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THE SPANISH ECONOMY

Monthly Report

BANKING, UNDER PRESSURE

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2010	2011	2012	2010		2011			
				3Q	4Q	1Q	2Q	3Q	4Q
INTERNATIONAL ECONOMY		Forecast							Forecast
Gross domestic product									
United States	3.0	1.7	2.0	3.5	3.1	2.2	1.6	1.5	1.6
Japan	4.5	–0.6	2.5	5.2	3.3	0.0	–1.7	–0.8	0.0
United Kingdom	1.8	0.9	0.7	2.6	1.3	1.6	0.6	0.5	1.0
Euro area	1.8	1.6	0.3	2.0	2.0	2.4	1.7	1.4	0.9
Germany	*3.6*	*3.0*	*0.7*	*4.0*	*3.8*	*4.6*	*2.9*	*2.6*	*2.0*
France	*1.4*	*1.6*	*0.5*	*1.6*	*1.4*	*2.2*	*1.6*	*1.6*	*1.2*
Consumer prices									
United States	1.6	3.2	2.0	1.2	1.2	2.2	3.3	3.8	3.4
Japan	–0.7	0.1	0.3	–0.8	0.1	0.0	0.1	0.4	–0.2
United Kingdom	3.3	4.4	2.7	3.1	3.4	4.1	4.4	4.7	4.2
Euro area	1.6	2.7	1.6	1.7	2.0	2.5	2.8	2.7	2.7
Germany	*1.1*	*2.3*	*1.7*	*1.2*	*1.5*	*2.1*	*2.3*	*2.4*	*2.4*
France	*1.5*	*2.1*	*1.5*	*1.5*	*1.6*	*1.8*	*2.1*	*2.1*	*2.4*
SPANISH ECONOMY		Forecast							Forecast
Macroeconomic figures									
Household consumption	0.7	0.0	0.0	0.8	0.8	0.5	–0.3	0.4	–0.6
Government consumption	0.2	–1.8	–3.4	0.2	–0.9	0.4	–1.7	–2.3	–3.7
Gross fixed capital formation	–6.2	–4.4	–1.3	–5.5	–5.4	–4.9	–5.5	–4.2	–3.1
Machinery and capital equipment	*5.5*	*2.7*	*1.2*	*7.5*	*5.8*	*5.8*	*1.6*	*2.5*	*0.9*
Construction	*–10.1*	*–7.5*	*–2.3*	*–9.5*	*–9.3*	*–9.3*	*–8.4*	*–7.4*	*–5.1*
Domestic demand (contribution to GDP growth)	–1.0	–1.3	–1.0	–0.7	–0.9	–0.7	–1.7	–1.2	–1.8
Exports of goods and services	13.5	9.0	2.3	11.8	14.9	13.9	8.7	8.1	5.4
Imports of goods and services	8.9	1.3	–1.6	7.0	8.0	7.1	–0.7	0.8	–2.0
Gross domestic product	**–0.1**	**0.7**	**0.2**	**0.4**	**0.7**	**0.9**	**0.8**	**0.8**	**0.4**
Other variables									
Employment	–2.6	–1.7	–2.4	–2.0	–1.4	–1.4	–1.1	–1.9	–2.5
Unemployment (% labour force)	20.1	21.5	22.8	19.8	20.3	21.3	20.9	21.5	22.4
Consumer price index	1.8	3.2	1.4	1.9	2.5	3.5	3.5	3.1	2.8
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	–3.6	–3.3	–6.6	–3.3	–3.1	–3.1
Net lending or net borrowing rest of the world (% GDP)	–3.9	–3.3	–3.0	–3.1	–2.6	–5.9	–2.4	–2.2	–2.6
General government financial balance (% GDP)	–9.3	–7.3	–5.0	–7.9	–13.4	–5.3	–9.9		
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	1.2	1.0	1.0	1.0	1.0	1.2	1.5	1.3
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	2.4	2.4	2.6	3.2	3.1	2.3	1.9
Exchange rate									
$/Euro	1.33	1.40	1.35	1.29	1.36	1.37	1.44	1.41	1.36

Contents

Banking, under pressure

The delicate economic situation being faced by developed economies is affecting many economic agents. And banks are certainly no exception. Recent tensions and turbulences have been closely related to the financial system. Subprime mortgages, real estate bubbles and rising debt in the non-financial private sector are all significant examples. As a consequence, since 2008 the share prices of European banks have clearly fared worse than those from other sectors. Moreover, the risk premium for the banking sector is way above the levels considered to be normal, the sector's credit default swaps have reached a peak and most institutions have seen their ratings significantly lowered by rating agencies.

This tough economic situation makes it difficult for banks to redress their balance sheets. Low growth in activity, high unemployment and the fragile pulse of consumer and business confidence are not helping credit to flow or doubtful loans to decrease. The weakness in the real estate market, the drop in corporate earnings and funding problems in wholesale markets are upping the tension on intermediation between savers and investors, the very foundation of bank operations. But it's not just the macroeconomic context. New regulatory proposals are also adding tension and complicating the management of balance sheets.

These proposals focus on capital. It started with the reforms known as Basel III, aimed at increasing levels of capital and toughening up the definition but with a long-term schedule of implementation. However, the markets and regulators have been pressurizing to bring this schedule forward. The exercise carried out recently by the European Banking Authority has been aimed at demanding higher levels of capital depending on the deterioration of the sovereign debt on institutions' balance sheets. Consequently, either due to credit exposure or sovereign exposure, the financial systems of most European countries are still under tension. On the other hand, national supervisors, individually and independently, have used disparate criteria for their definitions and requirements of capital, as well as different schedules to apply these new rules.

Beyond capital, there are other regulatory initiatives of all kinds, such as those related to liquidity. Changes have also been proposed in the accounting of financial assets, adjustments in the calendar of provisions and duties on financial transactions. Some countries are thinking of splitting investment banking from retail banking. At a global level, more capital is required from systemically important institutions.

In short, the tensions on the financial system are both structural and regulatory in nature. The aim is to construct institutions that are more efficient, better capitalized and with less debt and more liquidity. And this is good for the financial system as a whole, for the economy in general and for customers and citizens. All that remains is for these requirements to be the same everywhere and for them not to be excessive at such a fragile economic juncture.

EXECUTIVE SUMMARY

2012: subtle prospects

Growth is consolidating in the United States.

2012 is starting in the midst of widespread uncertainty regarding whether the world economy will continue to grow. While the United States seems to have a relatively solid expansionary profile, the euro area is very likely to sink into recession and the emerging countries are showing a gradual loss of steam. Although there are many different reasons for these trends, the euro area's sovereign debt crisis looks to be the main source of tension and the cause of a lack of confidence, although December's summit has produced some hope.

China is decelerating, albeit maintaining a notable pace of expansion.

For the moment, the good news lies in the pull provided by the US economy. This has affirmed its growth and has continued what, at first, seemed to be an upswing of limited scope. The latest indicators suggest that fourth quarter growth might exceed 0.7% quarter-on-quarter, clearly above what was expected a month ago. This trend would leave growth for the whole of 2011 at 1.8%. However, this does not mean the crisis has been averted. For 2012, this modest improvement in the outlook for domestic demand might be reduced by the effects of the European crisis and by a probable withdrawal of fiscal policies. Consequently, growth is not expected to go much beyond 2%, a pace that is not enough to bring about the end of a weak labour and housing market.

Brazil's economy slows up.

The slowdown in the pace of economic growth is of some concern in China, although the country continues to stand out from the rest of the emerging economies. For 2012 we predict 8.4% growth, which represents a slowdown although it is still consistent with a soft landing scenario. In the summer, inflation was the greatest hazard and one month ago there was a talk of a fine adjustment but, at the end of the last meeting of the economic authorities, it was established that the main aim of economic policy must be to maintain fast growth within a tough, complicated international environment. Inflation fell sharply in November, with the consumer price index (CPI) posting a rise of 4.2% year-on-year when, in July, this had reached 6.5%. Business indicators also continue to slow up, pointing to a moderation in growth consistent with a soft landing.

The other large emerging country emerging of reference, Brazil, stood still in the third quarter with 0.0% growth compared with the previous quarter. In year-on-year terms growth was 2.2%, the worst figure since the start of the recovery at the end of 2009. Although we already expected the moderating tone to become more accentuated, we did not anticipate such a marked halt, forcing us to revise our central forecast scenario downwards, both for 2011 and 2012. In both cases we have placed the expected rate of growth at around 3%. With a view to 2013, we expect activity to pick up in line with the improved tone expected for the world economy and given it's hosting of the football world cup.

But most concern has been generated by Europe's economy. In the euro area, a slowdown in economic activity will be tone for the coming quarters. From the point of view of demand, household consumption will decline due to the

unfavourable trend in the labour market, whose unemployment rate has gone from 9.9% in April to 10.3% in October. In this six-month period, the number of unemployed in the euro area increased by 634,000. Moreover, the tougher conditions to grant bank credit for families, according to the latest survey carried out by the European Central Bank (ECB), and political uncertainty have discouraged consumers, as reflected by their confidence index which hit a low in December that had not been seen since 2009. With regard to investment, we also expect this to slow up due to the slight deterioration in business sentiment indices in the last few months. For example, the business confidence indicator for the euro area, calculated by the European Commission, has fallen to the same level as in February 2010, after dropping for the last ten months. In addition, the fall in the degree of industrial capacity utilization to below its historical average points to less dynamism in the investment component.

In the euro area, the economy posts a drop in confidence among agents...

However, the main cause of uncertainty in the euro area continues to be the persistence of the sovereign debt crisis and the inability of European leaders to find a way out. Another summit was held on 9 December which aroused great attention given the failure of previous summits and the increasingly delicate situation of the euro area. Its results helped to ease tensions but the decisions adopted did not offer the longed-for definitive solution to the crisis.

...which the sovereign debt crisis has a lot to do with.

The most outstanding agreement was the drawing up of an international treaty between most member states of the European Union (the United Kingdom has now separated itself from this), laying the foundations for strict surveillance of states' budget policies. The maximum structural fiscal deficit allowed will be 0.5% of gross domestic product (GDP) and the maximum conventional deficit will be 3% of GDP, as to date; each state must incorporate an automatic fiscal rebalancing mechanism in its legislation in case the aforementioned maximum deficits are exceeded; the European Commission will supervise the annual budgets of those states involved in an excessive deficit procedure before these budgets can be approved by their respective parliaments; when a state's debt exceeds 60% of its GDP, it will have to present a plan to reduce this debt; there will be automatic penalties for non-compliance for those countries violating the rules, unless a qualified majority of member states opposes this.

The summit held in December proposes strict fiscal discipline...

This is a significant step forward regarding the fiscal discipline of EU states. However, there is uncertainty regarding the final content of the treaty and how it will be drawn up, approved and ratified. Also of concern is the great emphasis on austerity and the absence of objectives such as growth or external competitiveness. Moreover, in the summit's conclusions there are no mechanisms that take decisive action on the immediate problems of the crisis; i.e. on the uncertainty that has taken hold of the markets regarding the solvency of peripheral states. In this respect, it was only agreed that the private sector will not assume any losses due to default by a member state (the case of Greece will not be repeated) and to bring forward the start-up of the European Stability Mechanism (ESM) to 1 July 2012.

In fact, the measures adopted by the ECB have been more effective, lowering the official interest rate by 25 basis points to 1% due to the increased risks faced by the economy because of worsening financial tensions. Moreover, and very importantly, ECB announced two three-year liquidity auctions, a widening of the collateral accepted for bank loans and a reduction

...while the ECB extends its supply of liquidity.

in the reserve requirement from 2% to 1%. Towards the end of the month, the first of the two three-year liquidity auctions was held, providing European banks with 489 billion euros at 1%. On the other hand, the financial and political events occurring during the month have led to a turning point in the trend in risk premia. The chain reaction caused by these factors has resulted in a drop in the risk premia of the economies in the firing line, Italy and Spain.

In spite of this improvement, Spain's risk premium ended 2011 at a significantly higher level than the 250 points recorded at the start of the year. The country's great need for financing in 2012, estimated at more than 160 billion euros, means that the trend in its financing costs takes on a key role.

The Spanish economy suffers drops in GDP and employment.

The Spanish economy is embarking on 2012 with numerous challenges. After posting a positive GDP growth rate for almost two years, the bulk of the evidence available suggests that the engine is faltering again. According to our forecasts, this decline will be modest, just 2 tenths of a percentage point in the fourth quarter of 2011 and, after a first quarter that will also be weak, the economy should be back on the road to growth in the second quarter. This should allow activity to advance by 0.2% for the year as a whole. But the significant fall in growth prospects revealed by the consensus of analysts in December highlights the significant risks threatening the Spanish economy. According to this, growth for the whole of 2012 will be clearly negative, namely –0.2%, a figure that is way below the one given the previous month.

The new government is facing big challenges.

The fast deterioration in growth prospects in the second half of 2011 is largely due to the aforementioned ups and downs in the debt crisis and this has had a severe effect on the performance of the labour market. In November, 111,782 people who were registered as employed with Social Security withdrew their registration. Even assuming that this figure is almost halved when seasonal factors are taken into account, the loss of registered employed in November is the worst since 2008. Since June, the Spanish economy has lost 313,355 registered employed, seasonally adjusted, which is 91,010 more than in these same five months in 2009, when the economy was falling by 3.5% on average.

In spite of this trend, wages rose by 1.2% year-on-year in the third quarter. If the rest of the labour costs are added (such as redundancy payments), the result is a rise of 1.5% in the growth of total labour costs, a surprising figure within the context of job losses. In any case, this rate is lower than average inflation as measured by the CPI, which has remained close to 3% over the last few months. In December, inflation is expected to fall to a level close to 2.5% and this rate is expected to moderate further throughout 2012.

The new government formed after November's elections is facing the challenge of pushing forward with the stabilization of public finances and the restructuring of the financial system, as well as taking measures to boost the competitiveness of the Spanish economy in the medium term. Challenges that are not easy but which the new team has prioritized above all else. The different measures that will probably be revealed over the coming weeks, and particularly the details of the central government budget that must be approved in March, will be fundamental for determining the route the Spanish economy will take.

27 December 2011

CHRONOLOGY

2010

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	**7**	The **European Central Bank** raises the official interest rate to 1.50%.
	21	The countries of the euro area approve a second **bail-out plan for Greece** 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.
October	**26**	The euro summit agrees to launch a **new aid programme for Greece**, with a write-down of 50% of the debt for private investors, to substantially enlarge the lending capacity of the EFSF and to raise the Core Tier 1 **capital ratio of banks** to 9%.
November	**3**	The **European Central Bank** lowers its official interest rate to 1.25%.
	20	The Partido Popular wins the **general elections** with an absolute majority.
December	**8**	The **European Central Bank** lowers the official interest rate to 1.00% and announces two extraordinary auctions of liquidity at 36 months, a widening of the assets accepted as collateral and a reduction in the reserve ratio.
	9	The **European summit** seals a pact to ensure **greater fiscal discipline** by means of an agreement that would involve the 17 members of the euro area plus other EU states that wish to join the agreement.

AGENDA

January

11 Industrial production index (November).
12 Governing Council of the European Central Bank.
13 CPI (December).
17 EU HICP (December).
25 Producer prices (December).
26 Fed Open Market Committee.
27 Labour force survey (fourth quarter).
GDP flash estimate of the United States (third quarter).
30 GDP quarterly flash estimate (fourth quarter).
31 Advance CPI (January). Balance of payments (November).

February

8 Industrial production index (December).
9 Governing Council of the European Central Bank.
15 CPI (January). EU GDP flash estimate (fourth quarter).
16 Quarterly National Accounts (fourth quarter).
24 Producer prices (January).
29 GDP flash estimate (February). EU HICP (January).
Balance of payments (December).

INTERNATIONAL REVIEW

The United States: the winds of improvement

The United States ends 2011 in a more robust state than expected.

The US economy is affirming its growth and continuing what, in principle, appeared to be an upswing limited to the third quarter. The latest indicators suggest that fourth quarter growth might exceed 0.7% quarter-on-quarter, clearly above what was expected a month ago, which would leave growth for the whole of 2011 at 1.8%. However, this does not mean that the crisis has been averted. In 2012, this moderate improvement in the prospects for domestic demand will be reduced by the European crisis and the expected withdrawal of fiscal policy, so that growth is not expected to go much beyond 2.0%, a rate that is not enough to bring about an end to the weak labour and housing market.

Growth will be modest in 2012, affected by the European crisis.

The good tone expected for the fourth quarter is based equally on the robustness of capital goods investment in addition to an upward stock cycle and private consumption that, judging by the latest indicators, will maintain the good tone of the third quarter. Another positive factor to take into account for 2012 might be less of a fiscal withdrawal than expected. The heads of agreement reached by the Senate to extend the lower tax rate on wages and unemployment insurance, should it be approved by Congress, would avert the threat posed to the development of

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011				
			4Q	1Q	2Q	3Q	October	November
Real GDP	–3.5	3.0	3.1	2.2	1.6	1.5	–	...
Retail sales	–7.0	6.4	7.6	8.2	7.8	8.0	7.5	6.7
Consumer confidence (1)	45.2	54.5	57.0	66.9	61.8	50.3	40.9	56.0
Industrial production	–11.2	5.3	6.2	5.4	3.8	3.7	4.3	3.7
Manufacturing (ISM) (1)	46.3	57.3	57.9	61.1	56.4	51.0	50.8	52.7
Housing construction	–38.4	5.6	–5.1	–5.3	–4.9	4.4	16.5	24.3
Unemployment rate (2)	9.3	9.6	9.6	8.9	9.1	9.1	9.0	8.6
Consumer prices	–0.4	1.6	1.3	2.1	3.4	3.8	3.5	3.4
Trade balance (3)	–381.3	–500.0	–500.0	–520.4	–536.0	–540.5	–544.5	...
3-month interbank interest rate (1)	0.7	0.3	0.3	0.3	0.3	0.3	0.4	0.5
Nominal effective exchange rate (4)	77.7	75.4	73.0	71.9	69.6	69.8	71.6	72.2

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

THE UNITED STATES: PRIVATE CONSUMPTION CONTINUES TO ADVANCE

Real retail sales without vehicles or petrol

NOTE: (*) Data adjusted by the consumer price index without energy or foods.
SOURCES: Department of Trade and own calculations.

employment and private consumption by such measures coming to an end.

However, this improved outlook is likely to be sullied by the European crisis. Europe's banks hold 3.3% of the total gross debt of the US economy, 1.8 trillion dollars combining that of households, firms and the public sector. Should the European crisis continue for some time, this would result in tougher financing terms for this debt which could deduct up to 0.8% points from growth in 2012, a probability that pushes the 2012 forecast down.

The good performance shown by private consumption was mainly reflected in the sharp rise in consumer confidence. In November, the Conference Board Consumer Confidence index saw its highest monthly increase of the last 15 years, going from 40.9 to 56.0 points. Although this level is still more consistent with recession than expansion, such improvement confirms that the recovery is becoming more firmly established. A good example of this is the good performance by retail sales. Excluding the volatile automobiles and petrol, retail trade was up 5.6% year-on-year in November, with a slight slowdown in the indicator due to, in part, the upwardly revised figures for October and September. Nevertheless, during the first half of 2012 the push from private consumption will be limited by the trend in household income, still growing less than consumption.

Consumer confidence improves.

This necessary improvement in income will depend on the trend in the labour market, which is the true touchstone for this crisis. The weakness in the labour market has been closely linked to the bursting of the real estate bubble but some figures suggest that employment might recover faster than housing. To date, the recovery in the labour market has been partly hindered by the high rate of under-employment; i.e. workers who are involuntarily working part-time. This

The labour market is still weak, with a slow recovery.

The recovery might start with a reduction in under-employment.

is the case because, when the demand for labour increases, these under-employed workers recover the hours they had lost, delaying the hiring of new employees. The share of under-employed workers is still very high, with 8.4 million workers stating that they are working part-time due to a lack of demand. Of the 8.75 million jobs lost during the crisis, only 2.5 million have been regained in the last 21 months.

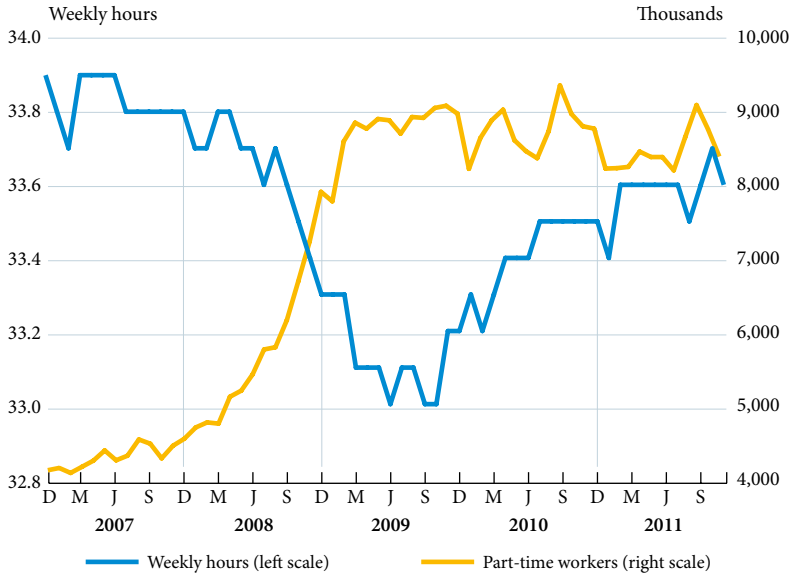
However, things might be starting to change. In November, the figures for hours worked reached 33.6 hours a week on average, close to the pre-crisis level (33.8) and leaving behind the minimum of 33.0 hours that had prevailed between June and October 2009. Historically, an increase in hours worked per week precedes a reduction in under-employment so that, should this pattern continue, we might start to see some reduction in under-employment over the coming months. This would result in an effective recovery of the labour market, which would start to be seen in the second half of 2012. The road is still plagued with difficulties, however. In November, unemployment fell to 8.6% but this improvement was largely due to a smaller labour force and all the evidence suggests that it won't move very far from 9.0% throughout 2012. The two million jobs lost in the construction industry, whose workers are difficult to relocate, the high number of discouraged workers and the proportion of long-term unemployed continue to weigh heavy on its recovery.

House prices continue to fall.

The housing market is still afflicted by excessive supply, boosted by mortgage foreclosures. Consequently, prices have yet to touch bottom. The drop in the Case-Shiller index for second-hand housing, which in September was sharper than in August, points to the recovery still being some time off (the second half of 2013, according to our forecasts). The

THE UNITED STATES: A RECOVERY THAT HAS TO BE CONFIRMED

Weekly hours and part-time workers due to economic reasons



SOURCES: Department of Labor, US Census and own calculations.

improvement in construction activity is based on low base levels. The 685,000 new homes started in November, in annual terms, represent a rise of 24.3% year-on-year, which will mean that the sector will contribute to growth, but the reality is that these levels are still less than half the typical levels in the period 1995-2000, prior to the bubble.

With regard to investment, improvements in corporate earnings and tax breaks for investment, which might also be extended to 2012, contributed to a strong advance in the third quarter that will probably moderate gradually. The question here is one of sustainability. Perhaps because of this, the improvement in the business sentiment indices of the Institute of Supply Management (ISM) for manufacturers and services is much more timid that the growth in investment spending in the third quarter. The manufacturing ISM for November rose by 50.8 to 52.7 points, while the services index went from 53.8 to 56.2 points.

Levels that, although better, are still consistent with modest economic growth. Along the same lines, although industry still has a long way to improve, its rate of recovery is tending to subside. Proof of this is the trend in industrial production, which dropped back slightly in November, as well as the slowdown in the improvement in production capacity utilization, which has been slower throughout 2011 than in 2010.

Industry has plenty of room to improve but moderates its recovery.

The persistence of low growth and commodity prices whose trend is nothing like the one seen in the first half of 2011 should make inflation ease throughout 2012. However, in November the consumer price index (CPI) saw a minimal slowdown, with a year-on-year rise of 3.4% (3.5% in October) while, for its part, core inflation, which excludes energy and food prices, halted its downward slide of the last few months to post an increase of 2.2% year-on-year, slightly higher than the 2.1% of October. The contribution to inflation of rent

The CPI rises 3.4% and core inflation by 2.2%, but it should ease in 2012.

THE UNITED STATES: A DISTANT RECOVERY FOR CONSTRUCTION

Homes started in annual terms

SOURCES: Department of Commerce and own calculations.

Japan sees a decline in 2011, while it expects 2012 to be a year of expansion.

attributed to housing moderated in November but was replaced by other components, such as clothing and healthcare.

The correction in the foreign sector's trade imbalance continues. The trade balance of goods and services for October was 43.5 billion dollars, 24.4 billion excluding oil and its derivatives, the lowest figure since June. However, in October the improvements were more because of weak imports than increased exports that, after two months of rises, suffered from weaker global demand. The foreign sector's contribution to growth will therefore be limited in 2012, so the US economy will have to continue to look to its domestic demand for support.

Japan: worse than expected

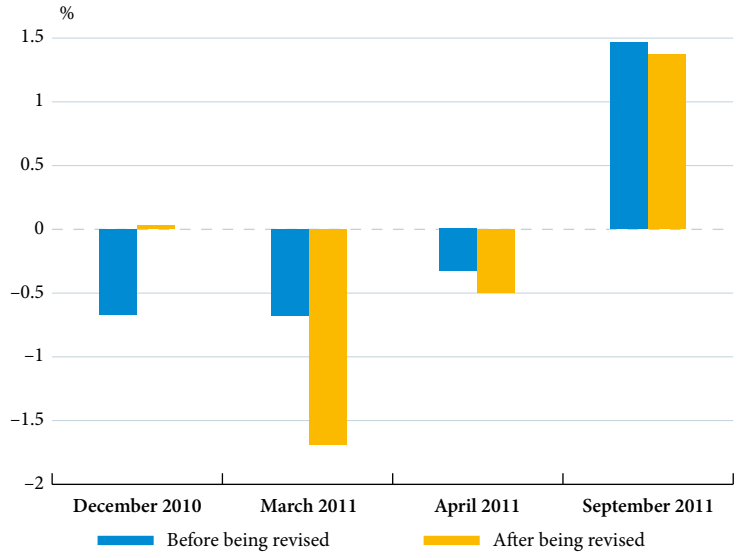
But growth will suffer from weak global demand.

Japan significantly revised downwards its growth for the first three quarters of 2011, particularly the first quarter. This reveals that the consequences of the earthquake in March and of the Fukushima nuclear crisis were more severe than had initially been thought, so we believe that the economy will decline by close to 0.6% for 2011 as a whole. The recovery should gain in strength in 2012, with growth coming close to 2.5%. This strength will be based on low base levels, as the declines of 2011, added to those of 2009, will mean that the economy will still be clearly below its production potential for the next two years.

Given its dependence on exports, which provided five sixths of the economy's total growth in the third quarter, the recovery will be hindered by the slowdown in world demand. Exporters blame the strong yen and have lowered their expectations, as shown by the Tankan business sentiment index published by the Bank of Japan. Similarly, the 3.5% drop in exports month-on-month in October points to more modest rises in the fourth quarter.

JAPAN: MORE SERIOUS THAN WAS THOUGHT

Quarter-on-quarter growth in GDP



SOURCES: Japanese Ministry of Communications and own calculations.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011				
			4Q	1Q	2Q	3Q	October	November
Real GDP	–5.5	4.5	3.3	0.0	–1.7	–0.8	–	...
Retail sales	–2.3	2.5	–0.4	–3.0	–1.7	–1.0	1.9	...
Industrial production	–21.8	16.6	6.8	–2.5	–7.0	–2.0	0.1	...
Tankan company Index (1)	–40.8	0.0	5.0	6.0	–9.0	2.0	–	–4.0
Housing construction	–27.7	2.7	6.8	3.2	4.3	7.8	–5.7	...
Unemployment rate (2)	5.1	5.1	5.0	4.7	4.6	4.4	4.5	...
Consumer prices	–1.3	–0.7	–0.3	–0.5	–0.4	0.1	–0.2	...
Trade balance (3)	4.0	7.9	7.9	6.5	3.4	1.3	0.2	...
3-month interbank interest rate (4)	0.58	0.39	0.34	0.34	0.34	0.3	0.3	0.3
Nominal effective exchange rate (5)	98.6	106.0	111.0	110.6	109.3	115.5	118.8	118.0

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.

Another difficulty lies in the indebtedness of the country's public coffers. In this respect, after several extraordinary reconstruction budgets, public expenditure was already showing signs of exhaustion in the third quarter. On the positive side, industrial production grew by 2.2% month-on-month after September's bad figures.

The CPI also fell in October to 0.2% year-on-year, while the core CPI, the general index without energy or food, fell to 1.1% year-on-year, indicating that deflation continues.

China: the priority is to go on growing

The possibility of lower economic growth has become the main risk for China's economy. For 2012 we predict 8.4% growth, which represents a slowdown although it is still consistent with a soft landing scenario. In the summer, inflation was the greatest hazard; one month ago there was talk of a fine adjustment but, at the end of the last meeting of the economic authorities, it was established that the main aim of economic policy must be *to maintain fast growth in a tough, complicated international environment.*

Inflation fell sharply in November, with the CPI posting a rise of 4.2% year-on-year, when in July this had reached 6.5%. The CPI for food, which in China accounts for half the general index, slowed up even more to 8.8%, clearly lower than the 14.8% for July. Similarly, business indicators continue to decelerate, pointing to a moderation in growth consistent with a soft landing. Industrial production advanced by 12.4% year-on-year, the slowest pace since April 2009, and electricity production and retail sales moved along the same lines.

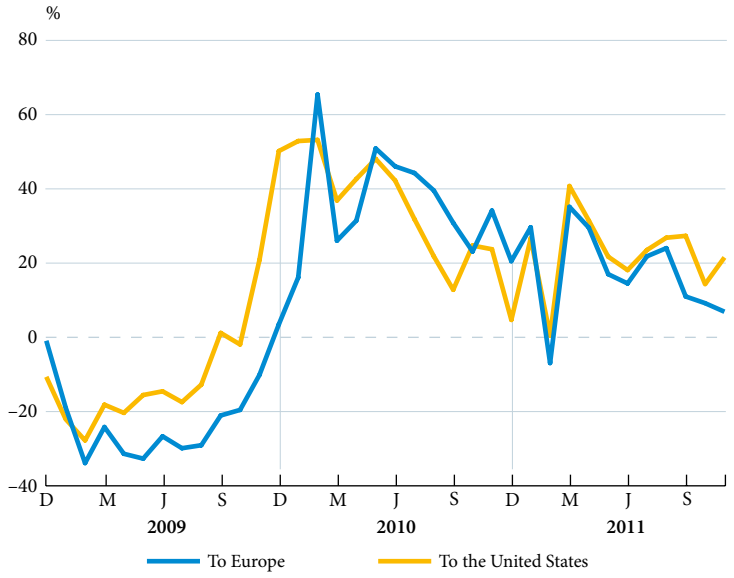
The foreign sector, once the bastion of economic expansion, continues to

Public indebtedness is high and deflation continues.

China is slowing up, with a growth forecast of 8.4% for 2012.

CHINA: EXPORTS AREN'T WHAT THEY USED TO BE

Year-on-year change in exports



SOURCES: Chinese National Statistics Office, London Market and own calculations.

Exports continue to fall behind, affected by the European crisis and Asia's lower demand.

weaken. November's trade surplus fell to 14.5 billion dollars, a little more than half the average of 2008, prior to the crisis in world trade, and with exports that continued to fall behind compared with the economy as a whole. By geographical area, the slowdown in exports to the rest of Asia is particularly significant, accounting for half the total and whose year-on-year growth of 13.4% is the lowest since the 2009 crisis in trade flows. The European crisis is also having an effect on Chinese exports. Exports to Europe rose by a meagre 6.9% year-on-year while those for the United States grew by 21.5%.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2009	2010	2010	2011				
			4Q	1Q	2Q	3Q	October	November
Real GDP	9.2	10.4	9.8	9.7	9.5	9.1	–	...
Industrial production	12.5	14.5	13.3	14.5	13.9	13.8	13.2	12.4
Electrical power generation	6.8	14.0	6.2	12.1	12.0	10.8	9.4	7.5
Consumer prices	–0.7	3.3	4.7	5.1	5.7	6.3	5.5	4.2
Trade balance (*)	196.4	185.1	185.1	169.4	174.8	172.9	162.8	154.4
Reference rate (**)	5.31	5.31	5.81	6.06	6.31	6.56	6.56	6.56
Renminbi to dollar	6.8	6.8	6.7	6.6	6.5	6.5	6.4	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.

With a private consumption that still accounts for less than 40% of gross domestic product (GDP) and a foreign sector that is losing its drive, the supports for growth are limited to investment. Of particular note within this area of investment is the housing sector. Construction accounts for 13% of GDP and absorbs close to 40% of the steel consumed by China, the world's largest importer. Real estate operations have fallen sharply over the last few months due to monetary restrictions and there are signs of a hangover in prices. These are particularly falling in Wenzhou, in the province of Zhejiang, one of the most dynamic in the country, and are perhaps acting as an early indicator. Another clue to this exhaustion in real estate might be the price of iron, one of the commodities that have fallen the most over the last few months. The bad practices of local authorities, monopolizing land and selling it to the highest bidder in order to sort out their debt, as well as interest rates that are below the rise in the CPI have all led to price rises.

The land acquired by developers and the large number of vacant properties point to the existence of excess supply, although we should remember that it's difficult to compare the housing situation in China with other economies, given the significant growth in incomes and migratory flows to urban areas. An abrupt end to real estate expansion could push growth down but if, as stated by the conclusion from the authorities' meeting, the main priority is now to maintain growth, we should expect expansionary monetary policies to continue, helping to minimize the risk to housing.

Residential construction shows signs of exhaustion and constitutes a risk to growth.

Brazil: a hard landing or just downtime?

Brazil's economy stalled in the third quarter, advancing by 0.0% compared with the previous quarter. In year-on-year terms growth was 2.2%, the worst figure since the start of the recovery at the end of 2009. Although we already expected the moderating tone to become more accentuated, we did not anticipate such a marked halt, forcing us to revise our central forecast scenario downwards, both for 2011 and 2012. In both cases we have placed the expected rate of growth at

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011				
			4Q	1Q	2Q	3Q	October	November
Real GDP	–0.3	7.6	5.4	4.2	3.2	2.2	–	...
Industrial production	–7.3	10.5	4.1	2.5	0.6	0.1	–2.7	...
Consumer confidence (*)	138.3	159.7	159.9	161.8	155.4	153.3	151.9	155.4
Unemployment rate (**)	8.1	6.7	5.7	6.3	6.3	6.0	5.8	...
Consumer prices	4.9	5.0	5.6	6.1	6.6	7.1	7.0	6.6
Trade balance (***)	25.3	20.2	20.2	22.5	25.3	30.5	31.1	31.3
Interest rate SELIC (%)	9.92	10.00	10.75	11.75	12.25	12.00	11.50	11.50
Reales to dollar (*)	2.32	1.78	1.66	1.63	1.56	1.88	1.72	1.81

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.

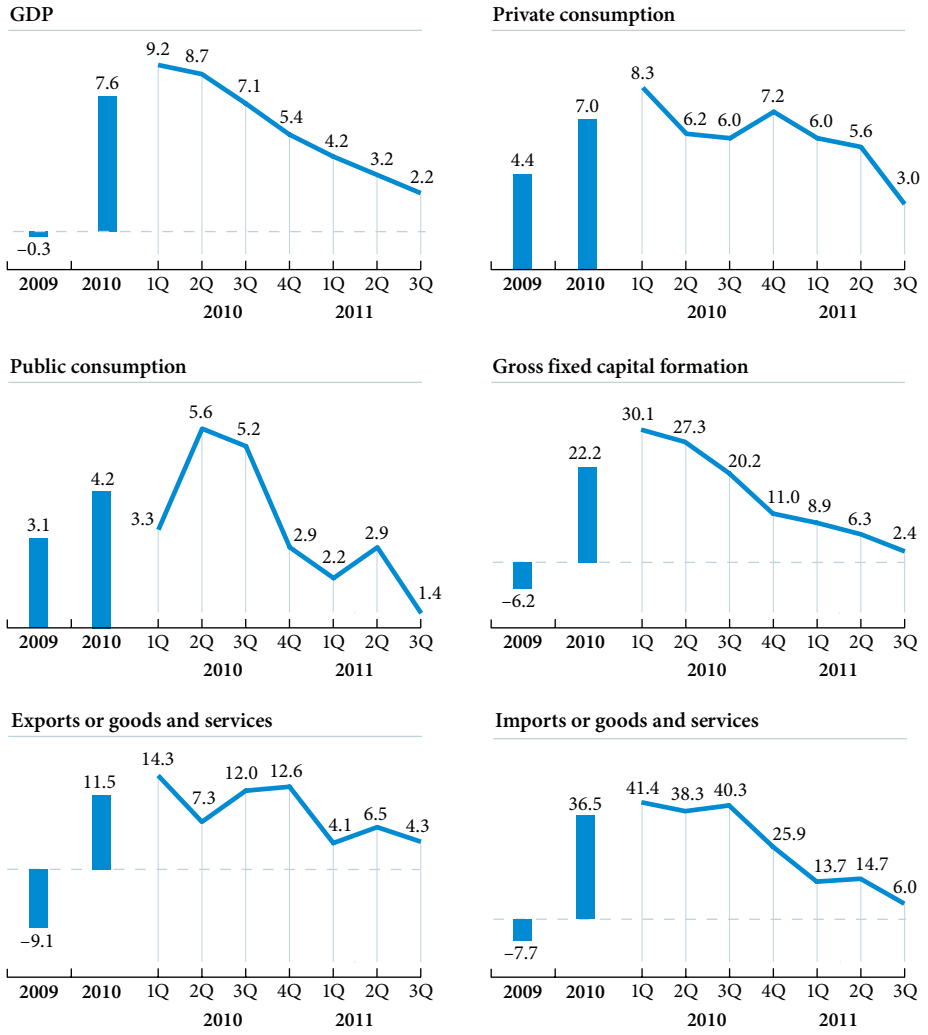
Brazil's economy stalls in the third quarter.

around 3.0%. With a view to 2013, we expect activity to pick up in line with the improved tone expected for the world economy and given the impending football world cup.

Brazil's economic growth is still being supported by strong domestic expenditure although this is losing steam somewhat. After growing by an average of 6.1% year-on-year for nine consecutive quarters, consumption halved its growth (+3.0% year-on-year) in the third quarter of 2011. Imports also dropped off and went from a 14% increase year-on-year in the second quarter to 6% in the third. Investment and public consumption slowed down less, advancing 1.4% and 2.4% (year-on-year) respectively. Exports were able to maintain their position better than the rest of the items and grew by 4.3%, benefitting from a weaker real.

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms



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

In spite of the standstill reflected by the data for the third quarter, Brazil's government continues to forecast growth in GDP of around 3.5% in 2011. Nonetheless, and although the confidence of Brazilian consumers in their economy remains historically high and picked up again in November, most leading indicators for activity do not provide much support for this prediction as they are pointing to weak growth for the last quarter of the year. To begin with, industrial production dropped markedly in October (–2.7% compared with the same month in 2010). That same month, retail sales surprised many with a fall of 0.5% compared with September, in spite of the robustness of employment. On the other hand, although it's true that the purchasing managers' index (PMI) improved for the second month in a row in November, thanks to the good performance by services, the manufacturer index remains at levels indicative of a decline, despite a slight upswing that took it to 48.7 points.

Given this scenario and with prices also tending to ease, we predict that, in 2012, the central bank of Brazil will introduce further interest rate cuts and the government will continue to implement both fiscal and macroprudential stimuli, such as relaxing reserve requirements for credit. This countercyclical tone of economic policies is not without its risks, given that inflation has yet to fall back down to its target range and the real's recent weakness is not helping to ease pressure on prices. However, the fear of a rough landing is currently stronger than the spectre of inflation.

Macroeconomic indicators continue to point to weakness.

Monetary policy will remain countercyclical in 2012.

Mexico: watching the peso

A breakdown of GDP for the third quarter revealed stronger domestic expenditure than expected, especially in terms of growth in private consumption, which more than offset the loss of steam in the exports of goods and services (see the graph below). In this way, supported by growing domestic demand and the relative resistance of foreign demand, the Mexican economy is continuing to advance with reasonable expansion, resisting the winds of moderation

The Mexican economy continues to advance with reasonable expansion.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011				
			4Q	1Q	2Q	3Q	October	November
Real GDP	–6.2	5.4	4.2	4.3	3.6	4.5	–	...
Industrial production	–7.3	6.0	4.7	4.9	3.9	3.4	3.3	...
Consumer confidence (*)	80.5	86.3	89.6	92.1	90.7	93.7	90.6	89.6
Leading business index (*)	110.5	116.6	118.1	119.8	120.8	123.1	...	...
Unemployment rate (**)	5.5	5.4	5.3	5.1	5.2	5.7	5.0	...
Consumer prices	5.0	3.9	4.2	3.5	3.3	3.4	3.2	3.5
Trade balance (***)	–4.7	–3.0	–3.0	–1.5	0.0	–1.5	–1.2	...
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	12.35	11.90	11.72	13.78	13.21	13.60

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

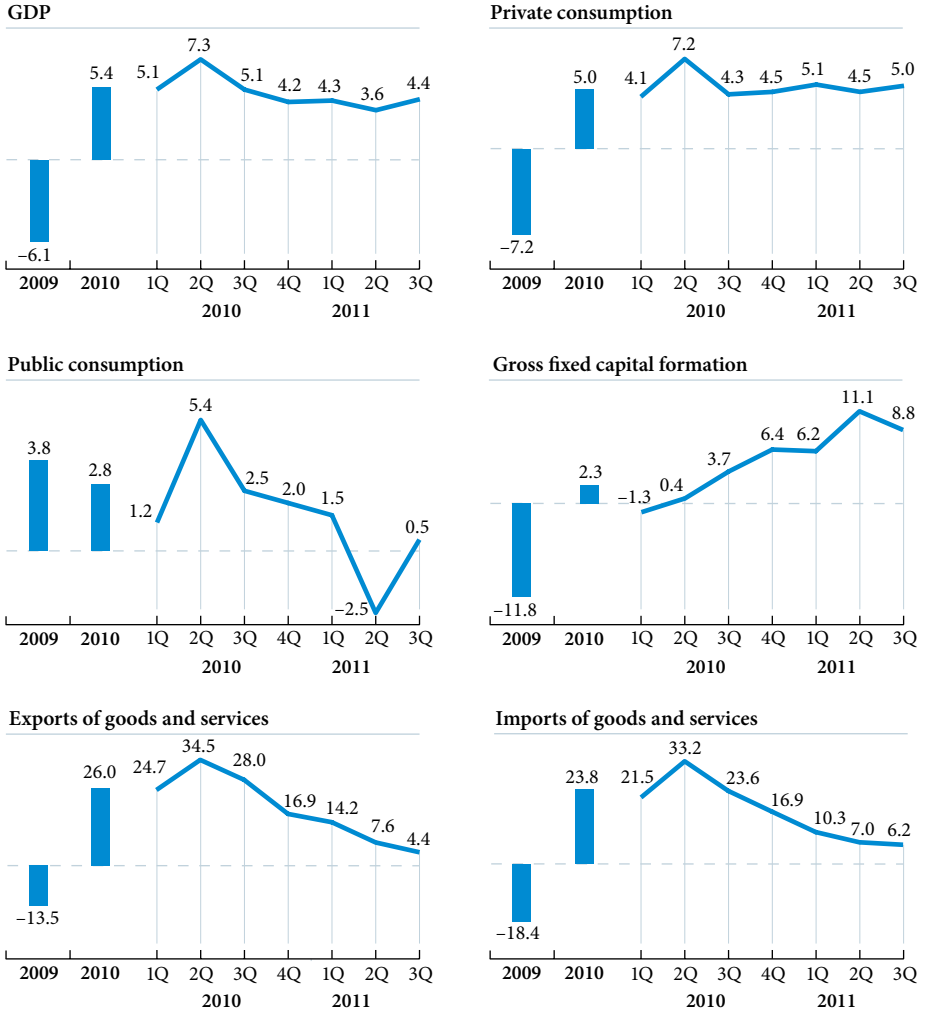
The peso's depreciation might complicate the expansionary shift in monetary policy.

affecting part of the world's economy. In 2012, these winds are likely to end up forcing a more notable slowdown in Latin America's second economy but it still has some leeway to implement more economic stimuli in order to contain such a slowdown. With a view to 2013, growth should regain its momentum.

In any case, the peso's recent depreciation, although boosting activity, might complicate the countercyclical resource of monetary policy. For now, the general and core inflation rates are still within their target ranges and, provided there are no setbacks, should remain there throughout 2012. However, the last minutes of Banxico's Monetary Policy Committee hinted at some concern due to the greater than expected impact on domestic prices of the trend in the exchange rate. Should this be the case, the official interest rate is less likely to be cut over the coming months, something that

TREND IN MEXICO'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Banco de México and own calculations.

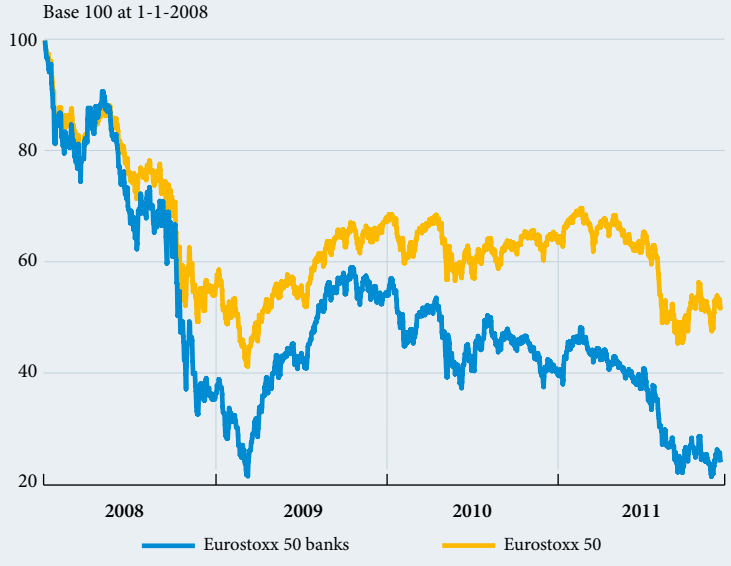
had become more possible after the minutes for November. Nonetheless, the weakness of the global recovery and an output gap that is still in negative terrain and which will ease the pressure on prices also rule out any restrictive shift in monetary policy.

In any event, 2012 looks a little more complex than 2011 for the Mexican economy. The main threat continues to come from abroad: a sharper decline in the pace of economic growth or a marked upswing in risk aversion, both at a global level, could result in a bigger slowdown than expected. Nonetheless, the seriousness and orthodoxy of the economic management over the last few years boost confidence in Mexico's economic future and suggest that the expansionary path embarked upon after the crisis will continue.

Strong and continuing pressures on the financial system

Looking at the evolution of bank shares in the stock markets, it can be deduced that, over the last few years, they have been especially gripped by the international crisis. Since 2008, when the financial crisis originating in the United States erupted in Europe, bank stocks have performed worse than the average (Eurostoxx Index). There were signs of a recovery at some points in 2009 but, in 2011, the difference between banks' and the average performance has widened, as can be seen in the graph below. The risk premium of the banking sector has also shot up and the sector's Credit Default Swaps (CDS) went above 300 basis points in the summer of 2011. Most of the banks have had their rating downgraded by rating agencies.

STOCK MARKET EVOLUTION OF THE EUROSTOXX 50 INDEX AND BANKS OF THE EUROSTOXX 50



SOURCE: Bloomberg.

Many events that have occurred regarding the financial system help to explain this trend and the complex perspectives. On the one hand, the economic situation is having a direct effect. A weak macroeconomic environment affects business volumes and, particularly, the flow of credit. Moreover, lasting high unemployment rates influence consumption and the doubtful debt rate. This, together with the trend in property prices, means that doubtful loans related to the real estate sector continue to damage banks' balances, especially in those countries with a real estate bubble. In fact, the stress tests carried out by the European Banking Authority (EBA) are mainly aimed at making credit exposure more transparent, as well as requiring higher levels of capital to cope with deterioration forecasts and potentially risky economic scenarios. In this respect, countries such as Spain and Ireland stood out due to their high exposure to real estate. In Ireland, this situation, together with other factors, led to the country's bail-out and that of its financial system and, in Spain, to an unprecedented restructuring which is still ongoing.

But the international banking scenario is even more complex since, for the rest of the countries, exposure to sovereign debt has turned out to be a great risk. The levels of public indebtedness in some euro area countries are very high and, given the lack of clear political commitment in the euro area, these are creating doubts and tensions in the financial markets. The risk premium has, therefore, reached historically high figures. In Greece, it has risen to 3,000 basis points and in Portugal it stands at around 1,200 basis points. In Italy and Spain it has often gone way above 400-450 basis points and France is not exempt from this tension either, with levels close to 200 basis points.

In general, the financial system's exposure to euro area sovereign debt is high. The main problem is the bad perception of solvency, leading to tension in debt markets and real liquidity problems for financial institutions, beyond the rising cost of funding. Because of this, the EBA has also carried out a detailed analysis and is demanding higher levels of capital depending on the deterioration of the sovereign debt on institutions' balance sheets.[1] For example, while French and German institutions were not among those mentioned in the first stress tests on credit exposure, they stand out in the new analysis due to their high sovereign exposure. Consequently, either due to credit exposure or to sovereign exposure, financial systems from most of the European countries are under huge tension.

The capacity of institutions to generate profits is also being significantly reduced due to business tensions: less revenue and higher costs resulting from greater risk and more expensive financing. Therefore states and central banks have had to adopt new measures to support the financial system.

Within this already difficult context, numerous regulatory proposals are being planned, aiming to achieve more efficient, better capitalized, less in debt and larger instiutions in the medium term. And this is good for the financial system as a whole, for the economy in general and for customers and citizens. However, higher requirements, constant regulatory changes and the current lack of specific details are generating uncertainty and pressure in the short term.

Most of the measures that have been proposed/adopted are related to capital. Everything started with the Basel III proposal to increase the level of capital and toughen up its definition but with a long implementation schedule, which in practice markets are anticipating. Moreover, the stress tests and markets have increased demands, up to the 9% of Core Tier 1 required in the last analysis developed by the EBA. And different criteria have been applied

(1) See Jordi Gual (2011), «The Eurozone debt crisis: is this a banking problem?», published in VoxEU.org, 13 September.

by different national supervisors, individually and independently. In Spain, in February 2011, a minimum of 8%-10% for a new concept of capital, namely principal capital, was demanded. In Austria, the application of Basel III has been brought forward to January 2013 and additional buffers of 3 percentage points will be required. In the Netherlands, United Kingdom and Switzerland capital requirements have been increased for systemically important institutions.

As a result of these proposals, the procyclicality of capital requirements is increasing, as well as uncertainty regarding future levels and definitions, forcing banks to make an additional effort to retain profits and have access to capital markets, thereby restricting their capacity to grant credit.

SOME REGULATORY PROPOSALS AND DIFFERENT CIRCUMSTANCES THAT ADD TENSION TO THE FINANCIAL SYSTEM

European Banking Authority

- 2010 stress tests: 5% Tier 1.
- 2011 stress tests: 5% Core Tier 1.
- Sovereign debt: 9% Core Tier 1.

European Union

- Proposal to tax financial transactions.
- *Ex ante* provision for deposit guarantee funds (1.5% of available funds).

Basel III

- Minimum ratio increased from 2% to 7%.
- Implementation from 2013 to 2019.
- Tougher definition of capital.
- Short and long-term liquidity ratios introduced.

Financial Stability Board

- Plans to resolve and liquidate systemically important institutions.

Denmark

- Resolution of institutions: 2 institutions bankrupt without government bail-out.

Austria

- BIS III brought forward to 2013.
- Additional capital requirement of 3 p.p.
- Loans/deposits ratio in CEE (*) below 110%.

Ireland

- Aggressive deleveraging plan for the system.
- Stress test and recapitalization: 9% of capital in the stress scenario.

United Kingdom (Vickers report)

- Proposal to separate investment and retail banking.
- Greater capital requirements for large institutions.

Spain

- Royal Decree Law 2/2011: capital requirement of 8%/10% of principal capital.
- Royal Decree 771/2011, penalizing high return deposits.

Hungary

- Exchange rate altered for mortgages in Swiss francs.

NOTE: (*) CEE: Central and Eastern Europe.
SOURCE: Own calculations.

Apart from capital, there are regulatory initiatives of all kinds. Among others, changes have been proposed in the accounting of financial assets, as well as adjustments in the calendar of provisions and/or duties on financial transactions. Moreover, in Anglo-Saxon areas, there are plans to separate investment banking from retail banking. In Austria, subsidiaries in Eastern Europe must maintain a ratio of credit over deposits below 110%, forcing them into divestments. And, to give one last example, a strict system was implemented in Denmark to liquidate institutions with private sector involvement, which led to the bankruptcy of two institutions and generated doubts regarding the system.

In summary, the pressure on the financial system comes from both structural tensions related to business as well as tensions due to the need to comply with new regulatory requirements. As a result, between 2008 and 2010, European states have been forced to restructure or liquidate up to 37 financial institutions in 14 countries. Moreover, European states have allocated 1.1 trillion Euros to grant debt issues by financial institutions and a further 0.5 trillion Euros to recapitalize them, as well as other forms of support. But the situation is clearly not the same for all institutions. Although no-one is free from pressure, depending on the business model and especially their ability to manage and anticipate it, some institutions are handling the situation better and maintaining their ability to grant the flow of credit, a fundamental mission of the financial system to boost the economy.

This box was prepared by Anna Mialet Rigau
Economic Analysis Unit, Research Department, "la Caixa"

At 107.4 dollars, oil prices are still more reluctant to fall than other commodities.

The downward slide continues, including gold.

Widespread drops except for oil

The price of crude remained practically unchanged between 22 November and 22 December, dropping a minimal 0.7%, taking it to 107.40 dollars per barrel (Brent quality, for one-month deliveries), 15.9% higher than the start of the year and 14.4% higher than last year's level.

Oil prices were still reluctant to fall in spite of OPEC announcing that it would not reduce production below 30 million barrels a day. One possible explanation for this resistance, which contrasts particularly with the price of metals, is that its demand is falling at a slower rate than demand for the rest of commodities in general. The persistence of political unrest in oil-producing areas such as North Africa and the Middle East and the tensions in Iran and Russia are also buoying up the price of crude.

Commodities had a markedly downward month. The CRB index fell by 2.2% between 20 November and 22 December, accumulating a 17.8% drop since the annual peak at the beginning of April. Precious metals increased the losses in the general index, a trend that included gold, down 5.1% in the month and which, standing at 1,610.0 dollars per ounce, was 11.8% below the peak reached in August. Base metals continued to suffer from China's weaker demand, with both iron and aluminium falling. However, nickel and copper picked up in reaction to previous falls. Losses also predominated among foods, with the exception of wheat and tea.

EUROPEAN UNION

The euro area: the right direction but slow speed in legislative changes

Since the European Coal and Steel Community was set up in the 1950s, the embryo for the future European Union (EU), the member states have clearly leaned towards economic and political unity. The last European summit, held on 9 December, has been no exception and this path has been furthered through the agreements reached.

The following are particularly important among the main measures adopted: 1) The maximum structural fiscal deficit allowed will be 0.5% of gross domestic product (GDP) and the maximum conventional deficit will be 3% of GDP, as it is at present; 2) Each state must incorporate an automatic fiscal rebalancing mechanism in its legislation in case the aforementioned maximum deficits are exceeded; 3) The European Commission will supervise the annual budgets of those states involved in excessive deficit procedures, before these budgets are approved by their respective parliaments; 4) When a state's debt exceeds 60% of its GDP, it will have to present a plan to reduce this debt; 5) There will be automatic penalties for non-compliance for those countries violating the rules, unless a qualified majority of member states oppose this; 6) The private sector will not assume losses due to default by a member country (the case of Greece will not be repeated); 7) The European Stability Mechanism (ESM) will start up on 1 July 2012. It will have a capacity of 500 billion euros and will replace the temporary structures comprising the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM).

Economic and Finance Ministers are also studying the possibility of providing the International Monetary Fund with around 200 billion euros for it to make additional loans to EU countries.

However, two provisos need to be made regarding the scope of these reforms. Firstly, the new treaty being drawn up to contain these decisions has not been approved by the United Kingdom, which has preferred to use its right to veto. However, the rest of the EU countries have accepted and approved the proposals. Secondly, there is a great deal of uncertainty regarding the period of time required for its definitive approval (possibly March), the specific details, which will be very important, and how it will be implemented legally.

It is precisely this lack of resolution regarding the far-reaching decisions in political and economic terms in order to put a stop to the crisis, throughout this year, that is damaging economic activity. In this respect, the breakdown of GDP growth for the third quarter highlights the lethargy of aggregate demand.

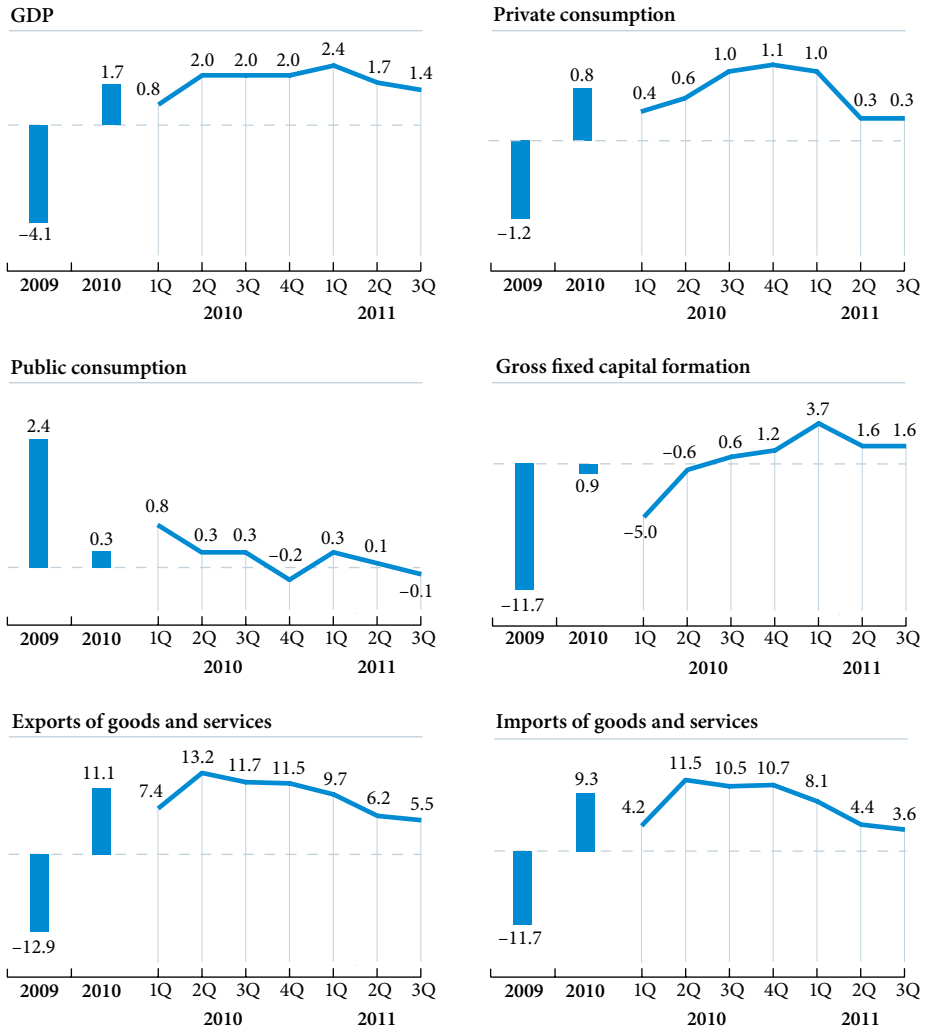
Behind the moderate GDP flash estimate for the euro area in the third quarter, which stood at 0.2% in quarter-on-quarter terms, we find moderate growth

The European summit on 9 December approves a package of measures to improve economic governance...

...although the United Kingdom exercises its right to veto and uncertainty remains regarding the specific details of the pact.

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCES: Eurostat and own calculations.

Macroeconomic indicators reflect the weakness of economic activity.

in private consumption of 0.3% and a slight contribution from investment of 0.1%, while the continued cuts in public expenditure resulted in zero growth in the third quarter. Foreign demand provided a large part of the growth in the third quarter in comparison with domestic demand.

According to leading economic indicators, this tendency for economic activity to slow up should continue in the coming quarters. From the point of view of demand, household consumption will decline over the coming months. On the one hand, the unfavourable trend in the labour market is likely to damage the trend in consumption. The unemployment rate has risen from 9.9% in April to 10.3% in October and, although this rise might seem slight, over this six-month period the number of

unemployed increased by 634,000 people in the euro area.

Moreover, consumers have been discouraged by the tougher conditions to grant bank credit to households, according to the latest survey carried out by the European Central Bank, and by the political uncertainty, as reflected by their confidence index which hit a low in November that had not been seen since August 2009.

Given this situation, the weakness of retail and consumer goods comes as no surprise, in November falling by 0.4% year-on-year, accumulating six months of negative figures.

Moreover, the exports from the euro area that have provided growth in the last few quarters are likely to lose steam somewhat given the slowdown in the world economy expected for this year.

With regard to investment, this is also likely to slow up due to the slight deterioration in business sentiment indices in the last few months. For example, the business confidence indicator for the euro area, calculated by the European Commission, is at its lowest since February 2010 and has been falling for the last ten months. In addition, the drop in the degree of industrial capacity utilization to 79.7%, below the 81.6% historic average since the series started, points to less dynamism in the investment component.

From the point of view of supply, industrial production continued its slowing trend that started in May 2010, posting 1.3% year-on-year in October. The drop in new industrial orders and the difficulties in securing credit, together with the lethargy of aggregate demand, lie behind a large part of this industrial slowdown.

Tougher credit conditions and political uncertainty discourage consumers.

Industrial production continues its slowing trend.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011				
			4Q	1Q	2Q	3Q	October	November
GDP	–4.2	1.7	1.9	2.4	1.7	1.4	–	...
Retail sales	–2.5	0.8	0.6	0.1	–0.5	–0.6	–0.4	...
Consumer confidence (1)	–24.8	–14.0	–10.4	–10.6	–10.4	–15.6	–19.9	–20.4
Industrial production	–14.7	7.5	8.0	6.6	4.2	4.0	1.3	...
Economic sentiment indicator (1)	80.7	100.9	105.7	107.4	105.7	98.8	94.8	93.7
Unemployment rate (2)	9.5	10.1	10.0	10.0	10.0	10.1	10.3	...
Consumer prices	0.3	1.6	2.0	2.5	2.8	2.7	3.0	3.0
Trade balance (3)	10.7	4.6	4.6	–10.3	–16.5	–20.0	...	...
3-month Euribor interest rate	1.2	0.8	1.0	1.1	1.4	1.6	1.6	1.6
Nominal effective euro exchange rate (4)	111.7	104.7	104.4	103.7	106.4	104.6	104.0	103.5

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.

Higher risk of growth being moderately negative for the last quarter of 2011 and the first quarter of this year.

On the other hand, the harmonized index of consumer prices in the euro area for November rose by 3% year-on-year, the most volatile components (energy and food) being responsible for this level since core inflation, which excludes these items, remained at around 1.6% year-on-year. Given the economic situation and providing there are no further hikes in oil prices, European inflation should moderate over the coming quarters.

An overall view of economic indicators published on the euro area as a whole suggests a slowdown in economic activity. In short, there is now a greater risk of moderately negative growth in the last quarter of 2011 and the first quarter of this year. Looking to the future, if we had to point to one of the fundamental elements that will set the economic tone for this year, it would be the restoration of credit channels.

Weakness in the German macroeconomic situation in the fourth quarter.

It is precisely this aspect that has been key to the European Central Bank taking the decision to hold three-year liquidity auctions, granting 489 billion euros to 523 financial institutions. The success of this auction might be crucial to relieving liquidity tensions in interbank markets.

It is evident that financial markets will remain volatile, since uncertainty has not fallen to any great extent. This makes it difficult for European banks to secure funding in wholesale markets. Precisely one of the biggest risks for economic activity comes from the impact of even tougher time constraints and terms for granting loans to the rest of the economic sectors on the part of financial institutions.

We keep to our growth forecast for German GDP of 0.7% in 2012, but with a risk of this being lower.

In summary, the important decisions approved at December's European summit are moving in the right direction although uncertainty still remains regarding how the euro crisis will be resolved. Moreover, macroeconomic indicators suggest that we may have embarked on a period of negative economic growth for the euro area as a whole. The future trend for economic growth will be closely linked to tensions easing in financial markets so that credit can once again flow to consumers and businesses.

The deterioration in German economic sentiment slows up in December

In 2011, the German economy consolidated its exit from the great recession of 2008-2009 and its GDP is now above its pre-crisis level. Domestic demand has taken over from foreign, although this is still contributing positively. In 2011, German GDP will have therefore grown by around 3% if forecasts are confirmed, although this figure represents a slowdown compared with the 3.6% growth recorded in 2010. However, in the fourth quarter available indicators point to only a slight rise or even a small drop after the strong quarterly growth of the July-September period.

Macroeconomic weakness will probably continue early in 2012. However, December saw a halt to the deterioration in economic sentiment. The Ifo index rose more than expected, posting an improvement for the second consecutive month. The ZEW indicator increased for the first time in nine months. The Purchasing Managers' Index got back to the level of 50 points, which indicates expansion. All this points to strong foundations for the German economy and we have therefore kept to our forecast of 0.7% year-on-year growth in 2012. However, this figure might be lower if

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011				
			4Q	1Q	2Q	3Q	October	November
GDP	–5.1	3.6	3.8	4.6	2.9	2.6	–	...
Retail sales	–3.2	1.4	1.1	0.8	2.4	0.8	1.2	...
Industrial production	–15.5	10.0	11.7	12.8	8.1	8.1	4.0	...
Industrial activity index (Ifo) (*)	90.7	107.8	113.4	114.7	114.2	109.6	106.4	106.6
Unemployment rate (**)	7.8	7.1	6.7	6.3	6.0	5.8	5.5	...
Consumer prices	0.4	1.1	1.5	2.1	2.3	2.4	2.5	2.4
Trade balance (***)	138.7	154.9	154.9	157.9	159.0	159.7	156.8	...

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 sovereign debt crisis worsens, given the importance of foreign trade with the partners in the euro area.

Private consumption will be the main support for economic growth in 2012. Consumer expectations regarding the overall situation improved for the first time in five months according to the GfK indicator and consumer confidence remains at a level that is slightly above its historic average.

This optimism is supported by the rise in real disposable income and by the favourable outlook for the labour market. Although the household-friendly fiscal reform announced in November was for the years 2013 and 2014, in 2012 there are other changes in the fiscal treatment of households, such as an improvement in the consideration of childcare costs. On the other hand, in November the BA-X indicator for job demand reached a high level and unemployment continued to fall. Nonetheless, the rise in private consumption will probably ease back to some extent.

With regard to investment, this will remain quite vigorous given the push from domestic demand. In October 2011, the production of capital goods posted a strong monthly increase of 2.2%. However, investment in capital goods will tend to moderate due to the slowdown in the global economy.

Looking at supply, in October industrial orders rose by 5.2% after three months of declines. Although their level is relatively high, some loss of dynamism can be observed, so that the secondary sector is likely to slow up over the coming months. With regard to construction, in the period January-September 2011 building permits rose by 21.6% year-on-year. However, in October new construction contracts fell by 6.0% in real terms in comparison with the same month of 2010. Consequently, the panorama points to a slowdown in activity in 2012 from the point of view of supply as well, although we should remain moderately optimistic.

Private consumption will be the main support for German economic growth in 2012.

The French economy; going through a weak phase

After the summer, the economic climate has become murky in France, in the

The French economy might shrink slightly in the fourth quarter of 2011.

midst of the sovereign debt crisis of the euro area. Available leading economic indicators point to a slight economic slowdown in the fourth quarter after having recorded 0.4% economic growth quarter-on-quarter in the third. The economic sentiment index continued to fall in December, pointing to an unfavourable outlook. GDP might therefore shrink again slightly after the contraction recorded in the second quarter of 2011.

With regard to demand, household consumption can be seen to be advancing weakly. The consumption of manufactured goods by households stabilized in October compared with the previous month. The number of retail and consumer goods hardly rose by 0.1% quarter-on-quarter in the period September-November. And the short-term outlook seems to be worse, as consumer confidence fell again in November, affected by the standstill in purchasing power and by fears of an upswing in unemployment. Investment in capital good will probably continue to perform poorly given the continued low level of production capacity utilization, the slowdown in demand and tougher financing terms.

With regard to the foreign sector, the trade deficit shrank slightly in October. This occurred thanks to exports increasing by 0.5% month-on-month while imports fell by 0.3%. However, given the prospects for foreign demand, especially in the euro area, in the fourth quarter the foreign sector's contribution will most likely be negative, after its positive contribution in previous quarters.

From the point of view of supply, a widespread deterioration can also be seen in short-term expectations. Industrial production posted zero quarter-on-quarter growth in October while the year-on-year change for the last three months stood at a moderate 2.3%. Order portfolios fell to below their normal level, revealing a loss of dynamism. The sector's climate therefore worsened in December, falling further from the long-term level. Economic sentiment also worsened in services. The climate in construction remained below its historic average.

Widespread deterioration in leading indicators on the supply side.

In this environment, there have been warnings from credit rating agencies that French sovereign debt might lose its top rating should the situation in the euro area get any worse, as the French

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011				
			4Q	1Q	2Q	3Q	October	November
GDP	–2.6	1.4	1.4	2.2	1.6	1.6	–	...
Domestic consumption	–0.4	1.7	0.9	3.5	1.1	–1.2	0.5	...
Industrial production	–12.6	4.6	4.3	4.8	2.0	2.8	1.8	...
Unemployment rate (*)	9.5	9.8	9.7	9.7	9.7	9.8	9.8	...
Consumer prices	0.1	1.5	1.7	1.8	2.1	2.1	2.3	2.5
Trade balance (**)	–44.8	–51.5	–51.5	–59.3	–64.4	–68.7	–71.6	...

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

economy would be affected. However, thanks to the efforts made by the European and French authorities, the risk premium of French sovereign debt compared with German for ten-year bonds was around 107 basis points towards the end of December, appreciably below the peak of 189 points since the euro was launched, posted on 16 November. However, the premium was substantially higher than the figure recorded at the start of 2011, namely 47 basis points.

On the other hand, within this context in the second week of December, the rating agency Moody's downgraded the long-term rating for the large banks of Société Générale, BNP Paribas and Crédit Agricole by one notch. Financial tensions are also starting to show in the slowdown in bank credit to firms and households.

With regard to the forecasts for 2012, the lethargy of the last few months will tend to continue on to the start of the New Year. However, we keep to our forecast of GDP expanding by 0.5% for the whole of the year. It should be noted that this growth is quite likely to be less, partly due to the effect of austerity measures. However, should confidence be restored in the euro area, actual growth might be higher than our forecast.

Financial tensions are starting to be reflected in a slowdown of credit to firms and households.

Italy: on the point of economic recession

On 21 December, the Italian statistics institute published the change in GDP for the third quarter, which was – 0.2% compared with the second. This was the first fall in the level of economic activity since the end of 2010. All components of domestic demand decreased and this could not be entirely offset by the contribution of foreign demand. In year-on-year terms, the rate of expansion continued to fall to just 0.2%. This weakness will probably continue in the fourth quarter as available indicators point to a strong slowdown. GDP will therefore have grown by around half a point in 2011 as a whole, half the rate forecast by the consensus of economists a year earlier.

Forecasts do not improve for 2012. At the beginning of December, the new government presided over by the former European commissioner, Mario Monti, approved a decree to sort out Italy's critical economic situation. The so-called

Italy's GDP decreases in the third quarter, with a view to this continuing.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011				
			4Q	1Q	2Q	3Q	October	November
GDP	–5.1	1.4	1.6	0.8	0.7	0.2	–	...
Retail sales	–1.7	0.1	0.1	–0.4	–0.3	–1.4	–1.3	...
Industrial production	–18.7	6.5	5.7	2.4	1.6	–0.1	–3.2	...
Unemployment rate (*)	7.8	8.4	8.3	8.2	8.1	8.2	8.5	...
Consumer prices	0.8	1.5	1.7	2.3	2.6	2.8	3.4	3.3
Trade balance (**)	–5.9	–29.3	–29.3	–34.9	–36.0	–34.0	–32.8	...

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

The «Save-Italy» decree of Mario Monti's new government is along the right lines but will shrink activity in the short term.

«Save Italy» decree involves tough budget cuts complemented by measures to stimulate the economy and an initial phase of structural reforms to regain the competitiveness lost. These decisions are necessary and along the right lines. However, the short-term effect of this package will tend to depress activity as it raises taxes and cuts public spending. Consequently, within a context of a slowdown in the world economy and the impact of austerity measures, GDP might shrink by at least one percentage point in 2012.

The «Save Italy» decree entails a budget cut of around 20 billion euros in structural terms for the three-year period of 2012-2014 and is currently going through parliament before it becomes law, although it is already in force. One of its key measures is a tax hike: higher VAT (from 21% to 23% and from 10% to 11% as from September 2012), the reintroduction of a municipal tax on the main residence, taxes on some luxury goods (powerful cars, yachts and planes), together with measures to combat tax evasion by prohibiting the use of cash for payments in excess of 1,000 euros. Among the spending cuts, we should mention pension reform, with modifications in its calculation, the winding up of some public bodies and the Prime Minister giving up his salary.

One part of the budget savings will be allocated to boosting economic growth, with tax benefits for hiring staff and incentives to capitalize firms. Certain economic sectors and activities will also be opened up.

One aim of the new package is to ensure the budget is balanced by 2013. On the one hand, the cumulative central government accounts up to November were on target, both in terms of expenditure and revenue. On the other hand, in mid-December the Senate approved a bill to introduce balance between revenue and expenditure in the constitution, another step forward towards the ultimate goal.

The markets welcomed the «Save Italy» decree. The spread between yields for Italian and German ten-year sovereign bonds, which had reached a peak of 550 basis points on 9 November, fell to 373 when the decree was published on 6 December. However, it picked up again slightly afterwards. In spite of the notable parliamentary support achieved by the new government, Italy's typical political instability augurs a volatile phase in the risk premium for Italian debt.

The United Kingdom: new political challenges

Two highly important political decisions have been taken in the United Kingdom in the last few months. Firstly, at the last European summit of heads of state and government, held on 9 December, the British Prime Minister used his power of veto to stop the United Kingdom from joining the new treaty to strengthen fiscal discipline in the euro area. David Cameron believes that the conditions agreed by his European partners are unacceptable for the United Kingdom as no special safeguards were accepted for his country's financial system. This system is particularly important for the country's gross domestic product as, according to a report by the Bank of England, it accounts for around 10%.

The second important political decision occurred with the traditional autumn speech by the Chancellor of the Exchequer, George Osborne, announcing an ambitious plan of measures to

stimulate the economy. The aim is to revitalize the economy within a complicated environment, as acknowledged by the British Office for Budget Responsibility (OBR), which lowered its growth forecast for 2012 in the United Kingdom from 2.5% to 0.7%. Our forecast, made the month before, coincides with that of the OBR.

Four of the economic measures announced by George Osborne stand out in particular. Firstly, a plan to invest in infrastructures allocated with 6.3 billion pounds sterling to carry out up to 500 public works projects. Moreover, it is hoped that private pension funds can be persuaded to invest up to 20 billion pounds over the coming years in this kind of project. Secondly, the government will raise the tax on banks, for the third time, to 0.088%. It hopes to gain 3 billion pounds through this measure. Thirdly, it has been announced that civil service wages, which are currently frozen, will only be able to rise by 1% over the next two years. Lastly, the United Kingdom will raise the retirement age from 66 to 67, effective as of 2026.

The head of the British treasury has acknowledged that the stock of debt compared with GDP will hit a peak of 78% in the tax year ending on 31 March 2015. Given the lower official growth forecasts, the government expects to meet its target to start reducing the stock of debt one year later, namely 31 March 2016, after the next general elections to be held in 2015. Given this panorama, it is not surprising that the rating agency Moody's has announced that the United Kingdom's worsening public accounts substantially reduce the country's ability to hold on to its top credit rating.

This economic plan attempts to revitalize the economy within an environment in which macroeconomic data reflect the weak tone of the British economy. From the point of view of retail sales, these grew by 0.7% year-on-year in November, less than the previous month's figure of 1.2%. A movement affected by the

The Finance Minister announces an ambitious project to revitalize the economy in the United Kingdom.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011				
			4Q	1Q	2Q	3Q	October	November
GDP	–4.9	1.4	1.3	1.6	0.6	0.5	–	...
Retail sales	1.0	0.4	–0.9	1.5	0.5	–0.3	1.2	0.7
Industrial production	–10.1	2.2	3.0	1.3	–1.3	–1.4	–1.7	...
Unemployment rate (1)	4.7	4.7	4.5	4.5	4.7	4.9	5.0	5.0
Consumer prices	2.1	3.3	3.4	4.2	4.4	4.7	5.0	4.8
Trade balance (2)	–82.4	–96.2	–96.2	–98.4	–98.7	–100.8	–101.4	...
3-month Libor interest rate (3)	1.2	0.7	0.7	0.8	0.8	0.9	1.0	1.0
Nominal effective pound exchange rate (4)	73.9	80.4	79.3	78.4	78.6	77.1	79.4	80.1

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.

reduction in consumers' disposable income and a slight increase in the unemployment rate, which remains at 5%. From the point of view of supply, October's industrial production fell by 1.7% year-on-year, this being the eighth month in a row of negative growth. One of the few positive indicators has been inflation, down by two tenths of a percentage point in November compared with the previous month, posting a rise of 4.8% year-on-year.

Emerging Europe: forecasts are down

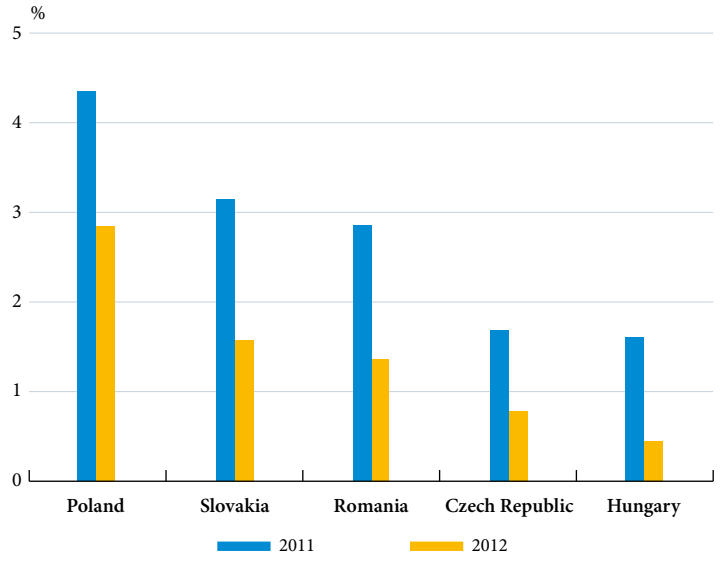
The euro area entering recession forces down the 2012 growth forecasts for emerging Europe.

Emerging Europe is changing its economic phase. In strong contrast with its past macroeconomic trend, still relatively dynamic, substantial evidence is coming to light that the final part of 2011 will have been notably weak and the bulk of the evidence available points to this trend getting worse during the first few months of 2012. Nevertheless, as 2012 advances, activity should recover quite quickly and the year should end in a more vigorous phase in preparation for a slightly better 2013. Let us develop the arguments that construct the scenario in a little more detail.

First of all, let's begin with the business indicators published. In particular, the indicator of economic sentiment, whose aggregate nature and available data for October and November make us expect the growth rate to have slackened off in the fourth quarter in the Czech Republic, Hungary, Slovakia and Romania. The exception, due to the inertia of its domestic demand, will be Poland, which will keep an almost unchanged rate from the good figure posted in the third quarter. From here on, the first quarter will probably be the weakest since the 2009 recession. In 2012 as a whole, this group of five countries will grow on average by 1.4%, practically half the rate for 2011 and far

EMERGING EUROPE: FACING A 2012 WITH LOW GROWTH

Real growth forecast



SOURCES: National statistics offices, Eurostat and own calculations.

from the 2.3% being forecast just a few months ago.

These are notably worse figures than the ones being proposed at the end of the summer, justified by two negative developments that, although anticipated, are looking more serious than expected. The first of these developments is the lower growth forecast for the euro area. Only three months ago, analysts in general expected growth for the euro area to be around 1.3% in 2012. The most recent forecasts have reduced this figure to a GDP flash estimate of 0.3%. Moreover, it is now more likely that the actual figures will be worse for the euro area. In short, the reference market for emerging Europe, the euro area, is moving away from a scenario of moderate slowdown to a much sharper deceleration.

The negative development of the euro area is not limited to the area of activity. The sovereign debt crisis has negatively and simultaneously affected the country-risk indicators of the five aforementioned economies. Although the market discriminates according to different fundamentals (in particular, assigning more solvency risk to Hungary than to the rest), the upswing in the risk premium has moved in line with the risk premia of those countries most affected in the euro area.

In a word, the sum of these two events (a sharper economic slowdown than expected in the euro area and greater contagion of financial stress) justifies the growth forecast being cut. At this juncture, we should ask ourselves what would happen if 2012 turned out to be even worse than expected and the gentle recession expected in the euro countries in the fourth and first quarters mutated into a serious, full-blown recession. One simple way of analyzing those countries hardest hit by this situation is to classify the five countries in terms of their level of country-risk and degree of commercial exposure to the euro area. The intuitive logic underlying this categorization is the belief that, if a serious recession occurs in their export markets, those countries with a higher country-risk will have less fiscal leeway to alleviate the loss in activity.

Under such premises, the region's weak spot is Hungary, whose exports to the euro area account for 38% of GDP and whose risk premium for three-year bonds is in the order of 500 basis points. It is no surprise that, given the fiscal and economic risks, the Hungarian government has initiated talks with the International Monetary Fund and the European Union to access some kind of international credit of a preventative nature. Although negotiations are expected to be complicated, given the not very conventional way the government has attempted to restrain its public deficit, one initial encouraging sign has been the government's readiness to amend the harmful banking legislation it has been implementing over the last two years.

Poland is in an almost opposite position. Although its fiscal leeway is not as wide as what it had (and took advantage of) in 2009, its smaller commercial exposure (exports to the euro area account for just under 20% of GDP) isolates it somewhat from the cycle of Germany and other euro area countries. Moreover, its country-risk premium, slightly above 200 points, does not represent the great limitation under which Hungary's fiscal policy has to operate.

The other three countries are in positions of intermediate risk. Impact via exports

In 2012, growth overall will be 1.4%, half the figure for 2011.

Peripheral debt tensions infect the risk premia of emerging Europe.

Should the situation in the euro area get worse, Hungary might be the most affected and Poland the least.

is greater for the Czech Republic and Slovakia but doubts regarding public solvency are stronger in Romania. In short, and although these considerations do not pretend to summarize all the national idiosyncratic risks, we believe that, in a more adverse scenario, Hungary would be highly exposed while Romania, Slovakia and the Czech Republic would be next in seeing their growth affected. In all these cases, in a scenario of serious recession in the euro area, their respective economies would also enter recession. Poland, which would undoubtedly see its growth affected, might avoid a fall in GDP or, should a drop occur, this would not be very extensive.

Together, yet apart? Separation of activities in banking

In November 1999, the United States officially repealed the Glass-Steagall Act, which it had used for more than 65 years to keep the activities of investment banking and retail banking completely separate. A mere 9 years later, subprime mortgages led to the worst financial crisis since the Great Depression. Once again, the numerous conflicts of interest entailed by the integration of both activities within the same financial institution became evident. This is why many are now demanding again their total separation, arguing that investment banking is too risky and is financed, in part, by the implicit insurance provided by the guarantee of retail banking deposits and the fact that institutions had become too large and complex. Some have gone even further and are advocating narrow banking, i.e. that institutions dealing with deposits should not be allowed to carry out any activity that involves risk, including granting credit. However, the fact that there are efficiency-based reasons to integrate activities complicates the decision to be taken by regulators. Given this situation, what alternatives are available to tackle the problem? And which factors need to be taken into account?

The integration of activities subject to regulation and other, non-regulated activities within the same firm presents significant problems not only in banking but also in other sectors. In the case of banking, the regulated activity is deposit management. However, it had not been deemed necessary to monitor the risks associated with investment banking. As this is aimed at skilled investors, and in spite of the complexity and continual innovation of its products, it was assumed (at least until now) that investors had the technical know-how and sufficient incentive to monitor for themselves the risks incurred by the investment bank in question. When the same bank carries out both kinds of activity, regulated and non-regulated, monitoring the risks that might be run by the former becomes difficult for the supervisor due to the added complexity of the investment segment. As the supervisor is less able to observe the real level of risk, there is more incentive for the bank to take too much risk and use the higher returns to expand in the market. This situation is even worse when institutional investors perceive that the institution is likely to be bailed out as a result of either its retail banking, the complexity of its structure or its size, and consequently loosen their monitoring.

The experience of other industries with similar problems, such as electricity, gas or telecommunications, shows that the solution does not necessarily have to be all or nothing but that activities can be separated to a degree. The idea underlying the regulation of these industries is that, to a greater or lesser extent, activities are integrated essentially in order to take advantage of economies of scope. However, the resulting greater efficiency must be able to be passed on to users in some significant way, which entails limiting the integrated firm's potential to abuse its market power. In this respect, regulatory frameworks vary between industries and countries in terms of the

preferred degree of separation, ranging from the mere separation of accounts to a legal separation into two companies and even structural separation, which eliminates any kind of link of ownership between the two. The greater the degree of separation, the less advantage is taken of the economies of scope but the smaller potential of abuse and the greater ease of supervision (see the table below).

When the economies of scope between the regulated and non-regulated activities are very high, considerations related to efficiency take pride of place in the decision. In this case, both activities are still integrated but, in exchange, a highly intrusive and information-intensive supervisory system is implemented, both in economic and technical terms. The supervisor's technical skill and powers needs to be very extensive, as it must be able to detect and correct any aspect that might lead the firm to use regulation for its own ends. When the economies of scope are not sufficiently significant to justify the resources required to achieve effective supervision, it is still possible to take some advantage of these by imposing a legal separation of the activities into two different companies that belong to the same group. The success of this alternative lies in minimizing conflicts of interest and stopping the regulated company from giving preferential treatment to the non-regulated company, forcing it to behave in the same way as it would with third parties. This reduces the capacity of both firms to arbitrate the regulation and, together with its more limited complexity, makes the job of supervising easier. Lastly, only when the economies of scope are not very significant or when the consequences of bad supervision are too costly has it been decided to separate these industries structurally.

KEY ASPECTS TO DETERMINE THE DEGREE OF SEPARATION BETWEEN INSTITUTIONS

Intensity of the economies of scope	Supervisor's technical and information requirements	Consequences of faulty supervision		Degree of separation
High	Can be met	Easily fixed	➧	Separate accounts
High	Can be met	Fixable	➧	Separate accounts with behavioural restrictions
Moderate	Moderately feasible	Difficult to fix	➧	Legal separation
Moderate	High	Difficult to fix	➧	Legal separation with restrictions on the group structure
Low	Too high	Impossible to fix	➧	Structural separation

SOURCE: Own calculations.

Applying this conceptual framework to the case of banking, the differences between the solution adopted by the United Kingdom and the one adopted by the United States become evident.

The United Kingdom has opted to demand legal separation between activities with the introduction of retail bank ring-fencing. Activities with significant economies of scope with deposit-taking and the payment system and whose risk might be reasonably supervised are allowed for banks with a deposit guarantee. These include granting loans to households and SMEs, as combining these with the deposit business improves information gathering regarding the quality of the borrower, thus minimizing problems of asymmetric information. Similarly, most

services offered by traditional retail banking are included, due to reasons of diversification and consumers' preferences to cover most of their financial needs through a single institution. These activities can therefore be carried out in the same institution, subject to greater regulation due to the essential nature of the services in question.

Those activities that are not necessary in order to provide these services and that, on the other hand, introduce unnecessary risk and complicate supervision, must be split off into another institution whose shares cannot be held by the ring-fenced bank (although both can belong to the same holding). These include all activities related to investment banking, as well as those giving rise primarily to market risk or counterparty risk. On the other hand, the operational ties between both institutions must allow the ring-fenced bank to operate normally, irrespective of the financial health of the rest of the holding. With regard to economic ties, these must avoid preferential treatment; i.e. any transaction between both banks must be valued as if it had been carried out between totally independent institutions. Together with the rest of the provisions proposed by the Vickers Committee and the new international regulations regarding so-called shadow banking, the United Kingdom trusts that this is enough to moderate investment banking's conflicts of interest.

The United States, however, has opted to reintroduce structural separation via the Volcker Rule, although this includes a much more limited range of separate activities than the English case. In particular, it bans banks from engaging in proprietary trading, as well as from investing in or sponsoring hedge funds or private equity funds. However, with the aim of preserving « robust and liquid capital markets and financial intermediation », the law allows some exceptions, such as some forms of market making or underwriting securities. In practice, however, these are difficult to distinguish from proprietary trading, so that not all risk is eliminated nor has the need for intensive supervision disappeared.

We have yet to see which of the two systems will work the best. In any case, what does seem to be true is that the supervisor's requirements in terms of information, necessary for either of the two alternatives to be effective, have yet to be met. We will just have to hope that the rest of the reforms being implemented to shadow banking change this situation.

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FINANCIAL MARKETS

Monetary and capital markets

A year of adversities

2011 has not been a very good year from the point of view of the financial markets. The slowdown in the world's economic activity, the increase in prevailing fiscal imbalances on both sides of the Atlantic and the restrictive monetary policies of the emerging countries during the first three quarters have been the main obstacles influencing investors' decisions. In addition to these factors, in the first half of 2011 a series of events also took place of a diverse nature (the earthquake in Japan and social revolts in the Middle East) which added a further dose of tension to the markets. The joint effect of these factors has resulted in a financial scenario where investors' lack of confidence and aversion to risk have hit the price of financial assets hard.

In the new year, the outlook for the markets is subject to a high degree of uncertainty although, on the other hand, the medium and long-term prospects appear more favourable, based on belief in the success of the monetary and fiscal policies adopted in developed economies and renewed dynamism in global economic growth.

The goal of economic growth reigns supreme in monetary strategies

Since the summer, most economic indicators have been showing a slowdown in the pace of growth for activity at a global level. In developed economies, growth's loss of steam is due to the materialization of risks resulting from the US and European financial crises and the policies adopted to resolve them. For their part, the growth rates in developing countries have slowed up as a consequence of the restrictive economic policies applied by their authorities over several quarters and of less foreign investment from the West. Although the degree of moderation in growth differs from region to region, one common element to most countries is the persistence of inflationary tensions resulting from rising commodity prices. Given this situation, the different monetary authorities have started to turn their strategies around, in most cases prioritizing the goal of economic growth above price stability.

The global financial scenario starts the new year dependent on several risks.

Central banks react to avoid recession.

In the United States, the message transmitted by the Federal Reserve (Fed) on the economy and the organization's monetary strategy was along the same lines as in previous months. After the last meeting of the Federal Open Market Committee, its Chairman, Ben Bernanke, confirmed the slight improvement the US economy has been enjoying since the summer. The favourable progress made by indicators such as household consumption and corporate investment are helping the economy to continue its recovery. But, as acknowledged by Bernanke, this trend still has some signs of fragility, such as the absence of activity in the residential sector. However, he also referred to the existence of significant downward risks for the economy, most

The US economy is developing well but it is still fragile.

The Fed's monetary policy hopes to boost employment and ensure price stabilization.

being related to the sovereign debt crisis in the euro area.

The Fed Chairman also referred to the favourable trend in the figures for the net creation of jobs, albeit not mentioning the fact that the current figures for the labour market are those befitting a still vulnerable economic situation. With regard to inflation trends, the gradual moderation in core inflation for consumer prices, as well as the containment of inflationary pressures in the medium term, give the organization more leeway to keep to its current strategy. Specifically, the Fed's aim is to continue to boost employment and ensure price stability. To this end, the central bank repeated its commitment to keep interest rates within the already familiar minimum range of 0%-0.25%, and confirmed that exceptional measures would continue. Within this area, the Fed is using a series of non-standard monetary policy instruments to ensure optimum levels of liquidity in the system. Of note among these measures is the programme to extend maturities of public debt in portfolio (the so-called Operation Twist) and the plan to reinvest the interest and principal of the commercial paper and mortgage-backed securities on its balance sheet. Over the last few months, and given the economic situation, there had been speculation that the Fed might decide to start up another round of quantitative easing. Although this has not been confirmed by the monetary authority, it has stated its readiness to make changes in the composition of its asset portfolio, if necessary.

For the moment, the Fed is not planning any further purchases of US Treasury bonds.

The ECB lowers interest rates to 1%...

For its part, the European Central Bank (ECB) lowered the official interest rate by 25 basis points to 1%. In the words of its President, Mario Draghi, the decision to cut interest rates further was because of increased risks for the region's real economy, due to the worsening of financial tensions in the euro area. This has led the ECB to lower its growth estimates for the area over the coming years, placing GDP growth for 2012 between –0.4% and 1%.

...and extends extraordinary measures to help to improve financial markets.

A series of extraordinary measures were also adopted at this meeting, with which the organization aims to help reduce the net borrowing of Europe's banks in 2012 and 2013. In addition to the already unlimited financial operations with various maturities, the ECB also announced the following: i) the holding of two three-year liquidity auctions; ii) an extension of the collateral accepted for bank loans; iii) the lowering of reserve requirements from 2% to 1%, and iv) a cut in marginal credit and deposit facilities (to 1.75% and 0.25% respectively). Towards the end of last month it carried out the first of the two three-year liquidity auctions, in which European banks received 489 billion euros, according to the ECB itself.

This whole battery of temporary measures, as specified by the ECB, is in addition to the coordinated action agreed at the end of November by the main international central banks. The ECB, the Federal Reserve, the Bank of England, the National Bank of Switzerland and the Bank of Japan agreed to offer the necessary liquidity in dollars to Europe's banking sector given the greater difficulty of institutions securing funding in secondary capital markets.

With regard to its work to resolve the sovereign crisis of the euro area, the ECB has maintained its firm commitment to restoring investor confidence and to

making access to funding more flexible for the banking sector. To this end it has used several different instruments, particularly its programme to buy up the sovereign debt of countries with difficulties, and more specifically of Italy and Spain. Although this measure has been highly criticized by policymakers in Germany, the ECB has always extolled the independence of each of its decisions, also stressing the temporary and extraordinary nature of this type of intervention. The ECB is also playing a primordial role by advising on and diagnosing the problems of the euro area. In the last edition of its Financial Stability Report, it identified several risks to the region's successful development, the most important being the risk of increased contagion and the negative interaction between public finances, the financial sector and economic growth.

With regard to the monetary context in emerging countries, the main characteristic is the shift in direction which the main central banks have started to adopt in these economies in their monetary policy strategies. During the first part of the year, the monetary authorities' aim was to moderate the unfavourable effects of a sharp rise in inflation on their economies and they therefore used restrictive monetary measures. However, as the year wore on, signs of a slowdown in indicators for global activity have led to these restrictive interest rates being out of synch with the moderation in activity. Given this dilemma, the central banks have started to modify their monetary strategies, prioritizing the goal of sustained economic growth over the traditional aim of price stability. Monetary policy decisions are normally implemented through interest rates, although there are also other valid instruments to achieve monetary targets. This has been precisely the case of China, where the authorities have opted to lower the reserve requirement for private banks for the first time in three years, in an attempt to ease credit tension.

The ECB takes part in public bond markets by buying up Italian and Spanish debt.

Within this economic and monetary policy context, interbank market interest rates remain important as they constitute a basic indicator of the financial and monetary situation. In the present situation, these markets are also reflecting the tensions resulting from the European debt crisis and its effects on liquidity and the solvency of financial institutions at a global level. In the United States, Libor interest rates are still immersed in the upward spiral started last summer, reaching their highest level in the last 18 months. Far from reflecting the Fed's intention to raise interest rates, this circumstance is due to the high degree of uncertainty caused by Europe's financial crisis. Meanwhile, in the euro area, Euribor interbank interest rates have seen a slight drop as a consequence of the further reduction in official rates by the ECB. The Euribor's rate of fall would surely have been more acute had the risk premia related to Europe's financial sector been lower.

The central banks of the emerging countries ease their monetary policies.

Investors opt for US debt

Yields on the debt of the United States and Germany have continued to accumulate drops in the course of December. This new movement forms part of the slow downward adjustment occurring since the summer in the yield for the main economies' bonds. The fundamental reason underlying this

Tensions generated by the European crisis are being passed on to the interbank markets.

Yields on the public debt of the most solvent countries remain exceptionally low.

trend is a loss in confidence and high volatility, generated by the European debt crisis and causing capital to flow towards assets with less risk and greater security. In the case of the United States, this can be seen via the trend in the yield for 10-year bonds, which has remained below the barrier of 2% since November. But the increased investor preference for quality assets is not the only reason for the fall in yields on long-term US debt and two other aspects stand out from the rest. Firstly, the Fed's intervention in secondary markets by selling and buying debt with different maturities, thereby managing to keep long-term interest rates low. Secondly, the scepticism concerning the negotiation of the budget plan between Republicans and Democrats, which is hindering the US economy's long-term growth projections.

US long-term debt stands out for its profile as a safe haven.

In the case of the euro area, the trend for German debt was quite similar to that of the United States. The yields on 2 and 10-year bonds (0.22% and 1.94% respectively) speeded up their fall in December as a consequence of investors' response to advances in the areas of fiscal and monetary policy occurring over the last few weeks in the euro area. Although it's true that the price of German bonds has been determined, over the last 18 months, by the outcome of the region's crisis, the fiscal pact agreed by European leaders at the last summit of the year has given German debt even more leeway to definitively promote itself as the only European safe haven. However, there are a number of aspects related to the immediate future that might lead to new episodes of volatility in the German bond market. On the one hand, the schedule to develop and implement the fiscal

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								
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	1.89	2.60	5.14	5.54	1.92	1.03	2.43	0.94
October	2.03	3.10	5.54	6.09	2.11	1.05	2.44	1.00
November	2.26	3.68	6.69	7.25	2.00	1.06	2.29	0.89
December (*)	1.95	3.10	5.35	6.82	1.94	0.98	2.04	0.72

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

measures agreed at the European summit. On the other, France's lower credit rating. Although this possibility is already partly taken into account by the risk markets, France losing its triple A rating could increase uncertainty regarding the repercussions for Europe's banks and the bail-out mechanisms.

With regard to those countries of the euro area in difficulty, the financial and political events occurring in December have marked a turning point in risk premium trends. We are specifically referring to the ECB's announcement regarding monetary policy, to the fiscal agreements reached between European leaders, to parliamentary changes in Italy and Spain and to the success of the LTRO auction by the European monetary authority. The chain reaction caused by these factors has led to a drop in the risk premia of the economies in the firing line, Italy and Spain. The narrowing of the spread between the Spanish bond and German bund and the change in political strategy towards greater fiscal austerity have also contributed to the success of the latest debt auctions by the Kingdom of Spain's Treasury. These circumstances have been reflected in fewer Spanish bonds being acquired by the ECB in the secondary markets.

The euro area crisis is hurting the euro

Within the current context, currency markets are still dominated by high volatility in the short term, although the range of variation is not particularly wide. Given the high uncertainty present in financial markets and the forecast of a slowdown in economic growth at a global level, most analysts agree that the volatile cycle of the currency markets will probably continue over the next few months. With regard to the dollar-euro exchange rate, once again the news regarding the euro area's debt crisis, as well as the negative effects of this on the region's economic growth, have led to the euro falling an additional 3% against the dollar. In Asia, the Chinese yuan reached its highest value against the dollar in December (6.33 yuan per dollar) since 1993, after intervention by the Chinese central bank in the currency markets to stop speculation given a possible depreciation in the renminbi.

The yield on German debt reflects the advances made in the peripheral debt crisis.

The measures of the European summit and the ECB's liquidity auction boost Spain's public debt.

Uneven performance by corporate bond markets

Corporate bond markets, which during a large part of 2011 had performed well given the global economic and financial situation, have started to be affected negatively by the sovereign crisis in the euro area. The recent increase seen by private sector risk premia is due to the slowdown in world economic activity and a feeling of latent slowness in any categorical decisions being taken in Europe. This is having a greater impact on the corporate bond market of the euro area, where the main reflection of the deterioration in risk premia can be observed in the bonds issued by the region's financial institutions, under huge pressure due to the uncertainty regarding the peripheral debt crisis. This situation is also making its mark on the pace at which corporate bonds are issued. While new, investment grade corporate bond issues have practically collapsed in Europe, in the United States the number of bonds issued has continued to rise,

The decline in economic activity and the debt crisis reduce the euro's value.

The euro area's financial instability is filtered in corporate credit markets.

EXCHANGE RATES OF MAIN CURRENCIES

December 22, 2011

	Exchange rate	% change (*)		
		Monthly	Over December 2010	Annual
Against US dollar				
Japanese yen	78.2	1.5	–3.8	–6.9
Pound sterling	0.639	0.1	0.3	1.7
Swiss franc	0.938	2.6	0.3	–1.4
Canadian dollar	1.026	–1.2	2.7	1.2
Mexican peso	13.803	–1.3	10.6	10.9
Against euro				
US dollar	1.304	3.5	2.6	0.5
Japanese yen	101.9	–2.0	–6.5	–7.4
Swiss franc	1.223	–0.9	–2.2	–2.0
Pound sterling	0.833	–3.8	–3.0	–2.3
Swedish krona	8.998	–2.5	0.1	0.1
Danish krone	7.434	–0.1	–0.3	–0.3
Polish zloty	4.439	–0.5	10.7	10.1
Czech crown	25.66	0.7	2.5	1.4
Hungarian forint	306.7	0.6	9.1	9.9

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

The financial situation of the periphery is stopping investment grade bonds from being issued in Europe.

consolidating the positive trend started last August.

In spite of the above, throughout December institutional investors continued to consider investment grade corporate bonds, together with long-term US debt and gold, as the best options to obtain both security and quality. On the other hand, the sector of high yield bonds (which offer a high risk and return) have continued to lose market share as a result of the uncertainty regarding the European crisis and its possible repercussions on the growth potential of the world's economy.

The corporate bond markets continue to offer attractive yields.

For their part, emerging corporate bond markets, to date on the rise, have also started to reflect the increasing caution of international investors. In this case, the decline has been due to the lower expectations of robust economic growth. However, the more expansionary shift of the monetary policies in these countries, by lowering official interest rates or reducing reserve ratios, and the improvement in the credit ratings of firms from the region, are providing some support for capital to flow to these markets.

Equity ends a year of losses

As has been happening throughout 2011, in December the main international stock markets were highly volatile, dominated by uncertainty, the fragile volume of trade and the outcome of the euro area's sovereign debt crisis. This has been further boosted by continued

deterioration in the confidence of investors who, far from seeing risk assets as a possible source of reliable returns, have preferred to choose a different kind of asset, less exposed to the confusing financial situation.

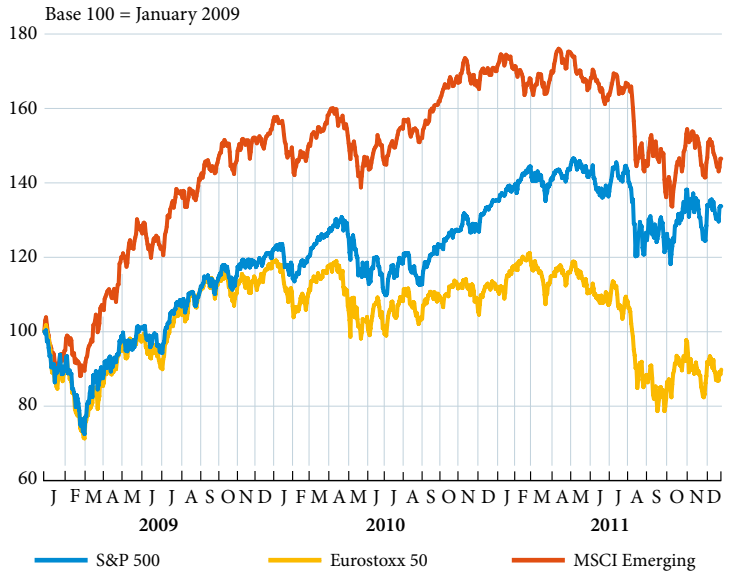
The main obstacles that have prevented shares from realizing their potential in 2011 can be easily classified into two groups. The first would be made up of the extensive fiscal imbalances in the United States and, especially, in the euro area. The fact that these difficulties have been going on for some time, the fear of the crisis spreading to the rest of the world and the sensation of a lack of far-reaching measures that mark a turning point in both scenarios have hindered many agents' expectations regarding their return on investment. The second group would contain the doubts regarding the pace of growth of the world economy. The gradual deterioration of business indicators in emerging countries and the hesitation of western economies given a possible recession have applied additional pressure on the viability of projections for corporate earnings. From a sector point of view, these aspects have mostly penalized companies whose business is linked to the economic cycle and the financial sector. Specifically, Europe's financial sector, and especially banking, has suffered the most from the European crisis as a consequence of its high exposure to the sovereign debt of bailed-out countries and of tougher regulations for the sector within the European Union. As we have already mentioned in the previous paragraphs, the ECB has stepped up its support for European banks in an attempt to reduce their funding requirements for the next two years, an aspect that should ease the stock market penalization of financial institutions.

International stock markets remain highly volatile throughout 2011.

Fiscal imbalances and the slowdown in world growth hinder stock market gains.

STOCK MARKETS END THE YEAR BELOW THEIR STARTING POINT IN JANUARY 2011

Stock market indices



SOURCE: Bloomberg.

INDICES OF MAIN WORLD STOCK EXCHANGES

December 22, 2011

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,107.7*	*5.3*	*4.6*	*4.7*
Standard & Poor's	*1,243.7*	*4.7*	*–1.1*	*–1.2*
Nasdaq	*2,578.0*	*2.2*	*–2.8*	*–3.5*
Tokyo	8,395.2	1.0	–17.9	–18.9
London	5,457.4	4.8	–7.5	–8.8
Euro area	2,278.0	6.6	–18.4	–20.6
Frankfurt	*5,865.5*	*5.9*	*–15.2*	*–17.0*
Paris	*3,078.6*	*7.2*	*–19.1*	*–21.5*
Amsterdam	*305.3*	*10.2*	*–13.9*	*–14.3*
Milan	*15,051.8*	*5.4*	*–25.4*	*–27.4*
Madrid	*8,459.3*	*7.0*	*–14.2*	*–16.9*
Zurich	5,834.6	7.1	–9.3	–11.0
Hong Kong	18,378.2	0.7	–20.2	–20.3
Buenos Aires	2,440.9	–1.7	–30.7	–29.8
São Paulo	56,695.9	1.5	–18.2	–17.2

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

Europe's sovereign crisis is the greatest source of instability for stock markets in the short term.

With a view to the new year, the short-term outlook is very confused, the European crisis being the main source of instability. But in the medium and long term, the expectations of relative improvement in the economic and financial scenario should create a beneficial context for capital to flow again towards riskier assets.

The bank risk profile: more is less?

The crisis that has been beleaguering us since 2007 has highlighted the fact that the capital held in reserve by some institutions during the economic boom was not enough. In many cases the losses made have been greater than the available equity capital and significant recapitalizations have been needed. Some institutions have been forced to resort to public capital to cover this deficit.[1] *Ceteris paribus*, in order to have avoided the use of public resources, their pre-crisis capital should have been 30% higher.

Under such circumstances, the Basel II regulation on capital was reformulated in order to strengthen the system and make it more stable. The reform undertaken, known as Basel III, has focused on raising the level and quality of equity, the numerator of the regulatory capital ratio, but has neglected any in-depth revision of the denominator, namely risk-weighted assets. The weighting of assets according to risk remains almost unaltered, in spite of the fact that it is precisely this factor that has rendered the regulatory capital ratio a poor indicator of the real risk assumed by institutions.

To analyze this assertion in greater detail, we shall look at an algebraic breakdown of the regulatory capital ratio, in line with the following expression:

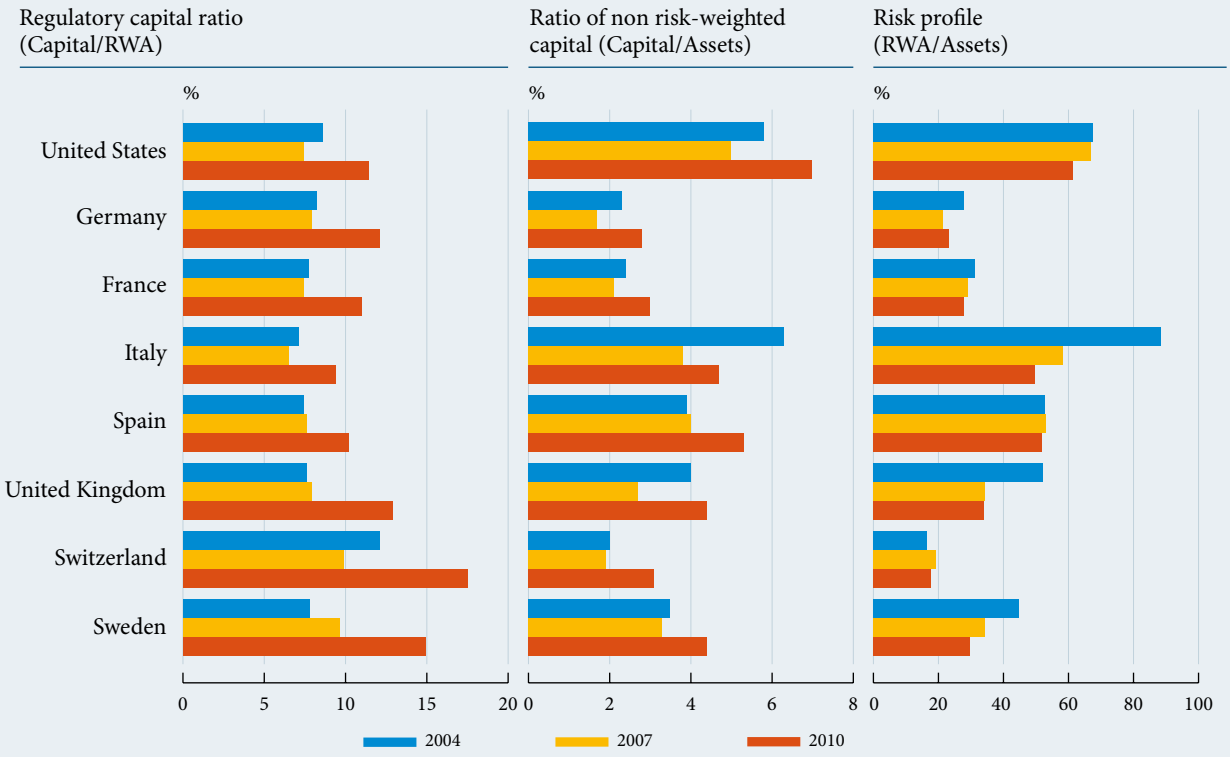
Regulatory capital ratio		Ratio of non risk-weighted capital		Risk profile
Capital / Risk-Weighted Assets (RWA)	=	Capital / Total assets	/	RWA / Total assets

The first factor, the ratio of non risk-weighted capital, is a fairly objective measure and also enjoys a considerable degree of harmonization, which will be further strengthened through Basel III. Differences across systems are therefore informative per se and provide complementary information to the regulatory capital ratio. The graph below shows that the higher regulatory capital ratios of Switzerland, Germany and France compared to Spain are supported by lower ratios of non risk-adjusted capital. In Spain, this ratio almost doubles that of Germany.

The second factor, the risk profile, provides an estimate of the inherent risk of assets. This measurement seems to have its limitations, as historical evidence highlights. The last graph illustrates its poor performance as an early indicator of which institutions are going to encounter real solvency problems.

(1) Calculated based on Bloomberg's information regarding public recapitalizations (19 institutions).

COMPONENTS OF TIER 1 REGULATORY CAPITAL RATIO (*)



NOTE: (*) Sample of 19 institutions: Royal Bank of Scotland, HSBC, Barclays, Lloyds Banking Group, Citigroup, Bank of America, JP Morgan, Wells Fargo, UBS, Credit Suisse, Banco Santander, BBVA, Unicredit, Intesa Sanpaolo, Deutsche Bank, Commerzbank, BNP Paribas, Société Générale and Crédit Agricole.
SOURCES: Bloomberg and own calculations.

In addition to the typical problems of the econometric models used, the bulk of the evidence suggests that the risk profile is contaminated by other elements that do not necessarily reflect a higher real risk. The risk profile should be related only to the business model and the macroeconomic and institutional environment, insofar as these affect asset quality. However, in fact it is also conditioned by other factors that do not necessarily reflect a real risk differential, such as supervisory practices or the discretion of institutions when implementing capital management models. This means that, although Spain is at the top of the list based on risk profile and Switzerland, Germany and France bring up the rear, it's still not clear which bank system concentrates the greatest risk.

A priori, differences in the business model should account for most of the variation in risk profiles. The Bank of England[2] has analyzed this issue in its Financial Stability Report and estimates that changes in the business mix of the country's largest banks between 2008 and 2010 explain approximately 50% of the cumulative decrease in the average weighting of assets according to risk.

(2) Financial Stability Report, Bank of England, December 2011.

CORRELATION BETWEEN RISK PROFILE AND EX POST RECOGNIZED LOSSES (*)

NOTE: (*) The four US institutions have been excluded from the sample of institutions used in the previous graph to avoid distortion due to the different legislative framework regarding the existence of a legal leverage ratio.
SOURCES: Bloomberg and own calculations.

M. Ledo also analyzes this issue in a recent study,[3] stating that, in 2010, credit risk (credit risk related RWA divided by total assets) accounted for more than 80% of the total risk profile. Institutions with a lower proportion of loans to assets have lower risk profiles. This is the case of German, Swiss, French and UK institutions. The timescale also reflects that a reduction in risk profile is accompanied by reductions in the relative weight of loans to assets. These findings highlight the importance of the business mix but raise serious doubts concerning one aspect of the calculation of RWA: assigning a higher risk weighting to loans than to the trading book. In the light of what has happened over the last four years, this is an issue that should be rectified without delay. Basel 2.5 is an initial step forward in this direction.[4]

Discrepancies in the risk profile which are not explained by differences in the business model can be attributed to the macroeconomic and institutional framework.[5] Some examples of differences in the institutional framework that have a direct effect on risk profile can be found in France and the United States. In France, the existence of Crédit Logement, an agency that guarantees mortgage loans, reduces the probability of default on these loans, pushing the risk weighting below the average figure. In 2009 this number was around 10% for French institutions whereas it reached 20% for Spain and the United Kingdom. In the United States, the accounting principles applied

(3) «Towards more consistent, albeit diverse, risk weighted assets across Banks», Mayte Ledo, Revista de Estabilidad Financiera del Banco de España, November 2011. Sample of 20 international banks.
(4) Basel 2.5 (CRD III) introduces modifications to several mathematical models used to measure and estimate the impact on capital of future losses in the trading book and resecuritization. Directive 2010/76/EU of the European Parliament and of the Council, 24 November 2010.
(5) Includes, among others, regulatory aspects related to procedures to foreclose mortgages, LTV.

(GAAP-US, Generally Accepted Accounting Principles) may explain most of the differences with Europe. In 2010, the assets of JP Morgan would have been up to 68% higher under the International Financial Reporting Standards (IFRS) used in Europe; i.e. its risk profile would have gone from 55% to 33%.

However, even after taking all these elements into account, there are still some differences that arise due to the discretion that can be exercised by supervisors and institutions. The transposition of Basel II into national legislation and, particularly, the process of validating and supervising internal management and risk measurement models (IRB models, or the Internal Ratings Based approach) introduce some degree of discretion and are a source of discrepancies in risk profiles.

In a simulation carried out in 2009, the British Financial Services Authority (FSA) created a portfolio of hypothetical investments and asked some of the country's largest banks to determine the associated RWA based on their IRB models. The results were highly disparate and yielded differences in the regulatory capital ratio of up to 2 percentage points.(6) Some of the differences might be due to the effectiveness of policies to recover deteriorated assets, although probably not all of them. Moreover, national supervisory practices vary in many different areas. Some examples are the time horizon for calculating the probability of default (through the cycle, point in time or a hybrid of both), how problematic assets are treated or the differing quality requirements to validate the models.

In short, behind the differences observed in the risk profile we can find a different real level of risk associated with certain business models and macroeconomic and institutional factors. However, we can also find other distorting factors that should be minimized. In a context of tougher capital requirements, it is essential to ensure coherence in calculating the RWA between institutions and jurisdictions, preserving the differences caused by different effective levels of risk and minimizing differences due to the discretion exercised by the institutions themselves and the supervisor. Only in this way can we avoid regulatory arbitrage or granting competitive advantages to some institutions.

Several proposals are being planned with this aim in mind. Many believe that Pillar III of Basel II, which requires information to be disclosed to the market, should be reinforced to make institutions easier to compare. Similarly, many others defend the use of the ratio of non risk-weighted capital as a complementary tool to the regulatory capital ratio, so as to take advantage of its objectivity and high degree of harmonization, in line with what is established in BIS III.(7) For the moment, the initiative adopted by the Basel Committee aimed at encouraging international coordination among supervisors stands out. In Europe, the European Banking Authority (EBA) will be responsible for pushing this project forward satisfactorily.

(6) Capital Discipline, Haldane, 2011.
(7) In 2010, the European Commission approved Requirement Directive (CRD) IV to start up the process known as Basel III within the area of Europe's single market. This initiative contains a maximum leverage ratio, calculated as capital over total assets, subject to supervisory review. However, its implications will be closely scrutinized before the possible transformation of this ratio into a binding requirement (in 2018).

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SPAIN: OVERALL ANALYSIS

Economic activity

2012, recession or recovery?

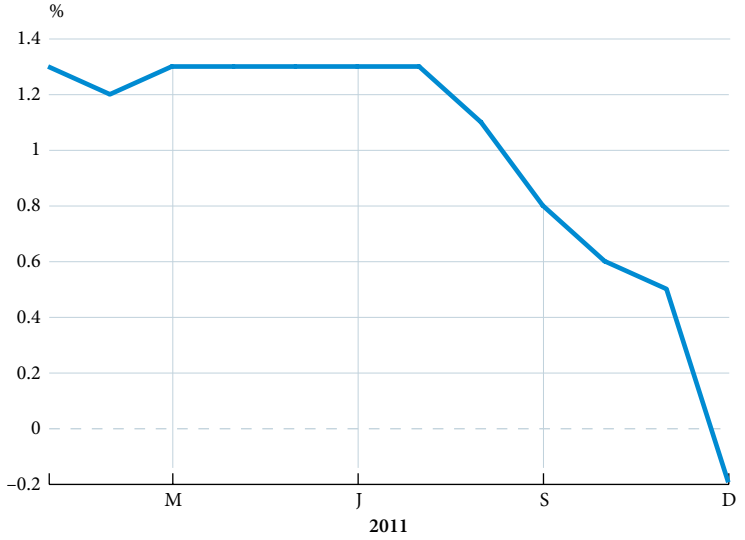
Numerous challenges are facing Spain's economy at the beginning of 2012. After posting a positive GDP growth rate for almost two years, the bulk of the evidence available suggests that the engine is faltering again. According to our forecasts, the decline will be modest, just 2 tenths of a percentage point in the fourth quarter of 2011 and, after a first quarter that will also be weak, the economy will be back on the road to growth in the second quarter. This should allow activity to advance by 0.2% for the year as a whole. But the significant drop in growth prospects revealed by the consensus of analysts in December highlights the significant risks threatening the Spanish economy. According to this, growth for the whole of 2012 will be clearly negative, specifically –0.2%, whereas an advance of 0.5% was still being expected for 2012 in the month of November.

Whether this scenario will be confirmed or not depends essentially on the resolution of the sovereign debt crisis and the measures taken by the new government. The European summit held at the beginning of December served to confirm that the process towards greater fiscal integration is underway. But it also confirmed that the road will be long and probably quite bumpy. Europe's main leaders announced new measures to ensure fiscal discipline and greater coordination in drawing up national budgets. But the negotiation of the details, which are no less important, is going to

Significant drop in growth prospects.

SIGNIFICANT DROP IN THE GROWTH PROSPECTS FOR 2012

Forecasts for GDP growth in 2012 throughout 2011



SOURCES: Consensus Forecasts and own calculations.

DEMAND INDICATORS

Percentage change over same period year before

	2010	2011	2010	2011				
			4Q	1Q	2Q	3Q	October	November
Consumption								
Production of consumer goods (*)	–8.2	0.8	0.1	–1.5	–0.8	0.7	–2.2	...
Imports of consumer goods (**)	–5.8	–9.5	–13.7	–1.1	–8.7	1.2	24.6	...
Car registrations	–17.9	3.1	–29.3	–27.3	–26.4	–0.7	–6.7	–6.4
Credit for consumer durables	–11.5	–12.3	–14.6	–13.9	–10.1	...	–	...
Consumer confidence index (***)	–28.3	–20.9	–21.0	–19.6	–16.1	–15.8	–19.6	–15.4
Investment								
Capital goods production (*)	–22.1	–3.3	–3.2	3.0	2.5	2.6	–1.3	...
Imports of capital goods (**)	–26.3	6.5	4.8	2.3	–4.9	–1.5	–8.7	...
Commercial vehicle registrations	–40.0	7.0	1.4	–2.2	–11.2	5.8	–7.0	–23.8
Foreign trade (**)								
Non-energy imports	–16.9	10.3	5.4	7.4	–0.7	0.8	2.3	...
Exports	–9.8	15.6	15.3	16.0	9.0	10.9	5.1	...

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.

Uncertainty lessens but remains high.

keep uncertainty high over the coming months. This will make it difficult to revive investment and consumption in the euro area as a whole and the contribution by the foreign sector is therefore unlikely to be the same as in 2011.

The risk premium fell notably throughout December. The spread between Spanish and German 10-year bonds, which in November averaged 426 basis points, had fallen to 325 basis points by 23 December. This partly reflects the warm welcome given by the markets to the agreements reached at a European level. The ECB holding three-year liquidity auctions also very probably helped to considerably reduce tensions in the financial markets. However, although the drop has been significant, the risk premium is still moderately high.

The new government's measures are crucial.

On the other hand, the new government is facing the trial of sorting out the public accounts, restoring the credibility of the financial system and taking measures to ensure the Spanish economy becomes more competitive in the medium term. A none too easy challenge but one which the new president of the Spanish government and his economic team have made a top priority. The different measures that will probably be revealed over the coming weeks, and particularly the details of the central government budget that must be approved in March, will be fundamental for determining the route to be taken by the Spanish economy.

All this will have to be achieved within a weak context that does not seem to have touched bottom as yet. One of the few leading indicators to provide a positive surprise was the consumer confidence index. After posting significant drops in the third quarter and, above all, in October, in November it regained part of the

SUPPLY INDICATORS

Percentage change over same period year before

	2010	2011	2010	2011				
			4Q	1Q	2Q	3Q	October	November
Industry								
Electricity consumption (1)	–4.9	2.9	2.2	0.5	0.5	–1.2	–4.0	–3.9
Industrial production index (2)	–15.8	0.8	0.4	1.8	–1.1	–1.4	–4.0	...
Confidence indicator for industry (3)	–30.8	–13.8	–9.2	–8.6	–10.9	–14.4	–13.8	–16.9
Utilization of production capacity (4)	71.2	72.0	72.9	72.6	74.7	73.3	72.7	–
Imports of non-energy intermediate goods (5)	–20.9	24.6	18.2	12.2	3.8	0.9	–6.2	...
Construction								
Cement consumption	–32.3	–15.5	–17.7	–3.1	–16.6	–21.0	–28.4	–28.9
Confidence indicator for construction (3)	–32.3	–29.7	–41.5	–54.1	–55.4	–58.6	–49.0	–52.7
Housing (new construction approvals)	–58.1	–17.3	–20.3	–6.8	–19.5	–5.3	0.4	...
Government tendering	–8.2	–37.9	–34.9	–45.5	–34.0	–45.4	–67.6	...
Services								
Retail sales (6)	–5.4	–1.0	–1.9	–5.9	–5.1	–4.2	–6.8	...
Foreign tourists	–8.8	1.0	1.4	2.9	10.4	8.5	8.0	3.6
Tourist revenue inflows	–9.0	3.9	5.4	6.7	12.2	8.8	...	...
Goods carried by rail (ton-km)	–28.4	6.4	–4.2	8.2	1.8	7.7	–5.0	...
Air passenger traffic	–7.9	2.9	4.3	5.0	10.6	6.2	2.3	–2.0
Motor vehicle diesel fuel consumption	–5.1	–1.2	–1.6	–1.6	–4.5	–2.8	...	...

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.

ground lost. The rest of the demand indicators, however, do not reveal any encouraging trend. Vehicle registrations, for example, continue to wane considerably and retail sales have accentuated their downward trend.

The news from the side of supply is not encouraging either. One of the most surprising indicators has been the large drop in industry's confidence, which to date had been relatively resistant to downward pressure but which, after November's figure, is now at the same level as February 2010. The industrial production index in October was also very weak, falling by 4.0% year-on-year, 2.6 tenths of a percentage point below the figure for September. It's true that this index is quite volatile but a 4.0% drop has not been seen since November 2009. All this results in a production capacity utilization that has once again decreased. After the recession of 2009, this rose gradually in 2010, reaching 74.7% by the second quarter of 2011. In the second half of the year, however, it started to fall again and investment is unlikely to recover this year.

Given this situation, the Spanish economy is therefore very likely to enter

Significant drop in supply indicators.

ACTIVITY WEAKENS

Industrial production index, year-on-year change

SOURCES: National Institute of Statistics and own calculations.

Spain is very likely to enter a recession.

a recession again. This is very clear from the trend in the purchasing managers' index (PMI), as it continues to fall and is moving away from 50 points, the level from which GDP generally posts positive growth rates. Consequently, the question is not whether a recession will occur but rather its intensity and duration. If there is more bad news about the trend in the so-called peripheral countries, risk premia might rise again. An upswing in uncertainty would increase the incentive to save for precautionary reasons, both in households and firms, which would further weaken domestic demand. Moreover, it would also make it difficult to restore the flow of credit, something of the utmost importance for the economic recovery to be solid.

However, it's also true that investors will become more confident as the new euro pact is defined further; a process that might be faster than expected and, if this is the case, might revitalize investment during the second half of the year.

The new government is therefore facing ambitious challenges. The scenario in which the Spanish economy finds itself is not the most desirable. Moreover, the high level of uncertainty surrounding it will not help either. However, everything points to the new government's agenda also being ambitious and it plans to attack, from the very start, the key problems facing Spain's economy. In this respect, any announcement of the measures it's going to take becomes particularly relevant and must be monitored with the utmost attention.

Labour market

The difficult path of internal devaluation

Just one decade ago, on 1 January 2002, Spain definitively adopted the euro as its currency and thereby gave up having its own monetary policy. Depreciation, used on many occasions in the past (for example, in the nineties), was no longer an option and any future adjustments due to lack of competitiveness would have to be made through internal devaluation. This is the path embarked upon today by the Spanish economy.

Given the difficulty in reducing wages, the adjustment continues to be made particularly in terms of quantities and, to a lesser degree, via prices. In this respect, November saw 7.6% growth year-on-year in the number of unemployed, bringing total registered unemployment to 4,420,462 individuals. The rise of 59,536 people compared with the

Unemployment rises by 59,539 people and returns to 2009 records.

EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2009	2010	2010	2011				
			4Q	1Q	2Q	3Q	October	November
Persons registered with Social Security (1)								
Sectors of activity								
Industry	*–10.6*	*–4.8*	*–3.2*	*–2.8*	*–2.4*	*–2.4*	*–3.0*	*–3.4*
Construction	*–23.1*	*–13.4*	*–11.3*	*–9.6*	*–11.4*	*–13.0*	*–14.0*	*–15.3*
Services	*–2.6*	*0.0*	*0.4*	*0.3*	*0.5*	*0.3*	*0.0*	*–0.4*
Job situation								
Wage-earners	*–6.0*	*–1.8*	*–1.2*	*–1.1*	*–0.9*	*–1.3*	*–1.9*	*–2.3*
Non-wage-earners	*–4.8*	*–2.8*	*–1.9*	*–1.6*	*–1.2*	*–1.0*	*–1.0*	*–1.0*
Total	**–5.8**	**–2.0**	**–1.3**	**–1.2**	**–1.0**	**–1.2**	**–1.7**	**–2.1**
Persons employed (2)	**–6.8**	**–2.3**	**–1.3**	**–1.3**	**–0.9**	**–2.1**	**–**	**–**
Jobs (3)	**–6.6**	**–2.4**	**–1.4**	**–1.4**	**–1.0**	**–1.9**	**–**	**–**
Hiring contracts registered (4)								
Permanent	–31.0	–6.4	0.0	–1.8	–5.0	–8.4	–17.9	–22.4
Temporary	–13.5	3.8	2.8	0.7	3.9	0.9	–2.5	–1.3
Total	**–15.5**	**2.8**	**2.5**	**0.4**	**3.1**	**0.2**	**–3.8**	**–3.2**

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.

Biggest drop in Social Security registrations in November since 2008.

previous month almost coincides with the data recorded in November 2009 and only 2008 provided worse figures in the series' history.

The figures for Social Security registrations are even more representative of the pace of job losses as 111,782 registered workers have been withdrawn from the lists of the employed in the last month. Even assuming this figure is almost halved when seasonal factors are taken into account, the loss of registered employed in November is the worst since 2008. Since June, the Spanish economy has lost 313,355 registered employed, seasonally adjusted, which is 91,010 more than in these same five months in 2009, when the economy was falling by 3.5% on average.

These employment figures reveal the little confidence of agents regarding hiring and investing in 2012, whose outlook for activity is posting negative figures for the start of the year. In particular, it's very likely that GDP will fall slightly between the last quarter 2011 and the first of 2012. In which sectors has this relapse occurred most severely and, especially, which sectors will continue to lose jobs?

In the summer of 2007, the Spanish economy reached its peak of employment with 20,510,600 employed. Four years later, the Spanish economy has lost 2,354,300 jobs. 60% of this adjustment has occurred in construction, which has seen its number of workers fall by 1,402,400 individuals. The contribution of construction to the total number of employed is therefore at a record low, around 7.6%. The other sector severely affected by the crisis is industry, with job losses amounting to 29%. Agriculture and the services sector have fared better, with drops of 8% and 6% respectively.

This trend is not going to turn around in 2012 and construction will more than likely continue to bear the brunt of the

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

November 2011

	No. of unemployed	Change over December 2010		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	151,597	24,768	19.5	17,901	13.4	3.4
Industry	500,436	8,798	1.8	14,995	3.1	11.3
Construction	752,150	–917	–0.1	28,059	3.9	17.0
Services	2,624,994	253,055	10.7	222,646	9.3	59.4
First job	391,285	34,685	9.7	26,567	7.3	8.9
By sex						
Males	2,179,563	126,375	6.2	151,998	7.5	49.3
Females	2,240,899	194,014	9.5	158,170	7.6	50.7
By age						
Under 25 years	486,203	52,429	12.1	24,794	5.4	11.0
All other ages	3,934,259	267,960	7.3	285,374	7.8	89.0
TOTAL	**4,420,462**	**320,389**	**7.8**	**310,168**	**7.5**	**100.0**

SOURCES: Public State Employment Service and own calculations.

adjustment. Falling public investment, which is already taking place, will be added to the lethargic demand in a sector that is already very weak. The rest of the sectors will be less affected by weak domestic demand because the foreign sector and tourism will slightly offset the correction in industry and services. As a result, the services sector will continue to gain weight in the Spanish economy and will account for more than 75% of all jobs. During the last expansionary cycle (1994-2007), and in spite of the real estate bubble, the services sector was responsible for 76% of the jobs created in Spain, a trend that looks like continuing in the future, according to the figures.

The services sector will be increasingly important for employment.

In fact, unemployment has had highly negative consequences in the last quarterly labour cost survey (ETCL in Spanish), with the cost of redundancies borne by firms in the form of non-wage income rising by 9.2% compared with the same quarter a year ago. However, the contribution made by redundancy payments needs to be looked at in more detail as most of the labour costs correspond to the wage component, which increased by 1.2%. Total labour costs for firms grew by 1.5% year-on-year and now stand at 2,457 euros per worker per month.

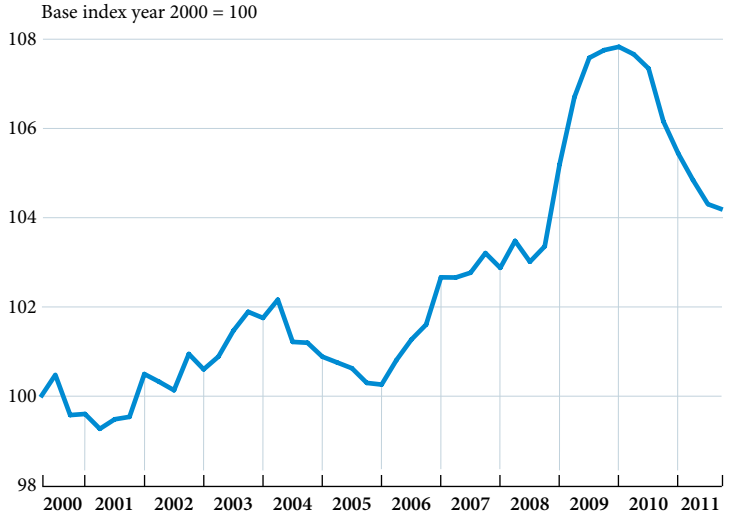
Given that wage costs grew by less than inflation in the third quarter (3.1%), at first sight we might say that wages lost purchasing power. If we construct an index whose base year is 2000 and we look at the total wage cost and inflation, seasonally adjusted, we can see that the only truly significant increase in the real wage occurred from the third quarter of 2008 to the last quarter of 2009, when the average real wage rose by 4.3%. Since then, wages have lost 3.4% of their value, thereby reversing a large part of the rise of the last few years.

Labour costs grow and real wages fall.

We should note that, in the medium term, it is positive for real wages to rise as this indicates that a worker with an average salary has more purchasing power than before. From 2000 up to

THE CRISIS AFFECTS THE REAL WAGE

Real wage



SOURCES: National Institute of Statistics (INE) and own calculations.

WAGE INDICATORS

Percentage rate of change over same period year before

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

Unemployment comes close to the 5 million mark, with a rate of 21.5%.

the summer of 2008, the real wage increased by 4.3% while GDP per capita rose by 13.5%.

The last quarterly labour cost survey (ETCL) throws light on the cost of the labour factor, key to price formation and of vital importance in the current context given that, at present, the foreign market is the only source of growth. To date, it seems we are on the right track, recovering levels of competitiveness. Nonetheless, the internal devaluation that is taking place is not without risk, as too sharp a devaluation could weaken domestic demand.

Prices

The strength of inflation and its inevitable fall

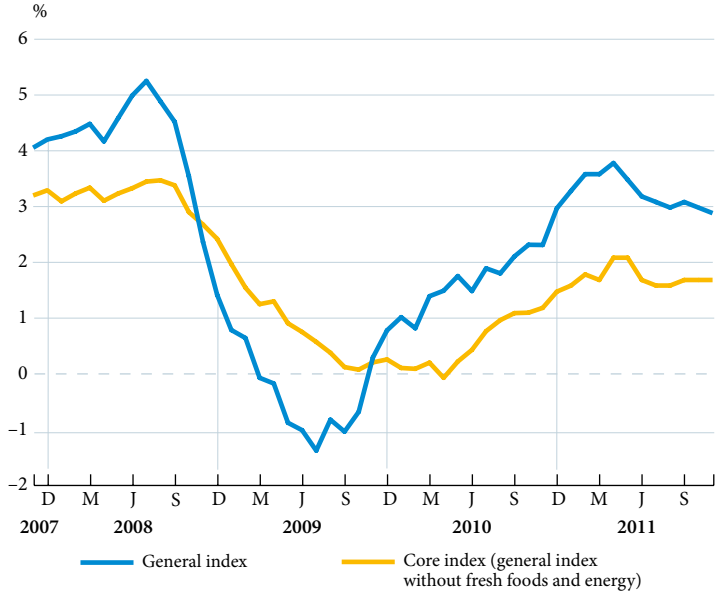
Every day we hear news about the weak state of the economy and, nonetheless, the basket of consumer goods seems to be increasingly expensive. We are not mistaken in our perception. GDP will grow by close to 0.4% in the fourth quarter in year-on-year terms and the forecast for the coming six months is for growth to be negative. But inflation has hardly fallen over the last five months, remaining at levels close to 3.0%. Why is the consumer price index (CPI) so persistent?

In November, inflation dropped by a mere tenth of a percentage point compared with the previous month and its change was 2.9% in year-on-year terms. This drop of 0.1% can be put down mainly to the decrease in medicine and transport. The reason for the fall in medicine is the encouragement given by the government last summer to the use of generic medicines, forcing doctors to prescribe by active ingredient and pharmacists to provide the cheapest equivalent drug. So drugs and other pharmaceutical products fell in November by 11.2% compared with last year and medicine by 2.9%.

Inflation falls by one tenth of a percentage point to 2.9%.

INFLATION AT AROUND 3.0% LOOKS LIKE DISAPPEARING

Year-on-year change in CPI



SOURCE: National Institute of Statistics (INE).

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	1.4	3.5
June	0.2	1.0	1.5	–0.1	1.2	3.2
July	–0.5	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	0.3	1.0	3.1
October	0.9	1.8	2.3	0.8	1.8	3.0
November	0.5	2.4	2.3	0.4	2.2	2.9
December	0.6	3.0	3.0			

SOURCE: National Institute of Statistics.

Inflation will fall to 2.5% in December.

For its part, inflation for fuels and oils was one percentage point lower in November than the previous month, its year-on-year rate of change standing at 15.2%. That's why, in spite of the drop of 5 tenths of a percentage point in transport prices, this has reached 7.1%. This group, added to that of housing and alcoholic beverages and tobacco, with rates of 6.0% and 10.5%, is pushing up inflation. These three components account for 29% of the basket used to calculate general inflation and half this figure corresponds to transport. This explains why core inflation, which excludes unprocessed foods and energy products, remained unmoved at 1.7%.

However, a significant drop in inflation is inevitable for December and the forecast is for the CPI to fall to levels close to 2.5%. The reason is the disappearance of effects produced by a 0.7% increase at the end of last year, when there were big price rises in commodities, principally oil, as well as the tax hike on tobacco, sharply pushing up inflation.

In contrast, in December 2011 a barrel of Brent quality oil posted a small decrease compared with the previous month and the forecast for 2012 is that this trend will continue until it stabilizes at around 77 euros per barrel. For its part, tobacco already saw a sharp price rise in September and no tax changes are expected that will affect December.

The small drop in November was also reflected in the harmonized index of consumer prices (HICP), which helps to compare European countries as it standardizes baskets of purchases. For the first time since the start of 2010, prices in Spain are growing less in year-on-year terms than in the euro area, 2.9% compared with 3.0% for our European peers. Lower price growth is crucial when exporting, as it leads to gains in competitiveness. Should this trend become consolidated, the price differential would boost a sector that, to date, has been the only driver of growth for the Spanish economy.

Inflation forecasts for 2012, both for Spain and the euro area, are downward. Proof of this is the lowering of interest rates to 1.0% carried out by the European Central Bank (ECB), as well as the full allotment of liquidity provided by the central authority of the euro area in an attempt to relieve liquidity tensions in wholesale finance markets, measures that will not push up inflation in the short term.

In the Spanish case, inflation is exposed to various questions that might alter the forecast by one tenth of a percentage point or so. In January we will hear the Ministry of Industry's decision regarding the last resort tariff (TUR in Spanish), which determines the price of electricity in more than 20 million households. The current tariff creates an annual deficit in excess of 3 billion euros and produces an accumulated debt of 22 billion, so that industry is pushing for a rise.

Prices rise more slowly than in the euro area.

CONSUMER PRICE INDEX BY COMPONENT GROUP

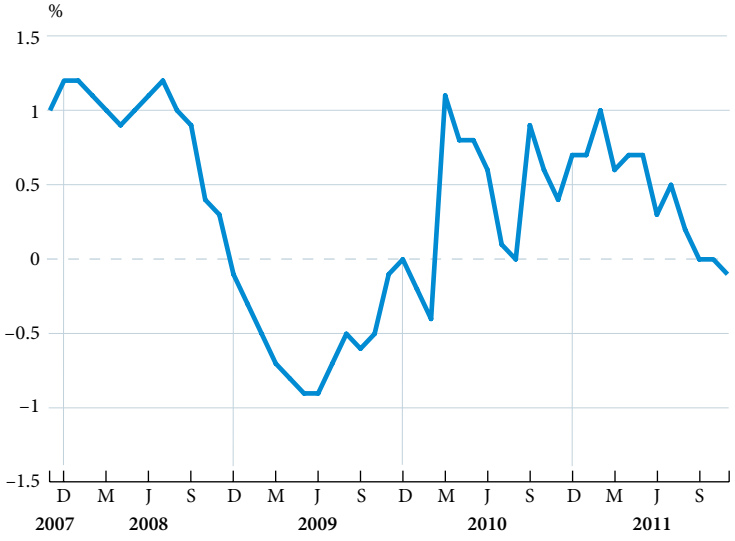
November

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2010	2011	2010	2011	2010	2011
By type of spending							
Food and non-alcoholic beverages	110.8	0.2	0.2	0.3	1.8	0.5	2.2
Alcoholic beverages and tobacco	151.2	0.1	0.2	8.6	4.2	8.5	10.5
Clothing and footwear	110.5	4.8	5.0	1.8	1.7	0.6	0.5
Housing	125.8	0.4	0.2	5.4	5.7	5.4	6.0
Furnishings and household equipment	109.6	0.2	0.4	0.8	1.0	0.9	1.2
Health	93.6	–0.2	–2.6	–1.3	–2.9	–1.2	–2.9
Transport	118.6	0.9	0.4	7.2	5.1	6.7	7.1
Communications	97.1	0.0	0.0	–0.7	–1.5	–0.7	–1.6
Recreation and culture	96.7	–0.9	–0.5	–2.4	–0.9	–1.0	0.4
Education	120.3	0.1	0.1	2.2	2.8	2.3	2.8
Restaurants and hotels	114.9	–0.2	–0.3	1.5	1.0	1.5	1.2
Other goods and services	115.7	0.1	0.1	2.6	2.5	2.7	2.6
By group							
Processed food, beverages and tobacco	118.2	0.2	0.3	1.2	3.0	1.3	4.4
Unprocessed food	109.8	0.1	0.0	2.0	0.2	2.2	0.8
Non-food products	112.7	0.6	0.5	2.6	2.3	2.5	2.8
Industrial goods	111.6	1.4	1.1	4.1	3.4	3.6	3.9
Energy products	*137.2*	*1.2*	*0.5*	*12.4*	*10.7*	*11.7*	*13.8*
Fuels and oils	*134.5*	*1.6*	*0.7*	*14.1*	*11.1*	*13.2*	*15.2*
Industrial goods excluding energy products	*103.0*	*1.5*	*1.3*	*1.2*	*0.6*	*0.8*	*0.3*
Services	113.9	–0.2	–0.2	1.2	1.2	1.5	1.6
Underlying inflation (**)	110.7	0.5	0.4	1.2	1.3	1.2	1.7
GENERAL INDEX	**113.5**	**0.5**	**0.4**	**2.4**	**2.2**	**2.3**	**2.9**

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

SPAIN GAINS COMPETITIVENESS WITH LOWER PRICES RISES THAN THE EURO AREA

Inflation differential between Spain and the euro area



SOURCE: Eurostat.

Moreover, some autonomous communities have announced a rise in various rates on products as diverse as university enrolment, transport, pharmaceutical prescriptions, overnight stays, etc. Whether these measures are finally adopted, their ultimate amount and possible extension to other areas will determine whether they have any visible effect on the CPI. In principle, the lethargy of demand and public consumption, as well as the slowdown in activity, will push inflation down.

Foreign sector

Has the correction in the trade deficit run its course?

The trade deficit for October 2011 posted a slight fall of 1.9% compared with the same month the previous year. An improvement that put an end to two consecutive months of deterioration in the trade imbalance. However, this correction was significantly lower than the figures recorded in the first half of 2011 of last year. Does this mean that the adjustment in the trade deficit is coming to an end?

The answer will depend on the performance of the main factors underlying the trend in the trade balance over the next few months: the variations in oil prices and economic growth both in Spain and the euro area.

With regard to the former, oil prices play an important role in Spain's trade balance due to the high relative weight of the energy component. In fact, the cumulative energy imbalance over the twelve months up to October 2011 accounts for 84% of

The trade deficit falls slightly in October by 1.9% year-on-year.

FOREIGN TRADE

January-October 2011

	Imports			Exports			Balance	
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	Export/ Import rate (%)
By product group								
Energy products	45,964	27.2	21	11,942.9	66.9	6.7	–34,021	26.0
Consumer goods	51,406	5.4	24	57,136.7	11.7	32.2	5,731	111.1
Food	*13,376*	*5.4*	*6*	*20,815.3*	*8.8*	*11.7*	*7,440*	*155.6*
Non-foods	*38,030*	*5.4*	*18*	*36,321.4*	*13.4*	*20.4*	*–1,709*	*95.5*
Capital goods	14,173	–3.3	7	15,287.9	18.1	8.6	1,115	107.9
Non-energy intermediate goods	105,188	9.8	49	93,248.5	15.1	52.5	–11,939	88.6
By geographical area								
European Union	114,508	6.7	53	117,551.3	13.8	66.2	3,043	102.7
Euro area	*92,991*	*7.6*	*43*	*93,809.6*	*10.5*	*52.8*	*819*	*100.9*
Other countries	102,223	16.1	47	60,064.7	22.5	33.8	–42,158	58.8
Russia	*7,415*	*52.4*	*3*	*2,099.2*	*29.8*	*1.2*	*–5,316*	*28.3*
United States	*8,690*	*14.5*	*4*	*6,648.8*	*24.0*	*3.7*	*–2,041*	*76.5*
Japan	*2,683*	*–7.1*	*1*	*1,551.7*	*32.7*	*0.9*	*–1,131*	*57.8*
Latin America	*13,927*	*20.4*	*6*	*10,006.5*	*22.0*	*5.6*	*–3,921*	*71.8*
OPEC	*22,601*	*20.2*	*10*	*6,786.7*	*23.0*	*3.8*	*–15,814*	*30.0*
Rest	*46,908*	*10.8*	*22*	*32,971.9*	*21.4*	*18.6*	*–13,936*	*70.3*
TOTAL	**216,731**	**10.9**	**100**	**177,616.0**	**16.6**	**100.0**	**–39,115**	**82.0**

SOURCES: Ministry of the Economy and own calculations.

At 40.5 billion euros, the energy component accounts for 84% of the deficit in the twelve months up to October.

the total deficit and amounts to 40.5 billion euros, 19.5% higher than the cumulative balance the previous year. This deterioration was due to the sharp rise in energy imports, 28.7% in this period, boosted by the 24.9% upswing in prices year-on-year. The standstill in oil prices during the last few months of the year and their slight fall predicted for 2012 will therefore reduce pressure on the energy deficit over the coming months.

All this will take place within a context of weak household consumption, which will be reflected in less dynamism for imports as a whole. In fact, the data for October point in this direction, with a 9.2% growth in imports year-on-year, a long way from the 17.5% of August. This effect is even more evident when the series is adjusted for the effects of import prices. In October, the volume of imports remained almost at the same level as a year before, with a year-on-year rise of just 0.5%.

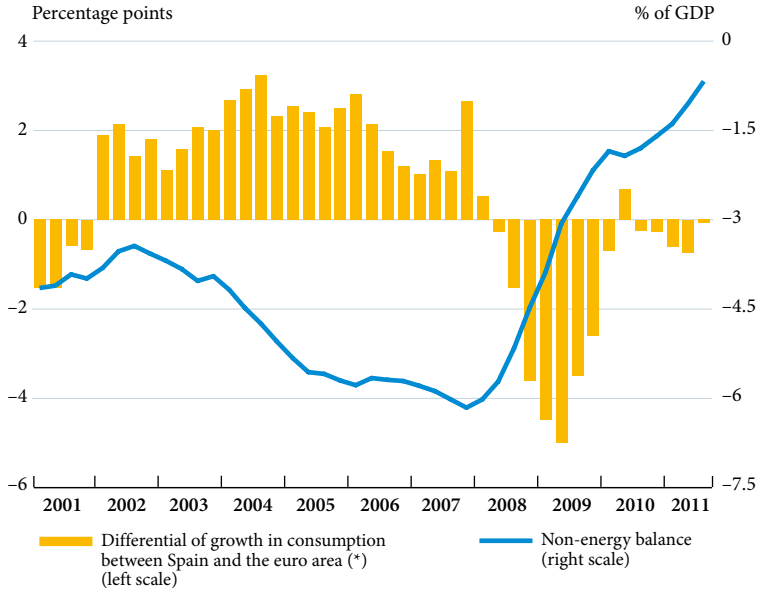
The rate of change for imports is expected to continue to decrease in 2012, even posting a reduction in some months. However, Europe, the main trading partner of Spain, will also suffer a slowdown in its economy in 2012 which will reduce the rate of growth of Spanish exports. Consequently, the performance of the non-energy trade balance will depend on which of the two trade flows (imports or exports) slows up the most.

The better performance of European consumption compared with Spanish will continue to correct the non-energy deficit.

As can be seen in the graph, the correction of the non-energy deficit coincides with those periods when European household consumption has performed better than Spanish. Of note is the sharp correction started in 2008, when the non-energy deficit fell from 6.2% of gross domestic product (GDP)

THE BETTER PERFORMANCE OF EUROPEAN CONSUMPTION HELPS TO REDUCE THE NON-ENERGY BALANCE

Differential between the growth in Spanish and European consumption and the non-energy deficit



NOTE: (*) Positive (negative) levels indicate more (less) growth in Spanish consumption than in the euro area.
SOURCES: Ministry of the Economy, Eurostat and own calculations.

to 0.7% for the third quarter of 2011. This adjustment was only cut short in the second quarter of 2010 due to consumption being brought forward as a result of impending tax hikes. Taking into account the fact that European household consumption is very likely to perform better than Spanish throughout 2012, this trend should remain in place for the coming quarters.

The current deficit is already at 2004 levels

With regard to the current deficit, September's figures show some slowdown in its rate of correction, with a 10.3% drop year-on-year. As a consequence of this new improvement, the sixth consecutive one, the cumulative balance for the last twelve months fell to 43.6 billion euros, equivalent to 4.1% of GDP in the same period. This figure reduces by two tenths of a percentage point the one recorded the previous quarter and now stands at levels similar to those in 2004.

A breakdown by component shows that the services and transfers balances are the main items involved in the adjustment of the current imbalance in the last quarter, offsetting the bad performance by the income balance. The cumulative service balance surplus increased to 3.1% of GDP, a level it has not reached since 2003. This is mainly due to the trend in the tourism balance, boosted by greater dynamism in Europe's economy during the first half of 2011 and the armed conflicts in North Africa. However, the slowdown in tourist visits in November, with a growth of 3.6% year-on-year, suggests that any further increases in the balance surplus during the last few months of 2011 and in 2012 are likely to peter out.

The current deficit falls to 4.1% of GDP in September.

On the other hand, we expect the income balance deficit to maintain its upward trend started in 2011. The accumulated deficit for the last twelve months rose to 27.6 billion euros in September. This figure is 5.7 billion euros higher than the one recorded in December 2010 and highlights the greater cost of financing Spanish debt in 2011.

The income balance deficit continues to deteriorate.

Public sector

2012: new measures to exit the debt crisis

New agreements reached at the European summit to tackle Europe's crisis.

The euro symbol (€) takes its inspiration from the initial of «Europe» and the letter epsilon from the Greek alphabet, in reference to what was the cradle of European civilisation. The two parallel lines crossing it represent the currency's stability. Paradoxically, it was Greece where the turbulence started that would end up infecting the rest of Europe's public debt markets, raising doubts as to whether the single currency will continue. Given this threat, the agreements reached at the European summit last December laid the foundations to overcome the sovereign debt crisis. Without doubt, the future implementation of what is, today, merely a rough draft, and the credibility of Spain's fiscal consolidation will determine the pressure on our public finances. All this within a context of a stagnant economy.

The measures agreed by most European Union (EU) states, with the exception of the United Kingdom, indicate their readiness to give up fiscal sovereignty. It was agreed to establish a stricter limit on public budgets, whose structural deficit (having discounted the effects of the economic cycle) cannot exceed 0.5% of their gross domestic product (GDP). Greater fiscal discipline can also be seen in the tougher corrective measures when a country's deficit goes over 3% of GDP and the capacity of the European Commission to supervise budget plans. The commencement of the European Stability Mechanism (ESM) has also been brought forward by one year to July 2012, albeit without increasing its allocation of 500 billion euros. To this amount we should add the 200 billion euros to be provided by the EU to the International Monetary Fund (IMF) so that it can be lent to countries in difficulty.

These agreements represent a small step forward in the right direction. However, their slow implementation and a delay in their results until the medium term might prolong uncertainty in the markets, especially given the expectations of a slowdown in Europe's economy in 2012.

Spain's risk premium falls to 325 basis points.

In this situation, the spread in yields from Spain's 10-year bonds compared with their German peers, known as the risk premium, fell by half a percentage point after the summit was held, down to 325 basis points (b.p.). This figure is far from the peak reached mid-November, when it exceeded 500 b.p. As a result, the 12 and 18-month bonds issued in December were placed at a cost that was one percentage point lower than the previous month, with demand outstripping supply by more than three to one.

In spite of this improvement, Spain's risk premium ended 2011 at a significantly higher level than the 250 points recorded at the start of the year. The country's huge need for financing in 2012, estimated at more than 160 billion euros, means that the trend in its financing costs is of prime importance. These costs will depend on various factors, particularly the solidity of Spain's fiscal consolidation and the direction of its economic growth.

With regard to fiscal adjustment, we estimate that the public sector deficit exceeded the target established of 6.0% of GDP in 2011 by more than one percentage point. The data available point towards budget deviations in the autonomous communities and Social Security as the main reasons. In effect, the deficit accumulated by the former between January and September was equivalent to 1.2% of GDP in 2011. This figure is one tenth of a percentage point below the limit set for the whole year. The reduction in costs of around 30 billion euros compared with the same period the year before was not enough to offset the fall in revenue of a similar amount. Given that the fourth quarter is usually accompanied by high expenditure obligations, we estimate that the total deficit will have exceeded 1.5% of GDP in 2011.

Similarly, during the first eleven months of the year, the Social Security offices cut their surplus by 41.8% year-on-year, down to 5.6 billion euros. The deterioration in employment and therefore in Social Security contributions in the last part of 2011 might have even placed the budget balance at the end of the year in the red, far from the 3.9 billion euros predicted by the government.

Neither did the weakness of economic activity help the country's deficit to fall more than the nine tenths of a percentage point predicted by the government, reaching 4.8% of GDP. Up to November, the budget imbalance, in national accounts terms, adjusted by 4.9% year-on-year, standing slightly above the target. Although the new financing system implemented in 2011 means that a full comparison cannot be made with the previous year, cash flows help us to make out the main forces underlying this improvement. In the case of central government payments, the main ways of adjusting public spending are real estate investment and current expenditure on goods and services. With regard to revenue, an analysis of the aggregate data for the central government and regional administrations reveals that tax revenue has remained practically at a standstill compared with the first ten months of 2010.

As a consequence, the lower than expected correction in the public deficit in 2011, the economy's weak pulse and the growing burden of interest repayments will require a greater effort to achieve the deficit targets for 2012. In this respect, in his investiture speech the new president of the government, Mariano Rajoy, threshed out a route map marked by austerity and budget discipline. Among the main measures, of particular note are the simplification of agencies and other public organizations, cuts in current expenditure for central government administration and the non-replacement of civil servants.

The country's financing needs for this year are estimated at more than 160 billion euros.

The deficit of the autonomous communities reaches 1.2% of GDP in 2011 in the third quarter.

The country's deficit accumulated up to October 2011 falls by 16.9% year-on-year, in line with the target figure of 4.8% of GDP.

Savings and financing

The ECB's liquidity will not guarantee growth in credit

The ECB injects 443 billion euros into European banks.

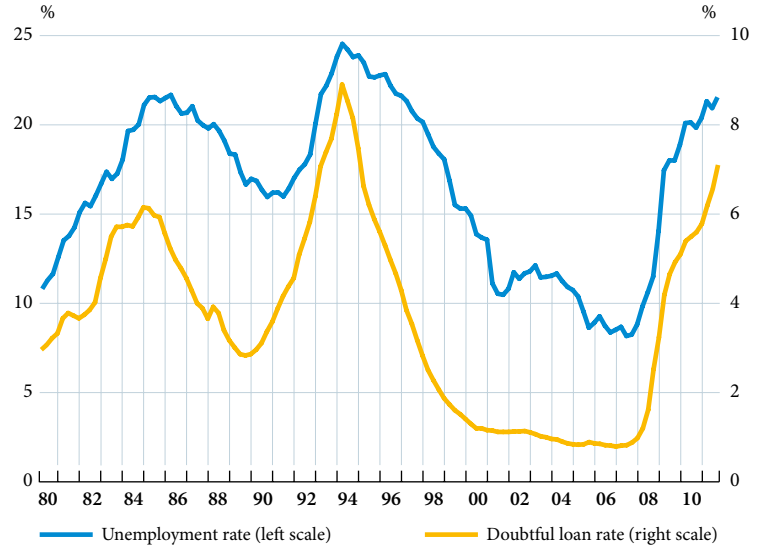
The New Year has brought renewed hope regarding a lessening of the tensions affecting the banking sector over the last few months. The commitment of the European Central Bank (ECB) to provide liquidity for Europe's banks and the speeding up of the restructuring of Spain's banking sector aim to dispel doubts in the finance markets. However, the stagnation of Spain's economic activity and the deleveraging being carried out in its private sector make it difficult for credit to recover this year.

In fact, the ECB's first three-year auction resulted in a net demand of more than 443 billion euros on the part of 531 European financial institutions. This was the largest amount injected by the monetary authority as it exceeded the auction held in June 2009, its first one-year auction. This liquidity facility eases Spain's banking system which, in 2011, suffered from the effects of the wholesale funding markets closing their doors. Its importance becomes evident if we take into account the large amounts of maturities for Spanish bank debt in 2012, slightly over 120 billion euros. This is practically four times the debt issued throughout last year, namely 31 billion.

In fact, in order to meet their liquidity requirements from the second half of 2011, Spain's banks resorted more to

THE DETERIORATION IN THE JOB MARKET WILL CONTINUE TO PUSH UP THE DOUBTFUL LOAN RATE IN 2012

Unemployment rate and doubtful loan rate



SOURCES: Bank of Spain and Ministry of Labour.

Eurosystem funding between April and November last year, up by 56 billion euros. Resorting to the ECB became one of their main channels of funding, totalling 98 billion euros, the highest since September 2010. This figure accounts for 26.2% of the total money loaned by the ECB to European financial institutions. A very high ratio if we remember that the assets of Spain's banks represent close to 12% of Europe's banking sector.

This fact reflects the uncertainty regarding the solvency of the Spanish banking system, which persists in spite of the restructuring carried out in 2011. A process that, at the same time, saw the recapitalization of some of the institutions up to the new limit of 8% demanded by the Bank of Spain. One of the main reasons for this uncertainty is the high doubtful loan ratio in Spain's banking system. This increased by 26 basis points last October, reaching 7.42% of loans to other resident sectors. The above graph shows that those periods with the highest rises in unemployment are usually accompanied by increases in the default rate. As a consequence, the deterioration in the job market forecast for 2012 leads us to predict further increases in default.

Spanish banks resort more to the ECB for funding, up to 98 billion euros.

Breaking down the figures by area of activity, the growth in the default rate responds largely to the rise in doubtful assets in the sectors of construction and property development. In September these reached ratios of 16.1% and 19.0% respectively, far from the 5.2% of industry or the 4.4% of services. Albeit starting from much lower levels, household bad debt also intensified its increase in this period, up to 3.4%.

Given that outstanding loans for real estate activities exceeded 405 billion

The doubtful loan ratio rises to 7.42% in October.

FINANCING OF NON-FINANCIAL SECTORS (1)

October 2011

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,145,479	–63,046	–2.0	75.3
Non-financial corporations	1,270,922	–39,039	–2.0	44.6
Resident credit institution loans (3)	*851,819*	*–45,656*	*–4.4*	*29.9*
Securities other than shares	*65,090*	*4,142*	*6.6*	*2.3*
External loans	*354,014*	*2,474*	*2.8*	*12.4*
Households (4)	874,557	–24,007	–2.0	30.7
Housing loans (3)	*668,847*	*–11,111*	*–1.1*	*23.5*
Other (3)	*202,290*	*–12,996*	*–4.9*	*7.1*
External loans	*3,420*	*100*	*4.5*	*0.1*
General government (5)	704,324	62,441	13.7	24.7
TOTAL	**2,849,803**	**–605**	**1.1**	**100.0**

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

The creation of a bad bank to group together nonperforming assets could quickly sort out the banks' balance sheets.

euros in the third quarter, 22.8% of all credit, it comes as no surprise that real estate risk is seen as the main threat to solvency for Spain's banking sector. According to the Bank of Spain, the volume of problematic real estate credit and assets in the hands of financial institutions had risen to 176 billion euros by mid-2011. This includes foreclosed real estate assets and bad and doubtful debt.

To reduce market uncertainty, the new government is therefore thinking of creating a bad bank to group together the nonperforming assets of Spain's banks. This proposal would help to quickly sort out the financial institutions' balance sheets. However, as shown by experience in countries such as Ireland and Germany, the design of this bad bank can lead to disparate results and is therefore a hugely complicated task. The degree of participation by the central government, the valuation of nonperforming assets and the mechanisms used to demand accountability from institutions benefiting from its implementation are important aspects.

Both the ECB's liquidity injections and the creation of a bad bank are measures attempting to revive financing for the private sector. Up to October, this fell by 2.0% year-on-year with similar decreases for households and firms.

The reduction was even greater over the same period if we take only bank credit to the public sector into account, falling to a level 2.5% below that of October 2011. A breakdown shows a widespread drop in all sectors. Of note is the fall in credit to construction, 15.8% compared with the third quarter of 2010. The services sector posted the smallest drop, 1.9% in the same period. With regard to credit to households, consumption items recorded the largest drop, while mortgage loans fell

CREDIT TO PRIVATE SECTOR BY PURPOSE

Third 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	22,203	–925	–4.0	–1,253	–5.3
Industry	145,503	–6,873	–4.5	–6,528	–4.3
Construction	102,258	–12,261	–10.7	–19,255	–15.8
Services	681,132	–14,002	–2.0	–13,242	–1.9
Total	**951,096**	**–34,061**	**–3.5**	**–40,278**	**–4.1**
Financing to individuals					
Acquisition and renovation of own home	655,734	–7,063	–1.1	–3,498	–0.5
Acquisition of consumer durables	38,478	–3,590	–8.5	–1,781	–4.4
Other financing	100,350	–7,566	–7.0	–10,875	–9.8
Total	**794,562**	**–18,219**	**–2.2**	**–16,154**	**–2.0**
Other	**43,188**	**–2,826**	**–6.1**	**8,001**	**22.7**
TOTAL	**1,788,847**	**–55,106**	**–3.0**	**–48,431**	**–2.6**
Acquisition of housing and real estate activities	***928,615***	***–19,616***	***–2.1***	***–20,170***	***–2.1***

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

by 0.5% year-on-year. However, the fact that demand for credit was brought forward in the last few months of 2010 due to the end of tax rebates for buying a primary residence suggests that these drops will be greater in the fourth quarter of the year.

Looking to the future, the measures adopted to revive credit will not be enough to avoid a further fall in 2012. We therefore predict that the stagnation of the economy and the deleveraging of households and firms will place the rate of change at –2.3% compared with the figure for 2011.

Deposits continue to fall

Within this context of a weak Spanish economy, household savings, in relation to disposable income, will probably go above the figure of 12.8% for June 2011. This will be due to greater precautionary savings because of the deterioration in the job market and consumer sentiment. In spite of this upswing, which will continue in the first few months of 2012, we do not expect savings to come close to the peaks recorded in 2009, namely 18.5%.

Notwithstanding this upswing in savings, the liabilities of Spanish households and firms in October speeded up their rate of reduction, down 2.2% compared with the same month the previous year. An analysis of different bank liabilities shows that this reduction affected both short and long-term instruments. However, this fall can be largely explained by the replacement of bank deposits with other kinds of financial instruments providing higher yields. Particularly public debt bonds and the commercial paper of financial institutions themselves which, unlike deposits, have no limit on the returns they can offer.

We expect that the greater liquidity injected into the markets will reduce the need for financial institutions to look for funds via retail deposits. This will ease the competition seen over the last few months to attract retail funds and will lower the interest rate for new term deposits, which stood at 2.72% in October.

Credit falls by 2.5% year-on-year in October 2011, pressurized by real estate loans.

The upswing in household savings weakens private consumption.

The greater liquidity injected will lessen the deposit war.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

October 2011

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	258,740	–3,026	–1.2	6,288	2.5	18.9
Savings deposits	197,144	–14,143	–6.7	–10,025	–4.8	14.4
Term deposits	716,874	–26,775	–3.6	–21,712	–2.9	52.3
Deposits in foreign currency	16,261	–3,122	–16.1	–4,121	–20.2	1.2
Total deposits	**1,189,019**	**–47,066**	**–3.8**	**–29,570**	**–2.4**	**86.7**
Other liabilities (*)	**181,614**	**–21,398**	**–10.5**	**–1,731**	**–0.9**	**13.3**
TOTAL	**1,370,633**	**–68,463**	**–4.8**	**–31,302**	**–2.2**	**100.0**

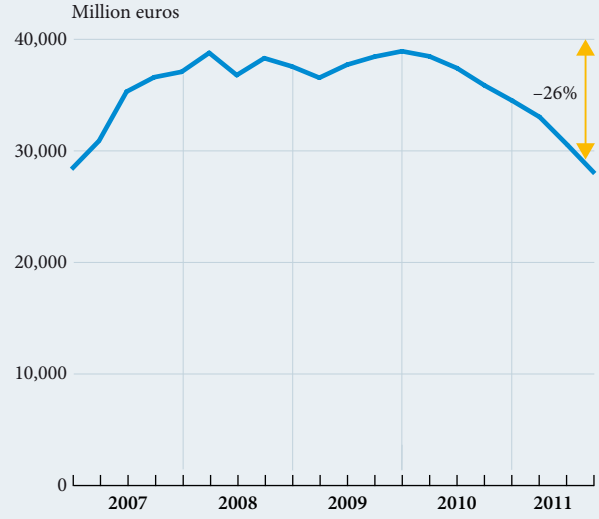
NOTE: (*) Aggregate balance according to supervision statements. Includes asset transfers, hybrid financial liabilities, repos and subordinated deposits.
SOURCES: Bank of Spain and own calculations.

The profitability of the Spanish banking system in the current situation and its future prospects

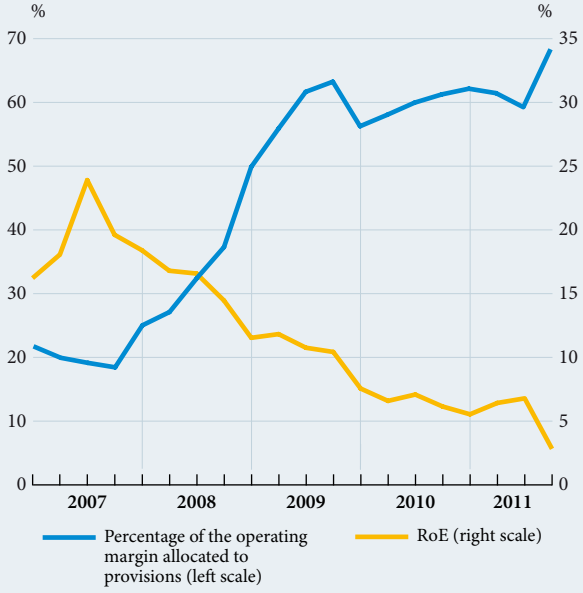
Spain's financial system is characterized by its great capacity to generate recurrent earnings but this capacity has decreased significantly over the last two years. For example, the system's pre-provision income (operating margin), which should be enough to sustain doubtful loans and also to provide returns on capital, has fallen by 26% compared with the peaks reached in 2007-2009. In the future, will it be possible to make enough profit to provide the necessary provisions and returns on equity so that we can generate and attract the necessary capital to meet the new requirements of the market and the new Basel III regulations? Which instruments can be used by institutions to improve their profits in such a difficult context as the present?

The following graphs show how, over the last few years, loan loss provisions have been consuming an increasing share of the operating margin and, consequently, the RoE has been falling to minimum levels (2.9%, in September), clearly below the cost of the capital, estimated at around 10%-12%.

TREND IN THE OPERATING MARGIN OF THE SPANISH FINANCIAL SYSTEM (*)



PERCENTAGE OF THE OPERATING MARGIN ALLOCATED TO PROVISIONS RoE OF THE SPANISH FINANCIAL SYSTEM (**)



NOTES: Deposit institutions, annualized profit (sum of 4 quarters of individual profits).
(*) Operating margin = Interest margin + Capital instruments + Commission + Profit from financial transactions – Operating costs.
(**) Does not include writedowns carried out against reserves in 2010.
SOURCE: Bank of Spain, INFBAL.

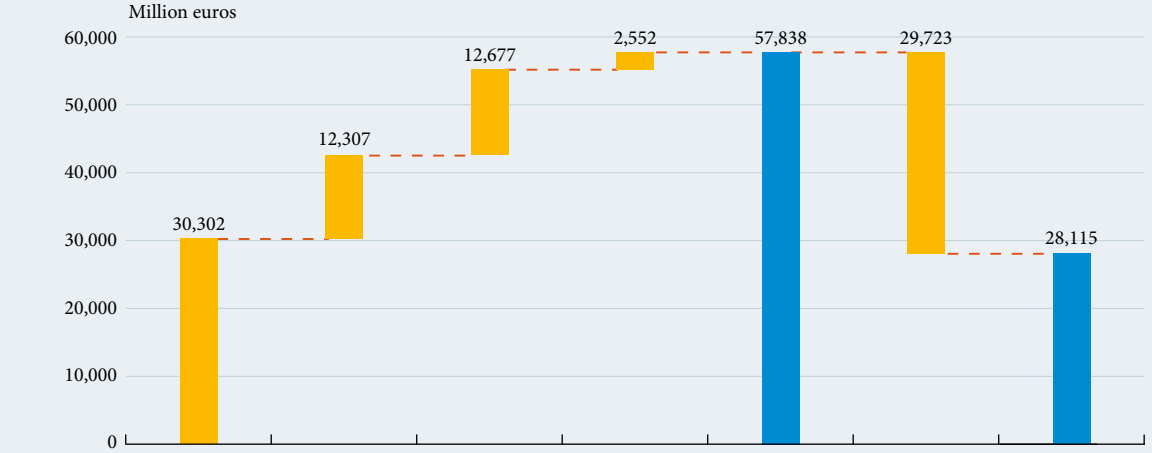
As this element has a high correlation with the economic cycle, and given the forecasts of high unemployment rates, we expect both the NPL ratio and foreclosures to remain at a very high level in the immediate future, with the current high volume of provisions having to be maintained as a result. It will be more in the long term,

with economic recovery, when we will return to risk cost levels (provisions/credit) closer to the historical average (0.27% during 1981-2008), far removed from the current figure of 1.2%, which means that 68% of the operating margin has to be allocated to provisions.

On the other hand, the trend in the RoE shows us that returns on capital are insufficient; in fact, this would still be the case at the average risk cost of the cycle and not the current high cost. These low returns are particularly worrying at present, given that Basel III requires capital to be generated internally and to be attracted, and this will only be possible by offering sufficiently enticing returns on equity.

But how can the operating margin be increased, allowing the necessary improvement in the return on capital? Let's look at the main components of this margin and their prospects.

OPERATING MARGIN OF THE SPANISH FINANCIAL SYSTEM, SEPTEMBER 2011 (*)



	Interest margin	Commissions	Capital instruments	Trading and other operating profit	Gross margin	Administration costs and amortization	Operating margin
Year-on-year change (%)	–14	–1	+6	–50	–10	–0.4	–19

NOTE: (*) Aggregate data based on individual (not consolidated) accounts of all deposit institutions during the period September 2010-September 2011.
SOURCE: Bank of Spain, INFBAL.

We can see that the interest margin accounts for more than 52% of the gross margin, extensively affecting the operating margin as a whole since operating costs (essentially personnel) are quite stable. This interest margin is expected to shrink by a further 10% in 2012 and only grow slightly in 2013, there being several factors behind this new contraction in the short term.

Firstly, economic agents have now started the inevitable **deleveraging** process, considerably reducing their demand for credit. This factor, together with the scarcity and high cost of liabilities for institutions, reduces the amount of new credit being granted. This fall in demand has yet to come to an end, it is a structural (and not only temporary) factor that will lower the volume of business and therefore the interest margin of the system for some time.

In addition, **official interest rates** will remain low. This will hurt institutions' interest margin as they normally benefit from high interest rates thanks to the rigidity of the cost of current and saving accounts.

On the other hand, the **cost of other liabilities** will remain unusually high. The causes: the large number of maturities faced by institutions in 2012 (120 billion euros) and their difficulty in accessing wholesale funding markets, so that competition to attract retail banking deposits will still remain and at very high prices.

Moreover, in addition to competition between institutions, over the last few months there has also been competition from the **public sector**: the high interest rates for the last government bond auctions has led to some deposits from the banking sector to be moved to public debt products, forcing institutions to offer high yields to be able to compete with these products.

As a consequence of the competition between banks, and between banks and the public sector, in many cases the interest rates offered are higher than the yield obtained by institutions from their loans, resulting in a situation that is unsustainable in the medium and long term.

Within this difficult context, **measures to support banking, implemented by the European Central Bank**, could be of great assistance: unlimited liquidity at a lower interest rate and a lower cash ratio reduce financial costs and release assets that can be used to generate profit. However, this source of funding has traditionally been considered as a last resort and with a certain cost in terms of reputation, so that institutions prefer not to use it too much.

Lastly, as has already been mentioned, banks have a large **volume of doubtful and foreclosed loans** which currently account for 11% of credit to private resident sectors. These assets damage the income statement twofold since, in addition to having to provide for them, they also negatively affect the interest margin as they are assets that still need to be financed but that do not generate financial income.

For all these reasons, the current conditions do not point towards any immediate improvement in the interest margin. Other means must be used to increase profitability. The first could be to widen the **spreads** for new loans, adjusting them to the new cost of liabilities, to the risk cost, which had been underestimated, and to the liquidity cost. However, this measure's impact is lessened by the weak demand for credit at present and would be significant only in the long term.

On the other hand, reducing the excessive cost of liabilities requires a solution to the debt crisis, something which would facilitate access to wholesale funding markets and thereby relax liquidity tensions, putting an end to the deposit war.

The second option to improve profitability is by raising the **commissions** charged, bringing prices closer to costs. However, this measure is difficult to implement within an environment of great competition and price sensitivity on the part of consumers.

Other sources of revenue, such as **dividends** and profit from equity accounting investee firms, depend on the results of these firms and on such investment in them continuing. On the other hand, treasury profits, the main component of the trading business profit, are highly volatile and do not constitute a stable source of profit.

This difficulty in improving revenue has forced many institutions to **cut costs**. Significant structural adjustments have already been made to reduce excess installed capacity: between 2008 and 2011, the number of employees and

branches fell by 10% and 13%, respectively. But there is a time lapse between measures being adopted and their impact on profits. Consequently, as of September 2011, in savings banks, which have carried out the greatest adjustments, operating costs had fallen by just 2.3% year-on-year, while the gross margin (before personnel costs and provisions) was down 27.7%. The adjustments carried out will have more impact once all the synergies of the mergers have materialized, although adjustments to the cost structure are bound to continue, either by reducing unit costs or capacity (via greater concentration in the sector).

Given this overall context, the situation between institutions is highly varied, in terms of the trends in profits, the adjustments carried out and problematic assets, as well as in terms of liquidity tensions that are encouraging banks to incur excessive costs in attracting funds or to be more conservative in granting credit. At an individual level, institutions will probably have to take action along the lines of one or more of these measures. But generating more revenue by increasing market share is also a valid and necessary option: more and better customer service, innovation and the constant search for additional business opportunities will help them tackle the current predicament and come out the other side much stronger.

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As of December 31, 2010

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

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

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

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