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THE SPANISH ECONOMY

Monthly Report

SAVING: VICE OR VIRTUE?

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RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2009	2010	2011	2010				2011	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast					Forecast	
Gross domestic product									
United States	–2.6	2.8	3.0	2.4	3.0	3.2	2.7	2.6	3.0
Japan	–6.3	4.0	1.3	5.4	3.3	4.7	2.6	1.5	1.3
United Kingdom	–4.9	1.7	2.1	–0.3	1.6	2.7	1.7	2.7	1.9
Euro area	–4.0	1.7	1.6	0.8	2.0	1.9	2.0	2.2	1.5
Germany	*–4.7*	*3.5*	*2.4*	*2.1*	*3.9*	*3.9*	*4.0*	*4.1*	*2.2*
France	*–2.5*	*1.5*	*1.8*	*1.2*	*1.6*	*1.7*	*1.5*	*1.9*	*1.9*
Consumer prices									
United States	–0.3	1.6	2.3	2.4	1.8	1.2	1.2	1.9	2.5
Japan	–1.4	–0.7	0.4	–1.1	–0.9	–0.8	0.1	0.1	0.3
United Kingdom	2.2	3.3	4.0	3.3	3.4	3.1	3.4	4.1	4.2
Euro area	0.3	1.6	2.1	1.1	1.5	1.7	2.0	2.5	2.3
Germany	*0.3*	*1.1*	*1.9*	*0.8*	*1.1*	*1.2*	*1.5*	*2.0*	*1.9*
France	*0.1*	*1.5*	*1.9*	*1.4*	*1.6*	*1.5*	*1.7*	*2.1*	*2.0*
SPANISH ECONOMY			Forecast					Forecast	
Macroeconomic figures									
Household consumption	–4.3	1.3	1.1	–0.3	2.2	1.5	1.7	1.1	0.0
Government consumption	3.2	–0.7	–1.5	–1.1	–0.1	–0.7	–0.9	–0.9	–2.3
Gross fixed capital formation	–16.0	–7.5	–2.2	–10.5	–6.7	–6.7	–6.1	–4.8	–4.2
Capital goods	*–24.8*	*1.9*	*4.4*	*–4.6*	*8.7*	*2.4*	*1.2*	*2.2*	*–0.2*
Construction	*–11.9*	*–11.1*	*–6.1*	*–11.3*	*–11.3*	*–11.2*	*–10.6*	*–9.2*	*–7.8*
Domestic demand (contribution to GDP growth)	–6.4	–1.2	–0.2	–3.0	–0.3	–0.7	–0.6	–0.7	–1.4
Exports of goods and services	–11.6	10.3	7.6	9.4	11.9	9.4	10.5	8.0	7.9
Imports of goods and services	–17.8	5.5	3.9	2.0	9.6	5.0	5.3	2.8	0.2
Gross domestic product	**–3.7**	**–0.1**	**0.7**	**–1.4**	**0.0**	**0.2**	**0.6**	**0.6**	**0.6**
Other variables									
Employment	–6.6	–2.3	–0.3	–3.8	–2.5	–1.7	–1.4	–0.6	–0.5
Unemployment (% labour force)	18.0	20.1	20.2	20.0	20.1	19.8	20.3	20.6	20.3
Consumer price index	–0.3	1.8	2.5	1.1	1.6	1.9	2.5	3.2	2.7
Unit labour costs	1.0	–1.5	–0.5	–0.9	–0.9	–1.9	–2.3		
Current account balance (% GDP)	–5.5	–4.5	–3.7	–6.0	–5.1	–3.7	–3.2		
Net lending or net borrowing rest of the world (% GDP)	–5.1	–3.9	–3.2	–5.4	–4.3	–3.1	–2.6		
General government financial balance (% GDP)	–11.1	–9.2	–6.4						
FINANCIAL MARKETS			Forecast					Forecast	
International interest rates									
Federal Funds	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	1.2	1.0	1.1	1.0	1.0	1.0	1.0	1.0	1.0
10-year US bonds	3.2	3.2	3.6	3.7	3.5	2.8	2.8	3.5	3.6
10-year German bonds	3.3	2.8	3.3	3.2	2.8	2.4	2.6	3.2	3.2
Exchange rate									
$/Euro	1.39	1.33	1.36	1.38	1.27	1.29	1.36	1.35	1.36

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Saving: vice or virtue?

When we were young, many of us were taught the virtue of saving and being prepared, together with values such as respect, responsibility and other virtues and customs that were intended to shape and strengthen our character. But at the most critical moments of the serious recession we have just gone through, and faced with a sharp upturn in household savings, the slogan was launched that it was better to consume. If we all decided to save, we were told, everyone would spend less and less and this would aggravate the recession in a vicious downward spiral. So is saving a private virtue but also a collective vice?

From the collective point of view, there are many different answers if we look at the disparity between the savings rates of different countries. Those that save the most, as a percentage of their gross domestic product, are the Asian countries, with China at their head, which puts aside 54% of its annual product as savings. At the other end of the scale we find the United States, which save 14% of their product.

In any case, the virtue or vice of saving is tending to wane. Over the last four decades, the household savings rate for advanced countries as a whole has fallen on average from 12% to 8% of disposable income. The crisis has led to an upswing in savings rates due to precaution but, once the recession and unemployment have been left behind, it is likely to return to its underlying trend.

Several factors lie behind the downward trend in the saving behaviour of individuals in advanced economies. The very existence of a welfare state that guarantees certain benefits in contingencies such as unemployment, illness or retirement takes the wind out of the saving lobby's sails. The degree of sophistication of the financial system and tax incentives established by the authorities also influence people's preferences when deciding between saving or consuming. But the most important factor is probably demographic. In the life cycle theory, individuals save throughout their working lives and spend their savings when they stop work; the ageing population in our societies therefore entails less saving. On the other hand, in emerging economies, the savings rate has been growing over the last few years, thanks to their dynamic growth and to younger generations joining employment.

In spite of this downward trend in global savings, in the last few years we have even heard talk of excessive saving. In 2005, the current Federal Reserve Chairman, Ben Bernanke, coined the term «saving glut» to refer to this situation. The fact is that, in advanced economies, the volume of savings has exceeded the volume of investment in real assets (infrastructures, buildings, machinery, equipment), playing a direct part in the notorious fall in real interest rates and the consequent drop in value of capital. However, we might be at the threshold of significant structural changes. The outlook for the coming years is one of contained savings in emerging countries due to their populations' greater desire to consume, among other reasons while, in developed economies, the downward trend in savings will probably not change. At the same time, there is some consensus that global investment will tend to increase, especially because of demand from emerging countries. If this occurs, the result, among others, will be the end of the low real interest rates we have been enjoying up to now, embarking on a new phase within the global savings framework.

EXECUTIVE SUMMARY

Rising commodity prices threaten the global recovery

Global growth consolidates early on in 2011...

The growth of the world's economy consolidated early on in 2011, continuing the trend recorded at the end of last year. Indicators for this year are still few and far between and, in some cases, have been slanted by January's peculiar weather. However, they clearly point towards a consolidation of companies' good performance. The emerging countries are driving world demand and advanced economies are taking advantage of this, although their domestic demand is still weak in general and, in some cases, the withdrawal of fiscal stimuli is not promoting greater dynamism.

...but the rise in commodities and particularly oil prices is causing concern.

The dark side of this recovery is made up of price tensions resulting from a much higher rise in commodity prices than expected. Global activity itself is pushing up prices in these markets, which started from very low levels in 2009. But the tension caused by disturbances in the Arab world, such as Tunisia, Egypt, Bahrain and particularly Libya, has been added to these pressures. Libya is an exporter of hydrocarbons and the violent situation that has erupted in the country has made oil prices rocket up to 120 dollars per barrel, three times the minimum at the end of 2008. This is probably a transitory episode but apprehension is high, particularly when thoughts go back to the record high of 147 dollars per barrel reached in July 2008, just before the start of the great recession.

Rising commodity prices within a context of recovery allows firms to pass on higher costs to the end product and this seems to be starting to occur, given the results of the surveys carried out directly on companies. This has therefore complicated the management of central banks as the main developed economies are still operating under the premise of lax monetary policy that resulted from the recent recession. But now the risks are shifting more towards tensions of growth and possible inflation. In emerging economies, most of the central banks adopted more restrictive monetary policies months ago, raising their official interest rates.

The United States prioritizes growth over adjusting its public sector imbalance.

In any case, there are substantial differences between countries. In the United States, the budget proposed for the 2011 tax year by Obama's administration contains a deficit larger than 9% of gross domestic product (GDP) for the third year running. The necessary fiscal consolidation has therefore been left for the future and the priority is to bolster the improvement in activity. Entrepreneurs are optimistic: the business sentiment index of the Institute for Supply Management continued to pick up in January, both in manufacturing and services. Inflationary risks are not a worry: production capacity is still underused and the consumer price index (CPI) is contained. Neither are there any labour tensions: employment is improving, albeit very slowly. In January, the unemployment rate fell again to 9.0% but this improvement was due to the bad weather, which reduced the number of people actively looking for work and only 36,000 new jobs were created.

In China, the latest business indicators, corresponding to December, merely confirm the economy's vitality. Tensions in the prices of the basket of goods and housing have forced the central bank to continue adopting restrictive measures in their monetary policy. Although to a lesser degree, something similar is happening in Brazil, the other large emerging economy, with a progressive tightening up of the monetary policy within a context of activity overheating.

In Europe, the engine is Germany, thanks to its solid export capacity and to the recovery in its domestic demand. In February, the business climate index of the Munich-based institute IFO was up for the ninth consecutive month and set a new record since the country reunified, confirming the good feelings of entrepreneurs. Consumers are also looking good, with car sales up 16.5% year-on-year in January. Consumption's progress is supported by the good labour market prospects, as in January the unemployment rate fell by one tenth of a percentage point to 7.4%. Inflation is tending to rise but core inflation, excluding energy and foods, is at 1%.

German dynamism is spreading out to its neighbours, as highlighted by the growth figures for the fourth quarter. Sweden, Finland and Poland exceeded Germany's rate of 4.0% year-on-year, immediately followed by Denmark, Czech Republic, Austria, Netherlands and Hungary. At the other extreme, Greece, Ireland and Romania posted negative rates. In spite of such disparities, the growth of the euro area, on average, stood at 2% in the last quarter of the year, a cruising speed that remained stable throughout most of the year.

But while average growth has remained stable for the last few quarters, it's a very different story with inflation. In January, Eurostat's flash estimate gave a year-on-year rate of 2.4% in the euro area compared with 1.0% a year earlier. Several members of the European Central Bank (ECB) have stated that, in 2011, they expect inflation to remain above 2% year-on-year for a longer period than desired, before it moderates. Is the ECB's objective of price stability in danger? Its President has attempted to convey the message that this upswing is due to one particular phenomenon that does not alter the institution's strategy but everyone realizes the complexity of the decisions being made within a monetary union with such disparate growth rates and prices disturbingly on the rise.

The emerging countries are facing the dangers of their economies overheating.

In any case, investors' expectations have shifted towards sooner and faster rises in the ECB reference rate, at 1% since May 2009. The 12-month Euribor rate has risen appreciably, reaching the levels of spring 2009. Over the coming months, we cannot rule out variability in interbank rates increasing even further, as the euro area's economic growth consolidates and the ECB's discourse becomes more combative with inflation, as a prelude to rises in the official interest rates in the second half of the year.

German dynamism is spreading out to its neighbours.

To further complicate the panorama, the sovereign debt crisis, although somewhat deactivated in February, has by no means been averted. The decisions taken at European Union summit held between 24 and 25 March will be very important, regarding the different aspects to coordinating economic policies and changes in the instruments created to tackle the crisis caused by the fiscal situation of several member states in the euro area.

In Spain, GDP grew by 0.2% in the last quarter of 2010 compared with the third, placing the year-on-year rate at 0.6% and the drop in GDP for the year as a whole at

Expectation increases that the ECB will raise interest rates soon.

The Spanish economy closes 2010 with a decline of 0.1%.

0.1%. The gradual progress made by the Spanish economy was therefore consolidated throughout 2010, but it is still at a relatively low level and its pace is slower than euro area as a whole. The data from the National Accounts system published by the National Institute of Statistics show that the gains in GDP in the last quarter of 2010 were thanks to exports, up five tenths of a percentage point. On the other hand, domestic demand fell by three tenths of a percentage point in the same quarter, in spite of improved household consumption. Nonetheless, domestic demand performed better because it reduced its negative contribution to growth by one tenth of a percentage point, down to –0.6 points. Exports increased their contribution to GDP by three tenths of a percentage point, up to 1.2 points.

Jobs are still being lost and inflation is rising...

Exports played an important part, speeding up their rate of growth in year-on-year terms to 10.5%. It should be noted that, unlike the pattern seen in the last two years when the improvement occurred mainly due to a drop in imports, in 2010 the foreign sector's positive contribution was dominated by exports performing well. The better performance by foreign tourism is significant, with a large rise in the number of visitors and reversing the downward trend of the last two years.

...but the increase in exports, as well as improved labour costs and productivity, restore faith in the recovery's solidity.

The weak pulse of the recovery can be explained by the still negative trend in the labour market, although this deterioration is tending to disappear. In this respect, the trend in new employment registrations with Social Security is significant, down in January compared with the previous month by 223,143 people, although this becomes zero when seasonally adjusted. The seasonally adjusted monthly figures by sector show that services generated some jobs in January while industry and construction continued to lose jobs that month, although less sharply.

The same fragility in domestic demand is reducing the risk of inflation but this has not stopped the CPI from climbing up to 3.3% in January, in year-on-year terms, compared with the 1.0% of January 2010. Higher prices for electricity, fuel, tobacco and, to a lesser extent, some components of food lie behind January's rise. The upswing in inflation observed in Spain in the last few months has been higher than the one recorded in the euro area, so that the inflation differential has gone from zero in December 2009 to 0.6 percentage points in January 2011.

In spite of this rise in inflation measured by consumer prices, the fact is that unit labour costs have fallen considerably and that productivity is growing at a notable pace. It's true that this is mainly due to labour market adjustments but it is also because wages have entered a phase of moderation which is helping to improve the competitiveness of Spain's industry. In short, the adjustment in the Spanish economy is on course, now supported by a foreign sector in expansion and a domestic demand that is slowly becoming more stable. These are the trends we expect throughout 2011, providing the prices for oil and the rest of commodities don't upset the apple cart.

25 February 2011

CHRONOLOGY

2010

April	7	The government presents its **extraordinary Infrastructure Plan**, which will involve 17 billion euros in the coming two years.
	9	The government passes a **new package of measures to boost economic activity**.
	10	The Finance Ministers of the euro area announce the **conditions for helping Greece**.
	12	The government proposes **a new plan to reform the labour market**, to be discussed within the context of social dialogue.
May	2	Countries in the euro area **approve financial aid for Greece**, totalling 110 billion euros.
	10	The European Union adopts a **European Stabilization Mechanism**, provided with 750 billion euros, with the involvement of the International Monetary Fund.
	20	The government approves a Decree-Law to adopt **extraordinary measures to speed up the planned reduction in its public deficit**.
June	17	The European Council decides to publish the **stress tests** for the main European banks, to levy a **new tax on banks** and improve the **budget discipline and macroeconomic standards**.
	22	The Spanish parliament **approves a Decree-Law with urgent measures to reform the labour market**, proposed by the government.
	26	One year after the Fund for Orderly Bank Restructuring (FROB) was set up, the Bank of Spain considers the **process of restructuring savings banks** in Spain to be almost complete.
	27	The **G-20** summit decides to halve the deficits of advanced economies by 2013.
July	1	**Rise in the general VAT** rate from 16% to 18%, and the reduced rate from 7% to 8%.
	9	The government approves the **reforms of the Savings Bank Governing Body Act**.
	22	The Ministry of Public Works specifies its **cuts in public works spending**.
	23	The Committee of European Banking Supervisors publishes the results of the **stress tests** on European banks.
September	9	The Spanish lower house passes the **labour reforms**.
	24	The government passes the bill for the **2011 General State Budget**, involving strong adjustments aimed at reducing the public deficit.
	29	**General strike**, called against the labour reforms.
October	20	Extensive reshuffle in the **Spanish government**.
November	19	The government establishes a **legislative calendar** that includes **pension and collective bargaining reforms**.
	24	**Ireland** presents an **adjustment plan** with tough measures to cut its public deficit in order to receive **financial aid** from the EU and the IMF.
December	3	The government approves a package of **economic policy measures** that includes, among others, the partial privatization of the state lotteries management body and the public corporation AENA, as well as raising taxes on tobacco.
	16	The European Council agrees to create a **European Stability Mechanism** in 2013, which will replace the current bailout fund, as well as to enlarge the capital of the European Central Bank.

2011

January	1	Estonia joins the **euro area**, which grows to seventeen member states.
	14	Ben Ali's regime in Tunisia falls, the first in a chain of **political changes** in North Africa and the Middle East, with repercussions for oil prices.
February	2	Signing of the **Social and Economic Agreement** by the government, trade unions and employers, including pension reform.
	18	The government passes a Decree-Law to reinforce the solvency of **financial institutions**.

AGENDA

March

- **2** Registration with Social Security and registered unemployment (February).
- **3** Governing Council of the European Central Bank.
  EU GDP (fourth quarter).
- **4** Industrial production index (January).
- **10** Retail and consumer goods (January).
- **11** CPI (February).
- **15** Fed Open Market Committee.
- **16** EU HCPI (February). Labour costs (fourth quarter).
- **22** International trade (January).
  Government revenue and expenditure (February).
- **24** European Council.
- **25** European Council. Producer prices (February).
- **30** Retail and consumer goods (February).
  HCPI flash estimate (March).
- **31** Balance of payments (January).

April

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

INTERNATIONAL REVIEW

The United States: how to reduce unemployment without getting into debt

The United States must grow above 3% to reduce unemployment but debt is a burden.

The economy's growth will be corseted in 2011 by an upper limit of around 4%, imposed by the need to reduce the high level of household debt, and by another lower limit of 3%, which is the growth threshold as from which unemployment starts to fall. The positioning between these two references will be modulated by fiscal and monetary policy that, as weak growth is perceived to be a greater risk than inflationary tension, is clearly biased towards expansion. The budget proposed for the 2011 tax year by Obama's administration involves a budget deficit that, in 2011, might continue above 9% of gross domestic product (GDP) for the third consecutive year, leaving the necessary fiscal consolidation for the future.

The economy grows by 2.8% in 2010, boosted by private consumption.

GDP grew by 0.7% quarter-on-quarter in the fourth quarter, 2.7% year-on-year, which gives a growth (rate) of 2.8% for the whole of 2010. The national accounts were characterised by strong private consumption, up 1.0% compared with the previous quarter; a strength that is supported by a lower savings rate and government stimuli. With significant quantitative effects but without setting a trend, inventories deducted a substantial part from growth, offset by large reductions in imports due to modifications in the prices paid. In addition to the

UNITED STATES: MAIN ECONOMIC INDICATORS

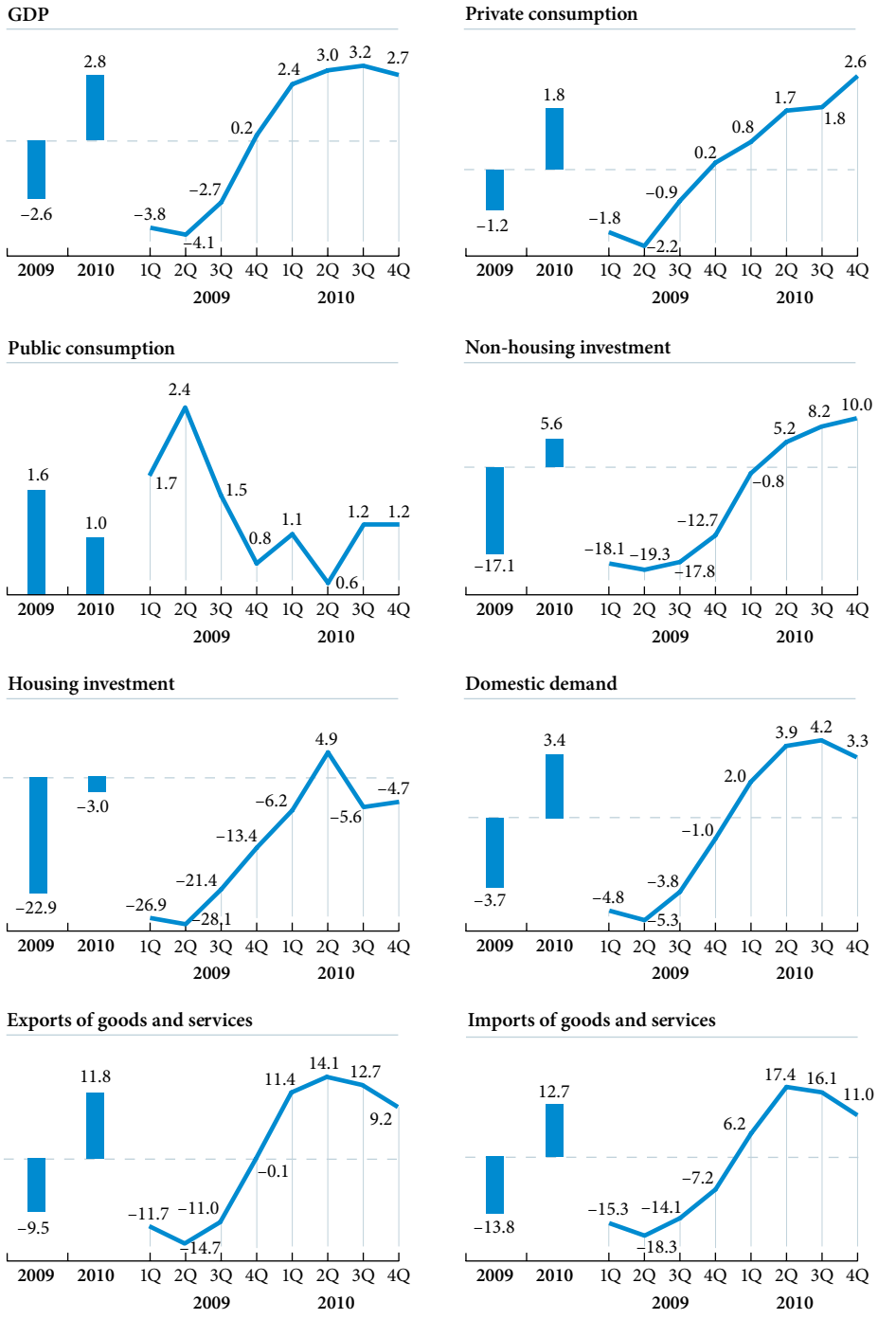
Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011
			1Q	2Q	3Q	4Q	January
Real GDP	–2.6	2.8	2.4	3.0	3.2	2.7	–
Retail sales	–6.4	6.5	5.6	6.9	5.8	7.7	7.8
Consumer confidence (1)	45.2	54.5	51.7	58.2	50.9	57.0	65.6
Industrial production	–9.3	5.7	2.7	7.4	6.9	5.9	5.2
Manufacturing (ISM) (1)	46.3	57.3	58.6	57.6	55.2	57.9	60.8
Housing construction	–38.4	5.6	16.5	12.2	0.4	–5.5	–2.6
Unemployment rate (2)	9.3	9.6	9.7	9.6	9.6	9.6	9.0
Consumer prices	–0.4	1.6	2.4	1.8	1.2	1.3	1.6
Trade balance (3)	–374.9	–497.8	–398.5	–450.7	–485.4	–497.8	...
3-month interbank interest rate (1)	0.7	0.3	0.3	0.5	0.3	0.3	0.3
Nominal effective exchange rate (4)	77.7	75.3	74.8	77.6	75.9	73.0	73.0

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.

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Bureau of Economic Analysis and own calculations.

Consumers should curb the intensity of the upswing to restore their savings.

upswing in consumption, the most noticeable trait of the period was the slowdown in capital goods investment, together with an improvement in residential investment, which is now contributing positively to growth.

Private consumption has been growing faster than income for the whole of the second half of 2010, but the retail sales of December and January point towards this upswing in consumption easing. Although solid, the 5.7% year-on-year growth, discounting the more volatile cars and petrol, has slowed down compared with previous months, which should be seen as a return to some rationality, considering that gross household debt is still 117.7% of gross disposable income. The required reduction of debt needs savings and growth.

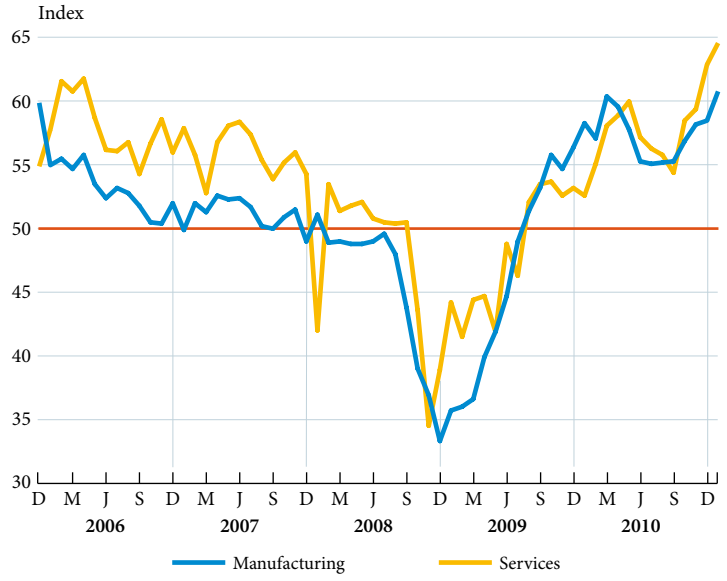
Entrepreneurs, with less debt and expectations of profit, appear optimistic.

In December, household savings stood at 5.3% of disposable income, when in June this was 6.3%. The need not to delay too much in sorting out consumer finances and the public treasury, as well as the trends in the latest activity indicators, suggest that growth is unlikely to go much above 3% in 2011, consistent with a savings rate of 5.5%. Even so, if confidence in US assets means that expansionary policies can be maintained, higher growth rates cannot be ruled out. The Fed upped its forecasts for 2011 and 2012, with growth around 3.6% and 4.0%, respectively, implying greater private consumption and a lower savings rate, close to 4% of disposable income.

With a marked upward trend, optimism continued to catch on among entrepreneurs. Within this context, we should remember that non-financial firms have a lower debt level than banks, households and the public sector and, moreover, its trend is downwards. If we add to this the expectations of higher profits, boosted by rising demand

THE UNITED STATES: BUSINESS OPTIMISM IS PATENT

ISM index levels (*)



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

without too many cost tensions due to low production capacity utilization, we can understand why corporate America sees the situation as more positive than consumers. The business sentiment index of the Institute for Supply Management continued rising in January, climbing to the level of 60.8 points for manufacturing and 64.6 points for services, figures that have not been seen since 2005. The counterpoint to this optimistic view is provided by employment. While, in manufacturing, we can see a certain consolidation of the recovery, the expectations are somewhat less buoyant in services, which account for 80% of private employment.

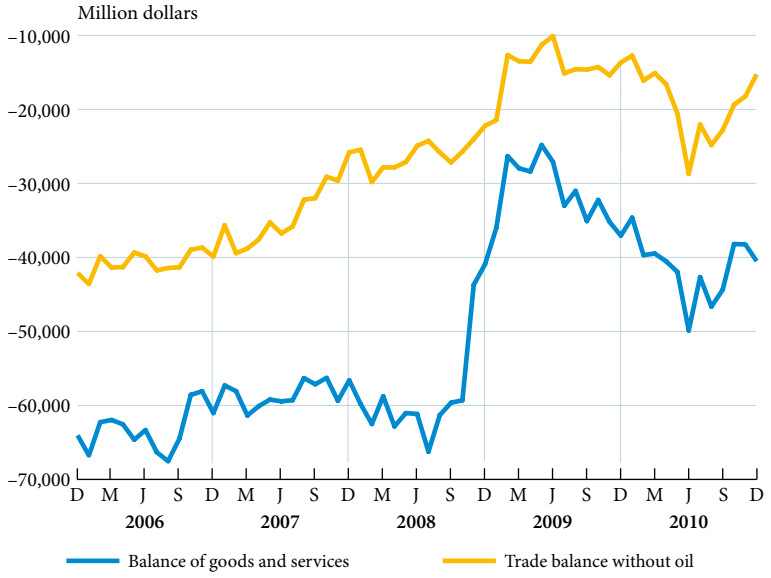
Although the unemployment rate fell again in January to 9.0%, this improvement was due to the bad weather, which reduced the number of people actively seeking work. This same bad weather meant that only 36,000 new jobs were created, clearly insufficient to help reduce the 8.5 million lost during the crisis. But more wood has been added to the fire in the labour market. The high proportion of long-term unemployed and the large number of discouraged workers and those working fewer hours than they would like mean that the vicious circle of unemployment is difficult to break, hence the expansionary budgets of Obama's administration.

During the crisis, high unemployment has been the main factor behind the rise in bad debt, ending up with mortgage foreclosures that add to the oversupply of housing, pushing prices down and keeping construction at a minimum. The Case-Shiller index for second-hand house prices fell in November for the fifth consecutive month, accumulating in this period a correction of 3.5%, 4.8% discounting inflation, which, if it gets worse, might have negative consequences for consumption and bank balances. For this very reason, construction continues at a level that is a third of what might be considered normal in the United States.

The larger number of discouraged workers will make it difficult for the unemployment rate to fall, currently at 9.0%.

THE UNITED STATES: WITHOUT OIL, THINGS SEEM CLEARER

Monthly balance of goods and services



SOURCES: Department of Trade and own calculations.

The CPI rises 1.6% but inflation is under control with the core CPI up 1.0%.

However, there are signs that the sector's confidence is starting to improve.

In prices, inflation is still under control in spite of rising prices for oil and the rest of commodities. The general consumer price index (CPI) for January continued rising to 1.6% year-on-year, pushed up by oil prices. However, within the current context of surplus production capacity, neither tensions in production prices or energy prices are affecting the core CPI, which excludes energy and food prices and is a more accurate reflection of the fundamental trends, as shown by its moderate 1.0% increase year-on-year, close to October's record low. In this respect, the Fed continues to forecast moderate prices.

Japan shrinks by 0.7% and, with the end of the boost from exports, is looking at a 2011 with modest progress.

In December, the foreign sector provided a more than positive note. Although rising oil prices meant that the deficit rose to 40.6 billion dollars, 5.9% higher than the good figures for November, the deficit excluding oil and its derivatives fell to 15.3 billion, the best figure since January 2010, which coincided with the period when the deficit was abnormally low due to the credit crisis interrupting trade flows. These figures are even more positive because this improvement is due to a recovery in exports. As it is the trade balance excluding oil that sets trends, we expect the foreign sector to continue contributing to growth in the fourth quarter. Given the size of the US economy, the weight of the recovery must be supported by domestic demand but, at present, any help is appreciated.

Japan: back to reality

The Japanese economy deflated in the fourth quarter, down 0.7% compared with the previous quarter which, nonetheless, leaves the total growth rate for 2010 at a solid 4.0%, due mainly to the push from exports in the first half of the year and, to a lesser extent, to the different public stimuli received by

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2009	2010					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	–6.3	4.0	–1.8	5.4	3.3	4.7	–	2.6	–
Retail sales	–2.3	2.5	–0.7	3.8	3.7	3.2	–0.2	1.5	–2.2
Industrial production	–21.8	16.0	–5.1	27.1	21.1	12.9	5.8	4.2	4.9
Tankan company Index (1)	–40.8	0.0	–24.0	–14.0	1.0	8.0	–	5.0	–
Housing construction	–27.7	2.7	–20.9	–7.0	–0.8	13.7	6.5	6.9	7.1
Unemployment rate (2)	5.1	5.1	5.2	4.9	5.2	5.1	5.1	5.1	4.9
Consumer prices	–1.3	–0.7	–2.0	–1.2	–1.0	–0.8	0.2	0.1	0.0
Trade balance (3)	4.0	8.0	4.0	6.7	7.4	8.1	8.0	7.8	8.0
3-month interbank interest rate (4)	0.6	0.4	0.5	0.4	0.4	0.4	0.3	0.3	0.3
Nominal effective exchange rate (5)	98.6	106.0	99.6	101.1	102.8	109.1	111.2	110.7	110.9

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

private consumption throughout 2010. It is precisely these two sectors that weakened the most in the fourth quarter. Exports dropped by a small 0.6% compared with the third quarter, after having managed to grow more than 10%, while private consumption went from 1.1% growth to losing 0.7%.

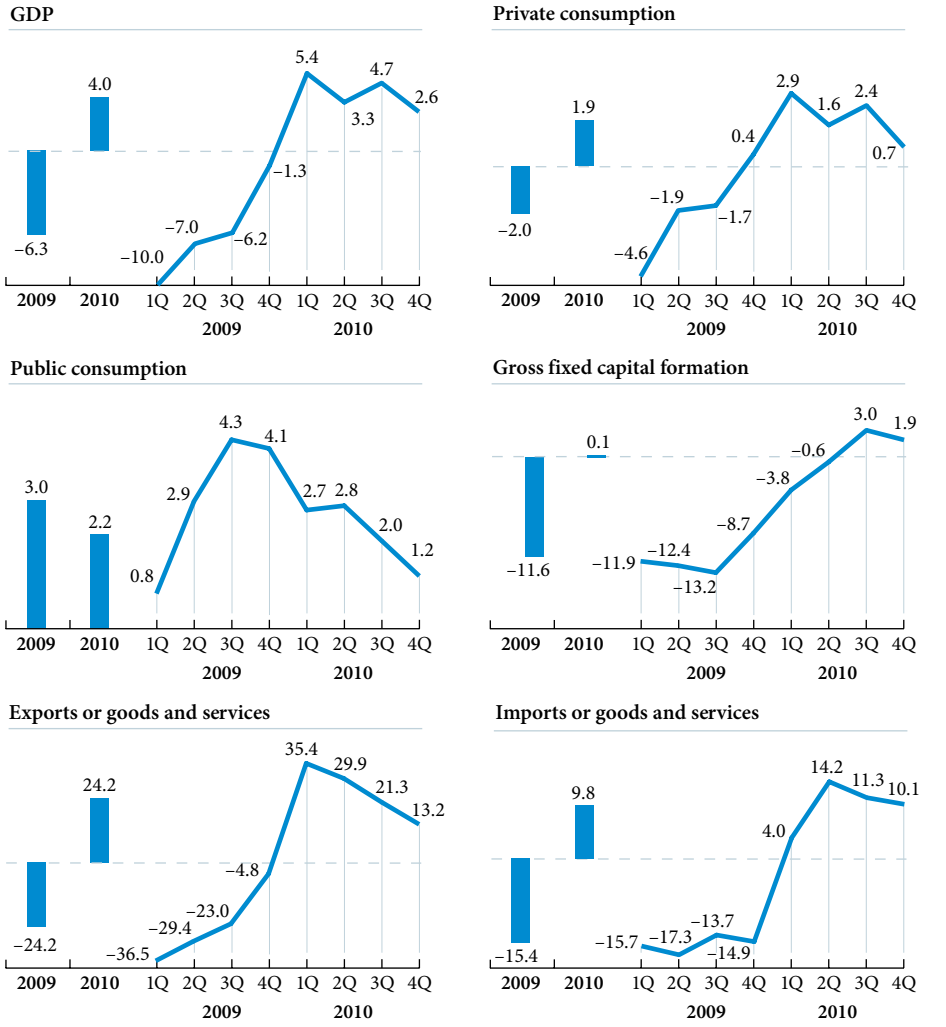
Capital goods investment slowed up, while construction was severely hit. The outlook for 2011 is therefore one of growth slightly below 1.5%, more in line with the production possibilities of an economy that is still deflationary and has recently had its sovereign debt downgraded which, in GDP terms, is the largest of all rich countries.

Business indicators show a weak domestic demand. In January, car sales fell for the fourth consecutive month after the withdrawal of public incentives, standing 23.8% below the same period a year ago,

Domestic demand weakens and heavy public borrowing restricts new stimuli.

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Institute of Economic and Social Investigation and own calculations.

Industrial production picks up but deflation continues.

while retail sales in December fell by 2.2% year-on-year.

The positive counterpoint was provided by supply, with industrial production intensifying its upswing in December, albeit starting from a very low point. Machinery orders followed a similar trend, these being an early indicator for investment although, in this case, we will have to wait and see whether the good figures of December continue. Another plus for the Japanese economy was December's slight drop in unemployment to 4.9%, but deflation's shadow is looking long. December's CPI fell again compared with the previous month, recording a zero year-on-year increase, while core inflation, the general index without energy or food, dropped 0.7% year-on-year.

China: new year, old inflation

Inflation in China stands at 4.9% year-on-year in January and forces new wage increases.

There's still a great risk of the Chinese economy overheating. The year of the rabbit has started with 4.9% inflation year-on-year in January, higher than December's figure of 4.6% and than the target level of 4% presented by the executive, although below the forecasts of the consensus.

Once again, the rise in food prices –10.3% year-on-year in January compared with the 7.2% average in 2010– and the rising trend in housing costs stand out. However, we must point out that the new composition of the price index, with food having less weight, might have contributed to inflation being lower than expected by the consensus.

Given these inflationary tensions, several regions in the country have chosen to raise the minimum wage. Shanghai and Guangdong province, in the south, will be the next regions to ride the wave of wage increases. Although some people are warning of rising labour costs as a factor that might encourage inflationary pressures, we mustn't forget that the gains in Chinese worker productivity (in the order of 10% annually in the last decade) largely offset these wage rises.

Within this context, the monetary authorities have continued to take a restrictive stand. At the beginning

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2008	2009	2010				2011
			1Q	2Q	3Q	4Q	January
Real GDP	9.6	9.2	11.9	10.3	9.6	9.8	–
Industrial production	12.6	12.5	19.8	16.0	13.5	13.3	...
Electrical power generation	6.7	6.8	22.6	17.8	11.8	6.2	...
Consumer prices	5.9	-0.7	2.2	2.9	3.5	4.7	4.9
Trade balance (*)	298	197	149	156	183	185	177
Reference rate (**)	5.31	5.31	5.31	5.31	5.31	5.81	6.06
Renminbi to dollar	6.9	6.8	6.8	6.8	6.8	6.7	6.6

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

of this year, the central bank once again raised the official interest rate by 0.25 basis points (up to 6.06%), the third rise since October. The further increase in the cash reserve ratio in mid-February was also a surprise, the second raise in little more than a month and the eighth since the start of 2010, putting the ratio close to 19.5% for large banks.

This marked tightening up of monetary policy seems to have had an effect on the indicator for credit which, at a little more than 430 billion renminbi in January, is starting to show the correction so desired by the central bank.

The regulations of the last few weeks have once again highlighted the tension existing between monetary policy and exchange rate policy. The recent hikes in the interest rate attract more capital flows towards China, which puts pressure on the country's aim for the renminbi to appreciate gradually. We believe this dilemma will be resolved with a somewhat higher appreciation rate than we are used to, but not much more (around 0.5% per month).

Undoubtedly, if the Chinese currency were more flexible, this would help to correct external imbalances. In particular, January's trade figures merely confirm the strength of exports. In spite of the reduction in the trade surplus, a consequence mainly of the festivities to celebrate the Chinese Lunar New Year, both exports and imports grew much more than the consensus expected.

Even tougher monetary conditions: interest rates and cash ratios.

Brazil: Rousseff steps on the brake

The solid reactivation of the economy after a fleeting recession, the strong push from credit and the prolonged fiscal aid before the presidential elections of October 2010 ended up increasing inflationary pressures in Brazil. Pressures that, together with the marked rise in agricultural prices and the higher commodity prices being passed on to some industrial components, have pushed inflation up to 6.0% in January. In the short term, such pressures are not expected to die down, so that the scenario facing the Brazilian economic authorities is relatively complicated.

The symptoms of overheating in the Brazilian economy demand a speedy reaction from the new government.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2010				2011
			1Q	2Q	3Q	4Q	January
Real GDP	5.2	–0.7	9.3	9.1	6.8	...	–
Industrial production	2.9	–7.3	17.4	14.2	8.1	3.5	...
Consumer confidence (*)	140.4	138.3	158.1	154.6	159.5	159.3	164.2
Unemployment rate São Paulo (**)	13.0	12.8	12.4	13.2	12.1	10.9	...
Consumer prices	5.7	4.9	4.9	5.1	4.6	5.6	6.0
Trade balance (***)	24.8	25.3	23.2	19.3	16.9	20.3	20.9
Interest rate SELIC (%)	11.25	11.25	8.75	10.25	10.75	10.75	11.25
Reales to dollar (*)	1.8	2.3	1.8	1.8	1.7	1.7	1.7

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion dollars.
SOURCES: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

Adjusting interest rates will not be enough; this must be accompanied by fiscal consolidation and credit limitations for public bodies.

It's even more complicated if we take into account the fact that Brazil's real interest rates are the highest among emerging economies, making the Amazon giant one of the main destinations for the world's abundant liquidity in search of good returns. The rocketing volume of capital inflows, 50% more in 2010 than in 2009 according to government estimates, is pushing up the real and reducing the competitiveness of Brazilian industry and exports, limiting the monetary authority's arsenal in their fight against inflation since it forces them, to a certain extent, to ration any interest rate hikes so as not to aggravate the situation. They have therefore opted to combine these measures with other instruments, fundamentally by controlling foreign capital inflows and restricting credit.

New adjustment measures should be expected throughout 2011.

These restrictions can only increase. In the storm of the crisis, the boost given to credit by publicly-owned financial institutions helped to moderate the effects of the recession. However, this vigour has remained in spite of private credit picking up, so that, given the obvious inflationary pressures, there is a great need to adjust public credit. Brazil's central bank has already taken various measures in this direction. To start with, it has reversed the reduction in reserve requirements for term deposits implemented after the crisis; similarly, after six months with no changes, the Selic rate was raised by 50 basis points in January, so that it has now accumulated a rise of 250 basis points since the recovery started, i.e. half of what it lost in the crisis. Lastly, it has been announced that, as from July, the capital requirements will increase for consumer loans with maturities longer than 24 months and for loans backed by salary and with maturities longer than 36 months.

Dilma Rousseff is also reining in on the fiscal side. After announcing, at the beginning of February, her intention to cut the budget for 2011 by 50 billion reales (2.5% of the total), she persuaded Congress to pass a lower minimum wage increase than requested by the trade unions, the opposition and even members of her own coalition government. It has therefore been increased from 510 to 545 reales (around €238), remaining more or less in line with inflation.

Nonetheless, the risk of overheating persists and the investment required in infrastructures for the 2014 World Cup and the 2016 Olympics is only making matters worse. Consequently, if Brazil keeps its commitment to macroeconomic stability, as we expect, there's no doubt that it will employ all the weapons available to anchor inflation expectations again. We can therefore expect further adjustment measures from all sides: via credit, via interest rates and via taxes.

Mexico: on track

Mexico ends 2010 with a GDP flash estimate of 5.5% and consolidates its recovery.

Without doubt, 2010 was a great year for the Mexican economy. With 5.5% growth in GDP, it exceeded all expectations and posted the best annual figures in ten years. Data for the fourth quarter also recorded a rise of 1.3% compared with July-September and thereby confirm the consolidation of the Aztec recovery; a recovery that has been based on strong exports and a gradual rise in domestic spending.

In year-on-year terms, the GDP flash estimate in the last quarter of the year was 4.4%. By component, the primary sector grew the most, up 9.9% compared with the same period a year ago, thanks to the higher production of grain and other agricultural products. The secondary sector, for its part, posted growth of 4.7% and continued to be largely boosted by manufacturing

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2010				2011
			1Q	2Q	3Q	4Q	January
Real GDP	1.5	–6.1	5.0	7.4	5.3	4.4	–
Industrial production	–0.4	–7.0	5.5	7.7	6.5	4.6	...
Consumer confidence (*)	92.2	80.5	81.5	84.9	89.2	89.6	92.3
Leading business index (*)	118.2	110.9	115.3	116.9	117.7	118.6	...
General unemployment rate (**)	4.0	5.5	5.4	5.2	5.6	5.3	5.4
Consumer prices	–11.8	0.0	4.8	4.0	3.7	4.2	3.8
Trade balance (***)	–17.3	–4.6	–1.9	–2.4	–2.0	–3.1	...
Official Banxico rate (%)	7.50	6.75	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	10.6	14.2	12.3	12.8	12.6	12.3	12.2

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

industry, up by 6%. With regard to services, these grew by 4.2% compared with the fourth quarter of 2009, although some sectors, such as trade, financial services and insurance, particularly stood out for their rises, up 9.5% year-on-year each one.

Leading indicators of activity and improved economic expectations in the United States, the destination for 83% of Mexico's exports, continue to point towards a relatively favourable economic scenario for the country. In December, the global economic activity index (IGAE), an indicator of how the Mexican economy is performing, grew by 4.1% year-on-year. Mexican consumer confidence also continues to improve and is already above 92 points, thanks to the favourable labour market and the gradual recovery in credit.

So, with regard to 2011, we can expect growth of around 4.5%, a level more in line with its potential. We also expect pressure on prices to increase as the output gap closes. Nonetheless, we do not expect any change in the monetary policy of Banxico until domestic confidence has returned to its pre-crisis level and the recovery is completely consolidated, which we expect will happen at the beginning of 2012.

The renewed health of domestic demand is verified by some services picking up.

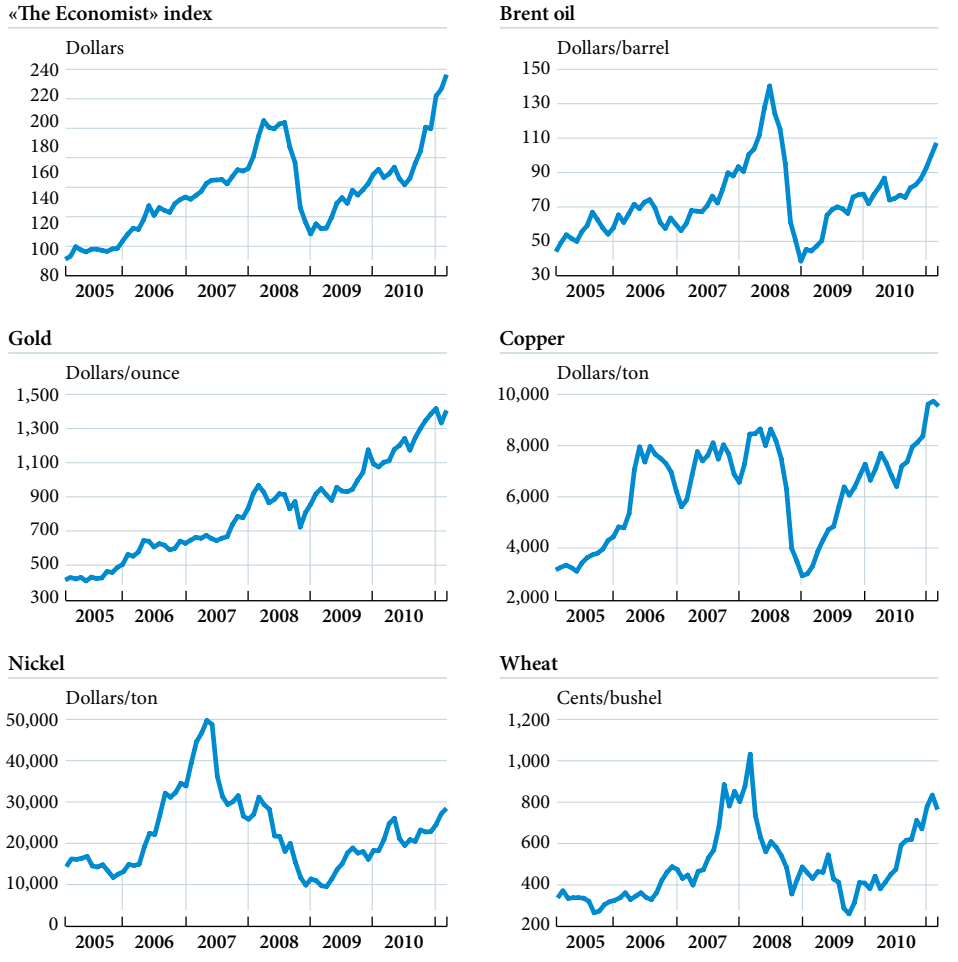
Oil prices break through the reference levels

The price of oil has started a decisive climb upwards. Between 20 January and 22 February, the price of crude increased by 11.2%, reaching 107.37 dollars per barrel (Brent quality, for one-month deliveries) and leading to an increase of 15.9% since the start of year and 38.0% since the start of 2010.

Political instability in the Middle East and North Africa has been added to other upward pressures, such as the expectations of greater world demand and the bottleneck in oil-producing countries that do not belong to OPEC, factors which pointed towards moderate increases throughout 2011. Whether crude returns to more normal prices will depend on how the area's political

The situation in North Africa will determine whether the price of oil falls below 100 dollars.

TREND IN VARIOUS COMMODITIES (*)



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

Gold benefits from being a safe haven, while coffee and tea dominate the rises in food.

situation pans out. Within a scenario of falling tension, oil prices might drop below 100.

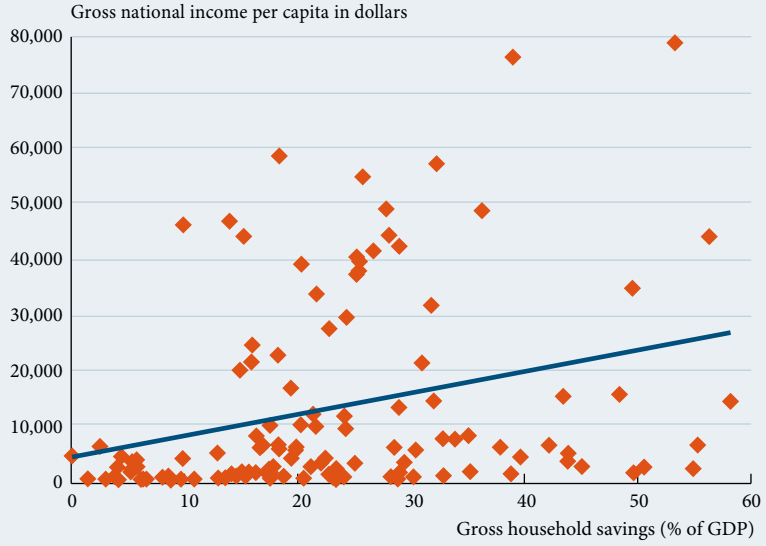
Rises continued to predominate in commodities as a whole, caused by growing demand in the United States, which has come into competition with demand from emerging economies. The Economist index was up 5.2% between 20 January and 22 February; however, there are significant disparities. Gold once again crossed the barrier of 1,400 dollars per ounce, benefiting from it being a safe haven, while the rise in nickel stands out among the base metals. While copper is showing signs of losing steam, aluminium, whose production is energy-intensive, should end up increasing if higher energy prices become consolidated. Among foods, the overall trend is still upwards, dominated by rising tea and coffee prices while, in the last two weeks, sugar lost everything it had gained in the previous two weeks, highlighting just how volatile the commodities markets have become.

Why do savings patterns differ over time and between countries?

In the last four decades, the household savings rate for advanced countries as a whole has dropped, on average, from 12% to 8% and, as a consequence, the pattern of growth has become more dependent on consumption. Although this figure is strongly influenced by changes in the composition of the population, mostly its ageing, the downward trend in the savings rates suggests that agents may have altered their consumption decisions. On the other hand, there are also significant differences in savings behaviour between countries. So which factors influence these differing savings patterns over time and between countries?

Firstly, the pattern of consumption can vary with the savings capacity or potential of each country and generation. We should therefore expect a region with a higher per capita income to find it relatively easier to save, so that richer economies should save proportionally more of their income than poorer countries. Within this context, this Box evaluates to what extent this relationship between income and savings holds true in practice. On the other hand, the savings model also depends on how agents' consumption reacts to changes in a series of economic variables, such as the interest rate, the degree of financial development, fiscal policies and inflation. Cultural factors also play an important part, as they help to construct the preferences that shape this propensity to consume.

A HIGHER PER CAPITA INCOME DOES NOT NECESSARILY ENTAIL HIGHER HOUSEHOLD SAVINGS



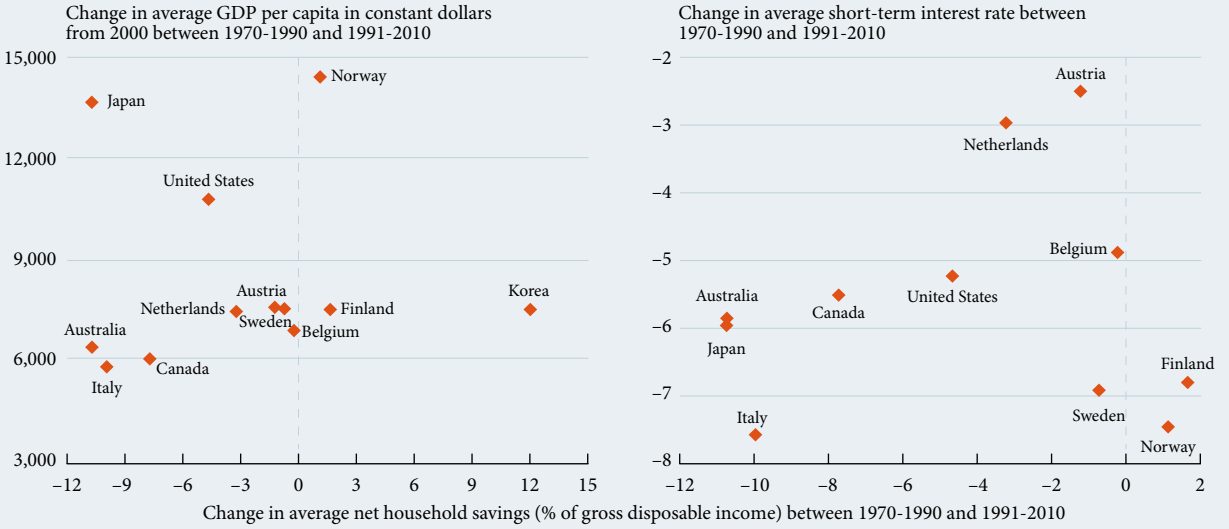
NOTE: 120 countries.
SOURCES: World Development Indicators (World Bank) and own calculations.

A comparison between countries reveals that the positive association between per capita income and the savings rate of households is not very solid, as shown in the previous graph. This suggests that the level of savings might be influenced by other factors. The same conclusion is also reached if we concentrate on the most advanced economies. The graph below shows that the fall in the savings rate has been widespread and independent of the rise in wealth of each country. One determining factor could be the fact that younger generations probably

economize less, although their per capita income is substantially higher than that of their predecessors. Other variables are therefore very likely to shape the propensity to consume and preferences, key factors in the savings pattern. If, on average, a country's households are relatively keener on consuming due to these factors or their tastes, then the national savings rate will be lower.

In fact, looking at those aspects that influence the desire to consume, of note is the role played by interest rates, perceived by agents as the price of spending now. The higher the interest rate, the more expensive it is to buy in the present, as depositing money in a bank will provide a better return and this will encourage people to save more. However, there may be an income effect (you need to keep less for the same gain in the future) that dominates this mechanism of substituting consuming today with consuming tomorrow, breaking this positive association between the interest rate and savings. The following graph shows that the downward trend in interest rates might certainly have had a negative effect on the savings rate over time, at least in advanced countries.

ADVANCED COUNTRIES HAVE SAVED LESS IN THE LAST TWO DECADES, PARTLY DUE TO FALLING INTEREST RATES



NOTE: Average 1975-1990 in France; 1978-1990 in Norway.
SOURCES: OECD, World Development Indicators (World Bank) and own calculations.

The degree of sophistication of financial instruments may have also contributed to the fall in the savings rate, particularly in more developed countries. On the one hand, the range of financial instruments for consumer credit has increased significantly and, in addition, the interest rate for these products has fallen over the last few decades. As a result, the year-on-year growth rate for consumer credit in the euro area between 1992 and 2010 was 5.1%, higher than the average growth rate for household consumption, which stood at 3.8%.

Other aspects of a demographic nature may have also led to differences in savings behaviour. In this respect, most studies agree that those countries with a higher ratio of dependent people, those aged under 16 and over 64, tend to save less. Insofar as the current population trend is leading, precisely, towards more ageing, this factor is expected to push savings down further, at least in the richer regions. According to data from the United Nations Organization,

the dependency rate of older people in developed regions rose from 15% in 1970 to 24% in 2010 and is expected to reach 45% by 2050.

From the perspective of fiscal policy (see the Box «Tax incentives for saving: do they work?»), this also alters incentives to save, as it can modify agents' disposable income. An example of how fiscal policy can alter savings decisions can be seen in Germany. According to an OECD study, fiscal stimuli to take out a private pension (*Riesterrente*) in the last decade have had a positive effect on this country's savings rate.[1] Certainly, this kind of aid can increase (or reduce) the cost of consuming today compared with tomorrow and this can result in individuals spending less (or more) in the present.

Lastly, agents' preferences influence how consumption reacts to different variables and thereby establish the different combinations of spending today versus tomorrow. Insofar as culture has a strong effect on shaping tastes, when this alters between generations, preferences change and consequently the consumption pattern. A society that was originally more adverse to risk and therefore more inclined to accumulate wealth might therefore no longer be so, and this would lead to a reduction in its savings rate. An example of this can be found in the case of Japan, where several studies have pointed out that the rise over time in the desire to consume today instead of tomorrow might have been a key factor in this country's falling savings rate.[2]

In short, although there are many different factors that lead to discrepancies in the savings pattern of different generations and countries, an analysis of the data shows that income level does not seem to be so decisive, whereas changes in interest rates, in financial development and in preferences, among others, are probably more crucial in explaining differing consumption patterns.

(1) Hüfner, F. and Koske, I. «Explaining household saving rates in G7 countries: implications for Germany», OECD, Economic Department, *Working Papers*, No. 754 (2010).
(2) Katayama, K. «Why Does Japan's Saving Rate Decline So Rapidly?», Policy Research Institute, Ministry of Finance, Japan (2006).

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EUROPEAN UNION

The euro area: the snow slightly hinders growth

The latest figures confirm the economic recovery in the euro area...

After closing the last quarter of 2010 and with almost all the economic data published, we can conclude that activity is definitely picking up in the euro area, although there's still a tailwind. In other words, various factors have slightly increased uncertainty regarding the growth trends in 2011. Among these are inflationary pressures and the tensions in some segments of the financial markets in the euro area, in particular public debt.

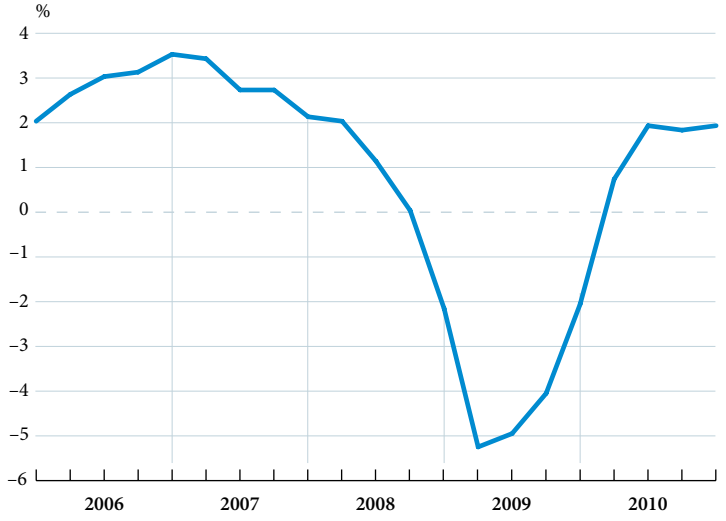
...in spite of adverse weather in the last quarter of last year.

In point of fact, the flash estimate for gross domestic product (GDP) for the fourth quarter 2010 published by the statistics office, Eurostat, showed an increase of 0.3% quarter-on-quarter with year-on-year growth at 2%. As can be seen in the graph below, the euro area has been advancing at this cruising speed of 2% since the second quarter of the year 2010.

Although we still don't have the breakdown of the GDP components, the bad weather suffered by the European continent in the months of November and especially December hit several economic sectors hard. For example, construction came to quite a standstill due to the bad weather in various countries, particularly Germany. We only need to think back to the collapse in transport due to the heavy snowfalls in Germany, France and Holland, among

THE EURO AREA CONSOLIDATES ITS ECONOMIC GROWTH

GDP year-on-year growth rate



SOURCE: Bloomberg.

other countries. Apart from the sectors of construction and transport, retail was also hard hit by the bad weather.

So what will happen now with consumption after the worst of the harsh winter has been left behind? Fortunately, the high frequency series give us an idea of how this key variable might perform. Of note are the consumer confidence indices, which continue to rise, indicating that consumption should behave relatively positively in the coming quarters, even more so considering that a large number of purchases were perhaps postponed due to the physical impossibility of getting to the shops.

For example, the consumer confidence survey carried out by the European Commission was up in February compared with the previous month, keeping intact the recovery started in March 2009. We must therefore conclude that the negative figures for retail sales in the months of November and December 2010 will not stretch into the first few months of this year. Moreover, the creation of jobs in countries such as Germany, France, Holland and Belgium should strengthen consumers' disposable income, although the unemployment rate is actually remaining stable at 10% for the euro area as a whole. However, we expect the unemployment rate for the whole area to fall over the coming months due to the slowdown in job losses in those member states that are not in such a good situation as the countries already mentioned.

Several countries in the euro area are already creating jobs.

Another important economic component to predict how economic activity will behave over the next few quarters is investment. This is where we might find the most positive surprises in the coming months. There are two reasons for such optimism. Firstly, it's highly revealing to analyze the performance of industrial production (excluding construction) for

High business confidence should bolster investment.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011
			1Q	2Q	3Q	4Q	January
GDP	–4.0	1.7	0.8	2.0	1.9	2.0	–
Retail sales	–2.4	0.7	0.6	0.6	1.5	0.2	...
Consumer confidence (1)	–24.8	–14.0	–16.8	–16.7	–12.1	–10.4	–11.2
Industrial production	–14.7	7.2	4.7	9.0	7.0	7.7	...
Economic sentiment indicator (1)	80.2	100.8	96.3	99.1	102.1	105.3	106.5
Unemployment rate (2)	9.4	10.0	9.9	10.0	10.0	10.0	...
Consumer prices	0.3	1.6	1.1	1.5	1.7	2.0	...
Trade balance (3)	–16.7	14.1	23.5	20.0	8.2	4.6	...
3-month Euribor interest rate	1.2	0.8	0.7	0.7	0.9	1.0	1.0
Nominal effective euro exchange rate (4)	111.7	104.7	108.7	103.2	102.3	104.4	102.4

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

Rising oil prices raise the price of imports...

the euro area as a whole, and this grew by 8.0% year-on-year in December. Secondly, business confidence indices remain at record high levels, a reflection of improved entrepreneur sentiment. This has been helped by orders from foreign orders and even to serve domestic demand.

However, there are two components that have reduced their contribution to economic growth: public expenditure and net exports. Regarding the former, although public spending grew by 2.6% year-on-year in 2009, in the third quarter of 2010 it did so at an imperceptible rate of 0.4%. The impact of budgetary restrictions can still be felt on public works, which at the end of 2010 were already falling at a rate of 14.4% year-on-year. Announcements regarding fiscal changes in member states of the euro area suggest that this component might even reduce economic growth in the first two quarters of this year.

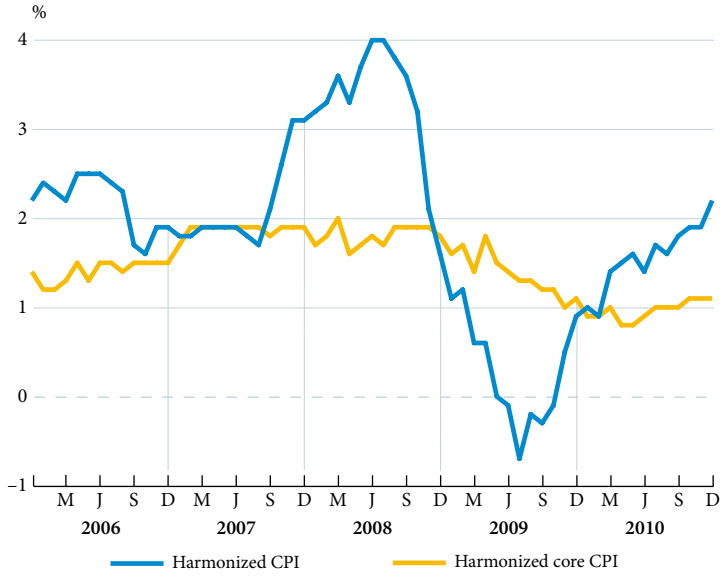
Regarding the figures for international trade, these point towards the risk of a negative contribution by the foreign sector to economic activity. In the months of November and December 2010, imports exceeded exports, totalling 1,549 and 533 million euros respectively. One of the main reasons for this situation is the rising price of oil and its effect on crude imports. Taking into account the recent upward trend in oil prices due to geostrategic problems in North Africa, we cannot rule out the possibility of the trade balance slightly reducing growth in GDP in the first six months of this year.

...and push up inflation in the euro area.

Considering all these factors, we expect economic growth for the euro area as a whole throughout 2011 will fall slightly towards rates of 1.5% year-on-year by the

INFLATION ISN'T BEING PROBLEMATIC BUT IT MUST BE CLOSELY MONITORED

Year-on-year rate of change



SOURCE: Bloomberg.

end of this year, so that the year overall might post an average growth in GDP close to 1.6%.

On the other hand, two big risks need to be highlighted: the tensions in prices and sovereign risk. Regarding the first risk, early figures for January put harmonized inflation at 2.4% year-on-year. The consensus of economists expect inflation to continue rising a few tenths of a percentage point over the next few months due to the sharp rises in food and energy commodities. Several members of the European Central Bank (ECB), among them Juergen Stark and Athanasios Orphanides, have even stated in various forums that they expect inflation in 2011 to remain above 2% year-on-year for a longer period before it moderates. For the moment, in our main scenario we have ruled out any second-round effects (such as wage rises) that might compromise the ECB's aim of price stability.

Regarding the second risk mentioned (sovereign debt), the various decisions taken at the European Union summit held on 24 and 25 March will be very important, concerning different aspects of coordinating economic policies and the changes in the instruments created to tackle the crisis caused by the fiscal situation of several member states of the European Union.

The European Union summit in March will be important for resolving the sovereign debt crisis.

In summary, the euro area's economic situation has a symmetrical risk. On the one hand, redirecting the aforementioned two risk factors might speed up growth, while, if they intensify, they could slightly slow down economic activity. It's no surprise that several supranational bodies, including the International Monetary Fund, have stated that the data confirm the euro area's economic recovery but that some turbulence remains that might disturb the plane's passengers.

The bad weather slows up the German engine in the fourth quarter

Germany's GDP grew by 0.4% in the fourth quarter of 2010 compared to the previous year, in seasonally and calendar

The German economy's gross domestic product grows by 0.4% in the fourth quarter, less than the previous quarter.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011
			1Q	2Q	3Q	4Q	January
GDP	–4.7	3.5	2.1	3.9	3.9	4.0	–
Retail sales	–3.2	1.4	1.1	0.6	2.8	0.9	...
Industrial production	–15.5	10.0	6.2	12.2	10.3	11.2	...
Industrial activity index (IFO) (*)	87.7	103.5	96.5	101.8	106.7	108.9	110.3
Unemployment rate (**)	8.2	7.7	8.1	7.7	7.6	7.5	7.4
Consumer prices	0.4	1.1	0.7	1.0	1.2	1.5	2.0
Trade balance (***)	142.8	149.2	143.3	150.2	149.9	153.4	...

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

Good labour market prospects support German consumption.

adjusted terms, a slowdown compared with the 0.7% of the third quarter. This slower rate of expansion can be put down particularly to the bad weather with the early onset of winter, leading to a sharp drop in construction. With regard to the rest of the GDP components, investment in capital goods and consumption contributed positively, as well as exports. All told, the year-on-year rate of change for GDP in the fourth quarter increased by one tenth of a percentage point to 4.0%.

In January 2011, car sales rose by 16.5% year-on-year, although this rate is inflated as it's compared with the weak figure of the previous year, after the subsidies had been withdrawn as from November 2009. Consumption's progress is based on the good prospects of the labour market.

The IFO indicator of economic sentiment is at its highest point since the reunification of Germany.

In fact, in January the seasonally adjusted unemployment rate fell by one tenth of a percentage point to 7.4% and the BA-X indicator for the demand for work clearly rose once again. Gross nominal wages will once again increase appreciably. However, an increase in Social Security contributions, and especially in inflation, will limit the growth of real disposable income and consequently the rise in consumption.

Consumption will probably continue to grow but at a more moderate rate. In fact, consumer confidence dipped in January, albeit after reaching record levels in November 2010.

Favourable expectations for investment in Germany thanks partly to foreign demand.

Consumer price inflation stood at 2.0% in January, 3 tenths of a percentage point above December's figure, boosted by rising prices for oil and other commodities. Core inflation, which excludes energy and seasonal foods, also increased to 1.0% but without showing any significant second-round effects to date.

The outlook for investment in capital goods is good, given the rise in industrial capacity utilization. Entrepreneur surveys confirm their willingness to invest more, both in extensions and also in new facilities. The increase in order portfolios, especially from abroad, validates such optimism. Investment in construction is also recording good prospects, as testified by the increase in permits granted. Moreover, February's IFO index of economic sentiment was up for the ninth consecutive month, setting a new record since the reunification of Germany and confirming the solidity of the economic recovery.

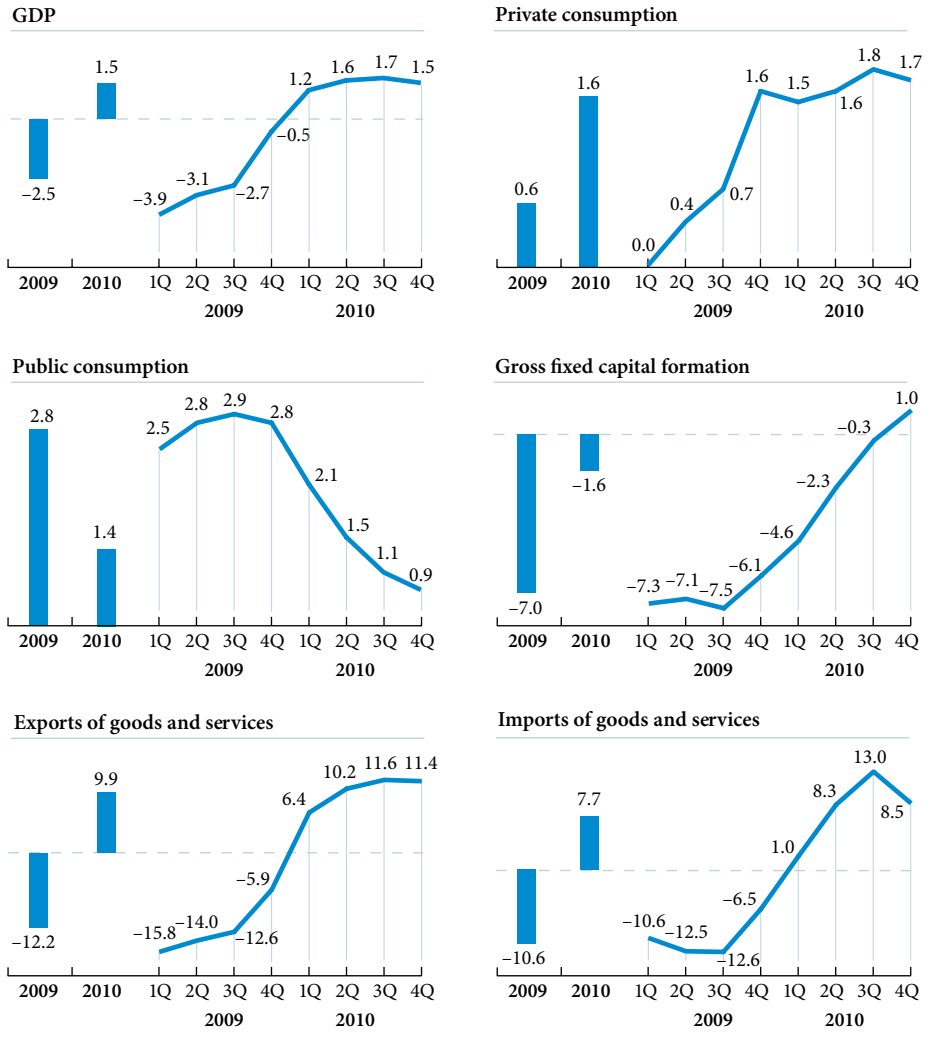
A clear increase in credit is also expected in 2011, which will help to boost economic activity. However, the withdrawal of budgetary stimuli in order to correct the public deficit and the slowdown of the global economy will work against this. For this year we therefore predict growth in German GDP of 2.4%, lower than the figure for 2010, namely 3.5%, but more balanced thanks to the sustained recovery in domestic demand. Economic activity will therefore exceed its pre-crisis level.

France: favourable growth prospects for the first quarter

Gross domestic product was expected to speed up in the fourth quarter but, at the end, the first official estimate posted quarter-on-quarter growth of 0.3%, only slightly above the figure for the third quarter. The level of economic activity in the last quarter of 2010 was affected by October's strikes against pension reform.

TREND IN FRANCE'S GDP BY COMPONENT

Percentage year-on-year change (*)



NOTE: (*) Data adjusted for seasonal and calendar effects.
SOURCES: INSEE and own calculations.

The year-on-year growth in GDP therefore fell by 2 tenths of a percentage point to 1.5% and the economy also expanded by 1.5% for the whole of last year. It should be noted that this rate is double the forecast in the central government's budgets for 2010 and represents a recovery after the biggest slump in 2009 of the post-war period, namely –2.5%. Nonetheless, GDP has still not regained its level before the crisis.

Household consumption speeded up notably in the fourth quarter, while investment lost a little steam, affected by the difficulties in public works due to the bad weather. However, domestic demand's contribution to quarterly growth was negative as a whole, due

The strikes against pension reform in France moderate GDP growth in the fourth quarter.

Entrepreneurs seem optimistic at the start of 2011.

to stock variations, while foreign demand contributed half a point after two quarters of negative contributions.

In January, the sales of new passenger cars fell by 13.9% compared with December, seasonally adjusted, after the withdrawal of subsidies to purchase a vehicle as from the start of 2011. However, these were 8.3% higher than the same month a year ago. Retail sales overall fell by 0.6% in volume in January compared with the preceding month, while consumer confidence fell very slightly in January, especially due to the unfavourable outlook for the labour market, standing below the long-term average.

Entrepreneurs were more optimistic and industrial activity picked up in January. This progress is expected to continue in February, albeit with less force. The increase in industrial capacity utilization also supported the rise in capital good investment, while the demand for new homes fell slightly in January, although above its historic average. For its part, the services sector improved appreciably at the beginning of 2011, with prospects of growth.

In 2010, the foreign sector contributed 4 tenths of a percentage point to the annual rise in GDP. This was boosted by the recovery in exports of goods and services, up 9.9% in volume after plummeting by 12.2% the previous year. This recovery in exports was in line with the trend in world trade, particularly spurred on by Asian demand. The world market share of French exports only fell by a few tenths of a percentage point to 3.5% in value and in dollars. However, imports of goods and services rose 2.2 points less than exports by volume. Nevertheless, the goods trade deficit widened in 2010, basically due to the higher energy bill. For 2011, exports' rate of expansion will probably slow up and the foreign sector's contribution is unlikely to continue being positive.

The unemployment rate refuses to fall and, in December, stood at 9.7% for the sixth month in a row. It was therefore slightly higher than the European Union's average, although a little

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011
			1Q	2Q	3Q	4Q	January
GDP	–2.5	1.5	1.2	1.6	1.7	1.5	–
Domestic consumption	0.8	1.0	1.8	0.4	1.5	0.5	...
Industrial production	–12.4	5.9	4.8	7.5	5.1	5.8	...
Unemployment rate (*)	9.5	9.7	9.8	9.7	9.7	9.7	...
Consumer prices	0.1	1.5	1.3	1.6	1.5	1.7	1.8
Trade balance (**)	–49.0	–47.0	–43.0	–45.1	–49.6	–50.4	...

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

lower than the average for the euro area. In the fourth quarter of 2010, salaried employment in the non-agricultural private sector rose by 0.2% compared with the previous quarter in seasonally adjusted terms. This increase was concentrated in the services sector and mostly corresponded to temporary jobs.

In February, the indicator of economic business sentiment remained stable, above its long-term average. Overall, the outlook for the first quarter is favourable thanks particularly to investment's good tone. It's moderately good for the year as a whole and we continue to expect annual GDP to rise by 1.8%.

We keep to our forecast of 1.8% annual GDP growth for France in 2011.

The Italian economy runs out of steam a little

In line with expectations, Italian gross domestic product grew by 0.1% in the last three months of 2010 compared with the previous quarter. This was the lowest quarter-on-quarter rate recorded last year, representing a slowdown in economic activity. From the point of view of supply, this slowdown can be explained by a fall in industry's value added, while both agriculture and services increased. For the year as a whole, GDP rose by 1.1%, the first positive annual figure after the falls of 1.3% in 2008 and 5.1% in 2009.

Italian GDP grows by 1.1% in 2010 after falls the previous two years.

Regarding demand, consumption advanced modestly according to indicators available for the fourth quarter while, in January 2011, consumer confidence slipped again. The rise in inflation, which stood at 2.1% year-on-year in January, did not help to encourage consumption insofar as it reduces real income. Neither did the situation of the labour market help to boost Italians' optimism, with zero job creation in December, seasonally adjusted, and with an unemployment rate still at 8.6% in the same month, in Eurostat's homogeneous terms. Consumption is therefore unlikely to progress more than moderately over the coming months.

The situation regarding investment appears to be more dynamic. In fact, industrial capacity utilization continued to rise at the start of the first quarter of 2011 and new orders for industry also rose in December, both national and foreign. Moreover, confidence improved in January for industry and services, although it worsened for construction.

With regard to the foreign sector, in the fourth quarter exports of goods were up 3.7% compared with the third quarter but less than imports, which rose by 5.3%. For 2010 as a whole, the trade deficit widened notably compared with the previous year due to the energy component. In 2011, the expected weakness in domestic demand means that the foreign sector might make a slight positive contribution to GDP growth.

Some encouraging signs can be seen in spite of the ups and downs in Italian politics. In 2010, the number of firms was up by 1.2%, the best figure since 2006. However, in December the OECD composite leading indicator for Italy pointed to a slowdown in the pace of growth for economic activity in the short term. Overall, for 2011 as a whole we expect Italian GDP to grow to a similar extent as in 2010, around 1%, below the euro area's average.

In Italy, consumer confidence is down at the start of 2011 but investment looks healthier.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011
			1Q	2Q	3Q	4Q	January
GDP	–5.1	1.1	0.5	1.3	1.2	1.3	–
Retail sales	–1.6	0.0	–0.3	–0.2	0.5	0.2	...
Industrial production	–18.2	5.4	3.5	7.7	6.3	4.4	...
Unemployment rate (*)	7.8	...	8.4	8.4	8.3	...	–
Consumer prices	0.8	1.5	1.2	1.4	1.6	1.8	2.1
Trade balance (**)	–10.2	–16.2	–7.7	–13.2	–19.1	–24.8	...

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

The United Kingdom: less growth and more inflation

The United Kingdom combines less growth and more inflation.

One of the worst nightmares of economic policymakers is an economy whose economic activity is slowing down combined with rising inflation and the figures for the fourth quarter confirm this situation for the United Kingdom. Fortunately, the prospects mean that we can wake up from this nightmare sensing an economic reality that gives cause for greater optimism.

The UK Office for National Statistics published the growth figures for gross domestic product for the fourth quarter, giving a nasty shock to all economists, who generally expected quarterly growth of around 0.5%. In fact, this figure was right but preceded by a minus. GDP actually fell by –0.5% and its year-on-year growth slowed up from 2.7% to 1.7%. After the initial shock, these bad figures were put down to the adverse weather that hit the United Kingdom in the months of November and especially December. Certainly, heavy snow closed the country's airports for weeks and caused chaos in transport, not only by air but also land, which obviously affected the whole economy but particularly the economic sectors of construction, transport and retail. However, those responsible for official estimates warned that, even taking into account the effect of the bad weather and correcting for this effect in the calculation, the economy would have presented a sad figure of zero growth. After the announcement of the GDP figures, the UK Minister of the Economy, George Osborne, stated that the bad weather will not change the course of fiscal policy and that no alteration was planned in the severe fiscal adjustment.

But the outlook for activity points to improvement.

However, the outlook for activity is better over the next few quarters. For example, industrial production in December maintained its growth at a pace of 3.6% year-on-year and, most importantly, the purchasing managers' index for economic sentiment (PMI), which is now available for the month of January, points to an intensification in growth, considering that both the manufacturing and the services indices have risen to 62 and 54.5, respectively. These indices are similar to a thermometer taking the temperature of the sector: when they go above 50 points, this indicates expansion, whereas a lower figure is indicative of shrinkage. In the

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2010				2011
			1Q	2Q	3Q	4Q	January
GDP	–0.1	–4.9	–0.3	1.6	2.7	1.7	–
Retail sales	1.7	1.0	–0.1	0.9	0.7	0.1	5.3
Industrial production	–3.1	–10.1	0.2	1.5	3.0	3.3	…
Unemployment rate (1)	2.8	4.7	4.9	4.6	4.5	4.5	4.5
Consumer prices	3.6	2.1	3.2	3.4	3.1	3.4	4.0
Trade balance (2)	–93.6	–86.8	–83.1	–85.2	–90.6	–95.3	…
3-month Libor interest rate (3)	5.5	1.2	0.6	0.7	0.7	0.7	0.8
Nominal effective pound exchange rate (4)	97.6	73.9	80.4	78.2	81.5	79.3	79.2

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.

case of the manufacturing index, its level is a record since it first started to be calculated. And the rest of the business confidence indices produced by public and private bodies point in the same positive direction.

Regarding consumption, its first quarter prospects were not so positive a few months ago, as January's VAT hike from 17.5% to 20% was expected to bring demand forward for high-priced articles. However, we now have the figures for retail and consumer goods for January and the year-on-year growth rate has actually gone from 0.1% to 5.3%. This figure is interesting for two reasons. Firstly, it suggests that the drop in consumption seen at the end of last year was actually caused by the bad weather. And secondly, that consumption is bearing up well given the slight decrease in disposable income.

In fact, according to the Office for National Statistics, in December the rate of growth in household income was 1.1% year-on-year, while inflation increased in January to 4%. This situation worsens consumers' capacity to spend and is one of the major concerns. Even the governor of the Bank of England, Mervin King, in his quarterly appearance to present the inflation report, stated that the risk is that inflation may continue to rise over the coming months.

Inflation hits the disposable income of households.

In short, the English economy faces two challenges for this year. The first, to make sure that fiscal adjustment does not affect the country's growth to any great extent. But perhaps the biggest challenge is households' loss of disposable income due to inflation rising higher than wage growth, and its negative effect on economic activity. Fortunately, high frequency data indicate that both consumption and investment will withstand the pressure, so that the United Kingdom may wake up from its nightmare of the last quarter of last year realising that the situation forecast for this year is more encouraging.

Retail sales pick up in January.

Emerging Europe on the road to expansion

In emerging Europe, notable economic growth in the fourth quarter confirms the scenario of consolidated expansion.

The economic situation as a whole is moving along the expected lines in Europe emerging and economic expansion is consolidating in all the region's countries. This had already been confirmed in the most advanced economies in the cycle (Poland, the Czech Republic and Slovakia) but now there are few doubts that this is also benefiting those countries that have had to make ensuing fiscal adjustments, such as Hungary and Romania, or that were starting from a more recessionary position, such as the Baltics.

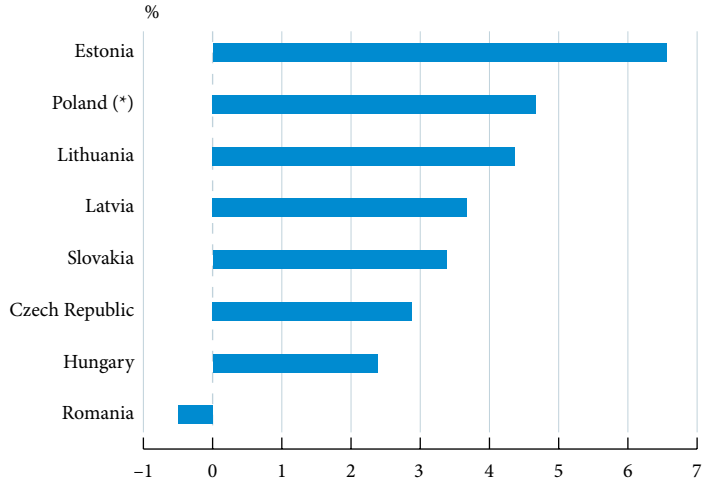
Of particular note, positively, is the strong drive shown by the Baltic economies.

Economic growth figures for the fourth quarter have substantiated this diagnosis. In the region as a whole, Estonia takes pride of place with its year-on-year rate coming close to 7%. Its Baltic neighbours were moving in the area of 4%, a lower figure but one that equally reflects very dynamic activity. As has been mentioned previously, these are three economies that, in 2009, suffered the worst recession among members of the European Union, a recession in which Lithuania and Latvia remained in 2010. It's therefore logical that they should now be posting dynamic growth figures.

A second block is made up of economies experiencing a more balanced growth pattern. Poland, the Czech Republic and Slovakia have benefited from relatively contained imbalances prior to the crisis and from their strong commercial and investment ties with the euro area. The figures are still pending from Poland but we do know that, in the fourth quarter, the Czech economy came close to 3% growth year-on-year, while Slovakia's growth rate was slightly higher (3.4% year-on-year). In the case of the Czech Republic, activity was a little disappointing but its quarterly profile suggests that the economy will speed up further in 2011. Slovakia, however, is moving in the opposite direction: it had grown more than expected but the trend is now towards a gradual slowdown.

DYNAMIC ECONOMIC EXPANSION IN EMERGING EUROPE

Year-on-year change in real GDP, fourth quarter of 2010



NOTE: (*) Data from the third quarter of 2010.
SOURCE: Eurostat.

Lastly, Hungary and Romania, which recorded a disappointing rate of change in GDP for the region's standards, are actually in better economic shape than at first appears. The Hungarian economy, which grew by 2.4% year-on-year in the aforementioned fourth quarter of 2010, has spent three quarters carrying out fiscal adjustment that was not expected one year previously. The fact that GDP is growing within such a context suggests that the country is starting to capitalize on the improvement in its exports and industrial activity, which has also benefited the region as a whole. The Romanian case is more complicated. The budgetary adjustment carried out has been more extensive and, consequently, it has also taken a higher toll on activity. Nonetheless, the worst of this process seems to be over, insofar as the drop in GDP for the fourth quarter, namely 0.5%, is an improvement on the 2.2% year-on-year drop of the third quarter.

Based on these trends in the final straight of 2010, should changes be considered in the scenario of clear economic recovery in 2011 that we are predicting for the region? The answer is no. The data published are hardly surprising and therefore confirm, rather than rule out, that practically all the countries in the region should be able to grow by around 3% in 2011 as a whole (with the probable exception of Romania, which would remain below such growth rates). However, this positive forecast depends on three fundamental events.

The first, always critical in a region that is so in synch with the economic cycle of the Old Continent, is that the euro area, and particularly the central economies such as Germany, do not record a sudden slowdown this year. Although we don't out any surprises on this front, the business indicators of the large economies in the euro area seem to point to the economy continuing to expand, an inertia that will probably spread over the coming quarters. The two other events that sustain the scenario of recovery in Eastern Europe are of greater concern: the doubts regarding the state of public finances not having a knock-on effect and inflation not going out of control.

So far, the episodes of higher country-risk in the peripheral countries of the euro area have only had a limited effect on the economies of emerging Europe. Since mid-October 2010, in four of the main economies of the region (Poland, Hungary, the Czech Republic and Slovakia) the value of Credit Default Swaps has hardly risen. This is a financial indicator that quantifies the cost of hedging sovereign debt against default and, therefore, the higher it is, the greater the perceived country-risk. In the case of Romania this value has even fallen, a result of the credibility granted by investors to the budgetary adjustment underway.

Certainly, the levels posted by Hungary and Romania are still slightly higher than those of their neighbours in the region but, in any case, the indiscriminate knock-on effect of financial doubts regarding public finances has been avoided. This is important, because the notable recovery in international investment flows towards these economies in 2010 was partly due to the belief that these countries are making an effort to guide their economic policies following the principles of orthodoxy and macroeconomic stability.

This latest consideration can be linked to the third prerequisite for the aforementioned growth scenario to materialize. Providing inflation does not threaten to remain high, monetary policy

Hungary and Romania are still hindered by budgetary adjustment, although most of this has already been carried out.

There are concerns regarding the risks resulting from a hypothetical drop in activity in the euro area, increasing financial volatility...

...and excessive inflationary pressure, which might call for tougher monetary policy than expected.

should gradually get back to normal, avoiding any nasty shocks for activity. This is the context within which the moderate rises in interest rates have been carried out to date (in Hungary, movement started at the end of 2010; in Poland, at the beginning of 2011).

Now, the impact of food and energy commodity prices on the CPI is starting to raise doubts as to whether the planned schedule and size of these interest rate hikes are plausible (in these countries and in those where this process has yet to be started). So far, in most countries inflation is within the target limits set by the central banks in their monetary policy. Should tensions in commodities get worse and remain, it's more than likely that these limits will be exceeded in 2011, probably leading to a response by the monetary authority to avoid second-round effects on inflation. This would most likely have a more disruptive effect on growth.

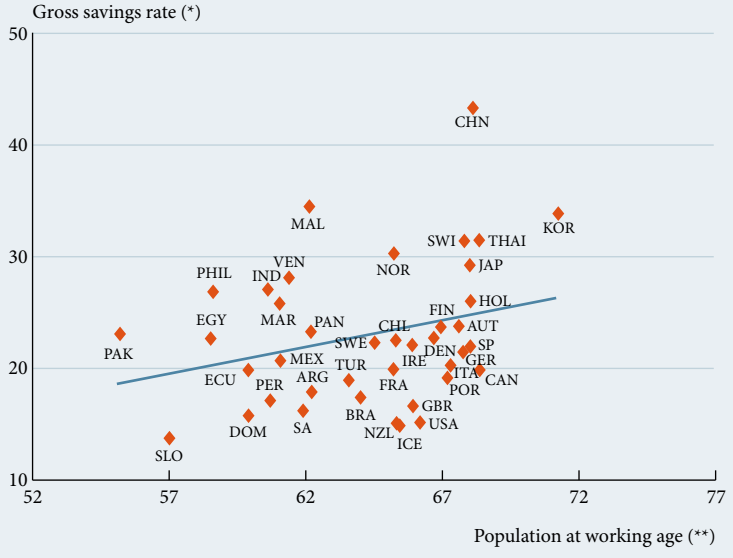
Emerging savings, the solution to ease the ageing of advanced economies?

Over the last few decades, the world's aggregate savings rate represented approximately 20% of income and, although it has fluctuated in certain periods, this ratio has remained relatively stable. However, such global stability doesn't mean that savings don't vary from country to country and a geographical breakdown of savings actually reveals appreciable variations. In the last twenty years, the average aggregate savings rate of developed countries has gone from 22.9% of GDP to 18.9%.(1) Compared to this fall of four percentage points, and during the same period of 1989-2009, emerging economies as a whole have increased their savings rate by 2.8 percentage points, standing at 24.8% of GDP in 2009.(2)

This national variability suggests that we should look at the factors that underlie savings in countries in the long term and, more specifically, their most important component, namely household savings. Savings are obviously a variable that determines the resources available for investment, affecting the possible redressing of the global imbalances that have abounded in the last few years and playing a part in determining the equilibrium interest rate. Although an analysis of such issues is beyond the space available for this Box, they all remind us of the key role played by savings in the global economy. One initial determining factor for household savings is demographics. This variable is particularly of concern because we know that industrialized countries are getting older, a trend that, intuitively, should affect savings. Such intuition receives theoretical backing from the so-called life cycle models of savings. These theories establish that, in a society, people of working age are likely to save towards their future retirement. Consequently, those countries with a higher proportion of their citizens aged between 15 and 64 will tend to have a higher savings rate than those with a lower proportion of their population at working age.(3)

(1) Specifically, these figures are the average national savings rates of Germany, Austria, Canada, Denmark, Spain, United States, Finland, France, Ireland, Italy, Japan, Norway, New Zealand, Netherlands, Portugal, United Kingdom, Sweden and Switzerland.
(2) Average of the national data from Argentina, Brazil, Chile, China, Ecuador, Egypt, El Salvador, Philippines, Iceland, India, Korea, Malaysia, Morocco, Mexico, Pakistan, Panama, Peru, Dominican Republic, South Africa, Thailand, Turkey and Venezuela.
(3) The original contribution was made by Franco Modigliani, who started working on this theory in the 1950s. For a complete version, see, for example, Modigliani, 1966, «The life cycle hypothesis of saving, the demand for wealth and the supply of capital», Social Research, 33.

DEMOGRAPHICS, A KEY DETERMINING FACTOR OF THE SAVINGS RATE



NOTES: (*) By percentage of GDP, average 1989-2009.
(**) Proportion of the population aged between 15 and 64 compared with the total population, average 1989-2009.
SOURCES: World Bank and own calculations.

A second aspect that helps to explain the savings rate is growth in income. Theoretically, the effects of greater economic growth on savings are ambiguous. Let us suppose that an economy is increasing its income, for whatever reason. This extra growth will probably benefit workers to a greater degree and the dependent population to a lesser degree. Given that the former have higher average savings rates than the latter, aggregate savings will rise. On the other hand, if we believe that the motivation to save in the present is to guarantee future consumption and we expect income will be greater at that time than at present, the logical response is to save less now, if permanent rises in income are expected in the future. Whether the first or second effect takes pride of place is a question that can only be settled via empirical analysis.

A third set of determining factors is related to the country's' degree of financial development. In general terms, the greater a country's financial sophistication, the lower the savings rate. Firstly, because a more advanced financial sector tends to relax restrictions on obtaining credit. Consequently, this availability helps to push a part of savings towards consumption. Similarly, the processes of financial innovation and the development of credit help to generate income as a result of higher asset prices (typically, at times of financial liberalization, of real estate assets). This increase in income is conceptually similar to what we talked about in the previous paragraph. Although, from a theoretical point of view, the joint effect of both channels (greater credit, greater income) might be ambiguous, in practice it has been observed that the greater the financial development, the lower the savings rate in countries.

These three determining factors primarily affect private individuals in an economy. However, private savings and public savings are not totally isolated spheres. First of all, if the public administration provides fewer essential public goods and services (education, health, pensions, etc.), this will affect private savings, since a part of these savings will go towards such services. Similarly, if the government decides to increase its spending (i.e. reduce

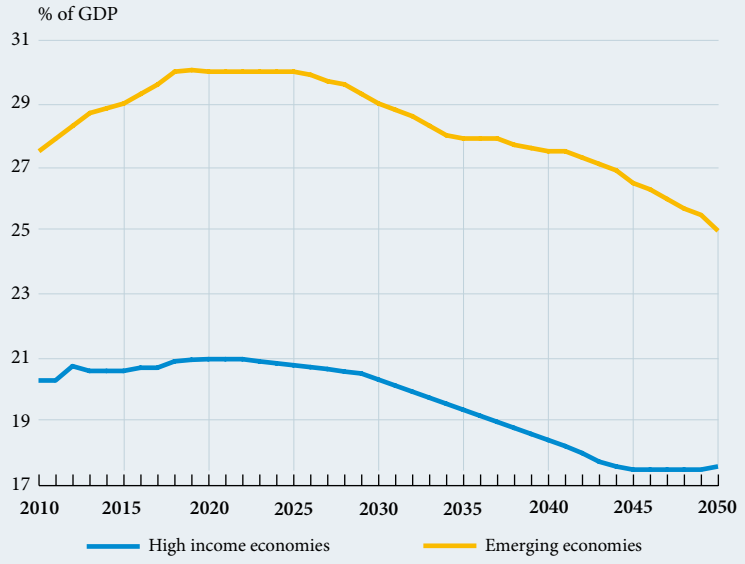
public savings), there might be a rise in private savings because economic agents might anticipate income being diverted towards higher taxes in the future. Whether both movements (public spending and greater private savings) completely offset each other or not (in terms of the academic literature, whether there is Ricardian equivalence) can only be determined through empirical work.

In short, the key issue is to determine empirically the relative weight of each of these causes for the private savings rate. A recent study, developed by economists from the European Central Bank, carries out this very analysis on a representative sample of countries with high incomes and emerging countries.[4] The main findings, which are in line with other previous studies, state that growth in income helps to increase the savings rate; that if a country undertakes fiscal consolidation, the national savings rate goes up, as only part of the greater public savings will reduce private savings; that greater financial development reduces the savings rate; and, lastly, that demographics play a decisive role and in the expected direction: the larger the proportion of dependents, the lower the savings rate.

This last point deserves more detailed attention as we know that, over the next few decades, the generational profile of the world's population will undergo a sea change. While the proportion of working age population in developed countries is currently around 67.3% of the total population, by 2050 the United Nations' demographic projections predict that this proportion will barely reach 58.4%. In the group of advanced countries, the working age population will go from the current rate of 66.7% to 64.9% by 2050.

GROWING PRESSURE ON THE SAVINGS RATE AS FROM 2025

Savings rate projections by region



SOURCES: G. Ferrucci and C. Miralles (2007) and own calculations.

(4) Ferrucci, Gianluigi and Miralles, César, 2007, «Saving Behaviour and Global Imbalances: The Role of Emerging Market Economies». ECB Working Paper No. 842.

According to the aforementioned study, the demographic variable is therefore more relevant in emerging economies than in developed. In particular, in emerging economies it is estimated that the savings rate falls by half a percentage point for every rise of one percentage point in the dependent population (all those aged under 15 and over 64, as a proportion of the total working age population). However, although this impact is still appreciable in industrialized economies, it is not so great: a drop of 0.2 percentage points in the savings rate for every one percentage point rise in the dependent population. Based on these findings, the study's authors use the United Nations' population projections to calculate the expected savings rates in the coming decades (see the previous graph).

Assuming this scenario transpires, it's difficult to provide an unquestionable diagnosis of global savings since we're going to see two clearly differentiated phases in the next forty years. Between 2010 and 2025, approximately, the savings rate will rise slightly in high income countries, while growing faster in emerging economies. However, as from 2025 the balance shifts and becomes more unfavourable, with the emerging countries as a whole starting to lose their demographic advantage. At the end of the road, in 2050, the savings rates of both emerging and advanced countries will be lower than the current rates. Auguste Comte used to say that demography was destiny, since it largely determined the economic and social development of the coming decades. If the demographic pressure of global ageing follows the expected course, the destiny of the world's savings will become a huge challenge.

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FINANCIAL MARKETS

Monetary and capital markets

Inflationary risks debated

Conflict in the Arab countries breaks onto the world financial scene.

The social and political conflicts in the countries of North Africa and the Middle East have unexpectedly become a significant factor on the world financial scene. The main effect is through oil prices, whose rise is threatening economic stability and complicating the management of monetary policies. Higher uncertainty and the possible damage to investor confidence are also worrying threats. Although the scope of these effects was limited at the end of February, their future development is unknown and is attracting a large part of attention.

Rising oil prices complicate the management of economic policies.

In any case, the performance of the various financial markets in the initial part of the year provided a good reflection of how the macroeconomic variables were developing in each region, as well as the actions, both implemented and planned, of the economic authorities. On the whole, the scenario that the markets appear to be taking as read is the consolidation of the world economy's growth, rising but moderate inflation and liquidity conditions that will continue to be comfortable. However, regional differences are so great that an aggregate diagnosis loses meaning as it hides, particularly, a notable difference between developed and emerging countries, manifested in very different dynamics for monetary policies, exchange rates and equity. The current downturn in emerging stock markets confirms their «decoupling» from western stock markets, which have continued firm. This correction can probably be explained by tighter economic policies in numerous emerging countries, given evident signs of overheating. In the United States and particularly the euro area, the debate regarding inflationary risks and monetary policy's response is becoming more intense, although both fixed-income security and bond markets are reacting in a relatively ordered way, for the moment.

With regard to developments in the sovereign debt crisis of peripheral Europe, the progress made in negotiations concerning the functioning of the European Financial Stability Fund and the future system of economic governance, as well as the appreciable effort being made to apply fiscal discipline by the countries affected, is generating a somewhat more encouraging and favourable framework for investors, visible in the stabilization of sovereign risk premia in Spain and Italy. However, the more problematic countries, namely Greece, Ireland and Portugal, are still subject to very high tensions. In this respect, March looks like being a key time in the resolution of the crisis, as an agreement is expected to be reached regarding the new legal framework that is meant to reinforce how monetary union works.

A la carte monetary policies

Central banks are still applying a range of actions, determined by cyclical divergences.

In response to the disparate speeds shown by world economic recovery,

the actions taken by central banks vary according to the country concerned. While, in the emerging countries, the authorities have opted, already very clearly, to tighten up monetary policy as a strategy to combat the upward pressure of inflation, in developed countries the central banks continue to rely on stimulating their economies through exceptionally low interest rates and quantitative measures (bond purchases).

The strength of the economic recovery in the United States in the last part of 2010 and early 2011 has continued to be a pleasant surprise. Such is the case that, in the last meeting of the Monetary Policy Committee, the Federal Reserve (Fed) decided to up its estimate for GDP growth for 2011, from the range of 3%-3.6% to 3.4%-3.9%, based on the prognosis of private demand and foreign trade continuing to revive. However, as in previous meetings, it stressed the need to substantially improve the labour market by creating jobs, as a way to consolidate sustained economic growth. Similarly, and as expected, in line with the opinion it has held for some time concerning the dynamics of inflation, the Fed, through its Chairman, Ben Bernanke, gave out a soothing message regarding the recent rises in the general consumer price index (CPI), interpreting them as a temporary phenomenon related to developments in the commodities markets. For this reason, most economists, and also the markets, predict that the monetary authority will continue its plan to leave interest rates at their current levels for the coming months and will keep to the US Treasury's bond purchase programme, in force until June, under the terms announced last November.

In the euro area, the European Central Bank (ECB) is still immersed in the arduous task of keeping monetary stability between countries with ostensibly different growth rates, at the same time as helping to resolve the sovereign debt crisis of the periphery. The panorama has recently become more complicated due to the impact from the rising price of oil and other commodities, reflected in a notable upswing in the region's general CPI. ECB President, Jean-Claude Trichet, has attempted to convey the message that this increase is due to a transitory phenomenon and does not alter the institution's strategy, provided medium and long-term inflation expectations appear to remain stable and there are no second-round effects through, for example, wage negotiations. However, other leading members of the ECB have been more belligerent, warning of the need to toughen up monetary policy if inflationary tensions do not ease soon. On the other hand, regarding its action in the sovereign debt markets, the fact that the risk premia for peripheral countries eased during February (thanks to the favourable development of budgetary discipline by the governments in question and to agreements between members of the euro area) has led to the ECB buying less debt, with private agents taking on more weight in the secondary market.

This scenario is quite different for the central banks of the emerging countries. Over the last few months, they have entered a cycle of tougher monetary measures in response to the high rate of economic growth and to avoid the second-round effects that might result from recent rises in inflation (basically originating in commodities). In most cases, this gradual rise in interest rates is being complemented by other measures of a diverse nature (for example, administrative, price and exchange

The Fed and the ECB maintain their monetary policy strategies, albeit keeping an eye on how inflationary risks develop.

Bernanke has given out soothing messages regarding inflation.

Some ECB members are more concerned about inflation.

The emerging countries' phase in the economic cycle requires gradual monetary restriction measures.

controls) whose aim is to contain any excessive increase in liquidity and credit. The most representative case is that of China, whose central bank, after raising its reference rate by 25 basis points (to 6.06%), has opted to once again increase the minimum reserve requirements for banks to 19.50%. Under the main scenario of high global growth, most economists estimate that, over the year, there will be further interest rate hikes in the emerging countries, as a basic tool to suffocate any signs of overheating that threaten the sustainability of growth in these countries.

Within this context, interbank markets have performed differently depending on the economic framework in which they operate. In the United States, developments in the money markets have continued to be characterized by stability, thanks to the abundant liquidity provided by the Fed and to the maintenance of expectations regarding the future action of the Federal Reserve in the area of official interest rates. Meanwhile, in the euro area the pulse of the markets has altered as investors have adapted their expectations to the surprise caused by rising inflation and warnings from the ECB. In fact, although tensions resulting from the sovereign debt crisis seem to be under control and only local in scope, the recent volatility observed in European interbank rates is in response

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									
February	1.00	0.66	1.22	0.25	0.25	0.25	0.50	0.64	0.36
March	1.00	0.63	1.21	0.25	0.29	0.24	0.50	0.65	0.28
April	1.00	0.66	1.24	0.25	0.35	0.24	0.50	0.68	0.21
May	1.00	0.70	1.26	0.25	0.54	0.25	0.50	0.71	0.13
June	1.00	0.77	1.31	0.25	0.53	0.24	0.50	0.73	0.28
July	1.00	0.90	1.42	0.25	0.45	0.24	0.50	0.75	0.42
August	1.00	0.89	1.42	0.25	0.30	0.24	0.50	0.73	0.59
September	1.00	0.89	1.43	0.25	0.29	0.22	0.50	0.73	0.32
October	1.00	1.03	1.52	0.25	0.29	0.20	0.50	0.74	0.23
November	1.00	1.03	1.53	0.25	0.30	0.19	0.50	0.74	0.20
December	1.00	1.01	1.51	0.25	0.30	0.19	0.50	0.76	0.20
2011									
January	1.00	1.03	1.59	0.25	0.30	0.19	0.50	0.78	0.33
February (1)	1.00	1.09	1.75	0.25	0.31	0.19	0.50	0.80	0.26

NOTES: (1) February 24.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-10-08 (3.75%), 6-11-08 (3.25%), 4-12-08 (2.50%), 5-03-09 (1.50%), 2-04-09 (1.25%), 7-05-09 (1.00%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).
(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 4-12-08 (2.0%), 7-01-09 (1.5%), 5-02-09 (1.0%), 5-03-09 (0.50%).
(5) Interbank rate.
SOURCES: National central banks, Bloomberg and own calculations.

to the debate on possible inflationary risks and the central bank's actions. In just a few weeks, investors' expectations have shifted towards sooner and faster rises, so that the 12-month Euribor rate has picked up appreciably, reaching the level of spring 2009. With a view to the coming months, we cannot rule out an even greater increase in variability of interbank rates, as the euro area's economic growth consolidates and the ECB's discourse becomes more combative with inflation, as a prelude to interest rate hikes in the second half of the year.

The foreign exchange markets develop calmly

As we move through the initial part of the year, we can observe remarkable stability in the international foreign exchange markets, for the moment contradicting the predictions just a few months ago regarding an imminent «currency war». Trends in exchange rates are responding reasonably to the cyclical and structural differences between regions, while the hot spots of financial instability (debt crisis in the euro area) or political instability (Arab country conflicts) are having a reduced effect. As a result of this, the foreign exchange markets have become less volatile.

Tranquillity in the international foreign exchange markets.

In the case of the emerging countries, the prudent action taken by their authorities is helping their currencies to appreciate gradually against the dollar, and all evidence points to this continuing over the next few months. However, whether this recent calm will continue for longer is more debatable and we might very well

EXCHANGE RATES OF MAIN CURRENCIES

February 24, 2011

	Exchange rate	% change (*)		
		Monthly	Over December 2010	Annual
Against US dollar				
Japanese yen	81.8	–0.9	0.8	–10.2
Pound sterling	0.618	1.2	3.5	4.7
Swiss franc	0.927	–2.4	–0.9	–16.7
Canadian dollar	0.983	–1.1	–1.5	–7.2
Mexican peso	12.172	1.0	–1.4	–5.2
Against euro				
US dollar	1.379	–1.1	–3.0	–1.8
Japanese yen	112.7	0.2	3.8	–8.2
Swiss franc	1.277	–1.4	2.1	–14.6
Pound sterling	0.852	–0.1	–0.6	–3.1
Swedish krona	8.788	–2.1	–2.3	–11.1
Danish krone	7.455	0.0	0.0	0.2
Polish zloty	3.987	2.8	0.6	0.2
Czech crown	24.53	1.3	–2.0	–5.6
Hungarian forint	273.0	–0.7	–2.1	1.2

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

The euro-dollar rate reflects how the sovereign debt crisis has stabilized.

witness episodes of tension or correction regarding the trend, for example with sudden flows of «flight to quality» in favour of the dollar if the situation in the abovementioned hot spots gets worse.

Regarding the euro-dollar exchange rate, the trend has been more stable throughout February than the one seen between the end of 2010 and the start of 2011. The reasons for this moderation in euro exchange rate fluctuations can be found in the favourable developments in the sovereign debt crisis of the periphery of the euro area, as well as in the consolidation of underlying economic and financial fundamentals on both sides of the Atlantic.

Economic data move the bond markets

Yield on 10-year US debt picks up as a result of developments in the economic cycle.

The fast rise in yields for US public debt, starting in October 2010, reached a peak in February. By the middle of the month, the yield for 10-year debt reached 3.74% and that of 2-year debt came close to 0.90%. This can be explained essentially by surprises in the process of economic growth. Also of influence, although to a lesser extent, was the rise in inflation expectations and its risks (as revealed by the relative price of nominal and index-linked bonds). At the same time, bond prices have become more volatile. This phenomenon may continue, particularly as the date approaches for the Fed's bond purchase programme to come to an end, when the market will become more unstable. However, given the speed of adjustment in the last few months, it would be no surprise if, in the immediate future, yields were to fall (as has been seen in the month's final sessions), picking up again once the Fed starts to effectively withdraw its stimulus. At that time it will also be crucial for the budgetary adjustment that must be carried out by the country

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								
February	3.10	3.40	3.86	4.00	3.61	1.31	4.03	1.90
March	3.09	3.42	3.82	3.98	3.83	1.40	3.94	1.88
April	3.02	3.29	4.03	4.02	3.65	1.29	3.85	1.78
May	2.66	2.92	4.26	4.14	3.28	1.27	3.58	1.54
June	2.58	3.05	4.56	4.09	2.93	1.09	3.36	1.48
July	2.67	2.95	4.21	3.95	2.91	1.07	3.33	1.46
August	2.12	2.47	4.05	3.83	2.47	0.97	2.83	1.13
September	2.28	2.66	4.12	3.88	2.51	0.94	2.95	1.40
October	2.52	2.91	4.21	3.94	2.60	0.94	3.08	1.49
November	2.67	3.15	5.50	4.67	2.80	1.19	3.23	1.56
December	2.96	3.36	5.45	4.82	3.29	1.13	3.40	1.72
2011								
January	3.15	3.48	5.24	4.67	3.40	1.24	3.67	1.87
February (*)	3.14	3.52	5.37	4.83	3.44	1.24	3.64	1.87

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

to be defined, otherwise investors may become nervous.

Meanwhile, European debt markets continue to be characterized by the dichotomy generated by the sovereign debt crisis of the region's periphery. On the one hand, the German 10-year bund has followed a similar pattern to the one described for the United States, by mid-February reaching 3.30%, the rate it recorded at the beginning of 2010, before the peripheral crisis erupted and before fears emerged of a double-dip recession. Subsequently, yields began to fall again in response to the events in Arab countries. On the other hand, in spite of the fact that the risk premia of members as important as Spain and Italy have benefited from the advances made in the European Union and the Eurogroup in resolving the crisis and the reinforcement of economic governance, there is still only a very unequal stabilization. The spreads between debt of those countries with the highest debt (Greece, Ireland and Portugal) are still wide. The important events planned for March in the euro area, regarding final agreements to resolve the current crisis, might lead to a more definitive change in the trend of risk premia for peripheral sovereign debt over the coming months.

Developments in the debt of emerging countries obey other parameters: this has entered what could be called a corrective phase, after having performed extraordinarily throughout 2010. The factors leading to this change in direction, upwards, of spreads (compared with the United States) and the absolute levels of yields are of two types. Firstly, the tightening up of monetary policy, to a large extent, of these countries, together with the application of administrative measures that discourage foreign investment. Secondly, the social and political conflicts emerging recently in Arab countries, which have served as a reminder of the notable political risks still existing in many emerging countries. Both factors are likely to be transitory and of limited scope but, in any case, the conditions for these markets look less favourable in 2011 than they were in 2010.

In the euro area, fiscal and structural measures have led to Spain's risk premium stabilizing.

High yield corporate bonds shine

Taken as a whole, corporate bonds remained positive in February. The narrowing of credit spreads for corporate bonds in the investment grade segment has been moderate but in the high yield segment this was more than significant. For its part, the stabilization of the debt issued by the European banking sector, encouraged by the favourable developments in the sovereign debt crisis, is another notable factor boosting the appeal of corporate bond markets.

March looks like being a crucial month for political negotiations between European partners.

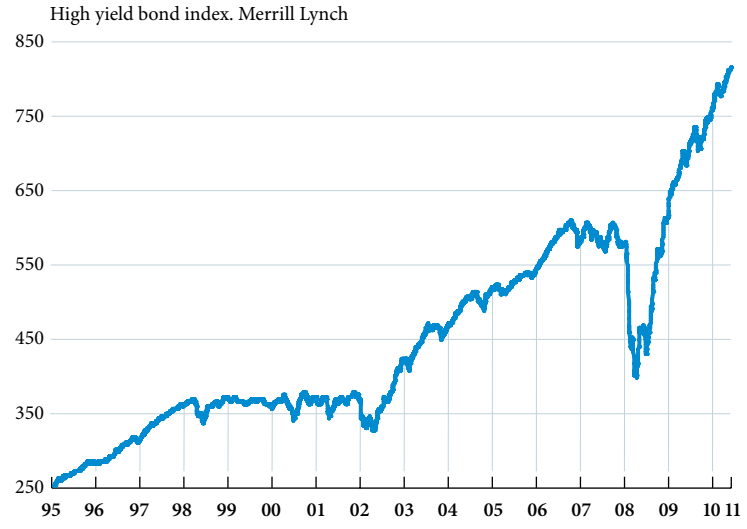
The fact that financial reform in the United States is more developed than in Europe is resulting in a firmer, more mature tone in the US corporate bond market. This is favouring a positive trend in the high yield debt segment of this country, where the global geopolitical risks have hardly affected rates and in which investors are still finding a wide-ranging, continuous offer of debt issued since the start of the year.

From the point of view of the returns offered, some signs can now be seen of the US market starting to slow up, where in many cases historically low returns are being offered for the level of risk assumed. However, there are still some markets and issuers offering sufficient spreads to cushion the potential losses in value produced by a widespread rise in interest rates. Another of the alternatives

Corporate debt remains healthy thanks to narrowing credit spreads.

GAINS SPREAD IN HIGH YIELD CORPORATE BONDS

Trends in the total return of high yield corporate bonds



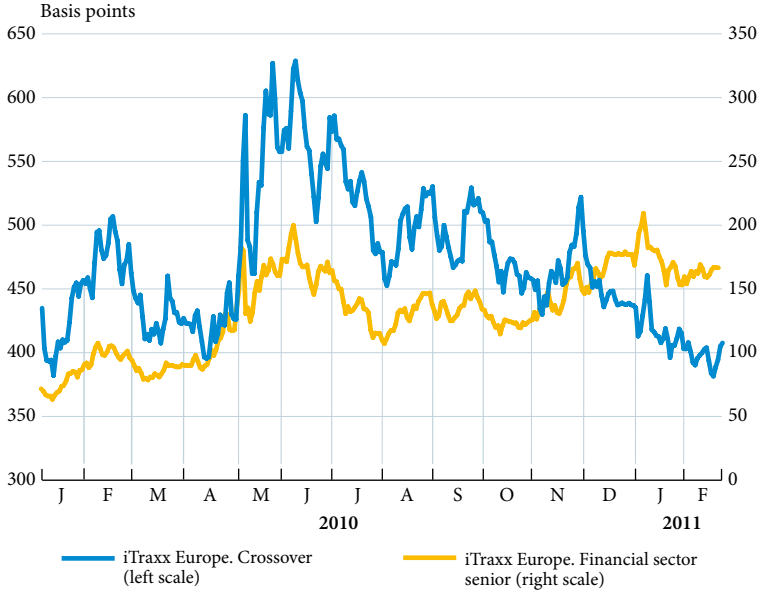
SOURCE: EcoWin.

In the medium term, investors are turning their attention to equity in the search for higher returns.

prioritized by investors over the last few weeks in their search for the best possible risk-return ratio are the bonds of European banks, whose value has stabilized given the prospect of a satisfactory resolution to the sovereign debt crisis in Europe.

THE BONDS OF FINANCIAL INSTITUTIONS ARE STILL SUFFERING FROM THE SOVEREIGN DEBT CRISIS

Trends in the iTraxx credit spread indices for Europe



SOURCE: Bloomberg.

With a view to the future, the conditions still look relatively positive for the corporate bond markets of developed countries, thanks to the support received by the constant inflow of capital and high trade volumes, but we cannot ignore the effect a gradual increase in the interest rate term structure might have on bonds with a distant maturity and fixed coupon.

Equity gains importance in investor portfolios

In February, the world's stock market scenario maintained the positive tone with which it had started the year, thanks to support from the consolidation of global economic growth prospects and the continuity of the expansionary business cycle. Given this situation, which encourages the reduction of variables such as uncertainty and risk aversion, investors (whose portfolios have a high margin to take risks after the recession) have started to find an attractive alternative in equity, in risk-return terms, compared with other assets from more mature markets such as corporate bonds.

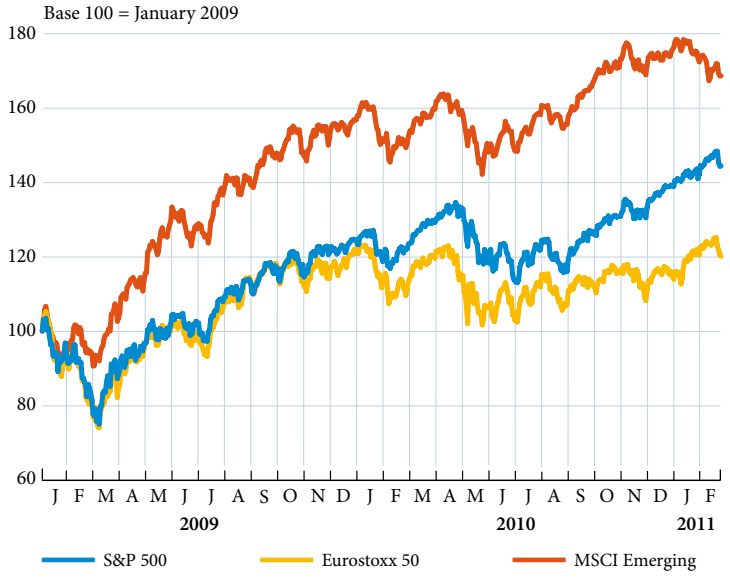
However, and as can be seen in the rest of the financial markets, the tightening up of monetary policies in the emerging countries is leading to a decoupling of these stock markets in relation to the advanced economies. Specifically, while the US indices are leading the way in stock market gains (25% on average since September), the equity of emerging countries has remained within the same price range for the last six months.
In the case of Europe, the stabilizing of sovereign risk premia, as a consequence of the fiscal discipline adopted by the peripheral countries together with improved economic conditions, are giving rise to a new cycle of increases in all European markets and specifically in the Spanish stock market.

Global equity markets maintain their positive tone.

US stock markets lead the way in gains, followed by the European markets.

THE STOCK MARKETS OF EMERGING COUNTRIES ARE IN A CORRECTIVE PHASE

Trends in the main international stock markets



SOURCE: Bloomberg.

INDICES OF MAIN WORLD STOCK EXCHANGES

February 24, 2011

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,105.8*	*1.0*	*4.6*	*16.7*
Standard & Poor's	*1,307.4*	*1.3*	*4.0*	*18.3*
Nasdaq	*2,723.0*	*0.2*	*2.6*	*21.8*
Tokyo	10,452.7	1.0	2.2	2.5
London	5,908.4	–0.6	0.1	10.6
Euro area	2,942.2	–1.2	5.3	7.6
Frankfurt	*7,114.3*	*0.7*	*2.9*	*26.7*
Paris	*4,004.0*	*–0.7*	*5.2*	*7.8*
Amsterdam	*364.3*	*0.9*	*2.7*	*13.5*
Milan	*21,998.6*	*–0.7*	*9.0*	*3.1*
Madrid	*10,602.7*	*–2.0*	*7.5*	*3.4*
Zurich	6,529.3	–1.1	1.4	–2.4
Hong Kong	22,601.0	–5.0	–1.9	10.4
Buenos Aires	3,429.1	–5.6	–2.7	49.6
São Paulo	66,910.5	–3.6	–3.5	1.7

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

The outlook for the stock markets is favourable, although some specific risks can be observed in the short term.

Consequently, the confirmation of a satisfactory global economic scenario, the continuity of the expansionary business cycle, as well as the fall in credit risk should enable a favourable stock market environment in the medium term. However, we should mention that there are certain risks of a financial nature (such as the debt crisis re-emerging in the euro area) and of a technical nature (such as the excessive overbuying shown by some US indices) that might lead to corrective episodes in the short term. Moreover, now added to this group of potential risks are the effects of the recent political tensions in the countries of North Africa and the Middle East (which have already made themselves felt on the last sessions of February).

SPAIN: OVERALL ANALYSIS

Economic activity

Spain's GDP makes better progress than forecast

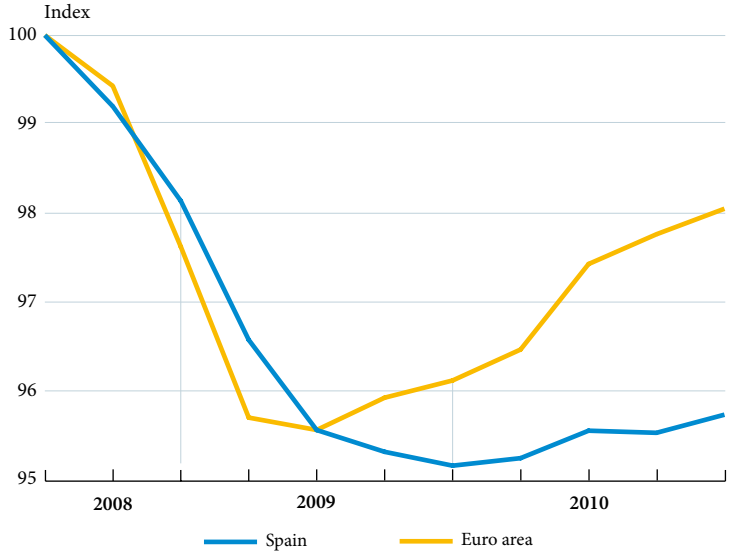
Gross domestic product (GDP) grew by 0.2% in the last quarter of 2010 compared with the third, this coming after a period of stagnation and bringing year-on-year growth to 0.6% and the drop in GDP for the year as a whole to 0.1%. The gradual advance being made by the Spanish economy therefore consolidated in the second half of 2010, although still at a relatively low level and below its potential. This trend is likely to continue in 2011, partly thanks to support from the foreign sector. However, the pace of growth will be quite moderate until private consumption and investment pick up, something that will happen gradually over the year.

With this GDP growth in the last quarter of 2010, there have now been four periods of progress since the lowest point of the recession, the last quarter of 2009, when GDP stood at almost 5% below the peak reached in the second quarter of 2008. Although trends in the figures point towards the recovery continuing, it's important to note that the reactivation of the Spanish economy last year was slower than for the euro area as a whole, as can be seen in the graph below. While the Spanish economy recovered half a point of the GDP it had lost, recovery was much faster in the euro area.

GDP down 0.1% in 2010, better than analysts' expectations.

SPAIN'S EXIT FROM THE GREAT RECESSION IS SLOWER THAN THE EURO AREA AS A WHOLE

Gross domestic product by volume (*)



NOTA: (*) Series adjusted for seasonal and calendar factors.
SOURCES: National Institute of Statistics, Eurostat and own calculations.

Household consumption advances more than expected in the last quarter...

The data from the National Accounts system published by the National Institute of Statistics show that GDP growth in the last quarter of 2010 was thanks to exports, up five tenths of a percentage point, while domestic demand shrank by three tenths of a percentage point during the same quarter, in spite of the progress made by household consumption. Nonetheless, the performance of domestic demand improved, reducing its negative contribution to growth by one tenth of a percentage point, down to –0.6 points. For their part, exports increased their contribution to GDP by 3 percentage points, up to 1.2 points.

From the point of view of demand, household consumption was up three tenths of a percentage point over the third quarter, a greater increase than expected and now 1.7% higher than in the fourth quarter of 2009. By component, consumer durables, more sensitive to the economic cycle, continued to perform more weakly, while non-durables and services performed more positively. The wages of salaried workers, households' main resource to cover their consumption, continued to fall, both due to the drop in employment and also to lower average wages, falling 1.7% year-on-year. Although it helps to improve Spain's competitiveness compared with other countries, this downward trend in average wages could reduce household spending if it continues over the next few months.

...but investment in capital goods is a little disappointing.

While the performance of household consumption, which accounts for approximately 60% of GDP, was better than expected, both public spending cuts and weak investment led to domestic demand falling overall. With regard to public consumption, in the fourth quarter this was down seven tenths of a percentage point over the previous period, increasing its shrinkage to 0.9% year-on-year. This fall was mostly the result of the cut in government employee wages. Given the government's commitment to reduce its public deficit, this heading is expected to go on falling throughout the coming year, although its rate of decline should slow up.

Regarding investment, this performed somewhat worse than expected, even though this component's tendency to improve continued. In fact, the slight advance in investment in capital goods was not enough to offset the drop in investment in construction. Over the next few months, investment in construction is not expected to liven up, as suggested by this sector's indicators, which clearly point towards the situation getting worse. For example, although cement consumption fell by 15.1% in 2010, half the drop for 2009, this decrease sharpened in the last quarter of 2010 to 16.1% year-on-year. Other variables also quickened their rate of decline, such as confidence in construction and permits for new builds.

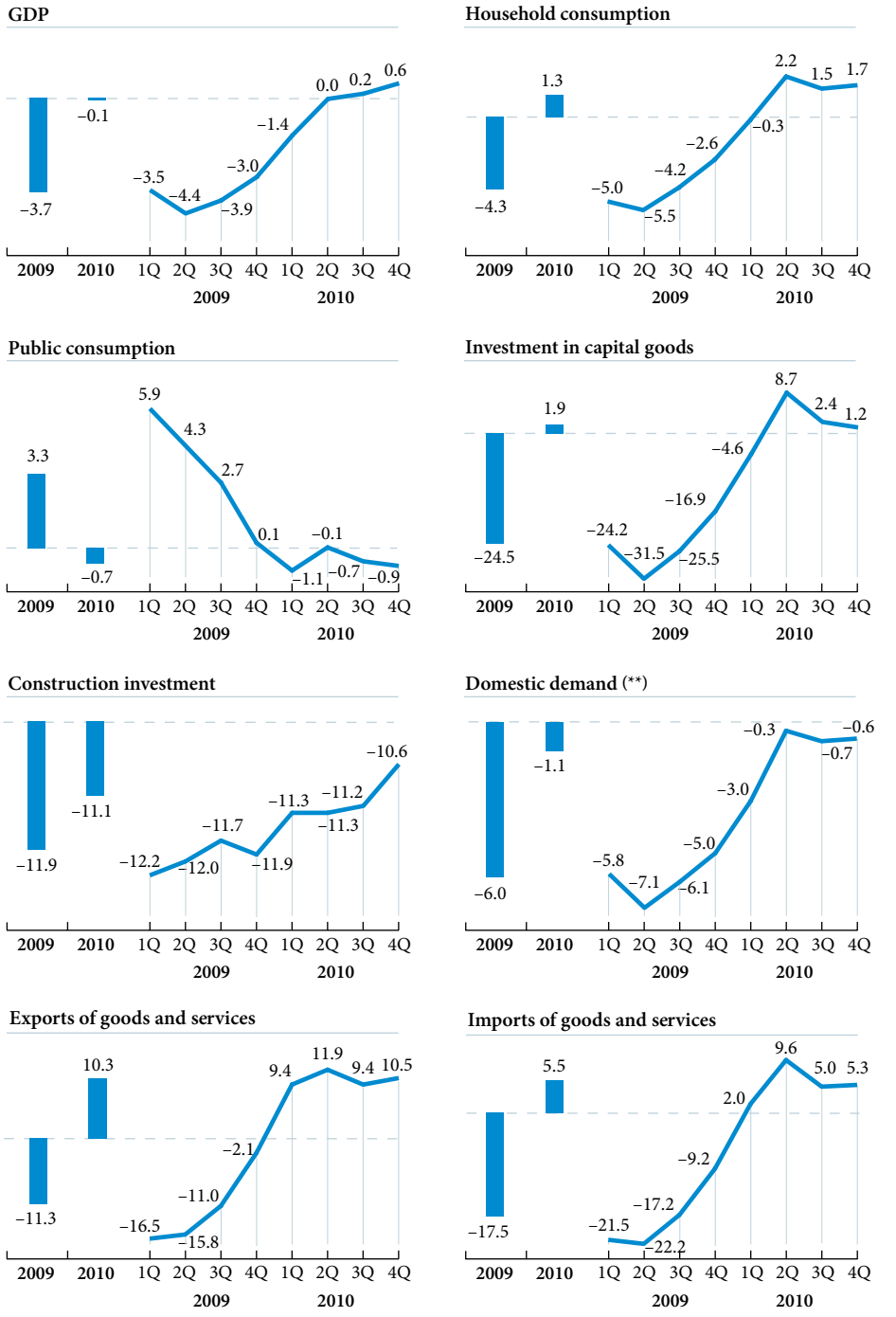
Investment is expected to speed up its growth in 2011.

The recovery in investment as a whole will depend on the dynamism shown by those sectors not directly related to construction. Within this context, imports of capital equipment ended 2010 with signs of their growth slowing up. Nonetheless, these rose by 22.4% for the year as a whole, contrasting with the fall of 21.6% recorded the previous year. Investment in capital goods is likely to speed up over the coming months, ending 2011 by offsetting the divestment in construction. Investment as a whole will therefore probably see positive quarter-on-quarter growth as from the second quarter of 2011 and the first positive year-on-year growth rate in the last quarter of the year.

On the other hand, the favourable trend in exports was the main engine behind

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



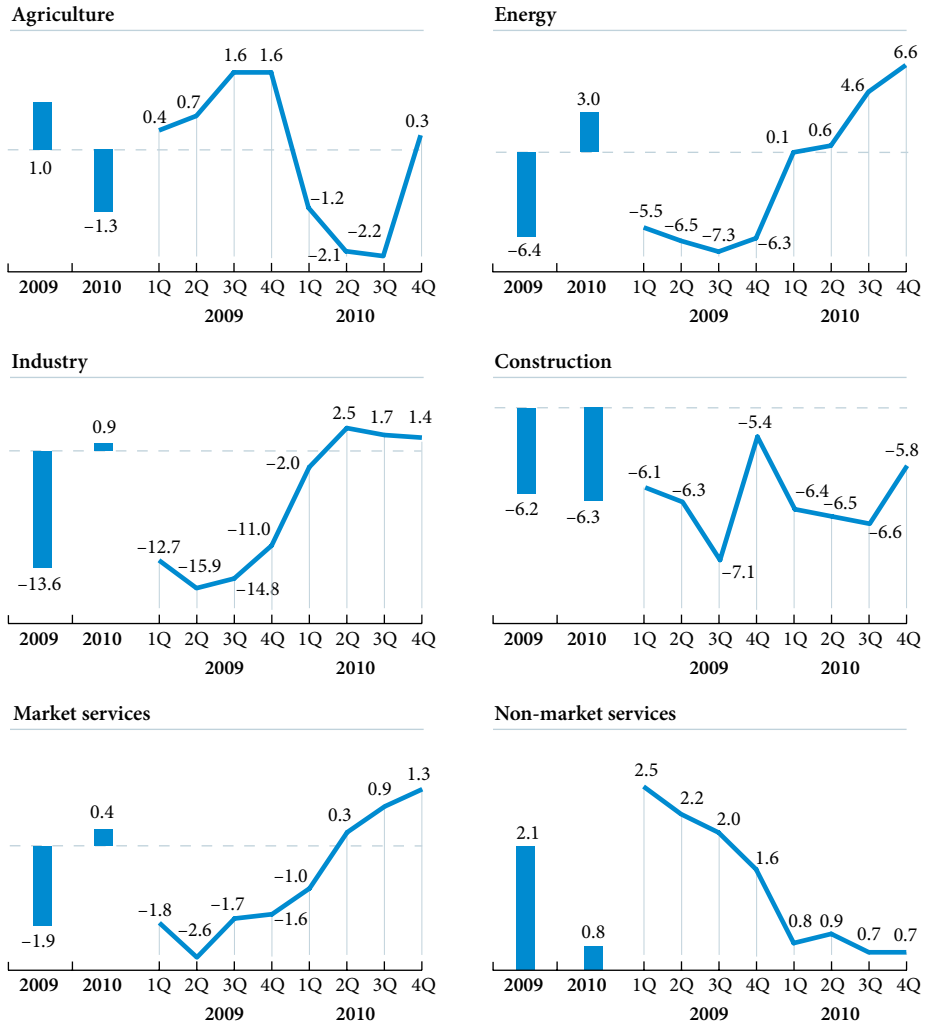
NOTES: (*) Data adjusted for seasonal and calendar effects.
(**) Contribution to GDP growth.
SOURCE: National Institute of Statistics.

The foreign sector gives a boost to growth.

the progress made by the Spanish economy during the fourth quarter of 2010, once again softening the limiting effect of domestic expenditure on activity. Both exports and imports increased their growth in this period, boosting their year-on-year rate of growth by 10.5% and 5.3%, respectively. Consequently, the foreign sector once again played a fundamental role in alleviating the fall in domestic activity. It should also be noted that, unlike the pattern seen in the last two years when improvement occurred mainly because of plummeting imports, in 2010 this effect was dominated by the good performance shown by exports. This was possible thanks to the recovery in global trade and a more ambitious strategy to make this sector a more powerful and stable source of growth. It was also helped by the improved performance of the tourism sector which

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)



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

saw a significant rise in the number of tourists, reversing the downward trend of the last two years.

This gradual reactivation of the economy can also be seen in the trends in various sectors, albeit somewhat disparately. While industry slowed up its improvement in the fourth quarter of 2010, other branches, namely energy and services, speeded up their rate of growth in their value added. Providing these sectors continue to perform as well, the recovery in activity may accelerate. On the other hand, both agriculture and construction improved their year-on-year rates, with the primary sector becoming positive at 0.3%.

Another key to economic recovery lies in worker productivity trends. Although this was up by one tenth of a percentage point to 2.0% year-on-year in the last quarter of the year, such a slight improvement in productivity was due mostly to the drop in employment, down 1.4% year-on-year.

In short, the economy will continue to make progress in 2011, albeit with less intensity than its potential growth. Consumption will gradually improve, although its progress will be held back by the rather unfavourable situation of the labour market, the falling purchasing power of workers and private sector deleveraging. On the other hand, the more favourable environment of the world economy will boost the foreign sector and this will probably stimulate corporate investment except in construction, which will continue to record negative year-on-year rates. As a result, GDP will see positive growth in 2011 after two years of decline.

Positive growth in 2011 after two years of decline.

Labour market

The labour market situation continues to worsen

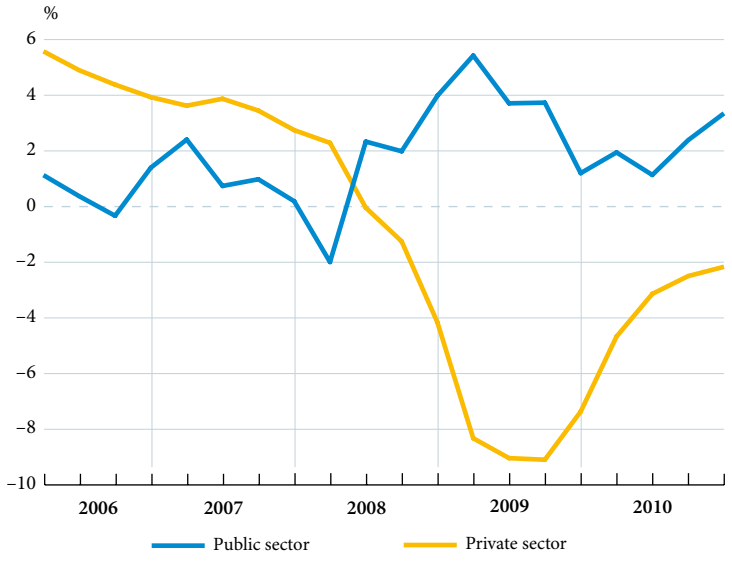
Almost 140,000 jobs lost in the last quarter of 2010.

The weak recovery in economic activity prevented the labour market from reactivating in the last quarter of 2010, as shown by the figures from the labour force survey (LFS). In fact, due to the declines recorded in services and the construction industry, employment fell by 138,600 people in the last quarter of 2010 with a total of 18,408,200, bringing the year-on-year drop in the employment level to 1.3%. These figures confirm the inability of the labour market to generate employment in the fourth quarter of the year.

One sign of the labour market's continuing weakness can be seen in the trends in the private sector, the largest employer and providing a more accurate reflection of the extent of the economy's dynamism. Consequently, the labour market is not expected to consolidate its recovery until the private sector can create jobs. Almost 340,000 jobs were lost in this sector in the fourth quarter compared with the same period the year before and, although this drop was a third of the figure recorded for the previous year, job losses continued apace. On the other hand, public administrations and corporations created employment, around 100,000 jobs.

THE PUBLIC SECTOR GENERATES EMPLOYMENT DURING THE RECESSIVE PERIOD

Year-on-year change in employment estimates



SOURCES: National Institute of Statistics and own calculations.

However, the significant differences should be noted between autonomous communities in terms of employment trends by sector. While salaried workers in the private sector fell by 2.2% year-on-year in the fourth quarter of 2010, the Basque Country, Catalonia and Extremadura saw positive rates. These regions' generation of private sector jobs might point to a change in trend over the coming months, particularly if this somewhat more favourable performance is passed on to the rest of the economy.

For its part, employment in local government bodies grew by 3.4% year-on-year, with marked rises in the Basque Country, Madrid, Asturias and Navarre, while public sector employment fell in Aragon, Catalonia, Extremadura and La Rioja.

Another sign that the recovery in the labour market is still weak is the listless trend in services, this being the sector employing the highest number of workers. More than 115,000 jobs were lost

The private sector continues to lose jobs except in Catalonia, Extremadura and the Basque Country.

ESTIMATED EMPLOYMENT

Fourth quarter of 2010

	No. of employees (thousands)	Quarterly change		Annual change		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	804.5	50.5	6.7	21.9	2.8	4.4
Non-farm	17,603.6	–189.2	–1.1	–259.7	–1.5	95.6
Industry	*2,622.8*	*22.2*	*0.9*	*–58.1*	*–2.2*	*14.2*
Construction	*1,572.5*	*–95.6*	*–5.7*	*–230.2*	*–12.8*	*8.5*
Services	*13,408.3*	*–115.8*	*–0.9*	*28.6*	*0.2*	*72.8*
By type of employer						
Private sector	15,239.6	–131.3	–0.9	–340.6	–2.2	82.8
Public sector	3,168.5	–7.4	–0.2	102.8	3.4	17.2
By work situation						
Wage-earners	15,314.2	–142.2	–0.9	–178.4	–1.2	83.2
Permanent contract	*11,513.9*	*7.4*	*0.1*	*–92.5*	*–0.8*	*62.5*
Temporary contract	*3,800.3*	*–149.6*	*–3.8*	*–85.9*	*–2.2*	*20.6*
Non-wage-earners	3,084.1	–1.3	0.0	–56.5	–1.8	16.8
Entrepreneurs with employees	*1,013.2*	*5.2*	*0.5*	*–37.8*	*–3.6*	*5.5*
Entrepreneurs without employees	*1,933.3*	*5.7*	*0.3*	*2.6*	*0.1*	*10.5*
Family help	*137.6*	*–12.2*	*–8.1*	*–21.3*	*–13.4*	*0.7*
Other	9.9	4.9	98.0	–2.8	–22.0	0.1
By time worked						
Full-time	15,933.7	–241.1	–1.5	–241.5	–1.5	86.6
Part-time	2,474.5	102.6	4.3	3.8	0.2	13.4
By sex						
Males	10,209.7	–166.5	–1.6	–230.9	–2.2	55.5
Females	8,198.5	27.9	0.3	–6.8	–0.1	44.5
TOTAL	**18,408.2**	**–138.6**	**–0.7**	**–237.8**	**–1.3**	**100.0**

SOURCES: National Institute of Statistics and own calculations.

Employment in the services sector rises 0.2% year-on-year in the last quarter of 2010.

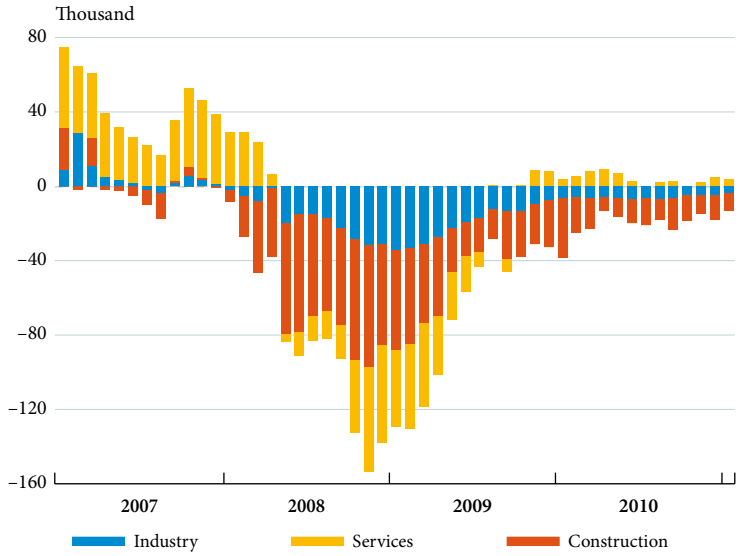
here in the last quarter of 2010, although part of this decline was expected due to seasonal factors. Nonetheless, in year-on-year terms the figure was positive for the services sector, up by 0.2%, while employment data for the industrial sector were a little more optimistic, rising in the fourth quarter by around 22,000 jobs. Insofar as economic recovery depends on exports, a more favourable trend in foreign sales might boost the manufacturing sector due to its export orientation, and this could result in a slight improvement in the labour market.

After the worsening labour market figures for the last quarter of 2010, the first few months of this year will be decisive in judging whether the recovery is still at a standstill or whether, on the other hand, economic reactivation is finally putting an end to job losses. As shown by the average monthly figure of new employment registrations with Social Security for January, the labour market is likely to go on improving very gradually. According to the Ministry of Labour and Social Affairs, total registrations were down by 223,143 people over the previous month, standing at 17,361,839 (a zero change once seasonally adjusted). The monthly figures by sector, seasonally adjusted, show that only the services sector generated some employment in January, while the industrial and construction sectors continued with job losses, albeit less sharply.

Returning to the LFS, in the fourth quarter of 2010 employment trends were more favourable for women than men, as the former work in the sector that performed better last year, namely services. The year-on-year drop decreased to 0.1% for women and held steady at 2.2% for men.

ONLY THE SERVICES SECTOR IS CREATING SOME EMPLOYMENT

Monthly change in the number of employed people registered with Social Security (*)



NOTE: (*) Series corrected for seasonal factors.
SOURCES: Ministry of Labour and Social Affairs and own calculations.

With regard to age, the sharp fall in employment among those under 25, down 11.7% year-on-year in the fourth quarter, led to a Royal Decree being passed on 11 February with a shock plan to promote stable employment. Among other measures, it promotes part-time contracts for young people and the long-term unemployed, with lower company contributions to Social Security for twelve months. This programme also provides for a bonus of four hundred euros for those who have run out of unemployment benefit, provided they carry out employment guidance and training actions. The unfavourable trend in unemployment figures, up by 121,900 people in the fourth quarter to 4,696,600, partly explains why this shock plan was passed relatively quickly. Of note is the very high unemployment rate among young people, reaching 42.8% this quarter.

Lastly, regarding labour policy, we should also note the pension reform agreement reached this month between the government, trade unions and employers. This raises the retirement age to 67 and the number of years' contributions to Social Security to 37 in order to be entitled to a full pension. Moreover, a minimum of 38.5 years has been established for workers wanting to retire at 65 years, with an increase in the mandatory contribution period to calculate pension entitlement from 15 to 25 years and delaying early retirement to 63. These reforms will come into force in 2013 but will be applied gradually, becoming fully applicable in 2027.

A Royal Decree-Law is passed with guidelines to promote employment.

ESTIMATED UNEMPLOYMENT

Fourth quarter of 2010

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	2,545.2	65.0	2.6	152.7	6.4	54.2	20.0
Females	2,151.4	56.8	2.7	217.4	11.2	45.8	20.8
By age							
Under 25 years	840.6	–20.1	–2.3	24.2	3.0	17.9	42.8
Other	3,856.0	141.9	3.8	345.9	9.9	82.1	18.2
By personal situation							
Long-term unemployment	2,154.7	184.4	9.4	937.4	77.0	45.9	–
Seeking first job	356.8	–21.6	–5.7	57.0	19.0	7.6	–
Other	2,185.1	–41.0	–1.8	–624.3	–22.2	46.5	–
TOTAL	**4,696.6**	**121.8**	**2.7**	**370.1**	**8.6**	**100.0**	**20.3**

SOURCES: National Institute of Statistics and own calculations.

Prices

The rise in official electricity prices pushes up inflation in January.

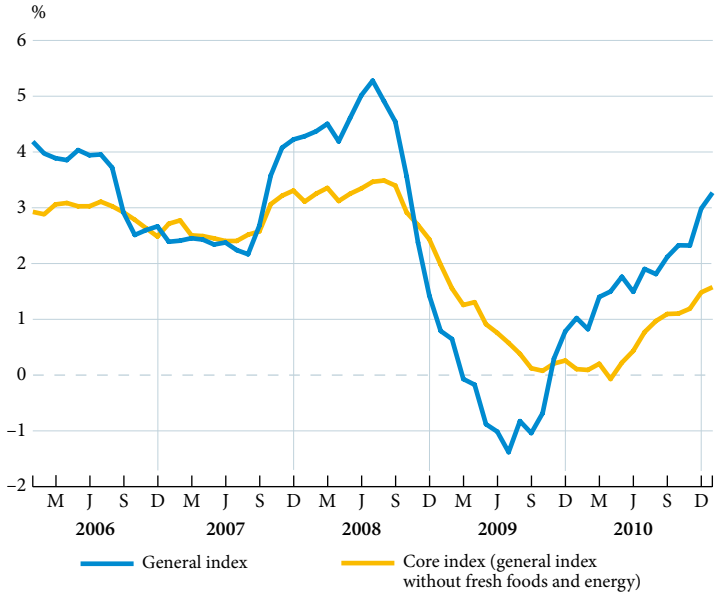
Inflation rises to 3.3% due to energy products

In January, the year-on-year change in the consumer price index (CPI) increased by three tenths of a percentage point to 3.3%, in spite of the monthly inflation rate falling by seven tenths of a percentage point as a result of the sales. The characteristic discounts on clothes and footwear in January were therefore not enough to offset the rising price of energy products compared with the same month last year, meaning that inflation continued its upward trend of the last few months. This upswing in the CPI's year-on-year rate was particularly due to higher prices for electricity, fuel, tobacco and, to a lesser extent, some foods, such as sugar. In fact, general inflation would have reached 2.3% just with the contribution of tobacco (0.5%), electricity (0.4%) and fuel and oils (1.4%).

So, as expected, 2011 has begun with an upward trend in prices within a context of relatively moderate consumption. In other words, the recent rise in inflation reflects the greater relative weight of its volatile components and taxes and cannot be attributed to more dynamic consumption. One sign of this is the fact that January's core inflation, which excludes energy and fresh foods, was up by just one tenth of a percentage point to 1.6% year-on-year.

ENERGY PRODUCTS PUSH UP INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

Rising inflation due to temporary reasons, such as the situation seen recently, can be a cause for concern if the purchasing power of households falls, thereby restricting domestic consumption even further. This can aggravate the economic environment and result in stagflation: stagnant growth and high prices.

However, the most recent figures suggest that the risk of stagflation is low. On the one hand, the slight improvement in consumer confidence in January and the 0.3% rise in household consumption in the last quarter of 2010 compared with the previous period, higher than expected, have calmed fears of household consumption coming to a halt. On the other hand, the temporary effects of rising prices will probably dissipate over the coming months, so that inflation is unlikely to remain persistently high. Moreover, although inflation continued to rise, it was still below the maximum of 3.6% reached in October 2008.

In fact, a temporary situation of price pressure could eventually become permanent if consumers expected inflation to be higher in the future or if it leads to demands for wage increases. However, neither factor is very likely. Firstly, inflation expectations are still relatively low in most advanced countries. Secondly, in spite of higher prices, high unemployment is stopping employees from demanding wage rises that could spark off an inflationary spiral. Such wage containment is even more likely because of the new political movement in Europe that defends divorcing wage rises from inflation and wants to link such rises more closely to increases in productivity.

From another perspective, one worrying factor related to rising inflation in Spain could be the loss of competitiveness if this country's rise in prices is higher than the rise recorded in the rest of the countries of the euro area. According to Eurostat figures, the euro area's harmonized rate of inflation for January stood at 2.4%,

The contribution made by energy products to inflation is likely to decrease over the coming months.

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			
March	0.7	–0.5	1.4			
April	1.1	0.6	1.5			
May	0.2	0.8	1.8			
June	0.2	1.0	1.5			
July	–0.4	0.6	1.9			
August	0.3	0.8	1.8			
September	0.1	0.9	2.1			
October	0.9	1.8	2.3			
November	0.5	2.4	2.3			
December	0.6	3.0	3.0			

SOURCE: National Institute of Statistics.

The price differential with the euro area stands at 0.6 percentage points.

while Spain's rate was 3.0%. The upswing in inflation observed in Spain over the last few months has therefore been sharper than that of the euro area, with the inflation differential going from zero in December 2009 to 0.6 percentage points in January 2011. This can largely be put down to the energy component, which contributed 0.5 percentage points to this larger differential during 2010.

In fact, the higher expenditure by Spanish households on oil derivates compared with the euro area means that its CPI is more dependent on oil prices, with the addition of higher increases of official gas and electricity prices in Spain over the last few months.

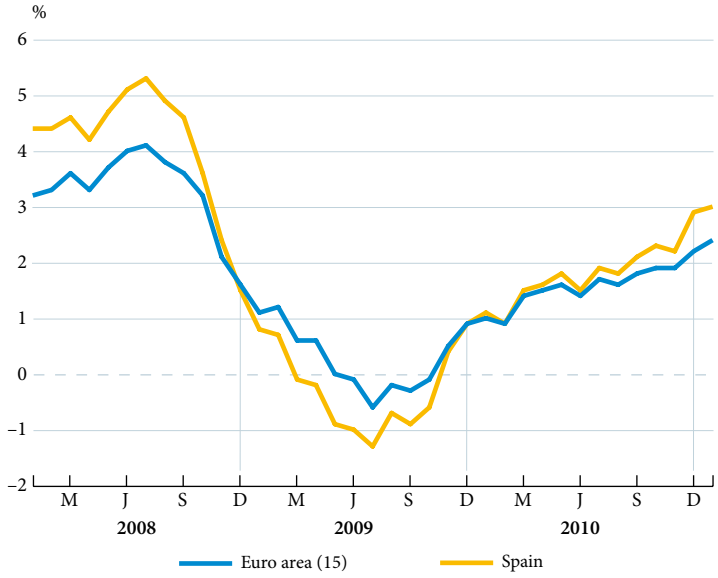
The inflation rate should slow up substantially in the last few months of 2011 given the size of base effects.

Inflation is expected to continue rising slightly in February due to higher oil prices. However, it will then tend to fall as a result of the base effects that are associated with past events. According to this purely statistical effect, the impact of 2010's tax hikes and rising commodity prices on inflation will tend to disappear in 2011, helping to contain the year-on-year rate of change throughout this year. We should therefore see a reversal both of the effect of value added tax in the third quarter of 2011 as well as of rising oil prices in the fourth quarter. However, there is a risk that tensions in the Middle East may continue for longer than expected, causing commodity prices to rise further and thereby pushing up inflation.

Lastly, inflation trends in the coming months will also depend on trends in production costs, which are closely linked to commodity prices. Producer prices continued their upward trend in December, up nine tenths of a percentage point to 5.3% year-on-year, boosted particularly by energy and

THE INFLATION DIFFERENTIAL WITH THE EURO AREA HAS WIDENED IN THE LAST FEW MONTHS

Year-on-year change in HCPI



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

intermediate goods. The increase in import producer prices was greater, 10.4% in the last twelve months up to December, a higher rate than the previous month's and largely due to rising oil prices.

CONSUMER PRICE INDEX BY COMPONENT GROUP

January

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2010	2011	2010	2011	2010	2011
By type of spending							
Food and non-alcoholic beverages	109.0	–0.1	0.1	–0.1	0.1	–2.4	0.9
Alcoholic beverages and tobacco	148.2	1.3	2.1	1.3	2.1	11.8	16.1
Clothing and footwear	93.2	–14.1	–14.2	–14.1	–14.2	–1.1	0.4
Housing	122.3	0.8	2.8	0.8	2.8	1.2	7.8
Furnishings and household equipment	107.6	–0.9	–0.9	–0.9	–0.9	0.6	1.0
Health	96.3	0.2	0.0	0.2	0.0	–1.3	–1.4
Transport	114.5	1.7	1.4	1.7	1.4	6.3	9.0
Communications	98.5	0.0	0.0	0.0	0.0	–0.5	–0.8
Recreation and culture	95.8	–1.9	–1.8	–1.9	–1.8	–1.6	–1.0
Education	117.2	0.0	0.1	0.0	0.1	2.6	2.3
Restaurants and hotels	113.8	0.1	0.1	0.1	0.1	1.1	1.7
Other goods and services	113.6	0.6	0.6	0.6	0.6	1.8	2.8
By group							
Processed food, beverages and tobacco	115.4	0.1	0.6	0.1	0.6	0.5	3.1
Unprocessed food	109.5	0.2	0.0	0.2	0.0	–3.2	2.3
Non-food products	109.0	–1.3	–1.0	–1.3	–1.0	1.5	3.4
Industrial goods	105.7	–2.6	–2.1	–2.6	–2.1	1.6	5.2
Energy products	*129.6*	*2.8*	*4.6*	*2.8*	*4.6*	*11.4*	*17.6*
Fuels and oils	*125.0*	*3.2*	*3.2*	*3.2*	*3.2*	*13.9*	*18.4*
Industrial goods excluding energy products	*97.6*	*–4.4*	*–4.6*	*–4.4*	*–4.6*	*–1.7*	*0.7*
Services	112.5	–0.1	0.0	–0.1	0.0	1.2	1.6
Underlying inflation (**)	107.7	–1.6	–1.5	–1.6	–1.5	0.1	1.6
GENERAL INDEX	**110.2**	**–1.0**	**–0.7**	**–1.0**	**–0.7**	**1.0**	**3.3**

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

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 (**)	
2009											
December	–5.5	0.4	–0.5	0.1	–2.7	6.3	1.9	–1.0	0.7	–1.9	–
2010											
January	–5.5	0.9	–0.5	–0.3	–0.9	6.3	3.4	–0.9	0.2	0.2	–
February	1.0	1.1	–0.6	0.0	–0.4	6.8	4.8	–0.5	0.3	1.5	0.6
March	5.6	2.3	–0.1	0.0	0.4	10.1	7.4	1.2	0.5	4.3	–
April	2.8	3.7	0.1	–0.1	2.4	13.1	8.5	2.1	0.7	6.7	–
May	13.7	3.8	0.2	–0.1	3.5	12.0	10.2	4.2	1.6	9.9	0.5
June	8.6	3.2	0.3	0.1	3.7	8.7	10.1	5.3	2.0	10.9	–
July	4.5	3.3	0.2	0.2	3.2	9.8	9.3	4.9	2.0	10.5	–
August	5.1	2.7	0.0	0.5	3.4	7.0	8.7	6.0	1.8	10.2	1.3
September	8.0	3.4	0.2	0.5	4.0	9.1	9.2	6.0	1.8	10.6	–
October	...	4.1	0.6	0.5	4.3	10.5	8.6	6.4	1.7	10.5	–
November	...	4.4	0.9	0.6	5.1	10.6	9.2	7.7	2.2	10.9	1.4
December	...	5.3	1.3	0.7	5.7	13.5	10.4	8.2	2.5	11.9	–

NOTES: (*) Seasonal and calendar effects adjusted data.

(**) Except energy.

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

Foreign sector

The energy component widens the trade deficit

Figures from the National Accounts system show that, for the second consecutive year, the foreign sector was the main engine of the Spanish economy in 2010, making a positive contribution of 1.1 percentage points. However, unlike in 2009, this contribution occurred within a context of recovering trade flows of goods and services at a global level. In the case of Spain, the annual growth in exports practically doubled that of imports (up 10.3% and 5.5%, respectively). This better performance is largely due to the faster pace of economic growth for Spain's main trading partners in the last year and this differential is expected to continue in 2011. However, the balance of goods, without taking services into account, shows a slight decline due to the sharp upswing in oil prices. Should this trend continue, it would hinder the correction of the Spanish trade deficit.

The foreign sector once again contributes to the Spanish economy's growth in 2010.

FOREIGN TRADE

January-December 2010

	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	44,417	29.8	18.7	8,983	32.0	4.8	–35,434	20.2
Consumer goods	59,306	–8.2	24.9	63,005	0.0	33.9	3,699	106.2
Food	*15,639*	*7.1*	*6.6*	*23,844*	*11.6*	*12.8*	*8,205*	*152.5*
Non-foods	*43,668*	*–12.7*	*18.3*	*39,161*	*–5.9*	*21.1*	*–4,506*	*89.7*
Capital goods	18,303	8.9	7.7	15,714	17.0	8.5	–2,590	85.9
Non-energy intermediate goods	116,055	25.1	48.7	98,097	30.7	52.8	–17,958	84.5
By geographical area								
European Union	129,959	6.9	54.6	125,767	15.4	67.7	–4,192	96.8
Euro area	*104,520*	*4.6*	*43.9*	*103,241*	*15.0*	*55.6*	*–1,279*	*98.8*
Other countries	108,123	24.5	45.4	60,032	21.9	32.3	–48,090	55.5
Russia	*6,126*	*33.5*	*2.6*	*1,995*	*35.0*	*1.1*	*–4,131*	*32.6*
United States	*9,364*	*10.1*	*3.9*	*6,530*	*12.5*	*3.5*	*–2,834*	*69.7*
Japan	*3,472*	*11.3*	*1.5*	*1,423*	*16.9*	*0.8*	*–2,048*	*41.0*
Latin America	*14,335*	*32.2*	*6.0*	*10,239*	*30.3*	*5.5*	*–4,096*	*71.4*
OPEC	*23,185*	*35.7*	*9.7*	*6,847*	*9.1*	*3.7*	*–16,337*	*29.5*
Rest	*51,641*	*20.9*	*21.7*	*32,998*	*24.0*	*17.8*	*–18,644*	*63.9*
TOTAL	**238,082**	**14.2**	**100.0**	**185,799**	**17.4**	**100.0**	**–52,283**	**78.0**

SOURCES: Ministry of the Economy and own calculations.

The trade deficit widens due to trends in the energy component.

In fact, according to Customs figures, in 2010 the trade deficit reached almost 52.3 billion euros, 4.2% more than the previous year. This put an end to more than two consecutive years of corrections, placing the trade imbalance at 4.9% of gross domestic product (GDP). A percentage that, although far from the peak reached in March 2008 (namely 9.7%), has not improved at all over 2009.

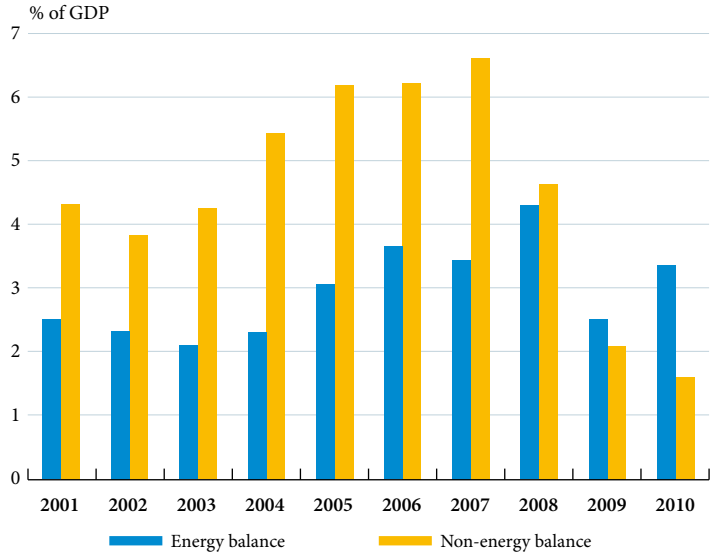
What was the reason for such stagnation? Breaking the deficit down into its different components eliminates any doubts in this respect. The sharp rise in oil prices last year pushed the energy deficit up to 35.5 billion euros, 29.3% higher than the balance recorded in 2009. As shown in the graph below, this figure accounted for more than two thirds of the total trade imbalance, representing 3.4% of GDP. This trend in the energy deficit contrasts with that of the rest of the trade balance which fell to 1.6% of GDP, the lowest level since the series began in 1995.

The upswing in oil prices in 2011 makes reductions in the deficit unlikely in the short term.

This improvement is due to Spain's good trading performance with its main partners in the euro area, the destination for more than half its exports. During 2010, exports to this area rose by 15% year-on-year, almost double the rise in imports. As a consequence, Spain's trade deficit with the euro area fell significantly, practically reaching zero. The economic recovery of these countries might maintain this trend in 2011, correcting the non-energy trade balance even further. However, this will be hindered by trends in the energy balance which, boosted by further hikes in oil prices at the start of the year, will make it difficult for the deficit to fall over the next few months.

THE ENERGY DEFICIT ACCOUNTS FOR MORE THAN 3 POINTS OF SPANISH GDP

Annual data



SOURCES: Ministry of the Economy and own calculations.

Spain's competitiveness continues to improve in 2010

In spite of this slight deterioration in the trade balance, the figures from the National Accounts system show an improvement in the current deficit in 2010. The imbalance was equivalent to 4.5% of GDP, one percentage point better than the deficit a year ago. Of note is the good performance by the service balance surplus, which increased in 2010 and the transfer balance also played a large part in improving the current deficit.

This reduction of the imbalance in the current balance can be interpreted in two different ways. Firstly, it reflects the deleveraging of the Spanish economy, which reduced its net borrowing to 3.9% of GDP, far from the 9.2% of 2008. A second perspective is from the point of view of competitiveness. In this respect, the correction in the current imbalance means competitiveness has improved over the last few years.

With regard to financial flows, November's lower net borrowing led to a fall in foreign capital inflows. The figures point to short-term investment as the main source of financing that month, followed by direct investment, while the Bank of Spain hardly took any funds from the Eurosystem in November. Portfolio investment, the main channel of financing during the first eleven months of the year, decreased.

The current deficit falls to 4.5% of GDP...

...reflecting the Spanish economy's improved competitiveness.

BALANCE OF PAYMENTS

November 2010

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–41,411	0.0	–45,121	2,239	–4.7
Services					
Tourism	*25,839*	*3.6*	*26,930*	*804*	*3.1*
Other services	*635*	–	*923*	*2,194*	–
Total	26,474	10.5	27,853	2,998	12.1
Income	–21,300	–25.0	–23,417	7,302	–23.8
Transfers	–8,367	0.0	–7,983	–1,095	15.9
Total	**–44,604**	**–17.8**	**–48,667**	**11,444**	**–19.0**
Capital account	**5,453**	**66.8**	**6,242**	**2,768**	**79.7**
Financial balance					
Direct investment	934	142.1	–554	748	–57.4
Portfolio investment	30,794	–31.9	30,505	–12,649	–29.3
Other investment	7,234	–26.8	654	–8,067	–92.5
Total	**38,963**	**–29.8**	**30,605**	**–19,968**	**–39.5**
Errors and omissions	–8,038	104.6	–7,118	–5,542	351.6
Change in assets of Bank of Spain	8,227	–	18,939	10,969	137.6

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 government's austerity begins to bear fruit

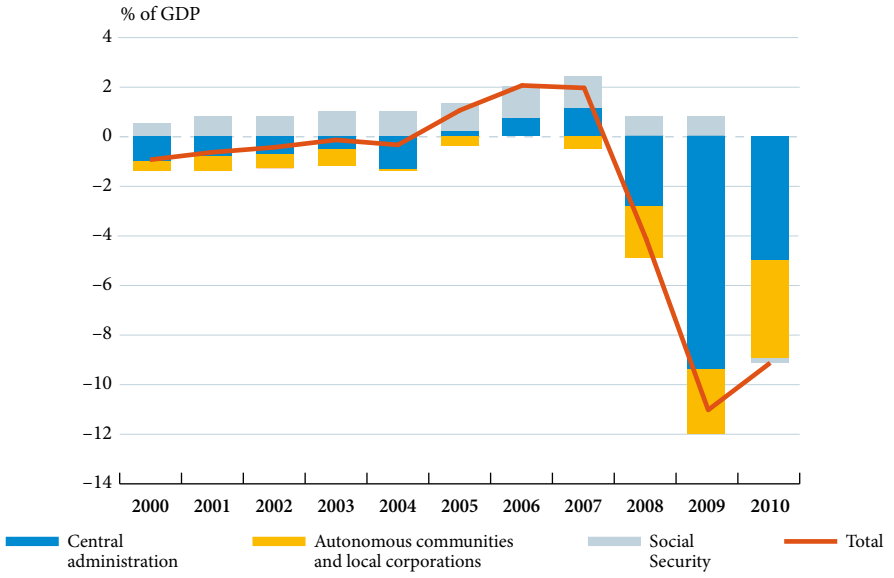
The public deficit is adjusted to 9.2% in 2010, improving on the government's forecast.

The public sector deficit fell by almost two percentage points to 9.2% of gross domestic product (GDP) in 2010. This reduction exceeded the government's forecast and highlighted the effectiveness of the measures adopted throughout last year to redress the fiscal imbalance. This has partly helped to calm tensions in the Spanish sovereign debt market, which peaked last December. However, the Spanish government's still high net borrowing, only exceeded by Ireland and Greece, means that this austerity policy will have to remain in place in order to reach the target deficit of 3% by 2013.

The deficit's good performance over the last year is due exclusively to the figures recorded by the central administration, which includes the state and the autonomous bodies that depend on it. This institution closed 2010 with a deficit of 5.0% of GDP, eight tenths of a percentage point lower than expected and almost half the deficit recorded by the same administration in 2009, namely 9.4%. The main reason for this reduction was the rise in revenue, which increased by almost 5% more than forecast thanks to the larger amount of taxes collected.

THE CENTRAL ADMINISTRATION LEADS THE REDUCTION IN THE PUBLIC SECTOR DEFICIT

Breakdown of net lending (+) and net borrowing (–) by institutions



SOURCE: Bank of Spain.

Furthermore, spending remained practically the same, since the savings provided by the austerity measures have been offset by the rise in financial payments.

However, as can be seen in the graph above, this strong improvement in the central administration's deficit was not echoed in the rest of the institutions, which posted worse balances than forecast. According to the advanced figures, part of this improvement in the central government's deficit was neutralized by the autonomous communities and local bodies. They overshot their target deficit by almost 4 billion euros and placing it above 4%. Controlling the deficit of these administrations is one of the government's main concerns this year, in order to meet the target deficit of 6.0% for all administrations. That's why the executive increased control over regional public accounts during the second half of 2010, conditioning further debt issues on meeting the deficit targets for this year (namely 1.3%).

On the other hand, the figures suggest that, after eleven years of surpluses, Social Security recorded a slight deficit during 2010. This is due to the deterioration in the Spanish labour market, which affected the State Employment Service (previously INEM) accounts, as well as to higher pensions.

Regarding 2011, the Spanish Treasury aims to reduce the deficit by a further 3.3 percentage points, getting it down to 6.0% of GDP. This reduction will be fundamentally recorded by the lower central administration imbalance. However, the underlying factors behind this deficit correction will be different from those recorded last year.

In 2010, two thirds of the improvement in the public sector balance came from revenue, due to the hike in value added tax (VAT) and the end of the 400-euro discount, whereas a cut in spending is expected to become the main factor in correcting the fiscal imbalance in 2011, reducing it by 2.3 points. Of note are the measures to save on personnel costs, to reduce investment and pharmaceutical expenditure, among others.

Without any doubt, the specifics of the government's reforms concerning the lower deficit and the announcement of reforms of the Spanish financial system were warmly welcomed by investors. The interest rate spread between ten-year Spanish public debt compared with German went below 200 basis points at the beginning of February, far from the peaks reached at the end of 2010. The Treasury took advantage of this situation to issue more debt, at a lower interest rate than demanded recently. In February, it placed around 13 billion euros in bonds and Treasury bills. This figure practically doubles if we take into account the issues carried out this year so far. As a result, the critical maturities in April have been covered, one of the three months in which there will be more maturities, together with July and October.

The cost of financing sovereign bonds is expected to go on falling over the next few months. One key factor in this development will be the outcome of the extraordinary summit of European heads of state in March. The aim of this meeting is to agree the guidelines for a new Competitiveness Pact that will help to reduce the tension hovering over European sovereign debt, to be achieved through greater fiscal harmonization,

The autonomous communities present significant fiscal imbalances.

According to the government, austerity measures will cut the deficit to 6% in 2011.

A warm welcome for the latest Spanish debt issued.

as well as measures to limit debt and to improve the competitiveness of countries in the euro area.

In short, the public sector accounts are meeting the targets set by the government. Nevertheless, there's still a long way to go to fall below the limits agreed in the Maastricht Treaty, namely 3.0% of GDP.

Tax incentives for saving: do they work?

The low level of savings of many households lies behind the policies of tax incentives for saving, especially for retirement, that are present in many countries. However, in spite of their good intentions the actual effectiveness of these policies is under debate by governments and economists.

Various kinds of distortions can lead to a suboptimal level of household savings. Several studies talk about the short-sighted behaviour or temporal inconsistency of households, as they do not entirely internalize the consequences of their decisions. This lack of foresight could lead them to save less than is desirable. And, in spite of the clear benefits, who hasn't ever put off the task of giving up smoking or going to the gym? To a certain extent, the same thing happens with savings. There can also be cases of opportunistic behaviour («free riders» in the jargon) when some people don't save enough because they know that society will guarantee them a minimum level of welfare tomorrow. Lastly, the authorities also justify intervention in order to counteract the harmful effects on savings that might be caused by other policies. To a certain extent, this is therefore a distortion to mitigate the effects of another distortion. Tax incentives for savings can be used, for example, to offset the tax burden on income from savings.

While the logic behind tax incentives for saving is not very controversial, the lack of consensus on their effect is astounding. Although some studies claim that these policies significantly increase household savings overall, others find a very small or zero effect, as well as highlighting the effect on the composition of individuals' savings portfolio. In other words, according to these latter studies, the increase in contributions to certain savings instruments encouraged by fiscal policy is detrimental to other types of savings.

In one of the most frequently cited articles that deal with this issue, professors Poterba, Venti and Wise conclude that tax relief for contributions to North American pension plans have significantly increased the total savings of households.[1] However, this study bases its findings mainly on the behaviour of people who had already taken out pension plans. Insofar as these individuals are more likely to save, as seems to be the case, the findings cannot be extrapolated to the population as a whole (which is known as a self-selection bias). Another problem with this study is the difficulty in covering all savings substitutes. A rise in pension plan contributions can be offset by a fall in other kinds of savings (in bank deposits or the acquisition of property, for example).

Various later studies, which attempt to control these problems of self-selection and the composition of the savings portfolio, find that tax incentives affect the composition of the savings portfolio but do not increase savings as a

(1) Poterba, J. M., S. Venti and D. Wise (1996). «How Retirement Saving Programs Increase Saving», Journal of Economic Outlook, 10 (4), pp. 91-112.

whole. For Spain, the study carried out by Ayuso, Jimeno and Villanueva, from the Bank of Spain, shows that tax incentives have a moderate effect on savings for retirement, although they stress its variability depending on the participants' age and income level. Specifically, the most significant impact occurs in the high income bracket with people aged between 46 and 55.[2]

More recently, two studies by Esther Duflo with other co-authors throw more light on the effectiveness of tax incentives for savings.[3] In the first of these, the authors designed an experiment where a group of individuals (an experimental group) was offered the chance to complement their pension plan contributions with an additional percentage. This is known as a matching strategy. In this case, the matching percentage was set at between 20% and 50%, i.e. for every 100 dollars provided by the participant, the authors of the experiment added between 20 and 50 dollars (the experiment was carried out with real money provided by a sponsor). The savings behaviour of this group was compared with that of the other group (the control group), which was not offered any kind of incentive. The findings revealed that the experimental group contributed, on average, between four and seven times more to their pension plans than the control group.

However, in their second article, the authors were surprised to find a lack of reaction in savings terms to tax incentives promoted by the government that were equivalent to the incentives designed in their own laboratory experiment. According to the authors, the explanation for this lies in the complexity of the tax incentives typically offered by governments. Although, from an economic point of view, tax relief for savings can be equivalent to matching incentives, individuals do not perceive both alternatives in the same way. Specifically, people understand the benefits of matching rates much more readily than those of the equivalent tax relief. By way of example, tax relief for pension plan contributions for someone subject to a marginal tax rate of 33.30% is economically equivalent to a 50% matching rate. In the first case, a contribution of 100 euros leads to tax relief of 33.30 euros, while in the second case a contribution of 66.60 euros to the pension plan is rewarded with an additional contribution of 33.30 euros, also resulting in a total of 100 euros. However, in spite of their economic equivalence, the more direct and simpler presentation of the matching strategy makes it more effective in promoting savings.

In short, the logic behind tax incentives for savings promoted by numerous countries is to correct the short-sightedness of individuals, their opportunistic behaviour and the distortion that may be caused by other policies. Although households appear to increase their savings with such incentives, the lack of transparency and the complex framework surrounding many policies promoted by public administrations considerably limit their effectiveness.

(2) Ayuso, J., J. F. Jimeno and E. Villanueva (2007). «The effects of the introduction of tax incentives on retirement savings», Documentos de Trabajo, no. 0724, Bank of Spain.
(3) Duflo, E., W. Gale, J. Liebman, P. Orszag and E. Saez (2006). «Saving Incentives for Low- and Middle-Income Households: Evidence from a Field Saw with H&R Block», The Quarterly Journal of Economics, MIT Press, vol. 121(4), pages 1311-1346, November.
Duflo, E., W. Gale, J. Liebman, P. Orszag and E. Saez (2007). «Savings Incentives for Low- and Moderate-Income Households in the United States: Why is the Saver's Credit Not More Effective?», Journal of the European Economic Association, MIT Press, vol. 5(2-3), pages 647-661, 04-05.

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Savings and financing

The government announces new measures that raise the solvency requirements for institutions.

Reforms of the financial sector restore confidence

The Spanish government has as a goal to restore market confidence in the solidity of the country's financial system. 2011 has therefore started with the announcement of a Reinforcement Plan for the financial sector that particularly entails an increase in the basic capital requirement for financial institutions. A measure that will complete the sector's restructuring process started throughout 2010 with the approval of the Savings Bank Act. Undoubtedly, the successful implementation of this plan will be key to the development of flows of credit and savings in the Spanish economy in 2011.

In fact, the new plan has raised the minimum basic capital for financial institutions to 8% of the risk-adjusted assets; a figure that goes up to 10% for those institutions that are not listed or do not have at least 20% of their capital held by private investors. Given the warm welcome received by this measure on the part of private investors and the solvency of the Spanish financial system as a whole, with capital exceeding 8% of the risk-adjusted assets, we can be optimistic about the recapitalization of those institutions that need it. Moreover, even those institutions that do not manage to comply with the required level might receive an injection of public capital from the Fund for Orderly Bank Restructuring (FROB).

FEWER SPANISH FINANCIAL INSTITUTIONS RESORT TO THE ECB

Bank of Spain's net lending to financial institutions

SOURCE: Bank of Spain.

This higher capital requirement is aimed at dispelling any doubt concerning the solvency of financial institutions, as well as strengthening banks' ability to withstand even adverse scenarios. An aim that has been reinforced by the Spanish banking sector exercising transparency when providing detailed information on their real estate risk. This is expected to open up the wholesale financing markets to financial institutions, ensuring credit is channelled into the real economy. Moreover, this opening up should consolidate the lower dependence on financing from the European Central Bank (ECB). The graph above shows this phenomenon. Spanish banks are clearly resorting less and less to the ECB.

Given this situation, bank credit grew by 0.4% year-on-year in 2010, leaving behind the squeeze recorded the previous year. This increase is due to more credit being granted to households, in particular mortgage credit, up 0.8% year-on-year, boosted by the end of tax deductions.

Financing for the public sector and non-financial firms also increased in 2010, with annual growth rates of 13.7% and 1.0% respectively. The gradual recovery of the Spanish economy should increase demand for credit over the coming months.

However, there are some factors that might slow up this recovery in bank credit during 2011. Firstly, inflationary pressures are raising expectations of an increase in the interest rate by the ECB earlier than expected. This would maintain the upward trend in the interest rate for new credit operations, standing at 3.56% in December 2010, and would harm credit demand.

A second element that might act against growth in the outstanding balance for credit in the economy is related to the system's bad debt, which grew again in December to 5.81%. In particular, due to the large amount of problematic real estate assets (defined as non-performing

Wholesale finance markets are expected to open up.

FINANCING OF NON-FINANCIAL SECTORS (1)

December 2010

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,215,160	2,202	0.8	77.7
Non-financial corporations	1,314,742	5,540	1.0	46.1
Resident credit institution loans (3)	*897,961*	*–18,400*	*–1.0*	*31.5*
Securities other than shares	*64,241*	*8,042*	*14.3*	*2.3*
External loans	*352,539*	*15,898*	*4.3*	*12.4*
Households (4)	900,418	–3,338	0.4	31.6
Housing loans (3)	*680,367*	*1,816*	*0.8*	*23.9*
Other (3)	*216,449*	*–5,376*	*–0.9*	*7.6*
External loans	*3,602*	*222*	*5.2*	*0.1*
General government (5)	637,385	76,763	13.7	22.3
TOTAL	**2,852,545**	**78,966**	**3.4**	**100.0**

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

The rise in the interest rate in 2010 increases the number of fixed-term deposits.

loans, those under imminent risk or apartments and land that have been awarded). According to the data provided by institutions and requested by the Bank of Spain, these would total 150 billion euros in 2010, a figure that's equal to two thirds of the total loans to property developers in the hands of banks and savings banks. If part of these assets were declared unrecoverable and were no longer accounted as credit assets, the financial institutions' credit stock would decrease. This would mean that, even when loans were again being granted, the outstanding credit balance would fall due to purely accounting reasons.

The wholesale markets opening up will put a brake on the deposit war

In addition to this impact on the flow of credit, these new measures to restore credibility to the Spanish financial system will also have an effect on the distribution of institutions' liabilities. The possible improvement in wholesale financing channels is expected to reduce the need to capture new customer deposits. This will ease the competition for private customer liabilities that raged between financial institutions in 2010. This boosted the financial system's deposits in 2010 by 23,488 million euros, 1.9% higher than the figure one year before. These new deposits were achieved by putting up interest rates, particularly for term deposits, which rose by more than half a point during the same period, reaching 2.74% in December last year.

We can therefore expect the interest rates for new deposits to gradually fall over the next few months, reducing pressure on financial institutions' margins. This, together with the improved returns for equity over the last few months, might lead the financial savings of households and firms to cross over to mutual funds, which have seen their assets fall to a little more than half since 2007. This reactivation is still not evident in the figures for January, however, a month when mutual funds recorded withdrawals of 623 million euros.

An upswing in mutual funds is expected in 2011.

Nevertheless, the gradual recovery of the Spanish economy and the improvement in economic sentiment are expected to reduce the savings rate of Spanish households throughout 2011. No significant rises are therefore expected in the different types of savings.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

December 2010

	Balance	Change over 12 months		% share
	Million euros	Million euros	%	
On demand deposits	261,766	–969	–0.4	18.2
Savings deposits	211,287	3,496	1.7	14.7
Term deposits	743,605	23,593	3.3	51.7
Deposits in foreign currency	19,383	–2,632	–12.0	1.3
Total deposits	**1,236,041**	**23,488**	**1.9**	**85.9**
Other liabilities (*)	**203,012**	**–10,118**	**–4.7**	**14.1**
TOTAL	**1,439,053**	**13,370**	**0.9**	**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.

Household savings: towards normality

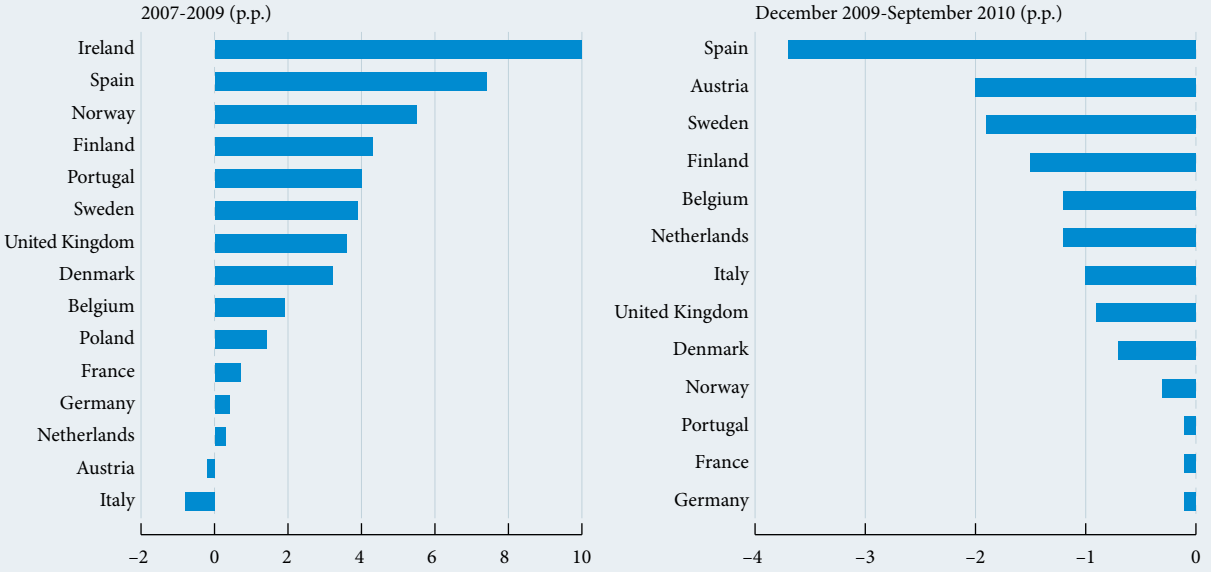
As from the start of the economic recession, the savings rate of Spanish households was extremely volatile. Between 2007 and 2009, it rose by almost seven percentage points to 18% of the disposable income of families, going above that of other traditionally more savings-oriented countries such as Germany and Belgium. The improved economic outlook has subsequently reduced this rate to 14%. These sharp changes have characterized the profile of Spanish economic development over the last few years and will be key to determining its capacity to recover. It's therefore important to understand what lies behind this greater volatility in the savings rate of Spanish households.

It's no surprise that, when the economy shrinks, uncertainty regarding future expectations damages the confidence of the different institutional sectors. In the case of households, this falling optimism usually leads to a rise in their rate of savings in order to prepare for future contingencies. As shown by the graph below, the behaviour of most European households when the recent crisis erupted followed this pattern. Except for some exceptions such as Austria and Italy, between 2007 and 2009 the household savings rate rose in the main countries of the European Union (EU). During this period, only Irish households recorded a higher rise in the savings rate than their Spanish peers. We can also see that it was in Spain where households recorded the biggest slump in savings during the subsequent months, once confidence began to recover.

This different sensitivity of household savings throughout the economic cycle may be in response to different factors. It's logical that the rise in the household savings rate should be particularly marked in those countries where

THE SAVINGS RATE OF SPANISH HOUSEHOLDS SHOWS GREATER VOLATILITY

Change in the savings rate



SOURCE: Eurostat.

the recession has had a greater impact on the economy of families. This is shown by the first graph on the next page. The biggest increases in the savings rate occurred where the drop in employment was greatest. It's also logical that, as the situation of households stabilizes, the savings rate will get back to normal.

But in addition to these reasons related to the economic situation, there may also be other fundamental factors behind this greater volatility in Spanish savings. In this respect, the Household Financial Survey (EFF in Spanish), produced every three years by the Bank of Spain to gather itemized information on the structure of Spanish families' assets and debts, points to some possible reasons. Among the data gathered by this survey, of note is the composition of Spanish households' assets, clearly biased towards real assets (such as property, their own business, works of art, jewellery, etc.). In the first quarter of 2009, these accounted for 89.1% of the total assets, with financial assets making up the remaining 10.9%.[1] This major concentration on real assets, which has remained practically constant over the last few years, focuses fundamentally on investment in property. Specifically, 80% of households' total assets are property, a figure that falls to 60% if we only take primary residences into account. The smaller weight of real assets recorded in similar surveys in the United States, Italy or the United Kingdom, accounting for less than 70% of total assets, highlights the greater propensity of Spanish households to accumulate real estate.[2]

This composition of the Spanish households' wealth may well be crucial for both the level and the development of their savings rate. On the one hand, greater investment in property has reduced savings in financial assets and has therefore placed the average savings rate for Spain at a relatively low level, specifically 11.3% between 2000 and 2007. This figure is lower than the average for the main European countries, such as France, Germany and Italy, with 15.4%, 16.0% and 15.6% respectively in the same period. In other words, as they have a real asset, Spanish households believe it's less necessary to save part of their income.

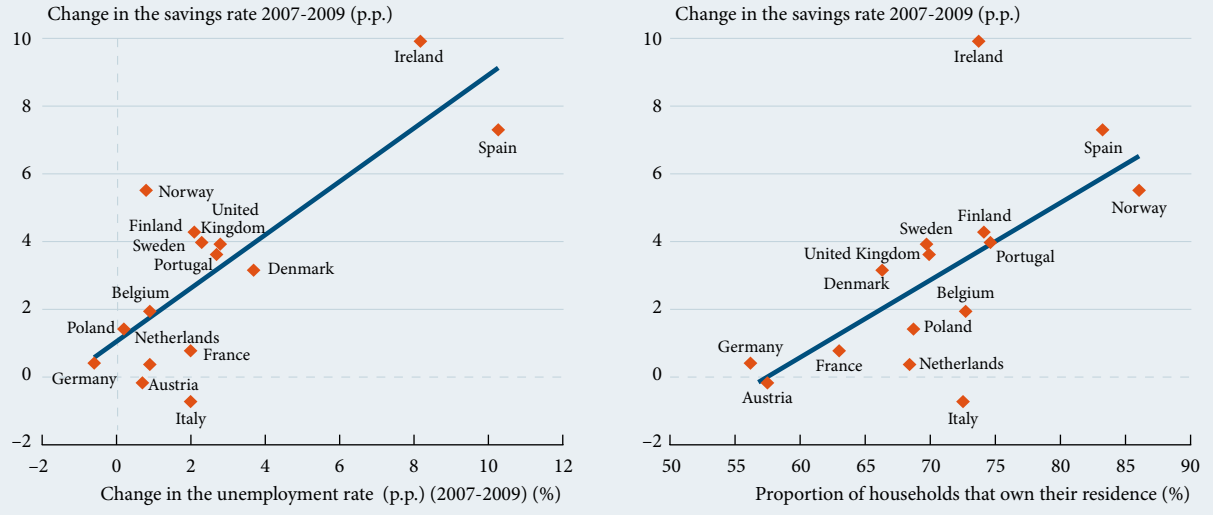
On the other hand, this significant proportion of investment in property means that the wealth of Spanish households is highly concentrated in illiquid assets, as these cannot be converted quickly into cash without significant loss of value. This lower liquidity is no drawback during a boom, when the need for liquidity is unlikely to increase suddenly. In fact, the dynamism of real estate markets during years of strong growth and the possibility of using real assets as collateral for credit operations meant that liquidity could be obtained without incurring too high cost. This contributed to reducing the savings rate during the expansionary period. However, during the last recession, the distribution Spanish households' wealth affected their savings. Falling house prices led to a reduction in families' wealth, so they restricted their consumption. Moreover, within this context, it was more difficult to sell property quickly. Consequently, part of the sharp rise in households' financial savings could be explained by the high concentration of wealth in property.

A simple way to verify this relationship is to observe whether the volatility of savings is proportional to the percentage of property owned by households. Although this hypothesis cannot be confirmed directly due to the lack of data measuring the composition of households' asset portfolio at a European level, we can use the percentage of households that own their residence as an approximation. As can be seen in the graph below, those countries with a higher proportion of households that own their residence were, on average, the ones recording the highest rise in their savings between 2007 and 2009.

(1) For more details, see: «Encuesta Financiera de las Familias (EFF) 2008: métodos, resultados y cambios desde 2005», Boletín Económico del Banco de España. 01/2011.
(2) O. Bover, *et al.*, «The wealth of Spanish households: A microeconomic comparison with the United States, Italy and the United Kingdom», Boletín Económico del Banco de España 07/2005.

UNEMPLOYMENT AND THE DISTRIBUTION OF WEALTH OF SPANISH HOUSEHOLDS EXPLAIN WHY THEIR SAVINGS ARE MORE SENSITIVE

Change in the savings rate



SOURCE: Eurostat.

Cultural factors undoubtedly play a very important role in the composition of Spanish households' wealth. The importance of acquiring a home in Spain is reflected in the high proportion of households that own a residence, reaching 83% and only exceeded by Norway. Even the 78% of Spanish households with lower incomes own their residence, a figure that's higher than the average of all EU households, standing at 73.5% in 2009. But this cultural bias towards owning housing does not have to be at odds with economic rationality. Unlike the main European economies and the US, the gross return on Spanish property over the last twenty years exceeded that of bonds and equity, with annualized growth rates of 7.5%, 7.3% and 6.9% respectively. A figure that would rise to 11.4% if we took the period 1970-2010 as our reference.

Although the recent fall in house prices might make investment in property seem less attractive at the moment, in the long term the returns should become positive again and we can therefore expect the composition of households' wealth not to vary too much. This means that it will continue to be a decisive factor in the evolution of the savings rate of Spanish households. A rate that will go on falling in the short term if the Spanish economy and consumer confidence continue to recover at the same pace returning, thus, to levels similar to its average of the last few years.

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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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