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THE SPANISH ECONOMY

Monthly Report

THE OTHER EMERGING ECONOMIES

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2010	2011	2012	2010		2011			
				3Q	4Q	1Q	2Q	3Q	4Q
INTERNATIONAL ECONOMY		Forecast						Forecast	
Gross domestic product									
United States	3.0	1.7	2.0	3.5	3.1	2.2	1.6	1.6	1.4
Japan	4.0	–0.5	2.7	4.8	2.5	–0.7	–1.1	–1.1	0.7
United Kingdom	1.3	1.1	1.7	2.5	1.5	1.6	0.7	0.5	1.5
Euro area	1.7	1.6	1.3	2.0	2.0	2.4	1.6	1.3	1.2
Germany	*3.6*	*2.9*	*1.5*	*4.0*	*3.8*	*4.6*	*2.8*	*2.3*	*1.8*
France	*1.4*	*1.7*	*1.4*	*1.6*	*1.4*	*2.2*	*1.7*	*1.4*	*1.5*
Consumer prices									
United States	1.6	3.2	2.3	1.2	1.2	2.2	3.3	3.8	3.7
Japan	–0.7	0.2	0.3	–0.8	0.1	0.0	0.1	0.5	0.1
United Kingdom	3.3	4.3	2.7	3.1	3.4	4.1	4.4	4.4	4.2
Euro area	1.6	2.7	1.8	1.7	2.0	2.5	2.8	2.7	2.7
Germany	*1.1*	*2.3*	*1.8*	*1.2*	*1.5*	*2.1*	*2.3*	*2.4*	*2.3*
France	*1.5*	*2.1*	*1.6*	*1.5*	*1.6*	*1.8*	*2.1*	*2.1*	*2.1*
SPANISH ECONOMY		Forecast						Forecast	
Macroeconomic figures									
Household consumption	1.3	0.7	0.7	1.5	1.7	0.7	–0.2	1.1	1.2
Government consumption	–0.7	–0.3	–2.4	–0.7	–0.9	2.6	–1.0	–1.3	–1.6
Gross fixed capital formation	–7.5	–5.0	0.1	–6.7	–6.1	–6.0	–6.7	–4.2	–3.2
Capital goods	*1.9*	*0.6*	*4.3*	*2.4*	*1.2*	*0.3*	*–3.7*	*3.1*	*2.7*
Construction	*–11.1*	*–8.2*	*–1.9*	*–11.2*	*–10.6*	*–10.4*	*–9.3*	*–7.6*	*–5.6*
Domestic demand (contribution to GDP growth)	–1.2	–0.8	0.0	–0.7	–0.6	–0.4	–1.9	–0.6	–0.3
Exports of goods and services	10.3	9.7	6.4	9.4	10.5	12.1	8.4	10.1	8.1
Imports of goods and services	5.5	3.2	2.3	5.0	5.3	6.3	–1.7	4.2	3.9
Gross domestic product	**–0.1**	**0.8**	**1.1**	**0.2**	**0.6**	**0.9**	**0.7**	**0.9**	**0.8**
Other variables									
Employment	–2.3	–0.9	0.3	–1.6	–1.4	–1.4	–1.0	–0.7	–0.6
Unemployment (% labour force)	20.1	21.5	21.8	19.8	20.3	21.3	20.9	21.5	22.4
Consumer price index	1.8	3.2	1.6	1.9	2.5	3.5	3.5	3.1	2.7
Unit labour costs	–1.5	–1.0	0.1	–1.9	–2.3	–1.5	–1.5		
Current account balance (% GDP)	–4.5	–4.0	–3.5	–3.7	–3.2	–6.4	–2.9	–2.7	–3.8
Net lending or net borrowing rest of the world (% GDP)	–3.9	–3.5	–3.1	–3.1	–2.6	–5.9	–2.4	–2.2	–3.4
General government financial balance (% GDP)	–9.3	–7.5	–5.0	–7.9	–13.4	–5.3	–9.9		
FINANCIAL MARKETS		Forecast							Forecast
International interest rates									
Federal Funds	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	1.0	1.3	1.5	1.0	1.0	1.0	1.3	1.5	1.5
10-year US bonds	3.2	2.8	2.1	2.8	2.8	3.4	3.2	2.4	2.0
10-year German bonds	2.8	2.6	2.7	2.4	2.6	3.2	3.1	2.3	2.0
Exchange rate									
$/Euro	1.33	1.40	1.40	1.29	1.36	1.37	1.44	1.41	1.39

Contents

The other emerging economies

While advanced economies (North America, Western Europe, Japan) are struggling within a context of low growth, dangerous imbalances in their public accounts and an uncertain economic outlook, the rest of the world is progressing well in terms of growth and improvements in its standard of living. While the rich countries will hardly grow by 1.5% in 2011, the rest will exceed 6%. More or less the same as what has happened in the last decade and what is expected to happen in the coming years. The relative weight of the developed world is declining before the relentless advance of the developing world and the gap between both is starting to narrow.

This surge by less developed economies started in the 1990s, principally in Asia and then spreading to other regions throughout the last decade. The Great Recession of 2008-2009, which affected the rich countries so directly, hardly impinged on the rest. The glittering stars of this turnaround in the world economy are the large emerging countries: China, India and Brazil, to which we might add Russia. Large in population, size and their potential to expand. Each of their economies is very different but they share the common denominator of having altered the established pattern of international trade, the availability of labour, commodity flows and the exchange rate system.

But the large emerging countries are merely the most visible part of this phenomenon. Many other countries are managing to grab a foothold within the structure of world trade and the global economy and, by this means, increase their standard of living. These are located in Eastern Europe, Latin America, Asia and Africa. In general, their good performance is believed to be a consequence of advances in several decisive spheres, such as macroeconomic stability; i.e. keeping imbalances within acceptable parameters and avoiding, for example, situations such as hyperinflation. They are also countries with economies open to trade and external investment, with an acceptable level of development in their human capital and technological skills and, above all, political and institutional conditions that encourage and help business and corporate transactions to be carried out.

Certainly, there are also a large number of countries that are finding it very difficult to establish a minimal foundation from which to forge a path towards economic prosperity. The main obstacle is usually the spiral of conflict and violence, political or criminal, that affects numerous states. The breeding ground for this conflict can be found in the poverty and low levels of per capita income with which millions of people survive. In these countries, the existence of natural resources accentuates the risk of violence, while corruption has a lethal effect on how well institutions can function. Others factors of a non-economic nature can also light the touch paper of conflict, such as the marginalization or inequality suffered by certain regional, religious or ethnic groups. What is true is that, in these cases, sorting out the country and managing to get the basic institutions to work properly are delicate, fragile processes that take many years to achieve.

Which countries will be capable of crossing the boundary to emerging status in the next few years? The answer is of interest because investing in these countries might bring big returns in the future. But there are also risks, since there is no guarantee that what has happened in the past will continue indefinitely. In any case, the emergence of new countries will always be good news for the global economy as a whole.

EXECUTIVE SUMMARY

The economic outlook becomes muddied

At last, the euro summit achieves a common standpoint to tackle the sovereign debt crisis.

The European summit of 26 October reached a number of agreements that are hoped will alleviate, at least for the moment, the critical status reached by the euro area. Two years after the problems of the Greek budget started to be noticed and after thirteen European summits, this time the heads of state and of government have found a common standpoint that we believe has some positive elements but for which many details have yet to be specified. That's why we believe that, provided these details are specified satisfactorily, the situation might gradually improve, although further tension cannot be ruled out if such details are disappointing.

The voluntary write-down of Greek debt rises to 50%, the Core Tier 1 capital ratio for the main European banks increases to 9%...

The first point of agreement is the restructuring of Greece's bail-out plan. After the favourable report by the negotiating troika (European Central Bank, International Monetary Fund and European Commission), the payment of the eighth tranche of aid has been given the go-ahead. But the most important thing is the agreement to reduce the Greek debt by writing down the 50% that, voluntarily, can be accessed by the private sector. This measure has been forced by the significant deterioration in the Greek economy over the last few months in order to ensure its public debt can be sustained in the long term. The new bonds will be traded at the beginning of 2012 but it's not clear just how well this offer will be accepted.

...the bail-out fund's lending capacity is extended and the most severely affected economies are given their homework.

The second point is the recapitalization of Europe's banking sector. Although the banks of the old continent passed the stress tests carried out in the spring, and with flying colours, it has been deemed necessary to raise the Core Tier 1 capital ratio to 9% for the most important banks. Although the origin of the uncertainty regarding the banks' solvency lies in the sustainability of public debt, it's argued that this step is necessary to dispel the danger of contagion surrounding the sector and thereby reopen the wholesale financing markets. This recapitalization must occur by 30 June 2012. The risk is that this might toughen up credit terms and weaken or lengthen the process of economic recovery in the euro area. In the case of Spain, the recapitalization will affect its five main banks and, according to preliminary calculations, will account for 26.16 billion euros of the 106 billion calculated by Brussels as the total necessary for Europe's banks.

Thirdly, in the marathon meeting of the European leaders, it was agreed to enlarge the lending capacity of the bail-out fund, the European Financial Stability Facility, up to around a billion euros, although no specifics have been given regarding how this enlargement will actually be carried out. At the moment the fund has been given 440 billion euros as an initial allocation. The mechanisms have also been discussed that will be used by the fund to support sovereign debt in difficulty, which in any case will have to be specified further in the future.

Lastly, the euro summit underlined the importance of continuing to improve European governance and fiscal discipline. Moreover, the summit's

conclusions refer to the progress being made by Ireland and Portugal in implementing their adjustment plans, as well as the two countries most affected by rising risk premia, Italy and Spain. In this case, the euro area's heads of state and of government have praised the progress made by Spain in reducing its public deficit, restructuring its banking sector and reforming its labour and product market, but they have stressed the need to make the labour market more flexible and improve competitiveness, particularly in the services sector.

The adaptation of these measures to the resolution of the sovereign debt crisis is fundamental in order to curb the intense decline in economic activity recorded in the euro area over the last few months. In general all indicators, both of supply and demand, have initiated a marked downward slide. Particularly surprising is the speed with which the confidence of European consumers has started to decline as from July, after remaining at levels similar to its historical average for one year. This bad trend contrasts with the solid performance of industrial production in August, growing by 5.3% year-on-year. However, several leading indicators point to economic activity deteriorating, with the Purchasing Managers' Index (PMI) falling below the level of 50 points, a level that indicates shrinkage, and negative results from business confidence surveys. For these reasons, we believe that the risk of recession in the euro area has increased slightly, although for the moment we have maintained our growth forecast for the next few quarters.

We have also maintained our prediction that the European Central Bank (ECB) will keep the official interest rate at 1.50% but accept the possibility that it might lower interest rates if the recessionary scenario is confirmed. In the last Governing Council, held in October, Jean-Claude Trichet, in his last appearance as ECB president, followed the script of previous occasions by stating the adaptable profile of the institution's monetary policy, acknowledging that the current risks related to the heavy borrowing of some peripheral countries and the slowdown in international trade are increasing downward pressure on the euro area's growth rate. According to Trichet, the ECB is fully committed to adopting the extraordinary measures required to restore financial stability and to ensure markets function properly, its most significant intervention being the purchase of sovereign bonds from peripheral countries. Although initially this programme was exceptional in nature, the increased risk of a possible contagion of difficulties to other economies in the region, such as Spain or Italy, have turned the ECB into a habitual purchaser of sovereign bonds.

Indicators for the euro area start to slide sharply downwards...

...which might make the ECB reconsider keeping official interest rates at their current level.

Outside the euro area, the risk of a global slowdown has decreased appreciably. In the United States, the gross domestic product (GDP) of the third quarter grew by 1.6% year-on-year, a rate somewhat higher than we had expected, with notable growth in household consumption and corporate investment. This result is coherent with indicators, already published, such as the business confidence indicator, retail sales and even employment. In addition to the creation of 103,000 net jobs in September is the upgrade of 99,000 jobs in the months of July and August, bringing the total net jobs created over the year to 1,074,000.

With regard to emerging economies, in general these are experiencing a gentle slowdown, with China's GDP rising by 9.1% in the third quarter. In other countries where activity has slowed up more, such as in Brazil, the monetary policy is becoming more lax, reducing

The risk of global slowdown has decreased notably outside the euro area.

Growth prospects have also cooled off considerably in the Spanish economy.

the risk of a rough landing. In Mexico, the financial turbulence and slowdown in the large advanced economies are the main reasons for expectations of lower growth in the remainder of 2011 and also in 2012.

With regard to the Spanish economy, and as is happening in the euro area, growth prospects have cooled off significantly. In addition to the less favourable international environment, especially in terms of its main trading partner, the euro area, confidence has also slumped due to the continuing sovereign debt crisis and its consequences in terms of credit availability and cost. Business indicators in the third quarter show a situation in which the little growth was provided by a foreign sector boosted by foreign tourism, benefitting from the diversion of travellers due to the conflicts in North Africa. However, indicators such as retail sales and consumer confidence are clearly falling, pointing to a weaker performance than expected in the coming quarters.

Job losses continue to hinder private consumer spending.

One of the reasons for households restricting their spending are the job losses that are still being recorded. In September, the number of new employment registrations with Social Security fell by 64,956 people, bringing the cumulative figure for the last year to 235,918 registrations lost, a rate of decline that is still somewhat higher than 1% in year-on-year terms. This gradual loss of jobs is translated into a growing number of unemployed. Spain provides 31% of the 15.7 million unemployed estimated for the euro area, meaning that one out of every three unemployed people in Europe is Spanish, although Spain accounts for just 14% of the 17-strong euro area population. Spain leads the ranking for European unemployment with a rate of 21.2%, followed, at a long distance, by Greece and Ireland.

Private consumer spending, although weak, has managed to keep afloat thanks to households reducing their savings rate, according to the data available up to the second quarter of 2011. In this period, households put aside 12.8% of their income for savings, very far from the record high reached in 2009, when precautionary savings were in excess of 18%. We expect the savings rate to go on falling, reaching 11.4% by the end of 2011.

For its part, the foreign sector shows an appreciable reduction in the current account deficit, with a year-on-year fall of 16.3% in July. This correction is largely because of the good performance by the trade balance, due to the fall in imports. However, the foreign trade figures point to a smaller adjustment in the coming months. One relevant component of this is energy, whose cumulative deficit between September 2010 and August 2011 accounts for more than 80% of the total trade deficit for the period. With regard to the services balance, its cumulative surplus for the last twelve months increased by 20.9% compared with the figure recorded in the same period a year ago, thanks mainly the aforementioned rise in the tourist component.

The foreign sector will moderate its contribution to growth in the coming quarters.

In any case, the foreign sector's contribution to growth will tend to moderate in the coming quarters, so that the performance of domestic demand will be crucial, for the moment being subject to great uncertainty. Taking into account the fragile situation in the private sector (firms and households) and the adjustment that has yet to be applied to the public sector, one crucial factor will be the combination of adjustments and reforms adopted to restore the Spanish economy to a growth rate that will help to once again create employment.

27 October 2011

CHRONOLOGY

2010

October	**20**	Extensive reshuffle in the **Spanish government**.
November	**19**	The government establishes a **legislative calendar** that includes **pension and collective bargaining reforms**.
	24	**Ireland** presents an **adjustment plan** with tough measures to cut its public deficit in order to receive **financial aid** from the EU and the IMF.
December	**3**	The government approves a package of **economic policy measures** that includes, among others, the partial privatization of the state lotteries management body and the public corporation AENA, as well as raising taxes on tobacco.
	16	The European Council agrees to create a **European Stability Mechanism** in 2013, which will replace the current bailout fund, as well as to enlarge the capital of the European Central Bank.

2011

January	**1**	Estonia joins the **euro area**, which grows to seventeen member states.
	14	Ben Ali's regime in Tunisia falls, the first in a chain of **political changes** in North Africa and the Middle East, with repercussions for oil prices.
February	**2**	Signing of the **Social and Economic Agreement** by the government, trade unions and employers, including pension reform.
	18	The government passes a Decree-Law to reinforce the solvency of **financial institutions**.
March	**25**	The **Euro Plus Pact** is approved and the foundations are laid to set up the **European Stability Mechanism** in the European Council.
April	**7**	The **European Central Bank** raises the official interest rate to 1.25%.
May	**17**	The Council of Economic and Finance Ministers of the European Union approves the **financial bail-out plan for Portugal**, totalling 78 billion euros.
	22	**Elections** are held in thirteen autonomous communities and in the municipalities.
June	**10**	The government approves a Decree Law that **reforms collective bargaining**.
July	**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%.

AGENDA

November

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

December

2 Registration with Social Security and registered unemployment (November).
5 Industrial production index (October).
8 Governing Council of the European Central Bank.
13 Fed Open Market Committee
14 CPI (November).
15 EU HICP (November).
16 Labour costs (third quarter).
20 Government revenue and expenditure (November).
22 Foreign trade (October).
23 Producer prices (November).
30 Flash CPI (December).
Balance of payments (October).

INTERNATIONAL REVIEW

The United States: an upswing that avoids the worst

The United States grows by 1.6% and moves away from a double dip scenario.

The upswing in aggregate demand is moving the US economy away from the feared scenario of a double dip recession, although the prospects for the last part of 2011 and the whole of 2012 have not improved. Gross domestic product (GDP) in the third quarter grew by 0.6% quarter-on-quarter (1.6% year-on-year) thanks to private consumption regaining some of its dynamism of the expansionary years and a foreign sector that benefitted from July's upswing in exports and more favourable oil prices.

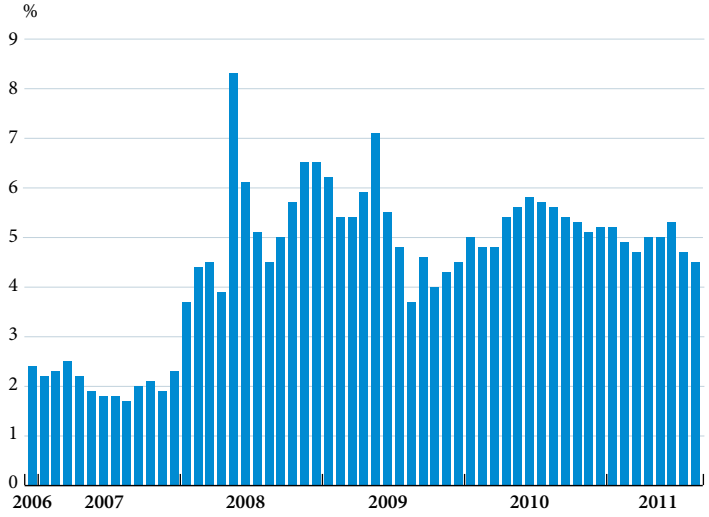
For its part, public consumption continued to look weak, reflecting the gradual disappearance of the fiscal stimuli that have helped to push public debt up to 100% of GDP. In the case of investment, of note was the strong performance by capital equipment expenditure, increasing by 10% year-on-year, supported by the industrial sector. Construction once again made a small positive contribution to growth.

Business sentiment improves slightly, except in employment prospects.

The slight improvement in business perception is consistent with the strength of the third quarter. The Institute for Supply Management (ISM) sentiment index, both for services and manufacturing, showed slight advances that left both indices at levels consistent with around 2% growth in the economy as a whole. The weak point of these figures lies in the services employment component, which was below the reference level of 50, the boundary between expansion and recession, indicating that the labour market is still not having a very good time.

THE UNITED STATES: SOMEWHAT FEWER SAVINGS... LATELY

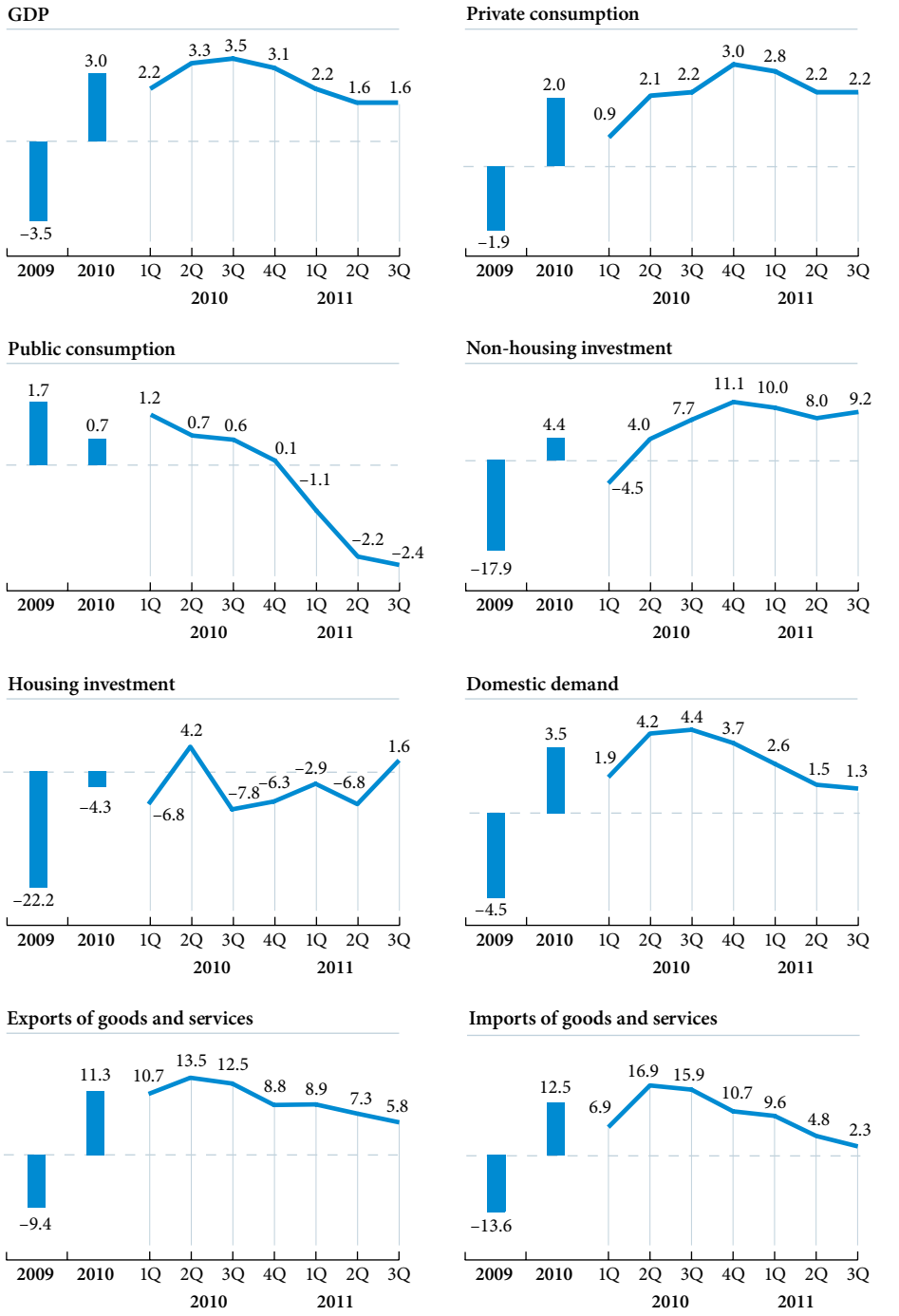
Household savings as percentage of gross disposable income



SOURCES: Bureau of Economic Analysis 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.

The fourth quarter should be weaker than the third.

Although this upswing must be a sign of greater confidence among the different economic sectors, making the hypothesis of a double dip recession less likely, we should expect a somewhat weaker fourth quarter than the third given the temporary nature of some of the supporting factors. Firstly, the disposable income of households slowed up its advance in the third quarter, so that the push by consumption in this period was achieved at the cost of a drop in the savings rate, in an economy that needs the deleveraging of households whose gross debt is still at a high 114.4% of disposable income. Secondly, the strength in consumption was concentrated in consumer durables, which behave more erratically than non-durables and services, these remaining almost at a standstill. Thirdly, there's still the impediment of expensive oil that, although cheaper than in the first half of the year, appears to be dropping back down more slowly than expected. In a context of falling commodity prices, the price of oil is still very much above 100 dollars per barrel, reducing the capacity of households to make other purchases.

September's retail sales continued the vigorous pattern of private consumption in the third quarter, with an increase of 5.9% year-on-year, not including cars or petrol, strengthened by good automobile sales, a strength that isn't as strong as it looks, however, as a large part of these sales were achieved thanks to significant price discounts.

Prices take a breather, with the CPI at 3.9% and core CPI at 2.0%.

The moderation in inflation perspectives also points to lukewarm demand in the coming quarters. The consumer price index (CPI) for September rose by 3.9% year-on-year, slightly above August's rate of 3.8% thanks to energy prices still reflecting the high oil prices of months ago. However, the core CPI, the general index excluding energy and foods, which is a more accurate reflection of price

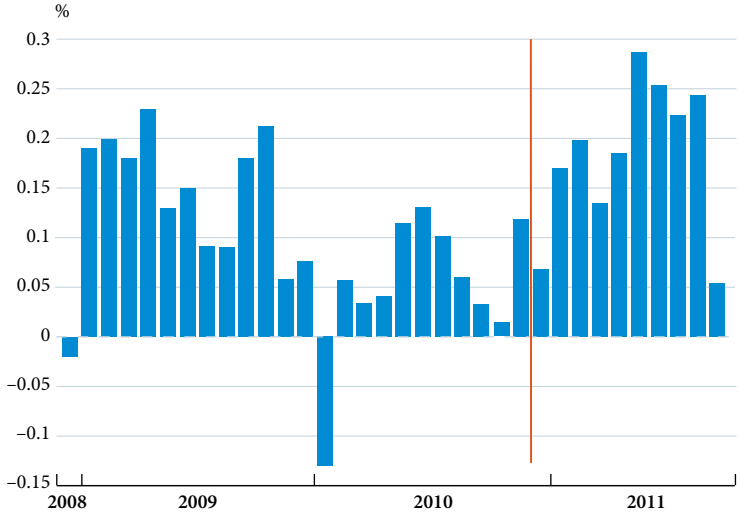
THE UNITED STATES: PRIVATE CONSUMPTION PICKS UP

Real retail sales without vehicles or petrol

SOURCES: Department of Trade and own calculations.

THE UNITED STATES: THE CPI EASES OFF

Change month-on-month in the core consumer price index (*)



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

trends, put an end to five consecutive months of rises with just a minimal increase on August, accumulating gains of 2.0% year-on-year. Likewise, September's rise would have been almost zero without the contribution of rents. Clothing and particularly consumer durables saw their prices fall, due to the already mentioned discounts on automobile sales. The positive aspect of this moderation in inflation in September is that the Federal Reserve should have more room to manoeuvre in case new expansionary policies are needed.

The trend in the labour market also followed a similar pattern, reviving somewhat but without any improvement in its medium-term prospects. Added to the creation of 103,000 net jobs in September is the upwardly revised figure of 99,000 jobs in July and August, bringing the cumulative net jobs created this year to 1,074,000. However, the unemployment rate remained stuck at 9.1% and there was a slight increase in the broadest unemployment rates, which include discouraged workers and those working part-time involuntarily, a rise that makes any further significant reductions in unemployment unlikely throughout 2012, as these discouraged and underemployed workers will absorb a large part of the jobs created.

Job creation livens up but the unemployment rate is still 9.1%.

Business perception has improved slightly in the housing market, although a significant recovery is not expected to arrive until well into 2013. In this respect, prices are still stuck at the bottom, with the Case-Shiller index of second-hand house prices remaining almost unchanged in July. Similarly, mortgage foreclosures, which increase the excess supply of property, continued apace. The sector is positioning itself towards rented property and apartment blocks, whose demand boosted the figure for homes started in September to 658,000, in annual terms, a 15.0% rise in just one month, although this does

The real estate market shows tentative improvement thanks to apartment blocks.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011		
			4Q	1Q	2Q	3Q
Real GDP	–3.5	3.0	3.1	2.2	1.6	1.6
Retail sales	–7.0	6.4	7.7	8.2	7.8	8.0
Consumer confidence (1)	45.2	54.5	57.0	66.9	61.8	49.9
Industrial production	–11.2	5.3	6.2	5.4	3.7	3.3
Manufacturing (ISM) (1)	46.3	57.3	57.9	61.1	56.4	51.0
Housing construction	–38.4	5.6	–5.1	–5.3	–4.9	5.2
Unemployment rate (2)	9.3	9.6	9.6	8.9	9.1	9.1
Consumer prices	–0.4	1.6	1.3	2.1	3.4	3.8
Trade balance (3)	–381.3	–500.0	–500.0	–520.4	–534.8	...
3-month interbank interest rate (1)	0.7	0.3	0.3	0.3	0.3	0.3
Nominal effective exchange rate (4)	77.7	75.4	73.0	71.9	69.6	69.1

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

The upswing in exports and cheaper oil bring the trade deficit down.

not alter the fact that we are still very far from the figure of 1.6 million homes started, which could be considered normal.

Cheaper oil affected the foreign sector more than it did consumer prices. The reduction in import costs represented by the fall in the price of crude and its derivates, which account for 57.1% of the total trade deficit, added to the upswing in exports in July, which was largely continued August, meant that the combined trade deficit for goods and services for July-August was 91.2 billion dollars, 10.3% below the figure for May-June. Where there are still no signs of improvement is in the United States' bilateral relation with China, which is the reason for almost all its external imbalance, if we exclude oil, an imbalance that means the US is still pressurizing China to speed up its currency's appreciation. Nevertheless, the foreign sector's potential contribution to growth should be limited due to the slowdown in world growth. In this respect, the fraction of the total represented by US exports to East Asia which is, today, the fastest growing region, is 22.8% and falling.

Japan: a recovery that has its burdens

Japan might decline by a minimal 0.5% in 2011 with the expectation of a dynamic 2012.

The Japanese economy, whose GDP fell by –0.5% in the second quarter, expects an expansionary third quarter that should confirm the recovery in its industrial fabric after March's earthquake and tsunami. A vigour that would not prevent the Japanese economy from posting a decline for 2011 as a whole, which should be around 0.5%, but which might catapult growth to 2.7% in 2012. This spirited comeback after the catastrophe must not make us forget, however, the weakness of an economy whose gross public debt exceeds 230% of GDP, as well as an excessive dependence on its foreign sector which, within a

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	–6.3	4.0	4.8	2.5	–0.7	–1.1	–	...	–
Retail sales	–2.3	2.5	3.2	–0.4	–3.0	–1.7	0.6	–2.6	...
Industrial production	–21.8	16.6	13.3	6.8	–2.5	–7.0	–1.7	–1.0	...
Tankan company Index (1)	–40.8	0.0	8.0	5.0	6.0	–9.0	–	2.0	–
Housing construction	–27.7	2.7	13.7	6.8	3.2	4.3	21.1	14.0	...
Unemployment rate (2)	5.0	5.1	5.0	5.0	4.7	4.6	4.7	4.3	...
Consumer prices	–1.3	–0.7	–1.0	–0.3	–0.5	–0.4	0.2	0.2	...
Trade balance (3)	4.0	7.9	8.1	7.9	6.5	3.4	2.5	1.8	...
3-month interbank interest rate (4)	0.58	0.39	0.37	0.34	0.34	0.34	0.3	0.3	0.3
Nominal effective exchange rate (5)	98.6	106.0	109.1	111.0	110.6	109.3	112.6	115.8	118.3

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

context of global slowdown, supposes a burden and which has yet to avert the threat of deflation, largely due to a chronic weakness in domestic demand.

In this respect, the tsunami's inflationary effects have been very limited, which suggests that, although deflation has not been eliminated, many of the supply chain bottle necks caused by the tsunami and nuclear crisis have been resolved. August's CPI rose a meagre 0.2% year-on-year, helped by the upward pressure of oil, which should die down over the coming months. Without this factor, the core CPI, the general index without foods and energy, has been at a standstill for three months and, in August, accumulated a drop of 0.4% compared with the same period a year ago. The GDP deflator still shows a sharper deflationary trend than the consumer price indices.

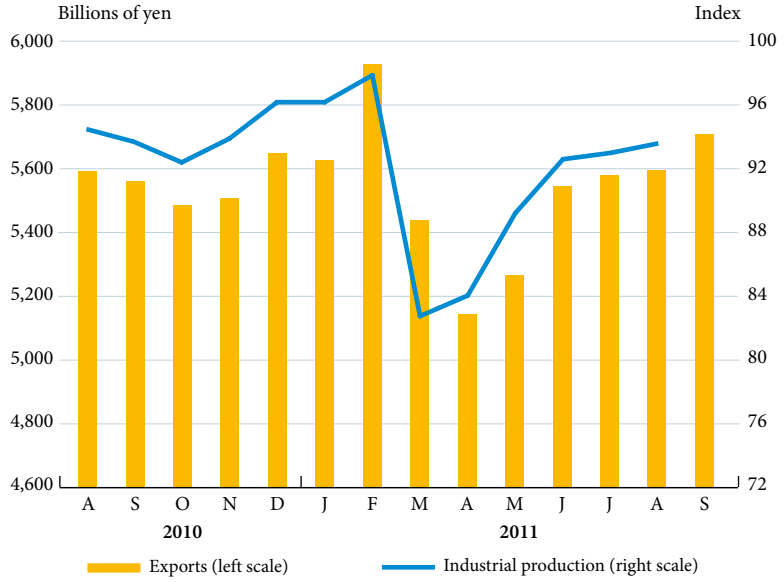
The muscle of the Japanese economy continues to be faithfully reflected in its industrial production which, in August, continued its upward trend and has already regained 71.7% of what it had lost after the tsunami, a recovery that, if possible, is even more evident in the industrial production of consumer goods, which have already exceeded the levels prior to the tragedy in March. Along the same lines, machinery orders, which are a leading indicator of investment expenditure, reported growth in August. Similarly, the Tankan business sentiment index of Japan's central bank for large manufacturers also improved notably in the third quarter.

For their part, indicators for domestic demand also continue to confirm the recovery, albeit at a lower rate. Automobile sales in September reported a year-on-year rise that, although minimal, is the first since August 2010. Jumping on the bandwagon, August's retail sales showed a modest increase, as did consumer confidence in the third quarter

Industry continues to recover, followed by domestic demand, albeit more calmly.

JAPAN: THE RECOVERY HOLDS FIRM

Japan's monthly exports and industrial production



SOURCES: Japanese Ministry of Communications and own calculations.

Exports should contribute significantly to growth in the second half of the year.

which, in spite of its gains, is still at a very low level compared with its historical average.

In the real estate sector, construction continued to pick up in August, with the number of homes started recording its second month of strong increases. The number of properties sold in the Tokyo area also increased in September. Prices, however, continued to fall, failing to share in the sector's greater activity.

For its part, the foreign sector continued with its gradual improvement. September's trade deficit dropped to almost zero, according to customs figures, thanks to the progress made by exports. The foreign sector's positive contribution to growth in the third quarter should be significant as it is based on the exceptionally low level of the second quarter due to the halt in exports caused by the tsunami.

China: looking for a soft landing

The Chinese economy grew by 9.1% in the third quarter, a relatively robust pace that, although the slowest in the last two years, points to a soft landing for the Asian giant. The reasons for this slowdown lie in the sluggish recovery of the foreign sector, which is losing its relative importance for growth due to the lower demand of the world economy and a slowdown in investment.

China grows by 9.1% and expectations remain of a soft landing.

The risk that growth will lose a lot more pace is, however, limited. Firstly, China has great potential to increase its domestic demand. Although the ownership of mobile phones, television sets and domestic appliances is coming close to normal levels in urban areas, there's still a long way to go for goods such as automobiles. In the case of investment, the factors behind the slowdown may be limited. Investment's

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

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

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

slowdown in the third quarter is centred on infrastructures and construction. The former was hard hit by the enforced stoppage of construction of the high speed railway line for safety reasons, after the Wenzhou train accident last July. In the case of construction, although house prices are growing very slowly and the credit restrictions imposed to curtail inflation have left many construction firms with financial problems, the contingent of more than 300 million people in rural China ready to move to urban areas means that there is a pool of demand for the housing sector. The latest indicators for activity also indicate growth's resistance, with industrial production advancing 13.8% year-on-year in September and copper imports, which indicate the health of industry and manufacturing, picking up after falling for several months.

However, this slowdown in growth has led to a relaxation of the monetary restrictions whose aim was to contain inflation which, today, is the greatest risk for China's economy. Although September's CPI rose by 6.1% year-on-year, when in July this figure had reached 6.5%, a moderation in inflation is still far from being a reality. The CPI for food, which is China accounts for 50% of the total and has considerable social importance, continued to rise at the fast pace of 13.4%.

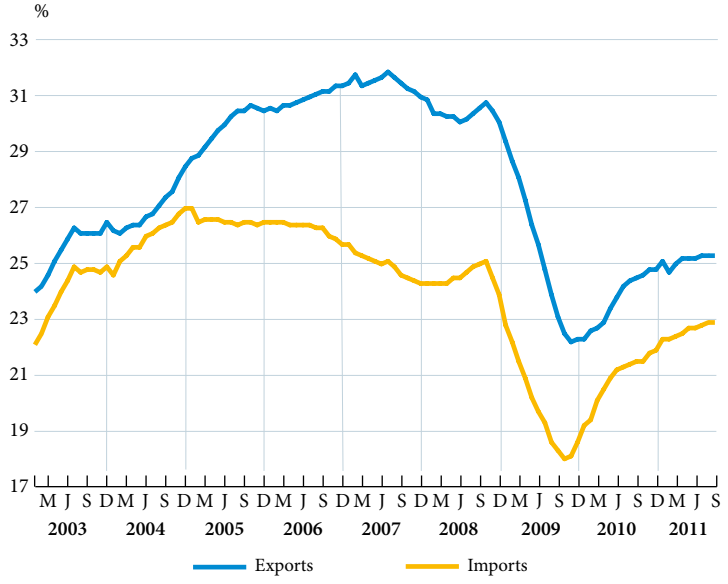
The CPI slows up to 6.1% but food inflation is still at a high 13.4%.

Price rises also affect labour costs, which in the medium term will erode the competitive advantage of cheap labour and will force China to redirect its economy towards greater domestic consumption and other, more sophisticated products. In this respect, the recovery of China's foreign sector after the trade crisis of 2009 has been quite a lot slower than expected. The slowdown in exports reduced September's trade surplus to 14.5 billion dollars, a figure that is not much more than half the average monthly balance for 2008. In fact, the foreign sector's contribution to growth is practically zero. Similarly, exports, which in 2007 had come to account for 31.9% of the economy as a whole, now account for 25.3%, a much sharper drop than imports, which in the same period of time have gone from 25.1% to 22.9%.

The trade surplus falls due to a decline in exports.

CHINA: EXPORTS AREN'T WHAT THEY USED TO BE

Relative weight of exports and imports to GDP over the last 12 months



SOURCES: China's Official Statistics Office, Economist Intelligence Unit and own calculations.

Brazil: growth is a priority

The tendency for Brazil's economy to slow up is consolidating.

While Brazil's central bank surprised many by lowering interest rates in September, with inflation exceeding 7.2%, few found it odd in October when it cut the official discount rate again by another fifty basis points, down to 11.5%. Certainly, the slowdown in the global recovery is accentuating the decelerating trend of Brazil's economy, to a certain extent justifying the sudden change in direction of its monetary policy. However, equally true is the fact that the high inflation rate should have warranted more caution, especially when there is no guarantee that the fiscal area will offset the expansionary tone of the monetary area.

Brazil's central bank prioritizes growth and reduces interest rates again, although inflation is still far from the target range.

Prices rises are starting to run out of steam but much less than expected. In September, inflation rose to 7.3%, a figure that arouses doubts regarding the real capacity of Brazil's authorities to return inflation to the target range before the end of the year, particularly within a context of lower interest rates and moderation in the real. Although there's no doubt they'll do all they can to appease the old threats (and this has been made clear by the recent 16% cut in the tax on imports and wholesale petrol sales, in another manoeuvre to contain prices), if the gap between inflation and its target takes too long to narrow, prioritizing growth might end up harming the central bank's credibility, increasing expectations and making it even more difficult for prices to ease.

Nonetheless, over the coming months both base effects and the slower rate of activity should play in its favour. Although the economic sentiment of Brazilians is still buoyant, encouraged by the healthy labour market, the latest macroeconomic indicators suggest that

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	–0.7	7.5	6.8	5.0	4.1	3.1	–	...	–
Industrial production	–7.3	10.5	8.1	3.6	2.6	0.6	1.0	1.0	–1.6
Consumer confidence (*)	138.3	159.7	161.4	159.9	161.8	155.4	152.9	152.7	154.1
Unemployment rate (**)	8.1	6.7	6.6	5.7	6.3	6.3	6.0	6.0	6.0
Consumer prices	4.9	5.0	4.6	5.6	6.1	6.6	6.9	7.2	7.3
Trade balance (***)	25.3	20.2	16.8	20.2	22.5	25.3	27.1	28.6	30.6
Interest rate SELIC (%)	9.92	10.00	10.75	10.75	11.75	12.25	12.50	12.50	12.00
Reales to dollar (*)	2.32	1.78	1.69	1.66	1.63	1.56	1.55	1.59	1.88

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.

the decelerating trend of the first half of the year might have sharpened in the third quarter and could remain in the fourth. In September, industrial production fell by 2% compared with August while retail sales provided a nasty surprise by falling 0.4% in August, also compared with the previous month. On the other hand, September's figures revealed a sharp drop both in production and car sales.

In spite of everything, our main scenario still sees a soft landing for Brazil's economy and, towards the end of 2011, the latest stimuli might even encourage activity to pick up slightly. The risks for this scenario are symmetrical. On the one hand, inflationary pressures might remain stronger than expected, which would indicate that the relaxation of monetary policy has been premature. On the other hand, the slowdown might get worse if the external environment and commodity prices shrink more than expected. In this case, Brazil's economy might need further stimuli, beyond cutting interest rates again.

Mexico: dependent on abroad

The global slowdown and financial turbulence reduce Mexico's rate of growth and the peso.

The turbulence in the financial markets and the slowdown in growth of the large advanced economies, and particularly the United States, have affected the good progress being made by the Mexican economy. The slowdown in activity to the north of the Río Grande is largely to blame for the expectation of lower growth in Mexico during what remains of 2011 and also in 2012. In its October communiqué, the central bank emphasized this expectation in order to present, by surprise, the possibility of an interest rate cut in December, if the economic situation so requires and the trend in the exchange rate allows such a move.

Nonetheless, the progressive recovery in domestic demand has provided a new, strong base for the Mexican economy that, to some extent, offsets the weaker exports. Similarly, and unlike some of its Latin American neighbours, Mexico has additional supports that allow it to handle the external volatility of the last few

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	–6.2	5.4	5.1	4.2	4.4	3.6	–	...	–
Industrial production	–7.3	6.0	6.5	4.7	4.9	3.8	3.9	1.8	...
Consumer confidence (*)	80.5	86.3	89.2	89.6	92.1	90.7	95.5	93.4	92.4
Leading business index (*)	110.5	116.6	117.2	118.0	119.9	120.7	121.9	121.4	...
Unemployment rate (**)	5.5	5.4	5.6	5.3	5.1	5.2	5.6	5.8	5.7
Consumer prices	5.0	3.9	3.7	4.2	3.5	3.3	3.5	3.4	3.1
Trade balance (***)	–4.7	–3.0	–2.0	–3.0	–1.5	0.0	–0.1	–0.2	–1.5
Official Banxico rate (%)	6.75	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	14.18	12.33	12.60	12.35	11.90	11.72	11.73	12.35	13.78

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

Banxico surprises by stating it might cut interest rates before the end of the year.

months with greater ease. To begin with, its commitment to monetary and fiscal orthodoxy has helped it maintain, this time, macroeconomic stability during the recession and, moreover, it has some leeway to introduce anticyclical policies if necessary. Similarly, it has limited exposure to what is today's main focus of external volatility, namely the euro area, as the main destination for its exports is the United States. On the other hand, its banking sector also provides a solid support, as it is solvent and has a comfortable liquidity position.

Certainly, available indicators reveal that Mexican banks are much more robust than average in Latin America, thanks to a relatively solid macroeconomic position and a regulatory system that underwent notable improvements after repeated financial crises some years ago. The default rate has fallen by more than 30% compared with the middle of 2009 and the ratio of reserves to doubtful loans is 180%. This solidity has meant that credit can be gradually increased (up 14% year-on-year in July), although the pre-crisis rate has yet to be reached. The bulk of the evidence available suggests that this trend will continue, as credit to the private sector is still much lower than the region's average (25% of GDP compared with 44% of GDP in Latin America).

Frontier markets: the emerging economies of the future?

The term «frontier markets» was introduced by the economist Farida Khambata in 1992 to construct a financial index for small economies that still lacked the features of the emerging economies but did have the potential to evolve towards this economic status. This index was bought in 1999 by Standard & Poor's (S&P), an organization that launched different indices based on the frontier economy concept. Since then, other similar products have appeared on the market and the category has become widespread among financial managers. Although the criteria to include a country within these indices vary, those made explicit by S&P can be considered as representative of this kind of product. S&P establishes that, in order for an economy to be included within the index, an initial quantitative selection will be combined with a subsequent qualitative element of assessment. Or, as stated by S&P itself: classifying countries (into different categories of indices, i.e. frontier, emerging or developed) is both art and science.

Given the absence of information on the artistic (or qualitative) part of this process, we shall focus on the scientific-quantitative part. According to S&P, a country can be considered as a potential frontier economy if it meets two out of the following three criteria: a) the country's stock market capitalization is over 2.5 billion dollars; b) the annual value traded is greater than 1 billion dollars, and c) the stock market capitalization is greater than 5% of the nominal GDP. In short, what S&P is looking for is a certain depth in the capital market. As far as possible, the aim is to avoid becoming trapped in situations of limited liquidity in countries with a high level of risk, both economic and political.

Having applied S&P's art and science, its reference index, the S&P Frontier BMI, is made up of 36 economies (at September 2011), including Argentina, Bangladesh, Nigeria and the Ukraine, to give an example of each of the continents represented (see the map below). From a conceptual point of view, these should be some of the future emerging economies. However, history might prove our conclusion wrong. If we analyze the trend in the index since 1995 we can see that only one country has gone from frontier to emerging economy status, Colombia (precisely in 2011). It's surprising that, in a 16-year period that has seen sweeping changes in the world economy, with the eruption of emerging powers such as China, India and Brazil and the completion of the transition from planned to market economies in Eastern Europe and Russia starting in 1989, only Colombia has managed to join the emerging category.

The essential problem is that, although the financial indices of frontier economies, such as the aforementioned index, are excellent investment instruments and surely vital to build global portfolios, they are not such good predictors of future economic growth. To do so we must focus our attention in another direction, that of the economic theory of growth.

As vast as it is, the literature dedicated by economists to the determining factors of growth in the long term might be summarized into a few fundamental factors that countries have to consolidate in order to advance in their economic development. In general terms, there is appreciable consensus that the fundamental conditions for economic growth affect five different areas: macroeconomic stability (avoiding excessive imbalances, especially the very harmful hyperinflation), macroeconomic conditions (including how open an economy's trade is and the rate of investment), human capital, technological capacity and political and institutional conditions (including regulatory aspects, development of the rule of law, etc.).

FRONTIER ECONOMIES

1. Argentina	7. Cyprus	13. Jordan	19. Lithuania	25. Panama	31. Trinidad and Tobago
2. Bahrain	8. Ecuador	14. Kazakhstan	20. Mauritius	26. Qatar	32. Tunisia
3. Bangladesh	9. Estonia	15. Kenya	21. Namibia	27. Romania	33. Ukraine
4. Botswana	10. Ghana	16. Kuwait	22. Nigeria	28. Slovakia	34. United Arab Emirates
5. Bulgaria	11. Ivory Coast	17. Latvia	23. Oman	29. Slovenia	35. Vietnam
6. Croatia	12. Jamaica	18. Lebanon	24. Pakistan	30. Sri Lanka	36. Zambia

NOTE: Frontier economies that make up the S&P Frontier BMI.
SOURCES: Standard & Poor's and own calculations.

In principle, and except for some tragic accidents that are not insignificant (as we are reminded by the analysis provided in the Box entitled «The economies that won't emerge» in this Monthly Report), a country should pass on to phases of relatively greater prosperity the better its situation in the spheres we have just mentioned. One useful analysis, by way of an overview, is the one drawn up by Goldman Sachs every year that provides Growth Environment Scores (GES).[1] Goldman Sachs specifies the aforementioned dimensions by selecting 13 macroeconomic and political variables. In principle, we should expect those countries that improve appreciably in this encapsulating measure to have a greater chance of accessing the next grade of development, for example from frontier to emerging economy.

Between 1997 and 2010, four countries accessed the status of emerging economy in one of the most renowned classifications in the market, the one provided by the weekly magazine, The Economist: namely Egypt, Morocco, Peru and Saudi Arabia. With the exception of Egypt, the other three economies clearly improved their GES ranking between 1997 and 2010, with Saudi Arabia rising 48 positions (out of 182 countries), Morocco 26, and Peru 24.

(1) See, for example, the first study of this area, Goldman Sachs (2005), How Solid are the BRICs, Global Economics Paper, 134, and the most recent, Goldman Sachs (2010), Our 2010 GES: The Links Between Growth Conditions, Growth and Markets, Global Economics Paper, 206.

Moving on from history to future prospects, a further two countries that are often mentioned as firm candidates to become emerging in the next few years are Vietnam and Kazakhstan. Once again, these are countries that have tended to progress in terms of the basic prerequisites for prosperity: between 1997 and 2010, Vietnam rose by 52 places in the list and Kazakhstan by 26. Nevertheless, we must ask ourselves whether there are also «false positives» in this rule that associates improvements in the GES and the chance to plausibly join the emerging category. Of course there are. However, once we have ruled out those countries that are already considered to be advanced or emerging, only a few remain, and these are mostly small in economic terms (Bulgaria, Bahrain, Lithuania or Estonia would enter into this category).

In short, S&P is right: correctly establishing which is going to be the next China or the next Brazil is an exercise that must combine art and science, or intuition and formalization. In any case, should we wish to make a choice with any analytical scrupulousness, it would be better to concentrate on those countries that demonstrate a capacity to improve in the area of stability and macroeconomic conditions, technological capacity, human capital and political conditions.

This box was prepared by Àlex Ruiz
International Unit, Research Department, "la Caixa"

Trends shift downwards, except oil

The price of crude fell slightly between 20 September and 20 October, down 2.3%, taking it to 108.60 dollars per barrel (Brent quality, for one-month deliveries), 17.3% above its level at the start of the year and 31.0% above its level a year ago. Although the month's total shows a drop we should note that the price of oil rose by 7.2% from 4 to 20 October.

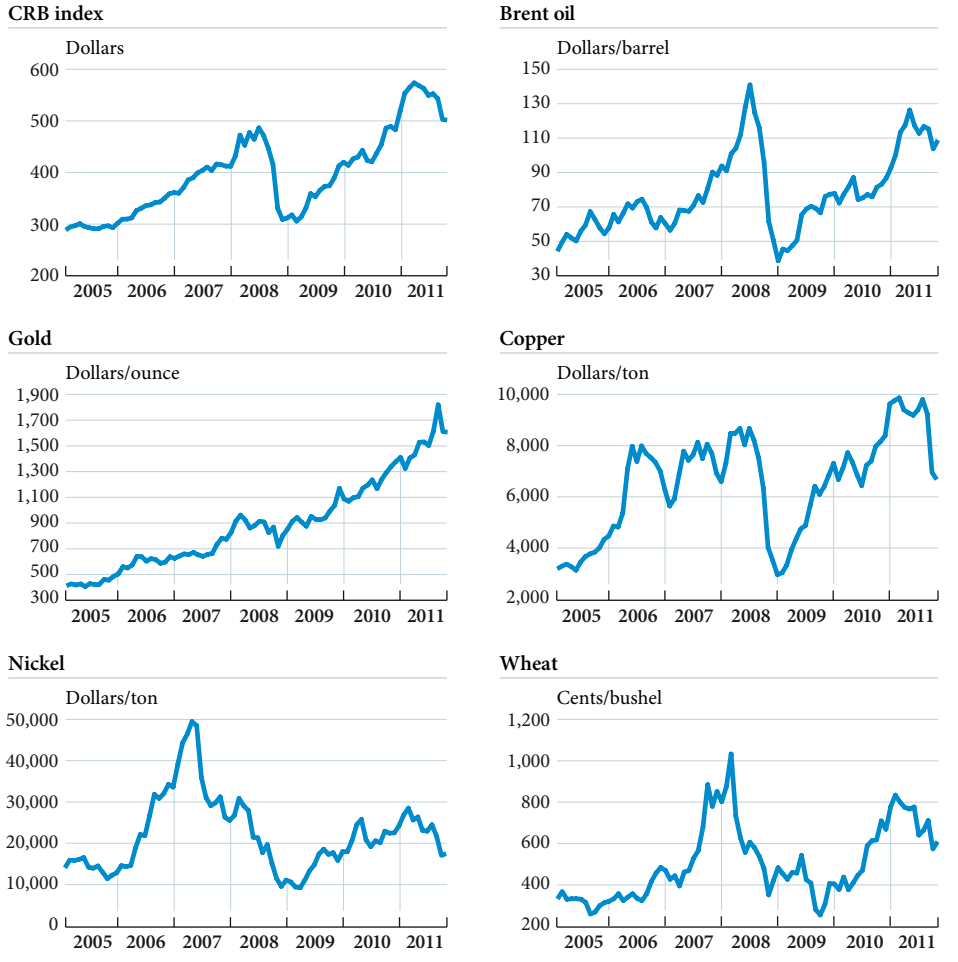
The fall in commodities is due to expectations of lower global growth. Added to the weak growth of advanced economies is the gentle slowdown of China, with the inherent expectation that the Asian giant will reduce its commodity purchases.

But these drops are unequal. While oil remained relatively firm, possibly helped by the uncertain situation in North Africa and the Middle East, the CRB commodity index fell by 4.4% between 20 September and 20 October. The worst hit were metals, more closely related to China's progress. Nickel lost 15.2%; aluminium, 9.8%, as its energy intensity was able to mitigate its fall; and copper, particularly affected by larger Chinese stocks than expected, was down 18.8%. There were also sharp falls in precious metals, with palladium and platinum losing 17.0% and 16.0%, respectively. Gold was no exception either, down 10.3%. The falls were less unanimous in the case of food, with decreases for wheat, barley and coffee but an increase for rice.

Oil falls to 108.6 dollars but avoids the losses of other commodities.

Metal prices are particularly hard hit due to the slowdown in China.

TREND IN VARIOUS COMMODITIES (*)



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

The economies that won't emerge

The globalization occurring over the last few decades has allowed many countries to access levels of growth and income that would have previously been unthinkable. The world economic-financial crisis, which has hit developed countries so hard, has hardly affected the progress being made by the group of emerging and developing countries and some have even accelerated their rate of growth. But there is another group of countries that won't join the emerging category for several generations and whose level of poverty and under-development are going to persist. These are low-income countries that lack the social and political mechanisms of an organized state and are often victims of repeated cycles of political and criminal violence, aggravating society's misery and failing structure. A recent study by the World Bank[1] stresses that, unlike natural disasters or economic cycles, one episode of violence

(1) World Bank. (2011), «World Development Report 2011: Conflict, Security and Development».

can erase a whole generation of economic progress. This is a problem that currently affects around 1.5 billion people and is reflected in many different ways: civil war (repeated at regular intervals in the same countries), high levels of violent criminality, links between politicians and delinquents, political violence, international ideological movements that join together against local discontent and possibly frustrated demands for change. None of the fragile or failed low-income states affected by conflict has achieved any of the «Millennium Development Goals» established by the United Nations (to eradicate extreme poverty and hunger, reduce infant mortality, universal primary education, combating AIDS, malaria and other diseases, etc.).

One way of identifying failed states is by using the ranking published by Foreign Policy, which in its latest edition analyzes 177 countries and classifies them according to 12 indicators such as the number of refugees or displaced persons, economic decline, delegitimization of the state, the human rights situation, security apparatus, etc. Most of the failed states are in Sub-Saharan Africa with Somalia topping the list, one of the poorest and most dangerous countries in the world where there is no effective political authority. Also of note is the poor situation in countries such as Chad, Sudan, Congo, Zimbabwe and the Central African Republic.

AFRICA, A FAILED CONTINENT

The top 25 countries on the failed states index

1. Somalia
2. Chad
3. Sudan
4. Democratic Republic of Congo
5. Haiti
6. Zimbabwe
7. Afghanistan
8. Central African Republic
9. Iraq
10. Ivory Coast
11. Guinea
12. Pakistan
13. Yemen
14. Nigeria
15. Niger
16. Kenya
17. Burundi
18. Burma
19. Guinea-Bissau
20. Ethiopia
21. Uganda
22. North Korea
23. East Timor
24. Cameroon
25. Bangladesh

SOURCES: Foreign Policy and Fund for Peace.

The Sub-Saharan region, which is highly fragmented politically, has hardly increased its per capita income in the last half century. Although some countries have grown notably in the last few years thanks to commodities, there are doubts regarding the sustainability of this growth and, in 30 years, their relative weight in the world's gross domestic product has gone from 3% to less than half. This trend contrasts radically with the one seen in southern Asia over the same period (excluding China), which has doubled its global economic weight and has multiplied its export share.

The latest challenge for the African continent lies in the north, in the so-called Arab revolutions occurring, with uneven results, in Tunisia, Egypt, Bahrain, Libya, Yemen and Syria. Another area of failed states can be found in the Middle East, particularly in Afghanistan, Pakistan and Iraq. Haiti, hit by the consequences of the earthquake early in 2010 and by its inability to put a credible political power in place, together with Burma, which has suffered from an interminable civil war, are the most outstanding failed states outside these two zones.

So how can these countries get back on the path of development? The crucial step is, of course, breaking the spiral of conflict or criminal violence. To this end they must overcome the stress factors that provoke such a trend, although it's not easy to distinguish between cause and effect. From an economic point of view, studies on this area point to low levels of income per capita initially being a clear cause of conflict. Youth unemployment is often cited as a reason for young people joining rebel movements or gangs. The existence of natural resources accentuates the risk of violence and control of these resources provides armed groups with the means to acquire weapons. Corruption has a lethal effect on institutions' ability to act, often being linked to illicit trafficking, money laundering and exploitation by selling off national resources or international contracts and licences. Other factors of a less economic nature can aggravate and intensify these risks, such as political exclusion and inequality among some regional, religious or ethnic groups, associated with a higher risk of civil war. And also external factors, such as climate change and increased competition for commodities.

Should these countries manage to put an end to conflict or their violent situation, the question is then whether they can get back on track in development terms. Europe's experiences of war might lead us to conclude that, when a war ends (either by a victory, defeat or truce), a period of reconstruction starts that generates rapid growth and recovery. Unfortunately, the experiences of the last few decades in most areas of conflict do not fit this model. On the contrary, many countries and subnational zones are suffering cycles of repeated violence and problems of governance and instability. Elections are often held once a conflict ends, contested by the very factions that have been fighting each other (no-one else has the necessary resources), in which the winning group takes over the institutions and changes their nature, resulting in the reorganization of an opposition that feels entitled to act violently, and so the cycle starts up again.

This is why institutions need to be strengthened in order to break this cycle. But such a transformation requires time and is no easy task. The World Bank points to the need to provide citizen security, justice and jobs as the only way to ensure lasting progress in social and economic development. In addition, of course, to facilitating the creation of infrastructures, especially for communications and a widespread electricity network. Without these conditions, private initiative and business investment cannot be expected to appear, the foundation of future economic development. External aid is relevant from the humanitarian point of view and to stabilize society but it does not seem to be related to the post-conflict economic outcome in any statistically significant way. In short, in addition to ending the vicious circle of conflict, exiting the spiral of a failed state requires good quality public

management and institutional strength that experience teaches us cannot be achieved in less than 15 years. Some have managed it: Bosnia and Herzegovina, Chile, Colombia, Ghana, Indonesia, Northern Ireland, Mozambique and South Africa have all managed to avoid escalating violence although they are still facing risks and challenges.

The world will go on turning in spite of the costs imposed on the developed and emerging economic system by the existence of failed states (piracy in the Horn of Africa, constant violence in the Middle East, drug trafficking on the American continent, instability in North Africa, etc.) but we cannot forget that a quarter of humanity still has no hope of a better economic future.

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

EUROPEAN UNION

The euro area approves a comprehensive anti-crisis plan

The euro area approves a comprehensive plan to tackle the sovereign debt crisis.

In the last 21 months there have been thirteen European summits in which, one way or another, how to handle the sovereign debt crisis has been on the agenda. But at the last summit, held on 22 and 23 October, an important step forward was taken to resolving this crisis. At last, European leaders decided to find a solution to those aspects causing uncertainty regarding the sustainability of the public debt of the so-called peripheral countries.

The write-down of Greek public debt is increased.

The first item on the agenda was the approval of the new bail-out plan for Greece. After the troika's favourable report, the Euro group approved the payment of the eighth tranche of aid for Greece. Moreover, the conditions were defined for the new bail-out plan and, particularly, the write-down of the public debt that can be accessed, voluntarily, by the private sector. In principle, this was going to be 21% but has been increased to 50% given the significant deterioration in Greece's economy over the last few months.

Other fundamental issues are bank recapitalization and making the European Financial Stability Fund more flexible.

The second item on the agenda was the recapitalization of Europe's banking sector. Although the banks on the old continent had passed the stress tests carried out in spring, and with flying colours, the sector was required to toughen up its capital ratios. Although the uncertainty regarding that banks' solvency lies in the sustainability of public debt, it is argued that this increase is essential to dispel the uncertainty surrounding the sector and thereby reopen wholesale financing markets. What is true is that, for the moment, this situation is also making credit terms tougher. A fact that, should it continue, might end up weakening the economic recovery.

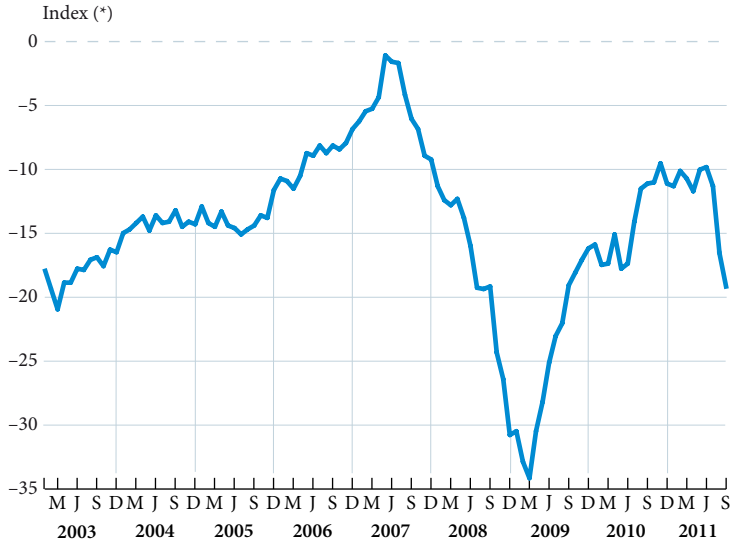
The third item on the agenda concerned the flexibilization of the European Financial Stability Fund. Its lending capacity, currently at 440 billion euros, is not enough to be able to finance the bail-out schemes for Greece, Ireland and Portugal, to help recapitalize Europe's banks and to convince investors that, if necessary, it could guarantee financing for other countries in their sights, such as Belgium, Italy or Spain. To this end, the Economic and Finance ministers of the Euro group are studying different ways to extend its capacity to act without it losing its maximum credit capacity and without the two main countries of the euro area, France and Germany, having to provide additional guarantees. Not an easy undertaking but one to which they seem to be dedicating all their efforts.

Last, but by no means least, was the debate on the best way to improve economic and fiscal integration. An element that, on repeated occasions, the German chancellor, A. Merkel, and the president of France, N. Sarkozy, have said must accompany the different emergency measures being taken.

The leaders of the euro area therefore took advantage of this opportunity to

CONSUMER CONFIDENCE FALLS

Consumer confidence indicator



NOTE: (*) Arithmetic average of respondents' answers.
SOURCE: European Commission.

effectively turn around the sovereign debt crisis. Many details have yet to be specified regarding the measures announced but it's a good sign that they have decided to tackle these issues.

It's vital to firm up these details over the coming months in order to curb the decline in economic activity. In general, all indicators, both of supply and demand, have initiated a marked downward slide recently. This is basically due to the uncertainty generated to date by the absence of credible measures to put a stop to the sovereign debt crisis.

Regarding demand, for example, the speed with which consumer confidence is falling is surprising. As can be seen in the above graph, after remaining stable for one year at levels similar to its historical average, it started to fall sharply in July this year and, for the moment, does not seem to have touched bottom. The data for retail and consumer goods aren't encouraging either and, with a 0.3% drop month-on-month in August, they are confirming a trend that is clearly downward.

The deterioration in the economic outlook reduces consumer confidence.

This bad news might be offset by the solid performance of industrial production in August, reporting growth of 5.3% year-on-year, although several leading indicators point to economic activity falling in the future. Firstly, the Purchasing Managers' Index (PMI) has fallen below the level of 50 points, a level that indicates widespread shrinkage. On the other hand, the results of business confidence surveys are also negative, as can be seen in the graph below.

This is partly due to the simultaneous slowdown in growth of the countries receiving European exports. In addition, the fact that companies are finding it more difficult to secure financing has also harmed the confidence of entrepreneurs.

Business indicators point to less dynamism over the coming months...

...partly due to the slowdown in the world economy and to firms' difficulties in securing financing.

And added to the weakening of the foundations of the European house are the leaks of inflation. The harmonized index of consumer prices (HICP) for September stood at 3.0%, half a point above the figure for August. A breakdown shows that the most inflationary items were fuels and oils, electricity and tobacco.

Two aspects of these figures need to be pointed out. Firstly, one element that affects all countries is the inertia of passing one energy prices to end goods. Energy prices rose by 12.4% year-on-year in September, compared with 11.8% in the same period a year ago. The second factor is Italy, whose harmonized inflation in September rose from 2.3% to 3.6%. Two factors, apart from the aforementioned, help to explain this rise: the hike in value added tax from 20% to 21% and the methodological change introduced by Eurostat which several countries, including Italy, have applied since January 2011 to estimate inflation of seasonal goods. Other countries joining this new calculation methodology is making the HICP more volatile.

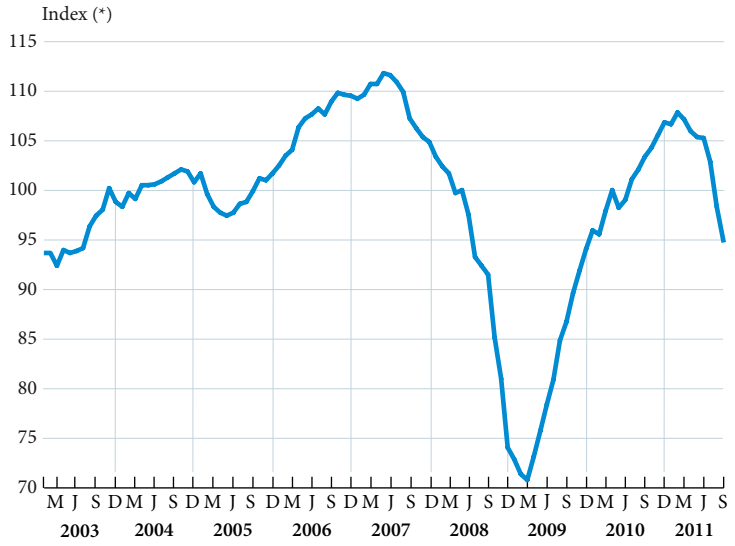
The inertia of passing on energy prices to end goods and methodological changes in the calculation increase inflation in the euro area.

In spite of this upswing, over the coming months the weakness in economic activity and the neutralization of the seasonal effect in September support the idea that inflation should ease off.

In summary, leading macroeconomic indicators point to economic activity remaining weak in the fourth quarter. The caution being shown by consumers and business people, the bad figures from the labour market and a foreign sector that is slowing up suggest that growth at the end of this year will be positive but very modest.

BUSINESS CONFIDENCE DETERIORATES

Economic sentiment indicator



NOTE: (*) Arithmetic average of respondents' answers.
SOURCE: European Commission.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011				
			3Q	4Q	1Q	2Q	July	August	September
GDP	–4.2	1.7	2.1	1.9	2.4	1.6	–	...	–
Retail sales	–2.5	0.8	1.5	0.6	0.1	–0.5	–0.4	–1.0	...
Consumer confidence (1)	–24.8	–14.0	–12.1	–10.4	–10.6	–10.4	–11.2	–16.5	–19.1
Industrial production	–14.7	7.5	7.1	8.1	6.5	4.2	4.4	5.3	...
Economic sentiment indicator (1)	80.7	100.9	102.3	105.7	107.4	105.7	103.0	98.4	95.0
Unemployment rate (2)	9.5	10.1	10.1	10.1	10.0	10.0	10.0	10.0	...
Consumer prices	0.3	1.6	1.7	2.0	2.5	2.8	2.5	2.5	3.0
Trade balance (3)	10.7	4.6	8.2	4.6	–10.2	–16.5	–20.4	–18.7	...
3-month Euribor interest rate	1.2	0.8	0.9	1.0	1.1	1.4	1.6	1.6	1.5
Nominal effective euro exchange rate (4)	111.7	104.7	102.3	104.4	103.7	106.4	105.2	104.9	103.8

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.

Growth prospects ease back for the German economy

After the sudden halt in the second quarter, economic activity revived somewhat in the summer. However, leading indicators have continued to get worse over the last few months, reflecting the slowdown of the global economy, which the second exporting country in the world can't manage to get out of.

In the third quarter, consumption showed a moderate tone, supported by job creation and the increase in the purchasing power of wages. In September, real retail sales without automobiles grew by 0.3% compared with the same month the year before. For their part, passenger car registrations rose by 11.6% in the third quarter in year-on-year terms. However, consumer confidence continued to fall in October, although it was above its long-term average. This was helped by the rise in year-on-year inflation to 2.6% in September, due mostly to energy prices. However, the inflation trend will be downwards.

The weakness in economic activity continues in the fourth quarter.

For its part, investment continues to grow. The industrial production of capital equipment increased by 15.4% in the last twelve months up to August. However, the decline in business economic sentiment, affected by the financial upsets, points to a slowdown in the next period.

The world's second exporter cannot escape from the global slowdown.

The foreign sector may also contribute to growth in the German economy. In August exports livened up and rose by 3.5% compared with the previous month, seasonally adjusted and corrected for calendar effects, and by 14.6% compared with a year earlier. On the other hand, imports remained at a standstill compared with the preceding month and rose 12.6% year-on-year. Thanks to the trade surplus, the current account posted a positive 7 billion euros, 23% more than in August 2010. However, the outlook of a

German consumer confidence weakens but stands appreciably above its normal level.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011				
			3Q	4Q	1Q	2Q	July	August	September
GDP	–5.1	3.6	4.0	3.8	4.6	2.8	–	...	–
Retail sales	–3.2	1.5	2.6	1.2	0.8	2.4	1.3	–0.8	0.3
Industrial production	–15.4	10.1	10.2	11.7	12.8	8.0	10.4	7.9	...
Industrial activity index (IFO) (*)	90.7	107.8	111.1	113.4	114.7	114.2	112.8	108.6	107.4
Unemployment rate (**)	7.8	7.0	6.9	6.6	6.3	6.0	5.9	5.9	...
Consumer prices	0.4	1.1	1.2	1.5	2.1	2.3	2.4	2.4	2.6
Trade balance (***)	138.7	154.5	155.9	154.5	157.5	158.3	155.3	157.9	...

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.

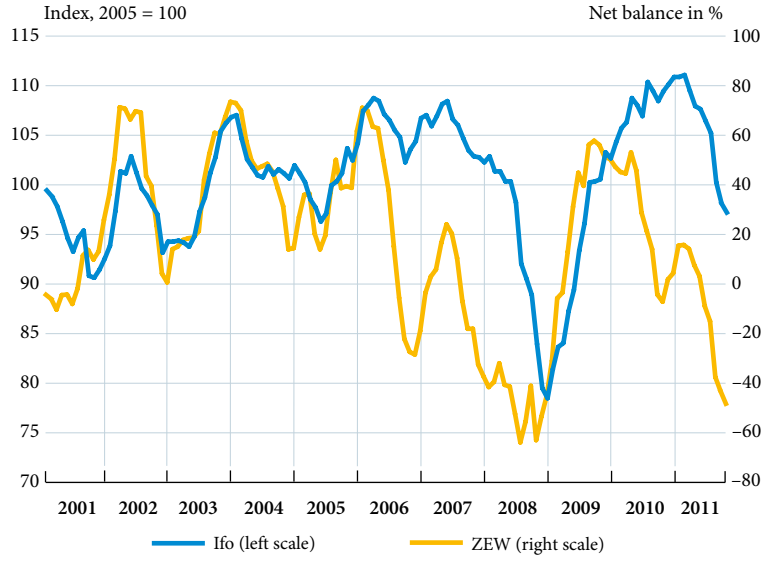
German industry is strong but tending to run out of steam.

slowdown in international trade suggests that exports will contribute less to GDP in the coming quarters.

The first thing we notice from the point of view of supply is the strength of industry. In the period July-August, secondary sector production increased by 3.1% compared to the previous two-month period. However, industrial orders fell in September. Although these were at a high level and the upward trend continues, a loss of steam could be observed. Construction also made progress. Its production rose by 1.4% in the core months of the summer

PROSPECTS WORSEN IN GERMANY

Components of expectations of business opinion indices



SOURCES: Ifo Institut, Zentrum für Europäische Wirtschaftsforschung and own calculations.

compared to the previous two months, although sector confidence fell slightly in September. Some branches of the services sector did not perform so well. In hotels and restaurants, the number of businesses posted a month-on-month rise in August of 1.5%, after 0.5% in July in real terms and adjusted for seasonal and calendar effects.

Within this context, in its predictions for autumn the German government increased its growth forecast for 2011 to 2.9%, 3 tenths of a percentage point higher than April's forecasts. However, it cut back its forecast for 2012 by 8 tenths of a percentage point to 1%, indicating the greater risks of the international situation, particularly those caused by the sovereign debt crisis in the periphery of the euro area. Nonetheless, Germany is expected to go on being the engine of Europe, although it will probably run a bit more slowly.

The German government cuts back its 2012 growth forecast to 1%.

The near future of the French economy darkens

The effect of budgetary restrictions, rising commodity prices in the first few months of the year, the consequent slowdown in exports and the financial turbulence led to a sharp halt in activity in the second quarter and brought GDP to a standstill. A slight upswing is likely in the third quarter. However, leading indicators have continued to get worse, reflecting the deteriorating outlook for the coming quarters. Although we have maintained our forecast of a 1.7% rise in GDP in 2011, there is the risk of a slight reduction in the last quarter of the year.

Private consumption fell appreciably in the second quarter, affected by special factors such as the withdrawal of subsidies for vehicle purchases. However, in the third quarter new passenger car registrations rose by 2.7% compared with the previous quarter, seasonally adjusted. The improvement in household purchasing power and job creation are boosting consumption. In this respect, the government's labour policy has helped to bring supply and demand together, particularly in some professions and jobs with vacancies. However, the unemployment rate grew slightly in August to 9.9% and the outlook for the labour market is relatively unfavourable. This has helped to weaken consumer confidence.

Activity will probably speed up in France in the third quarter, followed by a further stoppage in the fourth.

With regard to investment, although in September the degree of production

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011				
			3Q	4Q	1Q	2Q	July	August	September
GDP	–2.6	1.4	1.6	1.4	2.2	1.7	–	...	–
Domestic consumption	–0.4	1.7	2.7	0.9	3.5	1.1	–1.3	0.2	–1.4
Industrial production	–12.4	5.2	4.2	4.5	4.7	2.1	3.7	4.4	...
Unemployment rate (*)	9.5	9.8	9.8	9.7	9.7	9.7	9.8	9.9	9.9
Consumer prices	0.1	1.5	1.5	1.7	1.8	2.1	1.9	2.2	2.2
Trade balance (**)	–44.8	–51.5	–51.2	–51.5	–59.2	–64.2	–67.2	–66.8	...

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

The risk premium for France's long-term sovereign debt hits a new high in October.

capacity utilization rose a little and returned to July's level, the deteriorating economic climate and greater uncertainty point to this moderating. In August, industrial production of capital equipment increased by 1.0% compared with July, which represents a slowdown.

With regard to the foreign sector, in August the trade deficit fell to nearly 5 billion euros after recording 6.4 billion in July, thanks especially to aeronautical and aerospace exports. Exports over the last three months up to August rose by 2.9% compared with the previous quarter and by 5.7% compared with the same period twelve months before. For their part, imports grew less in June-August than in the previous quarter, up by 0.1%, but rose by 8.6% compared with the same period a year ago. The current account deficit fell in August to 2.9 billion euros, basically due to the improved trade balance. Consequently, the foreign sector might make a small positive contribution in the third quarter but this is unlikely to continue.

Credit flows slightly to French firms.

Looking at supply, it can be seen that industrial production expanded by 0.5% in August compared with July, representing a slowdown as quarter-on-quarter growth for the June-August period was 3.5%. The outlook for the secondary sector in the short term is not very positive, as the industrial order portfolio is shrinking a little, although it was above its historical average in September. With regard to the services sector, in July overnight hotel stays rose considerably, both due to domestic and foreign demand and in spite of adverse weather. However, confidence in the tertiary sector fell in September. In construction, the number of new building permits rose by 15.4% in August compared with the same month in 2010 and, although confidence in the sector fell in September, this remained above the long-term average.

On the other hand, and within a context of the peripheral debt crisis in the euro area, the risk premium of French long-term debt set a new record high since the euro was launched of 125 basis points compared with similar ten-year German bonds on 24 October. This occurred days after the agency Moody's warned that it might alter the outlook of its AAA rating for French public debt from stable to negative if the costs of a plan to resolve Europe's sovereign debt crisis placed too much pressure on the country's finances. Similarly, in the summer the French stock market was hit hard, affected by the sharp drop in share prices of its main banks, Société Générale, Crédit Agricole and BNP Paribas, due to their exposure to the debt of the peripheral countries in the euro area, although they had easily passed July's stress tests. There is therefore the risk of possible credit restrictions that might slow up demand even further.

However, the figures available up to August show that credit continued to flow slightly to non-financial firms, with a year-on-year increase of 4.5%. The bank survey of the third quarter revealed merely a slight toughening up of financing terms for the private sector, with an increase in overall costs. At the same time, it also showed a decrease in demand for housing credit.

The French government predicts that public debt will start to fall as from 2013.

Given this situation, when it presented its 2012 state budgets at the end of the September, the French government repeated that its priority was to control public debt by reducing the public deficit to 4.5% of GDP and to 3.0% in 2013. Consequently, its public debt would fall to 87.3% of GDP in that year, after the 87.4% planned for 2012. To this end, it

especially plans to cut structural public spending with an appreciable reduction in the number of civil servants and a cut in tax benefits, among other measures.

Economic activity flags in Italy

The revival in the Italian economy noted in the second quarter seems to have stopped in the third. The intensification of the sovereign debt crisis in the periphery of the euro area, falling stock markets, the slowdown in the world economy and new restrictive budgetary measures meant that economic sentiment continued to deteriorate, falling to significantly below the historical average in September. Consequently, GDP may stagnate or even fall slightly in the second half of the year. Its growth for 2011 as a whole would therefore stand at a meagre 0.7%. Growth will probably be even less in 2012 and we can't rule out a period of recession.

Consumption is weakening, affected by wages' loss of purchasing power. Real retail sales were down 0.1% month-on-month in July, seasonally adjusted, while vehicle registrations fell by 5.7% in September compared with the same month a year before. Consumer confidence fell in September for the fourth consecutive month, standing considerably below its average, influenced by the upswing in inflation and the unfavourable outlook for the labour market. The year-on-year inflation rate in September increased by 2 tenths of a percentage point to 3.0%. The hike in the general value added tax (VAT) from 20% to 21% at the start of the month contributed to this rise, which will probably continue in October.

Investment looks sluggish given the lethargy in demand and increasing uncertainty. The foreign sector continues to drive activity but only in a limited way due to the competitiveness problems afflicting the Italian economy. Over the last three months up to August, exports of goods rose by 0.1% compared to the previous quarter, while the corresponding rate for imports was –3.2%.

The situation is similar from the point of view of supply. Industrial production increased a moderate 0.7% in June-August compared with the three previous months. The production of construction fell by 1.2% in July

The Italian economy is saved by exports in the second quarter.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011				
			3Q	4Q	1Q	2Q	July	August	September
GDP	–5.2	1.2	1.4	1.5	1.0	0.8	–	...	–
Retail sales	–1.7	0.0	0.6	0.1	–0.3	–0.3	–1.2	...	...
Industrial production	–18.7	6.5	7.5	5.3	2.3	2.2	–0.7	3.8	...
Unemployment rate (*)	7.8	8.4	8.3	8.3	8.1	8.0	8.0	7.9	...
Consumer prices	0.8	1.5	1.6	1.7	2.3	2.6	2.7	2.8	3.0
Trade balance (**)	–5.9	–29.3	–22.5	–29.3	–34.9	–36.0	–36.2	–35.8	...

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

United Kingdom: the risks of economic stagnation increase.

compared to the previous month. With regard to future prospects, confidence was down in all large sectors in September, in all cases falling below the normal level.

In spite of this situation, in September the central government's accounts continued to perform well. In the fourth week of September, the Italian government reaffirmed its aim to balance its budget by 2013 and restructured its macroeconomic plan after approving the latest adjustment measures. With this, the official forecast of GDP growth was revised downwards to 0.7% in 2011 and to 0.6% in 2012. However, pressure from financial markets hardly eased, within the context of contagion of the Greek crisis and concerned about the high level of Italian debt, which would end 2011 at 120% of GDP according to government projections.

The risk premium of long-term sovereign debt reached its highest level since the single European currency started, namely 402 basis points on 22 September, two days after the agency Standard & Poor's had downgraded Italy's sovereign debt rating. On 4 October, the specialized agency Moody's also cut back Italy's long-term sovereign debt rating to A2, with a negative outlook due to the risk of a further deterioration in investor confidence in Italy and in the euro area. At the end of the fourth week of October, the differential with German ten-year bonds was 382 basis points, 50 basis points more than Spain's debt.

The United Kingdom injects steroids into the economy

Economic activity in the United Kingdom has been slowing up since the start of the year and leading indicators point to this trend continuing in the coming quarters. Of note among the demand indicators is the lethargy in retail sales, whose August figure indicates year-on-year growth of 0.1%. There are two reasons for consumer caution. Firstly, the unemployment rate has risen to 5% of

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011				
			3Q	4Q	1Q	2Q	July	August	September
GDP	–4.9	1.4	2.6	1.3	1.6	0.6	–	...	–
Retail sales	1.0	0.4	0.6	0.0	2.2	1.0	0.2	0.1	...
Industrial production	–10.1	2.2	3.1	3.3	1.9	–0.8	–0.7	...	...
Unemployment rate (1)	4.7	4.7	4.6	4.5	4.5	4.7	4.9	4.9	5.0
Consumer prices	2.1	3.3	3.1	3.4	4.2	4.4	4.5	4.5	5.2
Trade balance (2)	–82.4	–96.4	–91.1	–96.1	–98.1	–98.5	–99.2	–98.7	...
3-month Libor interest rate (3)	1.2	0.7	0.7	0.7	0.8	0.8	0.8	0.9	0.9
Nominal effective pound exchange rate (4)	73.9	80.4	81.4	79.3	78.4	78.6	77.1	78.6	78.2

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.

the labour force, half a percentage point higher than the level at the beginning of the year. Secondly, the average income of British households, excluding wage bonuses, have grown at an average rate of 1.7% year-on-year for the last two years, while inflation has been 3.7% on average during the same period. In other words, the real disposable income of households is tending to deteriorate.

This effect has become even greater over the last few months; specifically, inflation reached 5.2% year-on-year in September, although it's true that we are very close to the highest levels it will reach this year. The main reason for this increase in September is the inertia in passing on higher oil prices to electricity and gas bills paid by consumers. However, this effect will gradually reduce over the coming months, together with the progressive disappearance of other factors that have also pushed up inflation, such as the hike in value added tax and in other duties and taxes. Moreover, activity remaining weak will also help to contain inflationary pressures.

From the perspective of supply, companies have to face weak demand and tougher credit terms. Official statistics show how, since the start of this year, the outstanding balance of loans granted to non-financial firms in the United Kingdom has fallen by 3.2 billion pounds sterling. This represents a 3.3% reduction of credit year-on-year. For this reason, the Finance Minister of the United Kingdom, George Osborne, has announced a new plan for granting lines of credit to firms. The details of the plan will be published in November, although the following elements are already known: firstly, it will consist of buying bonds issued by large firms to reduce their financing costs. In a subsequent phase, the Treasury will encourage the granting of bank loans to SMEs by promising to purchase these securitized loans.

In terms of economic policy, the Treasury has a good ally as the central bank has not been left behind and, for its part, the Monetary Policy Committee of the Bank of England decided unanimously among its nine members to increase the asset purchase programme by 75 billion pounds sterling. This reinforcement of non-standard monetary policy aims to acquire public debt. The Bank of England justified its decision by stressing the risk of the economic slowdown becoming worse. And the elements it mentions are: the lower disposable income of households, the weakness in world growth and fiscal consolidation. Factors that are undoubtedly reflected by economic indicators and which must be tackled by the important measures announced.

For this reason, the central bank is increasing its programme to purchase financial assets.

Emerging Europe: temporary weakness, underlying resistance

The economic situation in emerging Europe has two problematic aspects that are attracting public attention. Firstly, the loss of pace in economic activity which started in the second quarter and is showing no signs of easing. This is a process whose origin lies in the cooling off of fundamental markets for the region's economies, in particular the euro area. In this respect, the deteriorating prospects afflicting the single currency zone at present, and which may lead to the economic growth expected for 2012 being revised downwards over the coming months, adds uncertainty to this situation.

A second focus of attention is related to the impact of Europe's financial crisis on the region's countries. Although it would

The extent of the economic slowdown and financial repercussions of the debt crisis are causes for concern in emerging Europe.

Hungary and Romania, the most affected by financial tensions.

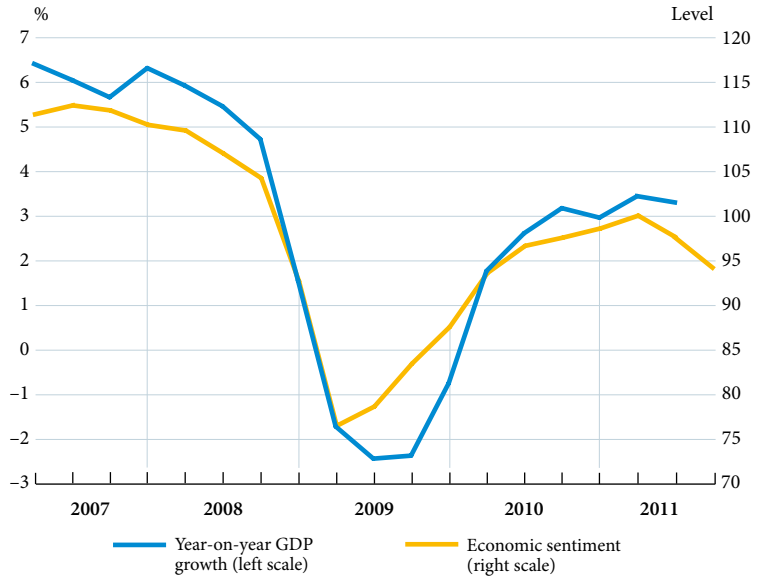
be unwarranted to talk of widespread contagion, what is true is that, since August, country risk indicators have deteriorated in the five economies (Poland, Hungary, the Czech Republic, Slovakia and Romania) we usually look at in this report. However, the current country risk levels are only notably high in the case of Hungary and Romania. These are two markets where the increased risk is fully justified.

Hungary is adopting an economic policy approach that is far from orthodox and not always entirely appropriate in the area of public communication. For example, the decision to allow mortgages in foreign currencies to be paid off early at a non-market exchange rate has been understood as a measure that excessively penalizes banks (according to our calculations, it could potentially involve a bank loss equivalent to 1.5% of private credit). At a time when growth is weakening, it does not seem appropriate to further affect the credit channel. This decision which, as we mentioned, is in addition to other, equally controversial decisions, is affecting the country's confidence. Romania, for its part, has significant commercial and financial links with Greece. This justifies an increase in country risk, while uncertainty regarding the Greek crisis does not disappear and the effects on Romania can be evaluated relatively accurately.

In short, the doubts regarding the economic cycle and financial repercussions of the sovereign debt crisis have led to fears in certain circles of a hypothetical relapse in the dramatic situation that affected the region in 2008 and part of 2009. In our opinion, this assessment has little justification. First of all, the global activity figures seem to rule out the probability of the most

EVIDENT PROSPECTS OF MODERATION IN ACTIVITY ON THE HORIZON

Indicator of economic sentiment and real GDP (*)



NOTES: (*) Weighted average for Poland, Hungary, the Czech Republic, Slovakia and Romania.
SOURCES: Eurostat, European Commission, Thomson Reuters Datastream and own calculations.

extreme scenarios, namely those of a double dip recession, emerging in the coming quarters. By itself, this is a huge contrast with the recessive situation that assailed Europe and other advanced economies in 2008.

But the differences are not limited to the external environment. The region's fundamentals are clearly more solid than they were in 2008. It should be noted that the Great Recession was reached in a very mature of the cycle, with most of the economies in emerging Europe accumulating imbalances in terms of private debt, inflationary pressures and balance of payments. There has been notable adjustment on these three fronts over the last few years, particularly in countries such as Romania and Hungary which, in their day, had to resort to loans from the International Monetary Fund and other multilateral institutions to resolve their external financing problems.

The strategy followed by the region's countries has been to provide themselves with greater independence and leeway in the area of economic policy to be able to handle negative economic shocks such as the one occurring now. This adjustment has focused on two issues in particular: reducing the public imbalance and cutting external borrowing.

In the area of fiscal adjustment, and although these countries have quite contained levels of public debt (with the exception of Hungary, whose public debt was equal to approximately 80% of GDP in 2010), it can be noted that, with different strategies, the five economies will probably see their public deficit in 2011 reach the area of 3%-4% of GDP (with the exception of Romania, which will remain above this threshold). On average, this is around two percentage points better than their position in 2008.

With regard to the balance of payments situation, the turnaround has also been notable as the region as a whole has gone from a current deficit equivalent to 7% of GDP in 2007 to one 3% lower in 2010. Here it's worth noting the exemplary case of Romania which, after having recorded in 2007 a current deficit of 14% of GDP, will end this year with a payment deficit in the area of 4% of GDP. In addition to this lower external borrowing there is also a buffer of international reserves that is appreciably larger than the one available in 2008 in the five countries.

All this means that we expect the economic deterioration, which is probably inevitable, will not be exceptional in scope, unlike the decline occurring three years ago. The most plausible situation is that the region as a whole will go through a temporary phase of low growth during this last part of 2011 and the first half of 2012, afterwards picking up speed in the final stages of next year.

Doubts increase regarding whether emerging Europe will avoid a similar slump to 2008...

...but we don't believe Europe is likely to go through a widespread double dip recession...

...nor do we think the situation in emerging Europe is the same, as the imbalances present in 2007-2008 have been extensively corrected.

The Mediterranean, a bridge or a boundary for economic development?

The word «trade» has historically been associated with the word «Mediterranean». This was the bridge through which, for centuries, the world's leading economic powers exchanged all kinds of goods. Today, the word «trade» is associated with China, Japan, Germany, Brazil, Asia and Eastern Europe but is rarely associated with the Mediterranean Sea. In fact, only 2% of the world's trade takes place between the countries of the European Union and those of the southern coast of the *Mare Nostrum*. The Mediterranean sometimes seems to be a boundary dividing the rich countries of the European Union from the developing countries located on its southern shores. But is this true?

The socio-economic situation of the EU countries is well-known but that of their neighbours is perhaps not so familiar.[1] A brief review of the main macroeconomic figures helps us to position these countries with respect to the main developing economic areas. As can be seen in the table below, the population of the developing Mediterranean countries totals 201 million. Quite a significant size; similar to that of all the countries in Eastern Europe. Their GDP per capita, 7,532 dollars per inhabitant, is slightly higher than that of the emerging Asian countries, although notably lower than in Latin America and Eastern Europe. One of the surprising aspects is that their growth has not been much lower than that of the other large emerging areas. In fact, it's slightly higher than that of Latin America and Eastern Europe. However, the IMF believes that their growth potential in the medium/long term is somewhat lower.

DEVELOPING MEDITERRANEAN COUNTRIES, A MARKET IN EXPANSION

	Population 2010 (millions)	GDP per capita 2010 ($)	Growth (1995-2010)	Growth (2011-2016)
	Millions	Dollars	Annual change	Annual change
Eastern Europe and Central[1]	175.5	14,572	3.9	3.7
Latin America[2]	329.4	11,666	3.6	4.7
Emerging Asia[3]	3,044.0	6,084	7.6	8.3
Mediterranean[4]	201.4	7,532	4.1	2.8

NOTES: (1) Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Montenegro, Poland, Romania, Serbia and Turkey.
(2) Argentina, Brazil, Chile, Colombia, Peru and Uruguay.
(3) China, Philippines, India, Indonesia, Malaysia, Thailand and Vietnam.
(4) Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Syria and Tunisia.
SOURCES: International Monetary Fund and own calculations.

Given these figures, one might think that there should be substantial capacity for growth in trade between the different countries around the Mediterranean. Numerous projects and programmes have shaped relations between the developed countries of the northern coast of the Mediterranean with their neighbours to the south. In this respect, the 1995 Barcelona Conference, bringing together Foreign Office ministers from the EU countries and the rest of the countries around the Mediterranean, was a turning point. All expressed their readiness to create an area of common prosperity in the Mediterranean and acknowledged that this would require a greater

(1) The following are considered to be developing Mediterranean countries: Morocco, Algeria, Tunisia, Libya, Egypt, Israel, Palestine, Lebanon, Jordan and Syria.

degree of integration and cooperation. One of the key policies agreed in the Barcelona Declaration was the gradual creation of a free trade area between all signatory countries.

The process has been slow but, today, all developing Mediterranean countries have now signed bilateral trade agreements with the European Union. But realizing that the economic and governance reforms had not been enough to attract the private investment required to improve the region's standard of living, in 2008 the Secretariat of the Union for the Mediterranean was set up. In addition to furthering free trade agreements, this initiative also aims to identify, coordinate and promote regional and transnational projects in areas such as energy, the environment and education.

In spite of such institutional efforts, the growth capacity of Mediterranean trade has yet to get going. In fact, a Report by the Center for Social and Economic Research that analyzes different studies on the growth capacity for this region's trade concludes that, at present, this is quite limited.(2) An article by Juan M. Ruiz and Josep M. Vilarrubia goes further and offers a surprising result.(3) According to the authors, while the developing Mediterranean countries' level of exports to EU countries is close to its potential or, in some cases, slightly over-exploited, the margin for these countries to increase their exports to the United States is wide.

For a better insight into the factors that are still eroding growth potential among Mediterranean countries, an extensive survey was developed for firms trading with these countries. This survey shows that, in spite of the efforts made to further free trade agreements, most companies in the European Union were not aware of them and also believed they could not benefit from them. On the other hand, entrepreneurs in developing countries are aware of these agreements. In any case, most believe that the European Union could do more to promote economic integration in the Mediterranean region. To this end, they believe that the process of trade liberalization needs to be completed, getting rid of other, non-duty barriers to trade and improving legal security and the ease of doing business in the region.

The conclusions of the Mediterranean Week of Economic Leaders last year, one of the main events to reflect on and integrate the different Mediterranean countries, also highlight the main issues in which the region's economic policy must make progress. Of note is the encouragement of public-private cooperation in projects promoted by the Secretariat of the Union for the Mediterranean, the creation of a Mediterranean development bank and of a Mediterranean transport agency. In this respect, at this year's summit, to be held in November in Barcelona, Brussels' support of the Mediterranean railway corridor will surely be valued positively.

The list of aspects that crucially need to be improved is long and unlikely to be completed within a short period of time. However, now more than ever, the countries of the European Union must get involved as much as possible. The regime changes occurring over the last few months in many of the countries on the shores of the Mediterranean have opened the door to economic and social changes that had been unthinkable until very recently. The European Union cannot let such an opportunity pass.

(2) Economic Integration in the Euro-Mediterranean Region, Center for Social and Economic Research.
(3) The wise use of gravity models: export potentials in the euromed region. Juan M. Ruiz and Josep M. Vilarrubia. Working Paper 720 of the Bank of Spain.

This box was prepared by Oriol Aspachs Bracons
European Unit, Research Department, "la Caixa"

FINANCIAL MARKETS

Monetary and capital markets

Combating risks

The slowdown in world economic growth grabs the attention of the financial markets.

The international financial scene is embarking on the final straight of the year dependent on the evolution of the same risk factors that have been affecting market performance for months. The first is the threat of a double dip recession in the global economy. The second, the uncertainty regarding the combined effects of fiscal, monetary and financial regulatory measures adopted in the different regions. And the third, the complex and vulnerable situation the euro area finds itself in due to the sovereign debt crisis.

Europe's political authorities negotiate categorical measures to be taken against the debt crisis.

Fortunately, the first two factors have seen promising improvement over the last few weeks. Both in the United States and in the emerging countries, the latest figures have not been as bad as feared and, moreover, the central banks have appeared willing to take action. It's more difficult to judge how the third factor is going, however. Optimists appreciate the fact that, since early October, the decision-making process has intensified on the part of political leaders in the euro area. European authorities have been pushed to take more categorical decisions given the growing deterioration in confidence towards crucial countries such as Italy, Spain and even France, with the consequent fear of systemic contagion of the crisis to the rest of the world. This declared proposal to stabilize the situation, reflected in the tight schedule of meetings for leaders, has restored tentative hope to some investors.

Central banks act to avoid economic recession.

Pessimists, however, doubt that the kind of measures capable of turning the situation around will actually be implemented.

The Fed does not hesitate to apply more stimulus measures, while the ECB halts interest rate hikes

As has been observed from the different macroeconomic indicators published, the rate of growth in international economic activity has been slowing up since spring. Depending on the geographical area, there are notable differences regarding the causes, nature, conditioning factors and implications. In any case, one common factor is the economic slowdown being accompanied by the impact on inflation of rising commodity prices during the first half of the year. Given this situation, the actions taken by monetary authorities have become particularly important. Logically, the decisions adopted differ due to the specific factors already mentioned and the differing preferences of central bankers but, on the whole, a widespread reaction has been observed towards more relaxed policies to put a stop to the risk of a double dip recession.

In the United States, throughout October the Federal Reserve (Fed) continued to convey its concern for the delicate situation in which the US economy finds itself. Both in the minutes of the last meeting of the Monetary Policy Committee as well as in the monthly

publication known as the Fed's Beige Book, as well as in the appearance of the authority's chairman, Ben Bernanke, before Congress, emphasis has been placed on the gradual moderation of economic activity. According to the Fed, an analysis of the key indicators has shown that the increases in household consumption and business investment are not enough to boost the economy's growth. The authority has also acknowledged that conditions in the labour market are still fragile, as well as the little improvement seen in the prospects for job creation over the next few months.

Based on this interpretation of the current economic situation, and as it has been doing since the Lehman Brothers went bust in 2008, the Federal Reserve has strived to pass on to the financial markets a message of commitment and adaptation of its monetary policy strategy to the need to stimulate the economy. That's why the central bank continues to keep interest rates within the minimum range of 0%-0.25% and, moreover, is stepping up its use of different unconventional instruments in order to stimulate growth.

In this respect, at the Committee's last meeting it was decided to introduce a new instrument called «Operation Twist». Through buying and selling Treasury bonds with different maturities, the Fed aims to reduce long-term interest rates and make the financing terms of firms and households more flexible. Moreover, the central bank confirmed that it would continue to reinvest the principal and interest from the public debt and mortgage bonds it currently holds in its portfolios. Another relevant aspect for the Federal Reserve is to make its communication policy more transparent and dynamic. The institution believes it is crucial to use communication as a means for financial agents to adjust their expectations regarding interest rates and macroeconomic targets. Among changes that could be debated are the setting of an inflation target (such as the one that exists in the euro area) and another for the unemployment rate.

The Fed acknowledges the risks to economic growth.

In the euro area, the European Central Bank (ECB) kept the official interest rate at 1.5% after its emblematic meeting in October. At his last appearance as president of the European Central Bank, Jean-Claude Trichet followed the same script as on previous occasions, highlighting the adaptable tone of the authority's monetary policy to justify this decision. However, one novelty was his clear reference to the moderation in growth of the region's economy, a trend that is expected to continue in the second half of the year. He stated that the current risks, related to the heavy indebtedness of some peripheral countries and the slowdown in international trade, are increasing the downward pressure on the euro area's rate of growth. To these risks we should also add the negative effect of rising tensions on the financial markets. With regard to the trend in consumer prices, he repeated that the monetary authority is closely monitoring any factors that might result in an upswing in inflation. His conclusion is that, although these seem to have eased in the medium term, over the coming months the central bank's estimates still point to inflation levels higher than its target of 2%. This was precisely the argument that several members of the Executive Board used to support keeping the official interest rate at its current level, against the group that prefers to gradually relax interest rates in order to boost economic growth. However, taking into account the fact that

The Fed opts for communication policy as the instrument to affect agent expectations.

The ECB keeps its official interest rate at 1.5%.

The ECB expects inflation in the euro area to remain above its target during the next few months.

the bank's president will change and the probable developments in the sovereign debt crisis of the periphery of the euro area, many analysts believe there might be interest rate cuts of up to half a point by the end of the year.

In this respect, the ECB has once again stressed its capacity to react to the region's financial problems by implementing important unconventional monetary measures. In the words of Trichet, the central bank is totally committed to adopting any extraordinary measures required to restore financial stability and the normal functioning of the markets. The European authority decided to keep its unlimited fixed rate liquidity facilities at 1, 3 and 6 months and it also added a further two long-term refinancing operations (LTRO), at 12 and 13 months, with the same full allotment of capital at a fixed rate, in order to ensure access to funding for those banks in the region that are having difficulties due to the credit squeeze. Similarly, the bank also announced that, in November, it would restart its purchases of covered bonds, totalling 40 billion euros.

The ECB provides new funding facilities for the region's banks.

The ECB is still playing a highly active role in negotiations to find an effective solution to the sovereign debt crisis in the periphery of the euro area, either taking part in the examinations of the troika (together with the European Commission and the International Monetary Fund) of the Greek economy or being involved in negotiating the future enlargement of the powers of the European Financial Stability Fund (EFSF). The ECB is being guided by its intention to safeguard the integrity of the monetary union but its most significant intervention lies in the purchase of the sovereign bonds of peripheral countries. Although this programme was initially exceptional in nature, the increased risk of difficulties possibly spreading to other economies in the area, such as Spain or Italy, has turned the ECB into a regular buyer of sovereign bonds.

The central banks of emerging countries revise the direction of their monetary policies.

For their part, the monetary scenario in emerging countries is undergoing a transition from a tough position to one of relaxation. Until the summer, these countries' central banks responded to the sharp pace of growth in their economies with interest rate hikes and other restrictive measures (increasing reserve ratios, etc.), thereby hoping to control inflation and prevent the creation of price bubbles in some assets. But for the last few months, the business indicators of these economies have started to show signs of moderation, clearly pointing to these economies coming in to land, with the risk that this manoeuvre might be sharper than desired. This situation marks the end of the cycle of tighter monetary policies in the emerging countries, giving way to a stage when the monetary authorities' challenge will be to avoid an abrupt halt in economic growth. One outstanding case is what is happening in Brazil, whose central bank has maintained a strategy of gradual interest rate cuts (it has cut rates by a further 50 basis points, down to 11.50%, in October). In China, the authorities have stopped their restrictive measures and, although the central bank of India decided to raise its official rate again in October, its message also points to the end of this process.

Given this macroeconomic and monetary policy scenario, interest rates in the interbank markets continue to play a very important role as they reflect investors' expectations regarding the future steps to be taken by central banks. But they also reflect the tensions resulting from the

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2010									
October	1.00	1.03	1.52	0.25	0.29	0.20	0.50	0.74	0.23
November	1.00	1.03	1.53	0.25	0.30	0.19	0.50	0.74	0.20
December	1.00	1.01	1.51	0.25	0.30	0.19	0.50	0.76	0.20
2011									
January	1.00	1.07	1.64	0.25	0.30	0.19	0.50	0.78	0.26
February	1.00	1.09	1.77	0.25	0.31	0.19	0.50	0.80	0.10
March	1.00	1.24	2.00	0.25	0.30	0.20	0.50	0.82	0.28
April	1.25	1.35	2.12	0.25	0.27	0.20	0.50	0.82	0.24
May	1.25	1.43	2.14	0.25	0.25	0.20	0.50	0.83	0.26
June	1.25	1.55	2.16	0.25	0.25	0.20	0.50	0.83	0.28
July	1.50	1.61	2.18	0.25	0.26	0.20	0.50	0.83	0.24
August	1.50	1.54	2.09	0.25	0.33	0.19	0.50	0.89	0.10
September	1.50	1.55	2.08	0.25	0.37	0.19	0.50	0.95	0.15
October (1)	1.50	1.59	2.12	0.25	0.42	0.20	0.50	0.98	0.56

NOTES: (1) October 25.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 4-12-08 (2.50%), 5-03-09 (1.50%), 2-04-09 (1.25%), 7-05-09 (1.00%), 7-04-11 (1.25%), 7-07-11 (1.50%).

(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).

(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 4-12-08 (2.0%), 7-01-09 (1.5%), 5-02-09 (1.0%), 5-03-09 (0.50%).

(5) Interbank rate.

SOURCES: National central banks, Bloomberg and own calculations.

European sovereign debt crisis, specifically its repercussions on liquidity and the perceived solvency of financial institutions, and not only European ones. For the United States, the Libor dollar interest rates have continued their upward trend started in the summer. This movement has been moderate, it has occurred over most of the maturities offered, placing rates at their highest levels in the last twelve months. This movement can hardly be put down to the anticipation of future hikes in official interest rates, given that the Federal Reserve has made it clear that this is not part of its plan. It's rather the influence, in the form higher risk premia and liquidity, of the lack of confidence in the international financial sector, caused by the European debt crisis. In the euro area, the increase in these premia has been much more notable in the last three months but, given that the market now expects the ECB to cut the official interest rate soon, the result has been that Euribor interbank interest rates have enjoyed a period of relative stability. In other words, the fall in the risk-free interest rate has been offset by the rise in interbank risk premia.

Interbank markets feel the effects of the European sovereign debt crisis.

The public debt of the United States and Germany continues to act as a safe haven

Slight rise in the yields on public debt from the most solvent countries.

Yields for the public debt of the main economies – United States and Germany – have increased slightly throughout October. However, in both cases this movement has occurred without hardly moving away from the record low levels reached this year. In particular, the yield of two-year bonds in the United States rose to 0.27%, while that of ten-year bonds broke through the 2% barrier, reaching 2.17%. These episodes are not particularly significant in principle, rather being reflections of the inevitable volatility related to the publication of macroeconomic indicators (which have been somewhat better than feared) and the ups and downs of the «flight to quality» given the European sovereign crisis. Over the coming quarters, US interest rates are bound to remain at exceptionally low levels due to the occurrence of three factors. The first, the likelihood that economic development will be tenuous, in the best of cases. The second is the action taken by the Fed via official interest rates and programmes related to its bond portfolio. And the third, the expected continuation of US debt being seen as a safe haven, given its excellence in the eyes of international investors.

Investors see US sovereign bonds as a safe haven.

In the case of the euro area, the yield on German debt in October performed similarly to US debt, but in this case it's more complicated to make a judgement. In the first part of October, the yield for 2 and 10-year bonds rose (to above 0.6% and 2.10%, respectively) then subsequently entered a more stable phase.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

10-year government bonds at end of period as annual percentage

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2010								
October	2.52	2.91	4.21	3.94	2.60	0.94	3.08	1.49
November	2.67	3.15	5.50	4.67	2.80	1.19	3.23	1.56
December	2.96	3.36	5.45	4.82	3.29	1.13	3.40	1.72
2011								
January	3.16	3.53	5.37	4.72	3.37	1.22	3.66	1.87
February	3.17	3.55	5.39	4.84	3.43	1.26	3.60	1.90
March	3.35	3.71	5.30	4.82	3.47	1.26	3.69	1.96
April	3.31	3.64	5.47	4.74	3.41	1.24	3.58	2.06
May	3.02	3.39	5.36	4.78	3.06	1.17	3.29	1.82
June	3.03	3.41	5.45	4.88	3.16	1.14	3.38	1.73
July	2.54	3.23	6.08	5.87	2.80	1.08	2.86	1.36
August	2.15	2.83	5.04	5.13	2.18	1.02	2.50	1.08
September	1.89	2.60	5.14	5.54	1.92	1.03	2.43	0.94
October (*)	2.15	3.31	5.55	5.97	2.25	1.02	2.60	1.06

NOTE: (*) October 25.
SOURCE: Bloomberg.

As in the preceding months, the successive episodes of the sovereign debt crisis in the periphery of the region constitute the key element behind the fluctuations in the yields for German debt. The fact that movements in yields have been upwards over the last few weeks begs the question of whether this might be the start of a movement of greater scope, linked to the perception by investors that the crisis will be redirected, with a greater burden on Germany. Although this is still a highly premature conclusion, it should come as no surprise if, within the current situation dominated by the political proposal to stabilize the monetary union crisis, the agreements reached by member countries lead to an upswing in German yields in the coming months.

For peripheral countries, their risk premia have continued to perform weakly and unevenly, as in previous months. The ECB's purchases of debt from the countries in the markets' sights, especially Italy and Spain, has acted as a highly significant mainstay but this alone is not having enough effect to calm investor confidence. The downgrading of both countries' ratings and the poor credibility of their fiscal restructuring and structural reforms have been sufficient motive for the spreads between Italian and Spanish debt compared with German to remain high. To a certain extent, this is a reflection of October's impasse, with investors awaiting the result of top-level political negotiations, which must now figure out not only how to get out of the worrying Greek situation but also the fundamentals of a solid and beneficial monetary union for its members. Even if this scenario emerges after political agreements have been reached, the reduction in tensions of peripheral risk premia has a long way to go, at present on standby.

The progress made towards resolving Europe's crisis push up yields on German debt.

The euro exchange rate relies on the sovereign debt crisis

In the economic and financial scenario described, volatility in the currency markets has increased notably. The actions taken by the different central banks to combat the economic slowdown, together with greater risk aversion on the part of investors, are the key aspects encouraging these upswings in volatility. The exchange rate between the dollar and the euro is a clear example of this statement. During October, the exchange rate of the euro appreciated against the dollar by around 5%, getting back to 1.38 dollars. Among the number of factors influencing the euro's exchange rate, the variability of news on Europe's credit crisis weighs particularly heavily. Because of this, the euro has risen in value as the desire has become known of the region's political authorities to act decisively on the crisis and their desire to put a stop to the risk of this spreading to the banking sector. In this respect, over the coming months the advances expected regarding the crisis, and the recovery in the world's economic growth prospects, will surely help the euro-dollar exchange rate to stabilize around 1.40 dollars.

The downgrading of Italy and Spain's credit ratings damages investor confidence.

The euro's exchange rate appreciates given the possible solutions to the sovereign crisis.

EXCHANGE RATES OF MAIN CURRENCIES

October 25, 2011

	Exchange rate	% change (*)		
		Monthly	Over December 2010	Annual
Against US dollar				
Japanese yen	76.1	–0.3	–6.6	–6.1
Pound sterling	0.626	2.6	2.3	1.6
Swiss franc	0.879	–2.6	–6.4	–10.5
Canadian dollar	1.002	–2.4	0.3	–1.8
Mexican peso	13.376	–1.2	7.7	7.6
Against euro				
US dollar	1.393	–2.9	–4.1	0.3
Japanese yen	106.0	2.5	–2.3	–6.4
Swiss franc	1.224	0.3	–2.2	–10.8
Pound sterling	0.872	0.3	1.7	–1.9
Swedish krona	9.117	–1.0	1.4	–0.9
Danish krone	7.445	0.1	–0.1	–0.2
Polish zloty	4.376	–0.9	9.4	10.2
Czech crown	24.89	1.1	–0.5	1.5
Hungarian forint	297.3	2.5	6.3	8.1

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

The constructive tone of European authorities is well received by corporative credit markets.

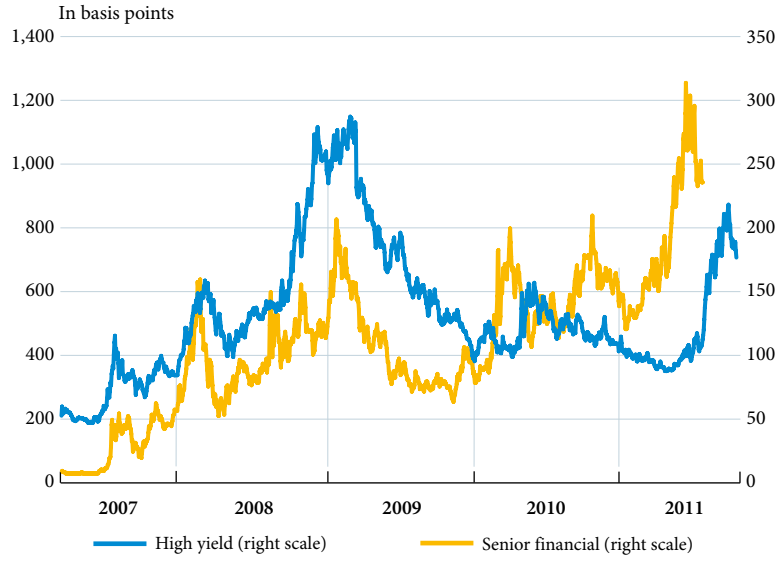
Issues of investment grade bonds return to some countries of peripheral Europe.

High quality corporate bonds hold firm

Since the now distant start of today's financial turbulences, corporate bonds have been one of the markets performing most stably. Although corporate debt indices have shown excellent resistance (only being affected in the summer) to the deterioration in the world's growth prospects and the ups and downs of the euro area's sovereign crisis, the encouraging news of this crisis being resolved is playing a key role in improving investor sentiment. The constructive tone adopted by European leaders has helped to contain the area's sovereign risk premia, this being a favourable aspect for the credit markets. Specifically, the stabilization of spreads is mainly benefiting investment grade corporate bonds, both US and European and emerging. In the case of the euro area, although the recovery in bond issues is slow, investment grade bond markets have witnessed the return of debt issues by high quality non-financial companies, mainly French, as well as firms with intermediate ratings, mostly from Italy and Spain. There has also been an increase in the issuance of covered bonds by financial institutions with good ratings, after the ECB announced that it would restart its programme to purchase this kind of asset. In summary, these circumstances have helped to strengthen the safe haven profile that has characterized investment grade corporate credit over the last few quarters, together with gold and the public debt of solvent economies, such as the United States and Germany.

CONTAINED SOVEREIGN RISK PREMIA BENEFIT CORPORATE BONDS

5-year Markit Itraxx indices



SOURCE: Bloomberg.

With regard to the high yield bond sector (bonds with a greater risk and return), a significant and encouraging improvement was seen in October, albeit still insufficient to complete make up for the deterioration occurring in August and September. In short, in spite of the recent calming macroeconomic figures, the uncertainty still hovering over the prospects of world economic growth is weighing heavily on this segment of the bond market that, traditionally, has always been highly sensitive to macroeconomic risks. For their part, the corporate debt markets of the emerging countries have also performed well. The gradual slowdown in growth prospects for these economies, as well as the gradual change in direction of their monetary policies, have given way to a scenario of greater stability in the trends of bond prices and their yields.

Uncertain growth prospects are weighing heavily on high yield bonds.

Risk aversion limits stock market gains

The main international stock markets have continued to perform erratically throughout October, albeit with a positive and encouraging final balance. The period started with a fragile tone. The doubts, not completely eliminated, regarding the outlook for world economic growth, the fear of a sharp landing for some developing economies and the mistrust regarding the degree of commitment of fiscal policies on both sides of the Atlantic were the main aspects that initially guided investors' sales. But during the second half of the month, markets started to perform favourably thanks to the relative improvement in economic data and the more decisive action being taken by monetary and governmental authorities to put a stop to the economic and

Uncertainty is setting the erratic rhythm of the world's stock markets.

Resolving the current uncertainty is key to improving the outlook for equity.

financial problems. In any case, given this volatile situation, investor sentiment has continued to be dominated by a high degree of risk aversion.

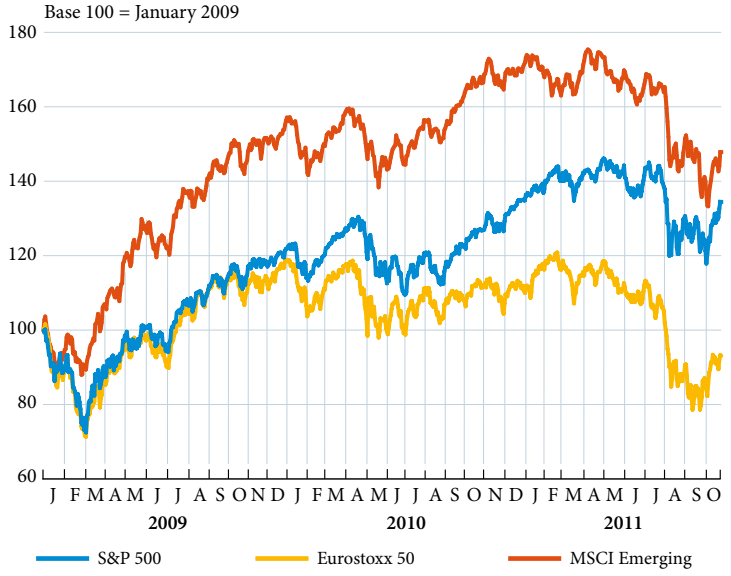
However, and given the latest advances in resolving the euro area's sovereign debt crisis, we can expect the risks currently threatening the economic and financial scenario to die down as the challenges faced are satisfactorily overcome. That's why the medium-term outlook for the world's stock markets looks favourable. Beyond the possible repercussions of the current risks on stock market indices, the potential of rising share prices in the coming quarters should be based on fundamentals such as a return to sustained growth at a global level, a reduction of sovereign credit risk and the solidity of the expansionary cycle for business margins. But, for the moment, the trends in Europe's sovereign debt crisis and the fear of its possible systemic contagion are the main obstacles to any potential rise in share prices.

Good corporate earnings augur a sustainable financial situation for profits in the future.

In the United States, the fear of a double dip recession, weak economic indicators and laborious negotiations of budgetary adjustments represent the greatest hurdle for stock markets. Nevertheless, the third quarter earnings season for S&P 500 companies is revealing the healthy state of corporate profits. To date, the profit per share of those companies that have already published their earnings (27% of the total) is 11% higher than the figure from the same quarter a year ago.
In Europe, fear of the sovereign crisis spreading and the uncertainty of the effects of the banking sector's recapitalization limit possible rises in the prices of shares that, according to fundamental aspects of value, would be worth more.

INTERNATIONAL STOCK MARKET PRICES REVEAL UNCERTAINTY

Stock market indices



SOURCE: Bloomberg.

INDICES OF MAIN WORLD STOCK EXCHANGES

October 25, 2011

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*11,913.6*	*10.6*	*2.9*	*6.7*
Standard & Poor's	*1,254.2*	*10.4*	*–0.3*	*5.8*
Nasdaq	*2,699.4*	*8.7*	*1.8*	*8.4*
Tokyo	8,762.3	2.4	–14.3	–6.8
London	5,557.9	9.7	–5.8	–3.4
Euro area	2,362.1	16.6	–15.4	–17.7
Frankfurt	*6,044.9*	*16.3*	*–12.6*	*–9.0*
Paris	*3,210.1*	*14.2*	*–15.6*	*–17.1*
Amsterdam	*308.6*	*16.6*	*–13.0*	*–9.9*
Milan	*16,217.1*	*18.7*	*–19.6*	*–24.3*
Madrid	*8,945.8*	*11.9*	*–9.3*	*–17.7*
Zurich	5,769.0	8.9	–10.4	–11.4
Hong Kong	18,968.2	7.4	–17.7	–19.7
Buenos Aires	2,861.8	15.3	–18.8	–1.9
São Paulo	56,892.0	6.9	–17.9	–18.2

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

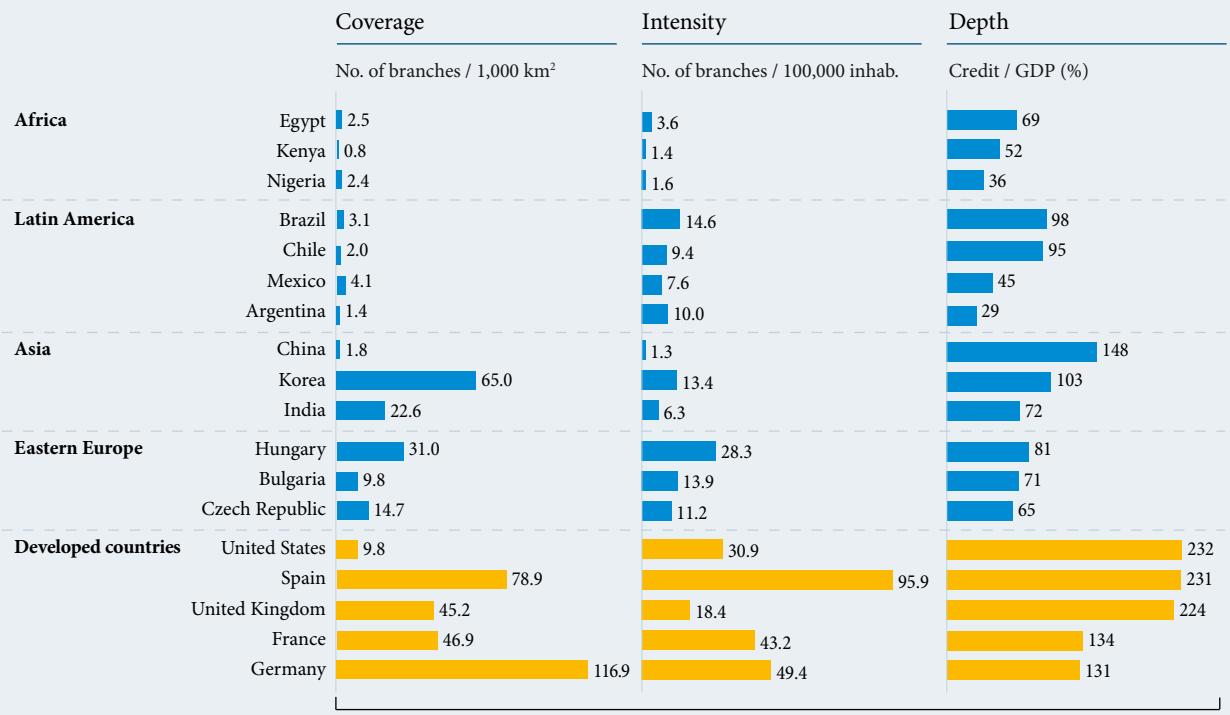
Mobile banking and its contribution to economic development

Beyond stability in terms of conflict and politics, the existence of an extensive financial system with broad access for the population is fundamental to a country's socio-economic progress. A formal financial system that encourages households to save, provides security for payments and facilitates credit is essential for future planning, trade development and business investment. For example, a study by Honohan(1) shows that an increase of 10 percentage points in access to financial services (measured as the ratio of credit over GDP) results in a fall of 0.6 percentage points in the Gini(2) inequality coefficient , among other socio-economic repercussions.

But, in the past, many emerging countries or frontier markets in Africa, Asia and Latin America have encountered a kind of vicious circle in which the financial system's limited development acts as a barrier to greater economic progress and vice versa. Reality shows that the degree of access to a traditional financial system is very limited in most of these countries. In general, there are few bank branches, measured both in terms of coverage of the area and also in relation to the number of inhabitants. Consequently, a large proportion of the population is not served

(1) Honohan, P. (2007). «Cross-Country variation in household access to financial services». The World Bank, Trinity College and CEPR.
(2) The Gini coefficient is used to measure income inequality. It's a number between 0% and 100% where 0% represents perfect equality (everyone has the same income) and 100% represents perfect inequality (one person has all the income and the rest none).

COUNTRY COMPARISON OF THE EXTENT OF TRADITIONAL BANKING



NOTE: Domestic credit given by banks. Credit to the public sector is net; the rest of the sectors, gross.
SOURCES: For the coverage and intensity, Beck, T., Demirgüç-Kunt, A. and Martínez-Peira, Mª S. (2005), «Reaching out: Access to and use of banking services across countries». For the depth, World Development Indicators, The World Bank (2010).

by systems that lack depth. In terms of the ratio of private credit over GDP, this appears to be around 100 percentage points higher in developed countries than in the rest, as shown in the graph above. This limits private investment and therefore economic growth.

But why, historically, has an extensive financial system not been developed in these countries? Mainly because constructing a traditional financial system such as the one we know in developed countries, based on an extensive branch network, is very costly. For example, infrastructures and communication systems are required but they are not always available in emerging countries where, moreover, the population is sometimes highly dispersed in geographical terms.

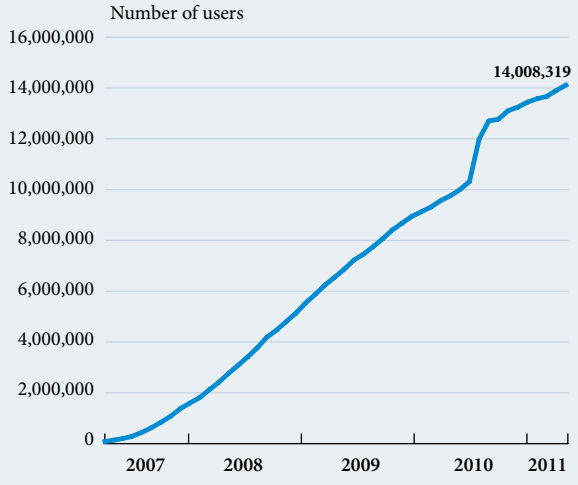
However, nowadays, thanks to new technologies, there are alternatives that can boost financial inclusion at a lower cost, without the need for an extensive branch network. This is possible thanks to mobile phones strongly penetrating many emerging countries and even frontier markets, allowing them to skip certain technological stages. For example, in 2008 Latin America already had more than 370 million users and this figure is expected to reach 530 million in 2012, placing the average penetration of mobiles in the region above 80 lines for every

100 inhabitants,[3] much higher than the landline penetration and, obviously, than banking. Providing financial services via mobile phone can, therefore, extend access to these services to a highly significant portion of the population at a much lower cost (economic and also in terms of time) than through traditional banking. In fact, some successful models already exist with this focus. By way of example, there is Paggio in Brazil, Easypaisa in Pakistan and Smart and Globe in the Philippines. But the M-PESA[4] system in Kenya is the ultimate exponent, given its fast penetration and success.

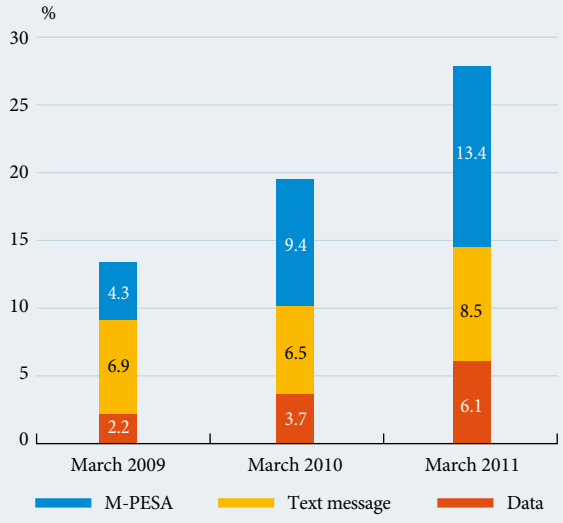
While in developed countries, mobile banking has adopted models providing additional services, i.e. it's a new channel for customer service within a multi-channel model, in emerging countries it is adopting a transformational model. M-PESA, set up in 2007 by Safaricom (Kenya's leading mobile operator), allows part of the Kenyan population that had been excluded from financial systems to exchange money via their mobile terminals. Safaricom and M-PESA are creating a new way of banking in these countries whereby, by simply sending a text message, you can deposit and withdraw money, transfer it, pay bills and top up mobile credit.

M-PESA has expanded very quickly in the country thanks to its extensive agent network, cash management and the high added value it offers to the population. In April 2011, it already had more than 14 million clients (approximately 40% of the population) and is growing by more than 10,000 clients per day. And the volume of transactions reached around 450 million euros that same month. M-PESA is already one of the services that provides the greatest revenue for Safaricom but, more importantly, it is contributing to Kenya's economic development as it has encouraged the development of trade thanks to the population being able to make payments while avoiding the insecurity of carrying cash.

TREND IN THE NUMBER OF M-PESA USERS



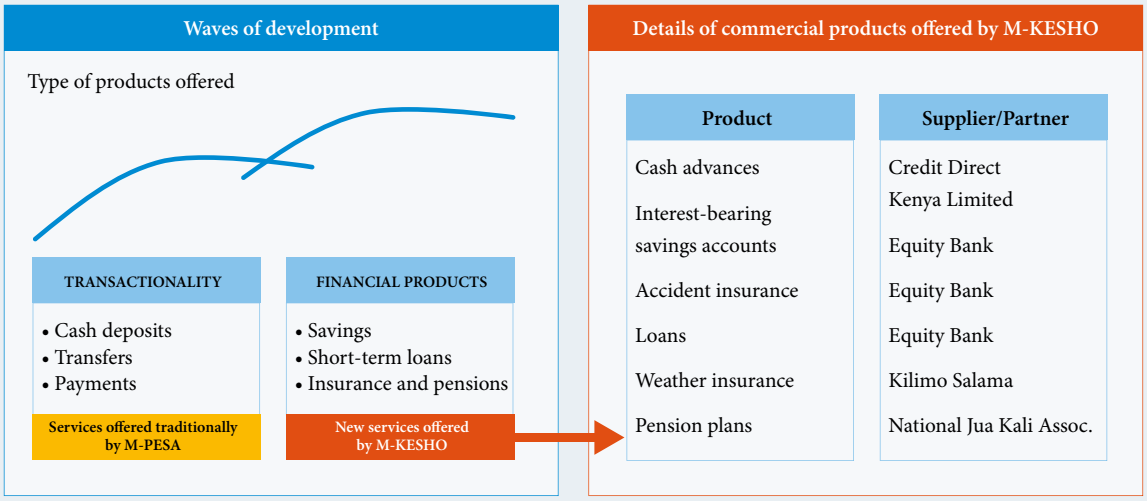
M-PESA CONTRIBUTION TO SAFARICOM'S REVENUE



SOURCE: Safaricom.

(3) Analistas Financieros Internacionales (2009), «Telefonía móvil y desarrollo financiero en América Latina».
(4) M is from Mobile and Pesa means money in Swahili.

DETAILS OF THE DEVELOPMENT OF SAFARICOM'S MOBILE BANKING SERVICES IN KENYA: FROM M-PESA TO M-KESHO



SOURCES: CGAP (2010), «Branchless Banking 2010: Who's Served? At what price? What's next?». Bill & Melinda Gates Foundation (2010), «Mobile payments go viral: M-PESA in Kenya». Safaricom. Own calculations.

However, to really encourage financial inclusion providers must go one step further and not only offer transactions but also financial products, such as savings, insurance, financing, etc., because this is what will help to construct the underlying fundamentals for economic development. Aware of this, Safaricom is also leading the field in this area. Due to issues related to regulations and the assumption of risk, it has taken out agreements with several financial institutions to develop its commercial products and services and has set up M-KESHO. The service is built on the M-PESA platform to also offer interest-bearing savings accounts, insurance (principally non-life) and loans, mostly linked to advances on wages or other income.

In summary, the progress made by mobile telephony is a great opportunity for a new banking model to penetrate emerging countries and frontier markets. Transactional coverage via text messages is a fundamental first step that helps to develop trade and familiarize the population with the banking system at a very low cost. With this base, more financial services can gradually be offered, also with credit products, in which traditional credit institutions can also take part to help to manage risk and provide financial advice, remotely or through traditional branches. Consequently, mobile banking provides the chance to break the vicious circle that has prevented these countries from developing financially, gradually closing the gap between the indicators for access to banking services in developed countries and in the rest.

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

SPAIN: OVERALL ANALYSIS

Economic activity

Uncertainty is affecting confidence

Since the Spanish economy started its recovery, quarter-on-quarter growth in gross domestic product (GDP) has remained relatively stable at around 0.2%. A rate clearly lower than the average of 0.9% posted between 1995 and 2007 but reasonable given the significant imbalances that have yet to be corrected.

The economic recovery is partly being hindered by private consumption, whose improvement is steady but slow. Its average rate of growth over the last year and a half has been 0.9% year-on-year, although it is still being affected by the high unemployment rate and the deleveraging that needs to be carried out in the Spanish economy. Moreover, although the stabilization of fuel prices and the disappearance of the effect of the hike in value added tax (VAT) should encourage consumption, the savings rate is already close to its pre-crisis level, so that any boost provided by further falls will now be more limited.

Investment is also unlikely to provide any wonderful news. Although gross fixed capital formation in capital equipment continues to make progress with an average growth of 0.7% over the last year and a half, investment in construction is

Both consumption and investment make slow but steady progress.

DEMAND INDICATORS

Percentage change over same period year before

	2009	2010	2010		2011				
			3Q	4Q	1Q	2Q	July	August	September
Consumption									
Production of consumer goods (*)	–8.2	0.8	0.4	0.1	–1.5	–0.8	–0.6	2.6	...
Imports of consumer goods (**)	–5.8	–9.5	–14.9	–13.7	–1.1	–8.7	–10.1	12.1	...
Car registrations	–17.9	3.1	–25.0	–29.3	–27.3	–26.4	–4.0	5.9	–1.3
Credit for consumer durables	–11.5	–12.3	–19.2	–14.6	–13.9	–10.1	–	...	–
Consumer confidence index (***)	–28.3	–20.9	–21.5	–21.0	–19.6	–16.1	–13.4	–17.0	–17.0
Investment									
Capital goods production (*)	–22.1	–3.3	–6.3	–3.2	3.0	2.5	2.1	9.3	...
Imports of capital goods (**)	–26.3	6.5	9.4	4.8	2.3	–4.9	–14.7	8.4	...
Commercial vehicle registrations	–40.0	7.0	–9.3	1.4	–2.2	–11.2	–0.5	11.2	9.4
Foreign trade (**)									
Non-energy imports	–16.9	10.3	6.0	5.4	7.4	–0.7	–9.9	12.6	...
Exports	–9.8	15.6	13.2	15.3	16.0	9.0	8.8	17.4	...

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.

Demand and supply indicators reverse their positive trend.

immersed in a sharper and longer lasting readjustment that will probably not finish until next year.

Moreover, any gradual recovery in these components has to offset the fiscal adjustment that needs to be carried out by the public sector over the coming quarters. Given this situation, GDP growth in the Spanish economy is likely to remain at a relatively weak rate over the next few quarters, albeit with an upward trend. However, the vast majority of supply and demand indicators have changed their positive trend over the last few months.

Concerning demand, of note is the severe correction being undergone by consumer confidence. After its fall in August, in September this indicator remained stable at a relatively low level. The bad figures for trends in the labour market aren't helping confidence to recover either. In particular, after a somewhat promising start to the year with some stabilization in job losses and in rising unemployment, in September the number of unemployed rose by 95,817 people, the highest increase in this period since the Employment Ministry started producing this series. The trend in inflation isn't helping either as, although

SUPPLY INDICATORS

Percentage change over same period year before

	2009	2010	2010		2011				
			3Q	4Q	1Q	2Q	July	August	September
Industry									
Electricity consumption (1)	–4.9	2.9	2.7	2.2	0.5	0.5	–2.4	0.3	–1.3
Industrial production index (2)	–15.8	0.8	–0.2	0.4	1.8	–1.1	–2.3	0.3	...
Confidence indicator for industry (3)	–30.8	–13.8	–13.5	–9.2	–8.6	–10.9	–13.3	–13.9	–16.0
Utilization of production capacity (4)	71.2	72.0	73.9	72.9	72.6	74.7	73.3	–	–
Imports of non-energy intermediate goods (5)	–20.9	24.6	20.0	18.2	12.2	3.8	–9.3	13.7	...
Construction									
Cement consumption	–32.3	–14.8	–15.5	–16.1	–2.0	–16.6	–26.1	–16.5	–19.8
Confidence indicator for construction (3)	–32.3	–29.7	–27.8	–41.5	–54.1	–55.4	–58.0	–53.7	–64.2
Housing (new construction approvals)	–58.1	–17.3	–13.2	–20.3	–6.8	–19.3	–11.1	...	...
Government tendering	–8.2	–37.9	–36.6	–34.9	–36.9	–11.4	–37.3	...	...
Services									
Retail sales (6)	–5.4	–1.0	–2.5	–1.9	–5.9	–5.1	–3.5	–4.0	...
Foreign tourists	–8.8	0.9	4.2	1.4	2.9	10.4	7.2	9.4	9.2
Tourist revenue inflows	–9.0	3.9	7.0	5.4	6.7	12.2	9.4	...	...
Goods carried by rail (ton-km)	–28.4	6.4	5.9	–4.2	8.2	1.8	–1.8	9.5	...
Air passenger traffic	–7.9	2.9	4.2	4.3	5.0	10.6	6.7	4.7	7.6
Motor vehicle diesel fuel consumption	–5.1	–1.2	–2.1	–1.6	–1.6	–4.7	–5.8	...	...

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

it's clearly downward, it has now remained above 2% for a year.

The figures aren't too encouraging on the supply side either. Electricity consumption, for example, fell to –1.3% in year-on-year terms in September, thereby maintaining a clearly downward trend. The confidence index for industry, which had remained relatively stable during the first half of the year, has fallen to the level of February 2010 in just one quarter. The economic sentiment index has seen a downward trend in the last few months and the purchasing managers' index (PMI) is also continuing to fall, now clearly below 50 points, the threshold as from which the economy is likely to shrink.

Within this context, it's no surprise that the summary activity index produced by the Ministry of Finance has seen a significant decline in the last quarter, warning of a rise in the risk of recession in the short term.

What lies behind this turnaround in the leading indicators? As has already been mentioned, there are no new fundamental elements to suggest that consumption or investment will halt their recovery. Quite the opposite, in fact. Their trend should be positive, albeit gradual.

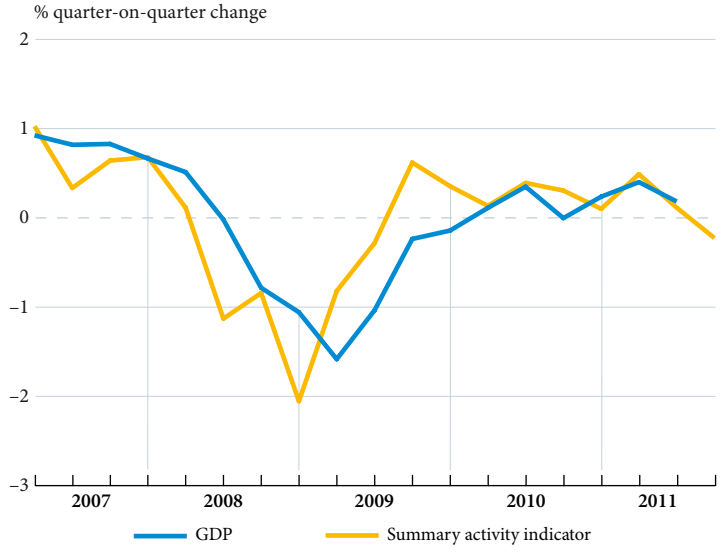
One of the possible reasons might be found in the deterioration in exports, one of the factors that, to date, have been key to recovering economic growth. For the moment, it's difficult to determine the extent of this factor's influence, as figures are only available up to August and, at present, no change in trend can be observed. In fact, in that month growth in exports rose to 17.4%, with a significant contribution by exports to European Union countries.

Another, more plausible explanation is the delay in resolving the sovereign debt crisis in the euro area. In fact, the deterioration in the PMI over the last few

The debt crisis is threatening to undermine the real economy.

INDICATORS WARN OF THE DANGER OF RECESSION

Summary indicator of activity and GDP



SOURCES: Ministry of Finance, National Institute of Statistics and own calculations.

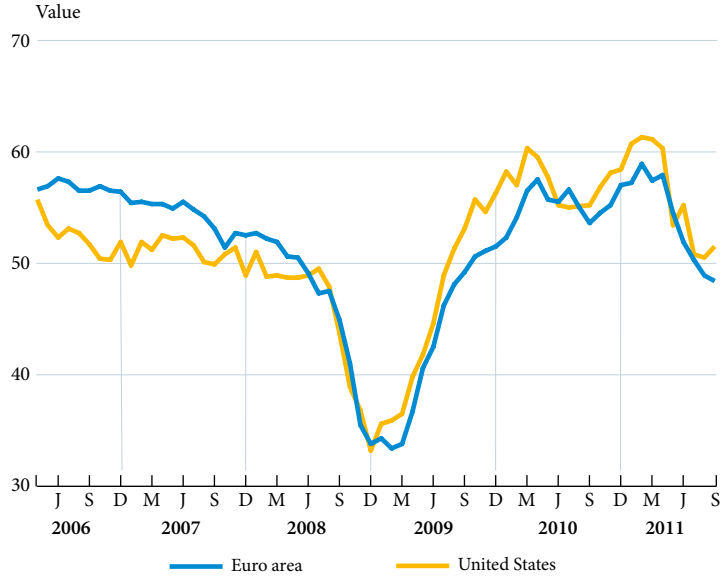
The new measures will determine the confidence of agents and the course of the economy.

months is a purely European occurrence. It's true that these indices also saw a significant drop in the United States and China in the first half of 2011 but there they have already started to pick up again while, in the countries of the European Union, they have speeded up their decline. Rising uncertainty, which led to higher stock market volatility in the summer, might be about to affect the real economy. The risk is increasing that both consumers and business people will, respectively, reduce their consumption and investment as a precaution and this might slow up the economic recovery.

It is therefore very important to define credible, effective measures in order to tackle the sovereign debt crisis. The main European leaders seem to be aware of this and, at the summit held during the last week of October, will finally deal with the key points to address this crisis. Defining a new bailout plan for Greece and specifying the relief for Greek public debt for private investors, increasing the loan capacity of the European Financial Stability Fund and recapitalizing the banking sector are on the agenda.
If they finally manage to achieve broad consensus on these issues, the confidence of agents might be significantly boosted over the coming months. The measures to be taken are unlikely to be defined down to the last detail because they are incredibly complex but it is very important both for the Spanish economy and for the euro area as a whole to get back on the right track.

BUSINESS CONFIDENCE IN THE UNITED STATES REMAINS HIGHER THAN IN EUROPE

Purchasing Managers' Index



SOURCE: Bloomberg.

Labour market

The lack of growth starts to have consequences

The job drought continues at the start of autumn. The latest figures provided by the State Employment Service (formerly INEM) indicate to what extent the slowdown in the economy is now affecting a labour market that never managed to fully recover. In the second quarter the economy hardly grew, just 0.2% compared with the first three months of the year, while the forecasts for the year-on-year change in gross domestic product for 2011 and 2012 are 0.8% and 1.1% respectively. These latest growth figures seem optimistic given the number of people unemployed and the number of registered employed published in September.

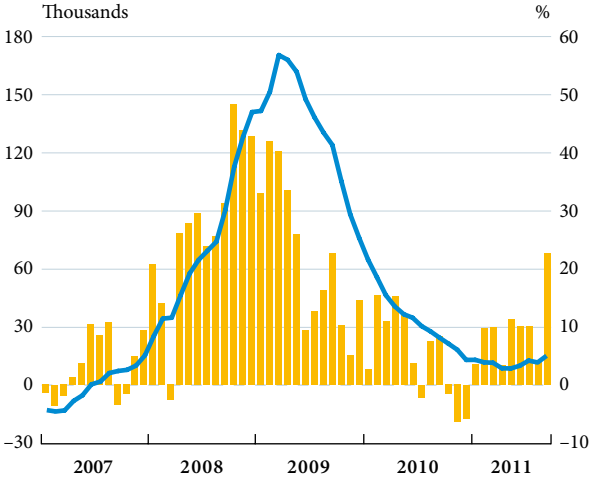
Unemployment increased by 95,817 people compared with August, its biggest rise in this period since the Ministry of Labour has been producing this series. Moreover, the data don't improve much when we take the seasonal component into account as the rise is still 77,010 people from this perspective. In total, 4,226,744 people are unemployed in Spain.

Why this sudden increase? The services sector saw very severe job losses, losing 74,590 employees. After an exceptionally good summer season in the tourism sector, the end of the summer has meant that, of all jobs lost, 78% occurred in this sector. This figure reveals the marked seasonal nature of our labour market.

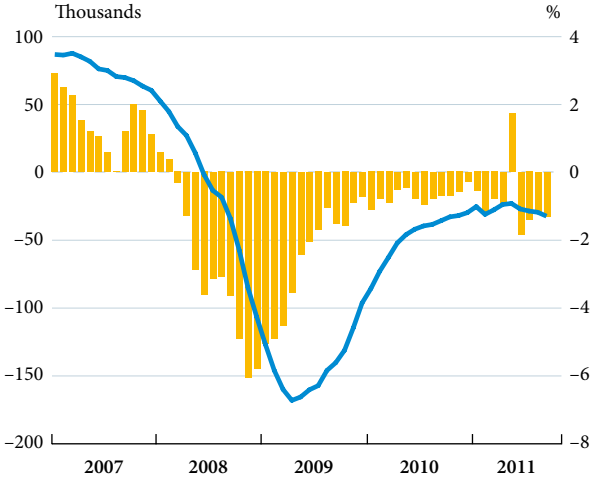
A rise of almost 96 thousand people in September takes registered unemployment to 4.2 million.

THE LABOUR MARKET IS HIT BY THE CURRENT UNCERTAINTY

Registered unemployed with Social Security



Employment registrations with Social Security



Monthly change adjusted for seasonal variations (left scale)

Year-on-year rate (right scale)

SOURCES: Ministry of Labour and Social Affairs, State Employment Services and own calculations.

EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2009	2010	2010		2011				
			3Q	4Q	1Q	2Q	July	August	September
Persons registered with Social Security (1)									
Sectors of activity									
Industry	*–10.6*	*–4.8*	*–3.8*	*–3.2*	*–2.8*	*–2.4*	*–2.3*	*–2.4*	*–2.6*
Construction	*–23.1*	*–13.4*	*–12.5*	*–11.3*	*–9.6*	*–11.4*	*–12.7*	*–12.9*	*–13.4*
Services	*–2.6*	*0.0*	*0.4*	*0.4*	*0.3*	*0.5*	*0.4*	*0.3*	*0.2*
Job situation									
Wage-earners	*–6.0*	*–1.8*	*–1.4*	*–1.2*	*–1.1*	*–0.9*	*–1.2*	*–1.3*	*–1.4*
Non-wage-earners	*–4.8*	*–2.8*	*–2.4*	*–1.9*	*–1.6*	*–1.2*	*–1.1*	*–1.0*	*–1.0*
Total	**–5.8**	**–2.0**	**–1.6**	**–1.3**	**–1.2**	**–1.0**	**–1.2**	**–1.2**	**–1.3**
Persons employed (2)	**–6.8**	**–2.3**	**–1.7**	**–1.3**	**–1.3**	**–0.9**	**–**	**–**	**–**
Jobs (3)	**–6.6**	**–2.4**	**–1.6**	**–1.4**	**–1.4**	**–1.0**	**–**	**–**	**–**
Hiring contracts registered (4)									
Permanent	–31.0	–6.4	–7.6	0.0	–1.8	–5.0	–6.2	–1.1	–14.2
Temporary	–13.5	3.8	3.5	2.8	0.7	3.9	–3.2	5.5	1.6
Total	**–15.5**	**2.8**	**2.6**	**2.5**	**0.4**	**3.1**	**–3.4**	**5.1**	**0.2**

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

Only 7.5% of new contracts are permanent.

The other major cause of higher unemployment is the rise in the number of first-time job seekers. This group grew by 5.23% compared with the previous month and, together with the services sector, accounts for 98% of the rise in unemployment.

On the other hand, job losses also led to a reduction of 64,956 people in the number of people registered as employed with Social Security in September. This figure falls to almost half when seasonally adjusted. Consequently, the cumulative figure for the last year shows a loss of 235,918 registered employed. Similar to the unemployment figures, the services sector, with hotels and restaurants and retail at the head, lead the fall in registered employed. In fact, the self-employed have been the hardest hit by September's adjustment, as they account for almost half the reduction.

One glimmer of hope comes from the number of contracts registered in September, up by 3,445 compared with the same month in 2010. However, only 7.51% of these new contracts were permanent, once again highlighting the dual nature and the importance of temporary workers in our labour market.

If we look at Europe, Spain's face must surely either go pale or redden with shame. Spain contributes 31% of the euro area's 15.7 million unemployed; i.e. one in three unemployed people in Europe is Spanish, whereas Spain only accounts for 14% of the total population of the euro area. Our 21.2% unemployment rate puts

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

September 2011

	No. of unemployed	Change over December 2010		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	137,392	10,563	8.3	19,994	17.0	3.3
Industry	484,475	–7,163	–1.5	–272	–0.1	11.5
Construction	732,437	–20,630	–2.7	4,880	0.7	17.3
Services	2,490,772	118,833	5.0	153,237	6.6	58.9
First job	381,668	25,068	7.0	31,142	8.9	9.0
By sex						
Males	2,071,510	18,322	0.9	86,577	4.4	49.0
Females	2,155,234	108,349	5.3	122,404	6.0	51.0
By age						
Under 25 years	456,546	22,772	5.2	9,922	2.2	10.8
All other ages	3,770,198	103,899	2.8	199,059	5.6	89.2
TOTAL	**4,226,744**	**126,671**	**3.1**	**208,981**	**5.2**	**100.0**

SOURCES: Public State Employment Service and own calculations.

us way down at the bottom of Europe's league, followed at a distance by Greece (16.7%) and Ireland (14.6%). The euro area, for its part, has 10% unemployment and this figure has remained more or less flat since the third quarter of 2009. Comparisons are even worse if we look at the 20 most powerful economies in the world as, together with South Africa, we are the only G-20 economy with a double digit unemployment rate.

During this crisis, Spain has demonstrated a spectacular capacity to destroy jobs, thanks to our dual-nature market and the end of the property boom, as it was capable of going from 8% to 18% unemployment in just two years. As of today, youth unemployment stands at 45%, more than double that of our European peers. Young people are the hardest hit by the crisis, as their unemployment rate doubles that of the economy as a whole, both in Spain and in the euro area.

Given the current outlook for our economy and the economic slowdown in the euro area, these figures aren't going to improve in the short term. The labour force survey (LFS), published at the end of October, will provide revealing figures on our labour market that will help to confirm this negative outlook, although we are not expected to go above 5 million unemployed for the time being.

Spain posts a record unemployment rate at an international level.

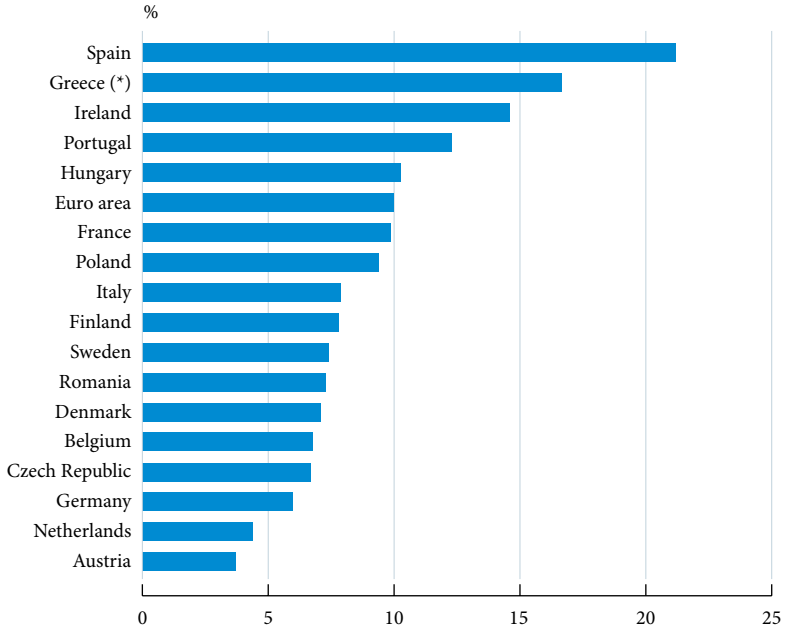
Positive data might come from the publication of labour costs for the third quarter. The pace of growth in total labour costs has moderated to date and, even more importantly, is below that of the euro area. Providing this continues, and thanks to wage containment, the Spanish economy looks like regaining its competitiveness.

Employment needs economic growth, like plants need water, to be able to flourish. The present situation seems to confirm the theory that it is very difficult

The labour force survey will clarify to what extent the labour market has deteriorated.

SPAIN'S UNEMPLOYMENT RATE IS UNPARALLELED IN EUROPE

Unemployment per working population of selected EU countries in August 2011



NOTE: (*) Data for Greece up to June 2011.
SOURCE: Eurostat.

to create jobs in any sustained way with the current growth rates. The further the economy moves away from the rains of growth, the more likely we are to hear bleak employment figures. If it doesn't rain, the tree doesn't produce fruit and society suffers from a lack of provisions. Manna from Europe looks like it's dwindling so, meanwhile, the Spanish economy is attempting to generate its own drizzle through gains in competitiveness.

Prices

Inflation picks up temporarily

The year-on-year rate of change in the general consumer price index (CPI) increased by one tenth of a percentage point in September and stood at 3.1%. After four consecutive months of falls, starting in April from a level of 3.8%, this figure represents a temporary break in inflation's downward trend.

The origin of this upswing can be found in the somewhat anomalous behaviour of certain components. The group of alcoholic beverages and tobacco increased by 9.2%, almost four tenths of a percentage point more than in the previous month. This increase can be explained by the change in tobacco prices, up by 12%, and this rise seems to confirm the end of the tobacco war that started at the end of spring. The oligopolistic nature of the tobacco industry helps to explain the great volatility of its components and the unexpected hikes in its prices.

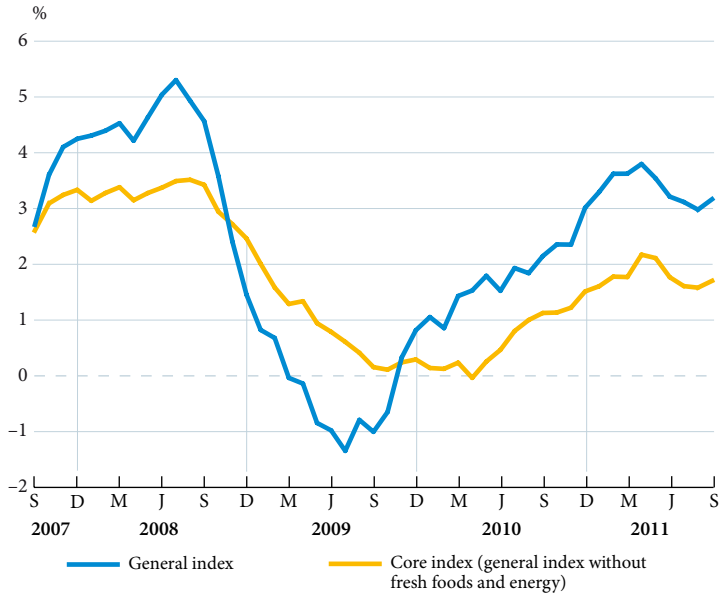
The other component responsible for the rise in inflation is the group of fuels and oils, posting a year-on-year increase of 16.4%. Unlike the rest of the components, and within the context of an economic slowdown, energy refuses to take a downward path and has remained at a practically flat rate of inflation for the last five months, fluctuating slightly

The CPI rises by one tenth of a percentage point and stands at 3.1% in September.

Tobacco and fuels are responsible for the upswing in inflation.

INFLATION INTERRUPTS ITS DOWNWARD TREND

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

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

SOURCE: National Institute of Statistics.

Economic indicators continue to point to a slowdown.

around 15.6% in terms of its year-on-year change.

Although unprocessed food and energy products are not included in the calculation for core inflation, the role played by tobacco explains why its annual rate rose to 1.7%. However, and as in the case of general inflation, this upswing has been interpreted as temporary, given that the rest of the indicators continue to point to weak economic growth.

The bitterest aspect of this slowdown is the labour market, which never managed to recover. In September, registered unemployment increased by 95,817 people compared with the previous month and the rest of the indicators are not exactly encouraging either. Both consumer confidence and the indicator for economic sentiment were worse than the previous month, while retail sales and industrial production fell by 4.8% and 1.5% compared with August last year.

This is why we believe the upswing in inflation to be temporary. Weak economic growth is still the key decisive factor for inflation, pushing it to a rate of almost 2.4% for the end of the year and below 2% for 2012, according to our forecasts.

We should remember that the behaviour of energy products might still provide the odd surprise in the form of small hikes. In spite of the Ministry for Industry freezing electricity prices, at some time in the coming months we will see a price adjustment that is more in line with production costs. On the other hand, the prices of some commodities, such as gas, might pick up slightly.

In fact energy, with a 12.4% year-on-year rise, has been partly responsible for inflation in the euro area shooting up to 3.0% in the month of September. The other key decisive factor is the methodological change introduced by Eurostat to estimate seasonal prices.

Although inflation in the euro area saw a rise in September of 5 tenths of a percentage point compared with the

CONSUMER PRICE INDEX BY COMPONENT GROUP

September

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2010	2011	2010	2011	2010	2011
By type of spending							
Food and non-alcoholic beverages	110.5	0.1	0.2	0.0	1.5	0.1	2.3
Alcoholic beverages and tobacco	149.5	0.0	3.5	8.6	3.0	8.6	9.3
Clothing and footwear	95.4	3.7	3.9	–11.5	–12.1	0.0	–0.1
Housing	125.0	0.1	0.1	3.6	5.1	4.2	7.2
Furnishings and household equipment	108.7	0.4	0.3	0.1	0.1	0.8	1.0
Health	95.8	0.0	0.1	–0.6	–0.5	–0.5	–1.1
Transport	118.3	0.1	0.6	6.1	4.8	6.8	7.9
Communications	97.6	0.0	0.1	–0.5	–1.0	–0.5	–1.2
Recreation and culture	98.0	–2.3	–2.4	–0.6	0.5	–0.7	0.0
Education	117.9	0.6	0.6	0.7	0.7	2.5	2.3
Restaurants and hotels	115.6	–1.0	–1.1	1.9	1.7	1.5	1.4
Other goods and services	115.5	0.1	0.1	2.2	2.2	2.6	2.8
By group							
Processed food, beverages and tobacco	117.5	0.1	0.8	0.9	2.4	1.1	4.1
Unprocessed food	109.9	0.1	0.3	1.6	0.3	1.3	1.3
Non-food products	111.1	0.1	0.1	0.8	0.8	2.4	3.1
Industrial goods	108.1	0.8	1.0	0.1	0.1	3.2	4.6
Energy products	*136.3*	*0.2*	*0.8*	*9.7*	*9.9*	*11.1*	*15.9*
Fuels and oils	*133.3*	*0.3*	*1.1*	*12.0*	*10.1*	*13.9*	*16.4*
Industrial goods excluding energy products	*98.7*	*1.1*	*1.1*	*–3.2*	*–3.6*	*0.4*	*0.5*
Services	114.3	–0.7	–0.7	1.5	1.6	1.5	1.6
Underlying inflation (**)	109.2	0.0	0.2	–0.2	0.0	1.1	1.7
GENERAL INDEX	**112.1**	**0.1**	**0.2**	**0.9**	**1.0**	**2.1**	**3.1**

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

previous month, inflation forecasts remain below 2% for 2012. Give that the medium-term aim of the European Central Bank (ECB) is precisely to keep inflation below this figure of 2%, pressure continues to lower interest rates.

However, this scenario might take some time to arrive due to the fact that the new ECB president, Mario Draghi, will want to make sure that the upswing in inflation is actually temporary, as well as certifying the slowdown in the euro area. However, other types of liquidity measures might be implemented sooner.

A comparison between the harmonized index of consumer prices (HICP) in the euro area and Spain helps us to gauge the competitiveness of the Spanish economy, given that the former is our main trading partner. In this case, the year-on-year change both for Spain and the euro area stood at 3.0%. These two rates had not coincided since August 2010 and this latest figure seems to confirm that

Inflation in the euro area is up by 5 tenths of a percentage point compared with the previous month.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2010											
January	–5.5	0.9	–0.5	–0.3	–0.9	6.3	3.4	–0.9	0.2	0.2	–
February	1.0	1.1	–0.6	0.0	–0.4	6.8	4.8	–0.5	0.3	1.5	0.6
March	5.6	2.3	–0.1	0.0	0.4	10.1	7.4	1.2	0.5	4.3	–
April	2.8	3.7	0.1	–0.1	2.4	13.1	8.5	2.1	0.7	6.6	–
May	13.7	3.8	0.2	–0.1	3.5	12.0	10.2	4.2	1.6	9.9	0.5
June	8.6	3.2	0.3	0.1	3.7	8.7	10.1	5.3	2.0	10.9	–
July	4.5	3.3	0.2	0.2	3.2	9.8	9.3	4.9	2.0	10.5	–
August	5.1	2.7	0.0	0.5	3.4	7.0	8.7	6.0	1.8	10.2	1.3
September	8.0	3.4	0.2	0.5	4.0	9.1	9.2	6.9	1.8	10.6	–
October	10.3	4.1	0.6	0.5	4.3	10.5	8.6	6.4	1.7	10.5	–
November	10.3	4.4	0.9	0.6	5.1	10.7	9.2	7.7	2.1	11.0	1.4
December	8.5	5.3	1.3	0.7	5.7	13.5	10.4	8.1	2.5	11.8	–
2011											
January	3.7	6.8	1.5	1.0	6.8	17.3	11.7	7.3	2.0	12.2	–
February	1.3	7.6	1.9	0.9	7.9	18.5	11.1	6.2	1.4	13.1	1.8
March	–5.2	7.8	2.1	1.2	8.0	18.6	10.8	5.4	1.5	11.6	–
April	–4.7	7.3	2.5	1.3	7.1	17.1	10.0	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	2.0
June	6.7	6.7	2.6	1.3	6.5	15.4	7.8	2.6	0.6	6.9	–
July		7.5	2.8	1.4	6.8	17.9	9.1	3.3	1.0	8.0	–
August		7.1	2.7	1.2	6.2	17.3	8.9	2.4	1.0	7.3	...

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

Spain narrows its inflation differential with the euro area in September.

Spain is indeed regaining some of its competitiveness. Nonetheless, we must be very cautious until we can confirm the significance of Eurostat's methodological change in closing the inflation gap with the euro area.

In summary, the upswing seen by inflation in September is merely an interruption in the downward trend taken by prices both in Spain and in the euro area. The refusal of energy products to join this descent might hold back a process that seems inevitable given the sharp slowdown in the European economy, including Spain.

Foreign sector

The trade deficit, caused by oil and the European economy

August's trade deficit increased by 10.4% year-on-year, putting an end to four consecutive months of correction. This large imbalance results from the upswing in imports, up by 17.5% year-on-year, after their moderate fall in July. In spite of this temporary decline, the bulk of the evidence available suggests that the foreign sector will continue to be the main engine of the economy during the second half of the year. Weak domestic demand, which is reducing the pace of growth of imports, will play in its favour. However, there are two factors that will determine the future trend of the trade balance: the pace of growth of Europe's economy and trends in oil prices.

In fact, close to two thirds of the Spanish goods exported during 2011 went to a country in the European Union. The good performance of exports to these countries, up 19.3% year-on-year in

Trade deficit up 10.4% year-on-year in August.

FOREIGN TRADE

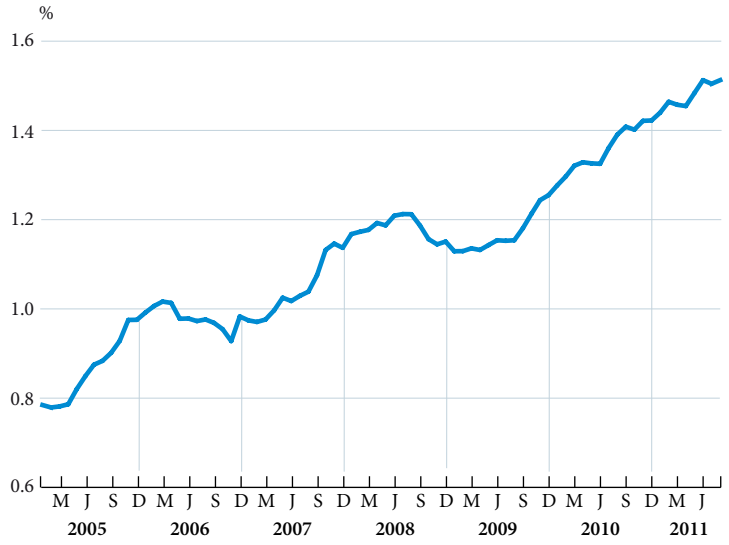
January-August 2011

	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	36,577	26.6	21.4	8,672	58.5	6.2	–27,905	23.7
Consumer goods	39,224	2.0	22.9	45,360	12.8	32.3	6,136	115.6
Food	*10,470*	*6.2*	*6.1*	*16,825*	*8.9*	*12.0*	*6,355*	*160.7*
Non-foods	*28,754*	*0.6*	*16.8*	*28,536*	*15.2*	*20.3*	*–218*	*99.2*
Capital goods	11,107	–2.5	6.5	12,278	21.9	8.7	1,171	110.5
Non-energy intermediate goods	84,164	11.8	49.2	74,132	17.2	52.8	–10,033	88.1
By geographical area								
European Union	89,288	5.5	52.2	92,625	15.3	66.0	3,337	103.7
Euro area	*72,463*	*6.5*	*42.4*	*73,887*	*11.9*	*52.6*	*1,424*	*102.0*
Other countries	81,784	17.9	47.8	47,817	23.6	34.0	–33,967	58.5
Russia	*6,171*	*56.1*	*3.6*	*1,623*	*35.3*	*1.2*	*–4,548*	*26.3*
United States	*6,980*	*17.2*	*4.1*	*5,494*	*29.0*	*3.9*	*–1,485*	*78.7*
Japan	*2,143*	*–7.8*	*1.3*	*1,150*	*23.4*	*0.8*	*–992*	*53.7*
Latin America	*10,970*	*20.3*	*6.4*	*8,118*	*26.6*	*5.8*	*–2,851*	*74.0*
OPEC	*18,132*	*20.9*	*10.6*	*5,464*	*24.5*	*3.9*	*–12,669*	*30.1*
Rest	*37,389*	*13.1*	*21.9*	*25,967*	*20.8*	*18.5*	*–11,422*	*69.5*
TOTAL	**171,072**	**11.1**	**100.0**	**140,442**	**18.0**	**100.0**	**–30,630**	**82.1**

SOURCES: Ministry of the Economy and own calculations.

EXPORTS TO CHINA CONTINUE TO GAIN IN SIGNIFICANCE

Weight of Spanish exports to China with regard to total



SOURCES: Ministry of the Economy and own calculations.

The slowdown in Europe's economy jeopardizes exports.

August, has resulted in a favourable trade balance for Spain with the European Union as a whole. This situation has not occurred since 1986. Of particular note is the case of France and Portugal, where the cumulative surplus for the last twelve months reached 9.3 and 7.8 billion euros respectively.

Energy imports grow by 27.7% year-on-year in August, boosted by the high price of crude.

Given these data, there's no doubt that the decline in economic vigour expected in Europe for the coming quarters will lead to a slowdown in Spanish exports. However, the rate of exports to countries with less trading tradition with Spain might absorb part of this drop. One clear example of this is China. As can be seen in the graph above, the volume of exports to the Asian giant has gradually increased in relative weight over the last few years.

The current deficit accelerates its rate of decline in July.

On the other hand, the trend in oil prices will also play an important role in determining the future trade imbalance. In fact, the cumulative energy trade deficit between September 2010 and August 2011 reached almost 40 billion euros, accounting for more than 80% of the total trade deficit in this period. The sharp rise in the price of crude since September 2010, easily exceeding 100 dollars per barrel, explains this imbalance. The breakdown of energy imports for this period confirms this. Although these grew by 27.7% year-on-year in August, their increase in real terms was just 2.7% in the same period.

Future stagnation in the price of crude, not discounting slight falls, could ease the pressure on the trade deficit for the coming quarters.

The current deficit falls in spite of higher interest costs

Within this context, the cumulative current deficit for the last twelve months speeded up its rate of decline in July with a fall of 16.3% year-on-year. This correction was largely due to the good

performance by the balance of goods, revived by the fall in imports. However, the foreign trade figures point to less adjustment in August. In addition to this current balance component, also of note are the items of services and income due to their opposing trends.

In the case of the former, the cumulative service balance surplus for the last twelve months reached 31.5 billion euros, 20.9% more than the figure for the same period a year ago. The rise in tourism was the main reason. This can be seen in the trend of tourism revenue, almost reaching 2008's record high in July. Europe's relatively healthy economy and the armed conflict in North Africa boosted visits by foreign tourists.

However, there are risks of a slowdown in tourism's rate of growth as from 2012. At the same time, we also expect the income balance deficit to go on increasing. Between August 2010 and July 2011, this reached 26.8 billion euros, up 14.8% year-on-year. The rise in payments due to the higher financing cost of Spain's public and private debt is one of the main reasons. Tension in the financing markets is expected to continue over the coming quarters, moderating the adjustment in the current deficit in the medium term.

The income deficit rises due to the higher financing cost for Spanish debt.

BALANCE OF PAYMENTS

July 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	–23,344	–16.6	–42,510	6,080	–12.5
Services					
Tourism	*17,157*	*14.7*	*29,158*	*2,890*	*11.0*
Other services	*1,572*	–	*2,298*	*2,539*	–
Total	18,729	24.3	31,456	5,429	20.9
Income	–18,174	36.4	–26,787	–3,444	14.8
Transfers	–6,129	4.8	–7,400	771	–9.4
Total	**–28,919**	**–9.9**	**–45,241**	**8,836**	**–16.3**
Capital account	**3,025**	**–27.6**	**5,142**	**–764**	**–12.9**
Financial balance					
Direct investment	–6,231	–	–9,353	–15,020	–
Portfolio investment	5,386	–	44,128	15,380	53.5
Other investment	31,593	–	63,188	114,815	–
Total	**30,748**	**–**	**97,962**	**115,176**	**–**
Errors and omissions	–10,691	306.4	–10,514	–5,586	113.3
Change in assets of Bank of Spain	5,836	–91.5	–47,349	–117,263	–

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

Public sector

The increase in the write-down of Greek public debt, up to 50%, affects European sovereign debt markets.

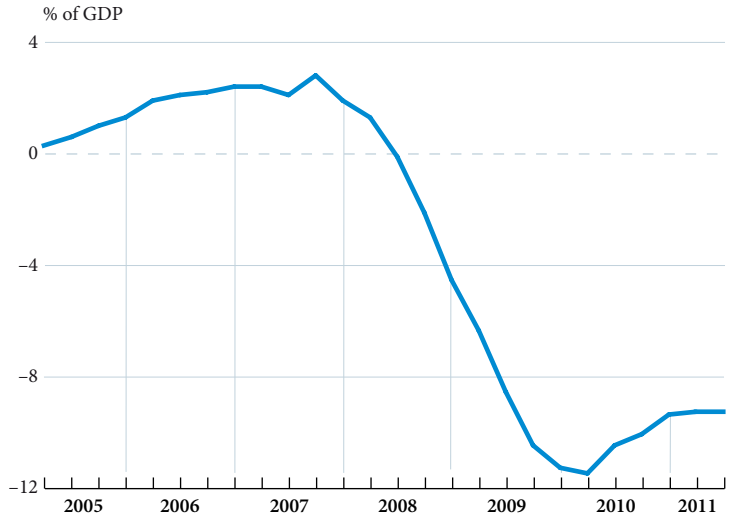
The deficit target looks difficult to achieve

The European public debt markets continue to be the focus of international attention and the main question is still the situation of the Greek economy and its ability to stabilize its public debt. In this respect, discussions on the need to raise the write-down of Greek debt above the 21% initially planned are keeping the European financial sector on edge. However, it seems that the main European leaders have finally decided to take far-reaching measures. The summit at the end of October is expected to define the conditions for recapitalizing Europe's banks and the mechanism to allow the EFSF to increase its lending capacity to avoid contagion.

These measures aim to restore investor confidence in the public debt markets; something that has already happened in Ireland, for example. The extensive correction in fiscal imbalances and the good performance of the Irish economy have reduced pressure on its public debt over the last three months. For Spain, on the other hand, rating agencies once again downgraded its public debt rating in October due to increased doubts regarding the solidity of its economic recovery. This increased pressure on the

NO ADJUSTMENT IN PUBLIC ADMINISTRATION BORROWING

Cumulative public sector lending (+) / borrowing (–) over the last four quarters



SOURCE: National Institute of Statistics.

risk premium for Spanish debt, with this rising above 350 basis points during the second half of October.

Moreover, there is the risk that the public deficit will not achieve the target set by the government for 2011. Data for the quarterly non-financial accounts of public administrations show that borrowing stagnated in the second quarter of 2011. As can be seen in the graph above, cumulative public borrowing over the last year accounted for 9.2% of the gross domestic product (GDP) in June. This represents a correction of just one tenth of a percentage point compared with the level at the end of 2010. In fact, if we compare the figures from the first half of this year with the previous year, we can see that borrowing increased slightly, up to 41.4 billion euros.

This stagnation is partly due to the inertia shown by some items of public spending. One clear example is social benefits, including unemployment benefit and retirement pensions, as well as social transfers in kind, principally education and health. In both items we can see that, in spite of halting its upward trend of previous periods, spending has hardly fallen during the first half of the year. This contrasts with the fall in spending on gross capital formation (investment) and payroll, a result of fiscal adjustment measures. This improvement, of 5.3 billion euros compared with the first half of 2010, was nevertheless neutralized by the higher interest paid on public debt and the lower revenue from taxes on production.

Public sector borrowing remains at 9.2% of GDP in June.

The public deficit seems unlikely to achieve the target of 6.0% of GDP set by the stability programme for 2011. Available figures to date present the fiscal imbalances of the autonomous communities as one of the main reasons for not achieving this target. The trend in the central government's accounts in the third quarter is not very encouraging either. The cumulative cash deficit between January and August fell by 9.1% year-on-year to 33.7 billion euros. Should this rate of shrinkage continue up to the end of the year, the imbalance would exceed the target set by the government by three tenths of a percentage point of GDP, the main reasons for this being the weak growth in taxes and the rise in financial costs.

Lower public investment and wage cuts reduce public spending by 5.3 billion euros during the first six months.

As a consequence, our public deficit forecasts for 2011 have been revised upwards to 7.5% of GDP, 1.5 percentage points above the fiscal consolidation target. Consequently, and given the postponement of the privatization of the state lottery and the airports of Barcelona and Madrid, we expect Spain's public debt to reach 69.7% of GDP in the same period. However, in spite of Spain's public deficit perhaps not achieving its target for this year, the level of debt will remain at a relatively low level compared with the main countries in Europe.

We have revised our deficit forecast for 2011 upwards to 7.5% of GDP.

Savings and financing

The private sector continues to reduce its indebtedness

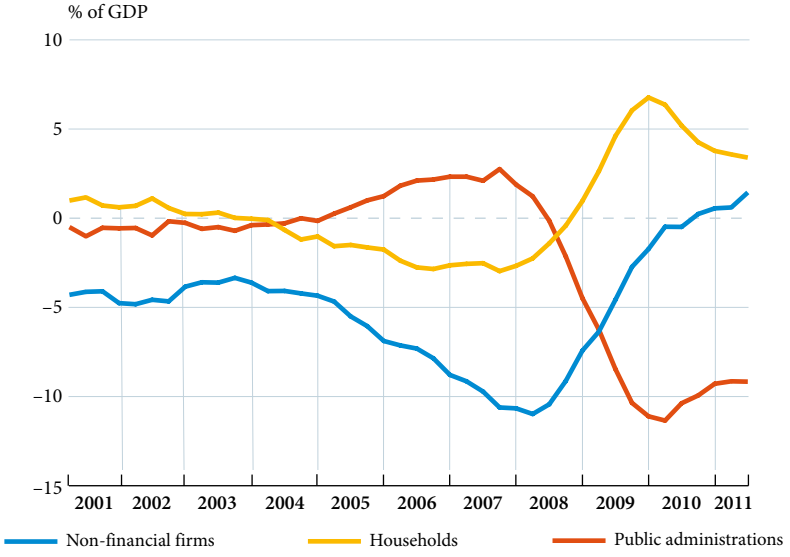
The new capital ratio requirement for the main European banks is raised to 9%.

Europe's banks have to recapitalize. Finally, tensions in the sovereign debt markets, particularly for the peripheral countries, have meant that measures must be taken to reinforce the solvency of the main holders of public debt, namely banks. The aim of this measure is to restore confidence in wholesale financing markets regarding the health of financial institutions and thereby help to channel credit towards different sectors of the economy. However, the requirement for banks to have more fixed capital might make it harder for credit to be granted in the short term. In Spain's case this situation would occur within a context of stalling economic growth and private sector deleveraging. All these factors auger further falls in credit for the remainder of 2011 and 2012.

It's certainly quite surprising that the decision to recapitalize the main European banks has come just three months after they passed the stress tests. The reason is that the scenarios simulated by the European Banking Authority did not include the possibility of a write-down of the public debt held by the banks. This scenario now seems more likely after the events of the last few months. That's why the new capital requirements have been raised by four percentage points to 9.0% of risk-weighted assets. Moreover, the value

THE PRIVATE SECTOR IS A NET LENDER IN THE FIRST HALF OF 2011

Borrowing (–) and lending (+) of institutional sectors



SOURCE: Bank of Spain.

of peripheral sovereign debt has been reduced. These reductions range from 50% in the case of Greek bonds to 2% for Spanish. These measures will only affect those banks that are large enough for their failure to jeopardize Europe's financial system as a whole, also known as systemic banks.

With regard to Spain, there are five banks that will have to meet these new capital ratios. However, the Spanish financial sector has little exposure to Greek public debt. This, and the slight discount carried out on Spanish bonds, places the sector's need for additional capital at 26.2 billion euros.

All this will occur within a context where the private sector will continue to maintain its rate of deleveraging. As can be seen in the graph above, Spain's non-financial private sector was a net lender between July 2010 and June 2011, lending the equivalent of 4.9% of Spain's gross domestic product (GDP). This figure is four tenths of a percentage point higher than the figure recorded at the end of 2010 due to improvements in the accounts of non-financial firms. As a consequence, private debt fell slightly in the second quarter, maintaining the trend started a year ago. This, however, was not enough to meet all the capital required by public administrations. During the first half of the year, public administrations saw almost no reduction in their borrowing, this remaining at 9.2% of GDP, so their indebtedness continued to grow.

The data available for the third quarter show that this trend has continued, with a clear drop in private sector financing, particularly in terms of bank loans. Debt in the hands of the private sector fell by 54.5 billion euros during the first eight months of the year, a drop of 2.5% year-on-year. This shrinkage affected both households and non-financial firms

Spain's main banks will require more than 26 billion euros of additional capital.

The private non-financial sector's lending represents 4.9% of GDP in June 2011.

FINANCING OF NON-FINANCIAL SECTORS (1)

August 2011

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,155,875	–54,528	–1.5	75.6
Non-financial corporations	1,277,603	–34,236	–1.1	44.8
Resident credit institution loans (3)	*857,223*	*–40,252*	*–3.4*	*30.1*
Securities other than shares	*65,739*	*2,914*	*7.4*	*2.3*
External loans	*354,641*	*3,101*	*3.5*	*12.4*
Households (4)	878,272	–20,292	–2.0	30.8
Housing loans (3)	*670,240*	*–9,719*	*–1.1*	*23.5*
Other (3)	*204,601*	*–10,684*	*–5.0*	*7.2*
External loans	*3,430*	*111*	*6.2*	*0.1*
General government (5)	696,388	54,586	13.7	24.4
TOTAL	**2,852,526**	**321**	**2.2**	**100.0**

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

Credit to other resident sectors falls by 3% between December and August.

in equal measure. If we look only at bank credit to the other resident sectors we can see that, over the same period, the drop in the outstanding credit balance was 3.0%.

Further drops in credit are more than likely in the coming quarters. On the one hand, the closure of wholesale markets will not allow interest rates for new credit transactions to fall. In fact, during the first eight months of the year, the cost of financing increased by one percentage point for households. Firms also recorded a significant increase of seven tenths of a percentage point in the same period. On the other hand, the slowdown in economic recovery expected for the coming quarters will continue to weaken demand for credit.

Both factors, the fall in the credit balance and weakening of Spain's economy, will push up the doubtful debt rate. In August, this rose to 7.15%, 22 basis points above the level recorded the previous month. The deterioration in property portfolios is seen as one of the main reasons. In this sector, the little dynamism in real estate activity and the adjustment of house prices represent a large part of the risks that will have to be faced by Spain's financial system in the future.

The Deposit Guarantee Fund will take on any losses resulting from restructuring.

Risks that, should they turn out to be losses, might partly be assumed by the financial institutions' Deposit Guarantee Funds, after the Decree Law of 14 October was passed. This regulation, which has unified the guarantee funds of banks, savings banks and cooperatives, aims to ensure that the banking sector itself can meet the net costs occurring due to its restructuring.

Household savings continue to fall

In the first quarter of 2011, the household savings rate continued its downward slide started a year ago, down to 12.8% of disposable income in cumulative terms for the four quarters. This figure is far from the maximum reached in 2009, when families' precautionary savings pushed it above 18%. We expect the savings rate to go on falling, reaching 11.4% by the end of 2011.

The data for bank liabilities are in line with this forecast. Bank liabilities in the hands of households and firms recorded a year-on-year drop of 0.3%. As can be seen in the table above, this fall is due to the trend in short-term deposits, especially savings accounts. Term deposits, for their part, remained almost at a standstill

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

August 2011

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	262,999	1,233	0.5	5,053	2.0	18.8
Savings deposits	202,760	–8,528	–4.0	–8,741	–4.1	14.5
Term deposits	727,919	–15,730	–2.1	737	0.1	52.2
Deposits in foreign currency	18,356	–1,026	–5.3	–1,205	–6.2	1.3
Total deposits	**1,212,033**	**–24,051**	**–1.9**	**–4,156**	**–0.3**	**86.9**
Other liabilities (*)	**183,384**	**–19,628**	**–9.7**	**634**	**0.3**	**13.1**
TOTAL	**1,395,418**	**–43,679**	**–3.0**	**–3,522**	**–0.3**	**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.

during the same period. Part of the fall in deposits is due to lower interest rates for new deposit operations which, in the case of households, were down by 8 basis points. This lower return continues the trend started a month ago, after the decree came into force that limits the interest rates offered by bank deposits.

The closure of wholesale financing markets since the end of August would have revived competition between financial institutions to attract retail deposits. As a consequence, September's figures might show a certain upswing both in interest rates and in the volume of deposits. However, there are two factors that might quickly slow up this increase. Firstly, October's injection of liquidity by the European Central Bank into the banking sector, with the reappearance of twelve-month auctions. This will reduce the financial institutions' borrowing in the short term. Secondly, the use of new instruments other than deposits to attract retail funds. As is the case of commercial paper, these do not require compliance of the aforementioned decree's conditions.

The household savings rate falls further, down to 12.8%.

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CAJA DE AHORROS
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Research Department

Av. Diagonal, 629,
torre I, planta 6
08028 BARCELONA
Tel. 34 93 404 76 82
Telefax 34 93 404 68 92
www.laCaixa.es/research

e-mail:
For enquiries regarding
The Spanish Economy
informemensual@lacaixa.es

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As of December 31, 2010

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

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

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

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