NUMBER 355 • MARCH 2012

THE SPANISH ECONOMY

Monthly Report

ENERGY IN THE 21ST CENTURY

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2010	2011	2012	2011				2012	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast					Forecast	
Gross domestic product									
United States	3.0	1.7	2.0	2.2	1.6	1.5	1.6	1.9	2.0
Japan	4.5	–0.9	1.6	–0.1	–1.7	–0.6	–1.0	1.3	2.2
United Kingdom	2.1	0.9	0.7	1.7	0.6	0.5	0.8	0.4	0.6
Euro area	1.8	1.5	–0.4	2.4	1.6	1.3	0.7	–0.3	–0.7
Germany	*3.6*	*3.1*	*0.5*	*4.6*	*2.9*	*2.7*	*2.0*	*0.8*	*0.6*
France	*1.4*	*1.7*	*0.1*	*2.2*	*1.6*	*1.5*	*1.4*	*0.3*	*0.4*
Consumer prices									
United States	1.6	3.1	2.1	2.1	3.3	3.8	3.3	2.6	1.9
Japan	–0.7	–0.3	0.2	–0.6	–0.4	0.2	–0.3	–0.2	0.2
United Kingdom	3.3	4.5	2.7	4.1	4.4	4.7	4.7	3.6	2.9
Euro area	1.6	2.7	1.7	2.5	2.8	2.7	2.9	2.3	1.7
Germany	*1.1*	*2.3*	*1.9*	*2.1*	*2.3*	*2.4*	*2.4*	*2.1*	*1.9*
France	*1.5*	*2.1*	*1.9*	*1.8*	*2.1*	*2.1*	*2.4*	*2.3*	*1.9*
SPANISH ECONOMY			Forecast					Forecast	
Macroeconomic figures									
Household consumption	0.7	–0.1	–1.5	0.4	–0.3	0.5	–1.1	–1.2	–1.7
Government consumption	0.2	–2.2	–6.2	0.6	–2.1	–3.6	–3.6	–6.8	–6.4
Gross fixed capital formation	–6.2	–5.1	–8.5	–4.9	–5.4	–4.0	–6.2	–8.8	–9.1
Machinery and capital equipment	*5.5*	*1.6*	*–5.3*	*5.7*	*1.1*	*2.2*	*–2.7*	*–6.2*	*–5.6*
Construction	*–10.1*	*–8.1*	*–10.0*	*–9.2*	*–8.1*	*–7.0*	*–8.2*	*–10.1*	*–10.9*
Domestic demand (contribution to GDP growth)	–1.0	–1.8	–4.0	–0.8	–1.9	–1.4	–2.9	–4.2	–4.4
Exports of goods and services	13.5	9.1	0.5	13.1	8.8	9.2	5.2	2.0	1.1
Imports of goods and services	8.9	–0.1	–9.3	6.0	–1.3	0.9	–5.9	–9.7	–9.5
Gross domestic product	**–0.1**	**0.7**	**–1.0**	**0.9**	**0.8**	**0.8**	**0.3**	**–0.5**	**–1.1**
Other variables									
Employment	–2.6	–1.9	–3.6	–1.4	–1.1	–1.9	–3.3	–3.3	–4.4
Unemployment (% labour force)	20.1	21.6	24.1	21.3	20.9	21.5	22.9	24.1	24.3
Consumer price index	1.8	3.2	1.6	3.5	3.5	3.1	2.8	1.9	1.5
Unit labour costs	–2.6	–1.9		–2.0	–1.7	–1.5	–2.5		
Current account balance (% GDP)	–4.5	–3.9	–2.1	–6.6	–3.2	–2.9	–2.8	–2.6	–2.0
Net lending or net borrowing rest of the world (% GDP)	–4.0	–3.4	–2.0	–6.1	–2.7	–2.4	–2.3	–2.1	–1.5
General government financial balance (% GDP)	–9.3	–8.5	–5.5	–5.3	–9.9	–6.1	–12.8		
FINANCIAL MARKETS			Forecast					Forecast	
International interest rates									
Federal Funds	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	1.0	1.3	1.0	1.0	1.3	1.5	1.3	1.0	1.0
10-year US bonds	3.2	2.8	2.0	3.4	3.2	2.4	2.0	2.0	2.1
10-year German bonds	2.8	2.6	2.0	3.2	3.1	2.3	2.0	1.9	2.0
Exchange rate									
$/Euro	1.33	1.39	1.30	1.37	1.44	1.41	1.35	1.31	1.31

Contents

Energy in the 21st century

Oil prices are on the rise again in the last few weeks of February. This time the reasons are the tough winter in this part of the hemisphere and tensions with Iran. In any case, petrol prices at the pump are reaching record highs. The Fukushima disaster after Japan's earthquake and tsunami last year is starting to fade from the memory but its effects on the public's perception of nuclear energy are unlikely to be erased for a long time yet. Conflicts related to natural gas regarding the security of supply and the deployment of gas conduits are reaching levels of diplomatic concern. The international struggle to contain greenhouse gas emissions and mitigate their effects is at odds with the great powers. Spain's policy to stimulate renewable energy sources has become highly controversial. Can anyone doubt that the energy sector is a high voltage issue?

Market efficiency and security in supply are traditionally the main concerns of national energy policymakers. In addition to these, in countries that have to import the energy they consume, there is the need to reduce dependency on other countries to prevent their energy bill from weighing heavily on their balance of payments. Now they also have to tackle the reduction in greenhouse gas emissions in generating energy. Finding the right policy is no easy task.

At an international level, the next few decades will see two big challenges. The first is to meet the growing energy demands of developing countries. The second is to reduce greenhouse gas emissions in order to combat climate change. It's very difficult to tackle these two challenges at the same time, as 87% of the energy consumed in the world comes from oil, coal or natural gas, the contaminating sources. «Clean» energy (hydroelectric, solar, wind, etc.) doesn't even account for 8%, while the rest is nuclear energy. Developed countries are making a big effort to contain their carbon emissions. Total carbon dioxide emissions have remained stable over the last 10 years in the 34 countries that make up the Organization for Economic Cooperation and Development. But in developing countries emissions have doubled over the same period. Maintaining the growth and development of these countries without increasing emissions is complicated and very expensive. At the recent climate change summit in Durban (South Africa), once again there were signs of great resistance to attempts to limit emissions, although we must admit that some progress was made.

Spain is highly energy deficient as its domestic production hardly covers a quarter of its total consumption. This takes its toll every year due to energy imports. If we deduct the energy balance from 2011's current deficit (3.9% of the gross domestic product), the country's accounts would almost be balanced. In line with the strategy agreed with the rest of the countries in Europe, Spain has decided to reduce its energy dependency and greenhouse gas emissions by increasing the proportion of renewable energy sources used to generate power. However, achieving this target involves a significant change in the generation mix, something that, far from easing controversy, presents even greater challenges for the sector's regulatory policy over the coming years. Undoubtedly, the controversy regarding many of the aspects surrounding energy policy will continue to plague the sector for a long time to come.

EXECUTIVE SUMMARY

2012 gets off to a recessionary start in Europe

The focus of instability represented by Europe's sovereign debt crisis is joined by rising oil prices.

The world's economy is going through a bad patch due to the expected decline in Europe's economy in the fourth quarter of 2011 and the not so expected contraction in Japan's gross domestic product (GDP). For its part, the United States posted significant but not brilliant growth while the emerging economies kept up the pace, albeit a little slower than a few quarters ago. The main focus of instability is still Europe's sovereign debt crisis, added to which is now the recent rise in oil prices resulting from the Middle East situation. However, the major central banks have again taken action against the risks of recession or stagnation, helping to improve the tone of financial markets.

The United States records acceptable growth while Japan stumbles in the fourth quarter.

The United States' recovery is gaining in strength, supported by a labour market that is moving away from the gloomiest omens and by a fiscal policy that, 2012 being an electoral year, will be more expansionary than had been predicted. However, the growth we expect for the year as a whole is 2%, not enough for the country to definitively avert the effects of the crisis. GDP picked up in the fourth quarter, growing by 0.7% quarter-on-quarter and 1.6% year-on-year, leaving the increase for 2011 as a whole at 1.7%. In spite of this upswing, a glance at the GDP components shows a less buoyant image that implied by the aggregate data. Firstly, because more than half this growth came from restocking. And, secondly, because the growth in private consumption, the main driving force behind activity in the second half of 2011, was based more on a reduction in the savings rate than in any improvement in revenue, which only grew slightly. And this in a context where households are still suffering from a gross debt of 114% of their disposable income.

The reconstruction after March's tsunami has stalled in Japan. Fourth quarter GDP fell by 0.7% quarter-on-quarter, a sharp change when compared with the 1.7% growth of the third quarter. This resulted in a 1.0% year-on-year drop, as well as the economy shrinking by 0.9% for the whole of 2011. Although greater than expected, this reduction does not substantially change our growth forecast for 2012, which remains at 1.6%, always assuming exports pick up.

In China, indicators for the beginning of 2012 are distorted by the effect of the festivities for the Chinese New Year but we still expect growth in excess of 8% for 2012. In general, Asia is starting to recover from the effects on the supply chain of Thailand's floods.

Activity falls off in the euro area towards the end of 2011.

With regard to the euro area, the advance in GDP for the fourth quarter published by Eurostat indicates a drop of 0.3% compared to the previous quarter (0.7% year-on-year growth for the year as a whole). This is the first reduction in activity since the second quarter of 2009. This decline will probably continue in the first quarter of 2012, so we can state that the euro area is now in recession again, according to the accepted convention (two consecutive quarters of decline). By country, at the end of 2011 Italy, the Netherlands and Belgium were already

in recession, joining Portugal. This might also be the case of Ireland and Denmark, although fourth quarter data for these countries are still not available. One positive note is provided by France's quarter-on-quarter growth of 0.2% which was higher than expected, although it was unable to totally offset the 0.2% drop in Germany.

Some indicators point to the decline in the euro area's economic situation stabilizing in December, for example in the case of retail sales, consumer confidence and exports. Germany's performance is particularly relevant as it is the main economy of the euro area and, in the last few months, its economic climate indicators have reversed their direction and are pointing to stabilization and even slight improvement for the first quarter of 2012. The German economy would therefore avoid recession, unlike other countries in the euro area, although it would not entirely escape unscathed from the economic weakness of most of its European trading partners.

Several factors were weakening activity in the euro area towards the end of 2011. One of the most significant, perhaps the most, is the nervousness caused by the area's continuing public debt crisis, now into its third year. A crisis that is spreading uncertainty regarding the capacity of some member states to meet their pecuniary obligations, is causing doubts regarding the solvency of the financial sector in general and slowing up the flow of credit. The result is a slowdown in growth, in a vicious circle that is difficult to get out of. So far, attempts to break this circle and get the euro area's economy and markets back on track have not been very successful.

Of note, however, is the green light given by the Eurogroup to Greece's second bail-out package on 21 February, totalling 130 billion euros. The agreement was reached after a package of economic policy measures was approved by the Greek parliament and having obtained guarantees from the leaders of the Greek coalition regarding the implementation of reforms after the general elections to be held in April. On the other hand, private creditors and Greece have reached an agreement for a voluntary write-down of public debt of 53.5% of the nominal value of Greek bonds. The aim is to reduce Greece's debt from 164.0% of the GDP forecast for 2011 to 120.5% by 2020.

The progress made in the Greek case is significant but the European Central Bank (ECB) is making an even greater effort to stabilize the situation, opting for an expansionary monetary policy to support the economy, as well as injecting a great deal of liquidity into the financial system and even directly buying up public debt from those countries under most pressure. As mentioned previously, other central banks are also acting along the same lines, such as the US Federal Reserve, whose strategy is to keep official interest rates as low as possible (0%-0.25%) until the end of 2014. For its part, the Bank of England has announced that it will enlarge its asset purchase programme to 325 billion pounds sterling. With regard to the emerging countries, most of the central banks have started to make their monetary policies more expansionary, a reduction in interest rates being the main instrument used to this end. The recent upswing in oil prices, caused by tensions in the Middle East, might hinder the design of this strategy of relaxation.

Among other consequences, the relative improvement in the euro area's financial situation has helped Spain's Treasury to place, since January, a third of all the public debt issuances forecast for 2012, at a lower price than in previous auctions

Some indicators point to the euro area's economic decline stabilizing.

The Eurogroup approves a second bail-out for Greece.

The ECB decides to implement an expansionary monetary policy to boost the economy.

The Spanish government passes a decree to sort out the financial system, aimed at dispelling doubts regarding the solvency of its banks.

and attracting a large number of investors. The current situation is also being helped by the application of the decree passed early in February to sort out the financial system. The main aim of this decree is to dispel doubts regarding banks' solvency, given the increase in troubled property assets on their balance sheets. To this end, banks are required to extend the financial safety net for their property portfolios, significantly increasing provisions to meet potential losses from property assets. Provisions will increase to 80% in the case of land, 65% for developments underway and 35% for finished housing and developments. With this increase, the banking sector reinforces its solvency against possible falls in price of its property assets.

An important change in labour legislation is also approved.

Another important action by the new government has been its labour market reform. The changes introduced are aimed at making the application of collective agreements more flexible, as well as the working conditions within companies, in order to help them survive. This reform brings Spanish legislation closer to that of most countries on the European continent and is expected to help many firms adapt to the crisis, encouraging them to give permanent contracts once they start to recover.

The change in labour legislation was crucial given an economy where unemployment stood at 22.9% of the labour force in January, according to Eurostat, affecting almost half the young population, figures that are unparalleled among developed countries. However, we don't expect any immediate effects of the reform in terms of employment, due to the Spanish economy having entered a recessionary phase. According to the National Institute of Statistics, GDP stalled in the third quarter of 2011, fell by 0.3% in the fourth and all indicators point to this decline continuing in the first quarter of 2012. This double dip recession can be explained by the weakness in domestic demand. Households are slowing up their consumption given the deterioration in the economic climate and rising unemployment. Companies are attempting to cut back on their current expenditure and investment due to the poor demand prospects and tougher credit conditions. Of note is the announcement, at the end of February, of a mechanism to settle the unpaid debts of local administrations. This measure will represent a significant injection of liquidity for the firms supplying these administrations.

The first official estimate for 2011's public deficit confirms that it is substantially off target.

The public sector is also attempting to adjust its spending given the need to sort out its accounts. Although public consumption decreased by more than 2% in 2011, the first official estimate for the deficit of public administrations as a whole in 2011 totals 8.5% of GDP. This is an improvement on the 9.3% deficit recorded in 2010 but is still quite far from the target of 6.0%. This difference is mainly due to the much worse macroeconomic situation than expected and the difficulty in cutting spending on items that have a lot of inertia, although the details of the accounts have yet to be published. The budgets for 2012, still pending presentation, will have to strike a delicate balance between an inevitable reduction in the deficit and the need to keep activity at acceptable levels.

28 February 2012

CHRONOLOGY

2011

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 a treaty that would involve the 17 members of the euro area plus other EU states that wish to join the agreement.
	30	The government approves a package of **economic policy measures** that includes spending cuts and tax hikes.

2012

January	25	Social agents sign a **wage moderation agreement** valid from 2012 to 2014.
February	3	The government approves a Decree-Law to **sort out the financial sector**.
	10	The government approves a Decree-Law of urgent measures to **reform the labour market.**

AGENDA

March

- **2** Registration with Social Security and registered unemployment (February).
  European Council.
- **7** Industrial production index (January).
- **8** Governing Council European Central Bank.
- **13** CPI (February). Fed Open Market Committee
- **14** EU HICP (February).
- **16** Labour costs (fourth quarter).
- **20** International trade (January).
- **23** Producer prices (February).
- **29** CPI flash estimate (March).
- **30** Balance of payments (January).

April

- **3** Registration with Social Security and registered unemployment (March).
- **4** Governing Council European Central Bank.
- **11** Industrial production index (February).
- **13** CPI (March).
- **17** EU HICP (March).
- **18** International trade (February).
- **25** Producer prices (March).
  Fed Open Market Committee.
- **27** Labour force survey (fourth quarter).
  CPI flash estimate (April). US GDP (first quarter).
- **30** GDP flash estimate (first quarter).
  Balance of payments (February).

INTERNATIONAL REVIEW

The United States: good but not good enough

The United States picks up in the fourth quarter but the 2012 forecast is still 2.0%.

The recovery is gaining in strength, supported by a labour market that is moving away from the gloomiest omens and by a fiscal policy that, 2012 being an electoral year, will be more expansionary than had been predicted. However, the growth we expect for the year as a whole is 2%, not enough for the United States to definitively avert the effects of the crisis.

Growth is sustained by consumption growing more than income and the inventory cycle.

Gross domestic product (GDP) picked up in the fourth quarter, growing by 0.7% quarter-on-quarter and 1.6% year-on-year, leaving the increase for 2011 as a whole at 1.7%. Despite this upswing, a quick look at the GDP components shows a less buoyant image than the one implied by the aggregate data. Firstly, because more than half this growth in absolute terms came from restocking, and this won't continue in the first half of 2012. Secondly, because the growth in private consumption, the main driving force behind activity in the second half of 2011, should drop off. Consumption's strength has been based more on a reduction in the savings rate, down from 5.0% to 3.5% of disposable income between June and November, than on any improvement in revenue, which only grew slightly. With household gross debt standing at 114,1% of disposable income, there is a limit to household consumer

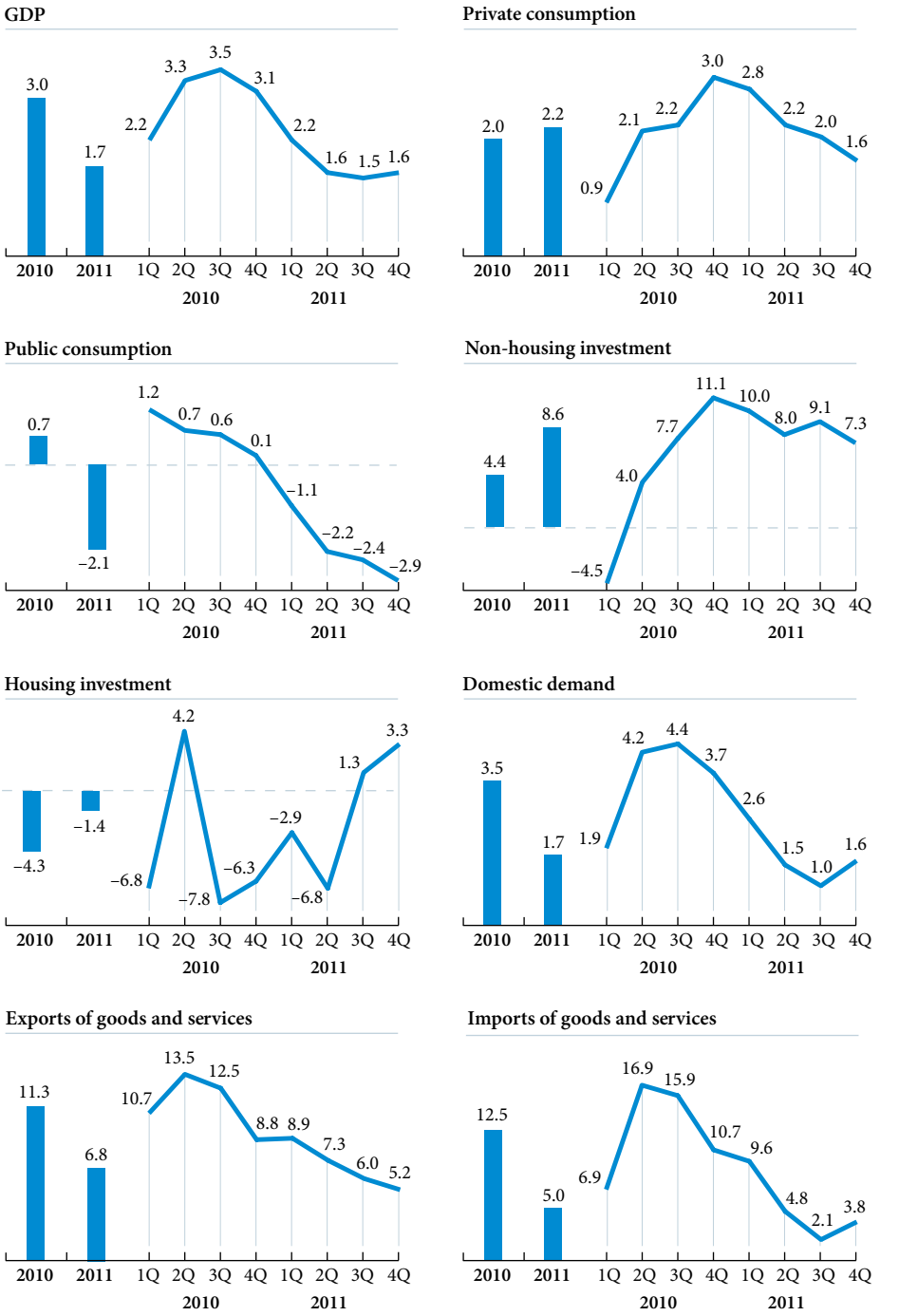
THE UNITED STATES: THE CONSUMER REACTION RUNS OUT OF STEAM

Real retail sales without vehicles or petrol, year-on-year change (*)

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

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Bureau of Economic Analysis and own calculations.

Retail sales point to a slowdown in private consumption.

appetite and this was already noticed in December, when the savings rate picked up again to 4.0%.

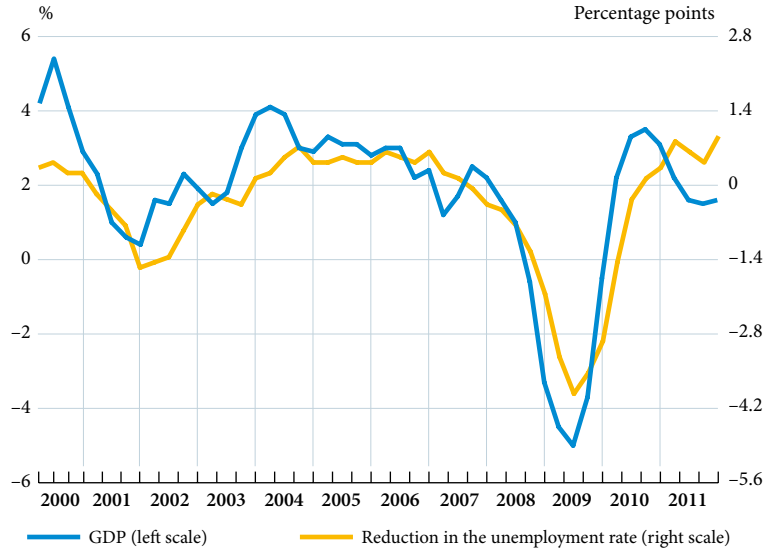
The slowdown in retail trade is a good sign of this greater thriftiness. The Christmas season was worse than the Thanksgiving campaign, in spite of a rise in consumer credit, while January's figures were disappointing. Trends in retail sales, without cars or petrol, grew by 2.4% year-on-year in real terms, barely half the rate of progress seen last July. Vehicle sales also dropped off in January, putting an end to a four-month run of rises. Consumer confidence showed a similar pattern in January, with a slight fall that put an end of two months of sharp increases and leaving the index clearly below its historical average.

The labour market confirms its improvement with an unemployment rate of 8.3%, but there's still a long way to go.

Households get 64.8% of their income from employment. In this respect, the labour market has recovered much better than expected, although this improvement is not leading to wage rises that boost income and it still has a very long way to go. 243,000 new jobs were created in January, taking the total number of jobs recovered since March 2010 to 3.2 million. But a further 5.6 million jobs still need to be created to make up for the jobs lost during the crisis. This means that, should January's good rate of growth continue, the process will take nearly two years. There are also 8 million under-employed people and a high proportion of long-term unemployed, who will hamper the recovery. Particular mention should be made of the unexpected improvement in the unemployment rate. Historically, unemployment would start to fall when GDP growth went above 2.5%. But January's unemployment rate stood at 8.3%, eight tenths of a percentage point below the level for the same period the previous year, in spite of the low growth, helped by a lower participation rate in the labour market. This means that idle

THE UNITED STATES: UNEMPLOYMENT FALLS WITH LOW GROWTH

GDP and unemployment rate. Year-on-year change



SOURCES: BEA, BLS and own calculations.

resources were probably lower than expected and this has probably helped to reduce the unemployment rate.

Looking at investment, construction grew by 2.6% quarter-on-quarter but the housing sector has yet to come of the tunnel. New homes started in January came close to 700,000 in annual terms, an improvement and one that coincides with more optimistic developer sentiment, but surplus supply is hindering the recovery and prices are still falling. The administration and banks agreed that the latter would pass on 40 billion dollars of refinancing and a reduction in mortgage capital to households whose debt exceeds the value of their property. Sector demand should benefit but the amount is not enough as the aggregate debt of these households is 700 billion dollars more than the value of their homes.

For its part, capital goods investment slowed up in the fourth quarter.

Investment will continue to grow in 2012 but it won't recover the strength seen in the third quarter. The business sentiment indices of the Institute of Supply Management (ISM) for manufacturing and services have gradually improved over the last few months, reaching 54.1 points in the case of manufacturing and 59.5 points for services, views that correspond with a rate of economic growth higher than 3.0%. This improvement in expectations is also in line with corporate earnings. Profits from non-financial firms produced in the United States rose by 11.6% year-on-year in the third quarter and went from 6.6% to 7.2% of gross domestic product (GDP) in the first nine months of 2011. However, this advance is expected to halve in the fourth quarter of 2011, so investment is unlikely to react upwardly.

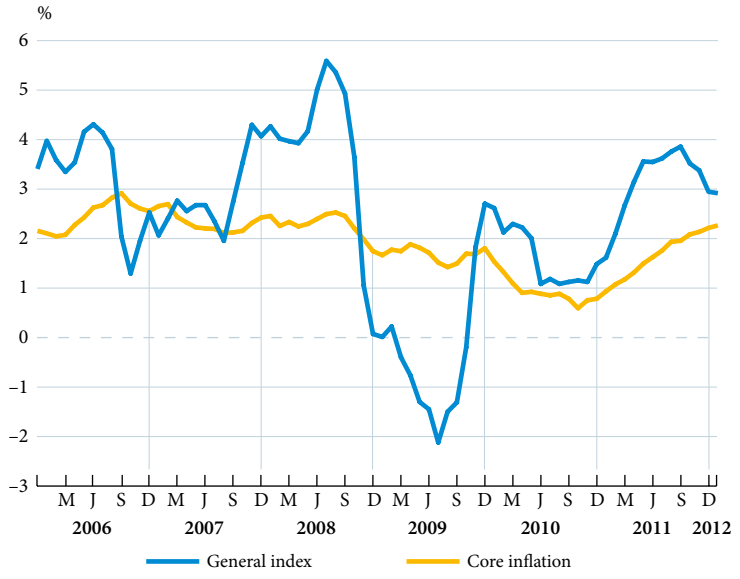
The slowness of the recovery is making the Federal Reserve cautious. Inflation continues to postpone its expected

Housing improves but, weighed down by excess supply, it will be the sector that takes the longest to recover.

Capital goods investment and corporate earnings look buoyant but the outlook is one of a slowdown.

THE UNITED STATES: A CPI THAT'S NO CAUSE FOR ALARM

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



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

The CPI is up by 2.9% and core inflation by 2.3%. 2012 will see a somewhat smaller moderation than anticipated.

moderation. The consumer price index (CPI) for January rose by 2.9% year-on-year, 3.0% in December, while core inflation, which excludes energy and food prices, rose by 2.3% year-on-year, somewhat more than expected, supported by rents attributed to housing, clothing and leisure. Lower unemployment and idle resources rates and persistently expensive oil might make inflation moderate more slowly than predicted. The Fed has therefore temporarily frozen its third round of quantitative easing. However, the risks of insufficient growth are still perceived as more serious than inflationary risks, as shown by the almost unanimous agreement to keep official interest rates at minimum levels until 2014.

Fiscal policy for 2012, an electoral year, will be slightly more expansionary than expected.

The other support for growth will come from fiscal policy. 2012 will be an electoral year and this will delay fiscal consolidation even more than expected, with a greater tendency for the two large parties to undertake expansionary policies. The public administration deficit, which is estimated at 9.6% of GDP in 2011, is unlikely to fall below 8.0% for 2012, with a public debt that should climb to 105% of GDP. The first sign of lax policy was the approval of the «mini-stimulus», the name given to the extension until 2012 of payroll tax cuts and jobless insurance. The first would represent 1,000 dollars of aid for families whose income is less than 50,000 dollars a year, which would suppose an additional government expenditure of 100 billion dollars; the second would add a further 30 billion. This agreement was easier than the norm in 2011, with a Republican party that did not ask for cuts in other spending to offset this policy.

The trend in the trade balance will be affected by the fortunes of Europe and oil prices.

With regard to the foreign sector, the weakness in the US's main trading

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
Real GDP	3.0	1.7	2.2	1.6	1.5	1.6	–
Retail sales	6.4	7.7	8.2	7.8	8.0	6.9	5.8
Consumer confidence (1)	54.5	58.1	66.9	61.8	50.3	53.6	61.1
Industrial production	5.3	4.2	5.4	3.8	3.7	3.9	3.4
Manufacturing (ISM) (1)	57.3	55.2	59.8	56.6	52.1	52.4	54.1
Housing construction	5.6	4.4	–5.3	–4.9	5.3	24.9	9.9
Unemployment rate (2)	9.6	9.0	9.0	9.0	9.1	8.7	8.3
Consumer prices	1.6	3.2	2.1	3.4	3.8	3.3	2.9
Trade balance (3)	–500.0	–558.0	–519.5	–534.3	–537.9	–558.0	...
3-month interbank interest rate (1)	0.3	0.3	0.3	0.3	0.3	0.5	0.5
Nominal effective exchange rate (4)	75.4	70.9	71.9	69.6	69.8	72.4	73.4

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.

partners, particularly in Europe, and the recovery in domestic demand will increase the trade imbalance. The trade deficit for goods and services in December rose again to 48.8 billion dollars. There was a slight upswing in exports but this did not alter their tendency to slow up. In the short term, the trade deficit will continue to increase due to the US economy's greater growth but, with the contribution by oil and its derivatives being 55.2%, its trend is linked to the price of crude which is refusing to fall for the moment.

Japan: linked to shrinking exports

Japan's reconstruction after March's tsunami has stalled. Fourth quarter GDP fell by 0.7% quarter-on-quarter, a sharp turnaround when compared with the 1.7% growth of the third quarter. This resulted in a 1.0% year-on-year drop, as well as the economy shrinking by 0.9% for the whole of 2011. Although this decrease is greater than expected, it doesn't substantially alter the forecast for 2012, which remains at growth of 1.6%.

Japan declines by 0.7% in the fourth quarter but is expected to grow by 1.6% in 2012.

The poor tone of domestic demand gave way to exports in the country's growth. Foreign sales, which went from 8.6% growth quarter-on-quarter in the third quarter to a drop of 3.1% in the fourth, are responsible, by themselves, for four fifths of the decline in the Japanese economy in the last quarter of 2011. This trend can be partly explained by the effect of Thailand's floods, which should start to be reversed in the next few months.

Private machinery orders for the fourth quarter grew by 10.0% quarter-on-quarter, indicating that investment is still strong, as it was already the most robust component in the last national accounts. Similarly, most of this upward reaction in

The slump is due to falling exports, affected by the strong yen and high energy costs.

JAPAN: MAIN ECONOMIC INDICATORS

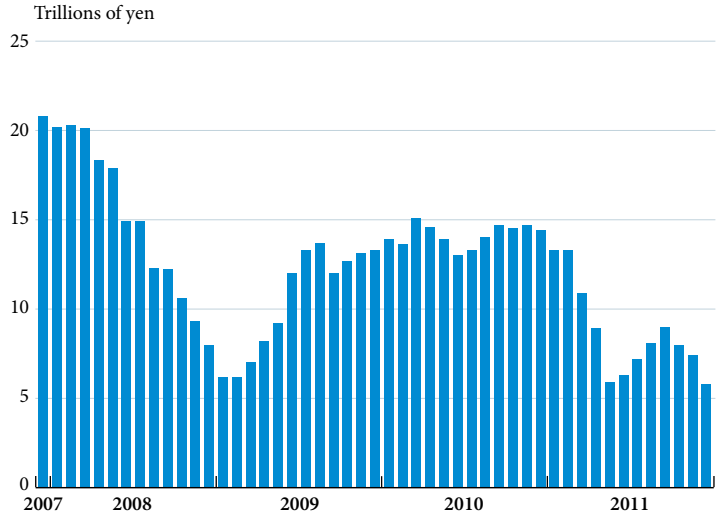
Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
Real GDP	4.5	–0.9	–0.1	–1.7	–0.6	–1.0	–
Retail sales	2.5	–1.2	–3.0	–1.7	–1.0	0.8	...
Industrial production	16.6	–3.5	–2.5	–7.0	–2.0	–2.3	...
Tankan company Index (1)	0.0	–1.3	6.0	–9.0	2.0	–4.0	–
Housing construction	2.7	2.6	2.9	4.6	8.0	–4.8	...
Unemployment rate (2)	5.1	4.6	4.7	4.6	4.4	4.5	...
Consumer prices	–0.7	–0.3	–0.5	–0.4	0.1	–0.3	...
Trade balance (3)	7.9	–1.6	6.5	3.4	1.3	–1.6	...
3-month interbank interest rate (4)	0.39	0.34	0.34	0.34	0.3	0.3	0.3
Nominal effective exchange rate (5)	106.0	113.5	110.6	109.3	115.5	118.6	120.9

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

JAPAN: A DECREASING BALANCE THAT MUST REMAIN POSITIVE

Current account balance. Monthly figures in annual terms (*)



NOTE: (*) Moving average of three months.
SOURCES: Japanese Ministry of the Economy, Trade and Industry and own calculations.

Exports should recover in 2012 but the risks are downwards.

machinery orders was in exporting firms. In addition, industrial production picked up in December, as well as automobile sales in January.

However, this scenario is most likely to weaken. The Tankan business sentiment index for large manufacturers fell in the fourth quarter, reflecting business concerns due to the erosion of competitiveness resulting from high energy costs and a strong yen. January's trade balance was negative again, hit by the slight drop in exports and by imports boosted by energy deficiencies inherited from the Fukushima nuclear crisis. The recovery in the trade balance is not only crucial due to its contribution to growth but also because it maintains the surplus in the current account balance. In an economy whose gross public debt totals 230% of GDP and which presented an expansionary budget for 2012 that involves more debt, stability lies in public debt continuing to be in the hands of Japanese households. A current account deficit would involve external net borrowing that would make sovereign debt more volatile. This situation hasn't happened yet but it's looming. In the last quarter of the year, the current account balance had a surplus of 5.8 trillion yen, 1.2% of GDP, a lot lower than the 3.0% of the same period a year ago.

The current surplus falls and deflation continues.

For its part, the CPI stalled in December, reporting a drop of 0.2% year-on-year while the core CPI, the general index without energy or food, went further and fell by 1.1% year-on-year.

China: a gentle slowdown with downward risks

China will slow up in 2012 but probably keep its growth above 8.0%, which is the rate that guarantees stability in the eyes of Beijing's government. However, the risks

are downwards and that's why ensuring a soft landing will take priority over controlling inflation in 2012. A good example of this bias is the reduction in the cash reserve ratio from 21.0% to 20.5% carried out by the People's Bank of China on 19 February, albeit coinciding with the publication of January's rise in inflation.

January's CPI increased by 4.5% year-on-year, interrupting a five-month run of falls. An upswing caused by the celebrations for the Chinese New Year, temporarily affecting the food CPI of more than a third of the general index, which rose by 10.5% year-on-year. For its part, core inflation continued to rise moderately by 1.6% year-on-year, leaving room for expansionary policies. Although inflation should not be a problem in 2012, the trend in the medium and long term points upwards. The tendency of cheap labour to move from the countryside to urban areas shows signs of running out, and the proportion of young people aged between 15 and 24 is relatively low, something that should push up labour costs in the coming years.

Another indicator affected by the Chinese New Year was the trade balance. January's surplus came to 27.3 billion dollars, 65.1% above December's figure, which should nevertheless not halt the downward slide. This upswing was due to the 15.3% fall year-on-year in imports, affected by the lower number of working days; 17 in January compared with 22 in December. However, there were rises for imports of copper and oil, two key commodities whose demand is a reliable indicator of the robustness of Chinese activity. This indicates that China's growth is essentially strong, although the real measure of the foreign sector is provided by the 0.4% drop year-on-year in exports, more closely related to global demand, whose relative weight in GDP in 2011 was 25.2%, far from the 30.1% of 2008, before the crisis hit.

The greatest risks to the main scenario of a moderate slowdown for 2012 still fall on the side of investment. Firstly, the real estate sector continues weak, accounting for 13.0% of GDP. Secondly, there is the problem of assigning capital in an economy where investment accounts for

China hopes to keep growth above 8.0% in 2012.

Inflation picks up to 4.5% due to the effect of the Chinese New Year.

The foreign sector continues to lose steam but copper and oil imports are still rising.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
Real GDP	10.4	9.2	9.7	9.5	9.1	8.9	
Industrial production	15.3	13.8	14.5	13.9	13.8	12.8	...
Electrical power generation	14.7	11.0	12.1	12.0	10.8	8.9	...
Consumer prices	3.3	5.4	5.1	5.7	6.3	4.6	4.5
Trade balance (*)	184.0	157.3	167.8	173.2	170.9	157.3	178.7
Reference rate (**)	5.39	6.35	6.06	6.31	6.56	6.56	6.56
Renminbi to dollar	6.8	6.5	6.6	6.5	6.5	6.3	6.3

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

CHINA: COPPER IS NEEDED - AND LOTS OF IT

Copper imports (*)

NOTE: (*) Base 100 = 2008 average.
SOURCES: Chinese National Statistics Office, London Market and own calculations.

Two risks: a halt in real estate and credit to state conglomerates.

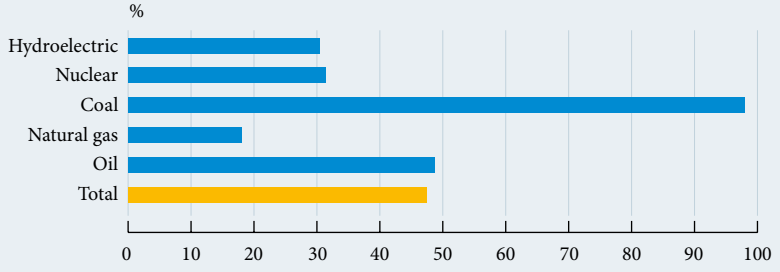
half of the GDP. In China, the extent of credit in GDP terms is much higher than in other economies with a similar per capita income, according to the International Monetary Fund. Credit to non-financial firms reached 98.0% of GDP with a marked bias towards state conglomerates, with greater credit facilities but less efficient. Replacing investment with private consumption is still one of the big challenges for the coming years. The starting point is low, with consumption accounting for less than 40% of GDP, but credit to households reached 28.5% of GDP in December 2011 when at the end of 2009 it was at 22.9%, and retail sales of consumer goods in December rose by 18.1% year-on-year, more than the economy as a whole.

The energy of China

Of the large economies, China is the one with the greatest growth at present. This growth is very much biased towards heavy industry, involving a high consumption of raw materials and energy. While China's gross domestic product (GDP) accounted for 11.7% of the world's total in 2008, expressed in purchasing power parity, its energy consumption reached 17.1% of the total. The forecasts for 2015 by the US Energy Information Administration (EIA) increases these percentages to 15.9% and 21.7%, respectively, with an energy consumption that already exceeds that of the United States. The relative weight in growth terms is even greater. China will contribute 31.5% to the world's economic growth and 55.2% to the increase in the world's energy requirements between 2008 and 2015. These figures mean that any changes occurring in the Chinese energy map have a huge impact on the global energy panorama.

CHINA: AN ALMOST LIMITLESS APPETITE FOR ENERGY

China's contribution to the world's growth in energy consumption 2008-2020 (*)



NOTE: (*) Percentage of world growth expected for the period.
SOURCES: US Energy Information Administration and own calculations.

The present

The three most notable features of China's energy structure at present are its high energy intensity, extensive coal dependence and growing oil imports. The preponderance of heavy industry means that the Chinese economy is very energy intensive. To generate one dollar of GDP in 2008, in purchasing power parity terms, China had to consume 11.2 Btu (British thermal units), much higher than the global figure of 7.7, the United States' figure of 7.6 and the figure of 5.5 in Western Europe. The comparison with the figure of 7.1 Btu in Brazil and 6.6 in India is particularly significant. On the other hand, this high energy intensity helps to make China the planet's worst polluter. In 2008, China was responsible for 22.5% of the world's carbon dioxide emissions, higher than the United States' figure of 19.3%, the other great polluter, and very far from Russia's 5.5%, India's 4.8% and Brazil's 1.4%. In addition to its high energy intensity, it is also dependent on a relatively high polluting energy source, namely coal. For each Btu consumed, China emits 30% more carbon dioxide than the world average. Its comparison with Brazil, which emits 60% less per Btu consumed, is significant. 47.2% of the energy consumed by Brazil is hydroelectric in origin, thanks to an advantageous geography with large bodies of water inland.

Regarding its coal dependence, in 2008 this energy source met 70% of China's energy requirements, whereas oil supplied 19%, hydroelectric energy 6%, natural gas 3% and nuclear energy less than 1%. In comparison, coal only accounts for 42% of the energy consumption of India, the other large emerging economy in Asia, and 22% in the United States. And, at a distance, comes Brazil's figure of 5%. China consumes almost half the world's coal. Up to 2000, China was capable of producing almost all the coal it consumed but the fast growth of its economy, particularly its heavy industry, has revealed limitations in its domestic coal industry, which is highly fragmented into small mines. Coal imports have therefore rocketed since 2000, reaching 183 million metric tonnes in 2011, 5% of China's total consumption.

The growing consumption of oil is particularly of note. In 2009, China consumed 8.3 million barrels a day (10% of the world's total), of which 4.3 million were imported. Estimates for 2011 point to a minimal growth in production that will go from 4.0 to 4.2 million barrels a day, while consumption will reach 9.6 million, an increase that will mean China will contribute 37.0% to the increased global demand for oil between 2009 and 2011. Projections of oil consumption for 2015 indicate that the rise in China's demand could be higher than the increase expected for the rest of the world between 2008 and 2015, according to the EIA.

Changes

China's excessive dependence on oil imports, together with its high energy intensity and coal dependence, which lead to problems of efficiency and pollution, are forcing changes to be made. Modern Chinese development usually means starting from way back in the pack to go much further ahead. The Chinese authorities are aware of the deficiencies in the current situation. The two large pillars for its energy policy are a reduction in coal dependence and also in oil imports. To this end, the country is investing heavily in infrastructures and is also freeing up energy prices. The Three Gorges hydroelectric power plant on the Yangtze should start to produce results in 2012. It is also investing heavily in promoting natural gas and improving coal mining. Coal's contribution to the country's energy consumption should fall to 60% by 2020, gradually being replaced by hydroelectric energy and natural gas which, combined, would supply close to 20% of China's primary energy consumption.

With regard to oil, the aim is not so much to alter its relative weight in the country's consumption, which should remain at around 20% of the total up to 2020, but to prioritize domestic production over imports. While old onshore infrastructures such as those at Daqing and Shengli will decline, investment will be concentrated on offshore oilfields such as those at Bohai Bay and in the South China Sea. Fields discovered in Xinjiang, Sichuan, Gansu and Inner Mongolia will also be supported.

Such investment and the liberalization of prices, together with the tertiarization of manufacturing, with the relative expansion of services, should reduce China's energy intensity and bring it close to the world average by 2020, according to estimates by the EIA. This, combined with a lower relative weight of coal, should result in a 10% reduction of carbon dioxide emissions per Btu consumed. However, this greater efficiency will not stop China's carbon dioxide emissions from approaching 30% of the world's total by 2020, due to the greater growth of its economy.

Influence on the global market

Forecasts are always revised by reality but China's influence will be huge in any scenario that occurs in the energy panorama. According to the EIA, the world's energy consumption will grow at an average annual rate of 1.7% up to 2020. In the case of China, this rate is expected to reach 4.2%. The extent to which China's increasing energy requirements are met by itself will have a great impact on the world's energy prices and particularly on the price of oil.

This box was prepared by Jordi Singla
International Unit, Research Department, "la Caixa"

Brazil: *déjà vu*?

Brazilian inflation continues to moderate.

Brazilian inflation rose again in January compared with the previous month, with the upswing in transportation and housing costs offsetting lower food prices, but it fell to 6.2% in year-on-year terms. This monthly upswing is deemed to be temporary and we expect the rate if inflation to continue to moderate throughout 2012, although the expansionary shift given to economic policies in the last part of 2011 will keep it above the main figure of the target range

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
Real GDP	7.5	...	4.1	3.2	2.2	...	–
Industrial production	10.6	0.3	2.5	0.6	0.1	–1.7	...
Consumer confidence (*)	159.7	156.4	161.8	155.4	153.3	155.2	158.3
Unemployment rate (**)	6.7	6.0	6.3	6.3	6.0	5.2	5.5
Consumer prices	5.0	6.6	6.1	6.6	7.1	6.7	6.2
Trade balance (***)	20.1	29.8	22.4	25.2	30.5	29.8	28.1
Interest rate SELIC (%)	10.00	11.79	11.75	12.25	12.00	11.00	10.50
Reales to dollar (*)	1.78	1.63	1.63	1.56	1.88	1.86	1.75

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.

(4.5%). This forecast assumes a scenario in which Brazil's economic growth in 2012, which we estimate at around 3.0%, will be less than in 2011 due fundamentally to the global slowdown.

The external influence is not only making its mark on growth but also on the exchange rate. As happened in the first half of 2011, the abundant liquidity resulting from the quantitative expansion of advanced economies, combined with lower risk aversion, has led to a notable increase in flows of capital towards Brazil and, consequently, to the real appreciating significantly. After depreciating by 13% between September and December 2011, the real rose by 5% in January and, discounting any dramatic scenario in the euro area, we expect upward pressures to continue.

Given this situation, the Brazilian Finance Minister, Guido Mantega, has already announced that the threat of a currency war has reappeared and that the Brazilian economic authorities are willing and able to defend any undesired appreciation in their currency. The first sign of this has been Brazil's central bank intervening again via an auction to purchase dollars on the spot market, in order to stop its currency from breaking through the barrier of 1.70 reals per dollar.

The real, however, is reviving the threat of a currency war.

Mexico: moderate moderation

In spite of the slowdown in the pace of world growth, and particularly in advanced economies, the Mexican economy admirably maintained its tone in 2011. Growth for the year as a whole stood at 3.9%, lower than 2010's figure of 5.5% but higher than many analysts were predicting halfway through the year. This certifies that the Mexican recovery is well established, thanks to the robustness of foreign demand and the gradual improvement in domestic spending, boosted by greater confidence, low unemployment and expanding credit.

Nonetheless, in line with expectations, Mexican GDP moderated its rate of growth in the last quarter of 2011, up 3.7% year-on-year (4.5% in the previous quarter), affected by the decline in the

The Mexican economy grows by 3.9% in 2011 but tempers its progress in the last quarter.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
Real GDP	5.5	4.0	3.9	3.9	4.4	3.7	–
Industrial production	6.1	3.9	4.9	3.7	3.5	3.4	...
Consumer confidence (*)	86.3	91.7	92.1	90.7	93.7	90.3	95.4
Leading business index (*)	116.5	116.5	119.6	120.4	122.3	122.7	...
Unemployment rate (**)	5.4	5.2	5.1	5.2	5.7	4.8	4.9
Consumer prices	3.9	3.2	3.5	3.3	3.4	3.5	4.0
Trade balance (***)	–3.0	–1.2	–1.5	0.0	–1.5	–1.2	–1.6
Official Banxico rate (%)	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	12.33	11.90	11.90	11.72	13.78	13.94	13.02

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

The confidence of Mexicans in their economy, both consumers and producers, advances in January.

primary sector (–0.5% year-on-year) resulting mostly from the devastating effect of an exceptional drought on agricultural production, and the loss of steam in the secondary sector (3.2% versus 3.5% in the third quarter). On the other hand, the services sector remained strong with an increase of 4.7% over the last quarter of 2010 (4.6% in the previous quarter).

The deterioration in the economic prospects of the euro area and its impact on the global economy suggest that the moderation that was the overall tone in the fourth quarter for the Mexican economy will remain in 2012, with a predicted growth of around 3.5%. Regarding domestic expenditure, the contained advance in employment, credit and real wages will also keep consumption at moderate levels in the short term. Nonetheless, the global index of economic activity (IGAE in Spanish), indicating the trend in Mexico's economy, was up 4.1% year-on-year in December, while Mexican consumer confidence advanced again in January and is now above 95 points.

In the area of prices, inflation rose for the fourth consecutive month in January and has already reached 4.0%. Nevertheless, and although this upward trend will continue in the first part of 2012, we believe the upswing is temporary and not underlying, so we have kept to our forecast that inflation will remain within its target range throughout 2012. In any case, an expansionary shift in monetary policy is now less likely in the short term.

Careful with oil - it's on the rise

Oil appreciated by 11.6% between 23 January and 23 February, intensifying its upward trend and reaching 123.50 dollars per barrel (Brent quality, for one-month deliveries), 15.3% above its level at the start of the year, equalling the rise for the whole of 2011 and 8.3% higher than its level a year ago, when the Libyan crisis erupted.

Oil prices rise to 123.5 dollars, intensifying their upward trend.

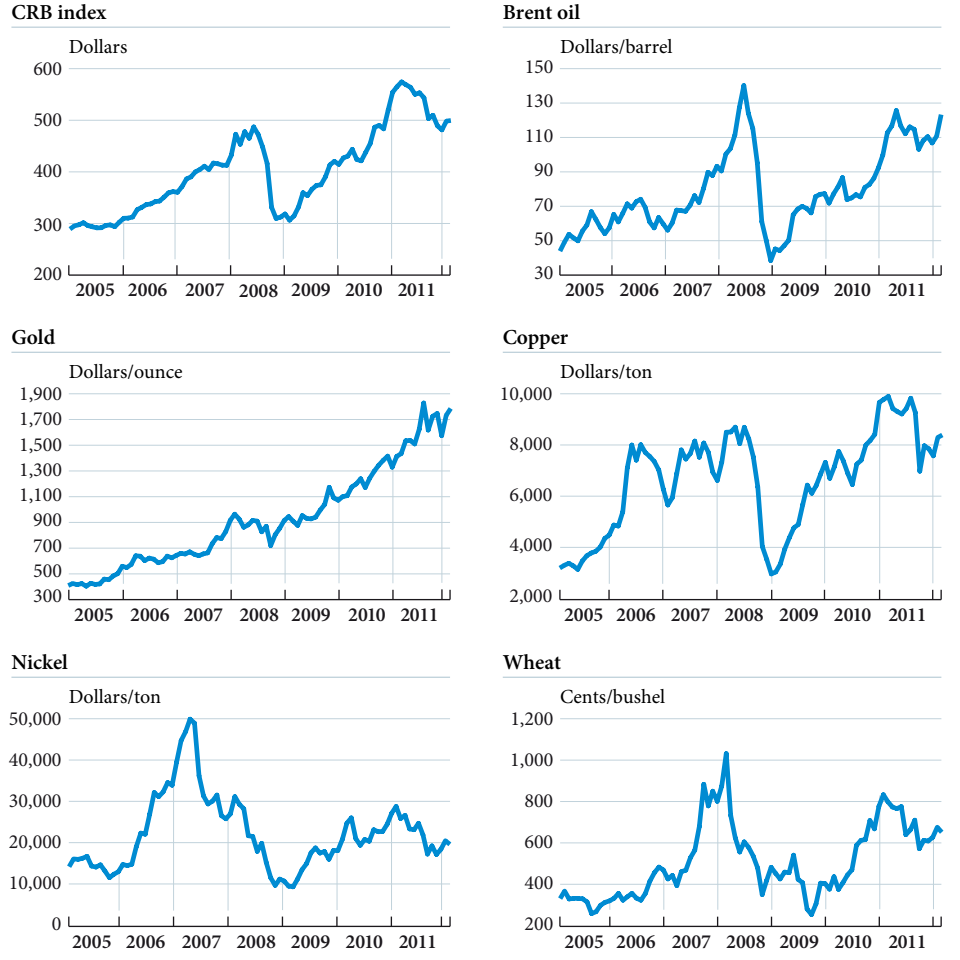
Instability in the Strait of Hormuz, resulting from the tensions between Iran and western powers, is an upward pressure that might last throughout 2012

and which, in turn, is reinforced by strong demand from emerging economies. All this means that crude is unlikely to fall from the benchmark price of 115 dollars per barrel. Expensive oil that hinders the growth of many economies, either because it affects consumer budgets or worsens the trade balances of advanced economies.

The rest of the commodities continued an upward trend in general, although less sharply than in January, perhaps affected by doubts regarding China's growth. The CRB index rose by 2.0% between 23 January and 23 February with precious metals appreciating the most. Platinum, which is still cheaper than gold, rose by 11.2% in the month, accumulating gains of 27.7% since the start of the year. This could be an indication that Europe's car industry, which uses platinum in diesel engine catalysers, might have bottomed out. Base metals took a breather in their appreciation apart from aluminium, whose energy intensity in its production makes it particularly sensitive to energy prices. For their part, food staples also rose, led by wheat.

The trend is upwards although base metal prices ease somewhat.

TREND IN VARIOUS COMMODITIES (*)



NOTE: (*) Figures for last day of month (last date February 23).
SOURCES: The Economist, Thomson Reuters Datastream and own calculations.

EUROPEAN UNION

The euro area: cautious steps towards stabilization

Greece and the new growth forecasts in the European Union attract economic and political attention.

Three significant factors have emerged in the euro area in the last month: the progress being made with the Greek situation, the new growth forecasts by the European Commission and the publication of its first alert mechanism report on macroeconomic imbalances in the European Union (EU).

The Eurogroup approves a second financial bail-out for Greece.

On 21 February, after a marathon meeting of more than thirteen hours of intense negotiations, Eurogroup approved Greece's second financial bail-out. Agreement was reached after the Greek parliament passed a package of economic measures; identifying additional savings of 325 million euros by the Greek government to close the fiscal deficit of 2012; and, lastly, after leaders of the Greek coalition had guaranteed that the necessary reforms would be implemented after the general elections to be held in April.

The agreement is complex and we shall outline its key points here. Firstly, this second bail-out totals 130 billion euros. Secondly, the aim of this new package is to lower the stock of Greek debt from 164.0% of its gross domestic product (GDP) forecast for 2011 to 120.5% in 2020. To achieve this, the interest charged to Greece for bilateral loans will have to be lowered, backdated to 2010. The margin is now 150 basis points, compared with the 200 for the first three years and 300 for subsequent years, reducing the country's net borrowing by 500 million euros.

Lastly, one of the key pieces in the agreement, which the Eurogroup mentions in its release, is the agreement reached by private creditors and Greece on a voluntary write-down of public debt of 53.5% of the nominal value of Greek bonds. Approval of the bail-out requires Greece's acceptance of greater control in situ by the troika's experts, as well as the creation of a blocked account to prioritize debt payments.

This agreement, subject to a minimum participation of international creditors in the write-down agreement (whose ultimate outcome is not known at the time of writing), prevents Greece from going bankrupt and halts the serious consequences of a disorderly default for the rest of the euro area. However, the challenge facing Greece is still considerable and the margin for error in implementing these new measures is very small, so volatility in the financial markets is unlikely to lessen over the next few months.

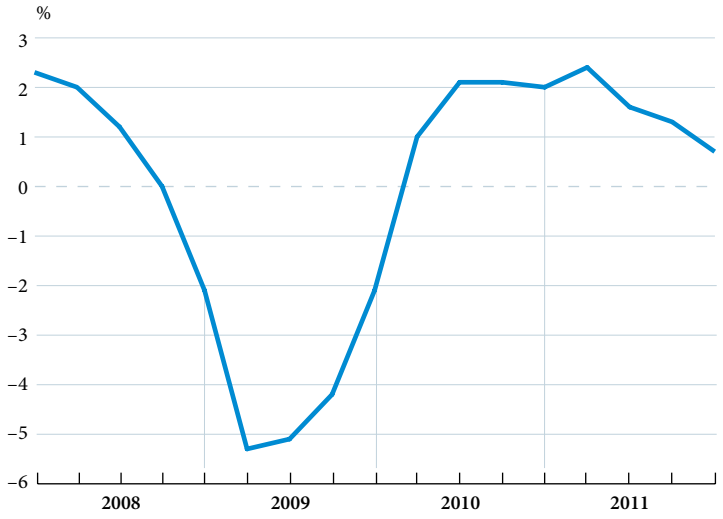
The European Commission publishes its new growth estimates for member states of the European Union...

On the other hand, the European Commission has published its update of the macroeconomic forecasts for the euro area. Due to the rapid change in economic conditions and the latest events, the Commission decided to recalculate its estimates for all countries.

There are three particularly significant changes in the new forecasts. Firstly,

UNCERTAINTY WEIGHED HEAVY ON GROWTH IN 2011

GDP year-on-year growth rate



SOURCE: Eurostat.

growth has been revised downwards in 2012 for Germany and France, to 0.6% and 0.4% respectively. However, Italy has suffered a sharper revision with a decline forecast of –1.3%. Of note is the sharp downward revision of some peripheral countries due to structural reforms being introduced that reduce growth in the short term but make the economies more flexible in the medium term. This is the case of the forecasts for Portugal and Greece, with drops of 4.4% and 3.3%, respectively.

Lastly, the European Commission publicized its first alert mechanism report on macroeconomic imbalances. This report forms part of the new macroprudential supervision system approved on 13 December last year in the European Union. The aim is to be able to advise on preventative economic policies before these imbalances jeopardize the stability of any member state and might even create negative externalities for the rest of the European Union's members.

Ten macroeconomic indicators have been chosen that highlight imbalances in external positions, competitiveness and also the internal imbalances of the different member states. The conclusion of the report selects several countries, including Spain, France and Italy, where a more in-depth analysis needs to be carried out to study whether these imbalances require recommendations from the European Commission for their correction. If the countries don't apply these recommendations, they could incur fines that might be imposed by the Council of Ministers.

...and the first alert mechanism report on macroeconomic imbalances.

All these events should help to reduce the level of uncertainty that afflicted Europe's economy during 2011. A lack of confidence that has had a negative effect on economic growth. According to flash figures for the fourth quarter on gross domestic product published by Eurostat, this fell by 0.3% compared with the third quarter, while year-on-year growth ended the year at 0.7%.

Fourth quarter GDP figures for the euro area show a drop of 0.3% quarter-on-quarter...

...although the latest leading economic indicators point to the decline stabilizing.

This was the first fall in activity since the second quarter of 2009 and the decline will probably continue in the current quarter due partly to the effect of the adjustment measures being applied by a large number of countries. The euro area would therefore go into recession again. In fact, at the end of 2011 Italy, the Netherlands and Belgium were already in recession, joining Portugal. On a positive note, France grew by 0.2% quarter-on-quarter, more than expected, although this could not entirely offset the 0.2% fall in Germany.

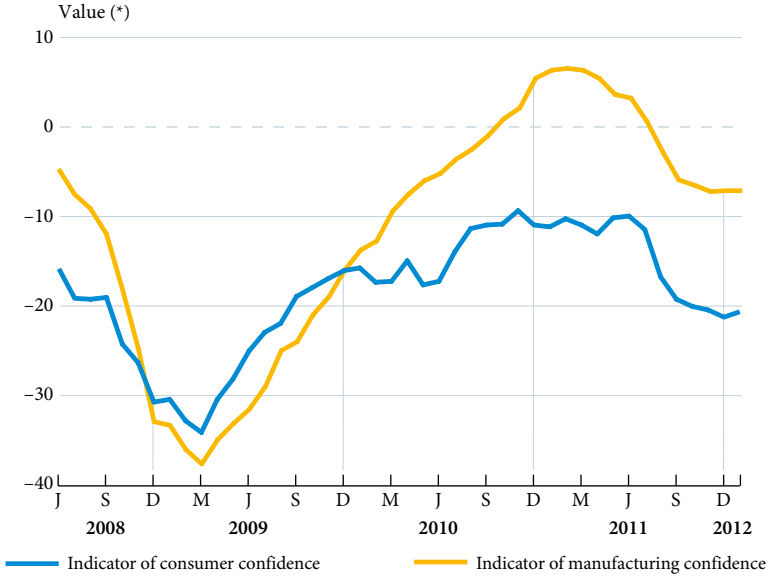
Developments in resolving the Greek bail-out have coincided with the publication of a series of economic indicators that point to the deterioration in the euro area's economic situation stabilizing. For example, retail sales shrank at the end of the fourth quarter last year but December's figures were slightly better than those posted the previous month, although the year-on-year drop was still 1.3%. On the other hand, consumer confidence, which hit a record low in December of –21.3 points, picked up in January to –20.7 and, in February, consolidated its improvement at –20.2 points.

The foreign sector is also boosting growth in the euro area as it is partly offsetting the slowdown in domestic demand. In fact, the euro area posted a surplus of 9.7 billion euros in December. Seasonally adjusted, while exports grew by 0.1% month-on-month in December, imports were down by 0.9%.

From the point of view of supply, industrial production in December continued its decline, widespread in several countries in the euro area. In particular, Germany's industrial production recorded a fall of 2.9% month-on-month. However, this figure

END OF THE DETERIORATION IN CONSUMER AND BUSINESS EXPECTATIONS?

Sentiment indicators in the euro area



NOTE: (*) Difference between the percentage of interviewees who answer in the affirmative and those in the negative.
SOURCE: European Commission.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
GDP	1.8	1.5	2.4	1.6	1.3	0.7	–
Retail sales	0.8	–0.6	0.1	–0.5	–0.5	–1.1	...
Consumer confidence (1)	–14.2	–14.6	–11.0	–10.7	–15.9	–20.6	–20.7
Industrial production	7.4	4.8	6.6	4.1	4.0	–0.2	...
Economic sentiment indicator (1)	100.5	101.0	106.9	105.2	98.4	93.6	93.4
Unemployment rate (2)	10.1	10.1	10.0	10.0	10.2	10.4	...
Consumer prices	1.6	2.7	2.5	2.8	2.7	2.9	...
Trade balance (3)	4.6	–17.2	–10.0	–16.5	–21.3	–17.2	...
3-month Euribor interest rate (%)	0.8	1.4	1.1	1.4	1.6	1.5	1.3
Nominal effective euro exchange rate (4)	103.7	103.4	102.7	105.2	103.5	102.1	98.9

NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Billion euros.
(4) Change weighted for foreign trade flows. Higher values imply currency appreciation.
SOURCES: Eurostat, European Central Bank, European Commission and own calculations.

should be interpreted in combination with the upward revision of figures for the previous month and the publication of Germany's factory orders for December, up by 1.7% month-on-month. France's industrial production was also negative, down 1.4% month-on-month, leaving the annual growth rate at 0.8%. On the other hand, although Italy posted positive growth of 1.4% month-on-month in December, this was not enough to offset the year-on-year drop of 7.7%. In short, the euro area's industrial production in December recorded a poor –2.2% growth year-on-year.

However, some improvement can be glimpsed in the situation, judging by business sentiment surveys. For example, business confidence for the manufacturing sector has stopped its decline of the last few months. This movement points to a certain stabilization for the euro area's industrial sector in the coming months.

Nonetheless, the possible improvement has yet to affect the labour market which, being a delayed indicator for the economy, is still seeing job losses. Certainly, the unemployment rate in December in the euro area rose by one tenth of a percentage point to 10.4%, continuing the upward trend started during the second half of last year. The number of unemployed in the euro area in December increased by 20,000 people and is approaching 16.5 million.

Industrial production continues to shrink.

Rising oil prices mean that inflation did not fall in January, according to the leading indicator published by Eurostat which shows a year-on-year increase of 2.7%, repeating the figure published in December. Although sluggish economic activity is more than likely to help push prices back down over the coming months.

In summary, the approval of Greece's second bail-out, accompanied by economic data that point to the economic

The unemployment rate increases to 10.4%.

The situation is too fragile to be able to claim with all confidence that the euro area has got over its last bad patch.

situation stabilizing, are good news for the rest of the year. However, this does not make the current economic situation any less serious, even more so taking into account the fact that a further rise in oil prices or a greater lack of confidence, caused by the fragile economic trends in the euro area's peripheral countries, might lead to economic activity going off the rails again.

From Kyoto to Durban: what does the European Union want?

As from January 2012, the airlines that use European Union (EU) airports have to pay a tax according to the CO_2 emissions they generate. At the beginning of February, the Chinese Civil Aviation Administration expressly prohibited Chinese airlines from paying the EU for their carbon emissions. A trade conflict has therefore emerged with the EU on one side and China, together with the United States, Japan, Russia and other countries on the other. Why is the EU demanding payment of a kind of environmental tax on air transportation even in the case of overseas flights, whose flight path is mostly outside EU air space?

The reason lies in the EU's decision to bring the aviation industry under the trading scheme for greenhouse gas emission allowances, set up in 2005. A scheme that sets the maximum amount of contaminating gases that can be emitted and shares this amount among the economic agents emitting them. This limited amount of emission allowances encourages emissions to be cut as, if agents exceed these levels, they must buy emission allowances from other agents. The desired outcome is a reduction in emissions. To date, only energy intensive industrial facilities came under this regime. The pollution caused by air companies is relatively small but growing fast, as is the industry itself. It is estimated that a passenger taking a return flight from London to New York produces the same emissions as an average EU citizen in heating their home for a whole year.

The case of civil aviation illustrates very clearly the EU's involvement in the issue of global warming and climate change. The EU has promoted actions by the United Nations in this area, from Kyoto to the recent Durban Conference in December 2011. Certainly, the world is facing two huge challenges in the area of energy. The first, meeting growing energy demands, particularly from developing countries. The second, to do so whilst also reducing greenhouse gas emissions.

The need to maintain the growth of developing countries is clear, in order to achieve goals such as reducing poverty and improving living conditions. But the issue of climate change could be more controversial. The scientific consensus states that, in the last 150 years, the average annual temperature has risen by 0.8 degrees Celsius, a little more in Europe, and this rise is tending to accelerate. Many experts believe that, in order to stop global warming from having irreversible consequences, the temperature should not go more than two degrees higher than the current levels within this century. As it is believed that the cause of climate change is the excessive emission of greenhouse gases due to human activity, the solution lies in limiting the emissions of these gases. The international body responsible for evaluating climate change data and its consequences is the Intergovernmental Panel on Climate Change (IPCC). Reports drawn up by the IPCC form the basis of the United Nations Framework Convention on Climate Change (UNFCCC), created in 1992, whose aim is to slow up global warming. Specifically, it is attempting to stop the annual global temperature from rising more than two degrees Celsius above pre-industrial levels. To this end, if believes that the concentrations of greenhouse gases (principally CO_2) should be stabilized, requiring a 50% reduction in the emissions of these gases by 2050.

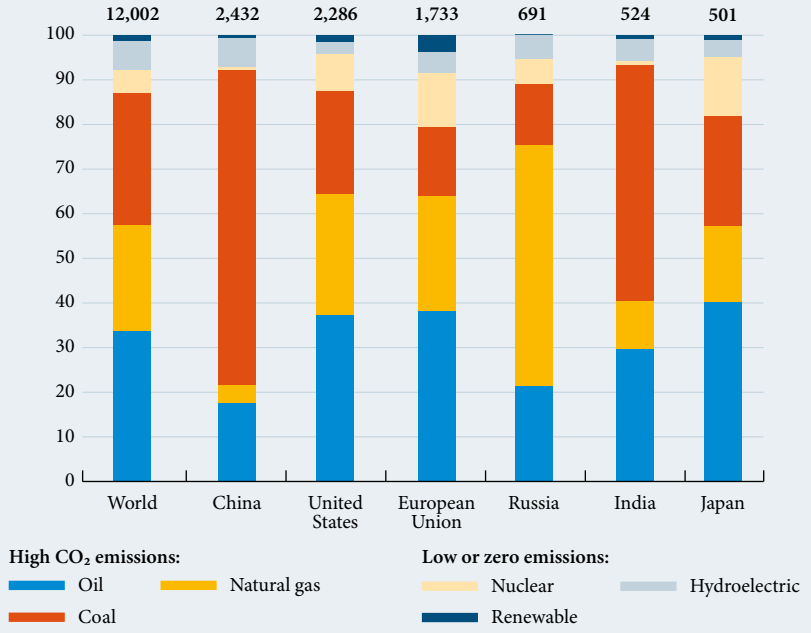
The Kyoto Protocol, which came into force in 2005, was an important first step but it only committed developed countries and, moreover, was not signed by the United States. This means that it only covers 30% of the world's total emissions. In any case, the 15 Member states of the EU that signed the Kyoto Protocol reduced their emissions by 10.7% in 2010 compared with the reference year of 1990, exceeding the target reduction of 8%. Other states that joined the EU afterwards also adopted targets to reduce their emissions and have achieved similar results.

The Kyoto agreement provided commitments until 2012 so that, in 2007, in Bali, negotiations started for a new agreement as from 2012. But these were unable to be completed in Copenhagen in December 2009, while one year later, in Cancun (Mexico), the only progress made was recognizing the need to limit global warming to the levels established by the UNFCCC.

The EU has promoted a second Kyoto agreement for the period 2013 to 2020, which perfects and furthers the commitments of the first. But Japan, Russia and Canada already made it quite clear that they weren't going to take part; neither would the United States or China. This second period of commitments would therefore only affect 16% of the world's emissions; not even a heroic effort by the EU (11% of emissions) in limiting emissions would result in any progress being made in the aim to slow up the world's climate change. For this reason, the EU's aim at the meeting in Durban (South Africa) was to achieve agreement on «a route map and deadline to achieve an ambitious, global, legally binding framework for climate action by all large economies», according to Barroso, President of the European Commission. After two weeks of negotiations, the outcome of the conference of the 195 states in Durban was somewhat ambiguous. The Kyoto developed countries agreed to extend the life of the protocol to continue reducing carbon emissions. For the rest, the EU did not achieve the binding commitment

ENERGY VERSUS CLIMATE?

Total consumption in 2010 (millions of tonnes of oil equivalent and percentage distribution by fuel type)



SOURCES: British Petroleum Statistical Review of World Energy and own calculations.

it wanted but a somewhat legally ambiguous agreement according to which an effort will be made to stop temperatures from rising higher than two degrees by means of a legal framework that will be ready in 2015 and come into force in 2020. Moreover, it was agreed to create a financial instrument (the Green Climate Fund) to help developing countries to combat the effects of climate change (100 billion dollars a year).

It is therefore clear that the EU's battle against climate change goes much further than these international commitments. In fact, in 2007, the European Council adopted some ambitious energy and climate change targets for 2020: a 20% cut in greenhouse gas emissions (compared with the reference year of 1990), or even a 30% cut if other countries join the effort to reduce emissions; to increase the renewable energy share to 20%; and to improve energy efficiency by 20%. A commitment was even established to reduce the emissions of the EU and other industrialized countries by 80% or 95% by 2050.

But energy policy is not limited to restricting carbon emissions. The EU Treaty has established the basic principles: to guarantee the energy market functions efficiently (secure energy supply and competition) and to conserve and improve the environment. Some progress has been made along the road towards an integrated market but adaptation is slow and the challenges are still growing. The domestic energy market is still highly fragmented by national borders, with state-wide companies and a multitude of rules and practices that are also national, as well as many barriers to competition. The security of energy supply is also a cause for concern, for example due to this fragmentation of the European market, the limited life of existing nuclear power stations and the gas supply crises already suffered. The European Commission has called for changes in the scope of production, supply and use of energy but the work required in this area is essentially titanic. Almost as titanic as achieving the climate change targets.

This box was prepared by Joan Elias
Research Department, "la Caixa"

Only investment contributes positively to Germany's quarter-on-quarter economic growth in the October-December period of 2011.

The German economy shrinks in the fourth quarter of 2011

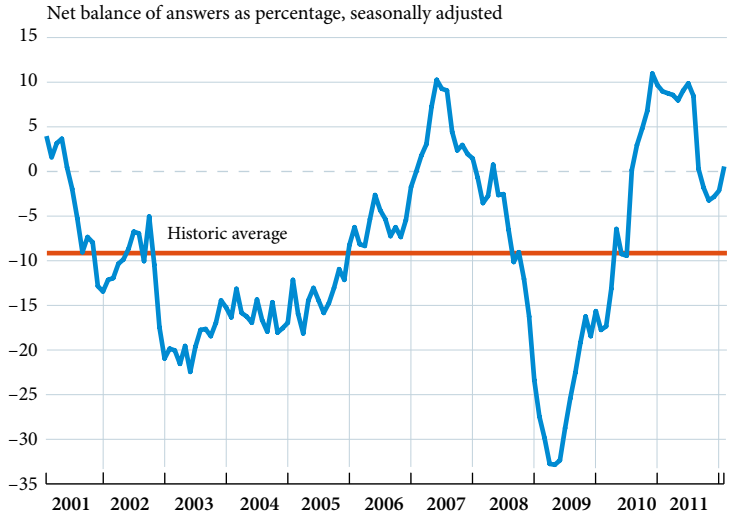
German GDP increased by a strong 3.1% in 2011 and exceeded the peak reached prior to the Great Recession of 2008-2009 after two years of recovery. However, this figure hides a slowdown in the level of activity since the middle of last year, culminating in a 0.2% quarter-on-quarter drop for GDP in the fourth quarter of 2011, in line with expectations. A contraction has not been recorded since the first quarter of 2009 and this took place after notable quarterly growth of 0.6%. This deterioration in the situation is mainly attributable to the effects of the slowdown in the world economy and particularly to the sovereign debt crisis in the peripheral countries of the euro area.

In the October-December period of 2011 only investment, particularly in construction, contributed to GDP growth. The foreign sector made a net negative contribution and consumption deducted slightly.

However, in the last few months economic climate indicators have reversed and are pointing to stabilization and even slight growth in the first quarter of 2012. In this way, the German

PRIVATE CONSUMPTION WILL SUPPORT GERMANY'S ECONOMIC GROWTH IN 2012

Indicator of consumer confidence



SOURCES: European Commission and own calculations.

economy, unlike other countries in the euro area, would avoid a technical recession. We have kept our previous forecast of an annual increase of 0.5% for GDP since, in spite of the improvement in the overall environment over the last few weeks, the German giant won't be able to entirely avoid the weak economic situation of most of its European trading partners, affected by the necessary austerity policies. Although it's true that there might be some pleasant surprises, there are also risks that might make these figures worse, such as those resulting from the sovereign debt crisis, which has not been entirely resolved.

Unlike a year ago, GDP growth in 2012 will be essentially down to domestic demand. There will be a rise in

Germany's labour market continues to perform well at the start of 2012.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
GDP	3.6	3.1	4.6	2.9	2.7	2.0	–
Retail sales	1.5	1.1	0.8	2.4	0.9	0.4	...
Industrial production	10.0	8.0	12.8	8.1	8.2	3.3	...
Industrial activity index (Ifo) (*)	107.8	111.3	114.6	114.1	109.7	106.8	108.3
Unemployment rate (**)	7.1	5.9	6.3	6.0	5.8	5.6	...
Consumer prices	1.1	2.3	2.1	2.3	2.4	2.4	2.1
Trade balance (***)	154.9	158.1	157.9	158.7	159.0	158.1	...

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.

A modest outlook for Germany's industrial sector in 2012 after a strong increase last year.

consumption, in particular. In fact, consumer confidence has improved appreciably over the last period and, in January 2012, it was significantly higher than its historic average. This was due to the good performance by the labour market and the rise in disposable income. In 2011, real wages rose by around 1%.

For its part, the labour market in the last quarter of the year avoided the contraction in activity and the number of employed people continued to rise. In January, the number of unemployed continued to fall in seasonally adjusted terms and the BA-X indicator for job demand went on rising, reaching a high level.

Similarly, low interest rates will encourage investment, in particular in construction. The improvement in economic sentiment will also boost investment prospects, as well as the slightly better degree of production capacity utilization in the first quarter of 2012. However, the rise in fixed capital formation will probably be moderate, given the existing uncertainty.

French GDP rises by 1.7% in 2011 but is still not at its level prior to the Great Recession.

From the point of view of supply, industrial production rose by 8.0% in 2011 but with clear signs of losing steam in the second half of the year. However, numerous branches posted year-on-year increases greater than two digits, such as electronics, the motor vehicle industry, metal machining and metallurgy. Nevertheless, the outlook for 2012 is not very optimistic due to the year-on-year drop in new orders in the last two months of 2011. In spite of this, the month-on-month rise of 1.7% recorded in December leaves some room for hope. For its part, confidence in the construction industry remains at a comfortable level and that of services improved appreciably in January.

Leading indicators in the first quarter of 2012 point to stabilization.

This generally strong context was also evident at a microeconomic level. In November 2011, the number of firms going out of business fell by 4.4% compared with the same month the previous year.

The French economy provides a pleasant surprise in the last quarter of 2011

The data published by the French statistics institute showed a slowdown in the French economy in the fourth quarter last year that was less than had been feared. GDP rose by 0.2% compared with the third quarter, only one tenth of a percentage point less than in the previous period. The slowdown in household consumption to 0.2% was offset by an acceleration in investment, thanks to capital goods. However, the main contribution to GDP growth came from the foreign sector, due to the decline in imports. In 2011 as a whole, GDP increased by 1.7%, compared with the expansion of 1.4% in 2010, so the level prior to the great crisis of 2008-2009 has still not been reached.

In spite of the pleasant surprise provided by GDP in the last quarter of 2011, we have kept our forecast of an annual rise of 0.1% for 2012. In fact, economic climate indicators are still generally below their long-term average and prospects have declined further. More in the short term, leading indicators from the first quarter of this year point to stabilization.

Consumer confidence improved slightly in January but was still below its historic average. There is still concern due to the unfavourable performance of the labour market. In fact, the unemployment rate has a slightly upward trend and is close

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
GDP	1.4	1.7	2.2	1.6	1.5	1.4	–
Domestic consumption	1.7	0.5	3.4	0.9	–1.4	–1.0	...
Industrial production	4.6	2.4	4.7	1.8	2.8	0.5	...
Unemployment rate (*)	9.8	9.7	9.6	9.6	9.7	9.8	...
Consumer prices	1.5	2.1	1.8	2.1	2.1	2.4	2.3
Trade balance (**)	–51.5	–69.6	–59.1	–64.4	–68.6	–69.6	...

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

to 10%, while there were net job losses in the last quarter of 2011.

In January, manufacturing entrepreneurs predicted a 7% rise in investment in value terms for 2012, with greater dynamism in the motor vehicle industry. However, their replies also suggest there might be a slight slump in the first quarter.

With regard to the foreign sector, although this posted a slowdown in 2011, the levels of goods purchased and sold abroad exceeded those prior to the Great Recession. Exports were particularly boosted by agricultural products and luxury goods, while imports rose mainly because of rising commodity prices. Overall, the trade deficit increased to 69.6 billion euros, a record level, with an annual rise of 35.1%, clearly showing the competitiveness problems of French industry.

Looking at supply, the situation is similar. In October-December, industrial orders not including transport except automobiles decreased by 1.1% in value terms compared with the preceding quarter and only rose by 0.8% compared with the same period in 2010, although foreign orders were up 2.4%. On the other hand, the confidence of the secondary sector was at a low, so there is not much optimism regarding the French industrial panorama in 2012. In construction, the level of confidence was closer to normal but deteriorated slightly in February. And the sentiment in services fared no better.

For its part, bank credit to the non-financial private sector continued to moderate but rose by 5.3% in 2011. Financing to firms was up by 4.4% year-on-year, while credit to households increased by 6.0%.

To tackle the problems of competitiveness, in February the government presented a revision of the budget act for 2012, which also resulted from a change in the GDP growth projected for the current year from 1% to 0.5%. Among other measures, as from 1 October 2012 company contributions to Social Security will be reduced, offset by a hike in the general rate of value added tax (VAT) from 19.6% to 21.2% and an increase of 2 points in capital gains tax to 10.2%. Moreover, budget items will be cut to ensure the target public deficit of 4.5% of GDP is achieved.

The French government reduces company Social Security contributions to boost competitiveness.

Double dip recession is confirmed for the Italian economy

Italy's external imbalance is being corrected but it's still not enough.

The publication of a 0.7% contraction in Italian GDP in the fourth quarter of 2011 compared with the previous quarter made the Italian recession official, as in the third quarter it had already posted a quarter-on-quarter fall of 0.2%. Not only had activity in the last quarter of 2011 not regained its pre-crisis levels, it was 0.5% below the levels of a year earlier. Nonetheless, GDP grew by 0.4% for the year as a whole.

With regard to 2012, leading indicators continue to fall and the economic climate is getting worse. Although the reformist measures undertaken will increase potential growth in the medium term, the contractive effects of budget adjustment packages predominate in the short term. We have kept our forecast of a 1.5% drop in GDP, which might decline even further if the Greek crisis goes out of control or commodity prices rise further than expected.

Fall in the risk premium for Italian sovereign debt, although Fitch and Moody's downgrade its rating.

Consumption continues weak at the start of this year. Automobile sales were down 16.9% in the last twelve months up to January. This tone isn't likely to change much over the coming months as, although consumer confidence picked up in February, it is still very low. Consumer sentiment is affected by the reduction in disposable income and the deterioration in the labour market. In December, the number of employed fell by 0.1% compared with the same month in 2010 and the unemployment rate increased to 8.9%, 8 tenths of a percentage point more than a year earlier. On the other hand, inflation barely came down in January, falling to 3.2% year-on-year.

Within this recessionary situation, the external imbalance is adjusting, although still not enough. Foreign trade improved in December as goods exports rose by 4.2% month-on-month and imports fell by 0.8%. For 2011 as a whole, exports rose by 11.4% and imports by 8.9%. The trade deficit therefore shrank by 19% to 24.3 billion euros. The current account deficit also corrected by 6.5% but still totalled 50.6 billion euros.

From the point of view of supply, January saw a reduction in confidence in various sectors except construction. In December, industrial orders were 4.3% lower than their level of twelve months ago. In the fourth quarter of 2011, the weakness

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
GDP	1.4	0.4	1.0	0.8	0.3	–0.5	–
Retail sales	0.1	...	–0.4	–0.3	–1.3	...	...
Industrial production	6.5	0.2	2.2	1.5	–0.1	–2.8	...
Unemployment rate (*)	8.4	8.4	8.2	8.2	8.4	8.7	...
Consumer prices	1.5	2.7	2.3	2.6	2.8	3.4	3.2
Trade balance (**)	–30.0	–24.3	–34.2	–34.1	–32.1	–24.3	...

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

in the real estate market intensified and production in construction fell by 1.2% compared with the third quarter.

However, at the beginning of the year, Italy's sovereign debt risk premium fell in terms of its differential with German 10-year bonds. In the fourth week of February this stood below 350 basis points, far from the record of 550 in November 2011. The reform programme of the Prime Minister, Mario Monti, has contributed to this improvement. However, at the end of January the ratings agency Fitch cut Italy's rating by two notches to A– with a negative outlook, and in mid-February Moody's downgraded its sovereign debt rating to A3. On the other hand, credit to the private sector continued to slow up, posting a year-on-year decrease in real terms at the end of 2011.

As a continuation of the previous reform packages, another Decree-Law came into force in February on normative and administrative simplification and economic development. With the aim of boosting Italy's productivity and competitiveness, the new package of measures simplifies bureaucracy by taking advantage of digital technology and innovation. A fiscal reform plan is also being drawn up for the end of February that would cut taxes for lower income groups, as well as labour reforms in March.

A new package of reforms to reduce the administrative burden for Italian firms and citizens.

The United Kingdom: the patient improves slightly but more painkillers are provided

Since the start of last year, the economic figures published on the United Kingdom's economy have reflected a growing deterioration in economic activity. For this reason, it came as no surprise that gross domestic product for the fourth quarter of 2011 should have fallen by 0.2% quarter-on-quarter, while year-on-year growth presented an anaemic increase of 0.8%. This is the first negative quarter since the last quarter of 2010. The breakdown for these figures is still not available but the bulk of the

The Bank of England increases its asset purchase programme to underpin the United Kingdom's economy.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
GDP	2.1	0.9	1.7	0.6	0.5	0.8	–
Retail sales	–0.3	0.7	1.5	0.4	–0.4	1.2	2.1
Industrial production	1.9	–1.3	1.1	–1.5	–1.7	–3.2	...
Unemployment rate (1)	4.7	4.8	4.5	4.7	4.9	5.0	5.0
Consumer prices	3.3	4.5	4.2	4.4	4.7	4.7	3.6
Trade balance (2)	–96.3	–100.9	–98.4	–98.6	–100.5	–100.9	...
3-month Libor interest rate (3)	0.7	0.9	0.8	0.8	0.9	1.0	1.1
Nominal effective pound exchange rate (4)	80.4	78.4	78.4	78.6	77.1	79.4	80.4

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.

evidence available suggests that the construction sector and the fall in industrial production have probably harmed economic activity.

These clear symptoms of an economic slowdown have had two consequences. Firstly, the credit rating agency Moody's has given the United Kingdom's rating, which is currently the highest possible at AAA, a negative outlook. The international agency has justified its action due to the deterioration in fiscal forecasts for the United Kingdom. This means that, if there is no change, Moody's might downgrade the country's rating in the medium term.

At its last monetary policy meeting, the Bank of England also increased its asset purchase programme by 50 billion pounds sterling, bringing the total to 325 billion. This is the programme's third enlargement. Its justification is to safeguard the British recovery given the threat of tensions created by the euro area's sovereign debt crisis. The meeting's minutes reveal that two of the Monetary Policy Committee members argued for a greater stimulus but the remaining seven members preferred to avoid this.

As interpreted by most of the reserve bank's members, in general the latest figures have been more positive. For example, retail sales in January posted month-on-month growth of 1.2%, raising the year-on-year growth rate from 1.4% to 2.1%. Price containment is probably still a positive factor underpinning this rate of growth in retail and consumer goods. In this respect, in January the United Kingdom's inflation fell to its lowest level in the last 14 months. The year-on-year change in the consumer price index for January fell to 3.6%. It should be noted that, a few months ago, specifically last October, inflation stood at 5%. There are two reasons for this fall: the disappearance of the base effect of tax hikes last year and the lethargy in demand.

With regard to the foreign sector, the trade balance has shown a smaller deficit than expected, thanks to the 0.4% drop in exports month-on-month compared with the 3.6% drop in imports. These positive economic figures can also be found on the side of supply, as December's industrial production recorded month-on-month growth of 0.5%, with transport equipment and foods seeing a significant upswing. Also of note is the fact that industrial production had not seen positive growth since last September.

This good tone is likely to continue, as the purchasing managers' index for manufacturing in January rose from the 49.1 points of December to 52.1 points, 50 points being the boundary between the sector's expansion and contraction. Moreover, the purchasing managers' index for the services sector in January picked up to 56 points from its previous figure of 54 points.

In short, leading economic indicators suggest that the British economy might be able to avoid a second (and consecutive) quarter with negative GDP growth. Moreover, the measure applied by the central bank to enlarge its quantitative easing monetary policy should also contribute to the economic recovery in the first half of this year.

In emerging Europe, activity weakens in the fourth quarter and the tone remains the same for the beginning of 2012.

Emerging Europe: economic slowdown and Hungary, the concerns of the moment

There are currently three fronts that need to be tackled regarding the economic situation of emerging Europe: the

slowdown in activity, the state of Hungary's public accounts and financial contagion from the euro area's debt crisis. The beginning of 2012 has been a lost period to some extent for the first two cases activity is still fragile and not much progress has been made with the Hungarian problem. On the other hand, the third of these risks has developed more positively, as financial tensions have lessened.

Looking more closely at the first of these three areas, namely activity, the key figure announced has been fourth quarter growth, available for Slovakia, Hungary, the Czech Republic and Romania (the figure for Poland is therefore pending publication). Although the forecasts being used already presented quite a widespread scenario of weakness, the real figures have introduced some fine distinctions.

The first of the economies mentioned, Slovakia, provided a welcome surprise by growing 0.9% quarter-on-quarter (3.3% year-on-year) in the fourth quarter. Without details on its components, some data suggest that this good performance might be due to investment in capital goods and more specifically to a large automobile investment project. The Hungarian economy also grew more than expected. Although the breakdown by component has not been published for demand, some sources point to exports being the key factor to the country's 0.3% growth in GDP quarter-on-quarter, equivalent to 1.5% year-on-year.

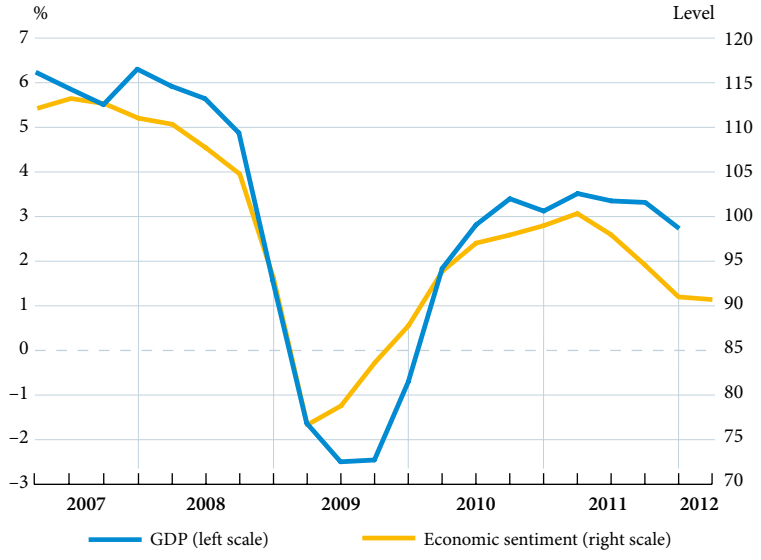
On the other side of the scales we find the Czech Republic and Romania. In these two countries, the quarter-on-quarter fall in GDP (0.3% and 0.2%, respectively) has been greater than expected. The partial figures available point to a deterioration

We predict that, in 2012, Hungary will enter into recession and the Czech Republic will hover around zero growth...

...while Romania and Slovakia will grow more than 1%.

EMERGING EUROPE IS GOING THROUGH A PHASE OF WEAK ACTIVITY

Indicator of economic sentiment and year-on-year change in real GDP (*)



NOTE: (*) Weighted average for Poland, Hungary, the Czech Republic, Slovakia and Romania. The fourth quarter figures for GDP growth in Poland are its own estimates. The first quarter figures for economic sentiment in 2012 correspond to January.
SOURCES: Eurostat, European Commission, Thomson Reuters Datastream and own calculations.

Hungary needs financial aid from the IMF and the European Union but is unlikely to get it without reforms.

in exports, hard hit by the euro area's recession, as the main reason for this drop in activity. In year-on-year terms, the Czech Republic grew by 0.5% in the fourth quarter and Romania by 2.1%.

What can we expect from now on in terms of the activity cycle? The few figures available for the first quarter, and in particular the economic sentiment indicator, suggest the region will remain weak during the first few months of 2012. In the case of the Czech Republic and Romania, whose foreign demand has adjusted quickly to the decline in the euro area, we believe the toll on exports will not be appreciably reversed before the summer. In the second half of 2012, the recovery in the euro area should help these to improve. In short, for the year as a whole, we predict 0.3% growth for the Czech economy and 1.1% in the case of Romania.

For Slovakia, we believe it is very unlikely that investment in capital goods will repeat the pleasant surprise in the fourth quarter of 2011 so that, added to weak foreign demand, its growth in 2012 will stand at 1.4%.

The Hungarian case is more complex and here we should introduce the second of the fronts of risk for the region, namely Hungary's financial problems. Unlike the previous countries, the Hungarian economy has a specific problem with its external financing. This led to negotiations starting with the International Monetary Fund (IMF) and the European Union last November for credit to offset this financial imbalance.

Unfortunately, expectations were cut short after the negotiations went badly in December 2011.

The lack of progress made in these negotiations is due to notable differences separating the parties regarding fundamental issues, such as the independence of Hungary's central bank, and other issues more related to how the budget adjustment was carried out in 2011 (via exceptional measures that distort the economy's long-term growth). A series of resources presented by EU institutions and the start of the so-called Excessive Deficit Procedure have merely complicated the panorama.

Although, in the last few weeks, the Hungarian government appears to be more open to changes in its economic policy and institutional modifications along the lines proposed by multilateral bodies, financial uncertainty is still high (the risk premium for 3-year bonds was around 460 basis points on 22 February). In addition, further budget adjustments seem inevitable, which would impact activity. In summary, our main scenario predicts a year of moderate recession (0.3% fall in GDP) with a high risk that activity will eventually decrease more than predicted.

Financial tensions ease in the region.

Lastly, on the third of the fronts, that of the repercussions of the euro area's debt crisis in the form of financial tensions, February has been a positive month. The current risk premium levels are moving slightly away from the values recorded at the start of 2012, a trend that even benefits the Hungarian case.

FINANCIAL MARKETS

Monetary and capital markets

A definitive turning point for markets?

In February, the global financial scenario was still dominated by the sources of instability that have been affecting investor mood for several quarters: namely the European debt crisis and fears of a sharp slowdown in the emerging countries (China in particular). As if this weren't enough, a growing number of analysts have recently started to include in their projections the impact of the Iran situation possibly getting worse, with the subsequent rise in oil prices.

But in spite of these threats, a favourable change has been glimpsed in the tone of financial markets since the start of the year. Decisive action by central banks, guaranteeing huge amounts of liquidity, and a firmer commitment on the part of European political leaders are contributing to an incipient change in the perception of the financial system's future and, ultimately, in the real economy. The containment of risks in the euro area's debt crisis (less likelihood of extreme scenarios of a break-up or similar), together with evidence of growth rates for the world economy being somewhat better than expected are helping to restore a crucial pillar: the confidence of agents. This is most directly reflected in the good performance by risk asset markets since the start of the year, specifically stock markets and corporate bonds.

Central banks play a vital role

Given the current economic and financial context, central banks are starting to play a crucial role. Firstly, they can boost growth. Secondly, they can ensure liquidity in the financial system. Thanks to the forcefulness of their actions, employing quantitative unconventional measures, they have managed to shore up the risk of systemic contagion of the current financial crisis, restoring investor confidence in capital markets and boosting the net lending of the banking sector.

Risks to the global financial scenario persist but are weaker.

In the United States, the actions of the Federal Reserve (Fed) are following the aforementioned pattern. We can find several keys to this in the minutes of the monetary authority's last meeting. The members of the Fed Committee decided to continue its strategy of keeping official interest rates as low as possible (0%-0.25%). What was new was the statement that this situation will probably last until the end of 2014, thereby prolonging investor expectations, who thought this would last until mid-2013. Similarly, for the first time in the institution's history the Fed announced a long-term inflation target for its monetary policy. In doing so, it hopes to keep inflationary expectations anchored and to ease the rise in long-term interest rates, which would help to boost employment. Specifically, the target inflation rate agreed was 2%, coinciding with the figure also set by the European Central Bank (ECB).

The actions being taken by central banks are crucial at this financial juncture.

The Federal Reserve says it will prolong its low interest rate strategy until the end of 2014.

The Fed is considering whether to implement new quantitative monetary measures.

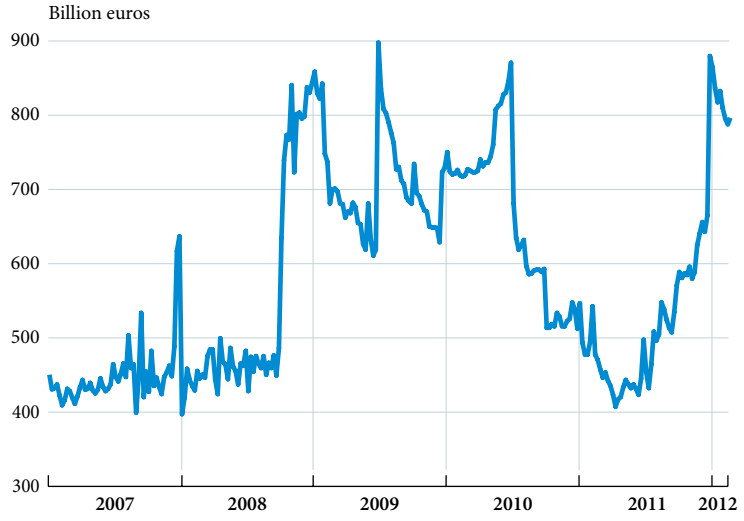
Among other aspects, at this meeting the exceptional monetary measures being carried out by the Fed since 2008 were also analyzed. In this respect, investors paid more attention to the likelihood of the Federal Reserve implementing a new round of extraordinary measures (quantitative easing) over the coming months. Regarding this possibility, the Fed is known to have two different positions. One group of Fed members is in favour of increasing the central bank's purchases of assets while the unemployment rate is high and no inflationary pressure is created. A second group believes this should only be carried out if the economy's recovery loses steam or if deflationary threats are perceived. For the moment, the Fed has decided to wait and see.

In the euro area, the ECB is also employing an expansionary monetary policy to sustain the region's economy, while at the same time it is injecting a large amount of liquidity into the financial system. In line with this proposal, the institution decided to keep the official interest rate at 1% in February. However, the ECB president, Mario Draghi, pointed out that, although a scenario of high uncertainty and downward risks for growth is likely for the euro area's economy in the near future, slight improvement could be seen in some of the region's economic indicators from the beginning of the year.

The ECB keeps the official interest rate at 1%.

Another of the premises supporting the ECB's current monetary policy is the provision of liquidity for Europe's banks and thereby the real economy. The institution is using a series of temporary unconventional measures to achieve this aim. Of particular note are its auctions of unlimited amounts of three-year loans (LTRO). According to Draghi himself, some favourable effects have been observed after the first of the two auctions (held in December), such as the credit crisis being less likely to deteriorate and lower funding costs for banks. He also said he was confident that the second auction announced for the end

ECB LOANS TO FINANCIAL INSTITUTIONS IN THE EURO AREA



SOURCE: Bloomberg.

of February would be a success. This meeting also approved the extension or relaxation of criteria to accept guarantees in ECB credit operations, and of the risk control measures proposed by seven central banks from the euro area (including those of Italy, France and Spain).

With regard to the direct action taken by the ECB in resolving the euro area's sovereign debt crisis, the most significant news is related to the authority's participation in restructuring Greek public debt. Given the conditions imposed by the ECB itself, it will not assume any cutback in its positions and would give up any profit made as its Greek bonds mature (acquired months ago in the Securities Market Programme) to national central banks. These, in turn, could distribute the profits to their respective governments, which would allocate the resources to aid packages for Greece.

Three-year liquidity operations help to improve funding conditions for banks.

For their part, the monetary authorities of the emerging countries are facing the challenge of handling the slowdown in economic growth within a context of still relatively high inflation. Most of these central banks have started to give their monetary policies a more expansionary bias, with lower interest rates being the

The monetary policies of the emerging economies are becoming more expansionary.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2011									
January	1.00	1.07	1.64	0.25	0.30	0.19	0.50	0.78	0.26
February	1.00	1.09	1.77	0.25	0.31	0.19	0.50	0.80	0.10
March	1.00	1.24	2.00	0.25	0.30	0.20	0.50	0.82	0.28
April	1.25	1.35	2.12	0.25	0.27	0.20	0.50	0.82	0.24
May	1.25	1.43	2.14	0.25	0.25	0.20	0.50	0.83	0.26
June	1.25	1.55	2.16	0.25	0.25	0.20	0.50	0.83	0.28
July	1.50	1.61	2.18	0.25	0.26	0.20	0.50	0.83	0.24
August	1.50	1.54	2.09	0.25	0.33	0.19	0.50	0.89	0.10
September	1.50	1.55	2.08	0.25	0.37	0.19	0.50	0.95	0.15
October	1.50	1.59	2.12	0.25	0.43	0.20	0.50	0.99	0.57
November	1.25	1.48	2.04	0.25	0.52	0.20	0.50	1.03	1.00
December	1.00	1.36	1.95	0.25	0.58	0.20	0.50	1.08	0.92
2012									
January	1.00	1.13	1.75	0.25	0.54	0.20	0.50	1.08	0.47
February (1)	1.00	1.02	1.65	0.25	0.49	0.20	0.50	1.07	0.60

NOTES: (1) February 22.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 2-04-09 (1.25%), 7-05-09 (1.00%), 7-04-11 (1.25%), 7-07-11 (1.50%), 3-11-11 (1.25%), 8-12-11 (1.00%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).
(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 4-12-08 (2.0%), 7-01-09 (1.5%), 5-02-09 (1.0%), 5-03-09 (0.50%).
(5) Interbank rate.
SOURCES: National central banks, Bloomberg and own calculations.

Interbank interest rates fall steadily.

main instrument used to achieve this, although not the only one. Certainly, inflationary pressures resulting from rising commodity prices at the beginning of 2011 have eased over the last few months. Thanks to this, the monetary authorities of the emerging countries have some leeway to avoid a sharp slowdown in their economic growth rates. Unfortunately, the recent upswing in oil prices, due to Middle East tensions, is hindering the design of these strategies of relaxation. All the evidence points to these authorities acting with caution, spacing out and scaling their measures. This is the case of China, where the central bank has reduced the reserve ratio for retail banks in order to boost credit to firms and households.

Yields on debt from the leading economies remain stable at very low levels.

Looking at the interbank markets in the euro area and in the United States, interest rates continued their downward trend started towards the end of last year. This trend is continuing largely because of the current lax scenario for official interest rates and the aggressive quantitative measures carried out by central banks. In the case of the Euribor interest rate, the progress made in the euro area in containing the risks of the credit crisis has helped to moderate one-year interest rates. However, dysfunctions in Europe's interbank market are still relatively high, as reflected in the high levels of overnight deposits made by banks with the ECB.

The drop in risk premia provides a breather for public debt

As has been happening since the last quarter of 2011, in February yields on

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
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	1.83	3.15	5.09	7.11	1.88	0.99	1.98	0.66
2012								
January	1.79	3.05	4.97	5.95	1.80	0.97	1.97	0.72
February (*)	1.93	2.99	5.11	5.52	2.03	0.98	2.15	0.79

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

public debt of the United States and Germany moved within a record low range. However, in spite of remaining within this low yield range, the factors determining trends in bond prices are slowly changing. At first, the uncertainty regarding the European crisis caused investors to flee to bonds from the United States and Germany as a safe haven, making them more expensive (decreasing their yields). Now that these risks appear to be more contained, the factor affecting these markets is investor certainty that official interest rates will continue to be very low for a long time, as well as high surplus liquidity. The consequence is a swamped market. In the case of the United States, the debt market's tone has been relatively stable during the month of February. Based on the figures announced for the trends in the economy and the Fed's strategy, over the coming months, this market is bound to perform well for some time yet. Nonetheless, in the medium-term we should not ignore the possible risks resulting from a rise in inflationary expectations or the loss of international investor confidence should the nation's fiscal imbalance deteriorate.

The Fed's interest rate strategy sustains bond prices.

In the euro area, the performance of German debt has also been dominated by equilibrium. Certainly, the progress made by the euro area in fiscal terms has reduced tensions in the European sovereign debt market. But the effects of this circumstance have hardly been reflected in German yields, which have remained at very low levels (below 2% over ten years). This, together with the aforementioned surplus liquidity, can also partly be attributed to the burden of the delicate situation of Europe's real economy. However, easing credit tensions has made it possible for the risk premia to fall for the sovereign debt of countries in difficulties. In this scenario, and except for Greece and Portugal, the investors' perception of solvency for the euro area's peripheral economies has increased since January. This aspect can be seen in each auction carried out by the governments of Italy and Spain. In the case of Spain, since January the Treasury has managed to place a third of the total issuances of public debt forecast for 2012, at a lower price than in previous auctions and attracting a large number of investors.

Over the last few weeks of February, some of the doubts were resolved regarding Greece being awarded its second bail-out and the restructuring terms for its sovereign debt. However, some important questions have yet to be cleared up. Over the next month, the conditions agreed between the troika and the Greek government will have to be approved by the parliaments of some countries, while private bond holders must state their position regarding the proposed write-down.

The easing of tensions in the euro area helps risk premia to fall.

The euro fluctuates to the sounds of the sovereign debt crisis

At the dawn of a reawakened appetite for risk on the part of investors, and given the favourable resolution of the controversial negotiations to award Greece its second bail-out package, the euro's exchange rate has been under pressure in both directions. Finally, on balance the month has been favourable for the euro, which appreciated by close to 1.5% against the dollar. This monthly change has occurred within a prolonged period of relatively high volatility but a flat trend for the euro-dollar exchange rate. February's level of 1.34 dollars per euro was also observed at the beginning of 2011 and 2010. Based on an analysis of the economic and financial projections

The euro's exchange rate reflects the progress made in resolving the region's crisis.

EXCHANGE RATES OF MAIN CURRENCIES

February 22, 2012

	Exchange rate	% change (*)		
		Monthly	Over December 2011	Annual
Against US dollar				
Japanese yen	80.3	4.0	4.2	–3.1
Pound sterling	0.638	0.7	0.8	–3.0
Swiss franc	0.912	–1.7	–2.8	–2.9
Canadian dollar	1.001	–0.8	–2.0	1.0
Mexican peso	12.838	–2.6	–8.6	5.5
Against euro				
US dollar	1.323	–1.7	–2.1	3.1
Japanese yen	106.2	5.6	6.2	–6.4
Swiss franc	1.207	0.0	–0.8	–6.2
Pound sterling	0.844	1.0	1.3	–0.2
Swedish krona	8.825	0.5	–1.1	0.3
Danish krone	7.437	0.0	0.1	–0.3
Polish zloty	4.189	–2.1	–6.6	5.1
Czech crown	25.19	–0.6	–1.6	2.6
Hungarian forint	288.8	–3.9	–9.1	5.5

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

Improved credit conditions stimulate activity in this market.

for both regions, this dynamic of more or less marked fluctuations around a flat trend is likely to continue for the rest of the year. On the other hand, the currencies of the emerging countries have started to appreciate again against both the dollar and the euro, boosted by the falling aversion to risk overall and the prospect of the emerging economies achieving a soft landing.

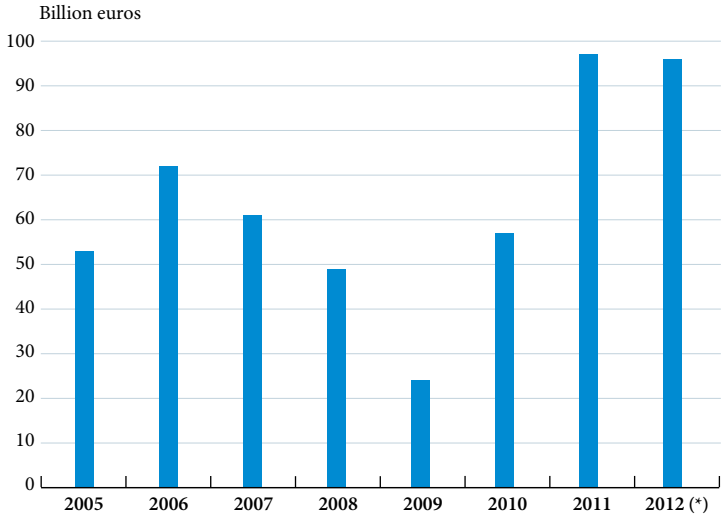
Corporate bond markets warm up

Credit market activity continued to increase in February. Factors such as the forceful action taken by central banks and the decrease in sovereign and financial risks at a global level have been strong enough to spark a new expansionary phase in corporate bond markets. It's therefore not surprising that this impetus is particularly being felt in the euro area. In line with the improvement in the area's sovereign spreads, corporate spreads have moved even closer this being particularly noticeable in the peripheral countries. Such a circumstance has been reinforced by the rise in investment grade bond issuances in various currencies, as well as the market gradually opening up for some issuers of proven solvency in Spain and Italy. Also of note is the success being enjoyed by European bank issuance, especially that carried out by institutions in stricken peripheral countries. Most banks have opted to secure funding by issuing the so-called covered bonds, which are often then used to obtain ECB loans. However, rating agencies have warned of the risk of depending too much on this kind of issuances for the holders of ordinary (senior) bonds, since their debt is subordinated.

Italian and Spanish companies are starting to issue bonds again.

THE YEAR HAS STARTED WITH A LARGE NUMBER OF BENCHMARK DEBT ISSUANCES

Corporate bond issuances Euro area covered bonds



NOTE: (*) Issuances 1 January - 23 February.
SOURCE: Bloomberg.

The situation is one of consolidated boom in the United States. The environment of economic recovery, abundant liquidity and very low interest rates is making private credit markets more stable and efficient. One remarkable fact has been observed in the high risk and high yield bond segment, where there has been a significant rise in capital flows towards these assets. In the scenario described, investors are encouraged to accept a higher risk to achieve their target returns. From the point of view of issuances, of note is the continued increase in (investment grade and high yield) debt being issued by non-financial companies compared with the lower rate observed among financial corporations. On the whole, US companies look financially solid, with long-lasting debt structures and high liquidity positions.

But where credit markets are seeing the highest rises is in the emerging countries. The favourable revision of the sovereign ratings for most of these economies over the last few months (principally in Latin America), together with the sustainability of their economic prospects thanks to the actions being taken by the monetary authorities, have boosted investor confidence and attracted a larger volume of international capital towards these markets.

The more stable economic and financial prospects in the United States benefit its credit market.

Investors return to the stock markets

In February, international stock markets continued to perform well, as they did in January. In fact, since the start of the year, the main indices have risen by around two digits on average, equity's best start to a year for the last two decades. Unfortunately, Spain's stock market is one of the few that has lagged behind. At a global level, several aspects are encouraging this performance.

Emerging corporate bond funds are attracting more foreign capital.

Stock markets continue their rise since the start of the year, while Spain lags behind.

In addition to the already mentioned improvement in the economic and financial scenario at an international level (and Europe in particular), of note is the improved investor sentiment towards risk assets, the gradual return of capital flows towards share funds and the increase in corporate profits distributed to shareholders via dividends or share buybacks. This practice, which is usually related to securities with a significant return by dividend, is being rewarded in stock markets with rising share prices.

The outlook for US companies is favourable.

In the United States, the quarterly earnings season for S&P 500 firms has been successful. Its effect on investor mood has been multiplied thanks to the Fed's own projection of 0% interest rates over the long term, as well as Congress approving the extension of fiscal aid for the unemployed. In short, these factors, and the improved economic and corporate prospects, are helping to push up US indices, already at their highest level for the last four years.

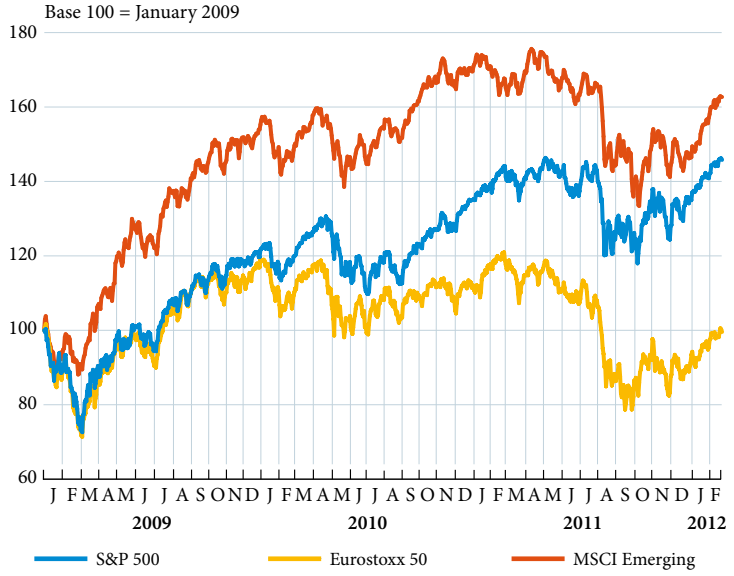
European stock market indices react positively to the progress made in resolving the crisis.

In the case of the euro area, it cannot be denied that the progress made in the region's peripheral sovereign debt crisis, and specifically with Greece, is significantly affecting the performance of its stock market indices. The relatively favourable outcomes of recent events and falling sovereign risk premia are being reflected in the region's main stock markets, of note being the German Dax. Easing tensions in European markets has also helped to lift the ban on short-selling shares of financial institutions in several European countries. Although initially there were fears of an avalanche of sales of bank stock, finally the fact that banks' balance sheets are getting back on track, added to the support by the ECB, have provided sufficient arguments to counteract this threat.

As in corporate bonds, the equity markets of the emerging countries are experiencing a boom. The ordered and controlled slowdown in their growth rates and the expectations of further cuts in

STOCK MARKETS ACCUMULATE SHARP RISES IN 2012

Stock market indices



SOURCE: Bloomberg.

INDICES OF MAIN WORLD STOCK EXCHANGES

February 22, 2012

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,948.4*	*1.8*	*6.0*	*6.0*
Standard & Poor's	*1,359.6*	*3.4*	*8.1*	*3.4*
Nasdaq	*2,940.5*	*5.5*	*12.9*	*6.7*
Tokyo	9,554.0	9.0	13.0	–10.4
London	5,918.7	3.3	6.2	–1.3
Euro area	2,522.7	3.9	8.9	–15.4
Frankfurt	*6,851.2*	*7.0*	*16.2*	*–6.4*
Paris	*3,450.9*	*3.9*	*9.2*	*–14.8*
Amsterdam	*327.1*	*2.1*	*4.7*	*–11.3*
Milan	*16,589.6*	*6.1*	*9.9*	*–24.6*
Madrid	*8,677.1*	*1.3*	*1.3*	*–18.9*
Zurich	6,182.2	1.0	4.1	–6.6
Hong Kong	21,549.3	7.2	16.9	–6.3
Buenos Aires	2,832.2	–1.2	15.0	–19.9
São Paulo	66,199.7	6.2	16.6	–2.7

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.

official interest rates promise foreign investors an attractive potential rise. Companies in these countries are also taking advantage of this circumstance to issue more shares to secure additional financing in order to undertake new investment projects.

Emerging stock markets rise, supported by expectations of interest rate cuts.

SPAIN: OVERALL ANALYSIS

Economic activity

A recession with important distinctions

In the fourth quarter, GDP falls by 0.3% quarter-on-quarter.

The recessionary scenario is gradually being confirmed but with important distinctions to be taken into consideration. In February, the Spanish statistics institute (INE) confirmed a 0.3% decline quarter-on-quarter in gross domestic product (GDP) for the fourth quarter of 2011. It's not easy to appraise this figure. This might seem like a relatively moderate decline, especially when compared with the 0.7% of Italy and the Netherlands or the 1.3% of Portugal. Moreover, preliminary activity indicators for January seem to have altered the recessionary tone of the last few months. However, we must be very cautious in our interpretation of these figures as a breakdown by GDP component reveals that the contraction in activity is being boosted by a larger drop in domestic demand than expected. We shall now weigh up these finer points.

With regard to the trend in GDP components, household consumption was already expected to be down on its third quarter figure. The rise in unemployment during the second half of last year and the increased uncertainty generated by higher tension in the euro area suggested this. But the extent of the adjustment, –1.0% quarter-on-quarter, has been a surprise. The trend in imports has also been very negative, down 6.5% compared with the previous quarter. A decrease that is reminiscent of the one suffered during the worst quarters of the last recession, between the last quarter of 2008 and the first of 2009, when imports fell by around 20%.

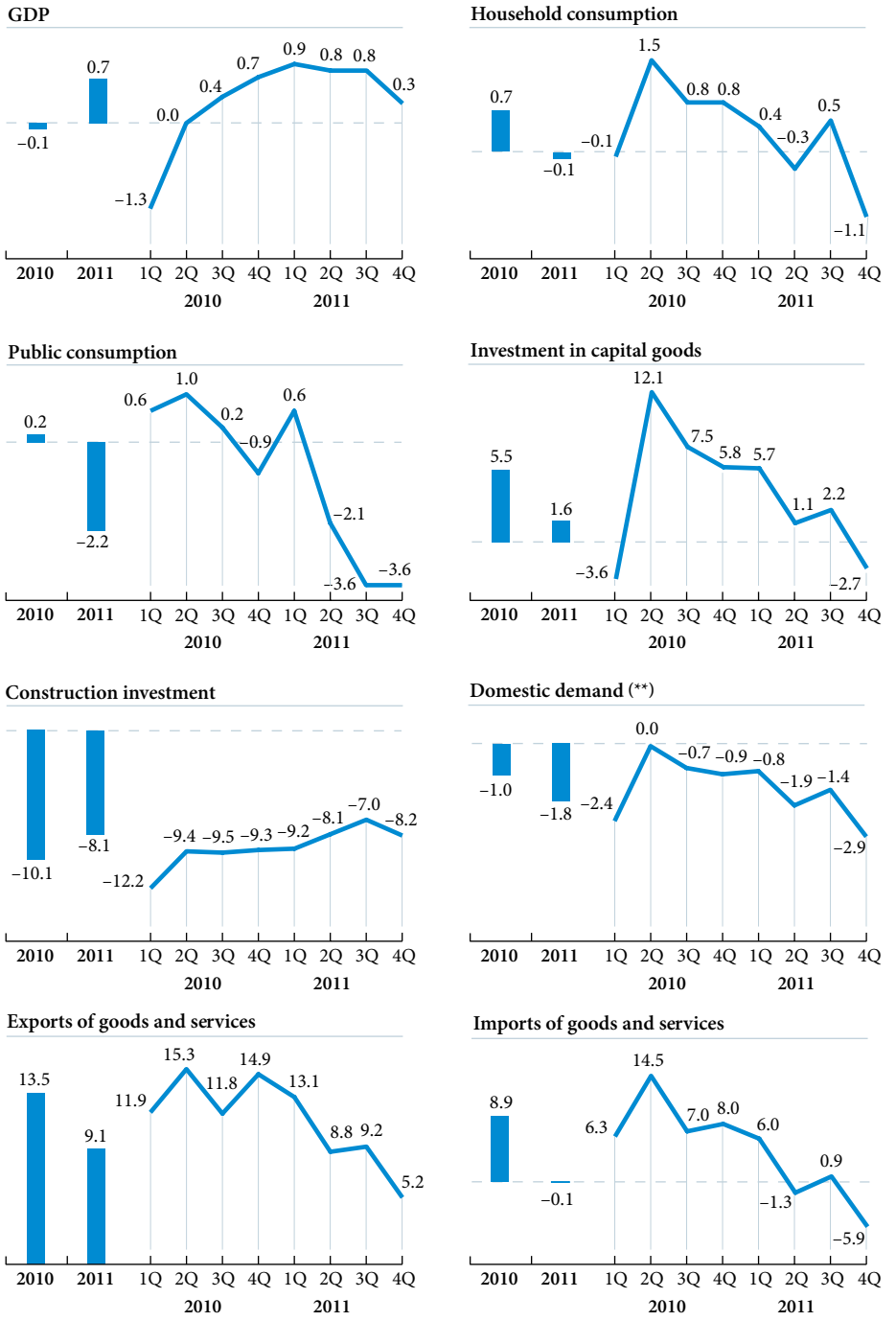
The reasons for the drop in consumption will shed light on the speed of its recovery.

It therefore seems that households are reacting to the change in economic outlook with extreme caution. It will be very interesting to analyze the trend in the savings rate for the fourth quarter, which has yet to be published. This will provide us with information regarding which part of the fall in consumption is due to less income, as a result of the deterioration in the labour market, and which part is due to higher savings as a precaution. The relative importance of each of these factors will determine the speed of recovery. If the main factor is precautionary savings, consumption might pick up relatively quickly as tensions in Europe's sovereign debt markets dissipate and the expectations of a recovery gain ground. If, on the other hand, the role played by the deterioration in the labour market has been significant, this might result in a slower recovery in consumption.

Historically, the labour market recovers quite a long time after activity and more gradually. In this respect, the greater flexibility in the market introduced by the labour reform might speed up this process (for an evaluation of this, see the section on the labour market). For the moment, the quarterly national accounts suggest that this factor has probably played a significant part. In the last quarter, the remuneration of salaried workers, which had fallen by 0.6% on average during the year, decreased by 2.1% in year-on-year terms.

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



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

Public consumption and investment also fall considerably.

On the other hand, the fall in public consumption has also been significant, namely 1.1% quarter-on-quarter, but in this case the large adjustment being carried out on public accounts was expected to result in a significant drop. The case of the investment is also notable. Both investment in capital goods and in construction recorded falls of close to 4% quarter-on-quarter. These figures are lower than those posted in 2009, when capital goods investment fell by more than 10% for two consecutive quarters, but they are nevertheless appreciable.

The only good news was provided by service exports, which grew by 2.4%. Nevertheless, the 3.4% decrease in the exports of goods pushed exports as a whole into negative terrain.

The information provided by the breakdown of the fourth quarter is therefore not very encouraging. The positive tone is provided by the leading indicators of January, particularly on the supply side. Electricity consumption, for example, fell by 2.6% in year-on-year terms, 2.3 percentage points less than

SUPPLY INDICATORS

Percentage change over same period year before

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
Industry							
Electricity consumption (1)	2.9	–1.1	0.5	0.5	–1.2	–4.3	–2.6
Industrial production index (2)	0.8	–1.4	1.8	–1.1	–1.4	–5.0	...
Confidence indicator for industry (3)	–13.8	–12.5	–8.6	–10.7	–14.4	–16.5	–14.8
Utilization of production capacity (4)	72.0	73.3	72.6	74.7	73.3	72.7	72.5
Imports of non-energy intermediate goods (5)	24.6	3.1	12.2	3.8	0.9	–4.0	...
Construction							
Cement consumption	–15.4	–17.0	–2.1	–16.6	–21.0	–26.8	–23.3
Confidence indicator for construction (3)	–29.7	–55.4	–54.1	–55.4	–58.6	–53.6	–58.4
Housing (new construction approvals)	–17.3	–12.9	–6.8	–19.5	–5.3	–22.5	...
Government tendering	–37.9	–43.8	–45.6	–34.7	–45.4	–53.7	...
Services							
Retail sales (6)	–1.0	–5.4	–5.9	–5.1	–4.2	–6.4	...
Foreign tourists	1.0	7.6	2.8	10.4	8.5	6.1	4.6
Tourist revenue inflows	3.9	8.8	6.7	12.2	8.8	6.1	...
Goods carried by rail (ton-km)	6.4	2.0	8.2	1.8	7.7	–9.8	...
Air passenger traffic	2.9	6.0	5.0	10.6	6.2	1.5	–3.0
Motor vehicle diesel fuel consumption	–1.2	–3.6	–1.6	–4.5	–2.8	–6.1	...

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.

in the month of December. The industrial confidence indicator improved slightly, reaching the levels of October last year and thereby correcting the big drop at the end of last year. Confidence in construction also improved slightly, although to a lesser extent. After the last few months, these data might suggest a turning point, although it is undoubtedly too soon to confirm anything. What is interesting is that the vast majority of supply indicators are pointing in this direction.

Regarding demand, we have fewer indicators from the month of January so our view is not so complete. In fact, one of the few indicators available, namely consumer confidence, in no way improved and actually dropped sharply, reaching levels it had not seen since April last year. The good news came from vehicle registrations, back to positive figures after four months of extensive falls.

This scenario therefore points to the squeeze in activity continuing at least for the first half of the year, although at present the rate of contraction does not look like reaching the levels recorded two years ago. According to our forecast scenario, GDP will fall by 1.0% for the year as a whole, the same forecast as the one published by the European Commission (EC). Its forecast, however, is somewhat more pessimistic, as this is the rate of contraction that would be reached without hardly adjusting the public deficit. If the target deficit is finally kept at 4.4% of GDP, the adjustment that will have to be made by the government will be so great that the contraction will be much bigger.

Most supply leading indicators are encouraging.

DEMAND INDICATORS

Percentage change over same period year before

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	January
Consumption							
Production of consumer goods (*)	0.8	–1.0	–1.5	–0.8	0.7	–2.2	...
Imports of consumer goods (**)	–9.5	–2.2	–1.1	–8.7	1.2	0.4	...
Car registrations	3.1	–17.7	–27.3	–26.4	–0.7	–5.5	2.5
Credit for consumer durables	–12.3	–9.7	–13.9	–10.1	–4.4	...	–
Consumer confidence index (***)	–20.9	–17.1	–19.6	–16.1	–15.8	–16.8	–20.2
Investment							
Capital goods production (*)	–3.3	0.7	3.0	2.5	2.6	–5.3	...
Imports of capital goods (**)	6.5	–3.1	2.3	–4.9	–1.5	–7.2	...
Commercial vehicle registrations	7.0	–6.6	–2.2	–11.2	5.8	–15.1	–17.4
Foreign trade (**)							
Non-energy imports	10.3	1.0	7.4	–0.7	0.8	–3.1	...
Exports	15.6	10.1	16.0	9.0	10.9	5.4	...

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.

The imbalances noted by the EC could lead to further adjustment.

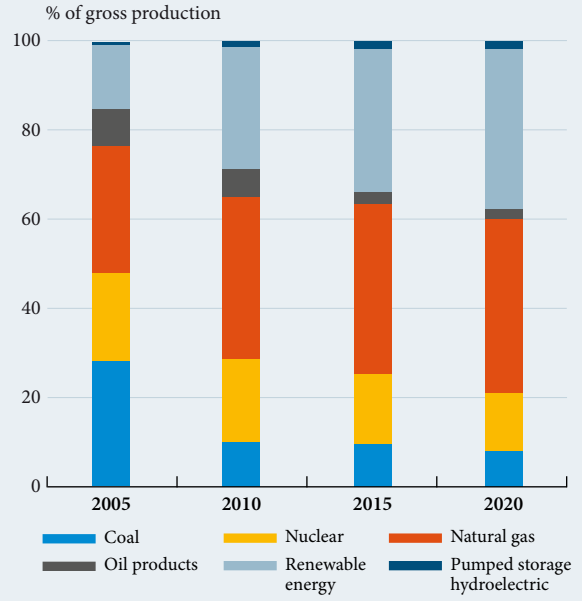
The EC also published its first alert mechanism report for macroeconomic imbalances. This consists of ten indicators that reflect potential internal and external macroeconomic imbalances in the different countries. Spain fails 6 of the 10. This has led to a more detailed study being carried out on the Spanish economy, together with a further 11 countries, of note being France, Italy and the United Kingdom. This analysis will form the basis of reforms recommended by the EC for each country. Consequently, in spite of the new government's tight reform schedule, Brussels might give it even more homework to do.

Renewables target for 2020: a complicated mix to regulate

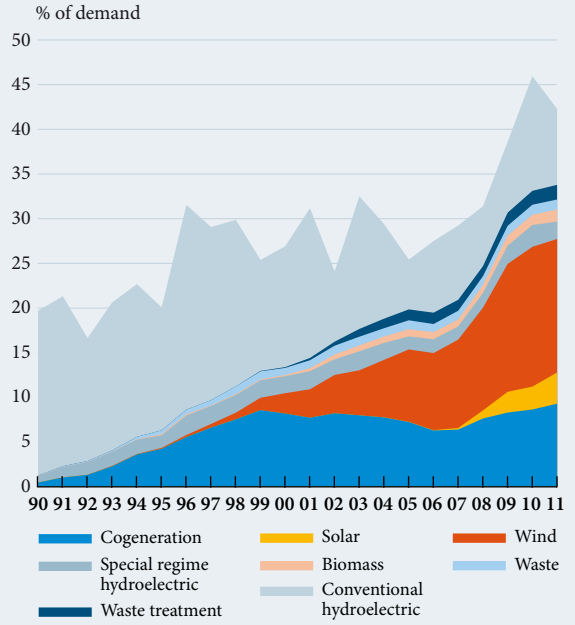
The regulation of Spain's electricity sector has been the focus of discussion for several years, mainly regarding how the transition has been carried out from a vertically integrated monopoly to another model in which regulated segments (transmission and distribution) exist side by side with more competitive segments (generation and sale). In addition to the problem of guaranteeing the supply of electricity to consumers and firms at a reasonable price, the need to minimise the negative environmental impact of energy production has also arisen over the last few years. Following the strategy agreed with the rest of Europe, Spain has decided to reduce its energy dependence

TRENDS IN SPAIN'S ELECTRICITY GENERATION MIX

PANER 2011-2020 targets



Production by renewable energy sources 1990-2011



SOURCES: PANER 2011-2020 and CNE (Monthly report on special regime energy sales).

and emissions of pollutants by increasing the share of renewable energy sources in producing electricity, setting a target of 38.2% by 2020.[1] This target takes into account not only Spain's great potential in terms of renewable resources but also industrial policy considerations, such as the benefits that can be derived from leading research into such vital sectors for the future. However, achieving this target involves a significant change in the generation mix of the Spanish market, something that, far from easing controversy, presents even greater challenges for the sector's regulatory policy over the coming years.

The first of these challenges is due to the method chosen to encourage investment in these technologies. As in most European Union countries, Spain has chosen to ensure an appropriate return for this investment by setting the wholesale price for the energy produced. More specifically, generators can choose between selling at a regulated tariff that is different for each technology or selling at a free price on the wholesale market plus a premium, which varies according to the technology and the market's hourly prices. Taking into account the fact that 7 renewable technologies are currently being employed, it is quite complicated to set rates in such a way as to ensure the desired generation targets are achieved at a minimal cost.

On the one hand, this should take into account the fact that the currently high costs of renewables will fall every year as the experience acquired through producing electricity leads to technological improvements. Consequently, in order to ensure these are encouraged at the minimum possible cost, the regulator must determine the optimal annual production path and therefore the volume of premiums required to achieve it, given its expectations regarding this learning curve and the trend in input prices for the rest of the non-renewable generators (oil, gas and CO_2 emission rights). On the other hand, setting tariffs and premiums for each renewable technology requires an implicit decision regarding the best combination of these technologies. Any error in the predictions of the relevant variables might not only result in an excessive cost for encouraging renewable energies but might also lead to overinvestment in some, making the mix of renewables less efficient than it could be.

A recent study by IESE[2] suggests that such errors might have been made in the Spanish case in the system applied up to 2009, worsened by the fact that no limit was established to the renewable production that could come under the tariff and premium system each year. As can be seen in the graph below, the equivalent premium (the sum of the compensation received via tariffs and via premiums) grew exponentially between 2008 and 2010. This is mainly due to the high remuneration established in 2007 for photovoltaic solar technology and the unexpected fall in wholesale prices, resulting from the low demand for electricity since the crisis. The study estimates that these premiums value the CO_2 emissions avoided in 2009 thanks to renewable energy at around 250 euros/tonne, when emission allowances are currently worth 15 euros/tonne and are expected to remain between 30 and 50 euros/tonne in 2020. It's true that the price of CO_2 is too low, due to problems with how emissions trading works, and that it probably does not measure environmental costs accurately. However, the large number of photovoltaic firms that have emerged over the last few years, much more than the targets set, does indicate that these targets could have still been achieved at lower premiums.

Although various royal decrees passed since 2009 have attempted to correct the design of the renewable scheme, the problem of the probable excess cost incurred is difficult to resolve without creating some legal uncertainty due to the long duration of the premiums promised (between 20 and 25 years). To this we must add the fact that, a

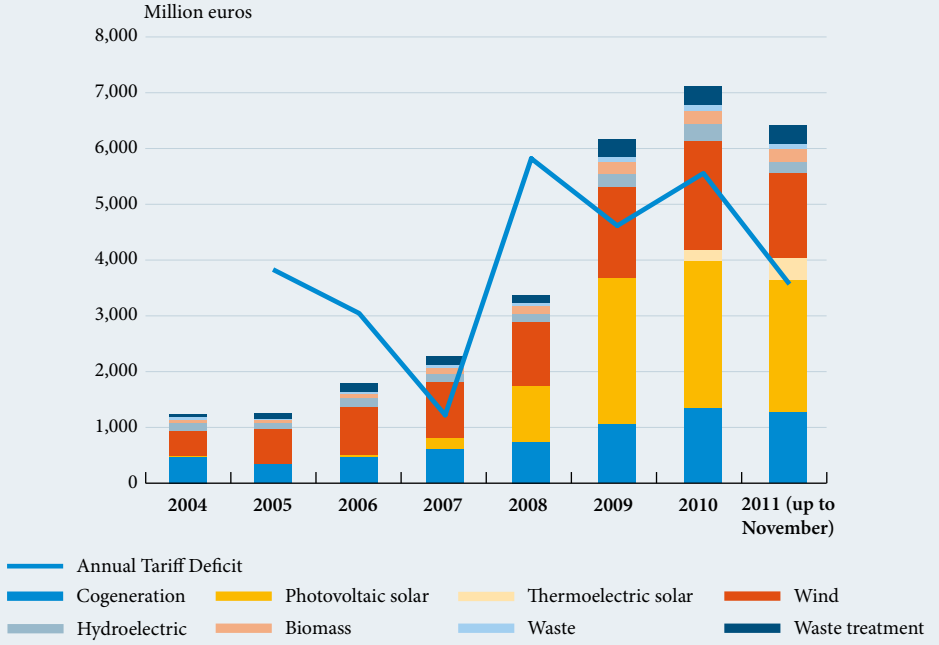
(1) The target is 38% of gross electricity production according to the Renewable Energy Plan (PER 2011-2020) and 36% according to the National Action Plan for Renewable Energy (PANER 2011-2020).
(2) Federico, G. (2010), The Spanish Gas and Electricity Sector: Regulation, Markets and Environmental Policies, Reports of the Public-Private Sector Research Center, IESE Business School.

priori, the cost of promoting renewables should be passed on to the end consumer via the regulated access and last resort tariffs. However, these are not enough to cover the system's transmission and distribution costs once this volume of premiums has been met. The consequence is a rise in the tariff deficit, which is borne by electricity distributors and swells the state debt burden through the FADE Fund.

Another of the challenges faced is the interaction of renewables support policies with policies to aid domestic coal. A low demand since the crisis and the growing contribution of renewables to the wholesale market are pushing coal-fired power plants, normally the least competitive, out of the market. This fact, although coherent with the regulator's environmental aims, is contrary to the aim of helping disadvantaged regions or sectors undergoing reconversion. The latter, curiously, are being accomplished through intervention in the electricity market. Royal Decree 134/2010 has modified the order of economic merit used to establish electricity prices in the wholesale market, replacing the production of other, more efficient fossil fuel power plants with production by domestic coal-fired power plants. Moreover, minimum amounts of coal have been set that must be acquired by the plants, also at a regulated price. The result is that correct price formation in the wholesale market has been distorted, producing erroneous signals for investment in sufficiently flexible generation technologies (such as combined cycle) which will be required with the growth in renewables.

This last point is precisely another of the challenges facing the regulator. The relatively low variable cost of many renewable energy sources make them ideal to provide the system with basic capacity. However, the intermittent nature of their production, subject to weather conditions, prevents them from being able to meet inopportune peaks in demand. These will have to be met by plants with flexible technologies, whose variable cost is higher and

TREND IN SPECIAL REGIME PREMIUMS BY TECHNOLOGY



SOURCES: CNE and own calculations.

with little possibility of taking part in the market during normal periods. Given that these plants must also cover their fixed costs and achieve a reasonable return, the regulator will have to adjust capacity payments in order to preserve these firms' investment incentives. If not, it will run the risk of high end prices during peaks or abusive conduct on the part of these flexible power plants. To minimize this, and as a complementary measure, it is vital to ensure there are alternative mechanisms to cover these peaks in demand. Among these are energy storage technologies and improvements in management and prediction systems for renewables in order to improve their combined performance.

In summary, there are many variables that must be taken into account by the regulator to find the right policy for the electricity market. It would therefore be reasonable to wonder whether another mechanism could have been adopted in order to boost renewables that is less information intensive. Whatever the case, we need to eliminate the distortions and complications added by targets that do not follow purely environmental, efficiency or energy security criteria. Regulating the industry will not be such a challenge if alternative mechanisms are found to meet these criteria.

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Labour market

Job losses, labour reform and future prospects

The number of unemployed reaches 5.2 million, and the unemployment rate 22.8%.

It's now official. The National Accounts system for the last quarter of 2011 revealed that the economy shrank by 0.3% in the fourth quarter compared with the third. This drop in activity resulted in a 3.3% year-on-year fall in employment; in other words, almost half the 570,000 full-time equivalent jobs that disappeared in 2011 were lost in the last three months.

The deterioration of the job market was also reflected in the labour force survey (LFS) for the fourth quarter. Over the last three months of the year, the number of unemployed rose by 295,300 people, 12.3% more than in the fourth quarter of 2010. Throughout 2011, 577,000 people joined the long list of the unemployed, which now totals 5,273,600. This figure, together with the slight fall in the labour force, has led the unemployment rate to reach 22.85%, a figure not seen since 1994. And if we take into account the methodological changes introduced in how the LFS is produced, the unemployment rate is probably the highest it has ever been since records began.

The start of 2012 hasn't brought any good news either. In January the State Employment Service posted a 4.0% monthly increase in the number of unemployed, which means that 177,470 more people were without a job than in December. Although this figure falls to 42,126 once seasonally adjusted, the year-on-year rate of change now stands at 8.7%, a figure only behind the one recorded in 2009 and 2010.

ESTIMATED UNEMPLOYMENT

Fourth quarter 2011

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	2,840.1	166.1	6.2	294.9	11.6	53.9	22.5
Females	2,433.6	129.2	5.6	282.2	13.1	46.1	23.3
By age							
Under 25 years	884.2	–33.7	–3.7	43.6	5.2	16.8	48.6
Other	4,389.4	329.0	8.1	533.4	13.8	83.2	20.6
By personal situation							
Long-term unemployment	2,638.0	239.5	10.0	483.3	22.4	50.0	–
Seeking first job	443.2	–15.0	–3.3	86.4	24.2	8.4	–
Other	2,192.4	70.8	3.3	7.3	0.3	41.6	–
TOTAL	**5,273.6**	**295.3**	**5.9**	**577.0**	**12.3**	**100.0**	**22.8**

SOURCES: National Institute of Statistics and own calculations.

Other indicators of how the job market is faring show the fragile state of employment. The number of people registered as employed with Social Security fell by 283,684 in the first month of the year, a drop only exceeded in 2009. On the other hand, the number of contracts recorded in January was down 6.9% in annual terms. Throughout 2011 the number of employees with permanent contracts decreased 4 times more than that of temporary contracts; i.e. 80% of the 485,000 salaried employees lost corresponded to people with a permanent contract.

Given this situation, the government decided to pass a decree law to implement the expected labour reform. The aim of this legislative change is to eliminate rigidity and the dual nature of the labour market. To this end, the government is creating a new training contract, is providing mechanisms to improve the internal flexibility of firms and is modifying the collective bargaining framework.

To boost employment, the reform provides a contract for training and apprenticeship, exclusively for people under 30. Moreover, via a permanent contract to support entrepreneurs, applicable only to the self-employed and SMEs with fewer than 50 workers, an allowance of up to 3,600 euros is paid for hiring unemployed people from this group. In the case of the long-term unemployed aged 45 or older, this allowance can reach 4,500 euros. This aspect of the reform aims to alleviate unemployment among the young and long-term unemployed, whose unemployment rates double that of the economy as a whole.

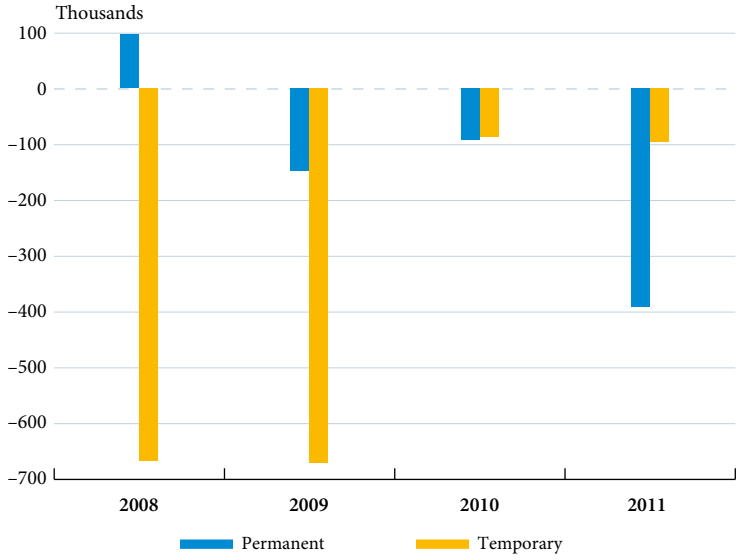
With the same idea of creating jobs, the reform also authorises temporary employment agencies to act as private recruitment agencies and limit successive fixed-term contracts to a maximum of 2 years. However, we're unlikely to see the slightest hint of jobs being created until the economy starts to grow again.

The number of salaried workers with permanent contracts falls 4 times more than that of temporary workers.

The reform makes the labour market more flexible and aims to boost employment.

THE NUMBER OF PERMANENT EMPLOYEES FELL SHARPLY IN 2011

Annual change



SOURCE: Ministry of Labour.

ESTIMATED EMPLOYMENT

Fourth quarter 2011

	No. of employees (thousands)	Quarterly change		Accumulated change		Annual change		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	808.5	100.8	14.2	4.0	0.5	4.0	0.5	4.5
Non-farm	16,999.1	–449.4	–2.6	–604.5	–3.4	–604.5	–3.4	95.5
Industry	*2,526.3*	*–50.0*	*–1.9*	*–96.5*	*–3.7*	*–96.5*	*–3.7*	*14.2*
Construction	*1,276.9*	*–93.8*	*–6.8*	*–295.6*	*–18.8*	*–295.6*	*–18.8*	*7.2*
Services	*13,195.9*	*–305.6*	*–2.3*	*–212.4*	*–1.6*	*–212.4*	*–1.6*	*74.1*
By type of employer								
Private sector	14,671.4	–264.3	–1.8	–568.3	–3.7	–568.3	–3.7	82.4
Public sector	3,136.1	–84.5	–2.6	–32.4	–1.0	–32.4	–1.0	17.6
By work situation								
Wage-earners	14,829.2	–350.2	–2.3	–485.0	–3.2	–485.0	–3.2	83.3
Permanent contract	*11,124.7*	*–104.2*	*–0.9*	*–389.2*	*–3.4*	*–389.2*	*–3.4*	*62.5*
Temporary contract	*3,704.4*	*–246.0*	*–6.2*	*–95.9*	*–2.5*	*–95.9*	*–2.5*	*20.8*
Non-wage-earners	2,968.7	–0.2	0.0	–115.4	–3.7	–115.4	–3.7	16.7
Entrepreneurs with employees	*903.6*	*–31.9*	*–3.4*	*–109.6*	*–10.8*	*–109.6*	*–10.8*	*5.1*
Entrepreneurs without employees	*1,935.2*	*25.5*	*1.3*	*1.9*	*0.1*	*1.9*	*0.1*	*10.9*
Family help	*129.9*	*6.2*	*5.0*	*–7.7*	*–5.6*	*–7.7*	*–5.6*	*0.7*
Other	9.6	1.6	20.0	–0.3	–3.0	–0.3	–3.0	0.1
By time worked								
Full-time	15,349.0	–408.7	–2.6	–584.7	–3.7	–584.7	–3.7	86.2
Part-time	2,458.5	60.0	2.5	–16.0	–0.6	–16.0	–0.6	13.8
By sex								
Males	9,805.6	–228.4	–2.3	–404.1	–4.0	–404.1	–4.0	55.1
Females	8,001.9	–120.3	–1.5	–196.6	–2.4	–196.6	–2.4	44.9
TOTAL	**17,807.5**	**–348.8**	**–1.9**	**–600.7**	**–3.3**	**–600.7**	**–3.3**	**100.0**

SOURCES: National Institute of Statistics and own calculations.

With regard to the dual nature of the labour market, the government has chosen to reduce the cost of dismissal as a means of making permanent employment more attractive. To this end, it has withdrawn the fast-track dismissal procedure and has reduced compensation for wrongful dismissal from 45 days per year worked to 33, applicable to a maximum of 24 monthly payments instead of the previous 42. Moreover, back pay has been eliminated in the case that the court rules dismissal has been wrongful and the worker is not readmitted. To ensure the cost of dismissal is reduced, the economic grounds for redundancies have been clarified (current or predicted losses or a reduction in income or sales over three quarters), administrative authorisation has been removed prior to redundancy plans (ERE in Spanish) and dismissal on economic grounds has been introduced for public corporations. The aim of these measures is to facilitate the use of fair dismissal, whose compensation is 20 days per year worked with a maximum of 12 monthly payments.

Another objective of the reform is to provide mechanisms to make companies more flexible internally, allowing them to adjust their activity via prices rather than dismissals. Once the decree law has been enacted, the company's agreement is allowed to prevail when there are current or predicted losses or if the level of income or sales falls over two consecutive quarters; i.e. the situations are clarified in which companies can modify their employment conditions.

Ultra-activity is also limited (the automatic extension of company agreements when workers and owners cannot reach a decision), up to a maximum of two years. This new flexibility provided to companies should help them make adjustments via wages or other working conditions instead of job losses.

The labour reform therefore opens up a wide range of possibilities. But it is difficult to evaluate its effect. This will partly depend on the courts' interpretation of the new conditions established for breaking the collective agreement or for using dismissal on objective grounds. And it will also partly depend on the desire of workers and owners to come to an understanding in tough times.

The decree law makes it cheaper to dismiss employees.

Prices

January sees inflation cool off

Inflation falls by 4 tenths of a percentage point to 2.0%.

In the first month of the new year, the year-on-year rate of change in the consumer price index (CPI) fell by 4 tenths of a percentage point compared with December and stood at 2.0%. Inflation therefore recorded almost nine consecutive months of falls with the only exception being last September, when it rose slightly by one tenth of a percentage point. This reduction of 1.8 points in less than one year can be explained both by the series of tax and tariff decisions taken by the government and also the recessive tone of activity.

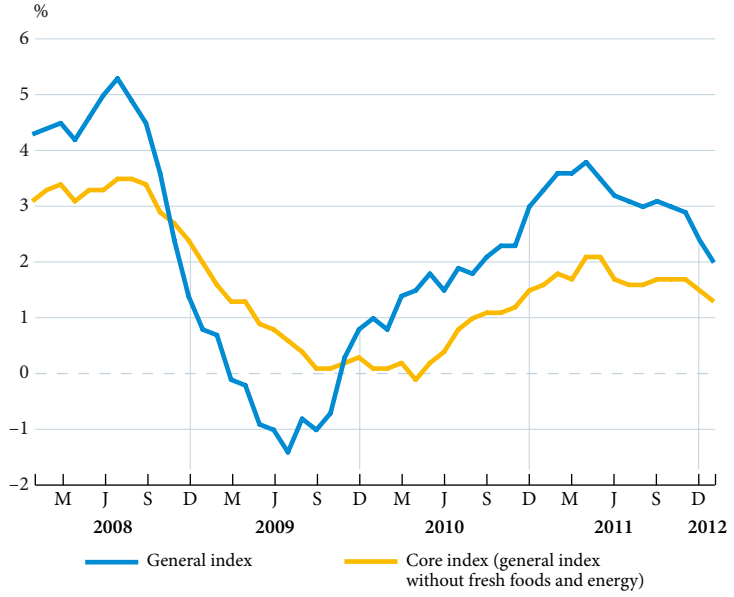
Stable electricity, tobacco and gas prices accentuate the disappearance of the base effect.

The freezing of the electricity tariff has been a major contributor to this fall in inflation. In stark contrast with January 2011, when electricity rose by 8.2% over the previous month, this year it has stayed the same, hence the base effect which has reduced its year-on-year rate of change from 9.6% in December to 1.3% in January.

Tobacco and gas prices haven't been raised either. The disappearance of the base effect caused by the tax hikes on tobacco in December 2010 has pushed its inflation rate down by 11.5 percentage points in the last two months. For their

INFLATION SEES ALMOST NINE CONSECUTIVE MONTHS OF FALLS

Year-on-year change in CPI



SOURCE: National Institute of Statistics (INE).

CONSUMER PRICE INDEX BY COMPONENT GROUP

January

	Indices (*)	% monthly change		% annual change	
		2011	2012	2011	2012
By type of spending					
Food and non-alcoholic beverages	101.4	0.1	0.3	0.9	2.3
Alcoholic beverages and tobacco	102.3	2.1	0.2	16.1	2.2
Clothing and footwear	93.2	–14.2	–14.4	0.4	0.1
Housing	101.7	2.8	0.5	7.8	3.4
Furnishings and household equipment	100.1	–0.9	–0.9	1.0	1.1
Health	97.6	0.0	–0.1	–1.4	–2.9
Transport	102.7	1.4	1.8	9.0	5.3
Communications	97.0	0.0	–2.1	–0.8	–3.6
Recreation and culture	98.9	–1.8	–2.4	–1.0	0.7
Education	102.1	0.1	0.1	2.3	2.8
Restaurants and hotels	99.9	0.1	–0.1	1.7	1.0
Other goods and services	101.2	0.6	0.5	2.8	2.6
By group					
Processed food, beverages and tobacco	101.7	0.6	0.3	3.1	2.8
Unprocessed food	101.0	0.0	0.2	2.3	1.0
Non-food products	100.0	–1.0	–1.5	3.4	1.9
Industrial goods	99.6	–2.1	–2.6	5.2	2.4
Energy products	*103.8*	*4.6*	*2.3*	*17.6*	*8.0*
Fuels and oils	*105.0*	*3.2*	*3.2*	*18.4*	*10.6*
Industrial goods excluding energy products	*97.9*	*–4.6*	*–4.7*	*0.7*	*0.2*
Services	100.3	0.0	–0.3	1.6	1.4
Underlying inflation (**)	99.7	–1.5	–1.7	1.6	1.3
GENERAL INDEX	**100.3**	**–0.7**	**–1.1**	**3.3**	**2.0**

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

part, stable prices have reduced gas's rate by 3.6 percentage points. However, although these three elements, electricity, tobacco and gas, have reported significant reductions individually, as a whole they scarcely add up to 6.6% of Spain's basket of consumer goods, so we must also credit some of the drop in inflation to the overall weakness in domestic demand.

The National Accounts system for the last quarter of 2011 revealed that the Spanish economy shrank by 0.3 percentage points compared with the previous quarter. In year-on-year terms, household consumption fell by 1.1% while general government reduced its consumption by 3.6%. The result of this lower demand can be seen in a widespread fall in prices in the market, visible in January's inflation figures.

The clearest case of price drops occurred in communications, down 3.6% in year-on-year terms, pushed by the prices of telephone services whose inflation fell by

Prices reflect the weak consumption.

Oil pushes up inflation.

the same amount over the same period. Another evident example of the weak demand is leisure and culture, whose prices fell by 2.4% overall just in the last month, their biggest monthly drop since the crisis began.

Weak domestic demand is precisely the reason for the year-on-year rate of change of core inflation, which excludes fresh foods and energy, falling by two tenths of a percentage point in January to 1.3%. Core inflation has followed a similar pattern to general inflation, accumulating a sharp drop of 4 tenths of a percentage point in the last two months. This decrease is quite significant as core inflation is less volatile than general inflation and such a sharp drop has not been seen since the start of the great recession (the similar decrease occurring last July was due to the disappearance of base effects because of the hike in value added tax).

On the other side of the spectrum, fuels and oils were the item that pushed inflation up the most in January, posting a year-on-year increase of 9.4%. As a result of updating the weightings of the different items in the consumer basket, energy products have increased their relative weight by 0.08 of a percentage point, now accounting for 11.4% of the shopping basket. This new weighting, together with the inflationary pressure of oil prices, might widen the gap between general and core inflation over the coming months.

In fact, the performance of oil prices affects the inflation forecast. Greater

INFLATION INDICATORS

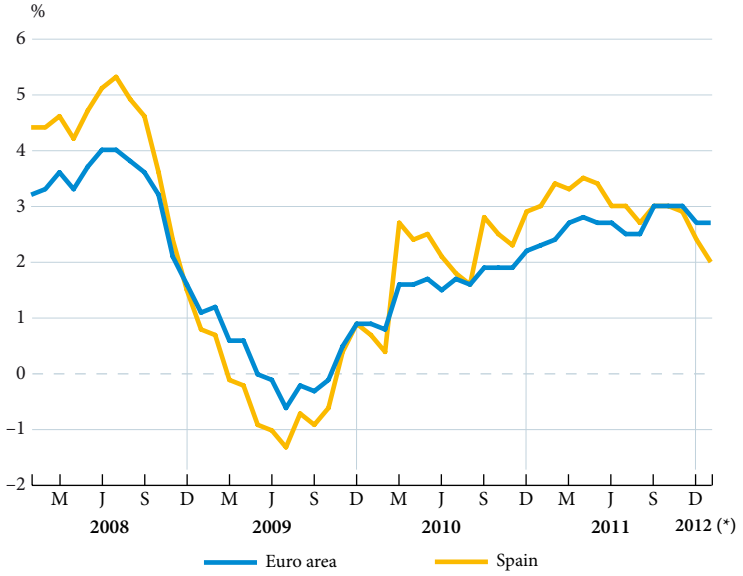
Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2010											
December	8.5	5.3	1.3	0.7	5.7	13.5	10.4	8.1	2.5	11.8	–
2011											
January	3.7	6.8	1.5	1.0	6.8	17.3	11.7	7.3	2.0	12.2	–
February	1.3	7.6	1.9	0.9	7.9	18.5	11.1	6.2	1.4	13.1	1.3
March	–5.2	7.8	2.1	1.2	8.0	18.6	10.8	5.4	1.5	11.6	–
April	–4.7	7.3	2.5	1.3	7.1	17.1	10.0	4.0	1.6	10.3	–
May	–8.1	6.7	2.6	1.3	6.6	15.4	8.7	2.9	0.8	8.2	1.6
June	6.7	6.7	2.6	1.3	6.5	15.4	7.7	2.5	0.6	6.9	–
July	5.1	7.5	2.8	1.4	6.8	17.9	9.1	3.3	1.0	8.0	–
August	4.2	7.1	2.7	1.3	6.2	17.2	8.9	2.4	1.0	7.2	1.4
September	5.2	7.1	2.5	1.2	5.5	18.8	9.6	3.2	1.3	6.6	–
October	2.6	6.5	2.4	1.3	5.0	17.0	9.7	3.8	1.4	5.8	–
November		6.3	2.6	1.2	4.1	17.0	8.7	2.6	1.2	4.8	1.2
December		5.2	2.3	1.2	3.0	14.1	6.8	2.4	1.0	3.4	–

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

THE DROP IN INFLATION HELPS TO RESTORE COMPETITIVENESS ABROAD

Year-on-year change in the HICP



NOTE: (*) January's figure corresponds to the Eurostat leading indicator in the case of the euro area. In the case of Spain, it corresponds to the definitive figure provided by INE.
SOURCES: National Institute of Statistics and Eurostat.

geopolitical uncertainty in the Persian Gulf has pushed up the price of Brent quality crude which, according to our forecasts, will be close to 119 euros per barrel on average until the end of the year. This new situation raises inflation slightly, which would be around 1.6% for 2012 as a whole.

Looking at Europe, although the quarter-on-quarter squeeze in activity in the euro area coincides with that of Spain, in year-on-year terms the euro area grew by 0.7% in the last quarter compared with Spain's 0.3%. This lower growth in gross domestic product (GDP) in Spain is reflected in January's harmonized index of consumer prices or HICP (the indicator that allows a comparison of the different European consumer baskets).

The figures provided by the Spanish Statistics Institute (INE) place the year-on-year rate of change in the HICP for Spain at 2.0% while Eurostat forecasts an HICP of 2.7% in January for euro area as a whole. A gap of this size (7 tenths of a percentage point) has not been seen since July 2009, suggesting that Spain is becoming more competitive abroad via prices.

The differential with the euro area returns to the levels of 2009.

Although the sharp drop in inflation seen over the last few months reflects weak domestic consumption, it is helping the economy to make progress in its process of internal devaluation. The culmination of this process will allow Spain to compete abroad via prices and to lay the foundations for future growth.

The drop in prices helps to restore competitiveness.

Foreign sector

The foreign sector cushions the drop in activity in the fourth quarter of 2011.

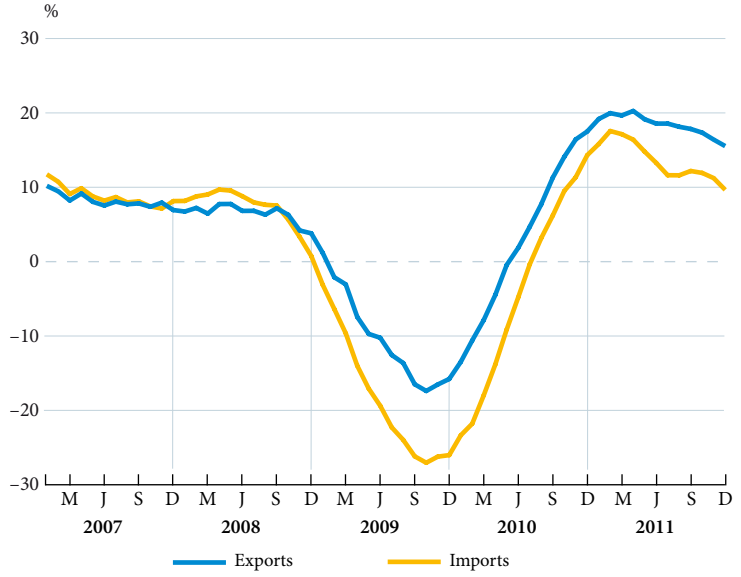
The trade deficit continues to fall, reaching the levels of 1998

Once again, in the fourth quarter of 2011 the foreign sector provided the only piece of good news for the Spanish economy. For the sixth quarter in a row, exports contributed positively to the quarter-on-quarter trend in Spain's gross domestic product (GDP). Their contribution of 1.4 percentage points to quarter-on-quarter growth was crucial to avoid a greater economic decline in this period. But, unlike what had happened in previous quarters, exports' good performance occurred within a context of a real reduction in trade flows. In 2012 we expect imports to fall again while exports stagnate. This will lead to further adjustment in Spain's trade deficit, which in 2011 represented 4.3% of GDP, 7 tenths of a percentage point below the previous year's figure. The trend in oil prices and the recovery of European economy, which in 2011 was the destination for 66.0% of Spanish exports, will determine the intensity of this adjustment.

In fact, both real exports and real imports were down in the last quarter last year, with quarter-on-quarter falls of 1.6% and 6.5% respectively. The greater weakness of Spain's domestic demand compared with the rest of the European Union is mostly to blame for this sharper fall in imports. This performance is also

TRADE FLOWS SLOW UP IN THE LAST FEW MONTHS OF 2011

Year-on-year change cumulative data twelve months



SOURCE: Ministry of Industry, Tourism and Trade.

reflected in the trend for the nominal series. As can be seen in the graph above, both trade flows slowed up their growth as from the second half of 2011.

Over the last few years, the trend in exports has always been more favourable than that of imports. This has helped to reduce the trade deficit to 46.3 billion euros, slightly above 4% of Spanish GDP, a level it has not reached since 1998. This gradual adjustment in the external imbalance is due to the good performance by the non-energy balance throughout last year. This can be put down to the acceleration in exports of capital goods in 2011, 15.2% year-on-year, and the fall in imports of consumer durables, namely 18.8% in the same period. For its part, the energy deficit rose by 4 tenths of a percentage point of GDP compared with December 2010, reaching 3.8% of GDP.

Looking to the future, our macroeconomic scenario foresees an adjustment in the trade deficit that is once again boosted by the good performance of the non-energy balance. It might even post a positive balance. This improvement will be partly offset by the price rise in Brent crude recorded in the first few months of the year, which we expect to remain high in the medium term. However, a greater rise in energy prices or a slower than expected recovery

The trade deficit falls to 46.3 billion euros in 2011.

All the evidence points to further corrections in the trade deficit in 2012.

FOREIGN TRADE

January-December 2011

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	56,258	26.7	22	15,098.9	68.1	7.0	–41,159	26.8
Consumer goods	61,247	3.3	23	68,572.8	8.8	32.0	7,326	112.0
Food	*16,417*	*5.0*	*6*	*25,741.9*	*8.0*	*12.0*	*9,325*	*156.8*
Non-foods	*44,829*	*2.7*	*17*	*42,830.9*	*9.4*	*20.0*	*–1,999*	*95.5*
Capital goods	17,587	–3.9	7	18,525.5	17.9	8.6	938	105.3
Non-energy intermediate goods	125,731	8.3	48	112,288.3	14.5	52.4	–13,443	89.3
By geographical area								
European Union	137,596	5.9	53	141,656.1	12.6	66.0	4,060	103.0
Euro area	*111,573*	*6.7*	*43*	*113,233.4*	*9.6*	*52.8*	*1,661*	*101.5*
Other countries	123,227	14.0	47	72,829.4	21.3	34.0	–50,398	59.1
Russia	*8,463*	*38.2*	*3*	*2,526.1*	*26.6*	*1.2*	*–5,937*	*29.8*
United States	*10,564*	*12.8*	*4*	*7,889.3*	*20.8*	*3.7*	*–2,675*	*74.7*
Japan	*3,199*	*–7.9*	*1*	*1,861.2*	*30.8*	*0.9*	*–1,338*	*58.2*
Latin America	*17,487*	*22.0*	*7*	*12,253.2*	*19.7*	*5.7*	*–5,234*	*70.1*
OPEC	*27,665*	*19.3*	*11*	*8,674.3*	*26.7*	*4.0*	*–18,991*	*31.4*
Rest	*55,850*	*8.1*	*21*	*39,625.3*	*20.1*	*18.5*	*–16,224*	*70.9*
TOTAL	**260,823**	**9.6**	**100**	**214,485.5**	**15.4**	**100.0**	**–46,338**	**82.2**

SOURCES: Ministry of the Economy and own calculations.

in the European economy could compromise the correction of the trade imbalance.

The current balance records its first surplus since 1998

The current deficit reaches 3.9% of Spanish GDP in 2011.

If we widen our analysis to the current balance as a whole, we can see that this had a deficit of 3.9% of GDP, according to National Accounts system figures. This means a reduction of 7 tenths of a percentage point compared with December 2010. Broken down by component, based on figures up to November, we can deduce that this smaller imbalance was the result of the improvement in all accounts except income. The latter declined due to the higher interest rates demanded for Spanish debt.

In addition to the smaller deficit in the balance of goods, the services balance also showed significant improvement last year. This was due to the good performance by tourism revenue, up by 8.4% year-on-year in November. For 2012 we expect tourist visits to slow up. Nevertheless, weak domestic demand will continue to improve the balances of goods and services. That's why we expect the current deficit to reach a level equivalent to 2.1% of GDP by the end of year.

BALANCE OF PAYMENTS

November 2011

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–36,060	–15.3	–40,646	5,809	–12.5
Services					
Tourism	*29,426*	*13.8*	*30,519*	*3,564*	*13.2*
Other services	*4,168*	*366.3*	*4,113*	*2,909*	*241.7*
Total	33,594	25.5	34,632	6,473	23.0
Income	–26,675	21.8	–26,708	–2,399	9.9
Transfers	–7,038	–13.4	–6,031	1,706	–22.0
Total	**–36,179**	**–21.1**	**–38,753**	**11,589**	**–23.0**
Capital account	**5,152**	**–4.9**	**6,027**	**–180**	**–2.9**
Financial balance					
Direct investment	–5,595	–	–4,020	–3,305	462.2
Portfolio investment	–909	–	–2,507	–33,978	–
Other investment	–28,086	–	–35,478	–32,813	–
Total	**–34,590**	**–**	**–42,004**	**–70,096**	**–**
Errors and omissions	–9,552	133.2	–7,909	–5,013	173.1
Change in assets of Bank of Spain	75,169	–	82,638	63,700	336.3

NOTE: The figure resulting from the sum of current account balance, capital account balance and financial balance is compensated by the change in assets of Bank of Spain plus errors and omissions.
SOURCES: Bank of Spain and own calculations.

With regard to the financial account, a significant modification can be observed in the pattern of financing for the external imbalance as from the second half of 2011. The main source of capital during the first eleven months of last year was the European Central Bank (ECB), up by 84.4 billion euros compared with the same period in 2010. This was because of the increased tensions in Europe's sovereign debt markets over this period, making financing conditions via other channels much tougher. Considering the large liquidity auctions held by the leading monetary authority in December 2011 and February 2012, we expect this trend to continue over the next few months.

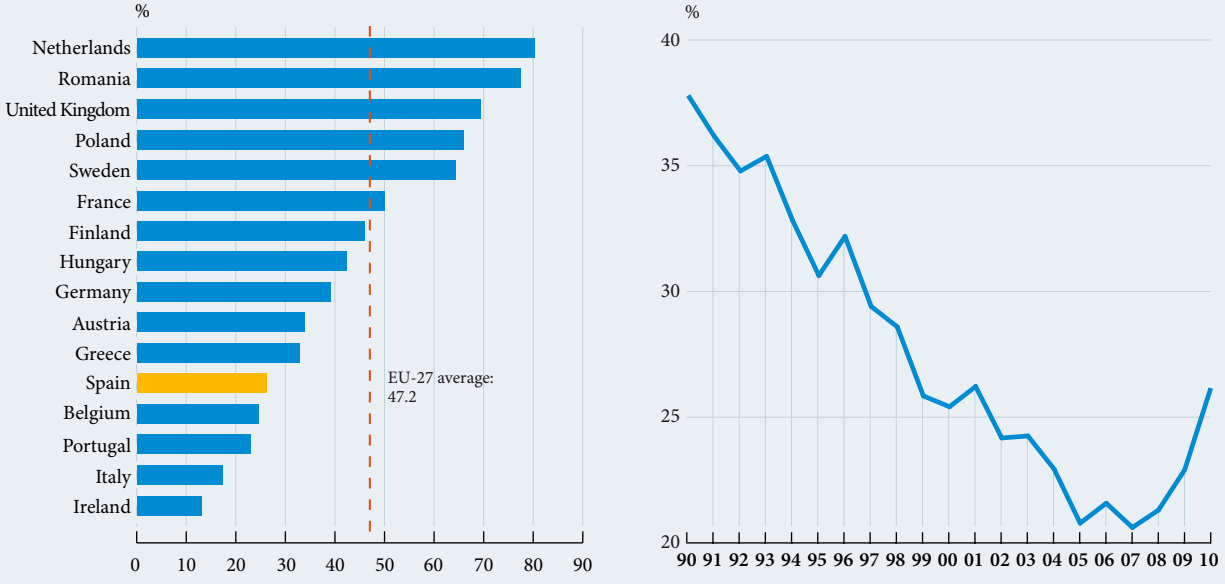
Resorting to the ECB becomes the main source of external financing in November 2011.

How to reduce Spain's costly energy bill?

In February, the European Commission warned of the risk to the sustainability of Spain's economy entailed by its high current deficit. In fact, despite the sharp fall in the external imbalance since 2008, when it had represented more than 10% of Spain's gross domestic product (GDP), this was still among the highest in the euro area in 2011, at 3.9% of GDP. The high energy deficit, close to 4% of GDP last year, is the main obstacle to adjusting the current deficit. Cutting the energy bill is therefore one of the main challenges facing our economy, particularly given the prospect of energy prices remaining relatively high. Increased efficiency and a domestically sourced energy supply are the main ways to progress towards this goal. The question is how much can the energy deficit improve.

SPAIN'S DOMESTIC ENERGY SUPPLY IS LOW DESPITE THE RISE OF THE LAST FEW YEARS

Energy produced in proportion to primary energy consumed. 2010



SOURCES: Eurostat and own calculations.

Spain's costly energy bill is largely due to two factors: the low amount of domestic energy production and the economy's energy efficiency level. Regarding the former, the graph above shows how Spain's energy production only supplied 26.2% of the total energy consumed in the country in 2010. This proportion is a long way from the European Union's average of 47.2%.

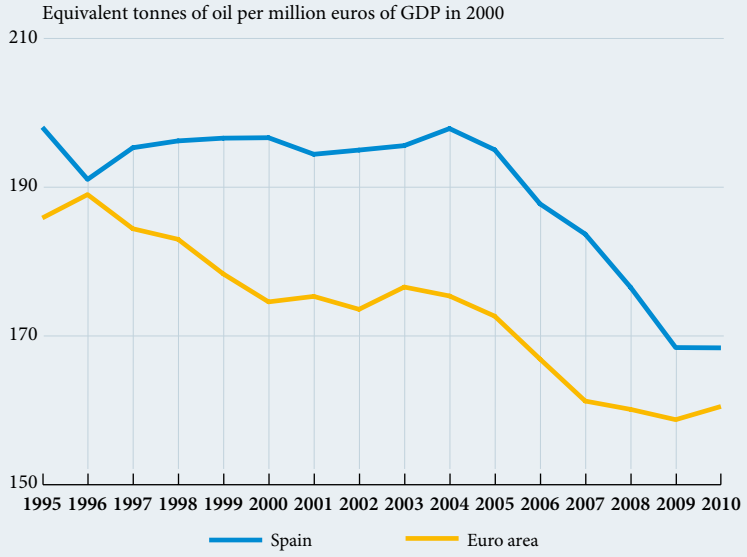
This lower dependency in Europe is due to several reasons. In some countries, it can be explained by the existence of large energy fields. This is the case of the Netherlands and the United Kingdom, whose main sources of domestic energy in 2010 were natural gas and oil, respectively. In other countries, on the other hand, renewable energy sources (mainly hydraulic, solar, wind, geothermal and biofuels) and nuclear energy make up most of the domestic energy produced. In France, 41.2% of the energy consumed that same year came from its own nuclear power plants, while in Austria the intense use of renewable sources supplied 24.8% of the country's energy consumption. In Sweden, both energy sources generated 63.0% of the total energy consumed.

With regard to Spain, nuclear energy and renewable sources generated, respectively, 47.0% and 43.0% of the country's energy production, while solid fuels contributed an additional 9%. Undoubtedly, of note is the increase in the relative weight of renewable energy, which in 2010 already produced 11.4% of the total energy consumed compared with the figure of 5.4%, recorded in 2002.

In spite of this good performance by the renewable energy industry, the significant weight of oil and natural gas in Spain's total energy consumption keeps the country's external energy dependence high. In fact, imports of both products accounted for around 70% of the energy consumed at the end of 2010, a figure that is 20 percentage

SPAIN'S ENERGY INTENSITY IS STILL HIGHER THAN EUROPE'S

Energy intensity: primary energy consumed per unit of GDP



SOURCES: Eurostat and own calculations.

points higher than the European average. This exposes the Spanish economy to the acute volatility of energy prices. A clear example was the hike in oil prices early in 2008, which pushed the energy deficit for the first quarter of that year up to 4.7% of GDP quarter-on-quarter, 1.6 percentage points higher than the figure recorded half a year earlier. Moreover, these imports come from a small number of countries that are very unstable politically. 67.3% of Spain's oil imports and 79.1% of its gas comes from countries in the Middle East or North Africa, suggesting that this volatility is unlikely to lessen in the medium term.

The need to reduce the country's external energy dependence is therefore clear. The objective contained in Spain's National Action Plan for Renewable Energies (PANER in Spanish) is along these lines, aiming to increase the energy produced via renewable sources to 17.9% of the primary energy consumed in the country by 2020. Should this target be met, and should the coverage provided by the rest of the energy sources remain stable, Spain's domestic energy production will continue to grow until it reaches almost 33% of final consumption. In fact, if it had reached this level in 2010, energy imports would have been 7.0% lower, which would have reduced the energy deficit by 0.3 percentage points to 3.1% of GDP. A significant decrease but perhaps not enough to reduce the pressure on the current account deficit. If more extensive measures were taken and Spain's domestic energy production reached a level similar to the European Union as a whole, its energy deficit could fall by approximately 1 percentage point to 2.4% of GDP.

In addition to increasing domestic energy production, a second factor that would help to correct the energy deficit is the economy's improved energy efficiency. If we take as a reference the energy consumed per unit of Spanish GDP, also known as the energy intensity index, we can see a significant fall as from 2005 (in other words, an improvement in efficiency). As can be seen in the graph above, this helped Spain to come close to the efficiency levels posted by the countries in the euro area as a whole. In 2010, Spain's energy intensity was only 4.9% higher than that of the euro area, compared with 14.0% in 2007. This narrowing of the efficiency gap can be put down to two factors: firstly, the greater sensitivity of Spanish energy consumption to decreases in GDP means that energy consumption fell more sharply than in the rest of Europe. Secondly, the increase in the weight of renewable energy in the composition of Spain's energy consumption, encouraged partly by significant subsidies, has also helped to improve efficiency. This is due to these sources producing electricity more efficiently than the other kinds of technology employed.

Continuing with the previous calculation, the potential effect of converging towards the efficiency level of the rest of the countries in the euro area would cut an additional 2 percentage point from the energy deficit relative to GDP. This, together with a similar domestic energy supply to Europe, would place the energy balance at 2.2% of GDP, a level close to the average imbalance recorded by European countries as a whole.

In short, the margin to correct Spain's high energy bill is wide. However, to achieve this objective, the country needs to implement additional reforms to bring efficiency and domestic energy production to similar levels as those in Europe. The progress made by Spain in both directions over the last few years show the path that must be taken but, without doubt, there is still a long way to go to lower its external dependency.

This box was prepared by Joan Daniel Pina
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Public sector

2011's public deficit is above 8% of GDP according to the government.

The general budget will set the course for Spain's adjustment

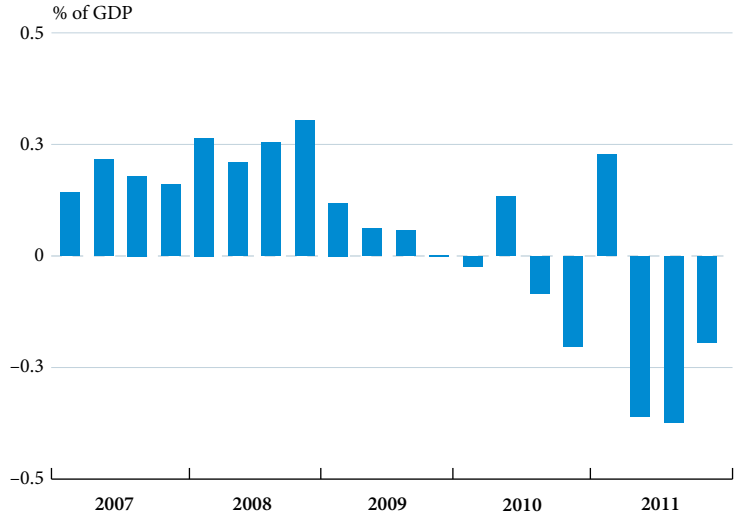
The government's announcements over the last few weeks placed 2011's public deficit higher than 8% of Spain's gross domestic product (GDP). This figure means a deviation of more than 2 percentage points from the target set by the stability programme. Pending the breakdown in the deficit by public institution, all the evidence points to the autonomous communities deviating the most from their targets. In March, expectation will focus mainly on the presentation of the Spain's general budget at the end of the month. This will help to remove doubts regarding the target deficit set for 2012.

In fact, according to the new government's estimates, the adjustment measures announced at the end of last year will cut the public deficit by more than 15 billion euros in 2012. However, this amount is not enough to correct the deficit to the target of 4.4% of GDP agreed with the European Commission for the current year. That's why additional measures will be required to reduce the budget imbalance.

Undoubtedly, the greater effort made to achieve this tough fiscal consolidation will have an effect on how the Spanish economy performs this year. In this respect, the European Commissions' forecast place the contraction in Spain's real GDP at 1.0% for 2012, taking into

FISCAL ADJUSTMENT REDUCES THE PUBLIC SECTOR'S CONTRIBUTION TO ECONOMIC GROWTH

Contribution of public consumption to the economy's growth



SOURCE: INE.

account only the measures announced to date. Adopting additional fiscal measures in the order of 3 percentage points of GDP might therefore result in the economy shrinking further.

In fact, data from the National Accounts system for 2011 highlight the negative impact of fiscal adjustment on economic growth. As can be seen in the graph above, public consumption's average quarter-on-quarter contribution last year was –0.2 percentage points each quarter. This figure was 5 tenths of a percentage point below the contribution achieved in 2008 when fiscal stimulus plans were implemented to reactivate the economy. It therefore seems logical to expect an extension to the demanding deadlines established in the stability programme. This would help to partially reduce the pressure of fiscal adjustment on the Spanish economy without jeopardising the solvency of public debt, given its relatively low level compared with the figure recorded for the euro area as a whole.

Introducing mechanisms that reduce the risk of suffering budget imbalances could reinforce the public accounts. In this respect, in January the Spanish government drew up its Act of Budget Stability and Financial Sustainability for Public Administrations. This limits growth in public expenditure, with the exception of items such as interest on debt or non-discretional expenditure on unemployment benefit, to below the long-term growth rate in nominal GDP. Similarly, as from 2020, the structural public deficit, adjusted by the economic cycle, won't be able to exceed 0.4% of Spanish GDP: a limit that can only be surpassed at times of economic recession or extraordinary emergency. This Act also establishes corrective mechanisms for when the established targets are not met, which can even involve economic sanctions.

Meeting the target deficit in 2012 could intensify the economic contraction.

The Spanish government approves the Budget Stability Act which limits public expenditure and the structural deficit.

Within this context, the risk premium required for Spain's public debt, defined as the spread between the yield on 10-year Spanish bonds and their German equivalent, remained at around 320 basis points in February. A considerably lower level than the peak reached three months ago, when this went up to 500 basis points. The Spanish Treasury took advantage of this situation to issue more debt at a lower cost than in previous auctions. This is good news if we take into account the sizeable amount of debt maturing in the last ten months of the year, totalling almost 134 billion euros.

The risk premium stabilizes around 320 basis points in February.

Savings and financing

The new financial reform won't manage to slow up the drop in credit

The new financial reform enlarges the financial safety net for property assets by an additional 50 billion euros...

In February the Spanish government passed a Royal Decree Law to sort out the financial system. The main aim of this reform is to dispel doubts regarding banks' solvency given the increase in troubled property assets on their balance sheets. To this end, banks are required to increase the financial safety net for their property portfolios estimated approximately at an additional 50 billion euros by the end of the year. This measure has initially been welcomed by analysts. However, there are questions regarding the law's possible effect on the trend in private sector credit.

According to the calculations presented by the Minister of the Economy, these additional provisions can be broken down as follows: close to 10 billion euros from the banks' profits will be allocated to cover up to 7% of healthy assets related to property developments. The remaining 40 billion euros will extend the safety net for troubled property assets that totalled 175 billion euros in June 2011. These include foreclosures, doubtful loans and loans at risk of default. Of these 40 billion euros, 15 billion will be charged to equity and capital instruments and the remaining 25 billion to profits.

...and will help to dispel doubts in the wholesale financing markets.

As a consequence of these new requirements, provisions for potential losses related to property assets will increase significantly; up to 80% in the case of land, 65% for developments underway and 35% for finished housing and developments. These provisions are 49, 38 and 10 percentage points higher than the levels prior to the current law, respectively. With this increase, the banking sector is reinforcing its solvency to contend with potential falls in property asset prices. This will help to dispel investors' doubts regarding the robustness of banks' balance sheets.

The gradual recovery in confidence will also be boosted by the restructuring to be carried out on Spain's banking sector in 2012. In fact, the financial reform is encouraging mergers between institutions. In this respect, those institutions immersed in mergers will be able to prolong by one year the period in which they have to comply with the provision requirements approved in the Decree Law, as well as write off any asset deterioration against equity. Moreover, the Fund for Orderly Bank Restructuring (FROB) has been enlarged by 6 billion euros to be able to finance these institutions via the acquisition of contingent convertible bonds. In exchange, the merged institutions will have to undertake to increase credit to households and firms.

February already saw wholesale funding markets opening up a little to banks, with more debt being issued by the main financial institutions. However, the large volume of maturities facing Spain's banks in 2012 will keep their net borrowing high. We therefore expect banks to continue looking to the European Central

Bank (ECB) as their main source of funding over the next few months. In January 2012, the ECB's net lending to banks reached a new peak of 133 billion euros. This growing trend is more than likely to continue over the next few months, particularly with the additional injection of liquidity by the ECB at the end of February.

But in spite of this greater liquidity in the markets, the process of private sector deleveraging and the deterioration in the macroeconomic situation will push credit down in 2012. The latest data available show a 10.9% fall in new credit transactions being granted in the second half of 2011. As a result of this, credit to other resident sectors posted its largest drop since the economic recession began, down 3.3% year-on-year at December 2011. As shown by the private sector financing figures in the table below, this fall was spread evenly between non-financial firms and households. Both sectors reduced their indebtedness by 2.4% year-on-year in 2011. This figure contrasts with the 13.7% rise in public debt in 2011.

According to the bank loan survey published by the Bank of Spain, the reasons underlying this drop are due to factors of supply and demand. Both the slightly tougher conditions for granting credit and the weak demand for loans, especially in terms of households, explain the weakness in credit. Looking to the future, the same survey expects further contractions in credit during the first quarter of this year, especially due to the worsening macroeconomic situation. This is in line with our own forecast for the trend in credit for this year as a whole, in which expect credit to decrease at a similar rate to the one recorded last year.

Resorting to the ECB is the main source of funding for Spanish banks.

Resident private sector credit falls by 3.3% year-on-year in 2011.

FINANCING OF NON-FINANCIAL SECTORS (1)

December 2011

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,132,332	–75,248	–2.4	74.3
Non-financial corporations	1,260,821	–48,195	–2.4	44.0
Resident credit institution loans (3)	*841,174*	*–55,656*	*–5.0*	*29.3*
Securities other than shares	*65,360*	*4,713*	*7.8*	*2.3*
External loans	*354,287*	*2,748*	*2.4*	*12.4*
Households (4)	871,511	–27,053	–2.4	30.4
Housing loans (3)	*665,410*	*–14,548*	*–1.9*	*23.2*
Other (3)	*203,025*	*–12,260*	*–4.0*	*7.1*
External loans	*3,075*	*–245*	*4.3*	*0.1*
General government (5)	736,250	94,367	13.7	25.7
TOTAL	**2,868,582**	**19,119**	**1.5**	**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.

Doubtful loans pick up again to 7.62% in December 2011.

Moreover, the expected deterioration in the Spanish economy this year will continue to push up banks' doubtful loan rate. The latest data available show further growth of 9 basis points, reaching 7.62% of all credit. Although a breakdown by production sector is still not available, all the evidence points to a widespread deterioration in rates in the last quarter, particularly in the case of property assets.

In short, the new financial reform passed by the government will consolidate Spain's banking sector and help to restore confidence in the wholesale funding markets. However, credit is unlikely to avoid a relapse in 2012. First the excessive debt in Spain's private sector needs to be corrected and the overall economic situation also needs to improve. Two requirements that will not be met this year.

A change in trend in household savings?

Household savings are expected to stagnate in the fourth quarter of 2012.

Within this weak context for the Spanish economy, the trend in the household savings rate becomes a key variable to determine the performance of domestic demand. In September 2011, this stood at 12.0% of the gross disposable income of Spanish households, far from the 18.5% reached in 2009. A peak that was due to preventative savings given the poor economic prospects at the time and which intensified the contraction in private consumption.

With regard to the fourth quarter of 2011, we estimate that the deterioration in Spain's macroeconomic scenario halted the fall in savings recorded over the last few years. This might even increase slightly in 2012 due partly to a possible decrease in the gross disposable income of households.

The data on the liabilities of financial institutions at year-end 2011 might shed some light on the performance of the savings rate at the end of last year. Of note is December's 4.6% year-on-year drop in bank liabilities in the hands of households and firms. This is largely due to the performance of term deposits, down by 5.5% in December over the same period. Part of this drop can be explained by savings being moved to public debt products, which saw their yield rise over

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

December 2011

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	270,041	8,275	3.2	8,275	3.2	19.7
Savings deposits	202,949	–8,338	–3.9	–8,338	–3.9	14.8
Term deposits	702,743	–40,905	–5.5	–40,905	–5.5	51.2
Deposits in foreign currency	17,719	–1,664	–8.6	–1,664	–8.6	1.3
Total deposits	**1,193,452**	**–42,633**	**–3.4**	**–42,633**	**–3.4**	**87.0**
Other liabilities (*)	**178,971**	**–24,040**	**–11.8**	**–24,040**	**–11.8**	**13.0**
TOTAL	**1,372,423**	**–66,673**	**–4.6**	**–66,673**	**–4.6**	**100.0**

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

the last few months of the year. For their part, short-term deposits as a whole (sight and savings), which react most to variations in preventative savings, remained the same at the end of last year. However, this performance contrasts with the falls recorded in the third quarter of 2011, so we may be seeing a change in trend in the household savings rate.

Bank liabilities fall by 4.6% in December, driven by term deposits.

"la Caixa" Research Department

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MONTHLY REPORT
March 2012

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"la Caixa" GROUP: KEY FIGURES

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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Design, page make-up and printing: www.cege.es - Ciutat d'Asunción, 42 - 08030 Barcelona

D. L.: B. 21063-1980 ISSN: 1134-1920

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