisis is getting worse.

In the months of August and September, we seemed to be reliving the atmosphere of extreme crisis from the end of 2008. Global economic activity is slowing down, the International Monetary Fund (IMF) and the World Bank are warning of the risk of a double dip recession and Europe's sovereign debt crisis still lingers and is getting worse. Whereas rescue strategies were proposed during the financial collapse of 2008, now the room for manoeuvre seems much more limited. The perception of risk is soaring in the financial markets, driven by a notable flow of capital towards assets considered safe havens, with the consequent deterioration in conditions to access financing for numerous agents.

The IMF cuts its growth forecasts.

In its World Economic Outlook for September, the IMF warns of a weaker and more uncertain recovery, with greater fiscal and financial risks for advanced economies. It has cut its global growth forecast for 2011 to 4.0%, still a high level but clearly below July's forecast. Recovery is unequal, as advanced economies will grow less than 2% in 2011 and 2012 while the emerging economies, where there is less risk of a slowdown, will grow by 6% this year and the next.

According to the IMF, the world economy is being hit by a dual imbalance. On the one hand, it's vital for private demand to take over from fiscal stimuli, something that is not happening in advanced economies due to a lack of confidence and the repercussions of real estate bubbles. The second refers to the imbalances in the balance of payments. While advanced economies such as the United States must correct their trade deficits and increase their exports, emerging economies such as China need to focus on strengthening their domestic demand to reduce their external surpluses.

Where could the forecast fail? The main risk is the European sovereign debt crisis getting out of hand, which would worsen economic and financial prospects with the consequent upset in the markets. On the other hand, fiscal and financial uncertainty is affecting countries such as the United States and Japan, with a low growth outlook that encourages doubts regarding the sustainability of their debts. In this respect, the IMF wants advanced economies, especially the United States, to strike an appropriate balance between stimuli for demand and a credible plan for fiscal consolidation in the medium term that guarantees the sustainability of their public accounts.

The United States is losing steam.

What should be the world's driving force, the United States, is failing to show any sign of dynamism. The private sector still hasn't taken over from the expansionary measures that avoided a depression and took growth for the whole of 2010 to 3.0%. Quarter-on-quarter growth in gross domestic product (GDP) in the first two quarters of 2011 was 0.1% and 0.3%, respectively. We don't expect there to be a double dip recession but there are still risks of growth decreasing further and the fundamental problems are still the same. A somewhat better tone is expected for the second half of the year thanks to the improvement in some factors that were

hindering growth, such as oil prices, although we don't expect growth to exceed 1.6% for 2011 as a whole.

The other pole of growth in the world economy, China, seems to be somewhat removed from the storms affecting the West. The strength of August's export and import data confirms the Chinese economy's solid growth. For their part, the strong increase in non-commodity imports is indicative of a robust domestic demand that will help to achieve economic growth of close to 9% this year and the next. The other great emerging economy, Brazil, is growing at a moderate rate, namely 3.1%, a looks like it's gradually slowing up. Household consumption is resisting but investment is losing steam and foreign demand is tending to stagnate, although exports have withstood the strength of the real surprisingly well.

In the European Union, and in the euro area in particular, economic and financial tensions have continued to rise on observing a marked deterioration in growth at the same time as the sovereign debt crisis was entering a new and worrying phase. The hopes raised in July after the approval of the second bailout plan for Greece and the enlargement of the scope of the current bail-out fund, the European Financial Stability Facility (EFSF), have quickly faded. The Greek central government's difficulty in meeting its commitments for adjustment is evident, so that there is a growing perception that the restructuring of its debt may be larger than expected. There are even fears of it leaving the euro, although we believe this possibility is highly remote. All this merely makes the already precarious financing conditions worse for the Greek economy, whose 10-year bonds are now quoted at more than 20 percentage points above those of Germany. Although the process of bailing and sorting out Ireland and Portugal is progressing satisfactorily, uncertainty reigns supreme and contagion is spreading, landing fully on two fragile peripheral economies, Italy and Spain, that have seen their risk premia rocket for no other apparent reason. This spiralling lack of confidence is also spreading to holders of debt from economies under pressure and speculation is rife on the need to recapitalize the banks with the greatest exposure.

Emerging countries remain somewhat removed from the turbulences of the West.

To tackle this situation, the European Central Bank (ECB) activated its asset purchase programme in July, acquiring Italian and Spanish debt on the secondary market in order to halt their rising risk premia. This action has led to friction within the monetary authority, as some interpret it as funding member states, something explicitly prohibited in the ECB's statutes. On the other hand, the ECB has maintained an adaptable monetary policy aimed at providing the banking system with all the liquidity it requires. Along these lines, in September it announced, in a joint action with the Federal Reserve, the Bank of England, the Bank of Switzerland and the Bank of Japan, that it would provide an unlimited amount of dollar liquidity at three months for any European banks that might need it.

Greece's difficulties are setting alarm bells ringing and contagion is spreading.

Together with the ECB, the other defensive front against debt is, or should be, the EFSF. In July, the 17 heads of state and government in the euro area decided to increase its flexibility so that it could act in a preventative way, giving it the capacity to recapitalize banks and allowing intervention in secondary markets. The problem is that this agreement must be ratified by each member state of the euro area, a process that could still take several weeks. Even if these modifications come into force, some believe that the EFSF will not have enough capacity to fulfil its functions.

The ECB is acting as a dam but euro area decisions are made very slowly.

Fear of the consequences of the debt crisis on banks and the stock market debacle.

Its current budget of 440 billion euros should be substantially increased or, alternatively, it should become a bank and thereby be able to access ECB funding. This approach is opposed by Germany and other member states that reject outright any movement aimed at strengthening fiscal links and co-responsibility in the area of budgets beyond what has already been agreed or established in the treaties.

The combination of the deterioration in economic prospects, together with the worsening of the sovereign debt crisis and the consequent need to recapitalize which European banks would have to face in the case of Greek default have all had a lethal effect on the stock market. This is precisely why banks' shares are still in the sights of investors, this punishment being reinforced after the downgrading suffered by some French and Italian banks. But practically all the world's stock markets have accumulated losses this year so far. Of note is Greece, down more than 40%, while Eurostoxx has lot 25%, the German DAX 19%, the Spanish Ibex 17% and London 14%. The losses suffered by emerging stock markets have also been high, while the United States' indices have fallen more moderately.

Spain completes its transformation of the banking system.

In the midst of these tensions, Spain's banking system took a decisive step in September in its restructuring process. Finally, only four savings banks have needed aid from the Fund for Orderly Bank Restructuring to achieve the new minimum capital requirements demanded by the regulator. Thanks to this, Spanish financial institutions have strengthened their balance sheets with a view to the last quarter of the year. Moreover, their exposure to peripheral debt is still far below that accumulated by banks in other countries, such as France or Germany. However, the challenges for the Spanish banking system have not disappeared and they must tackle the closure of debt markets and the deterioration in the default rate over the next few quarters.

On the other hand, liquidity tensions are reducing banks' capacity to grant credit. At the same time, the weak recovery of the economy, not enough to reactivate the labour market, is keeping demand for credit at a low level, so we expect credit to shrink further in 2011. The fundamental problem is the economy's low growth. Business and confidence indicators for the third quarter show a weak pulse, both for consumers and firms. For the last two and a half years, industrial production has been hovering around a level almost 25% below its level in 2007. For its part, construction continues to adjust. Only in services can a certain dynamism be perceived, in the area of services related to tourism. Our forecasts point to a rise in GDP of 0.8% in 2011, while we've cut growth to 1.1% for next year.

In spite of the economy's weakness, public account adjustment is almost on target.

The economy's weakness is having an effect on tax revenue, which in the first eight months of the year grew by 2.1%, compared with 6.2% predicted for the whole year. However, the spending cuts have allowed the central government to post, in this period, an 11.5% lower deficit than the one recorded for January-August 2010, a reduction in line with the target for the whole year. Where deviation can be noted is in the accounts of the autonomous communities, which will make it difficult to achieve the 6% GDP target in 2011 for public administrations as a whole. In any case, the IMF estimates that this deviation will be less than two tenths of a percentage point of GDP, so that fulfilment of the stability pact commitments will be satisfactory, taking into account that this year has been complicated.

28 September 2011

CHRONOLOGY

2010

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.
April	**7**	The **European Central Bank** raises the official interest rate to 1.25%.
May	**17**	The Council of Economic and Finance Ministers of the European Union approves the **financial bail-out plan for Portugal**, totalling 78 billion euros.
	22	**Elections** are held in thirteen autonomous communities and in the municipalities.
June	**10**	The government approves a Decree Law that **reforms collective bargaining**.
July	**21**	The countries of the euro area approve a second **bail-out plan for Greece** totalling 109 billion euros, among other measures to tackle the sovereign debt crisis.
August	**16**	The leaders of Germany and France, Angela Merkel and Nicolas Sarkozy, propose that **the euro area's institutions should be reinforced** by a series of mechanisms to improve coordination of economic policy.
	19	The government approves a package of **economic policy measures**, advancing the payment of corporate tax for large firms, rationalizing pharmaceutical expenditure and a temporary reduction in VAT for new housing.
	30	The Congress agrees to reform the Constitution to introduce the principle of **budgetary stability**.
September	**22**	The Spanish government ratifies Royal Decree Law 13/2011, which re-establishes **wealth tax** for 2011 and 2012.

AGENDA

October

- **4** Registration with Social Security and registered unemployment (September).
- **6** Industrial production index (August). Governing Council European Central Bank.
- **11** CPI (September).
- **14** EU HICP (September).
- **20** International trade (August).
- **25** Producer prices (September). Government revenue and expenditure (September).
- **27** GDP flash estimate of the United States (third quarter).
- **28** Labour force survey (third quarter). Flash CPI (October).
- **31** Balance of payments (August).

November

- **2** Fed Open Market Committee
- **3** Registration with Social Security and registered unemployment (October). Governing Council European Central Bank.
- **4** Industrial production index (September).
- **11** GDP flash estimate (third quarter).
- **15** CPI (October). EU GDP flash estimate (third quarter).
- **16** Quarterly national accounts (third quarter). EU HICP (October).
- **20** General elections.
- **22** International trade (September).
- **25** Producer prices (October).
- **29** Flash CPI (November). Government revenue and expenditure (October).
- **30** Balance of payments (September).

INTERNATIONAL REVIEW

IMF forecasts: risk of a double dip recession

The IMF expects 4.0% world growth for 2011 and 2012, with a significant risk of this being lower.

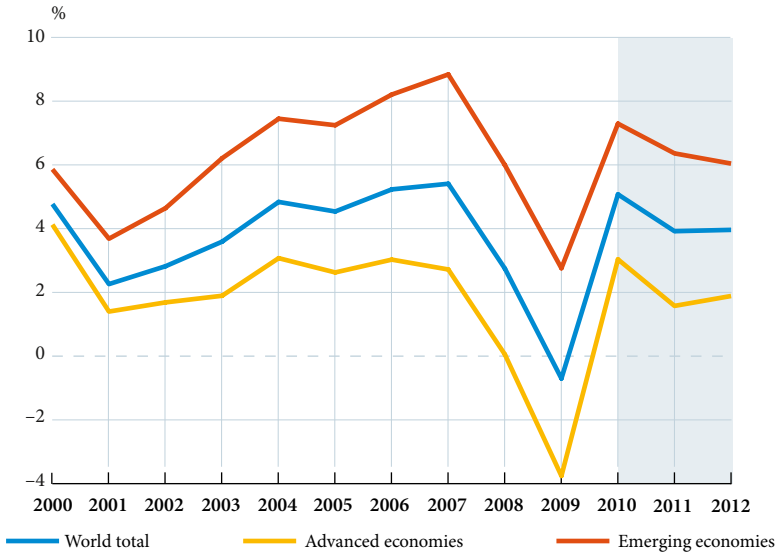
In its World Economic Outlook for September, the International Monetary Fund (IMF) sees a weaker and more uncertain recovery, with greater fiscal and financial risks for advanced economies. Global growth for 2011 has been reduced to 4.0%, a rate that will not vary in 2012, clearly below July's forecasts. The recovery is uneven, with some advanced economies that, according to the Fund, will grow less than 2.0% in 2011 and 2012 and with some emerging economies for which, although their growth has also been revised downwards, the risk of a slowdown is less, with advances that will probably exceed 6.0% this year and the next.

Private demand still fails to take over from public stimuli in advanced economies.

According to the IMF, the world economy is being afflicted by a twofold imbalance, internal and external. With regard to the former, it's vital for private demand to take over from fiscal stimuli, which is not happening in advanced economies because of a shortage of credit and the legacy of real estate bubbles. With regard to the external imbalance, while advanced economies such as the United States have to correct their trade deficits and increase their exports, emerging economies such as China need to focus on strengthening their domestic demand to reduce external surpluses.

AN ENDANGERED RECOVERY

Year-on-year change in gross domestic product



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

The risks are likely to reduce growth. The main risk is the European sovereign debt crisis spiralling out of control. Fiscal and financial uncertainty is affecting countries such as the United States and Japan, with low growth prospects that foster doubts regarding the sustainability of their debt. In this respect, the Fund wants advanced economies, particularly the United States, to strike a prudent balance between stimuli for demand and a credible medium-term fiscal consolidation plan that ensures the sustainability of the public accounts.

The economy whose growth has been revised downwards the most is the United States. The lack of political consensus, persistently weak employment and housing and the danger of excessive reticence on the part of consumers mean that, although greater growth is expected for the second half of the year, the advance forecast for the whole of 2011 remains at a meagre 1.5%, with 1.8% expected for 2012.

The United States' growth is revised downwards to 1.5% in 2011 and 1.8% in 2012.

For its part, the euro area expects to grow by 1.6% in 2011, but in 2012 a slowdown is forecast with 1.1% growth. Expectations for Germany have also cooled down, with growth forecast at 2.7% for 2011, which should slow up to 1.3% in 2012. For Spain, the forecast of 0.8% growth in 2011 has been maintained. However, in 2012 the recovery will be more lukewarm than expected, with 1.1% growth forecast due to lower demand on the part of its trading partners.

The euro area slows up. Germany, strong in 2011, will lose speed in 2012. Spain grows by 0.8% in 2011 and 1.1% in 2012.

Japan should fall to 0.5% in 2011 but reconstruction after the effects of the

IMF FORECASTS

Annual change as percentage (*)

	GDP		Consumer prices		Unemployment rate (**)	
	2011	2012	2011	2012	2011	2012
United States	1.5	1.8	3.0	1.2	9.1	9.0
Japan	–0.5	2.3	–0.4	–0.5	4.9	4.8
China	9.5	9.0	5.5	3.3	4.0	4.0
Germany	2.7	1.3	2.2	1.3	6.0	6.2
France	1.7	1.4	2.1	1.4	9.5	9.2
Italy	0.6	0.3	2.6	1.6	8.2	8.5
United Kingdom	1.1	1.6	4.5	2.4	7.8	7.8
Spain	0.8	1.1	2.9	1.5	20.7	19.7
Euro Area	**1.6**	**1.1**	**2.5**	**1.5**	**9.9**	**9.9**
Advanced economies	**1.6**	**1.9**	**2.6**	**1.4**	**7.9**	**7.9**
Developing countries	**6.4**	**6.1**	**7.5**	**5.9**	...	...
Latin America	*4.5*	*4.0*	*6.7*	*6.0*	...	...
Eastern and Central Europe	*4.3*	*2.7*	*5.2*	*4.5*	...	...
Emerging Asia	*8.2*	*8.0*	*7.0*	*5.1*	...	...
World Total	**4.0**	**4.0**	**5.0**	**3.7**	...	...
World trade by volume (***)	**7.5**	**5.8**				

NOTES: (*) Forecasts at September 2011.
(**) Percentage of labour force.
(***) Goods and services.
SOURCE: International Monetary Fund.

Japan recovers from its earthquake while China and emerging Asia continue to lead world growth.

earthquake and tsunami should raise growth to 2.3% in 2012. The outlook for emerging economies is still robust, particularly East Asia with the outstanding example being China's growth which, according to the IMF, will remain strong and advance by 9.5% in 2011 and 9.0% in 2012, while the economies of Eastern Europe and Latin America will continue to grow but somewhat less than the Asian countries. Similarly, inflationary risks should be eased by less upward pressure from commodity prices.

The United States has insufficient growth.

The United States: the road to recovery is long and narrow

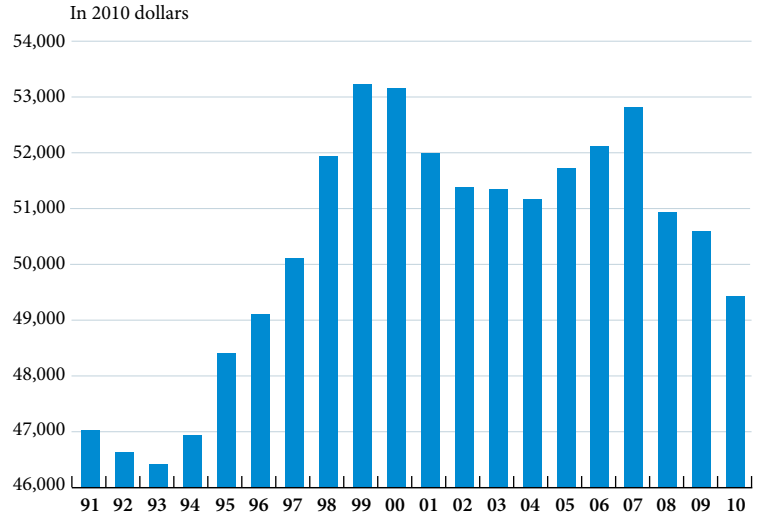
The United States' economy is weak. The private sector is still failing to take over from the expansionary measures that avoided a depression and took growth for the whole of 2010 to 3.0%. The quarter-on-quarter growth in gross domestic product (GDP) for the first two quarters of 2011 was 0.1% and 0.3%, respectively. This tone is expected to improve for the second half of the year thanks to the relaxation of temporary factors that hampered growth, such as oil prices. Nonetheless, growth for the whole of 2011 is unlikely to exceed 1.6%.

Unemployment, indebtedness and the housing market hamper the recovery.

Although the latest indicators do not point to a double dip recession, the risk is still that growth will be lower than expected and the underlying problems have not altered. Persistently high unemployment and continual losses in the housing sector are hitting the middle class particularly hard as, in debt, it is seeing the purchasing power of its income and wealth diminish. The purchasing power of the average household income is 7.1% below the level of 1999 and housing prices have yet to pick up. For its part, the gross indebtedness of households stood at 114.3% of disposable income in the second quarter, now far from the peak reached of 130.2% in September 2007 but still above the normal level. These factors mean that growth will remain weak throughout 2012, so we predict a growth rate of 2.0%.

THE UNITED STATES: THE DIFFICULTIES OF THE MIDDLE CLASS

Mean household income discounting inflation



SOURCES: US Census and own calculations.

The hardships of Joe public are reflected in consumption, namely the expectations for public and the weakness of private consumption, whose growth in the third quarter should nonetheless pick up a little. This improved tone is due to July's increase, although this improvement is unlikely to increase further, as the reaction was centred mostly on consumer durables while the consumption of services and non-durable goods, which are more indicative of the underlying trend, is still stagnant. Retail sales in August also showed a clear slowdown compared with the good month of July, with automobiles losing a large part of what they had gained.

Private consumption should pick up slightly in the third quarter.

In the case of surveys, in August the Conference Board consumer confidence index fell drastically. This drop is partly due to the uncertainty caused by negotiations to raise the legal debt ceiling in order to avoid default but the downward trend in future expectations is getting worse, in August coming close to the record lows of early 2009. Entrepreneurs, who started 2011 optimistically, have also gradually darkened their perceptions, with a business sentiment index from the Institute for Supply Management in August that is consistent with the current low rates of growth.

The problem for the coming years is that the leeway for expansionary measures has narrowed. With regard to monetary policy, interest rates are already at minimum levels and the Fed must opt for exceptional measures such as the purchase of public debt or, as announced this September, extending the maturities of its assets, selling 400 billion dollars in bonds with maturities of up to three years and buying other longer term bonds: measures whose effect on growth is limited.

But the greatest challenges lie in the area of fiscal policy. The authorities' priority must be to design a credible agenda for

Little leeway for expansionary policies.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
Real GDP	–3.5	3.0	3.5	3.1	2.2	1.6	–	...
Retail sales	–7.0	6.4	5.6	7.7	8.2	7.8	8.3	7.2
Consumer confidence (1)	45.2	54.5	50.9	57.0	66.9	61.8	59.2	44.5
Industrial production	–11.2	5.3	6.9	6.2	5.4	3.8	3.4	3.4
Manufacturing (ISM) (1)	46.3	57.3	55.2	57.9	61.1	56.4	50.9	50.6
Housing construction	–38.4	5.6	–0.7	–5.1	–5.3	–4.9	9.3	–5.8
Unemployment rate (2)	9.3	9.6	9.6	9.6	8.9	9.1	9.1	9.1
Consumer prices	–0.4	1.6	1.2	1.3	2.1	3.4	3.6	3.8
Trade balance (3)	–381.3	–500.0	–489.1	–500.0	–520.4	–534.8	–538.1	...
3-month interbank interest rate (1)	0.65	0.34	0.35	0.30	0.31	0.26	0.26	0.33
Nominal effective exchange rate (4)	77.7	75.4	75.9	73.0	71.9	69.6	69.1	69.1

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.

A fiscal consolidation plan combined with short-term stimuli is required.

fiscal consolidation. A task that the United States, with a gross public debt that will reach 100% of GDP in 2011, has been slow to undertake compared with other advanced economies. A context that, should the debt's sustainability be assured, would allow the authorities to implement temporary stimuli to support the recovery more decisively. One example of the prevailing disagreement in this respect is the lack of agreement regarding President Obama's plan to boost employment. This plan proposes an injection of 447 billion dollars through reductions on income tax and on small firms, which would be offset by higher taxes on high income brackets. The plan's net effect would stimulate GDP by 1.5% in 2012, but is unlikely to be passed in its entirety.

The recovery in wages slows up and the rate of activity is below its secular trend.

Looking in detail at the labour market, August's unemployment rate remained at 9.1%, but is likely to come close to 9.5% in 2012, given the weak growth forecast. Similarly, the big pool of discouraged workers and those working part-time involuntarily will absorb a large number of the jobs that may be created. Recovery in the labour market is key to the fortunes of the middle class improving. A rise in nominal income would help to improve households' gross debt-disposable income ratio and boost consumption. Employment has an effect on income via two mechanisms: wages and the activity rate.

But the recovery's loss of steam is also being felt by wages. The average weekly wage rose by 1.7% year-on-year in August, a rate that entails a loss of purchasing power and reveals a clear slowdown since the 3.7% of August 2010, when the economy was growing faster than now. With regard to the activity rate, the ratio between the employed workforce and the population, an exceptionally high number of jobs were lost during the crisis and the recovery is exceptionally weak, with zero net job creation in August. Consequently, the activity rate is still falling, standing at 44.6% in July, the lowest since 1984, far from the 48.2% of December 2007 and even further from the long-term trend.

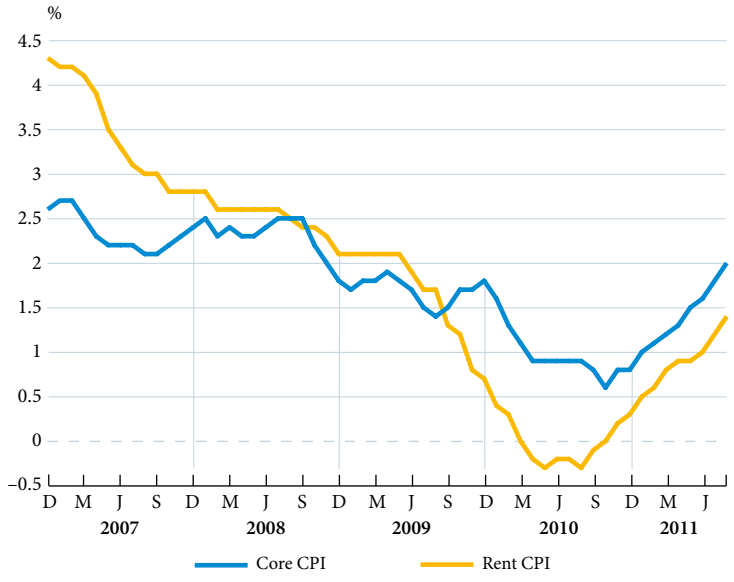
Persistently weak employment and income are prolonging the surplus supply of housing, which might continue beyond the end of 2013. In this respect, housing prices have yet to bottom out, with the Case-Shiller index of second-hand housing for the 20 most significant areas in June falling again, albeit by a minimal amount of 0.1%. Supply still shows no signs of life, with the number of new homes started remaining stagnant at less than 600,000 in annual terms, a third of the normal figure, while second-hand house sales seem to be gradually getting back to normal, in August exceeding 5 million in annual terms.

The CPI rises to 3.8% and core inflation to 2.0% but this should ease off in the fourth quarter of 2011.

Inflation continued to surprise by rising but the outlook for 2012 does not include a scenario of inflationary pressures so the Federal Reserve still has some room to manoeuvre. The general consumer price index (CPI) increased in August by 3.8% year-on-year, 3.6% in July, but more significant was the rise in the core CPI, which excludes energy and food prices, up by 2.0% compared with the previous month's figure of 1.8%. The core CPI continues to rise from its record low of 0.6% in October 2010, pushed up by the end of discounts in sectors such as automobiles, by higher oil prices being partly passed on to consumer prices and especially by the increase in house rents. Apart from the latter, which is due to the greater demand for rental family homes because of the crisis, the other components should start to ease in the last quarter of the year, given the low level of production capacity utilization.

THE UNITED STATES: RENTS FORCE UP THE CPI

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



NOTE: (*) Core inflation excludes food and energy. The rent index includes rents attributed to owners living in their own property.
SOURCES: Department of Labor, Datastream and own calculations.

The foreign sector might also provide economic activity with some breathing space. July's trade balance of 44,808 million dollars was 13.1% lower than the figure for the previous month. The improvement was mostly due to the upswing in export volumes after a bad June, which suggests a greater positive contribution to GDP growth.

The foreign sector might contribute positively to growth in the third quarter.

Japan: the recovery continues, albeit with doubts

After revising its GDP figures, the economy fell by 0.5% in the second quarter instead of the previously announced 0.4% but this does not alter expectations of a vigorous second half to the year. In 2011 as a whole, the Japanese economy will decline by 0.5%, picking up again in 2012 and advancing by 2.7%. This downward revision must be understood as a return to normality after an initial estimate that had been surprisingly high.

On the other hand, a breakdown in GDP shows the downward revision to be more ambiguous, based on a recovery in stocks that is better than had previously been estimated and a certain reticence in capital goods investment due to the uncertainty caused by the power cuts and the growth problems of advanced economies. However, private consumption fell less than expected and exports held firm.

In this respect, the foreign trade figures for July and August were lukewarm, with a slowdown in exports after a good June. But in spite of their current lethargy, exports should contribute positively to growth in the third quarter if we take into account the low starting point of the second quarter, whose 4.9% drop is only matched, most recently, by the figures in

Japan falls by a minimal 0.5% in the second quarter and is expected to improve in the third.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
Real GDP	–6.3	4.0	4.8	2.5	–0.7	–1.1	–	...
Retail sales	–2.3	2.5	3.2	–0.4	–3.0	–1.7	0.6	...
Industrial production	–21.8	16.6	13.3	6.8	–2.5	–7.0	–1.7	...
Tankan company Index (1)	–40.8	0.0	8.0	5.0	6.0	–9.0	–	...
Housing construction	–27.7	2.7	13.7	6.8	3.2	4.3	21.1	...
Unemployment rate (2)	5.0	5.1	5.0	5.0	4.7	4.6	4.7	...
Consumer prices	–1.3	–0.7	–1.0	–0.3	–0.5	–0.4	0.2	0.2
Trade balance (3)	4.0	7.9	8.1	7.9	6.5	3.4	2.5	...
3-month interbank interest rate (4)	0.6	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Nominal effective exchange rate (5)	98.6	106.0	109.1	111.0	110.6	109.3	112.6	115.8

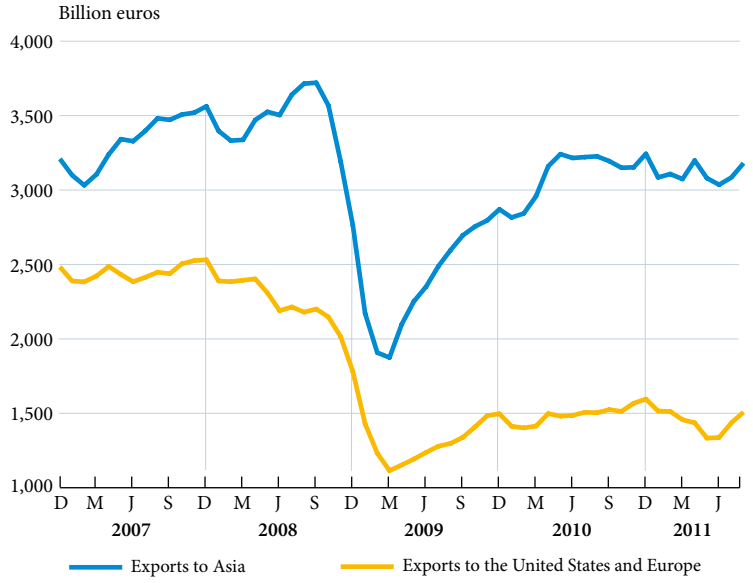
NOTES: (1) Index value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Trillion yen.
(4) Percentage.
(5) Index weighted for foreign trade movements. Higher values imply currency appreciation. Average in 2000 = 100.
SOURCES: OECD, national statistical bodies and own calculations.

Japanese exports depend on Asia and should contribute to its recovery in the second half of the year.

2009. Similarly, the recovery in exports since May has been based mainly on sales to the rest of the Asian continent, amounting to 50%, whose growth still appears robust.

JAPAN: EXPORTS DEPEND ON ASIA

Japanese exports to Asia, the United States and the European Union (*)



NOTE: (*) Moving averages of three months.
SOURCES: Japanese Ministry of Communications and own calculations.

Industrial production is following the example given by exports, with a recovery that has already regained two thirds of what was lost with the earthquake, in spite of August's slowdown. An image that improves if we remember that June's industrial production of consumer goods exceeded the level prior to the catastrophe. Also construction, particularly weak in the second quarter, presented good figures for homes started in July.

Industrial production continues its recovery but is slowing up.

Where doubts become more evident is in investment and confidence indices. Consumers did not improve their expectations in August, remaining at the low level of 37.0 points, close to April's minimum of 33.1 points, while machinery orders, which provide an early indication of investment costs, fell back in July, reflecting the dominant feeling of uncertainty. In the case of prices, August's CPI, which was up 0.2% year-on-year, the same rate as in July, proved that the end of deflation is by no means consolidated. The core CPI, the general index without energy or food, which had not changed from July, dropped by 0.4% year-on-year.

China continues strong

The strength of August's export and import data (growing by 24.4% and 30.4%, respectively, above the consensus forecasts) confirms the Chinese economy's resistance to the troubles affecting the West. Looking at its export figures, it's surprising that, some weeks ago, we were concerned about the possible adverse effects of a global double dip recession on China's foreign trade and its rate of growth. For their part, the vigorous growth of imports other than commodities is indicative of a robust domestic demand.

Similarly, this strong increase in imports, greater than the rise in exports, has helped to reduce China's trade surplus in August, which reached 17,759 million dollars, compared with 31,484 million in July. A reduction that does not occur in its bilateral imbalance with the United States, which continues to widen, with the cumulative figure from January to August now standing at 125.5 billion dollars, 9.5% higher than the figure for the same period in 2010. This bilateral surplus, together with the United States' expansionary monetary policy, is putting increasing pressure on the Chinese authorities to allow the renminbi to appreciate further, which would also help domestic demand to replace growth through exports. Over the last month, the renminbi rose by 0.7% compared with its monthly average of 0.4% last year; an acceleration we believe to be too slight to indicate any real change in the economy's foreign exchange policy.

China's foreign trade resists the effects of lower world growth.

Inflation moderated within this robust scenario, standing at 6.2% year-on-year in August after a strong upswing in July to 6.5%. This moderation, although still far from the 4% target set by the government, together with worse growth prospects in the United States and the euro area and to global financial agitation, suggests that China's tough monetary policy will relax, as has occurred in most of the countries in the region. The exception to this hiatus can be found in India which, on 16 September, raised its reference rate again by 25 basis points up to 8.25% (repo rate), given the upswing in inflation in August (of the wholesale price index) to 9.8% from 9.2% in July.

Inflation eases slightly to 6.2% and reaffirms the halt in tougher monetary measures.

Several business indicators in August show a somewhat more contained tone in the foreign sector, within this overall robustness. Retail sales advanced in nominal terms by 17%, slightly below the

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
Real GDP	9.2	10.4	9.6	9.8	9.7	9.5	–	...
Industrial production	12.5	14.5	13.5	13.3	14.9	13.9	14.0	13.5
Electrical power generation	6.8	14.0	11.8	6.2	12.1	12.0	12.6	9.1
Consumer prices	–0.7	3.3	3.5	4.7	5.1	5.7	6.5	6.2
Trade balance (*)	196	185	183	185	169	175	178	175
Reference rate (**)	5.31	5.81	5.31	5.81	6.06	6.31	6.56	6.56
Renminbi to dollar	6.8	6.8	6.8	6.7	6.6	6.5	6.5	6.4

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

The slight moderation in several business indicators contrasts with the foreign trade figures.

previous month's figure. The purchasing managers' index (PMI) rose very slightly to 50.9 points, still far from the 53 points of last March. And industrial production grew by 13.5%, compared with 14% in July. For its part, bank credit increased by 16.4%, considerably below the 17.6% monthly average of the first half of the year and the 20% at the end of 2010. However, here it's important to note a base effect that is still very much felt, due to the stimulus policies that encouraged institutions to give credit in 2009.

In short, while the strength of exports reinforces the foreign sector's predominance, the huge vitality of imports, particularly those other than commodities, suggests that domestic demand might start to gain in importance. Given this duality, it's obviously still too early to talk of changes in the country's growth engines towards domestic consumption and private investment, although this doesn't appear to be a cause for concern in the short term to maintain the Chinese economy's high growth rates. Specifically, the International Monetary Fund, in its biannual World Economic Outlook for September 2011, revises very slightly downwards the forecasts for 2011 and 2012, placing them at 9.5% and 9.0%, respectively, slightly above our own estimates.

Brazil: growth, industry and corruption in the hot seat

Brazil's economy grows by 3.1% in the second quarter, notably moderating its rate of progress.

In line with consensus expectations, Brazil's GDP grew by 3.1% year-on-year in the second quarter of 2011, 0.8% compared with the previous quarter, suggesting a gradual slowdown in the second Latin American economy. A breakdown by component verifies the following: the notable resistance of household consumption, boosted by an unemployment rate at a record low; investment's gradual loss of steam; and the stagnation in foreign demand, although exports withstood the strong real surprisingly well over the period in question. With regard to public expenditure, its growth was similar to that of the first quarter.

With a view to the second half of the year, macroeconomic indicators and the slowdown in the recovery of advanced

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
Real GDP	–0.7	7.5	6.8	5.0	4.1	3.1	–	–
Industrial production	–7.3	10.5	8.0	3.6	2.6	0.7	1.4	...
Consumer confidence (*)	138.3	159.7	161.4	159.9	161.8	155.4	152.9	152.7
Unemployment rate (**)	8.1	6.7	6.6	5.7	6.3	6.3	6.0	6.0
Consumer prices	4.9	5.0	4.6	5.6	6.1	6.6	6.9	7.2
Trade balance (***)	25.3	20.2	16.8	20.2	22.5	25.3	27.1	28.6
Interest rate SELIC (%)	9.92	10.00	10.75	10.75	11.75	12.25	12.50	12.50
Reales to dollar (*)	2.32	1.78	1.69	1.66	1.63	1.56	1.55	1.59

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.

economies point to few changes in the pace of activity for Brazil's economy compared with that observed in the last quarter, perhaps improving slightly by the end of the year, when the latest stimulus measures start to have an effect. Given this scenario, we have revised downwards our growth forecast for 2011, from 4.2% to 3.9%, and also for 2012, from 3.8% to 3.6%.

This palpable tone of moderation in growth prompted Brazil's central bank to lower the SELIC rate by 50 basis points after its meeting in August and not to rule out further decreases before the end of the year. This decision surprised many analysts as inflation has yet to let up and is still moving away from the target set by the Monetary Policy Committee (4.5% ±2). In August, it reached 7.2% and, contrary to expectations, the preliminary figures for September point to greater increases. With a view to the remainder of 2011, base effects should play in its favour but the marked depreciation of the real in the last month, to levels not seen since mid-2010, might compromise the necessary price correction.

Nonetheless, this appreciation is still good news for the export industry, particularly for manufacturers. A sector that was also thankful for the Brazilian government's recent decision to substantially raise the duty on imports of automobiles with low local content (except for those from Mercosur countries or Mexico), which would particularly affect vehicles from China and Korea.

This measure, clearly protectionist in nature, not only goes against the price moderation but might also lead to formal WTO disputes between the Brazilian authorities and those of countries affected by the duty. Should this happen, Dilma Rousseff's government would open up another front line, this time on the international scene, added to the battlefront already set up within its own borders. In the last few months, the Brazilian president has embarked on a tough fight against corruption that has already led to the resignation of four ministers and the exit from the coalition government of the Republic Party, an ally of Lula and Rousseff's Workers' Party

Brazil's central bank surprises by lowering interest rates, although inflation has yet to let up.

Risk aversion achieves what the Brazilian authorities did not: slowing up the real.

since 2003. Although public opinion supports Rousseff's tough approach in combating corruption, the PR's exit from the coalition may hinder the president's ability to keep a firm hand on the Brazilian economy's helm; a firmness that's essential given the uncertain seas at a world level.

Mexico: protected by domestic expenditure

A breakdown of GDP components for the second quarter of 2011 reveals a marked upswing in investment, up by 9.4% compared with the same period a year ago; a 4.3% growth in consumption; a 2.6% drop in public consumption; and upward trends in exports and imports of 8.1% and 6.8%, respectively (all these figures being year-on-year growth). Household spending and the good performance by private investment, as well as public, have confirmed their role as the main supports for Mexico's economic growth given a foreign demand that is increasingly hindered by the slowdown in the recovery of the advanced economies and particularly the United States.

Domestic expenditure's good tone is protecting the Mexican economy from the slowdown in growth in the United States.

At this juncture, there are few doubts that this slowdown will continue throughout the second half of the year, forcing us to revise downwards our growth forecasts for the Mexican economy to 3.9% in 2011 and 3.5% in 2012 (previously 4.5% and 4%, respectively), in line with the new scenario we're contemplating for the United States.

This scenario of moderation has not gone unnoticed by the Monetary Policy Committee of Banxico which, in its last minutes, left the door open to a possible reduction in interest rates before the end of the year. In this respect, the recent trend in prices has prepared the ground for them: in year-on-year figures, inflation fell to 3.4% in August and the bulk of the evidence suggests that it will end the year close to 3% (within the central bank's target range). Nevertheless, we still do not expect any changes in monetary policy in the remainder of 2011 unless economic activity deteriorates more than expected in our main scenario.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
Real GDP	–6.2	5.4	5.1	4.2	4.4	3.6	–	–
Industrial production	–7.3	6.0	6.4	4.7	4.9	3.9	4.1	...
Consumer confidence (*)	80.5	86.3	89.2	89.6	92.1	90.7	95.5	93.4
Leading business index (*)	110.5	116.6	117.3	118.1	119.9	120.7	...	...
Unemployment rate (**)	5.5	5.4	5.6	5.3	5.1	5.2	5.6	5.8
Consumer prices	5.0	3.9	3.7	4.2	3.5	3.3	3.5	3.4
Trade balance (***)	–4.7	–3.0	–2.0	–3.0	–1.5	0.0	–0.1	–0.2
Official Banxico rate (%)	6.75	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	14.18	12.33	12.60	12.35	11.90	11.72	11.73	12.35

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

The situation looks a little more agitated in the fiscal area. In the coming weeks, the parliament will debate the 2012 Budget Project presented by the Federal Government and the commitment to fiscal stability acquired over the last few years will more than likely be maintained. However, we do not expect any changes of a structural nature that reduce the public treasury's dependence on oil or generate the necessary resources to significantly improve the country's infrastructures or educational system. Although there's no doubt that these are necessary and, sooner or later, inevitable, the closeness of the presidential elections, in July 2012, does not facilitate agreement along these lines.

The bulk of the evidence available suggests that inflation will end the year within its target range, helping interest rates to fall should economic prospects worsen.

Oil prices: the role of fundamental factors vs. speculation

After the Great Recession of 2008 and 2009, when Brent crude plummeted to 40 dollars per barrel, oil prices once again started to rise and now seem to have stabilized over the last few months at around 115 dollars. This sharp rise and crude's strong resistance to a fall in price over the last few months, in spite of the weak recovery in advanced economies, has reopened debate regarding the role played by the fundamental laws of supply and demand compared with the importance of speculation.

Concerning demand, the growth of emerging markets (with a high income elasticity of demand for energy) lies behind a large part of the rise in crude prices in the first decade of the century, as well as their recovery since 2009. In other words, economic progress is actually the most important factor in determining energy demand. In particular, oil consumption increases with GDP growth, especially if the country's income level is relatively low. In other words, while high-income countries can maintain high growth rates without incurring big rises in their consumption of crude, this is not the case for less developed regions.(1) The dynamism of emerging economies, exceeding most forecasts, has therefore been reflected in a rise in the demand for crude that, given the limitations to an increase in supply, has inevitably led to notably higher prices. By way of example, while global consumption between 2007 and 2010 increased by 0.9 million barrels per day, in China (the great emerging consumer) this rise was 1.5 million (see the graph below). So global consumption not including the Asian giant must have fallen by 600,000 barrels per day, largely possible thanks to rising prices, although it's true that the economic decline in some advanced countries during this period has also helped to reduce their energy demand.

Looking at supply, the geopolitical instability in North Africa and the Middle East has also been a decisive factor in the higher oil prices during the first half of this year. In particular, the outbreak of the Libyan Revolution in mid-February represented a halt in 2% of the world's production. If we assume a short-term price elasticity of demand for crude of –0.07, which is the maximum value estimation (in absolute terms) given by the IMF's World Economic Outlook from April 2011, then a 2% fall in supply entails a rise in oil prices of a little more than 28%.(2) This increase is similar to the rise of 25% that occurred between February and April this year. In summary, a low price elasticity of demand means that small changes in the present and future supply lead to sharp variations in price.

(1) Several estimates place the income elasticity of energy demand for high-income economies at around 0.5 and close to 1 for low and middle-income economies.
(2) A price elasticity of –0.07 suggests that a 10% increase in price leads to a 0.7% fall in demand.

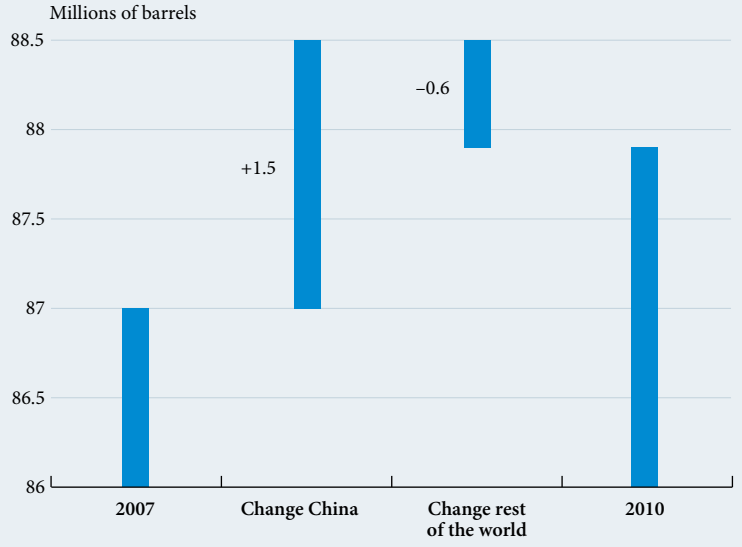
Lastly, the high and growing relevance of financial investment of a speculative nature in the futures market for crude and its effect on the level and volatility of prices is an issue that generates a wide range of opinions. On the one hand, numerous analysts conclude that the classic laws of supply and demand are the main factors behind the sharp rises and subsequent falls in price during the first decade of the century, arguing that the negligible evidence of stockpiling is proof that speculation has not played a significant role. Specifically, according to these analysts, if speculators bet on a rise in oil prices by acquiring futures, the futures price will rise to a level way above the spot price. In such a situation, there are incentives to buy spot-price oil, store it (thereby increasing stocks) and sell it on the futures market, so that the rise in the spot price in a speculative scenario occurs due to stockpiling.

However, those analysts that claim that financial investors in commodities have helped to create speculative bubbles also believe that stock variations are not a good indicator of the role played by speculators. They argue that if the futures price goes way above the spot price, the oil-producing countries themselves may decide to postpone extraction to sell oil on the futures market. In this case, the spot price would rise without any accompanying accumulation in stock. On the other hand, if the price elasticity of demand for crude is very low, as seems to be the case, neither stocks nor supply would change drastically due to speculative transactions. Lastly, in the presence of other disruptions that can also affect stocks, such as a small disturbance in supply, variation due to speculation may not be visible.

Continuing with those who defend the importance of speculative investment, most of these propose models wich assume that financial investors hold a somewhat heterogeneous range of opinions. In other words, and as happens in reality, not all investors believe the economy will develop in the same way, even though they may have the same sources of information. It is precisely because of this plurality that the equilibrium price does not coincide with the

CHINA'S DYNAMISM IS A KEY FACTOR IN OIL CONSUMPTION

Daily consumption of oil



SOURCES: International Energy Agency and own calculations.

price resulting from fundamental factors. The example of a «beauty contest» given in the mid-1930s by John Maynard Keynes to explain stock market prices is useful for understanding how this happens.[3]

The analogy used by Keynes is that of a contest where the participants must choose the six faces they believe are the most beautiful from a set of photographs. Once they have voted, a prize draw is held from among those individuals who chose the face that received the most votes. Although certainly some players would choose the faces they personally consider to be the most beautiful, other participants would go a little further and try to guess how most people would perceive beauty and would make their choice based on this supposition. Empirically, it has been observed that, when participants do not choose according to their own standards but predict what others might think or even try to predict what others might predict regarding the overall consensus, the winning face obtains a higher percentage of votes. Similarly, within a market scenario of mainly optimistic (pessimistic) speculators, the equilibrium price will be above (below) the price set by the classic factors of supply and demand, as would happen with the percentage of votes for the most beautiful face.[4]

In short, although the classic macroeconomic factors of supply and demand are two key factors in explaining a large number of the sharp short-term movements observed in the price of crude, the growing importance of commodities as a target for financial investment is something that cannot be ignored.

(3) For more details, see chapter 12 of «General Theory of Employment, Interest and Money» by John Maynard Keynes.
(4) For more details, see Allen, F., S. Morris and H.S. Shin (2006), *«Beauty Contests and Iterated Expectations in Asset Markets»*, *Review of Financial Studies*, v. 19 no. 3.

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Following lower expectations

The price of crude remained stable between 22 August and 27 September, down 0.9% which placed it at 106.60 dollars per barrel (Brent quality, for one-month deliveries), 15.1% above its level at the start of the year and 37.3% above last year's level. Although this drop is small, we should note that oil prices had risen up to 20 September by 4.3%.

Oil falls to 106.60 dollars due to fears of a double dip recession in advanced economies.

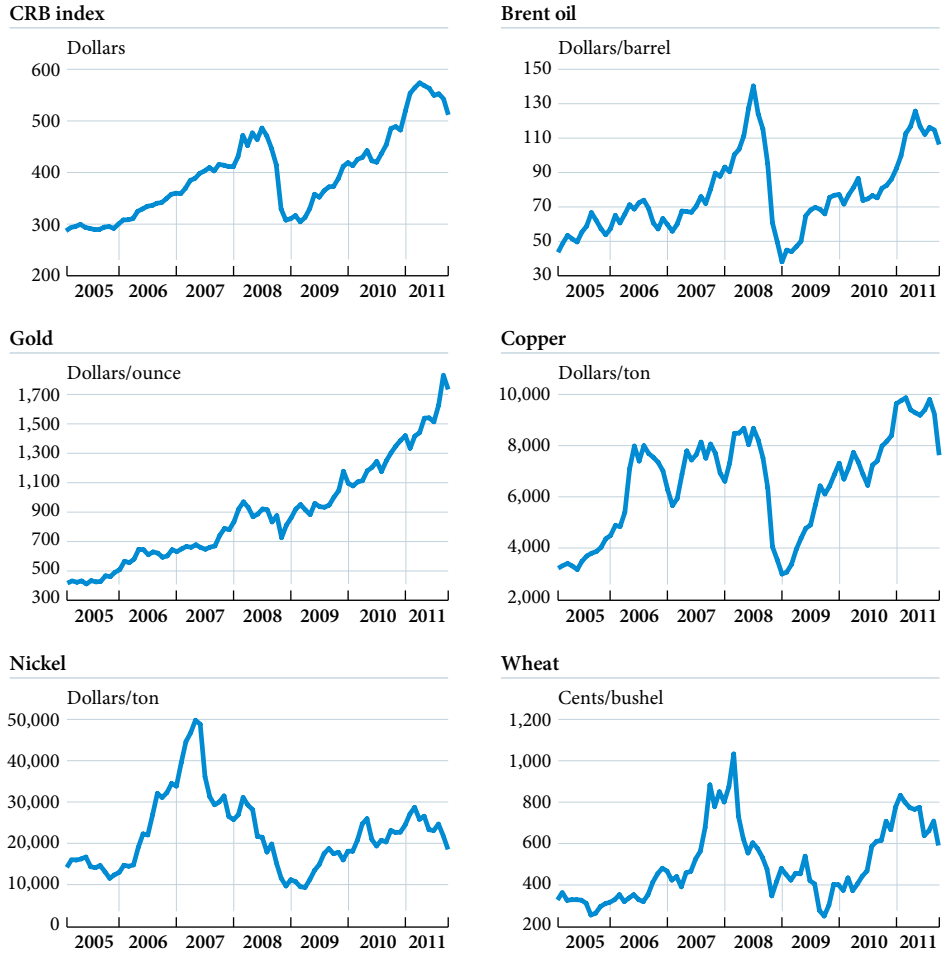
This drop in oil prices, and in the rest of commodities, should be seen within the context of less global growth, particularly in the United States and Europe. Political unrest in North Africa and the Middle East, difficulties in supply and also the continuing growth of emerging economies, which are more energy-intensive, have delayed a moderation in prices. Crude is unlikely to fall below 100 dollars per barrel before the end of the year but, at present, the most likely risks would result in a downward trend.

Falls predominate in the rest of commodities, resulting from the downward revision of expectations. The CRB commodities index lost 4.8% between 22 August and 27 September. Base metals, which are closely related to economic growth, fell across the board.

Metals far further than foods.

Particularly of note were the 12.9% drop in copper and the 9.0% drop in nickel, as well as the abrupt end to the upswing in silver and falls in the rest of the precious metals. The drop in gold is significant, not taking advantage, this time, of the prevailing uncertainty, perhaps suffering from vertigo. This precious metal fell by 12.2%, reaching 1,655 dollars an ounce, when at the beginning of September it had gone above 1,900 dollars intraday. The drops in foods were less unanimous, such as the fall in wheat and sugar prices combined with rises in barley and rice.

TREND IN VARIOUS COMMODITIES (*)



NOTE: (*) Figures for last day of month (last date September 27).
SOURCES: The Economist, Thomson Reuters Datastream and own calculations.

There's still oil... but it will be more expensive

In the year 2000, Saudi Arabia's former Oil Minister, Sheikh Ahmed Zaki Yamani, announced that «the Stone Age did not come to an end because we had a lack of stones, and the oil age will not come to an end because we have a lack of oil». According to his reasoning, there are sufficiently large reserves of this mineral to allow for an orderly transition towards a more widespread use of new energy sources. At first glance, this theory seems to be supported by the figures for global oil reserves. The discoveries of deposits and new non-conventional techniques for obtaining oil have meant that the potentially available stock has increased over the last ten years, postponing the day it will run out. However, this view could be misleading as the cost of extracting the oil must also be taken into account. Based on current growth patterns, permanently higher oil prices would affect the world's economic development. So the question we should be asking is how long can oil meet global demand at a reasonable price?

To find an answer to this question, we have to analyze the long-term trends in oil supply and demand. This is not without its difficulties, however. The appearance of new technologies and governments encouraging the use of alternative energy sources to introduce changes in the energy model might influence demand. At the same time, estimates of oil reserves are uncertain as these vary significantly between different sources and, moreover, new deposits might be discovered. Similarly, both series depend on the current and expected price of oil.

According to the statistics published by the English oil company British Petroleum (BP), the emerging countries led the growth in oil consumption during the first decade of the 21st century with an increase of 43.8%, while consumption in advanced economies fell slightly by 3.5%. As a consequence, the global consumption of oil rose by 14.1% during the first decade of the 21st century, totalling 87 million barrels a day.

In spite of rising oil consumption at a global level, the pace of growth is showing clear signs of a slowdown compared with the 21.8% rise recorded during the 1990s. This is essentially due to two reasons. Firstly, greater efficiency in the use of oil. This means that, today, the same goods and services can be produced with a lower consumption of the mineral. Secondly, the use of other sources to obtain energy. Although oil is still the planet's main energy resource, in 2010 its consumption accounted for a third of the world's total energy consumption, lower than the figure of 38.1% at the start of the century. Coal and, to a lesser extent, renewable energy sources and gas increased their share over the same period. These two underlying factors will maintain the slowdown in the growth of oil consumption over the coming decades.

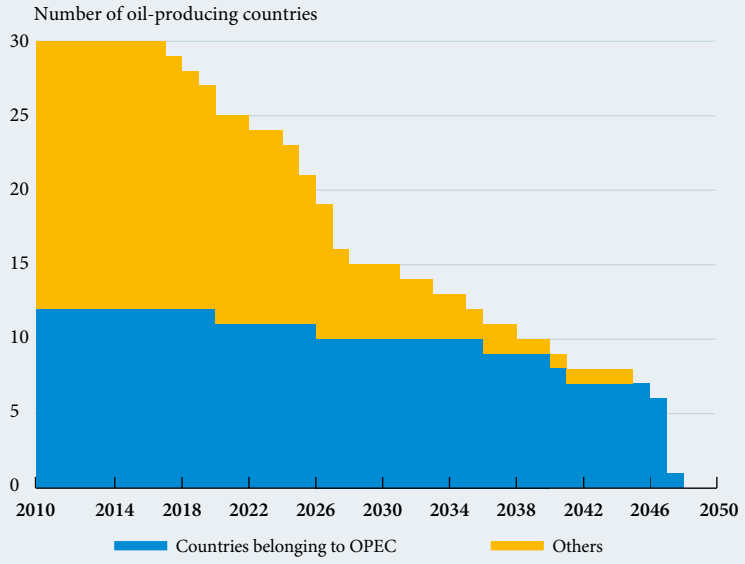
Most reports on long-term oil consumption trends support this scenario. In fact, both BP and the International Energy Agency (IEA) estimate that global oil demand will be around 100 million barrels a day by 2030.[1] This means a 13.9% rise in oil consumption over the next 20 years, much lower than the figure recorded during the preceding two decades, namely 31.4%.

In line with the statistics published by BP, proven oil reserves (the reserves that can be exploited profitably using existing technology) amounted to 1.4 trillion barrels in 2010. This means that, assuming weak growth in oil consumption as from 2030, today's reserves are enough to meet demand for the next 38 years.

(1) For further information, see BP Energy Outlook 2030 and IEA: World Energy Outlook 2010.

OIL RESERVES ARE IN THE HANDS OF FEW COUNTRIES

Producers with proven oil reserves



SOURCES: BP and own calculations.

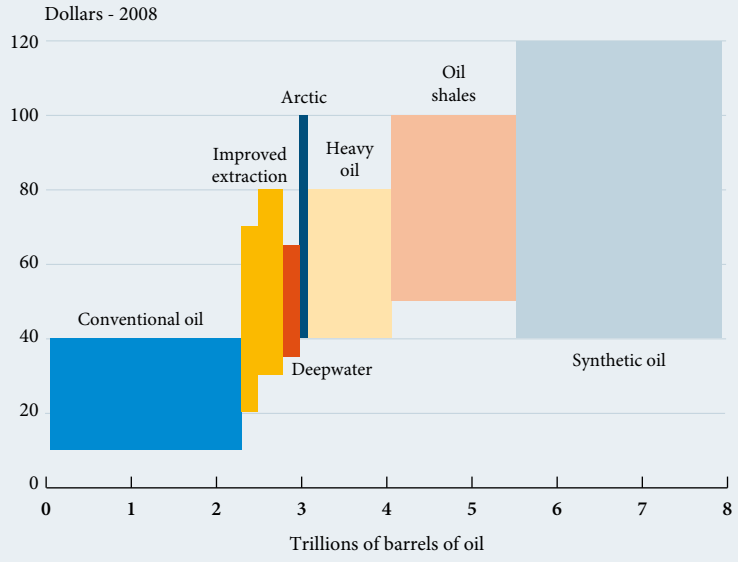
It must also be noted that these reserves are not spread uniformly among the oil-producing countries. The above graph simulates the number of countries that will still have reserves over time.(2) As can be seen, the number of countries with significant oil production will gradually fall. According to these calculations, in 18 years the number of countries that will still have oil reserves will have halved, from 30 to 15. Oil production will therefore be concentrated in the hands of very few agents. Moreover, 10 of these 15 countries are members of the Organization of Petroleum Exporting Countries (OPEC), a cartel whose aim is to coordinate oil production policies in order to control its price as far as possible. This will be very simple within just a few years. In 2029, for example, these countries will possess close to 95% of all proven oil reserves. But, at the same time, this high concentration means that, in order to meet the world's demand for oil, these countries will have to multiply their current production capacity by 2.6 in less than 20 years. Undoubtedly a big challenge that requires heavy investment. All this will push up oil prices in the medium term.

There are two factors that might ostensibly prolong the oil supply. These are: an increase in proven oil reserves and mineral extraction using non-conventional techniques. In the first case, the discovery of new deposits and the reduction in the cost of oil extraction techniques have increased proven reserves almost uninterruptedly. According to estimates by the US Geological Survey (USGS), and given the rate at which deposits have been discovered over the last few years, the planet still holds 0.8 trillion additional barrels of conventional oil. This would place proven reserves at around 2.2 trillion barrels, enough to meet world demand over the next 60 years. At the same time, the IEA estimates that the oil supply might increase by close to 5.8 trillion extra barrels through non-conventional

(2) We have assumed that the countries' production rate will increase at the same pace as consumption. When an oil-producing country runs out of reserves, the rest of the countries share out its production in proportion to their reserves.

NON-CONVENTIONAL OIL IS CONSIDERABLY MORE EXPENSIVE

Estimated range of incremental cost



SOURCE: IEA, World Energy Outlook, 2008.

techniques. Of note are oil reserves that are difficult to extract (as they are in deep sea locations or due to the use of techniques to recover oil from current deposits), heavy oil, oil shales and synthetic oil, obtained via coal and gas.

According to these figures, total oil reserves might meet the world's demand for more than a century. During this period, non-conventional oil would become more important, to the detriment of conventional. Production of the latter would steadily fall, once peak oil had been reached.(3) Nevertheless, as can be seen in the above graph, the cost of obtaining oil differs greatly depending on the technique used. In fact, a substantial difference can be seen between the marginal cost of extracting conventional and non-conventional oil, which can be three times as much in some cases. Undoubtedly, once conventional reserves have been exploited, the higher production costs will be passed on entirely to the end product. This gives us a long-term outlook where the price of oil is very likely to go on rising.

In conclusion, demand forecasts point to conventional oil running out during this century. Although it's true that new non-conventional extraction techniques could increase the supply of this mineral, this would happen at a cost that, today, is still very high. Consequently, and paraphrasing the words of Sheikh Yamani, perhaps the Oil Age will come to an end due to a lack of... cheap oil.

(3) Peak oil is the time when the maximum level of oil extraction is reached.

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EUROPEAN UNION

Uncertainty takes hold of the euro area

The uncertain Greek situation continues to weigh heavily on the economic climate.

In Greek mythology, Sisyphus was the founder and king of Corinth. Because of his impiety, the gods punished him in hell by making him push a huge boulder up a steep hill but, before he could reach the top, the boulder always rolled back down and Sisyphus would have to start all over again. And the Greek situation is starting to resemble this myth, as there seems to be no way to break the loop of uncertainty that has taken hold of the euro area.

Given the situation of the sovereign debt crisis in Europe, economic managers have expressed all kinds of opinions and suggestions.

Greece is willing the make all the effort necessary but is still facing big challenges.

The second financial bailout plan seemed to be enough to resolve Greece's problems but doubt surfaced regarding the country's capacity to achieve the new targets. Given this problem, the Greek finance minister, Evangelos Venizelos, decided to approve supplementary taxes to fill the fiscal gap.

On 19 September, via a joint conference, Venizelos and the permanent representative for Greece of the International Monetary Fund (IMF), Bob Traa, stated the seriousness of the situation and the importance of speeding up the restructuring of the Greek economy.

Finally, at the end of September, the troika made up of the International Monetary Fund, the European Central Bank and the euro area, decided to send a review mission to Greece to report on the country's situation at first-hand. This is a necessary condition before taking the decision whether to release the 8 billion euros of the sixth tranche of the international loan approved in May 2010.

Slowdown in economic activity for the euro area as a whole.

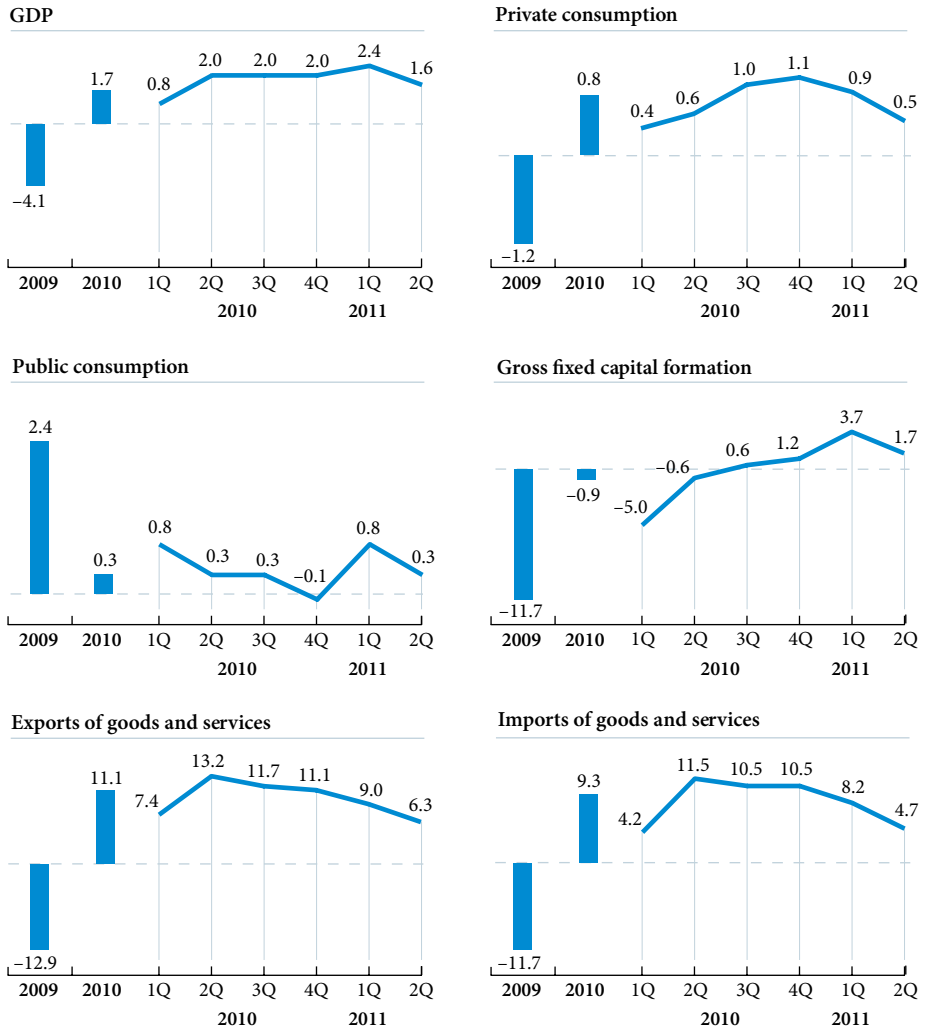
On the other hand, the economic environment is not helping the country, with all the economic regions in the world experiencing a downturn at the same time. And the euro area is no exception. In fact, the breakdown of data on gross domestic product (GDP) is now available for the second quarter and this slowdown can be observed in all subcomponents, without exception.

Household consumption and business investment have been hit by uncertainty regarding the outcome of the sovereign debt crisis. This has pushed up financing costs and has even led to a credit squeeze in some segments, resulting in investment and household consumption being postponed.

On the other hand, the fiscal restriction policies implemented in numerous countries in the euro area have resulted in growth of just 0.3% year-on-year in public expenditure. Lastly, the slowdown in the rest of the world has affected Europe's trade with a substantial drop in export growth. In short, the euro area's economy is growing by 1.8% year-on-year, very close to our growth forecast for this year of 1.7%.

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCES: Eurostat and own calculations.

It's difficult to predict an acceleration in growth during the third quarter when flash macroeconomic indicators point to moderate growth. Consumer and business confidence certainly deteriorated during the months of July and August and it's evident that those surveyed must have been affected by the high uncertainty caused by the sovereign debt crisis. This has led to great volatility in the financial markets, resulting in very pessimistic newspaper headlines.

However, not all economic indicators have been negative. For example, July's industrial production in the euro area rose by 1% compared with the previous month's figure, according to data published by Eurostat. Between June and July this year the production of capital goods grew by 3.0%, while consumer durables were up 2.9%. In year-on-year terms, industrial production saw growth of 4.2%; although it's true that these figures hide extensive geographical

Macroeconomic indicators point to moderate growth for the next two quarters.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
GDP	–4.2	1.7	2.0	2.0	2.4	1.6	–	...
Retail sales	–2.5	0.8	1.4	0.6	0.1	–0.6	–0.2	...
Consumer confidence (1)	–24.8	–14.0	–12.1	–10.4	–10.6	–10.4	–11.2	–16.5
Industrial production	–14.7	7.5	7.1	8.1	6.5	4.0	4.2	...
Economic sentiment indicator (1)	80.7	100.9	102.3	105.7	107.4	105.7	103.0	98.3
Unemployment rate (2)	9.5	10.1	10.1	10.1	10.0	10.0	10.0	...
Consumer prices	0.3	1.6	1.7	2.0	2.5	2.8	2.5	2.5
Trade balance (3)	10.7	4.6	8.2	4.6	–9.9	–16.1	–18.2	...
3-month Euribor interest rate	1.2	0.8	0.9	1.0	1.1	1.4	1.6	1.6
Nominal effective euro exchange rate (4)	111.7	104.7	102.3	104.4	103.7	106.4	105.2	104.9

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.

But some economic data are positive: industrial production and job creation.

heterogeneity. While Germany is enjoying 10.4% year-on-year growth in its industrial production, countries such as Greece and Ireland are seeing falls of 2.9% and 4.9%, respectively.

Paradoxically, there are two factors generated by the current crisis that should help Europe's economic activity over the coming quarters. Firstly, the depreciation of the euro reflected in the fall of the currency's nominal effective exchange rate. Secondly, the drop, albeit very moderate, in oil prices is also a factor positive. For example, since April this year, when a barrel of Brent quality oil peaked at 127 dollars, the price of crude has fallen by around 11%.

In the coming quarters, the Greek problem will not disappear, so further intense outbreaks of volatility cannot be ruled out.

These two elements are positive because they boost European exports and reduce energy costs. In both cases, the trade balance and industrial production aimed at exports will benefit, as well as job creation indirectly. Although the unemployment rate remains stuck at around 10%, job creation in the euro area in the second quarter was 0.3% year-on-year, according to Eurostat. This figure is up on the jobs created in the previous two quarters, which was just 0.1%, indicating a profile that is adjusting with the economic activity data available to date.

The Greek situation will continue to monopolize the headlines in the coming quarters. Hence the comparison with the myth of Sisyphus, which the poet Homer reminds us of in Book XI of the Odyssey. Fortunately, the hero Ulysses gets back home, albeit after numerous ups and downs, a positive ending we hope will be the same for the Greek situation. Although the return journey is bound to provide further chapters for the country, which is facing a huge challenge, namely substantially restructuring its economy, as it has been reminded by the IMF.

THE DOWNTURN IN THE EURO AREA IS AFFECTING THE EURO

Euro-dollar exchange rate

SOURCE: Bloomberg.

The German economy overcomes its dip in the second quarter

After the sharp downturn in the second quarter, when it posted a meagre 0.1% quarter-on-quarter growth, it seems as if the engine of Europe has livened up over the summer, with the boost mostly coming from domestic demand. However, the German economy can't completely escape the slowdown in the world economy and the turbulence in financial markets, and this has been reflected in the latest indicators for the economic climate, posting a notable deterioration. The International Monetary Fund recently revised its forecast for German GDP in 2011 by half a point in comparison to June, down to 2.7%, and lowered its forecast for 2012 by 7 tenths of a percentage point to 1.3%.

Regarding demand, consumption seems to have livened up to some extent. In August, automobile sales rose by 18.3% compared with the same month the year before and the favourable trend in the job market supports consumption's contribution to growth. In July, the number of employed rose by 1.4% compared with the same month last year and the seasonally adjusted number of unemployed continued to fall, albeit at a slower rate. Moreover, in August the BA-X indicator for job demand picked up.

However, consumer confidence continued to weaken in August, although standing at a relatively high level. Inflation remained above 2% for the seventh consecutive month, mainly due to the rising price of energy, and made consumers cautious.

Investment, however, continues to progress. In July, the industrial production of capital equipment was up 7.5% compared with the previous month. However, the sharp fall in the IFO

The deterioration in the global climate has led to growth forecasts for the German economy being revised downwards, especially for 2012.

The favourable trend in the job market supports consumption.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
GDP	–5.1	3.6	4.0	3.8	4.6	2.8	–	...
Retail sales	–3.2	1.4	2.4	1.0	0.7	2.4	1.3	...
Industrial production	–15.4	10.1	10.2	11.7	12.8	7.7	10.3	...
Industrial activity index (IFO) (*)	90.7	107.8	111.2	113.3	114.7	114.2	112.8	108.7
Unemployment rate (**)	7.7	7.0	6.9	6.6	6.4	6.2	6.1	...
Consumer prices	0.4	1.1	1.2	1.5	2.1	2.3	2.4	2.4
Trade balance (***)	138.7	154.5	155.9	154.5	157.5	...	...	...

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

The trade surplus shrinks in July.

indicator for the business climate points to a moderation in investment, although this is above its historical average.

With regard to the foreign sector, in July the current account surplus posted a 28% year-on-year drop to 7.5 billion euros. This was particularly due to the trade surplus shrinking. In any case, foreign demand is expected to make a positive contribution to GDP growth but there is the risk of world expansion moderating.

From the point of view of supply, the pleasant surprise was provided by industrial production in July. In fact, manufacturing production rose by 4.5% on June, adjusted for seasonal factors and calendar effects, reaching a peak and, for the first time, exceeding the level prior to the crisis. In the period of June-July, it posted a year-on-year rise of 10.0%. However, new industrial orders dropped off in July and, although the trend is still upward, this eased in pace, so that industrial production is likely to moderate in the coming period.

Industrial production provides a pleasant surprise in July but the outlook is one of moderation.

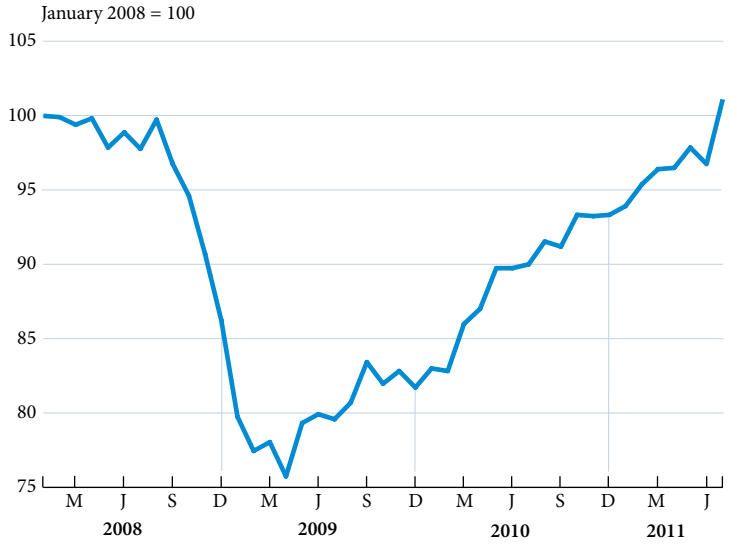
In August, unlike industry and services, confidence in construction improved and stood at a notably high level. In fact, in July the production of construction rose by 3.2% compared with the previous month. With regard to services, in the same month hotel stays were up 1% compared with the previous twelve months, particularly due to foreign demand.

The good performance of the German economy is reflected in its public accounts. In the first half of the year, the government deficit fell to 0.6% of GDP compared with the 3.1% recorded in the same period of 2010. This trend was due to a year-on-year increase in revenue of 6.0% and only 0.3% in expenditure, of which investment costs rose by 8.1%.

On the whole, the German economy has got its strength back. Its underlying fundamentals are solid and the expansion seems confirmed. However, growth will tend to slow up after the upswing in the third quarter.

INDUSTRIAL PRODUCTION EXCEEDS ITS PRE-CRISIS LEVEL IN JULY

Manufacturing production adjusted for seasonal and calendar effects



SOURCES: Statistisches Bundesamt Deutschland and own calculations.

Little dynamism in the French economy in the third quarter

After the stagnation of France's gross domestic product in the second quarter, indicators available for the third quarter point to meagre growth in this period. This trend is the result, on the one hand, of the weakness in domestic demand and, on the other, of the deterioration in exports, affected by the downturn in the world economy after the rise in commodity prices and in particular due to the sovereign debt crisis in the peripheral countries of the euro area.

French consumption looks sluggish. Consumer confidence has fallen in the last few months, affected by the upswing in inflation and the uncertain outlook in the labour market. Although salaried employment in market sectors rose by 1.1% in the second quarter in comparison with the same period of 2010, this still suggests a slowdown. In fact, the seasonally adjusted unemployment rate has risen slightly in the last few months to 9.9%, according to Eurostat's homogenized data. Nonetheless, new car sales were 2.0% up month-on-month in August, with a year-on-year rise of 3.3%.

With regard to investment, the industrial production of capital equipment in the period May-July rose by 1.6%, seasonally adjusted, compared with the previous three months, above the figure for industry as a whole. However, the degree of production capacity utilization continued to fall off in August, below the historical average. Within this context, in the July business survey for manufacturers, they slightly revised downwards their forecast for nominal growth in investment in 2011 to 14%, albeit predicting a rise in investment in the second half of the year compared with the first.

With regard to the foreign sector, which is suffering from some competitiveness problems, in the three months up to July goods exports dropped by 0.3% compared

French consumer confidence falls within a context of slightly rising unemployment.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
GDP	–2.6	1.4	1.6	1.4	2.1	1.6	–	...
Domestic consumption	–0.4	1.7	2.6	1.0	3.5	1.2	...	...
Industrial production	–12.4	5.1	4.2	4.6	4.8	2.2	3.7	...
Unemployment rate (*)	9.5	9.8	9.8	9.7	9.7	9.7	9.9	...
Consumer prices	0.1	1.5	1.5	1.7	1.8	2.1	1.9	2.2
Trade balance (**)	–44.8	–51.7	–51.4	–51.7	–59.3	–64.5	–67.2	...

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

French entrepreneurs revise investment forecasts down slightly.

with the previous quarter, although they were 6.6% higher than the same period a year earlier. Sales to the rest of the European Union moderated while the rest showed greater dynamism. On the other hand, after their decline in June, imports picked up again and posted a rise of 10.8% in the period May-July compared to twelve months before. Purchases accelerated from the rest of the European Union, particularly Germany. Consequently, in July the trade deficit widened to 6.46 billion euros, coming close to May's level.

From the point of view of supply, July's industrial production figures provided a pleasant surprise after the drop in June, up by 1.5% month-on-month and by 3.7% year-on-year. However, the outlook points to production stabilizing in the short term, although the level of industrial orders was above the norm. With regard to services, August's overall survey showed a moderation in activity but this was expected to improve in the short term.

The French government confirms the targets for public deficit cuts in spite of growth forecasts being revised downwards.

On the other hand, credit to firms continued to flow to some extent. In July, the credit balance to non-financial companies posted a year-on-year rise of 5.0%, although manufacturers saw a fall of 1.1%. On the other hand, credit to SMEs saw slightly higher growth, namely 5.7% compared with July 2010.

On the whole, indicators point to a modest rise in gross domestic product in the third quarter after the stabilization of the second. Given this context, and as a consequence of the contagion from the peripheral debt crisis, on 22 September 2011 the French government's risk premia for its debt hit a new record since the launch of the euro, at 89 basis points compared with German ten-year bonds. The government's difficulties in securing enough parliamentary support to introduce, in the Constitution, a mandate to limit public deficits did not help to improve the confidence of the financial market.

However, the government confirmed its public deficit targets for 2011 at 5.7% of GDP and 4.5% for 2012. To this end, and given that it slightly revised downwards its economic growth forecast to 1.75% for both years, during the parliamentary proceedings it altered the adjustment measures announced in August.
In addition to several cuts in spending, the plan is to bring in a new tax on overnight stays of more than 200 euros in luxury hotels.

The Italian government speeds up approval of its adjustment plan

In the second week of September, the publication of details of Italy's National Accounts system for the second quarter confirmed quarter-on-quarter growth of 0.3%. This rate represents a slight acceleration and was mainly due to the push from exports, contributing 9 tenths of a percentage point, while changes in stock deducted 8 tenths of a percentage point.

Consumption has looked weak in the first months of the third quarter. In July, the industrial production of consumer goods fell by 7.1% compared with the same month the year before. However, automobile sales improved in August, recording a year-on-year rise of 1.5%. Consumer confidence fell for the third consecutive month in August, affected by the lacklustre job market, whose unemployment rate refuses to drop below 8%, and by the upswing in inflation, which rose to 2.8% year-on-year the same month. Although the trend was expected to be downwards, the recently approved hike in value added tax will push up inflation to some extent in the short term.

Investment continues to make progress. In July, the industrial production of capital equipment advanced by 1.8% compared with June, seasonally adjusted, and by 4.8% compared with one year earlier. However, given the downturn in the economic climate overall, investment is likely to slow down to some extent.

With regard to the foreign sector, in July exports rose by 1.0% month-on-month, while imports rose by 1.6%, seasonally adjusted. On the other hand, the hotel sector performed well in August, thanks particularly to foreign tourism.

The view is also mixed from the point of view of supply. Industrial production fell by 0.7% in July compared with the previous month and by 1.6% in year-on-year terms, adjusted for calendar effects. However, confidence in the secondary sector picked up slightly in August thanks to the improved outlook for new orders. For its part, construction prospects improved slightly in July. Similarly, confidence in the tertiary sector increased in August thanks to services to firms, although retail was down.

Within this scenario of little dynamism, the concern of financial markets for

The Italian economy is saved by foreign demand in the second quarter.

The hotel sector performs well in August.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
GDP	–5.2	1.2	1.4	1.5	1.0	0.8	–	...
Retail sales	–1.7	0.0	0.6	0.1	–0.3	–0.3	–1.2	...
Industrial production	–18.7	6.5	7.6	5.2	2.2	1.8	–1.3	...
Unemployment rate (*)	7.8	8.4	8.3	8.3	8.1	8.0	–	8.0
Consumer prices	0.8	1.5	1.6	1.7	2.3	2.6	2.7	2.8
Trade balance (**)	–5.9	–29.3	–22.5	–29.3	–34.9	–36.0	–36.2	...

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

Standard & Poor's downgrades Italy's sovereign debt rating by one notch to A.

Italy's high level of public debt, accentuated by contagion from the Greek crisis, pushed up the risk premium again. On 22 September, the spread in yields of Italian ten-year government bonds compared with the same German bonds set a new record since the European single currency started, reaching 402 basis points, higher than the level for Spanish debt.

Pressure from the financial markets led the government to toughen up some aspects and speed up approval of the summer's second adjustment plan. Among other measures, during the parliamentary proceedings to convert August's Decree Law into an Act, it also introduced a rise in the general value added tax rate to 21%. Moreover, a new solidarity tax was created up to 2013 for taxpayers with incomes above 300,000 euros and the retirement age for women in the private sector was raised as from 2014. The government, which faced a general strike in the second week of September, also made the labour market more flexible.

In spite of the size of this new package, which involves a net reduction in debt of 0.7 billion euros in 2011, 22.7 billion in 2012, 29.9 billion in 2013 and 11.8 billion in 2014 in order to achieve a balanced budget by 2013, it might not be enough if risk premium levels persist remain high, due to the interest payments required on its large public debt.

On the other hand, within the context of an economic downturn, partly due to the effect of budget consolidation, it is vital to regain competitiveness, so that further structural measures might be required. In this situation, on 20 September the rating agency Standard & Poor's downgraded Italy's long-term sovereign debt rating by one notch to A, with a negative outlook, while the Italian government is preparing a plan to stimulate growth via incentives for the private sector to build infrastructures, liberalizing services and increasing privatization.

The United Kingdom: negative economic figures are pushing down growth forecasts.

The United Kingdom: growth forecasts are revised downwards

The storm is still rocking the boat of the United Kingdom in its journey towards a safe haven. The latest economic data have even led us to revise our growth forecast for gross domestic product (GDP) downwards for this year. Whereas our forecast was 1.6%, we have reduced this by five tenths of a percentage point to 1.1% for the whole of the year. However, we have maintained our 4.3% forecast for inflation. In short, a situation of less growth and high inflation, not a very encouraging panorama.

The economic figures are clear. On the one hand, we have the data on retail and consumer goods for August, with year-on-year growth close to 0%. By component, it's interesting to note that food retail sales fell by 0.8% year-on-year while shop spending, excluding food, was down 1.3% year-on-year. These figures reveal the fragility of the household consumption trend; a weak pulse that will probably continue throughout the rest of the year. Households are trying to reduce their consumption given the drop in disposable income, hit by the fall in real wages, higher taxes and limited access to credit.

Certainly, disposable income has been hit hard by stubborn inflation that remains

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
GDP	–4.9	1.4	2.5	1.5	1.6	0.7	–	...
Retail sales	1.0	0.4	0.6	–0.1	2.2	0.9	0.2	0.1
Industrial production	–10.1	2.2	3.1	3.3	1.9	–0.8	–0.7	...
Unemployment rate (1)	4.7	4.7	4.6	4.5	4.5	4.7	4.9	4.9
Consumer prices	2.1	3.3	3.1	3.4	4.2	4.4	4.5	4.5
Trade balance (2)	–82.4	–96.4	–91.1	–96.4	–98.4	–98.6	–100.2	...
3-month Libor interest rate (3)	1.2	0.7	0.7	0.7	0.8	0.8	0.8	0.9
Nominal effective pound exchange rate (4)	73.9	80.4	81.5	79.3	79.2	78.6	77.1	78.6

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

at 4.5% year-on-year and might even rise above 5% in the next few months due to higher energy prices which will influence, with a slightly delayed effect, households' energy bills in the coming months. July's industrial production also fell by 0.7% year-on-year. The upturn seen last year, after the recession, is fading while firms are adjusting to more modest domestic demand and a decline in exports. This moderation in activity is leading to a slight deterioration in the job market, with the unemployment rate rising to 4.9% over the summer.

Even the International Monetary Fund has commented that, depending on the pattern of growth, the authorities could postpone or relax the fiscal restrictions planned in order to avoid the risk of making the economic situation worse. In fact, this economic outlook has led economists to expect that the next move by the Bank of England might be expansionary in its quantitative easing programme; although certain scepticism still remains regarding the ability of this policy to kick-start the economy. However, due to the high level of inflation, expectations are that the reserve bank might wait until the beginning of next year to start this unorthodox expansionary monetary policy.

Inflation remains high.

In summary, it seems that the economy of the United Kingdom will not be able to consolidate its exit from the recession, started at the end of 2008 and from which it emerged in the second quarter of last year. However, it will have another chance to do so next year, when inflation will fall considerably and fiscal restrictions will ease a little. In other words, the United Kingdom will be sailing under more favourable conditions next year. The important thing is to avoid any obstacles for what remains of this one.

The Bank of England might intensify its expansionary monetary policy.

Change in direction in emerging Europe

Emerging Europe is embarking on a more prolonged and sharper slowdown than expected...

In the last few months, what in principle seemed to be a temporary slowdown in activity in emerging Europe has become a more significant development. At the beginning of this year, in the five economies we usually analyse in this report, namely Poland, the Czech Republic, Hungary, Slovakia and Romania, the indicator of economic sentiment, which summarizes the cyclical point of economic activity, was at its highest since the crisis of 2008-2009. From this point on, the indicator started to enter a more volatile phase, embarking on a noticeably downward trend from the second quarter of the year and even more clearly in July and August.

...which, added to the downturn in the euro area, means that its growth forecasts for 2011 and 2012 must be revised downwards.

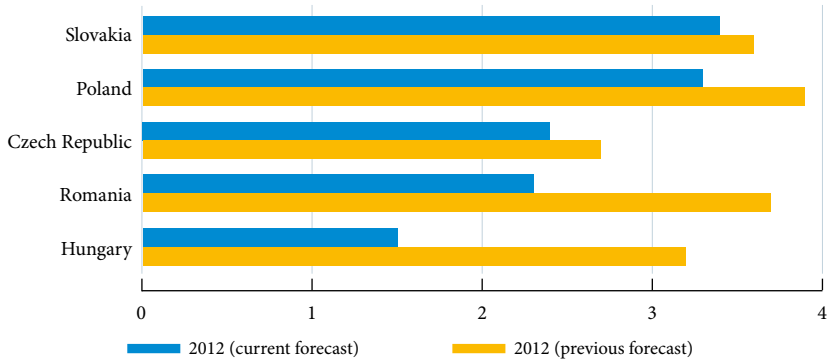
Economic growth figures for the second quarter, recently published, have confirmed the diagnosis suggested by the economic sentiment indicator: emerging Europe is completely immersed in a phase of slowing activity. Given this situation, the immediate question is whether this trend looks like continuing. With the information currently available, the answer is in the affirmative.

Firstly, the indicator's rate of decrease suggests that the decline in the economy is gaining in intensity, so that this process is unlikely to end suddenly. Moreover, if we consider that the main reason underlying the loss in economic dynamism is the economic downturn in the euro area, the main destination for the region's exports, then we must also rule out any fast improvement in this area, as current forecasts point to growth in the euro area over the next few quarters being less than had been expected before the summer. All this points to the need to revise downwards the economic growth forecasts we were applying for emerging Europe.

Necessarily involved in this downward revision are national factors that, in themselves, lie behind the current cyclical situation of the five economies in question. Given its economic weight and recent good performance, it is appropriate to begin our analysis with Poland. Unlike its neighbours, Poland is still benefitting from a more dynamic domestic demand, a trait that gives it more leeway to withstand weakening exports. This explains, for example, why its

EMERGING EUROPE WILL GROW LESS THAN EXPECTED

Real growth forecast, as a percentage



SOURCES: National statistics offices, Eurostat and own calculations.

economic growth remained unchanged in the second quarter. We believe this inertia will continue for some time and that it won't be until 2012 that the slowdown in activity will make its presence fully felt. A certain adjustment in fiscal policy will also contribute to this lower growth, very necessary after years of relaxation in this area. In short, we expect Poland to grow by 4.0% in 2011 and afterwards by 3.3% in 2012.

The Czech Republic and Slovakia, however, are already suffering from a decline in their exports. For both countries we have notably revised downwards our growth forecasts for 2011 and 2012. In the case of the Czech economy, we now expect GDP to remain stuck at a growth rate of just above 2% annually for both years, while in the case of Slovakia this will fluctuate around 3.5% (above, in 2011; below, in 2012). As a reference, it should be noted that, before the summer, we expected the Czech Republic to grow in the region of 3% and Slovakia by 4%.

Nonetheless, the least advantageous economic situation will be the one suffered by Hungary and Romania. These two countries have stumbled upon unfavourable international financial developments just as it seemed that the worst of the fiscal adjustment from years before lay behind them. In the case of Romania, Greece's financial tensions have had a notable effect, as suggested by the rise in country-risk indicators. This is a logical precaution taken by investors as the country's financial links are appreciable (especially through the significant banking presence of Greek banks).

In the case of Hungary, the punishment being doled out by investors is down to a different reason, namely the loss of credibility suffered by the country's fiscal policy over the last year and a half. This erosion has come from the combination of a communication policy that has sometimes surprised investors, economic policy decisions that are not very propitious for long-term growth (the most recent, a measure that would allow bank credit granted in foreign currencies to be paid off in advance at an exchange rate that would notably penalize financial institutions) and its difficulties in accomplishing the budget control plans announced (more due to negative economic developments than public apathy, it must be said).

Within this context of certain financial punishment and an economic scenario that is increasingly less propitious, the response of both countries must include reinforcing fiscal orthodoxy by means of restrictive fiscal policy for 2012. This measure is necessary but will hinder the growth expected. Should our scenario come about, Hungary would grow slightly above 1% in 2011, picking up marginally in 2012, while Romania would go from growth scarcely above 1% in 2011 to somewhat above 2% in 2012. In conclusion, emerging Europe seems to have embarked upon a phase of slower growth for the next few quarters. Nonetheless, and to end on a less circumspect note, we should be consoled by the fact that inflation, which had clearly become threatening in the first half of 2011, is now moving away from alarming levels. At least, although the slowdown might strangle the economy, inflation shouldn't suffocate it.

This revision is little in the case of Poland, protected by a resistant domestic demand.

In the Czech Republic and Slovakia, the brake on exports has worsened their prospects.

Hungary and Romania are forced to carry out further fiscal adjustment measures, a situation that will hinder their growth in 2012.

FINANCIAL MARKETS

Monetary and capital markets

Hard times

The slowdown in world economic growth affects the financial environment.

For months now, the current financial panorama has been dominated by a series of risk factors that are causing, in addition to the now familiar movement of capital flows towards high quality assets, a gradual deterioration in conditions to access financing for numerous agents. Among the most significant risks are the lower economic growth prospects at a global level, the temporary delay and geographical spread of the sovereign debt crisis in the euro area, as well as the different actions taken by the monetary authorities of emerging countries to allay the danger of their economies overheating and a subsequent brusque landing.

Monetary policy strategies differ depending on the country.

Certainly, the effects of these factors, with the different approaches and economic policies used to tackle them, will continue to determine the performance of financial markets in the short term. With sufficient perspective and, as the present setbacks dissipate, the conditions for financial conditions should improve, supported by the expansionary economic growth cycle and restored investor confidence.

Central banks react to the economic slowdown

The Fed adopts more measures to boost economic growth.

For the last few months, the world economy has been showing clear signs of moderating its rate of growth. March's adverse shocks gave way to a new stage in the global economic cycle, characterised by a moderation in activity, a situation that was initially meant be temporary and limited in nature. This process is at different stages of maturity depending on the geographical area, as is also the case with inflation rates, closely linked to rising commodity prices at the end of 2010. That's why the different central banks are using different monetary strategies based on the objectives they have defined and the conditions perceived in their areas. However, in the last few months the common denominator is a growing sensitivity of central banks to the risk of the slowdown being more intense than desired and ending up in recession, especially given the doubts regarding the situation of the balance sheet (indebtedness) of various countries and financial institutions.

In the United States, the Federal Reserve (Fed), after its Monetary Policy Committee meeting on 21 September, presented the conclusions of its analysis of the current state of the economy and the new guidelines for monetary policy it had agreed. Fed chairman, Ben Bernanke, once again referred to the weak phase the economy is currently going through, highlighting the small number of advances observed in the last few months in the main indicators for activity and private demand. He also confirmed that, given this scenario, the Fed believed that prospects for job creation were modest, predicting that the unemployment rate would remain

at a relatively high level for the next few months. Based on these circumstances, and as already suggested in August, the Fed decided to keep interest rates within the lowest possible range (0%-0.25%).

In addition, the Federal Reserve also introduced a new instrument in its monetary policy strategy, the so-called «operation twist». Specifically, the central bank has undertaken to buy up Treasury bonds with long-term maturities (between 6 and 30 years) for the sum of 400 billion dollars up to June 2012 and to sell government debt at 3 years or less. With this instrument, previously used by the Fed in the 1960s, the institution aims to reduce long-term interest rates and to make financing conditions more flexible for households and firms. The Fed also confirmed that it would continue to reinvest the interest and principal of the public debt and mortgage loans it currently holds in its portfolio. These measures highlight that the institution's proposal is to provide monetary conditions that are as lax as possible, postponing *sine die* any debate about its «exit strategy».

The Fed will restructure its Treasury bond portfolio in order to keep long-term interest rates low.

In the euro area, the European Central Bank (ECB) opted to keep the official interest rate at 1.5% after its meeting in September. As in his previous appearances, the central bank's president, Jean-Claude Trichet, referred to the adaptable nature of monetary policy, as well as confirming the start of a slowdown in the region's growth for the second quarter. In the words of Trichet, the current risks involved in Europe's situation (resulting from the peripheral sovereign debt crisis and the fiscal adjustments implemented in most member countries) are pushing growth down in the euro area, so the ECB has revised downwards its growth estimates for the area for 2011 to the range of 1.4% to 1.8%. With regard to consumer price stability, the main aim of monetary policy, the president admitted that the risk of further rises in inflation has eased in the medium-term, although he predicted that the general rate will remain above 2% for the next few months. This kind of statement suggests that the ECB will halt its series of official interest rate hikes which started in April. In fact, the monetary market expects that, before the end of the year, the ECB will have cut rates by half a point. This is certainly an aggressive prediction but it cannot be completely ruled out if the economic slowdown continues and market tensions become even worse.

The ECB revises downwards its growth estimates for the euro area.

In this respect, and in the area of the unorthodox monetary measures, the ECB decided to keep the existing mechanisms (unlimited liquidity facilities at 1 and 3 months, plus a special facility at 6 months) in response to the funding difficulties being faced by many of the region's banks as a consequence of the sovereign credit crisis. In addition, during September, and pressurized by the scarcity of funding in dollars, the ECB announced, in a joint action with the Federal Reserve, Bank of England, Bank of Switzerland and the Bank of Japan, that it would provide liquidity (also a limited amount) in dollars at three months for those European banks that require it. With regard to the ECB's work in resolving the crisis, the central bank's commitment is still total. In addition to playing an active role in the Troika negotiations (together with the European Commission and the International Monetary Fund) in aspects such as the bail-out packages for economies in difficulty and the enlargement of the European Financial Stability Fund's powers, the monetary authority

The ECB increases its purchases of sovereign debt from the peripheral countries of the euro area.

The emerging countries halt their monetary tightening.

has also continued with its programme to purchase the sovereign bonds of peripheral countries. Although the initial aim of this programme was to make selective purchases to sort out temporary dysfunctions in the debt markets, since August these purchases have become unexpectedly regular and large. This is due to the higher risk of the crisis spreading to economies such as Spain and Italy. Disagreement regarding this action in the debt markets was precisely the cause of the resignation of the ECB's head economist, Jürgen Stark.

Brazil cuts its official interest rates.

For their part, the general profile of the monetary policies adopted by the emerging countries continues to be restrictive. Over the last few months, the phase of the economic cycle in which these countries find themselves, more advanced than the one for developed economies, has required a more determined and faster normalization of interest rates and, in many cases, the use of alternative instruments to contain the rise in consumer prices, the increase in credit and the formation of price bubbles in some assets. However, since the

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									
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	1.00	1.24	2.00	0.25	0.30	0.20	0.50	0.82	0.28
April	1.25	1.35	2.12	0.25	0.27	0.20	0.50	0.82	0.24
May	1.25	1.43	2.14	0.25	0.25	0.20	0.50	0.83	0.26
June	1.25	1.55	2.16	0.25	0.25	0.20	0.50	0.83	0.28
July	1.50	1.61	2.18	0.25	0.26	0.20	0.50	0.83	0.24
August	1.50	1.54	2.09	0.25	0.33	0.19	0.50	0.89	0.10
September (1)	1.50	1.55	2.08	0.25	0.37	0.19	0.50	0.95	0.59

NOTES: (1) September 30.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 4-12-08 (2.50%), 5-03-09 (1.50%), 2-04-09 (1.25%), 7-05-09 (1.00%), 7-04-11 (1.25%), 4-08-11 (1.50%).
(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.

spring, signs have started to emerge of moderation in the growth of activity and credit in most emerging economies which might be the first steps towards their «soft landing». This indicates that the cycle of monetary tightening should be coming to an end, giving way to a phase of stability or even the application of some relaxation measures. This is the case of Brazil, whose central bank decided to lower interest rates (50 basis points to 12%) with the first references to slowdown in economic growth and although its rate of inflation is still very high.

Within this context of unequal monetary strategies between the United States and the euro area, interbank interest rates have reflected the expectations of investors regarding the actions of the respective central banks, as well as the outcome of the European sovereign debt crisis. In the United States, the Libor interest rate in dollars rose slightly, continuing the trend started in July. Both the three-month and one-year rates reached their maximum level since the start of the year, the highest level in the last twelve months. The main reasons behind this gradual rise in interest rates are, on the one hand, the worsening sovereign debt crisis in Europe (especially the delicate financial situation of Greece) and, on the other hand, the difficulties faced by European banks to secure funding in dollars (up to mid-September, when the ECB communicated its proposal to offer unlimited financing in dollars).

Interbank interest rates in the euro area (Euribor) are going through a relatively stable phase. After having reached its highest level since February 2009 (2.20%), in August the twelve-month Euribor started a slight downturn, which continued with slight falls in September.

This circumstance has largely been motivated by lower world growth expectations, which investors believe will also end up affecting the euro area, in turn suffering the shock of the debt crisis, and might lead to a change in the ECB's monetary policy strategy. The difficulties being faced by European banks to secure funding in the wholesale markets, either the interbank or the bond markets, have pushed up demand for ECB loans. In fact, the amount requested has been greater than immediate needs, thereby leading to surplus liquidity that has resulted in a rise in the ECB's own deposit facility balance. This factor is pushing down very short-term interbank rates, such as the EONIA.

The dollar interbank market deteriorates slightly given the tensions in the euro area.

The slowdown in growth is pushing down yields on high quality public debt

European banks resort more to the ECB for funding.

Continuing the process started last spring, yields on the public debt of leading economies, specifically the United States and Germany, have continued to accumulate drops during September. In fact, the most relevant note for the debt markets on both sides of the Atlantic is the fall in yields to record lows. In the case of United States, the yield on two-year bonds fell to 0.15%, compared with 0.85% in April. For its part, the yield on ten-year bonds fell for the first time below 2%. There are principally two aspects responsible for the increasingly widespread falls in yields. The first is the persistent weakness observed in economic indicators at a global level. The second is the action taken by the Federal Reserve as a buyer in the bond market. To these two factors we should also add the effect of growing investor concern in the US debt market regarding developments in the euro area's sovereign debt crisis.

Yields on debt from the United States and Germany fall to record lows.

The Fed's actions in the debt market are pushing down long-term yields.

This is causing a «flight to quality» that is benefitting assets issued by the US Treasury, in spite of the low yields. For the most immediate future, the key factor will be the effective implementation of the Federal Reserve's decision to act as a participant in the debt markets, buying titles with long-term maturities and selling them short, which should continue to push down the interest rate curve.

In the case of the euro area, the yield for German sovereign debt has behaved similarly to US debt. The yields on two and ten-year bonds continued to accumulate drops, falling to 0.48% and 1.81%, respectively. As has been happening for a few months now, the worsening sovereign debt crisis in the periphery of the euro area looks like the main reason why investors have continued to show their preference for this kind of asset over those with a riskier profile.

Fear of a possible Greek default is hitting Greek debt hard.

For its part, the risk premia of peripheral countries have performed erratically throughout the month. The main symptom of this behaviour could be seen in the dramatic rise in yield of Greece's short-term bonds (going above 70%) given the increase in rumours of a possible «controlled default» of the Greek economy. On the other hand, the spreads in yields for Italian and Spanish debt compared with Germany were more stable (within the exceptional parameters of the current crisis), partly thanks to the ECB buying up the debt of these countries, although the persistent lack of investor confidence in the structural reforms adopted by both economies continues to stop spreads from getting back to normal.

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								
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	3.35	3.71	5.30	4.82	3.47	1.26	3.69	1.96
April	3.31	3.64	5.47	4.74	3.41	1.24	3.58	2.06
May	3.02	3.39	5.36	4.78	3.06	1.17	3.29	1.82
June	3.03	3.41	5.45	4.88	3.16	1.14	3.38	1.73
July	2.54	3.23	6.08	5.87	2.80	1.08	2.86	1.36
August	2.15	2.83	5.04	5.13	2.18	1.02	2.50	1.08
September (*)	1.93	2.62	5.08	5.53	1.96	1.03	2.48	0.98

NOTE: (*) September 30.
SOURCE: Bloomberg.

The Swiss franc pegs its exchange rate to the euro

Within this scenario, the exchange rate of the dollar against the euro has been subjected to a high degree of volatility. The underlying trend has been a weak euro or a strong dollar (which has appreciated in general against a number of international currencies). In fact, the European currency has fallen below the barrier of 1.40 dollars for the first time in six months, quickly reaching 1.35. As has been happening for some months now, the euro-dollar exchange rate has been subjected to various forces, all simultaneously working against the former: the slowdown in global economic growth prospects, which in the last few weeks has led to more nasty surprises in the euro area; the expected reduction in the ECB official interest rate; the ups and downs of the sovereign debt crisis in the euro area and the risk of this spreading to the rest of the economies in the region and their financial institutions. In this respect, one decisive event for the relationship between both currencies was the ECB offering unlimited financing in dollars to European banks as from October.

Expectations of lower economic growth in the euro area weigh heavily on the exchange rate compared with the dollar.

Another relevant fact for the foreign exchange markets was the pegging of the Swiss franc exchange rate to the trend in the euro's price. In an effort to slow up the appreciation of its currency and to protect the interests of its exports, the National Bank of Switzerland announced that it will intervene as much as required to avoid depreciation beyond 1.20.

The National Bank of Switzerland caps the exchange rate between the euro and the Swiss franc.

EXCHANGE RATES OF MAIN CURRENCIES

September 30, 2011

	Exchange rate	% change (*)		
		Monthly	Over December 2010	Annual
Against US dollar				
Japanese yen	76.9	0.2	–5.6	–8.7
Pound sterling	0.641	–4.2	–0.1	–0.8
Swiss franc	0.901	10.6	–3.7	–9.0
Canadian dollar	1.044	6.3	4.4	1.4
Mexican peso	13.724	10.1	10.1	8.2
Against euro				
US dollar	1.352	5.9	–1.0	0.8
Japanese yen	103.9	–6.0	–4.4	–9.6
Swiss franc	1.219	5.0	–2.6	–9.9
Pound sterling	0.867	–2.0	1.1	0.0
Swedish krona	9.258	1.5	2.9	0.7
Danish krone	7.441	–0.1	–0.2	–0.2
Polish zloty	4.417	6.3	10.3	10.3
Czech crown	24.65	2.1	–1.5	0.2
Hungarian forint	292.3	7.2	4.7	5.5

NOTE: (*) Plus sign indicates appreciation of dollar (first group) or euro (second group).
SOURCES: Bloomberg and own calculations.

Investors choose to take refuge in investment grade bonds

High quality bonds act as a safe haven.

As in previous quarters, the performance of corporate bonds has been more stable than other markets given the scenario of a slowdown in world growth and the worsening debt crisis in Europe, although some sectors have started to suffer negative effects on their indices. In September, and breaking the trend observed over the summer, the main corporate bond indices fell slightly due to a widespread upswing in risk premia. On this occasion, the rise in premia accelerated after the Federal Reserve confirmed that it expected economic growth in the United States to slow up.

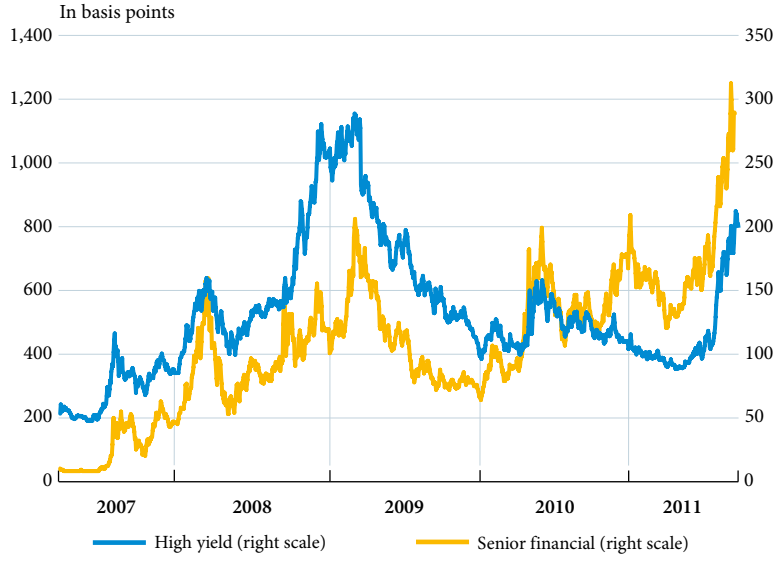
However, in spite of the slight correction in indices, corporate bonds have continued to act as a safe haven, behind gold and the public debt of the most solvent countries (such as the United States and Germany). Specifically, investment grade corporate bonds, both of the United States and the euro area, as well as some selected bonds from the emerging economies, have once again recorded slight increases in demand and consequent drops in their yields. In the case of the euro area, the indices of investment grade bonds, in spite of a relatively favourable performance, are still being affected by the debt issued by banks. The recent downgrades by rating agencies for the main French and Italian banks have added tension to bank-issued debt, with their risk premia reaching a record high. For its part, the high yield sector (bonds with a high yield and high risk), which in previous quarters a favourite destination for investors, has started to see an increasing decline giving the rising fear of a strong downturn in economic growth, implying higher bad debt and default rates.

High yield bonds deteriorate.

Given this financial situation, companies in developed countries have been issuing

SOME CORPORATE BOND SEGMENTS ARE DETERIORATING

5-year Markit Itraxx indices



SOURCE: Bloomberg.

fewer bonds. The lack of opportunities to sell their bonds in the markets is leading to a growing number of firms, mainly financial institutions, opting to use covered bonds as a means to obtain wholesale financing.

The markets punish the bonds of European banks.

Uncertainty dominates the stock markets

International stock markets have looked fragile and erratic throughout September. The world's worsening economic growth prospects and the perceived unstable financial scenario have been reflected in the upswing in volatility and movements in investor flows. The latter have continued to transfer their capital to assets with a less risky profile, such as gold, high quality corporate bonds and the public bonds of Germany and the United States.

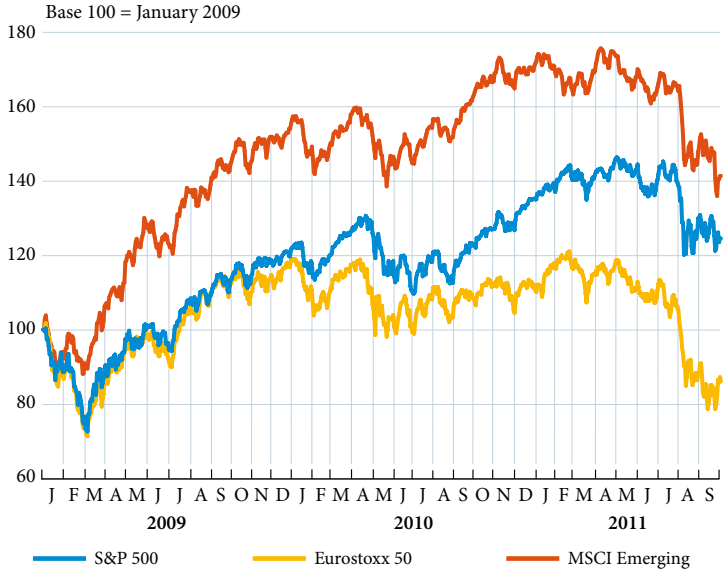
Assuming that the risks of the current economic and financial situation are gradually going to be resolved satisfactorily, the medium and long-term outlook for the world's stock markets is favourable. In this respect, in spite of the negative effect of the risks on profit forecasts made by analysts, the fundamentals for stock market gains are still the same. These include a recovery in the world's sustained growth cycle, resistance of the expansionary business cycle and a reduction in credit risk. However, in the short term investors are very sensitive to the risks to growth and the European sovereign crisis, a huge obstacle to potential stock market gains being realised.

International stock markets show a high degree of uncertainty.

In the United States, the weakness of economic indicators, fears of a possible double dip recession in the US and the as yet incomplete political negotiations

STOCK MARKETS ARE STILL VERY WEAK

Stock market indices



SOURCE: Bloomberg.

The resolution of the current financial uncertainty should give way to a more favourable period for equity.

regarding the deficit ceiling are the main obstacles challenging stock market indices. However, estimates by the consensus of analysts see as quite moderate the impact of current risks on the profits forecast for the coming year, expecting margins to be sustained within the financial scenario of the coming quarters.

The banking sector loses ground as a consequence of the European sovereign debt crisis.

In Europe, in addition to growing uncertainty due to the debt crisis possibly spreading to other countries, there is also uncertainty caused by the recapitalization requirements that would be faced by European banks in the case of Greek default. This is precisely why banks' shares are still in the sights of investors, reinforcing this punishment after the downgrading suffered by some French and Italian banks.

The stock markets of emerging countries have also suffered from the effect of the sovereign crisis, albeit to a lesser extent. The stock markets of these economies are still immersed in a circle of corrections caused by tougher monetary policies and the initial signs of a slowdown, the implications of the European debt crisis being an additional burden on any attempt at recovery made by their indices in the short term.

INDICES OF MAIN WORLD STOCK EXCHANGES

September 30, 2011

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*11,154.0*	*–4.0*	*–3.7*	*3.4*
Standard & Poor's	*1,160.4*	*–4.8*	*–7.7*	*1.7*
Nasdaq	*2,480.8*	*–3.8*	*–6.5*	*4.7*
Tokyo	8,700.3	–2.8	–14.9	–7.1
London	5,156.0	–4.4	–12.6	–7.1
Euro area	2,194.0	–4.7	–21.4	–20.2
Frankfurt	*5,552.8*	*–4.0*	*–19.7*	*–10.9*
Paris	*3,004.1*	*–7.8*	*–21.0*	*–19.1*
Amsterdam	*281.6*	*–3.9*	*–20.6*	*–15.8*
Milan	*15,007.5*	*–3.6*	*–25.6*	*–26.8*
Madrid	*8,590.9*	*–1.5*	*–12.9*	*–18.3*
Zurich	5,552.8	0.4	–13.7	–11.8
Hong Kong	17,592.4	–11.4	–23.6	–21.4
Buenos Aires	2,518.1	–15.1	–28.5	–4.7
São Paulo	53,384.7	–5.5	–23.0	–23.1

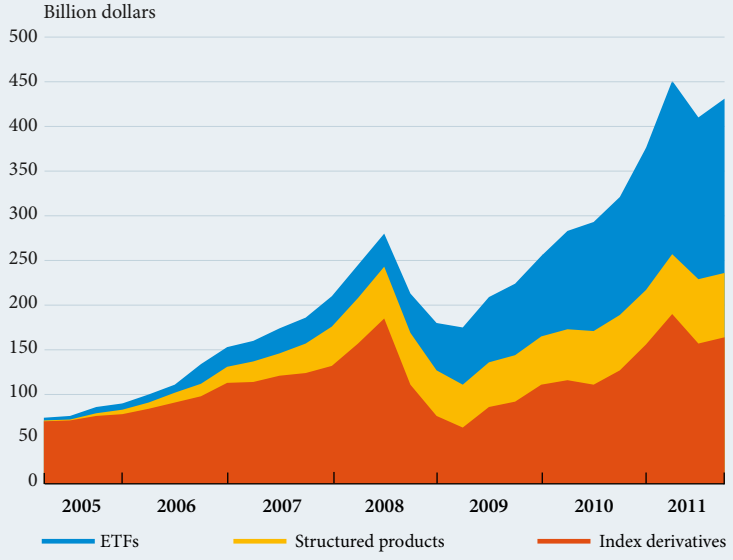
NOTE: (*) New York: Dow Jones Industrials, Standard & Poor's Composite, Nasdaq Composite; Tokyo: Nikkei 225; euro area: DJ Eurostoxx 50; London: Financial Times 100; Frankfurt: DAX; Paris: CAC 40; Amsterdam: AEX; Milan: MIBTEL; Madrid: Ibex 35 for Spanish stock exchanges; Zurich: Swiss Market Index;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

Speculation in the commodities markets: guilty or innocent?

The interest shown in commodities by many investors as an alternative asset to include in their portfolio strategies has grown considerably over the last decade. At the beginning, this approach was justified by the traditionally low correlation observed between commodities and other assets (especially equity), as well as by the fact that they could be used to hedge against sustained rises in inflation. In a few years, this phenomenon, which some call the «financialization» of commodities, has reached astounding proportions that have led to controversy. Specifically, it is accused of causing disproportionate increases in the prices of basic products for citizens.

Since 2005, the main commodities indices have appreciated significantly and have been highly volatile in a process involving a wide range of products, particularly energy, foods and precious metals. Many observers have blamed this situation on the growing presence of financial investors such as investment banks and hedge funds, whose actions have been linked to speculation (usually through the derivative markets and structured products). Others blame rising prices on the massive flows of savings from institutional investors (such as retirement funds) and private investors. For the latter, it has become much easier to channel their savings towards commodities thanks to a highly successful new product: ETFs (Exchange Traded Funds).[1] Over the last three years, the volume of assets managed by commodity ETFs has doubled and now accounts for almost half the total financial assets linked to commodities, as can be seen in the graph below.

FINANCIAL ASSETS MANAGED IN COMMODITIES



SOURCE: Institute of International Finance.

(1) ETFs (Exchange Traded Funds) are traded funds whose investment policy consists of tracking an index. A participation in these funds can be made up of shares, bonds or commodities and they are traded on stock markets as if they were shares.

In a debate that is very often dominated by demagogy and self-interest, a number of academic economists have attempted to examine, with as much conceptual and empirical thoroughness possible, the relationship between the increase in flows of financial capital and rising commodity prices. This issue became particularly relevant in the middle of 2008, when the indices for these assets reached a record high, coinciding with the sharp rise in the price of crude oil. The new spike occurring in 2010 merely increased the interest of more researchers. Unfortunately, the findings of these studies are not sufficiently conclusive to reach any resounding final verdict regarding the accusation in question. However, they do allow us to reasonably shift the discussion towards a short but useful list of conclusions.

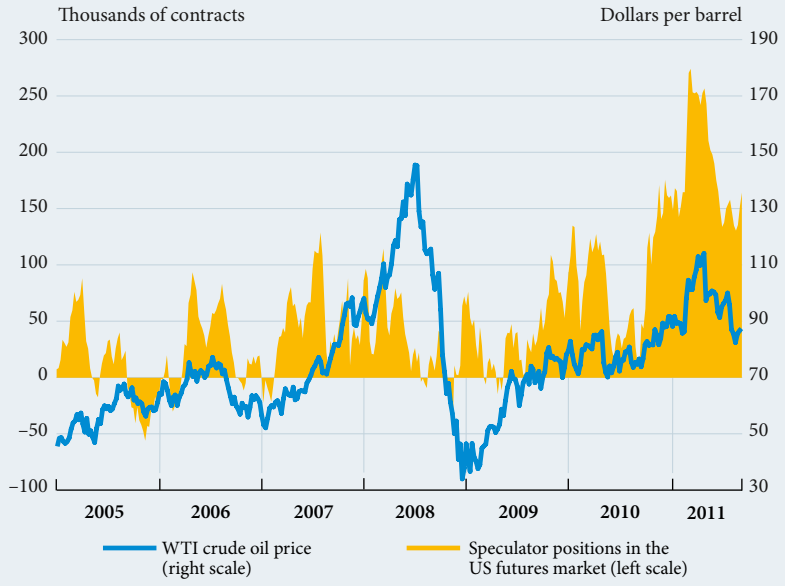
On a conceptual level, positions are divided along terms analogous to the already long and prolific debate regarding efficiency in financial markets. Those who claim that financial markets are efficient believe that the «financialization» of commodities does not entail drawbacks but advantages: it improves the price discovery mechanism, increases market liquidity and depth, provides stability, etc. Meanwhile, those who believe that markets are inefficient in disseminating and processing information suspect that, in the commodities markets, «financialization» has amplified phenomena such as herding, the formation of bubbles, predatory trading, panic, etc. Up to the financial crisis of 2008, the pro-efficiency paradigm was dominant but the commotion caused by the many different dysfunctions observed in the last few years in markets such as the monetary, mortgage and stock market seem to be moving the balance towards approaches that question their efficiency.

In any case, many different empirical studies have attempted to identify, measure or estimate the impact of financial activity in these markets. Some use sophisticated statistical techniques while others resort to basic data that can be observed directly, without processing. Among the former, there are many that use the database of the Commodity Futures Trading Commission (CFTC), the regulatory body in the United States for derivative markets, including commodities. This is one of the few sources of high frequency data where, in principle, the actions (transactions and positions) of «speculative» investors can be monitored. Evaluated as a whole, these analyses[(2)] do not find any significant or consistent causal relationship between financial/speculative activity and rising commodity prices. This is, for example, the interpretation proposed by the World Bank[(3)] in the conclusions of its report on Global Economic Prospects. On the one hand, the number of futures contracts of speculative investors tends to be much lower than that of non-speculative investors. More importantly, the behaviour of the former has a low correlation with trends in major commodity prices, such as crude and foods. And even more decisively, it has been statistically found in a range of episodes (the main ones in relation to crude) that variations in commodity prices led to modifications in the net positions of investors and not the opposite, as claimed by those against speculation.

Several criticisms have been levied against the family of studies based on the CFTC data, particularly the omission of transactions in very important areas of the market through which financial/speculative flows can also be channelled (other products and other countries), the use of sample periods that are not always representative (in particular the emphasis on studying the case of petrol in 2008), as well as weaknesses in the econometric techniques used.[(4)] In this respect, those studies that cover the events of 2010 tend to identify a more significant causal relation

(2) For example, the following: J. Hamilton, *Causes and Consequences of the Oil Shock of 2007-08*, Brookings Papers on Economic Activity, Spring 2009: 215-259. R. Alquist, and O. Gervais. *The Role of Financial Speculation in Driving the Price of Crude Oil.* Bank of Canada. Discussion paper 2011. S. Irwin, D. Sanders and P. Meerin, *Devil or Angel. The Role of Speculation in the Recent Commodity Price Boom*. Journal of Agricultural and Applied Economics No. 41, 2009.
(3) For more details, see «*Global Economic Prospects - Maintaining Progress Amid Turmoil*». World Bank. June 2011.
(4) K. Singleton, *Investor Flows and the 2008 Boom/Bust in Oil Prices*; working paper Graduate School of Business Stanford University, July 2011.

SPECULATOR POSITIONS IN THE FUTURES MARKET AND CRUDE PRICES



SOURCE: Institute of International Finance.

between speculation and rising prices.(5) Those claiming the innocence of speculation respond to this by providing another kind of «evidence». One piece is related to trends in stocks, which have not grown as would be expected if the actions by speculators had driven the market price above the equilibrium price between the final supply and demand (fundamentals). Another is the observation that products not involved in any financial activity, merely due to the absence of vehicles (derivatives or ETFs), have moved as or more sharply than commodities as a whole. For example, coal.

In summary, and with the necessary provisos due to the lack of sufficient consensus among the different studies, it seems reasonable to propose three important notions. Firstly: financial activity's long-term effect on the level of commodity prices is small; price trends are determined by fundamental variables (demand, stock, supply and production costs). Secondly: effects on the level of prices may be significant in the short term, generally pushing in the same direction and amplifying the fundamental forces, but these effects vary over time and are disparate, depending on the type of commodity. Thirdly, there are significant effects on price volatility in the short term.

Given these conclusions, we would expect a balanced judge to give a verdict of «not guilty», accompanied by provisions to prevent the harmful short-term effects from becoming greater than is acceptable. This is what the regulators are attempting in regions as important as the United States and the European Union, introducing different reforms (limits to positions in derivative contracts, obligations regarding transparency, etc.) for which, in fact, balance is highly advisable.

(5) For example: M. Lombardy and I. Van Robays, *Do Financial Investors Destabilize The Oil Price?*, ECB Working paper no. 1346, June 2011.

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

SPAIN: OVERALL ANALYSIS

Economic activity

Changing expectations

Volatility and financial tension pick up.

The Spanish economy has now seen six quarters of positive growth rates. In a typical cycle of economic recovery, this would be enough time for the different economic agents to believe recovery was sustainable, something that generally leads to increased investment and an improvement in the labour market. The size of the recession experienced two years ago has meant that, to date, the improvement in confidence has been somewhat slower than usual but, after the events of the last few weeks, it seems as if part of the ground regained is being lost.

The IMF revises growth for 2012 down to 1.1%.

There's no single explanation for the upswing in tensions in the financial markets and increased volatility in the main stock market indices. Poor growth figures for the second quarter in most developed economies, the lack of political consensus in the US economy to adjust the public deficit, the slowdown in growth in the main emerging economies and especially the lack of political leadership to find a solution to the sovereign debt crisis are the main reasons. For the moment, all this has already caused a sharp drop in growth prospects for the main advanced economies, both for this year and particularly the next.

Public consumption falls by 2.4% quarter-on-quarter, a historic figure.

The Spanish economy has not escaped this process. The International Monetary Fund (IMF) maintains its growth in gross domestic product (GDP) forecast for 2011 at 0.8% but has revised its forecast for next year down by six tenths of a percentage point, to 1.1%. A forecast that is in line with our own. The revisions of analysts as a whole have been a little more pronounced. The GDP growth predicted by Consensus Economics, which summarizes the forecasts of the world's leading analytical firms, is 0.7% for this year and 0.8% for 2012.

The Spanish economy's vulnerability to the recovery in the world economy has been reflected perfectly in the second quarter's GDP growth figures. Domestic demand's contribution to growth was negative for another quarter. This time the main culprit was public consumption, starting to reflect the austerity measures taken by the government in order to contain the fiscal deficit. Specifically, this component posted a drop of 2.4% quarter-on-quarter, a historic fall.

This figure was partly offset by the surprising increase in private consumption, namely 0.6% quarter-on-quarter. Surprising because the sources that might feed growth in private consumption are quite limited. In the second quarter, for example, Brent quality oil prices rose by 11% compared with the previous quarter and reduced the purchasing power of households. On the other hand, wages for salaried workers fell by 0.6% in year-on-year terms. This rise in consumption is therefore probably being fed by a drop in the savings rate, which is still at relatively moderate levels.

After the strong upswing in savings in 2009, standing at 18.1% of the gross

DEMAND INDICATORS

Percentage change over same period year before

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
Consumption								
Production of consumer goods (*)	–8.2	0.8	0.4	0.1	–1.5	–0.9	–1.2	...
Imports of consumer goods (**)	–5.8	–9.5	–14.9	–13.7	–1.1	–8.7	–10.1	...
Car registrations	–17.9	3.1	–25.0	–29.3	–27.3	–26.4	–4.0	5.9
Credit for consumer durables	–11.5	–12.3	–19.2	–14.6	–13.9	–10.1	–	...
Consumer confidence index (***)	–28.3	–20.9	–21.5	–21.0	–19.6	–16.1	–13.4	–17.0
Investment								
Capital goods production (*)	–22.1	–3.3	–6.3	–3.2	3.0	2.5	1.2	...
Imports of capital goods (**)	–26.3	6.5	9.4	4.8	2.3	–4.9	–14.7	...
Commercial vehicle registrations	–40.0	6.4	–9.3	1.4	–2.2	–11.2	–0.5	11.2
Foreign trade (**)								
Non-energy imports	–16.9	10.3	6.0	5.4	7.4	–0.7	–9.9	...
Exports	–9.8	15.6	13.2	15.3	16.0	9.0	8.8	...

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.

disposable income of households, it ended 2010 at 13.1%, a figure that could still fall further, although such a drop would now be quite limited.

This is the reason why, in the coming quarters, we are unlikely to see similar increases in private consumption to those of the second quarter. The retail trade index continues to appear very weak and points along the same lines. In particular, in July it posted a 3.9% drop in year-on-year terms. The trend in the consumer confidence index isn't very encouraging either, particularly after August's significant drop, which has returned it to April's levels.

The trend in the last component of domestic demand, investment, wasn't too buoyant either, although there are important nuances in this department. Investment in construction continues to fall in year-on-year terms by almost double figures, although it's true that a slowdown is slowly appearing in its rate of decline. After a year of quarter-on-quarter drops of 3%, on average, in the second quarter this was just 0.9%. The trend in capital goods investment is more satisfactory. With the exception of the third quarter last year, this component has recorded positive quarter-on-quarter growth rates since the third quarter of 2009. In the second quarter of 2011, the advance was modest, namely 0.3%, but continues to show the productive economy's capacity to recover.

However, the growth in capital goods investment might slow up in the coming quarters. This is reflected by industry's confidence index which, after a sharp drop in July, continued to fall in August, reaching the level of September 2010. The

Construction continues to adjust but moderates its decline.

The confidence indices for industry and industrial production do not inspire optimism.

SUPPLY INDICATORS

Percentage change over same period year before

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
Industry								
Electricity consumption (1)	–4.9	2.9	2.7	2.2	0.4	1.4	–1.4	0.1
Industrial production index (2)	–15.8	0.8	–0.2	0.4	1.8	–1.1	–2.8	...
Confidence indicator for industry (3)	–30.8	–13.8	–13.5	–9.2	–8.6	–10.9	–13.3	–13.9
Utilization of production capacity (4)	71.2	72.0	73.9	72.9	72.6	74.7	73.3	–
Imports of non-energy intermediate goods (5)	–20.9	24.6	20.0	18.2	12.2	3.8	–9.3	...
Construction								
Cement consumption	–32.3	–14.8	–14.1	–16.1	–2.0	–16.6	–26.1	–16.5
Confidence indicator for construction (3)	–32.3	–29.7	–27.8	–41.5	–54.1	–55.4	–58.0	–53.7
Housing (new construction approvals)	–58.1	–17.3	–13.2	–20.3	–6.8	...	...	...
Government tendering	–8.2	–37.9	–36.6	–34.8	–44.5	...	...	...
Services								
Retail sales (6)	–5.4	–1.0	–2.5	–1.9	–5.9	–5.1	–3.4	...
Foreign tourists	–8.8	0.9	4.2	1.4	2.9	10.4	7.2	9.4
Tourist revenue inflows	–9.0	3.9	7.0	5.4	6.7	12.2	...	...
Goods carried by rail (ton-km)	–28.4	6.4	5.9	–4.2	8.2	1.8	–1.8	...
Air passenger traffic	–7.9	2.9	4.2	4.3	5.0	10.6	6.7	4.7
Motor vehicle diesel fuel consumption	–5.1	–1.2	–2.1	–1.6	–1.7	–4.7	...	...

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.

Recovery largely depends on growth in the world economy.

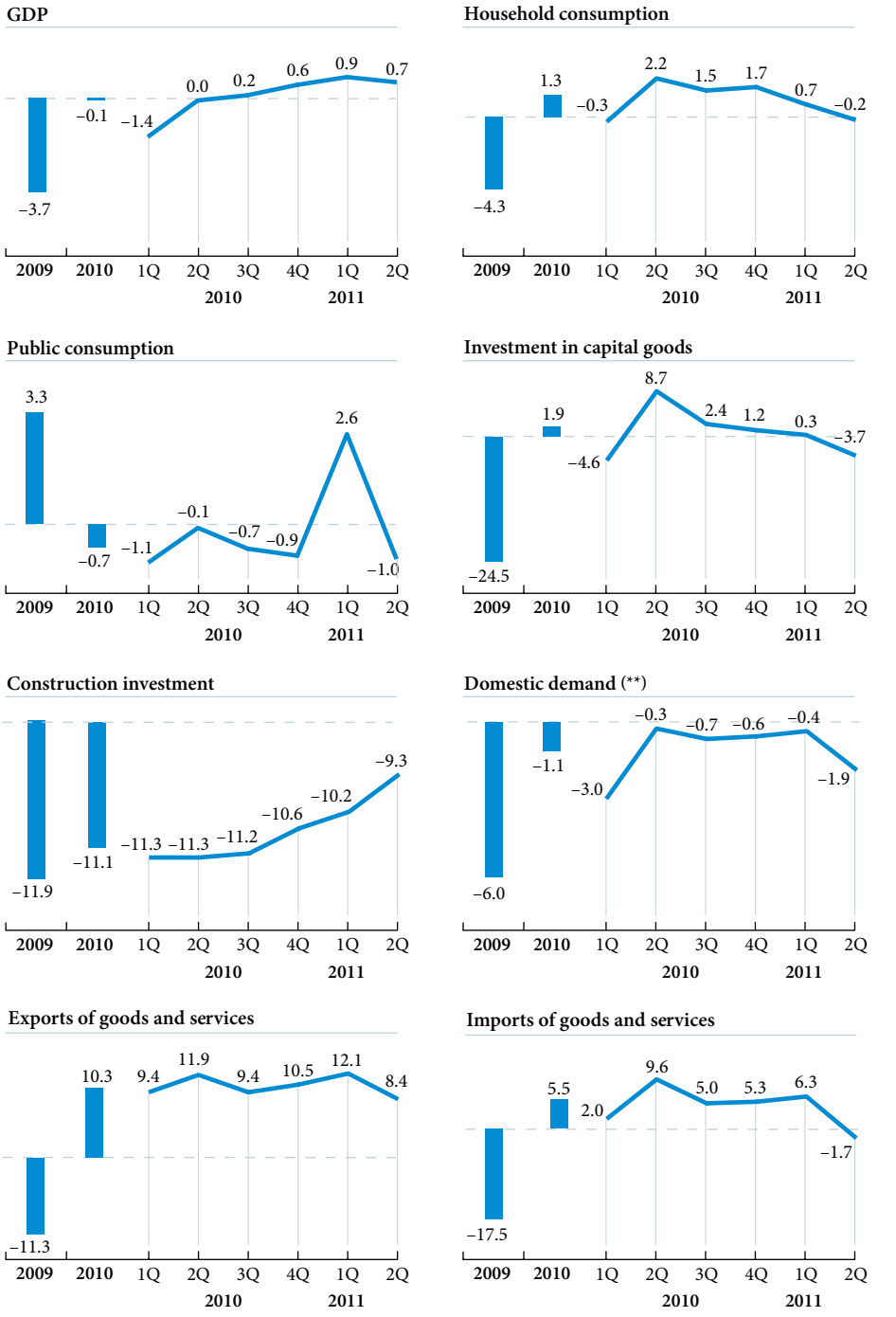
trend in the industrial production index didn't provide any good news either. In July its fall accelerated again to 2.8% year-on-year. Industrial capacity utilization in the third quarter also reflects the context of a weak recovery and, although at a relatively low level, posted a slight fall.

The weakness of domestic demand overall means that the Spanish economy's capacity to recover is especially influenced by the growth expectations for the world economy. Fortunately, some figures from the second quarter are optimistic. The foreign sector's contribution to growth was 2.7 percentage points, one of the highest ever recorded. However, this was particularly due to the fall in imports, down by 3.7% in quarter-on-quarter terms. Exports also slowed up their pace of growth but to a lesser extent, as the fall in exports of industrial goods was offset by a rise in exports of services.

The foreign sector's contribution to growth is expected to go on being

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



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

Growth trends for 2012 are still positive.

significant in the coming quarters but will gradually diminish. Nonetheless, we expect it to add 1.6 percentage points to GDP growth this year. Next year, although its contribution might fall by close to half a point, it will still be at a relatively high level.

In short, the growth prospects of the main advanced economies are changing significantly and this is affecting the Spanish economy's speed of recovery. However, although growth looks like being slightly lower than we expected next year, the trend is still positive. Moreover, it's important to remember that part of this rise in volatility is the result of political indecision in the world's main economies. When Greece's second bail-out plan is finally approved and the euro area manages to delimit the risk of contagion with effective measures, and in the United States the two large political parties reach an agreement on the direction fiscal policy should take, confidence might quickly regain the ground it has lost.

Labour market

Deteriorating expectations could have a negative effect

Once again, the figures being provided by the labour market are not very encouraging. No-one expected the recovery to be buoyant or immediate and it's common knowledge that the labour market starts to recover quite a long time after economic activity as a whole. This time lapse is the minimum period required for the different agents to regain confidence in the economy's ability to grow. That's when people start to invest again in the labour and also the capital factor. But we've already seen six quarters of positive growth in the gross domestic product (GDP) and the data on labour market trends are still not very optimistic.

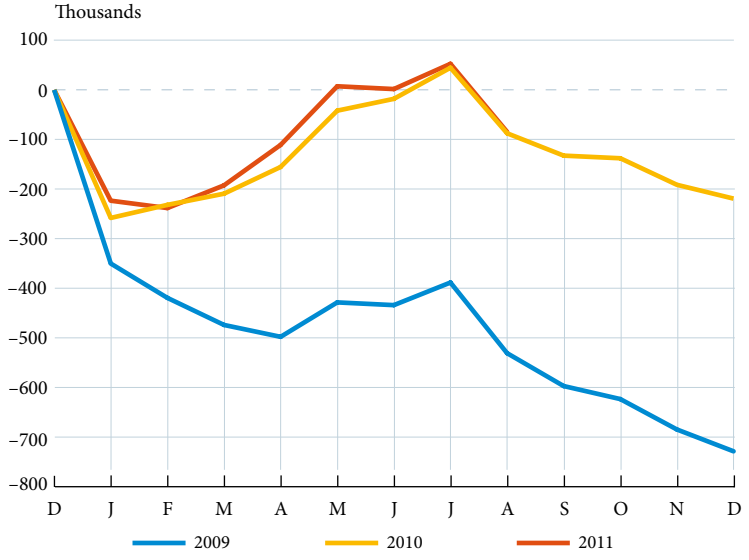
In August, for example, the number of people registered as employed with Social Security was down by 136,835. Jobs are normally lost in the second month of the summer, so this figure should not be taken too literally. For example, between 2005 and 2007, 154,000 jobs were lost during this month on average. However, the good tourist season allows us to be a little more optimistic. The figures for registered unemployment aren't very heartening either, as this rose by 51,185 people. However, if we take seasonal effects into account, the rise is less in this case as well, albeit still slightly positive.

The National Accounts system employment figures for the second

The labour market still isn't recovering.

EMPLOYMENT FALLS A LITTLE LESS THIS YEAR BUT CONTINUES IN NEGATIVE FIGURES

Cumulative year-on-year change in Social Security registrations



SOURCES: Ministry of Work and own calculations.

Market services are already creating jobs.

quarter confirm this scenario of a slow recovery. Full-time equivalent jobs fell by 1.0% in the second quarter, four tenths of a percentage point less than in the first. A figure that is still being strongly hit by job losses in the construction industry and, accordingly, it's important to note that the percentage change is now positive in other sectors, such as market services.

The delay in the labour market's recovery is partly due to the slow speed of the recovery in the economy as a whole. This means that the confidence of the different agents is also slow to improve.

The lack of confidence prevents substantial improvements in unemployment.

Within this rather discouraging scenario, we must now factor in a significant change in expectations. The upswing in tensions in European financial markets due to Greece's dwindling growth prospects and rumours of it defaulting on its public debt, added to the poor growth figures for the US and euro area economies in the second quarter, have ended up affecting the medium-term growth prospects for developed countries as a whole. As we explained before, this aspect is crucial to restoring confidence in order to invest in the labour factor. This has led us to slightly revise our forecasts for the unemployment rate in 2012.

But it's not all bad news. The figures for labour factor costs are more encouraging, particularly if we take into account the fact that the improvement in the Spanish economy's competitiveness depends on their adjustment. According to data from the National Accounts system, wages for salaried workers fell by 0.5% year-on-year in the second quarter. This was particularly due to the reduction in cost per salaried

EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2009	2010	2010		2011			
			3Q	4Q	1Q	2Q	July	August
Persons registered with Social Security (1)								
Sectors of activity								
Industry	*–10.6*	*–4.8*	*–3.8*	*–3.2*	*–2.8*	*–2.4*	*–2.3*	*–2.4*
Construction	*–23.1*	*–13.4*	*–12.5*	*–11.3*	*–9.6*	*–11.4*	*–12.7*	*–12.9*
Services	*–2.6*	*0.0*	*0.4*	*0.4*	*0.3*	*0.5*	*0.4*	*0.3*
Job situation								
Wage-earners	*–6.0*	*–1.8*	*–1.4*	*–1.2*	*–1.1*	*–0.9*	*–1.2*	*–1.3*
Non-wage-earners	*–4.8*	*–2.8*	*–2.4*	*–1.9*	*–1.6*	*–1.2*	*–1.1*	*–1.0*
Total	**–5.8**	**–2.0**	**–1.6**	**–1.3**	**–1.2**	**–1.0**	**–1.2**	**–1.2**
Persons employed (2)	**–6.8**	**–2.3**	**–1.7**	**–1.3**	**–1.3**	**–0.9**	**–**	**–**
Jobs (3)	**–6.6**	**–2.4**	**–1.6**	**–1.4**	**–1.4**	**–1.0**	**–**	**–**
Hiring contracts registered (4)								
Permanent	–31.0	–6.4	–7.6	0.0	–1.8	–5.0	–6.2	–1.1
Temporary	–13.5	3.8	3.5	2.8	0.7	3.9	–3.2	5.5
Total	**–15.5**	**2.8**	**2.6**	**2.5**	**0.4**	**3.1**	**–3.4**	**5.1**

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.

WAGE INDICATORS

Percentage rate of change over same period year before

	2009	2010	2010				2011	
			1Q	2Q	3Q	4Q	1Q	2Q
Increase under general wage agreements (*)	**2.3**	**1.5**	**1.4**	**1.3**	**1.3**	**1.5**	**3.1**	**2.7**
Wage per job equivalent to full-time work (**)	**4.1**	**0.7**	**1.7**	**1.5**	**–0.1**	**–0.4**	**0.8**	**0.2**
Quarterly labour cost survey								
Wage costs								
Total	3.2	0.9	1.9	1.8	0.1	0.0	1.0	0.6
Industry	*2.1*	*2.9*	*2.8*	*3.0*	*2.9*	*2.8*	*3.0*	*3.1*
Construction	*5.2*	*0.8*	*1.9*	*1.4*	*–0.9*	*0.6*	*2.3*	*3.2*
Services	*3.2*	*0.5*	*1.6*	*1.6*	*–0.4*	*–0.7*	*0.3*	*–0.2*
Average wages per hour worked	5.3	1.1	2.9	1.4	–0.9	1.3	0.2	1.3
Other labour costs	4.3	–1.1	–1.1	–0.6	–1.5	–1.0	0.4	1.5
Work day (***)	–2.0	–0.3	–1.0	0.3	1.0	–1.4	0.8	–0.6
Farm wages	**2.6**	**2.9**	**3.3**	**3.2**	**4.5**	**0.8**	**1.7**	...
Labour cost in construction	**4.7**	**1.0**	**3.1**	**0.7**	**0.1**	**0.0**	**1.3**	**2.0**

NOTES: (*) Does not include wage revision clauses. Cumulative figures.
(**) Quarterly National Accounts: data adjusted for seasons and public holidays.
(***) Effective hours worked per worker per month.
SOURCES: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fisheries and Food, Ministry of Public Works and own calculations.

worker, which went from a 0.8% increase in the first quarter to 0.2% in the second. Consequently, unit labour costs stabilized at –1.5%, three and a half points below the economy's implicit deflator.

The data from the quarterly survey on labour costs point in the same direction and the rate of growth in total labour costs continues to be relatively moderate. In the second quarter, this stood at 0.8% year-on-year, a much lower figure than the one recorded before the recession. This moderation is particularly due to the wage component, which only rose by 0.6%, while other costs increased by 1.5%. It is surprising, however, that the service sector is the one contributing most to wage containment, while total labour costs rose by 3.0% in the construction industry.

Consequently, a comparison with the euro area continues to be favourable in terms of the Spanish economy's improved competitiveness. In the second quarter, labour costs per hour grew by one percentage point less than in the euro area as a whole and the gap from the first quarter has therefore widened by one tenth of a percentage point.

In short, the labour situation continues to be somewhat gloomy and is now being affected by the diminishing growth prospects of advance economies as a whole. At least the underlying trend continues in terms of improving the competitiveness of the labour factor in the Spanish economy, a key factor to growth reviving.

Spain gains competitiveness through wage costs.

Prices

Inflation continues its downward slide

The CPI falls by one tenth of a percentage point, standing at 3.0% in August.

The year-on-year rate for the general consumer price index (CPI) in August stood at 3.0%, one tenth of a percentage point below the figure for July. This points to a consolidation in the downward slide initiated in April when inflation had reached 3.8%, its highest level since the start of the crisis.

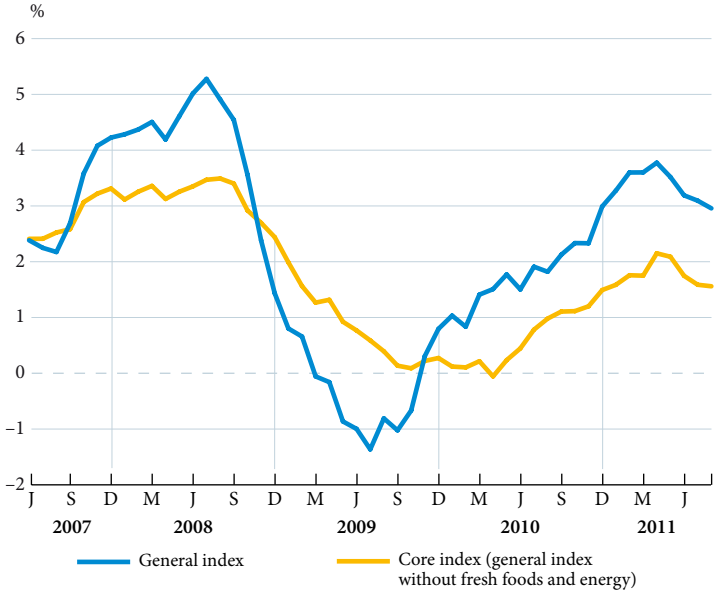
Commodities and unprocessed foods play a significant role in this reduction.

There are many reasons for this fall, occurring within a context of a slowdown in economic activity. On the one hand, and temporary in nature, is the fall in the price of Brent quality oil to 110 dollars per barrel, together with the drop in other commodities, forcing the fuel and oils component down. Unprocessed foods also cut back their month-on-month and year-on-year rates by five tenths of a percentage point, in clear contrast with the strong, anomalous rise they experienced last year. As the fall in both items, in addition to electricity, does not affect the calculation of core inflation, it's easy to see why the latter remained stable at 1.6% in terms of its year-on-year change.

On the other hand, the effects of the hike in value added tax (VAT), which took place in July 2010, have become more

INFLATION CONTINUES TO FALL FOR THE FOURTH CONSECUTIVE MONTH

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

	2010			2011		
	% monthly change	% change over December 2009	% annual change	% monthly change	% change over December 2010	% annual change
January	–1.0	–1.0	1.0	–0.7	–0.7	3.3
February	–0.2	–1.2	0.8	0.1	–0.6	3.6
March	0.7	–0.5	1.4	0.7	0.1	3.6
April	1.1	0.6	1.5	1.2	1.4	3.8
May	0.2	0.8	1.8	0.0	1.3	3.5
June	0.2	1.0	1.5	–0.1	1.2	3.2
July	–0.4	0.6	1.9	–0.5	0.7	3.1
August	0.3	0.8	1.8	0.1	0.8	3.0
September	0.1	0.9	2.1			
October	0.9	1.8	2.3			
November	0.5	2.4	2.3			
December	0.6	3.0	3.0			

SOURCE: National Institute of Statistics.

diluted, also helping inflation to come down. Although August's inflation figures were in line with our forecasts, we have revised downwards our estimates for 2012 due to weak domestic demand and the change in expectations regarding world economic growth.

The vast majority of indicators point to a slowdown in the Spanish economy. Consumer confidence has dropped again after recovering slightly over the last few months and is now below its historical average. Retail sales keep on falling, accumulating a year-on-year drop of 5.6%. Industrial production ended July down by 1.6% in year-on-year terms, while the indicator for economic sentiment also saw a slight relapse. Another sign suggesting weak domestic demand is the high contribution of fuels and oils to the total inflation rate, hence the core inflation under 2%.

Within this context, for the coming months and within a scenario of stabilizing oil prices, inflation will continue to fall until it reaches a level of around 2.4% at the end of the year. In 2012, the CPI will probably remain below 2% and might even come close to 1.5% by the middle of next year.

The economic slowdown will reduce inflationary tensions.

This scenario is not exclusive to Spain. In the euro area, inflation remained stable at 2.5% in August, although the forecast is for this figure to ease slightly by the end of the year.

Inflation forecasts for the euro area in 2012 are below 2% due to the slowdown in Europe's recovery. This outlook helps to explain the end of interest rate hikes, the change in discourse of the president of the European Central Bank (ECB), Jean-Claude Trichet, and the injection of liquidity that took place in September. The ECB has an essential mandate to keep inflation below 2% in the medium term, so it now has room to manoeuvre to lower interest rates in an attempt to revive the economy.

Lower activity is a European phenomenon.

CONSUMER PRICE INDEX BY COMPONENT GROUP

August

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2010	2011	2010	2011	2010	2011
By type of spending							
Food and non-alcoholic beverages	110.3	0.4	0.2	–0.1	1.3	–0.1	2.2
Alcoholic beverages and tobacco	144.4	0.0	–0.1	8.6	–0.5	8.6	5.6
Clothing and footwear	91.9	–0.8	–0.9	–14.7	–15.4	–0.1	–0.2
Housing	124.9	–0.1	–0.2	3.4	5.0	3.9	7.3
Furnishings and household equipment	108.3	0.1	0.1	–0.3	–0.2	0.7	1.1
Health	95.8	0.0	–0.5	–0.6	–0.6	–0.4	–1.2
Transport	117.6	0.1	–0.2	6.0	4.2	5.1	7.5
Communications	97.6	0.0	0.0	–0.5	–1.0	–0.6	–1.2
Recreation and culture	100.5	1.2	1.5	1.7	3.0	–0.1	0.1
Education	117.2	0.0	0.0	0.1	0.1	2.6	2.2
Restaurants and hotels	116.9	0.9	0.8	2.9	2.8	1.2	1.5
Other goods and services	115.4	0.2	0.1	2.1	2.1	2.6	2.9
By group							
Processed food, beverages and tobacco	116.5	0.2	0.2	0.8	1.5	0.8	3.3
Unprocessed food	109.6	0.7	0.2	1.5	0.1	1.6	1.1
Non-food products	111.0	0.2	0.1	0.8	0.7	2.0	3.0
Industrial goods	107.0	–0.2	–0.4	–0.7	–0.9	2.4	4.4
Energy products	*135.2*	*–0.1*	*–0.7*	*9.4*	*9.1*	*8.9*	*15.3*
Fuels and oils	*131.9*	*–0.2*	*–1.0*	*11.6*	*8.9*	*10.9*	*15.5*
Industrial goods excluding energy products	*97.6*	*–0.2*	*–0.2*	*–4.2*	*–4.6*	*0.2*	*0.4*
Services	115.1	0.6	0.6	2.2	2.3	1.5	1.7
Underlying inflation (**)	109.0	0.3	0.2	–0.3	–0.2	1.0	1.6
GENERAL INDEX	**111.9**	**0.3**	**0.1**	**0.8**	**0.8**	**1.8**	**3.0**

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

The good news comes from an analysis of price trends, key to gauging the competitiveness of the Spanish economy and diagnosing its prospects of recovery. The principal indicator is Spain's inflation differential with the euro area, as this is our main trading partner. The harmonized index of consumer prices (HICP), which provides a comparison of the different EU countries, stood at 2.5% in the euro area while the figure for Spain was 2.7%. Although this differential is still positive, it's getting narrower month by month. The reasons for this lie in the disappearance of effects resulting from the tax changes introduced in the second quarter of 2010 and in falling oil prices, as energy products weigh more heavily in the calculation of inflation for Spain than for its European peers.

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											
April	2.8	3.7	0.1	–0.1	2.4	13.1	8.5	2.1	0.7	6.6	–
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	10.3	4.1	0.6	0.5	4.3	10.5	8.6	6.4	1.7	10.5	–
November	10.3	4.4	0.9	0.6	5.1	10.7	9.2	7.7	2.1	11.0	1.4
December	8.5	5.3	1.3	0.7	5.7	13.5	10.4	8.1	2.5	11.8	–
2011											
January	3.7	6.8	1.5	1.0	6.8	17.3	11.7	7.3	2.0	12.2	–
February	1.3	7.6	1.9	0.9	7.9	18.5	11.1	6.2	1.4	13.1	1.8
March	–5.2	7.8	2.1	1.2	8.0	18.6	10.8	5.4	1.5	11.6	–
April	–4.7	7.3	2.5	1.3	7.1	17.1	10.0	3.9	1.6	10.3	–
May	...	6.7	2.6	1.3	6.5	15.4	8.6	3.0	0.8	8.2	2.0
June	...	6.7	2.6	1.2	6.4	15.4	7.7	2.3	0.6	6.8	–
July	...	7.4	2.9	1.3	6.8	17.8	9.2	3.4	0.9	8.1	–

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

However, there is another fundamental cause: the adjustment being carried out by Spain in its prices and labour costs in order to restore competitiveness. The labour cost index shows a growth in total costs per worker below the rate for the euro area. High unemployment is probably preventing second-round effects due to inflation. In other words, although it's a slow, tortuous route, Spain is on the way to regaining its competitiveness.

In summary, inflation is still falling and this will continue in 2012 thanks to the slowdown in the Spanish economy. The good news is provided by Spain's inflation differential with the euro area and the labour cost index, which suggest that Spain is gradually recovering its competitiveness, a source of economic recovery.

The tough adjustment is helping to regain competitiveness.

The volatility of food prices: also a growing problem?

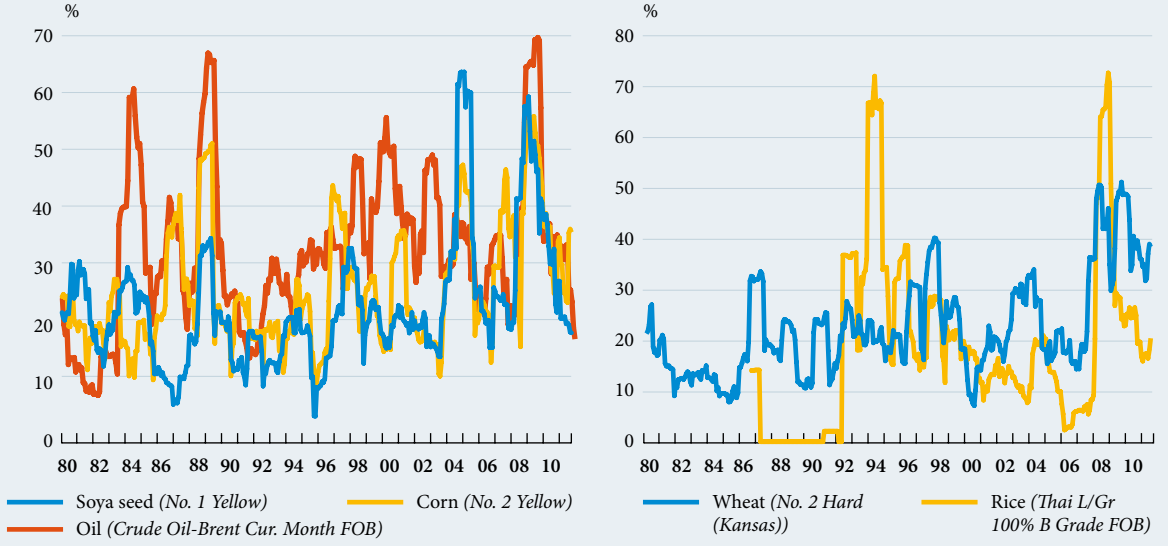
The price of food has been fluctuating wildly since 2006. Cereals and oils, for example, saw year-on-year growth of 80% and 100%, followed by a drop in the order of 30%-50% and then further rises of up to 60%, according to the FAO. This high volatility is damaging for those developing countries which are net importers of food. Not only does it jeopardize the survival of their population; the loss of human capital and deterioration in the public accounts due to the resources being aimed at relieving the situation also hinder the country's future potential development. Consequently, signs that volatility may be increasing underline the need to take action towards its reduction and to combat its effects.

Volatility in the prices of farm products is a usual phenomenon given the nature of the industry. On the one hand, the market's supply of products is already volatile per se, as harvests crucially depend on random factors such as weather and pests. On the other hand, it is not necessary to have dramatic changes in supply for this to have a highly significant effect on prices. The reason is that both demand and supply have a low price elasticity so that, after a shock, the equilibrium between the quantities demanded and supplied must be restored by adjusting prices. This adjustment is even greater at times of low stocks, when they are not enough to absorb part of the demand that pushes up prices given the rigidity of the supply.

The levels of volatility recorded since 2008 seem to be higher than in the past (see the graph below). This has led many to wonder whether volatility is gradually increasing. Recent studies show that, although there does not seem to be a widespread rise in volatility, it does appear to have increased for products such as butter, soya oil, sugar, powdered milk, corn, rice and wheat.[1] This increase is particularly significant in the last three cases where, during the period 2006-2010, volatility has exceeded the peaks reached during the 1970s.

PRICE VOLATILITY HAS SHARPENED OVER THE LAST FEW YEARS

Historic annualized volatility (1980-2011)



SOURCES: Thomson Reuters Datastream and own calculations.

(1) See OECD (2011), «Is agricultural commodity price volatility increasing? A historical review», OECD Working Document.

This greater volatility may be due to various reasons. One initial cause is related to demand growth being larger than that in supply, which is affected by the reduction in cultivated land in the most highly productive countries and the low mechanization and productivity of agriculture in developing countries. Stocks are gradually falling and, as a consequence, shocks in supply can have an increasingly large effect on prices. By way of example, global stocks in relation to demand in 2008 were at half their level in the 1990s.[2] Moreover, this sustained increase in demand is being accompanied by a larger proportion of the population living in urban areas and higher incomes in many poor countries. Both factors are making demand more inelastic, exacerbating the effect of shocks on prices. In the case of corn, for example, it is estimated that 58% of the average observed volatility could be due to this cause.[3]

Energy prices and a growing emphasis on biofuels are also contributing to the rise in price volatility. Traditionally, food prices have been linked to energy prices due to both production costs (through the use of machinery and fertilizers) and transportation costs (see the graph below). Increasing mechanization and the more intensive use of fertilizers tend to reinforce this link. However, the most substantial change may be due to the growing use of certain agricultural products to produce biofuels. Energy policies that encourage the use of biofuels stipulate minimum consumption levels to be achieved in the coming years and this is pushing up the demand for their inputs (corn, wheat, oils and sugar). In fact, and according to OECD figures, half the increase in the consumption of cereal between 2005 and 2007 was due to the production of biofuels. This closer link to energy prices is also spreading to other agricultural products through supply reactions, as there is a greater incentive to replace crops with those used to produce biofuels. The OECD's figures back up this increase in the correlation between oil prices and corn, wheat and soya oil. In fact, approximately 20% of the volatility in corn and wheat prices could be due to this connection.

The role played by greater speculative investment in futures and agricultural derivatives is more difficult to quantify.[4] The strategies of a large number of investors do not respond to changes in the fundamentals of agricultural markets. Instead, they follow hedging motives to take advantage, for example, of the negative correlation between the performance of agricultural products and that of bonds. It is difficult to determine the long-term effect of speculation on spot prices (prices for immediate settlement). However, numerous studies have not ruled out volatility being amplified in the short-term by the expectations generated in these financial markets, which might lead to preventive stockpiling or trade restrictions.

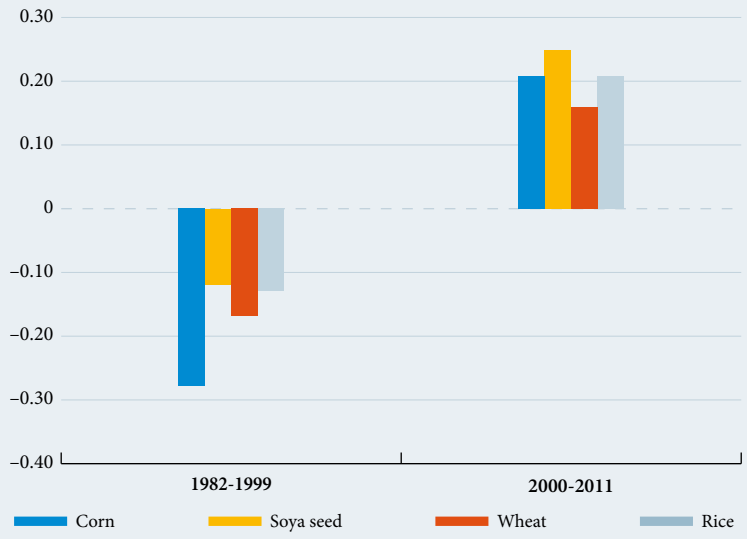
All these factors could interact to produce peaks in the volatility of international prices. However, the most relevant aspect for consumers and producers is how volatility is passed on to domestic prices. Governments frequently adopt measures in order to stabilize their domestic market. However, developed and developing countries have opposing interests. While the former tend to adopt policies to protect producers (to raise prices), the latter prioritize the population's food security (and reduce prices). This often results in the adoption of trade restrictions that distort the international market equilibrium and increase price volatility. As a consequence, other economies more open to trade may be harmed, especially if they are developing countries.

Given this growing volatility, it is essential to adopt measures aimed at both reducing it and relieving its effects. Perhaps the most effective measure is to increase productivity in developing countries, particularly among small-scale producers. This would not only help to balance supply and demand growth, but it would also improve food security in these countries. To achieve this, heavy investments are required not only in machinery but also in

(2) Data from the Departament of Agriculture of the United States. Average for wheat, rice, corn, soya oil, sunflower oil, rapeseed oil and sugar.
(3) See chapter 2 of the «Agricultural Outlook 2011-2020», OECD/FAO. Average volatility observed between 1976 and 2009.
(4) See the box entitled «Oil prices: the role of fundamental factors vs. speculation».

OIL PRICES, INCREASINGLY DECISIVE

Correlation with quarter-on-quarter growth in oil prices



SOURCES: Thomson Reuters Datastream and own calculations.

research, infrastructures and the quality of institutions to ensure that products reach the market. On the other hand, volatility can also be reduced by regulating derivatives markets to improve transparency in price formation (steps are already taken in this direction), as well as reviewing policies that encourage biofuels in order to minimize their distorting effects.

With regard to measures to relieve the effects of volatility, holding emergency reserves at a national or regional level is preferable to global food banks, as the conflicts of interest that arise in their management are thereby eliminated. On the other hand, it is important for small producers in developing countries to have easier access to credit, as well as access to instruments to hedge themselves against the risk caused by differences between the expected price at the time of sowing a crop and the price they are ultimately paid.

In summary, volatility in food prices is a problem that is likely to remain over the coming years due to the difficulty in encouraging a greater growth in supply above the current rates. Because of this, and given the terrible consequences of this volatility on a large number of people, reforms in agricultural, energy and regulatory policies are vital.

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Foreign sector

Exports keep up a good rate

Since the start of 2010, the foreign sector has become the main source of growth for the Spanish economy. The greater dynamism in world trade and the European economy, as well as the recovery in tourism, boosted the exports of goods and services. However, the deterioration in growth prospects of the main advanced countries for the second half of the year could weaken the foreign sector's contribution to the Spanish economy's growth. For the moment, the data available for July show no sign of this.

In fact, July's exports accelerated their year-on-year growth rate compared with previous months to 13.8% while weak demand reduced imports by 1.9% compared with July 2010. This led to further shrinkage in the month's trade deficit, standing at 61.7% year-on-year. As can be seen in the graph below, the main reason behind this reduction was the surplus in the non-energy component, the first recorded in the last 25 years. This improvement is particularly due to the good performance by exports of capital equipment and the automobile sector. However, exports of food fell again.

The deterioration in global growth prospects might affect exports...

The trend in the energy deficit is the opposite. In July, this continued to get worse, with a 4.7% rise year-on-year, although a significant slowdown is

...but, for the moment, they're progressing well.

THE NON-ENERGY SURPLUS BOOSTS THE IMPROVEMENT OF THE TRADE DEFICIT

Monthly non-energy balance

SOURCES: Ministry of the Economy and own calculations.

FOREIGN TRADE

January-July 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	31,946	26.3	21.2	7,514	65.5	6.0	–24,432	23.5
Consumer goods	33,952	0.1	22.5	40,821	12.2	32.7	6,870	120.2
Food	*8,985*	*5.1*	*6.0*	*14,971*	*8.7*	*12.0*	*5,986*	*166.6*
Non-foods	*24,967*	*–1.5*	*16.6*	*25,850*	*14.3*	*20.7*	*884*	*103.5*
Capital goods	9,776	–3.4	6.5	11,120	23.5	8.9	1,344	113.7
Non-energy intermediate goods	75,032	11.4	49.8	65,543	16.6	52.4	–9,489	87.4
By geographical area								
European Union	79,379	4.4	52.7	82,979	14.8	66.4	3,601	104.5
Euro area	*64,546*	*5.5*	*42.8*	*66,431*	*11.4*	*53.1*	*1,886*	*102.9*
Other countries	71,328	17.6	47.3	42,019	24.0	33.6	–29,309	58.9
Russia	*5,360*	*56.6*	*3.6*	*1,408*	*38.0*	*1.1*	*–3,952*	*26.3*
United States	*6,209*	*15.9*	*4.1*	*4,921*	*30.6*	*3.9*	*–1,288*	*79.3*
Japan	*1,900*	*–9.5*	*1.3*	*1,017*	*20.9*	*0.8*	*–884*	*53.5*
Latin America	*9,603*	*22.2*	*6.4*	*7,034*	*26.7*	*5.6*	*–2,569*	*73.2*
OPEC	*15,801*	*21.0*	*10.5*	*4,715*	*23.8*	*3.8*	*–11,086*	*29.8*
Rest	*32,454*	*12.5*	*21.5*	*22,924*	*21.3*	*18.3*	*–9,530*	*70.6*
TOTAL	**150,706**	**10.3**	**100.0**	**124,998**	**17.8**	**100.0**	**–25,708**	**82.9**

SOURCES: Ministry of the Economy and own calculations.

The energy deficit might stabilize over the coming months.

starting to be seen in the energy deficit's rise. This is the result of stabilizing oil prices which, after reaching a peak in April of 123 dollars per barrel of Brent quality, has now stabilized around 110 dollars per barrel.

Trade with European Union countries continues to flow apace and, thanks to this, the surplus increased again. However, we must watch its performance closely over the coming months to be able to gauge the extent that the deterioration in growth prospects for these countries might have on Spanish exports.

The correction of the external imbalance intensifies

Given the good performance of the trade balance, June's current deficit fell for the third consecutive month, with a drop of 38.6% year-on-year. As a consequence, the cumulative deficit for the last twelve months fell to 45 billion euros, equivalent to 4.2% of Spain's gross domestic product (GDP), a level it hasn't seen since mid-2004.

The reasons for this correction lie in improved balances for goods and

services. In the case of the former, the good performance by the non-energy deficit cut the trade deficit by two tenths of a percentage point of GDP compared with the previous quarter. Similarly, the surplus in the services balance grew by three tenths of a percentage point due to tourism's good performance during the second quarter. For their part, both the income and transfer balance remained stagnant. With a view to the future, the current deficit is expected to continue shrinking over the coming months, although at a slightly slower pace. The main engines behind this correction will be tourism and oil prices.

In the first case, the trends recorded during the first few months of the year are expected to continue. August's figures confirm this, with 7.6 million tourists coming to Spain, the highest figure since records began. The rate of growth is expected to fall next year, albeit remaining at a good level. The slower rate in exports might be offset by the slight fall in oil prices predicted for the coming months.

The tensions remaining in Europe's public debt markets will have an effect and this will be reflected in a deteriorating income balance, although it's important to note that this process will be relatively gradual. Nonetheless, the current deficit will end 2011 at around 4.0%, an improvement of 0.5 percentage points compared with 2010. For 2012, in fact, the adjustment is likely to be of a similar size.

The adjustment in the current deficit is progressing apace.

Tourism continues to pick up strongly.

BALANCE OF PAYMENTS

June 2011

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–22,116	–8.4	–45,102	2,529	–5.3
Services					
Tourism	*12,955*	*15.7*	*28,719*	*2,736*	*10.5*
Other services	*1,413*	–	*2,319*	*2,643*	–
Total	14,367	29.1	31,038	5,379	21.0
Income	–13,152	14.2	–23,578	312	–1.3
Transfers	–5,437	5.6	–7,405	475	–6.0
Total	**–26,338**	**–11.3**	**–45,046**	**8,695**	**–16.2**
Capital account	**2,703**	**–25.2**	**5,387**	**–131**	**–2.4**
Financial balance					
Direct investment	–7,572	–	–11,804	–17,662	–
Portfolio investment	11,640	–	57,356	27,055	89.3
Other investment	26,057	–	56,218	114,926	–
Total	**30,125**	**–**	**101,770**	**124,318**	**–**
Errors and omissions	–1,322	–42.1	–1,492	3,846	–72.1
Change in assets of Bank of Spain	–5,168	–	–60,618	–136,329	–

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

Never-ending doubts in the euro area

Spain's risk premium rises to 359 basis points in September.

Tensions in the sovereign debt markets became more intense in the month of September. The predicted slowdown in the European economy and doubts regarding the outcome of the Greek bail-out pushed up the risk premium of the so-called peripheral countries. On this occasion, the bond purchases carried out by the European Central Bank (ECB) did not have the same calming effect as in August. In Spain, the spread between ten-year Spanish and German bonds rose by 79 basis points up to 359 towards the end of the month. In order for this spread to fall to more favourable levels, doubts must fade regarding the solvency of Greek debt and the risk of contagion.

The target deficit for 2011 is 6% of GDP.

In fact, at a European level, the pay-out of the new tranche of aid to Greece and achievement of the targets set in Ireland and Portugal's adjustment plans would help to ease this tension. Moreover, the start-up of the European Financial Stability Facility (EFSF) over the next few months would help things get back to normal.

At the level of Spain, doubts mainly focus on whether the Stability Programme will be achieved. According to this plan, the public sector must reduce its deficit from the figure of 11.1% of gross domestic product (GDP) posted in 2009 to 2.1% of GDP by 2014. For 2011, the target is 6.0% of GDP. Most of this reduction falls on the central government (including the state, autonomous bodies and public corporations), with a target deficit of 4.8% of GDP. The target is lower for the autonomous communities, namely 1.3% of GDP.

The cash deficit falls by 30.6% year-on-year over the first seven months of the year.

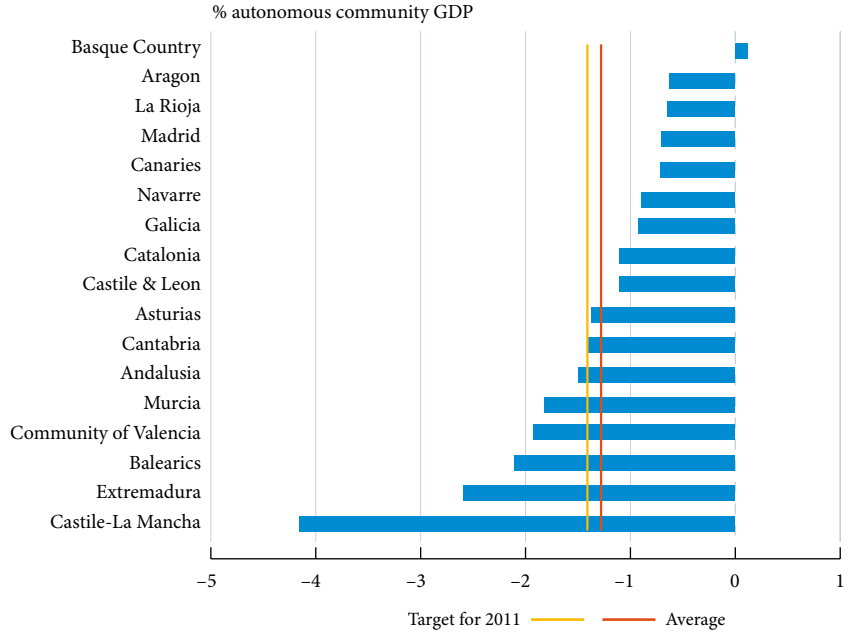
Data on the central government's actual budget situation place the cash deficit accumulated over the first seven months of the year at 20.61 billion euros, 30.6% lower than the figure recorded in the same period a year ago. This figure is in line with the government's target of 44.04 billion euros. In fact, if the current rate of shrinkage continues over the next few months, the final figure might be slightly lower.

An analysis of aggregate cash flow for the central government and the communities shows a certain slowdown in the rate of growth in tax revenue in the first seven months of the year. This is due to the lower contribution from value added tax (VAT) which, in this period, grew by 3.8% year-on-year compared with 9.4% in the first six months. In the case of payments, the government's austerity measures reduced real estate investment by 25.3% compared with the first seven months of 2010. Public employee wages also fell, in this case by 4.2% year-on-year, although the rise in social benefits slightly raised the personnel expenditure for this period.

Unlike the central government, there is the risk that the autonomous communities will not manage to meet their Stability Programme. In fact, during the first six months, the deficit for these communities already represented 1.2% of the GDP forecast for 2011, only one tenth of a percentage point below the

SIGNIFICANT RISE IN THE DEFICIT OF AUTONOMOUS COMMUNITIES

Cumulative deficit for the first two quarters compared with GDP forecast for 2011



SOURCE: Ministry of the Treasury.

target for the whole of year. As can be seen in the graph above, there are notable differences between the various communities. Given this situation, some of them have initiated adjustment plans to sort out their public finances. Nevertheless, the deficit of the autonomous communities is likely to end up slightly above this year's target.

These budget imbalances raise the level of the general government's gross debt to 65.2% of GDP, 4.8 percentage points above the figure for 2010. The privatization of Barcelona and Madrid's airports, as well as 30% of the National Lottery are expected to generate around 12 billion euros. This revenue will help to reduce Spain's debt by close to one percentage point, so that the government's debt target, namely 67.3% of GDP, seems achievable.

Summing up, within a context of high uncertainty in sovereign debt markets such as the present, it's essential for investors to believe in the solvency of Spain's public accounts. Meeting the Stability Programme will help this goal to be achieved. For the moment, the data available up to July are in line with by the targets set in this programme. Only the autonomous community accounts run the risk of deviating slightly from their target. But as this deviation will be slight, it will not increase doubts regarding the country's ability to adjust its public accounts.

The autonomous community deficit already represents 1.2% of GDP in the first six months...

...and runs the risk of deviating from the target set for the end of the year.

Savings and financing

Banks' funding difficulties reduce credit

Sovereign debt tensions fuel uncertainty regarding the solvency of Europe's banks.

Doubts regarding the solvency of European banks resurfaced with force in September. The ever-increasing turbulence in sovereign debt markets and the slowdown in growth in the Old World were enough to raise doubts regarding the stress test results published two months ago. Given this situation, numerous voices, among them the managing director of the International Monetary Fund, are championing the recapitalization of Europe's banking system. This would allow banks to more easily digest the latent losses resulting from their exposure to sovereign debt and, in turn, would reduce the lack of confidence in wholesale financing markets seen over the last few weeks. This last situation has forced the European Central Bank (ECB) to increase its injections of liquidity into the financial system.

In the midst of these tensions, in September the Spanish banking system put an end to half a year of far-reaching transformation. Finally, only four savings banks required aid from the Fund for Orderly Bank Restructuring (FROB) to achieve the new minimum capital requirements demanded by the regulator.

CREDIT TO PRIVATE SECTOR BY PURPOSE

Second quarter of 2011

	Balance (*)	Change this year		Change over 12 months	
	Million euros	Million euros	%	Million euros	%
Financing of production activities					
Agriculture, livestock raising and fishing	22,436	–692	–3.0	–930	–4.0
Industry	146,489	–5,887	–3.9	–5,924	–3.9
Construction	105,489	–9,031	–7.9	–18,566	–15.0
Services	689,436	–5,698	–0.8	–5,171	–0.7
Total	**963,849**	**–21,308**	**–2.2**	**–30,592**	**–3.1**
Financing to individuals					
Acquisition and renovation of own home	655,643	–7,154	–1.1	–4,793	–0.7
Acquisition of consumer durables	40,201	–1,867	–4.4	–4,510	–10.1
Other financing	108,412	497	0.5	–7,899	–6.8
Total	**804,257**	**–8,524**	**–1.0**	**–17,203**	**–2.1**
Other	**49,705**	**3,691**	**8.0**	**18,539**	**59.5**
TOTAL	**1,817,810**	**–26,142**	**–1.4**	**–29,256**	**–1.6**
Acquisition of housing and real estate activities	***933,446***	***–14,785***	***–1.6***	***–18,604***	***–2.0***

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

Thanks to this, Spain's financial institutions have strengthened their balance sheets for the last quarter of the year. Moreover, their exposure to peripheral debt remains very much below the exposure accumulated by institutions from other countries, such as France and Germany. Nevertheless, the challenges for Spain's banks have not disappeared and they must tackle liquidity tensions and the deterioration in the default rate over the next few quarters.

In fact, just like their European peers, Spanish banks have been affected by the closure of wholesale financing markets. Given this situation, in August the sector's dependence on the ECB's resources increased again to almost 70 billion euros, 34.3% more than in July. The high volume of maturities that must be faced by Spanish banks over the next 5 quarters, totalling 150 billion euros approximately, suggests that this trend will remain over the coming months if financing market conditions don't improve.

Financing via the ECB increases in August.

Liquidity tensions reduce the capacity of banks to grant credit. At the same time, the weak recovery of the economy, not enough to reactivate the labour market, is keeping demand for credit at a low level. We have therefore adjusted the drop in credit forecast for 2011 to 3.9% year-on-year. The intense shrinkage of credit in July, of almost 20 billion euros compared with the previous month, supports this revision.

A breakdown of the credit figures for the private sector show a widespread squeeze in the second quarter of the year. In the case of companies, of particular note is the sharp fall in the construction industry of 15% year-on-year. Credit to industry fell by 3.9% compared with the second quarter of 2010. It was a similar situation with credit for consumer durables, posting a year-on-year drop of 10.1%.

Banks' funding difficulties reduce the outstanding credit balance by 20 billion euros.

FINANCING OF NON-FINANCIAL SECTORS (1)

July 2011

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,169,851	–41,848	–1.3	75.7
Non-financial corporations	1,287,431	–25,704	–0.9	44.9
Resident credit institution loans (3)	*868,583*	*–28,892*	*–2.9*	*30.3*
Securities other than shares	*67,169*	*3,047*	*7.3*	*2.3*
External loans	*351,679*	*140*	*2.7*	*12.3*
Households (4)	882,420	–16,144	–1.7	30.8
Housing loans (3)	*671,308*	*–8,650*	*–1.1*	*23.4*
Other (3)	*207,707*	*–7,578*	*–3.7*	*7.2*
External loans	*3,405*	*85*	*6.8*	*0.1*
General government (5)	696,641	54,839	13.7	24.3
TOTAL	**2,866,492**	**12,991**	**2.3**	**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.

The process of private sector deleveraging intensifies.

Lastly, credit to acquire housing also fell, in this case by 0.7% year-on-year.

These figures confirm the intensification of private sector deleveraging in Spain, started in 2010. As can be seen in the above table, in the first seven months of the year, the debt accumulated by non-financial firms and households fell by 41.9 billion euros. We expect this process to remain intense until the end of 2012, allowing a partial correction in the imbalances recorded during the last expansionary cycle. In contrast to private deleveraging, the public sector continued to increase its liabilities, up by 54.8 billion euros between January and July 2011.

The doubtful debt rate keeps rising in July, up to 6.9%.

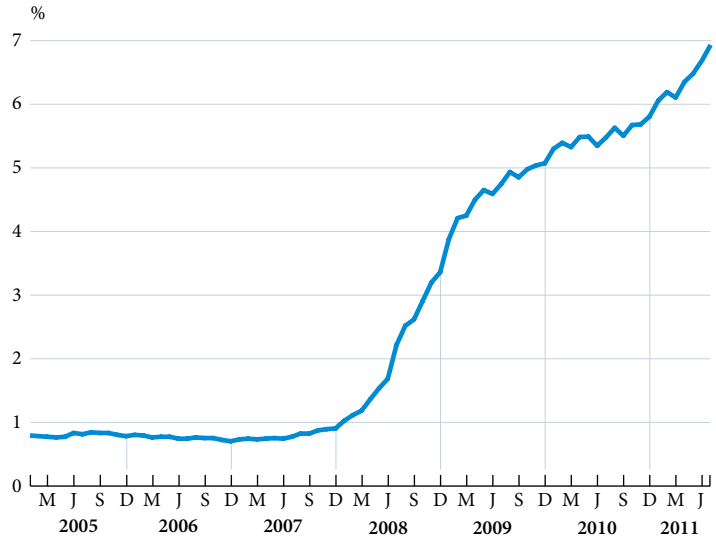
In July, the doubtful debt rate for the system as a whole rose to 6.94%, 25 basis points above the figure for June. Most of this increase was a result of the fall in the outstanding credit balance. The rise in doubtful assets, 2.5% month-on-month, lies behind a third of the deterioration in doubtful loans. By sector, the real estate sector continues to post the highest default rate, this rising to 14.3% and 17.8% for construction firms and developers, respectively. The rest of production kept its default rate at a more moderate level, within a range of 4.9% to 5.3%. Once again, household credit remained practically stable, up two basis points on the previous quarter.

However, the outlook for banks' doubtful loans is not encouraging and these are likely to go on rising over the next few months. This increase will be due to the expected drop in credit in the coming quarters and the weakness of Spain's economic recovery.

In short, the recent recapitalization has strengthened the solvency of Spain's banking system. However, this has not escaped the liquidity tensions affecting Europe's banks. As a consequence, private sector credit is falling faster. All this is

THE DOUBTFUL DEBT RATE WILL SPEED UP ITS RATE OF GROWTH

Doubtful debt rate



SOURCE: Bank of Spain.

happening within a context of a weak recovery for the Spanish economy, which will keep the doubtful debt rate high.

The liabilities war reactivates

Within this context of private sector deleveraging, the deposits of households and firms remained stagnant in July compared with the same month last year. However, an analysis of the different bank liabilities shows an increase in sight deposits while longer term deposits have fallen. This difference is probably due to the longer maturities of products sold a year ago and the discouraging effect of the Decree Law that regulates, as from June, the interest rate for financial institutions' deposits.

In fact, the interest rate for new deposits was reduced by 13 basis points in July, down to 1.65%, putting an end to four consecutive months of rises. This reduction was higher in the case of households. However, the upswing in tension in wholesale financing markets in August and September increased the need for banks to attract deposits from customers for refinancing purposes. This probable new liabilities war will push up interest rates again as from September, narrowing bank margins.

Term deposits are down in July.

With regard to mutual funds, these posted net withdrawals in August totalling 730 million euros.

Funding difficulties suggest that interest rates are likely to rise in the short term.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

July 2011

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	266,131	4,365	1.7	6,890	2.7	19.1
Savings deposits	205,852	–5,435	–2.6	–9,092	–4.2	14.7
Term deposits	724,583	–19,066	–2.6	4,894	0.7	51.9
Deposits in foreign currency	17,489	–1,893	–9.8	–2,119	–10.8	1.3
Total deposits	**1,214,055**	**–22,029**	**–1.8**	**574**	**0.0**	**86.9**
Other liabilities (*)	**182,654**	**–20,358**	**–10.0**	**–5,772**	**–3.1**	**13.1**
TOTAL	**1,396,709**	**–42,387**	**–2.9**	**–5,199**	**–0.4**	**100.0**

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

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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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