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THE SPANISH ECONOMY

Monthly Report

OUTLOOK 2012

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

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

Contents

Outlook 2012

The year 2011 is taking its leave in the midst of a sense of unease, giving rise to great concerns regarding the course of the economy in 2012. The year that's ending has confirmed that the recovery will be slower and more irregular than desired due to the complications arising in advanced economies. In emerging economies, on the other hand, although activity has slowed up slightly and this trend might last into the coming year, the rate of growth will still easily exceed 5%.

The loss of momentum in developed economies in 2011 was partly to be expected due to the nature of the 2008-2009 economic and financial crisis and the policies applied to overcome it. On the one hand, a recession largely caused by excessive debt usually gives rise to a slower, weaker exit from this recession. On the other, it was inevitable that the withdrawal of the substantial fiscal, monetary and financial policies employed to tackle the biggest recession for several decades would have a detrimental effect on subsequent growth, unless private sector demand could quickly replace the action taken by the public sector. However, four factors have helped to hinder the recovery of advanced economies, which in the first quarter of 2011 were still enjoying notable rates of growth.

Firstly, the private sector is taking over from the public sector as the economic driving force much more slowly than expected. Secondly, the earthquake and subsequent tsunami which, in March, affected the north-east of Japan led to a significant interruption in supply chains, particularly in automobiles and electronic components, which was felt globally. Thirdly, rising commodity prices in 2009 and 2010, after the lows recorded at the end of 2008, reached their peak at the beginning of 2011, thereby complicating the recovery of importing countries; in spite of their subsequent fall, the prices of the main commodities are still above the average for 2010. Lastly, Europe's sovereign debt crisis, which erupted at the end of 2009 and which, in 2010, saw the bail-out of two EU member states, has not only failed to improve in 2011 but has even spread and got worse, raising worrying questions about the capacity of European institutions to orchestrate the necessary remedies to stabilize the situation.

Within this context, business and consumer confidence has plummeted and financial markets have suffered serious setbacks. The dilemma of economic policy continues to be how to support the recovery in activity whilst also redressing fiscal imbalances. In the United States, the budget dispute continues to threaten stability but we expect growth to remain at around 2% in 2012. The great uncertainty lies in Europe, which is facing what might still turn out to be a double dip recession. The adjustment policies adopted to a greater or lesser extent depending on the country are inevitably affecting the purchasing power of households and of the public sector. The worsening of the sovereign debt crisis and the perception of the lack of a route map to overcome this are deterring private investment. Financial unrest, the tightening of financing terms and new regulatory requirements are hindering the normal flow of credit. All elements therefore seem to be in place for the debt crisis to end up affecting and contaminating the real economy, leading to a highly unfavourable environment for Europe's economy in 2012.

EXECUTIVE SUMMARY

The euro area goes into intensive care

The sovereign debt crisis continues to get worse.

The world's economic growth is losing steam but is still high thanks to the emerging countries, although they are not immune to the difficulties affecting the developed world. Here, consumer and business confidence is losing ground amidst growing concern regarding the expected developments for the coming year. Financial markets are suffering directly and harshly from this uncertainty. The biggest problem is still the euro area, which has yet to find a path out of a sovereign debt crisis that is threatening the very foundations of monetary union and has already contaminated the real economy.

Growth prospects improve for the United States but have yet to galvanize.

In the United States, October's business indicators show that the third quarter's upswing has continued, with gross domestic product (GDP) growing by 0.5% compared with the previous period, at 1.5% year-on-year. This should result in growth of close to 2% for 2011 as a whole. The risk of a double dip recession has therefore significantly diminished, thanks particularly to the mood of consumers, cheaper oil prices and industrial investment. However, the labour market is the true sounding board for this crisis. The problem here is the slowness of the recovery. Between March 2010 and October 2011, i.e. in 20 months of recovery, the US economy created 2.3 million jobs, a figure that is very far from the close to nine million lost between 2008 and 2009.

The emerging economies are still growing but somewhat less.

With this panorama of low growth, the favourable trend in inflation gives the Federal Reserve leeway to employ expansionary policies to boost employment and mitigate the problems of bad mortgage debt, with a real possibility of a third round of quantitative easing in 2012. For the moment, the US central bank has made clear its dual proposal to encourage sustained economic growth and keep prices stable. It has also repeated its commitment to keep the reference rate at the minimum range of 0%-0.25%, thereby confirming that its programme of exceptional monetary policy measures will continue. For now, the main issue resides in the lack of political agreement on what the route map for fiscal consolidation should look like.

With regard to Japan, after three consecutive quarters of declines, the economy confirmed its recovery from the effects of the tsunami and nuclear crisis in March. Third quarter GDP was higher than expected, up 1.5% quarter-on-quarter, leaving it just 0.2% below the level of the same period a year ago. This recovery was based on robust growth in private consumption, up by 1.0% quarter-on-quarter, and on the recovery in exports, growing by a resounding 6.2%, from a very low starting point. However, the latest figures raise doubts as to whether this expansion can go much further.

In China, the restrictive tone of its economic policy in the first half of 2011, aimed at containing inflation, has helped to slow up economic activity so that GDP will grow slightly below 9% in the fourth quarter. For the moment, the anti-inflationary battle is having an effect,

as the consumer price index (CPI) increased by 5.5% year-on-year in October, clearly lower than the 6.1% of September, while the rate for foods and production prices also moderated. This slowing trend in the economy has also intensified in Brazil over the last few months. In September, and without any warning, Brazil's central bank lowered its official interest rate, lowering it again in October, and the bulk of the evidence available suggests that it will cut the rate by another 50 basis points at the end of this month, leaving it at 11.0% until the end of the year. The capital requirements for consumer credit have also been relaxed and further stimuli of a similar nature have not been ruled out.

Third quarter GDP was not very encouraging in the euro area. In quarter-on-quarter terms it grew by 0.2%, resulting in a 1.4% year-on-year rate of change. However, macroeconomic indicators are producing worrying signs, pointing to a slowdown in economic activity for the coming quarters. Job losses and the fall in disposable income are slowing up household consumption, while the difficulty in accessing credit and fragile demand are affecting industry.

Given this outlook, we have reduced our growth forecast for GDP in 2012, which was 1.3%, to 0.3%. We expect the euro area as a whole to enter a moderate recession with two consecutive quarters of negative growth, something the new president of the European Central Bank (ECB), Mario Draghi, already warned of in his appearance in November. In fact, at its November meeting, the monetary authority lowered the official interest rate by 25 basis points to 1.25%. According to Draghi, this change in direction of monetary policy was adopted unanimously, this being the first cut in interest rates since May 2009. He also said that the decision was taken due to continued pressure in financial markets that is affecting the stability of the euro area, as well as the persistence of the current risks related to the delicate financial situation of the peripheral countries and the slowdown in activity.

The euro area is likely to suffer from a moderate recession.

Not only have the agreements reached at October's summit failed to contain the interminable sovereign debt crisis of the euro area's peripheral countries, this has even become bigger, and to a worrying extent. November was marked by a strong upswing in the risk premia of most economies, particularly in Italy and Spain. Albeit to a lesser extent, the spread between French debt and the German bund has also widened due to the doubts of some rating agencies regarding France's capacity to meet its deficit targets and its banks' high exposure to the debt of countries in the firing line. Within this context of growing instability, the ECB's purchases of Italian and Spanish debt barely calmed the nerves of investors, witnesses to how market pressure was forcing political changes in Greece and Italy. This situation has now been reflected in the recently issued Italian and Spanish bonds, whose yields rocketed due to greater risk aversion.

The ECB relaxes its monetary policy...

In November, the euro lost close to 3% against the US dollar but the crisis has hit stock markets the hardest due to the perception that the measures adopted are not very effective and too slow, as well as the widening spread between the countries affected and Germany and, above all, due to the consequent fear of the crisis infecting the rest of the euro area and countries lending funds to Europe. The sector that is being hardest hit by investors is banking, due to its high exposure to the region's sovereign debt and the limited prospects of gains in the new, more restrictive regulatory environment.

...but the key lies in the lack of progress made in resolving the sovereign debt crisis.

A squeeze is also starting to appear in Spain...

The greater tension in debt markets over the last few months is jeopardizing the capacity of economies such as Spain to secure external financing, a difficulty that is in addition to an increasingly complicated situation overall. The credit squeeze, job losses, fiscal adjustments, falling confidence and less favourable external environment all make for a contracting scenario. Spain's GDP growth stagnated in the third quarter and has probably entered recession in the last quarter of the year. We expect a slight contraction in activity, forcing us to adjust downwards our growth forecast for 2012 as a whole, from 1.1% to 0.2%. Moreover, while no credible solution is reached for the euro area crisis, any risks to this forecast are clearly downward.

...with a labour market that continues to destroy jobs.

One of the factors forcing us to lower our growth forecast for Spain for the coming quarters is precisely the loss of steam in world trade and the slowdown in growth of the European economy. The foreign trade figures for September show, for the second month in a row, an increase in the trade deficit due to the slight upswing in imports resulting from higher energy prices. In spite of this slight deterioration, the total current deficit accumulated over the last twelve months speeded up its rate of contraction in August, with an 18.0% year-on-year decrease. This correction is due to the good performance by the balance of services and transfers, offsetting the increase in the deficit recorded in the balances of goods and income.

But the greatest challenge still lies in the weak domestic demand. A cause and consequence of this is the bad situation of the labour market, once again highlighted by the labour force survey carried out every quarter by the National Institute of Statistics. According to this survey, the number of unemployed rose by 144,700 in the third quarter and is now close to five million. Consequently, the unemployment rate increased by a little more than 0.6 percentage points compared with the previous quarter and reached 21.5%. We have to go back to the mid-1990s to find a similar rate.

Of note is the fact that, in the third quarter, public employment continued to increase, so that it now accounts for 21.2% of all salaried employment. Since the start of 2008, 347,400 public jobs have been created while the private sector has lost almost two million jobs over the same period. However, cost-cutting policies have already started to produce declines in public consumption, namely 1.1% in the third quarter, thereby placing the year-on-year rate of change at –2.3%, 5 tenths of a percentage point below the figure for the previous quarter.

European leaders meet again in December to calm down the debt crisis.

It's vital to regain confidence and to relax financial conditions in order to improve growth prospects. As has been mentioned above, clear political agreement is essential in the European Union to achieve this aim, as well as setting up substantial mechanisms to support sovereign debt and the banking system. Is this possible? Right now, another meeting has been arranged for early December, in which new measures might be taken to advance towards economic and perhaps budgetary integration, giving a more relevant role to the central bank and perhaps even looking at the creation of Eurobonds, as proposed by the European Commission. We must hope that this meeting does not become yet another anti-climax, dashing the expectations created, as has happened on the last few occasions.

28 November 2011

CHRONOLOGY

2010

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

2011

January	**1**	Estonia joins the **euro area**, which grows to seventeen member states.
	14	Ben Ali's regime in Tunisia falls, the first in a chain of **political changes** in North Africa and the Middle East, with repercussions for oil prices.
February	**2**	Signing of the **Social and Economic Agreement** by the government, trade unions and employers, including pension reform.
	18	The government passes a Decree-Law to reinforce the solvency of **financial institutions**.
March	**25**	The **Euro Plus Pact** is approved and the foundations are laid to set up the **European Stability Mechanism** in the European Council.
April	**7**	The **European Central Bank** raises the official interest rate to 1.25%.
May	**17**	The Council of Economic and Finance Ministers of the European Union approves the **financial bail-out plan for Portugal**, totalling 78 billion euros.
	22	**Elections** are held in thirteen autonomous communities and in the municipalities.
June	**10**	The government approves a Decree Law that **reforms collective bargaining**.
July	**7**	The **European Central Bank** raises the official interest rate to 1.50%.
	21	The countries of the euro area approve a second **bail-out plan for Greece** among other measures to tackle the sovereign debt crisis.
August	**16**	The leaders of Germany and France, Angela Merkel and Nicolas Sarkozy, propose that **the euro area's institutions should be reinforced** by a series of mechanisms to improve coordination of economic policy.
	19	The government approves a package of **economic policy measures**, advancing the payment of corporate tax for large firms, rationalizing pharmaceutical expenditure and a temporary reduction in VAT for new housing.
	30	The Congress agrees to reform the Constitution to introduce the principle of **budgetary stability**.
September	**22**	The Spanish government ratifies Royal Decree Law 13/2011, which re-establishes **wealth tax** for 2011 and 2012.
October	**26**	The euro summit agrees to launch a **new aid programme for Greece**, with a write-down of 50% of the debt for private investors, to substantially enlarge the lending capacity of the EFSF and to raise the Core Tier 1 **capital ratio of banks** to 9%.
November	**3**	The **European Central Bank** lowers its official interest rate to 1.25%.
	20	The Partido Popular wins the **general elections** with an absolute majority.

AGENDA

December

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

January

- **11** Industrial production index (November).
- **12** Governing Council of the European Central Bank.
- **13** CPI (December).
- **17** EU HICP (December).
- **25** Producer prices (December).
  Fed Open Market Committee.
- **27** Labour force survey (fourth quarter).
- **31** Advance CPI (January).

INTERNATIONAL REVIEW

The United States: The vigour of autumn fails to clear the air

The United States picks up in the second half of year, without improving expectations for 2012.

The economy's recovery is consolidating. October's business indicators show the upswing continuing in the third quarter, where gross domestic product (GDP) grew by 0.5% quarter-on-quarter and by 1.5% year-on-year. This should take growth for 2011 as a whole to around 1.8%, a rate that is higher than what was expected in September. The reasons for this renewed vigour can be found in consumer behaviour, cheaper oil and industrial investment.

The push from consumption is supported by lower savings.

This improved tone of the US economy in the second half of the year averts the spectre of a double-dip recession and is particularly welcome in a situation where the global economy is feeble. Nevertheless, the United States is still having serious problems of insufficient growth, which means that a significant part of its production resources have been left idle, perpetuating the weakness in the labour and housing markets. This upswing, which seems temporary in nature, does not suppose any significant improvement for this problem. This is because the push from consumption is based on lower savings, because investment in industry will probably lose steam and, thirdly, because crude prices don't look like they will continue to fall with the same intensity. Similarly, the lack of political

UNITED STATES: MAIN ECONOMIC INDICATORS

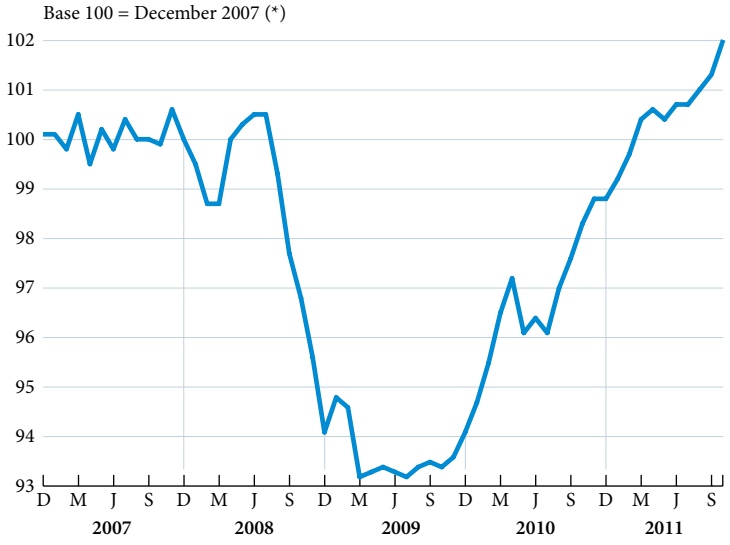
Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011			
			4Q	1Q	2Q	3Q	October
Real GDP	–3.5	3.0	3.1	2.2	1.6	1.5	–
Retail sales	–7.0	6.4	7.6	8.2	7.8	8.0	7.2
Consumer confidence (1)	45.2	54.5	57.0	66.9	61.8	50.3	39.8
Industrial production	–11.2	5.3	6.2	5.4	3.8	3.4	3.9
Manufacturing (ISM) (1)	46.3	57.3	57.9	61.1	56.4	51.0	50.8
Housing construction	–38.4	5.6	–5.1	–5.3	–4.9	4.4	16.5
Unemployment rate (2)	9.3	9.6	9.6	8.9	9.1	9.1	9.0
Consumer prices	–0.4	1.6	1.3	2.1	3.4	3.8	3.5
Trade balance (3)	–381.3	–500.0	–500.0	–520.4	–534.8	–537.4	...
3-month interbank interest rate (1)	0.7	0.3	0.3	0.3	0.3	0.3	0.4
Nominal effective exchange rate (4)	77.7	75.4	73.0	71.9	69.6	69.1	...

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

THE UNITED STATES: PRIVATE CONSUMPTION MAINTAINS ITS UPSWING

Real retail sales without vehicles or petrol



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

agreement regarding what the route map to fiscal consolidation should look like may result in fiscal policy being more of a burden than a stimulus in 2012. All this means that expectations have not improved for 2012, with growth that's unlikely to exceed 2.0%.

This consumer appetite could be felt in retail consumption which, excluding the volatile automobiles and petrol, continued to rise, growing by 6.0% year-on-year in October, meaning that, in real terms, it exceeded the pre-crisis levels of December 2007 by more than 2.0%. Automobile sales in the last three months up to October also intensified their growth while the University of Michigan consumer sentiment index for November left behind four months of lethargy.

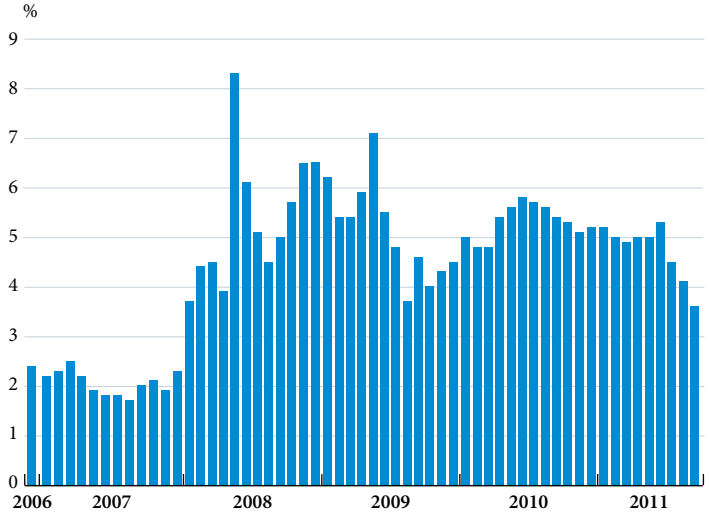
However, this push by consumption has been achieved thanks to a drop in the savings rate that, in terms of household disposable income, went from 5.3% in June to 3.6% in September, the lowest since December 2007, when the effects of the credit crisis had yet to be felt among consumers and indebtedness was not seen as a problem. Considering that household debt, after peaking at 130.2% of disposable income in September 2007, was still at a high 114.4% at the end of June, the savings rate is expected to rise over the coming months, with the consequent harmful effect on consumer spending. In addition, the good performance by automobile sales should tend to slacken in the next few months.

The verdict is less clear regarding the continuity of investment in industry, another support for the upswing. In 2011, industrial investment has been benefiting from generous fiscal conditions, allowing investment to be repaid very quickly. The reduction of these advantages in 2012 will probably lead to a slowdown to some extent. Along these lines, the Institute of Supply Management (ISM) business

Industry will moderate its upswing but still has a lot of room to improve.

THE UNITED STATES: A SHIFT TOWARDS LOWER SAVINGS?

Household savings as percentage of gross disposable income



SOURCES: Bureau of Economic Analysis and own calculations.

Job creation is slow and the unemployment rate is 9.0%.

sentiment indices for manufacturing and services point to a downward trend. In October, the ISM manufacturing index stood at 50.8 points, while the index for services was at 52.9, in both cases consistent with weak growth in the economy as a whole. Nevertheless, industrial investment might meet some resistance in 2012 as, in spite of the latest upswing, the recovery has a long way to go yet, as it is still 7.5% lower than the level at the start of the crisis, discounting price rises. The good figures for industrial production in October, up by 3.9% year-on-year, would reinforce this hypothesis.

The labour market is the true sounding board for this crisis. The upswing in the third quarter could be felt in job creation, accumulating 469,000 new jobs in the July-October period. The problem here is the slowness of the recovery. Between March 2010 and October 2011, i.e. in 20 months of recovery, the US economy created 2.3 million jobs, a figure that is very far from the close to nine million lost between 2008 and 2009. The high proportion of long-term unemployed, reaching 42.5% of the total unemployed and double the peak in the previous crisis, is creating problems of adjustment, with job vacancies that are not being filled because the applicants do not have the necessary skills. The insufficient growth in aggregate demand might make the unemployment rate, which in October stood at 9.0%, pick up again slightly in 2012. A change in trend is unlikely as the contingent of discouraged workers or those working part-time involuntarily, who are not included in the official unemployment rate, will absorb a significant part of any new jobs created.

Unemployment and the slowdown in wages are reducing household income and playing an important part in increasing mortgage default, resulting in foreclosures on housing that, pending auction, are swelling the numbers of properties for sale. If employment doesn't improve, any aid that does not reduce the amount of mortgage debt will fall on

stony ground as, after the grace period, people default again on their mortgage repayments. Both housing prices and construction activity are still at rock bottom and any recovery is unlikely before the second half of 2013. Because it's at rock bottom, residential investment no longer detracts from growth in the economy as a whole. But the well is deep and one gauge of this is the relative weight of residential investment in GDP, which in the third quarter was 2.4%, very far from the 5.2% for the period 1995-2000, prior to the bubble.

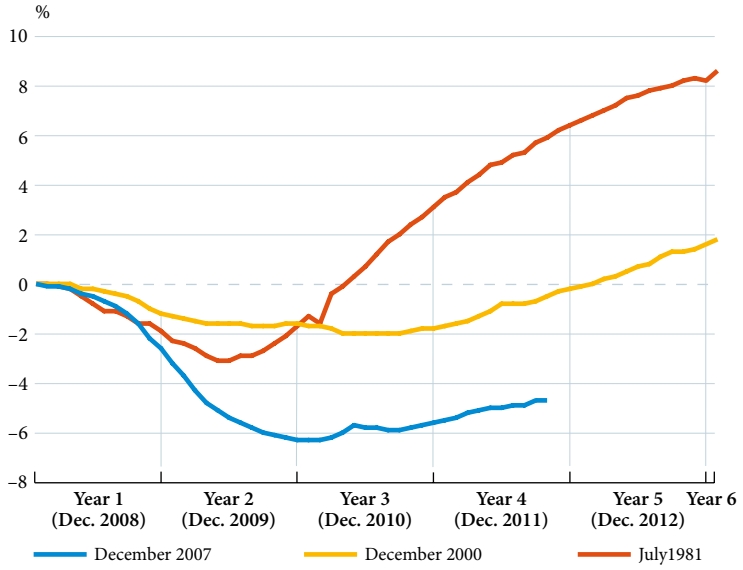
With this panorama of low growth, the trend in inflation gives the Federal Reserve leeway to employ expansionary policies to boost employment and lessen the problems of bad mortgage debt, with a real possibility of a third round of quantitative easing in 2012. The moderation in oil prices, which seems to be taking its time in being passed on to consumer prices, meant that the consumer price index (CPI) slowed up its rise to 3.5% year-on-year in October. A moderation in inflation that is more evident in the core index, which excludes energy and food prices, up by 2.1% year-on-year supported by the price of rented housing, an item that, in October, contributed more than half the rise in total core inflation compared with September. The moderation in commodity prices and persistence of low production capacity utilization should keep inflation moderating throughout 2012.

With regard to the foreign sector, the corrective trend in the trade imbalance has been confirmed thanks to a certain vigour in exports, coinciding with the moderation in oil prices and reducing the sum for imports. The trade balance deficit for goods and services in September was 43.1 billion dollars,

The CPI, up 3.5%, with 2.1% for core inflation, should moderate in 2012.

THE UNITED STATES: EMPLOYMENT IS SLOW TO RECOVER

Job losses as percentage of total employed at the start of the decline (*)



NOTE: (*) The dates in brackets correspond to the last recession (December 2007).
SOURCES: Department of Labor and own calculations.

Japan grows by a minimal 1.5% in the third quarter and confirms its recovery.

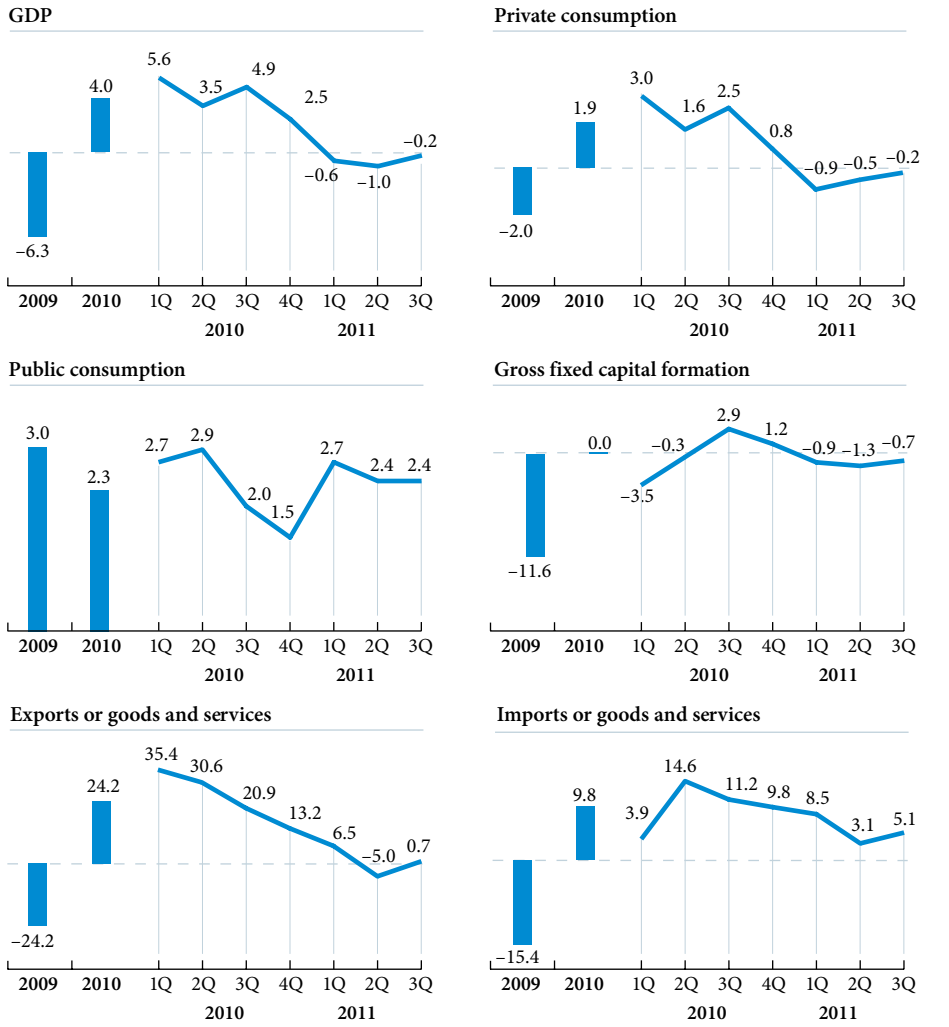
the best figure for the last year, endorsed by the good performance of the deficit excluding oil and its derivates, which is a better reflection of the underlying trend. But this good development is unlikely to lead to significant contributions to GDP growth over the coming quarters, as the world's economic slowdown will reduce the demand for US exports, at the same time as oil's resistance to sharper price drops will prevent imports from falling.

Japan: a recovery with an expiry date

After three consecutive quarters of decline, the Japanese economy confirmed its recovery from the effects of the

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.

tsunami and nuclear crisis in March. Third quarter GDP was higher than expected, up 1.5% quarter-on-quarter, leaving it just 0.2% below the level of the same period a year ago. This recovery was based on robust growth in private consumption, up by 1.0% quarter-on-quarter, and on the recovery in exports, growing by a resounding 6.2% but from a very low starting point. However, the latest figures raise doubts as to whether this expansion can go much further.

Monthly indicators for September point to quarterly growth being concentrated in the months of July and August. Industrial production, which had regained more than two thirds of the 15.2% it had lost with the tsunami in March, fell by 3.4% in September compared with August and showed some signs of exhaustion, also confirmed by machinery orders, an early indicator of investment spend. In the case of exports, what had been lost in August was made up again in September but the recovery looks unlikely to continue. Exports have already reached pre-tsunami levels so that, together with the slowdown in world growth, especially in Asia, which is where half of Japanese exports end up, there is little leeway left. The appreciation of the yen doesn't help either, with most exporters seeing their profits eroded more than in industry as a whole.

But growth will not improve. Industrial production is falling and exports will suffer from the global weakness.

Retail sales also joined the retreat being made by industry in September, as well as automobile sales in October and housing, which in September saw an end to the increases of July and August. Along the same lines, prices also turned somewhat deflationary in nature. In September, the CPI fell back to its level of a year ago, while the core CPI, the general index without energy or food, took another step backwards, down 0.4% year-on-year.

Demand weakens and prices fall again.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011			
			4Q	1Q	2Q	3Q	October
Real GDP	–6.3	4.1	2.5	–0.6	–1.0	–0.2	–
Retail sales	–2.3	2.5	–0.4	–3.0	–1.7	–1.0	...
Industrial production	–21.8	16.6	6.8	–2.5	–7.0	–2.0	...
Tankan company Index (1)	–40.8	0.0	5.0	6.0	–9.0	2.0	–
Housing construction	–27.7	2.7	6.8	3.2	4.3	7.8	...
Unemployment rate (2)	5.1	5.1	5.0	4.7	4.6	4.4	...
Consumer prices	–1.3	–0.7	–0.3	–0.5	–0.4	0.1	...
Trade balance (3)	4.0	7.9	7.9	6.5	3.4	1.3	...
3-month interbank interest rate (4)	0.58	0.39	0.34	0.34	0.34	0.3	0.3
Nominal effective exchange rate (5)	98.6	106.0	111.0	110.6	109.3	115.5	118.8

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

China: inflation and fine adjustments

The CPI slows up to 5.5%; the food CPI to 11.9%.

The prime minister, Wen Jiabao, almost certainly felt relieved on seeing the rate of inflation finally moderate in October; a long-awaited figure since, in January, the Chinese authorities established as their main macroeconomic priority for 2011 to put a stop to the excessive rise in prices. The general CPI rose by 5.5% year-on-year, clearly lower than the 6.1% of September, while the CPI for food, which in China accounts for half the general index, also slowed up, from 13.3% to 11.9%. Even so, the greatest achievement was in production prices, whose rise moderated from 6.5% to 5.0%.

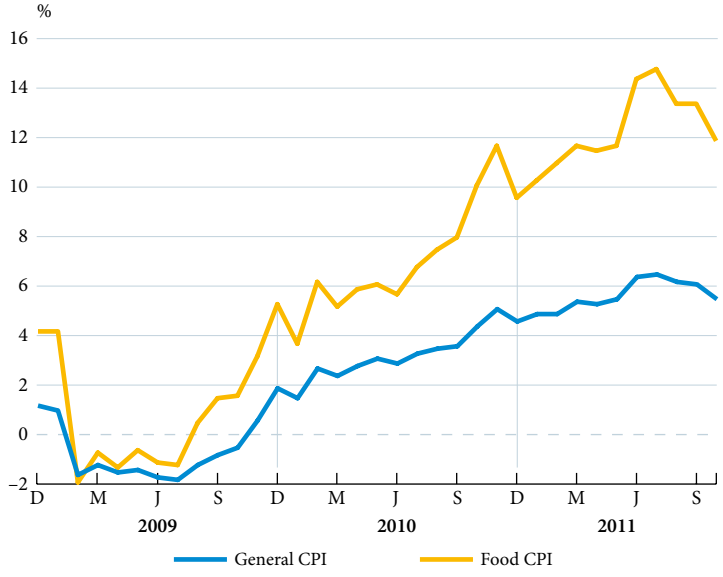
But good news doesn't last long in the present climate. To contain the inflation rate, China increased its interest rate six times in one year and established credit ceilings. These restrictions particularly hit small and medium-sized firms, which account for 80% of the jobs, as credit institutions preferred to lend to large conglomerates with a guarantee from the central government. The restrictive tone of the economic policies in the first half of 2011 has therefore helped to slow down economic activity and will probably result in GDP growing slightly less than 9.0% in the fourth quarter. The figure for industrial production in October, up 13.2% compared with the 13.8% in September, certainly points in this direction of a gentle slowdown, although other indicators such as motor vehicle production and electricity suggest a bigger slowdown.

Now the priority is once again growth and preparing for a gentle slowdown.

The slowdown in the global economy and the evident symptoms of fatigue shown by the real estate sector might also make the landing for China's economy less gentle that it would hope. That's why Wen Jiabao stated that the time had come for preventative fine-tuning; in other words, relaxing monetary policy and boosting growth. The first signs of

CHINA: THE BATTLE OF INFLATION LOOKS WON

Year-on-year change in the consumer price index



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

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

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

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

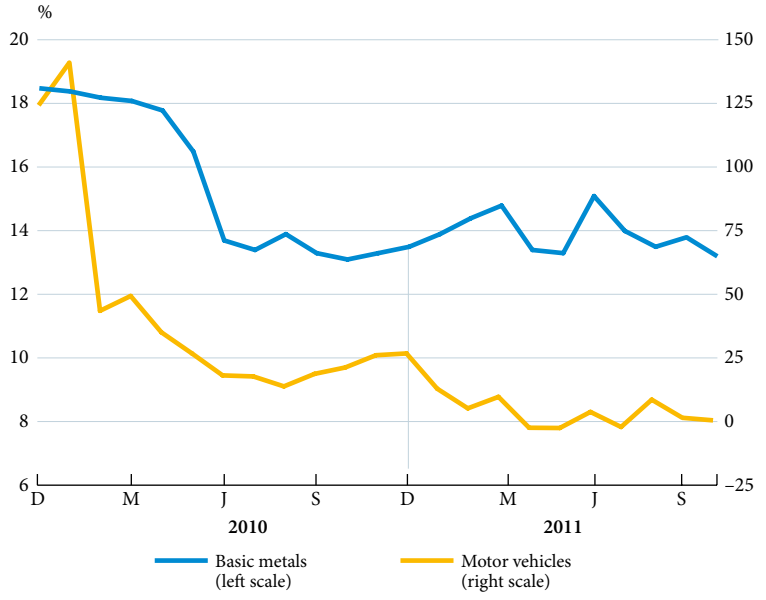
this change in direction in economic policy have not taken long to appear: in October, credit rose and the repo rate fell to seven days.

On the other hand, the foreign sector has become a weak factor, in contrast to the pre-crisis years. October's trade surplus grew to 17 billion dollars but this was due more to the drop in imports, especially commodities, than to exports performing well. Exports grew by 15.9% year-on-year, immersed in a slowdown that is likely to continue until year-end. By geographical

Exports continue to slow up but less than imports.

CHINA: A GENTLE SLOWDOWN?

Year-on-year change in industrial and motor vehicle production



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

The real estate market is showing signs of exhaustion.

area, of note is the drastic slowdown in exports to Europe, up by 9.2% year-on-year and, to a lesser extent, those aimed at North America, up by 13.0%. Exports to Asia, which account for 46.3% of the total, also slowed up but still advanced by 18.4%.

With regard to housing, October's prices fell in most of the main cities, with sales also in clear decline. Of note is the 5.5% cumulative drop compared with June in the city of Wenzhou, in the province of Zhejiang, one of the most economically active and with a large number of small and medium-sized firms. In any case, the continual migration from rural areas to cities is providing a support for growth that other economies lack. Private consumption also has quite a long way to rise and should offset smaller growth in investment and exports. The relative speed of these processes will set the pace of the economy for 2012 and beyond, hence the renewed importance of fine-tuning mentioned by Prime Minister Wen.

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

Brazil: the goal, a soft landing

The slowdown in the Brazilian economy has intensified over the last few months and this has been particularly confirmed by business indicators, especially the marked fall in industrial production in September (–1.6% year-on-year). There are basically three reasons for this: the delayed impact of tougher economic policies implemented as from the beginning of 2011 to counteract the risk of overheating; the persistence of an overvalued real for a long period; and the recent deterioration in the world's growth prospects. Given this scenario, Brazil's economic authorities have turned around their economic policies in order to ensure a soft landing for an economy that managed to dodge the crisis at almost breakneck speed.

There is little room to manoeuvre on the fiscal flank, although a reduction in the tax on foreign investment in shares is being studied, as well as resorting again to quasi-fiscal stimuli via public banking.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011			
			4Q	1Q	2Q	3Q	October
Real GDP	–0.7	7.5	5.0	4.1	3.1	...	–
Industrial production	–7.3	10.5	4.0	2.5	0.6	0.1	...
Consumer confidence (*)	138.3	159.7	159.9	161.8	155.4	153.3	151.9
Unemployment rate (**)	8.1	6.7	5.7	6.3	6.3	6.0	5.8
Consumer prices	4.9	5.0	5.6	6.1	6.6	7.1	7.0
Trade balance (***)	25.3	20.2	20.2	22.5	25.3	30.5	31.1
Interest rate SELIC (%)	9.92	10.00	10.75	11.75	12.25	12.00	11.50
Reales to dollar (*)	2.32	1.78	1.66	1.63	1.56	1.88	1.72

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.

For the moment, however, the weight of this task has fallen to monetary policy. In September, after a prolonged series of rises that took the SELIC rate to 12.5% in July and although the rate of inflation was still at a peak, Brazil's central bank prioritized growth and started to lower the official interest rate without any warning. It lowered it again in October and the bulk of the evidence available suggests that it will cut the interest rate by another 50 basis points at the end of this month, leaving it at 11.0% till the end of the year. The capital requirements for consumer credit have also been relaxed and further stimuli of a similar nature have not been ruled out.

The real has also joined in the fray. After a long period of appreciation, external uncertainty and increased risk aversion have weakened the currency to levels not seen since 2009. The expected monetary relaxation over the coming months should lead to even further depreciation in 2012, although the persistence of capital inflows and still favourable exchange periods will soften the blow.

In spite of the renewed countercyclical tone of economic policies, we do not expect any clear improvement in the rate of activity until mid-2012 (provided external conditions don't get much worse) and this improvement will probably be gradual. Moreover, the pace and intensity of stimuli will have to be carefully monitored while there is still pressure on prices. In this respect, the robustness of consumption and the inertia in wage formation (the main engine behind inflationary pressures) continue to cause doubts regarding the shift in monetary policy: inflation finally started to ease in October (to 6.97% and due particularly to favourable base effects) but refuses to move away from the level of 7% and is unlikely to return to the target range in 2011.

With a view to 2013, and if the prognosis of a soft landing comes about, we do expect the progressive upswing in the global economy and the proximity of the World Cup to provide a new boost to growth in Brazil.

Monetary policy is clearly countercyclical with interest rate cuts and more relaxed capital requirements for consumer credit.

Mexico: robust growth

The slowdown in the rate of recovery in the second quarter, not only in Mexico but at a global level and particularly in the United States, suggested a phase of moderation in growth that, for the moment, has diminished. The third quarter's GDP growth figures, up 4.5% in year-on-year terms and 1.3% compared with the previous quarter, certify that the Mexican economy is still advancing firmly along a path of robust recovery. Buoyed by resistant exports and the increasingly important support of domestic spending, Latin America's second economy refuses to give in to the winds of moderation affecting part of the world's economy.

The real, on a clearly downward trend, has joined in the fray.

The latest macroeconomic indicators also suggest that activity is looking good. The solid advance made by industrial production in September (3.6% year-on-year) and especially the good performance by manufacturing (the main beneficiaries of the upswing in growth in the United States) suggest that this economic improvement will continue. Nonetheless, we still expect a slower rate of growth for 2012 of around 3.5%, in line with the moderation in the pace of the world's recovery and with the gradual correction in the output gap.

The Mexican economy surprises with strong growth of 4.5% in the third quarter.

Actually, the fact that this gap is still negative explains, in part, why the notable dynamism in demand has yet

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011			
			4Q	1Q	2Q	3Q	October
Real GDP	–6.2	5.4	4.2	4.3	3.6	4.5	–
Industrial production	–7.3	6.0	4.7	4.9	3.9	3.4	...
Consumer confidence (*)	80.5	86.3	89.6	92.1	90.7	93.7	90.6
Leading business index (*)	110.5	116.6	118.1	119.8	120.8	119.9	...
Unemployment rate (**)	5.5	5.4	5.3	5.1	5.2	5.7	5.0
Consumer prices	5.0	3.9	4.2	3.5	3.3	3.4	3.2
Trade balance (***)	–4.7	–3.0	–3.0	–1.5	0.0	–1.5	–1.2
Official Banxico rate (%)	6.75	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	14.18	12.33	12.35	11.90	11.72	13.78	13.21

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

There is some leeway to implement new stimuli if the risk of an external slowdown materializes.

to put excessive pressure on prices: general inflation without food is at a cyclical minimum while core inflation for services is still falling. Relatively reasonable wage rises and the moderate impact of the peso's recent weakness have also helped prices' composure. The rest can be attributed to the firm commitment of the Mexican authorities to policies of macroeconomic stability.

This commitment has not only allowed their economy to come out of the crisis in an even stronger state and tackle the external slowdown from a relatively comfortable position, but has also given them some leeway to implement new stimuli (especially in the monetary area), if required. In this respect, the good growth figures for the third quarter confirm our main scenario, which does not foresee any reduction in the official interest rate up to the first quarter of 2012.

Nonetheless, the immediate future of the Mexican economy is still closely linked to what is happening on the other side of the Río Grande. If the situation in the United States becomes more complicated or even if the crisis in the euro area continues and the perception of global risk increases, this moderation in 2012 may be more extensive, leading the authorities to take their monetary ace out of their sleeves.

Oil withstands the troubled waters

The price of crude resisted falling between 20 October and 22 November, dropping a minimal 0.5%, taking it to 108.50 dollars per barrel (Brent quality, for one-month deliveries), 16.7% higher than the start of the year and 29.6% higher than last year's level.

Oil remains at 108.5 dollars and refuses to fall.

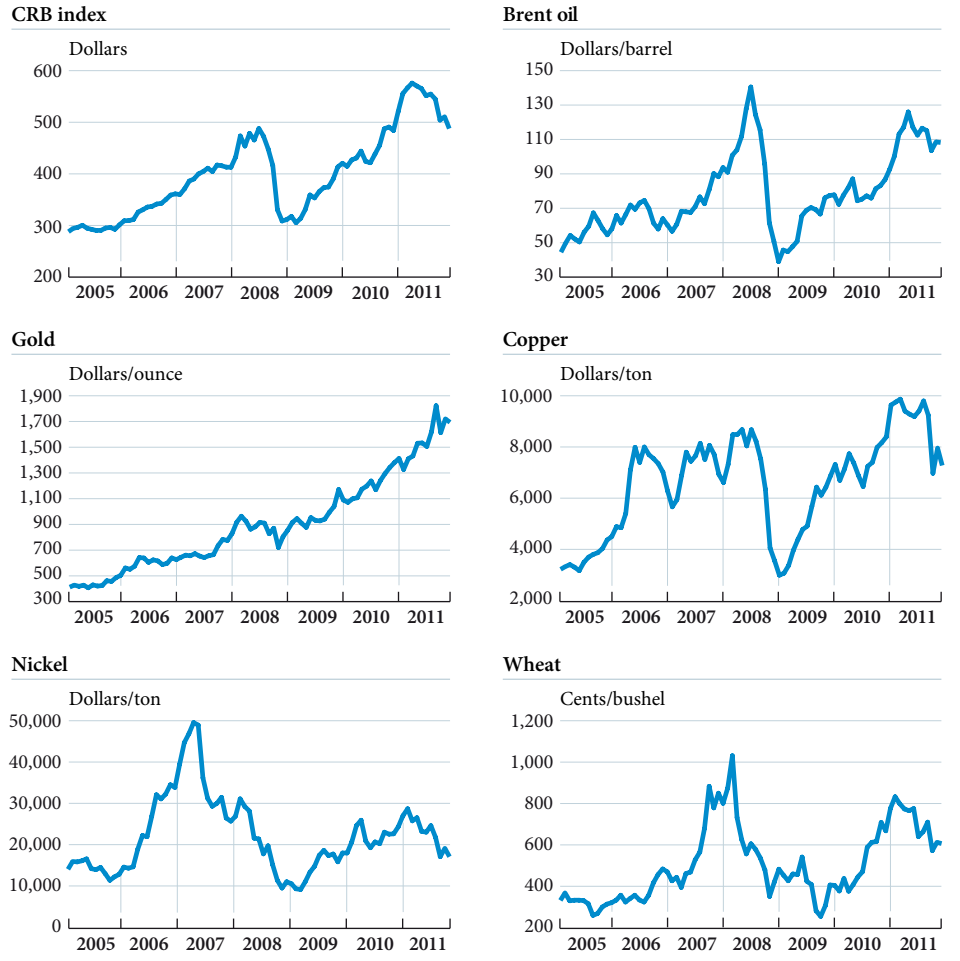
Oil prices still refused to fall, unlike the rest of commodities. This was primarily due to supply-demand factors. The International Energy Agency predicts that, in 2012, oil prices will remain above 100 dollars per barrel with a global demand that has altered very little in spite of lower growth and low stock levels. A second factor behind expensive oil is the ongoing political tensions in North

Africa and the Middle East. Particularly important in this case is the possibility of escalating conflict in the Iranian nuclear programme. With 4.3 million barrels a day, Iran is the world's second largest producer and an interruption in its production would particularly affect China and India, the destination for one third of all its exports.

Falls predominate in the rest of commodities, affected by lower global growth and the slowdown in China's demand. The CRB index dropped by 3.0% between 20 October and 22 November. Precious metals picked up in the last week of October but have been correcting downwards since then. Copper was also up 21.5% at the end of October, in reaction to the sharp drop in September, afterwards returning to the fold and falling by 10.6%.

The downward trend consolidates in spite of sporadic upswings.

TREND IN VARIOUS COMMODITIES (*)



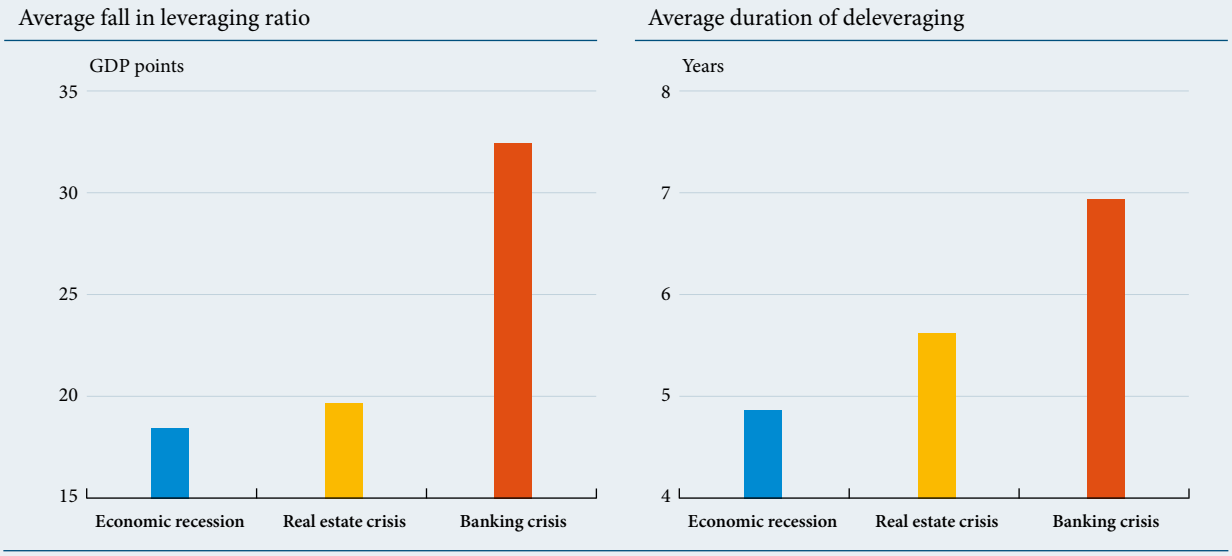
NOTE: (*) Figures for last day of month (last date November 22).
SOURCES: The Economist, Thomson Reuters Datastream and own calculations.

2012: more deleveraging in sight

Three years after Lehman Brothers went bust, advanced economies are generally undergoing a dubious recovery and some countries are at great risk of a double-dip recession. This weak tone can be put down essentially to two factors that are hindering economic growth: on the one hand, the need to carry out significant fiscal adjustments in order to stabilize and start to reduce the burden of public debt; and, on the other, the efforts that must be made by the private sector (households, firms and financial institutions) to reduce their high level of indebtedness. This Box focuses on the latter, namely private deleveraging, with the aim of clarifying, based on past experiences and the current circumstances, how this might be expected to develop, especially in the case of Spain.[1]

Over the long term, private indebtedness (or leveraging) has tended to rise due to the effect, for example, of innovations in the financial sector, the fall in real interest rates and globalization, which has improved access to external financing and to deeper capital markets. However, like many other economic variables, such leveraging behaves cyclically around this trend: a typical indebtedness cycle lasts around six years on average, during which time the leveraging ratio rises by about 24 points of GDP. This is followed by a deleveraging cycle that lasts, on average, around five years and where the debt rate falls by about 19 points of GDP. Around these averages, the duration and intensity of deleveraging episodes have tended to vary, from less to more, depending on whether they have been associated simply with an economic recession, whether this has been combined with a real estate crisis or whether, in addition to all this, there has also been a banking crisis (see the graph below). In the presence of a banking crisis, deleveraging cycles have averaged an adjustment in the debt ratio of around 32 points of GDP and have lasted about seven years.

NOT ALL DELEVERAGING PROCESSES ARE ALIKE



SOURCE: Jódar, Aspachs and Gual (op. cit.).

(1) To a large extent, the content of this box is based on the "la Caixa" Documento de Economía in the upcoming publication entitled «Perspectivas de desapalancamiento» by Aspachs, Jódar and Gual.

A typical deleveraging process also has different phases. Initially, both GDP and the volume of credit tend to contract, limiting the fall in the indebtedness ratio. After one year, and for approximately two years, nominal GDP growth recovers but credit continues to decrease, significantly reducing leveraging. For a further three years, in the last phase of the deleveraging cycle, growth in credit returns to positive figures, albeit lower than the growth in nominal GDP, thereby still allowing a reduction in the percentage ratio of debt to GDP.

Like other advanced economies, Spain is fully immersed in a deleveraging cycle. The credit boom associated with the real estate bubble pushed the credit ratio up sharply to 172% of GDP in 2008, some 55 points of GDP higher than the long-term trend. Since then, this ratio has embarked on a downward slide, for the moment gentle, reaching 167% of GDP in September 2011. An extrapolation of the long-term trend observed would show that, by the middle of the decade, the ratio should be around 145% of GDP, which would mean that the current level of leveraging would have to fall by 22 points of GDP over a timescale of little more than four years.

If this were the case, the size of the overall adjustment between 2008 and 2015 would be similar to the one observed in other economies which, in the past, were forced into deleveraging within a context of real estate and banking crises. This therefore seems to be a reasonable picture of what we might expect to happen. 17% cumulative growth in nominal GDP between the third quarter of 2011 and the end of 2015 (implying an average annual rate of 3.8%, for example resulting from real growth of 1.8% and 2.0% inflation), combined with very modest cumulative growth in credit over the same period, of less than 2%, would result in deleveraging of this intensity. In 2012, the outstanding balance of credit is likely to decrease by around 2.5% while nominal GDP will grow more than 2%, reducing the leveraging ratio to 155% of GDP by the end of year.

Nevertheless, several factors could affect the deleveraging trend over the coming years. To begin with, if the liquidity tensions that are currently upsetting wholesale financing markets persist for long, the supply of credit would be limited, thereby intensifying the deleveraging process. A prompt resolution of Europe's sovereign debt crisis is therefore essential to avoid a vicious circle of accelerated deleveraging. Similarly, Spain's deleveraging process will also depend on other factors related to the financial system, such as how quickly losses from doubtful loans are recognized. In this respect, quickly writing off damaged bank assets could, in theory, help new credit to be provided. However, a strategy of this kind might be costly in fiscal terms, presenting a serious risk within the current context of doubts regarding public debt.

Lastly, anything that helps towards greater GDP growth, fundamentally improved productivity, will make deleveraging more bearable as it will reduce the indebtedness ratio by increasing the denominator. When all is said and done, anything that reduces the role of the numerator in driving the evolution of the credit-to-GDP ratio, i.e. avoiding a sharp fall in demand or in the supply of credit, will alleviate the otherwise inevitable pain of deleveraging.

This box was prepared by Enric Fernández
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EUROPEAN UNION

Important political changes occur in Greece, Italy and Spain.

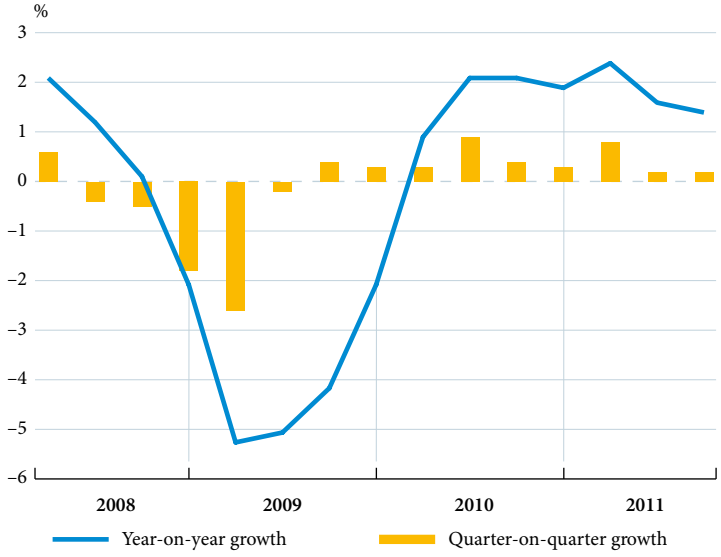
The euro area: changes and uncertainty

The following phrase is attributed to the diplomat Henry Kissinger, who served as Secretary of State for Presidents Nixon and Ford: «Who do I call if I want to call Europe?». At the end of 2011, the answer to this question consists of providing some yellow pages with the telephone number of 27 foreign offices, of the main bodies of the European Union (EU) and other European institutions. And the fact is that all these organizations are putting forward proposals, almost on a daily basis, of how to resolve the crisis in the European Union. In other words, lack of coordination seems to be the order of the day.

However, it would be mistaken to think that this division means the status quo is being maintained. Intense political changes are actually taking place. Among which we should note the changes in government in Greece, Italy and Spain. In Greece, Lucas Papademos, a former member of the European Central Bank (ECB), has replaced Giorgios Papandreu as the prime minister, forming a national, provisional coalition government. This government's aim is to implement the reforms agreed with the European Commission (EC) and to clear the way for new elections. On the other hand, in Italy, after the resignation of Silvio Berlusconi, the president of the country, Giorgio Napolitano, charged Mario Monti, a

SLIGHT SLOWDOWN IN GDP GROWTH

Change in GDP



SOURCE: Eurostat.

former European commissionaire, with forming a new government of technocrats whose mission will be to implement structural reforms and apply measures that ensure the solvency of public finances. In the case of Spain, the outcome of the general elections has also led to a change in government.

Significant changes at a European level are also still being debated, with three being particularly of note. The first, proposed by the president of the European Commission, José Manuel Barroso, consists of the creation of Euro bonds. An EC study argues that Euro bonds would allow a deep public debt market to be created that could compete with that of the United States and would resolve the financing difficulties of member countries of the euro area. The second is the possibility of the European Central Bank becoming more involved in resolving the crisis: intervening more fully in the euro area's public debt markets.

Lastly, Herman van Rompuy, president of the European Council, has proposed as a solution the adoption of greater European integration in terms of member countries giving up more sovereignty, strengthening the rules and mechanisms of fiscal accountability.

At a European level, debate continues on Euro bonds, the role of the ECB and the need for greater fiscal integration.

But although the list of measures is long, they are unlikely to reduce tensions in the debt markets immediately. The credibility of the different governments has been severely damaged, so markets will want to make sure these measures are approved and applied correctly. Given that they are far-reaching structural reforms, they cannot be carried out quickly and, in any case, the effects will not begin to be noticed until some time has passed.

Although these measures are unlikely to calm the tensions in financial markets in the short term.

Given this situation, instead of tensions abating in the debt markets they have now reached countries such as France, Austria and Belgium. One of the great questions is how this might affect the

Tensions in the debt markets reach countries such as France, Austria and Belgium.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011			
			4Q	1Q	2Q	3Q	October
GDP	–4.2	1.7	1.9	2.4	1.6	1.4	–
Retail sales	–2.5	0.8	0.6	0.1	–0.5	–0.5	...
Consumer confidence (1)	–24.8	–14.0	–10.4	–10.6	–10.4	–15.6	–19.9
Industrial production	–14.7	7.5	8.0	6.6	4.1	4.0	...
Economic sentiment indicator (1)	80.7	100.9	105.7	107.4	105.7	98.8	94.8
Unemployment rate (2)	9.5	10.1	10.0	10.0	10.0	10.1	...
Consumer prices	0.3	1.6	2.0	2.5	2.8	2.7	3.0
Trade balance (3)	10.7	4.6	4.6	–10.3	–16.5	–20.0	...
3-month Euribor interest rate	1.2	0.8	1.0	1.1	1.4	1.6	1.6
Nominal effective euro exchange rate (4)	111.7	104.7	104.4	103.7	106.4	104.6	104.0

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.

Macroeconomic data continue to show weakness.

real economy. In this respect, the third quarter figures for the gross domestic product (GDP) are not very heartening. In quarter-on-quarter terms, this grew by 0.2%, resulting in a 1.4% year-on-year rate of change. However, macroeconomic indicators are producing worrying signs, pointing to a slowdown in economic activity for the coming quarters.

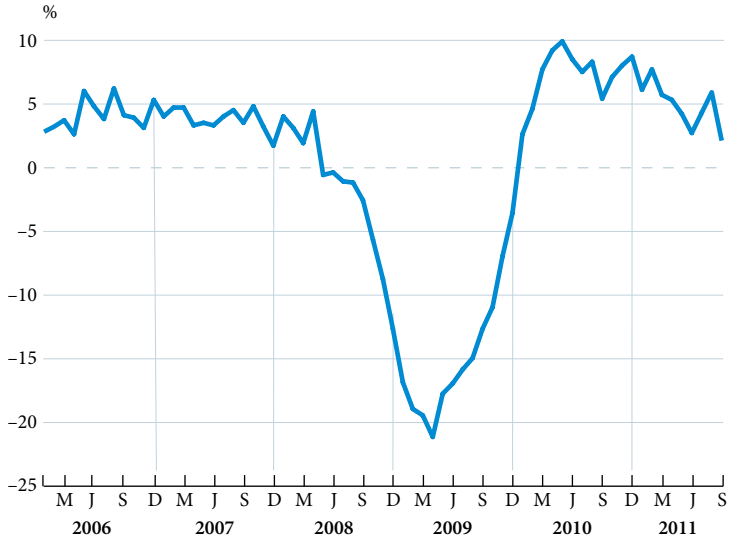
Retail sales for the month of September fell by 1.3% year-on-year, accentuating the weakness of the third quarter this year. This fall continues the downward trend in the consumer confidence index which, in October, reached a new low of 19.9 points. There are three factors weighing heavy on consumer mood. Firstly, political uncertainty. Secondly, job losses, resulting in higher unemployment in the euro area in September, up to 10.2%. Lastly, the reduction in household disposable income, whose earnings are growing at a slower rate than inflation.

Regarding supply, industrial production in September presented year-on-year growth of 2.2%, a considerable fall from the 6% of the previous month. Political uncertainty is also affecting the business sector, already hard hit by its problems in accessing credit and sluggish demand. Moreover, this fall in industrial production is likely to get worse, as the business confidence index for October dropped to 94.8 points from its level of 98.9 in the third quarter, reflecting the aforementioned factors.

All these reasons have led us to considerably reduce our growth forecast for the euro area for 2012. Our previous GDP forecast of 1.3% has been lowered to 0.3%. The risk of the euro area entering a moderate recession is high, having had two consecutive quarters of negative growth, as we were reminded by the president of the European Central Bank himself, Mario Draghi, in his appearance

WEAK DEMAND IS REFLECTED IN THE FALL IN INDUSTRIAL PRODUCTION

Year-on-year change in industrial production



SOURCE: Eurostat.

in November. We have also lowered our consumer price index (CPI) forecast for the coming year by two tenths of a percentage point, from 1.8% to 1.6%.

In summary, the economic trend over the coming quarters will probably be negatively affected by the uncertainty generated this year in the interminable political discussions to find a solution to the euro area's sovereign debt crisis. Now, it would be crucial to be able to reply to Henry Kissinger's question, answering that there are several telephone numbers but a single voice to ensure that economic growth won't suffer any more setbacks in the coming year.

We lower our 2012 growth forecast for the euro area to 0.3%.

The Euro area: remedies, not patches

The future of the euro area continues to be at the mercy of the outcome of a sovereign debt crisis which will soon be two years old, which has already put an end to several governments and has jeopardized the incipient economic recovery. But, no matter how serious it may seem now, and it is, this will all become merely anecdotal if the ultimate victim of the crisis ends up being... the single currency itself.

George Papandreu's failed initiative to hold a referendum on the Greek bailout plan opened up Pandora's box, placing in the mouths of the French and German authorities the threat of expelling Greece from the European Monetary Union. What was previously unthinkable suddenly appeared to be a real possibility. Nonetheless, whichever way you look at it, it's still crazy to think that the euro might be dismembered: the mere threat of the financial tsunami this would cause should ensure that European (and global) authorities will do their utmost to avoid such an outcome. The question is whether they have drawn up and are following the right strategy to overcome the crisis and bolster the viability of the euro area once and for all; or whether they have limited themselves to reacting to the ups and downs of the markets and to merely patching up the situation.

Prescribing a treatment requires, above all, a correct diagnosis of the illness, in this case the worst crisis faced by Europe since the Second World War. An examination should discern between the fundamental causes of the crisis (the root of the uncertainty regarding the single currency's viability) from other urgent but auxiliary factors, although these are also buffeting the financial markets.[1]

The ultimate reason why European public debt has gone astray lies in structural deficiencies in the euro area's design that restrict its capacity, firstly, to prevent and, secondly, to put an end to moments of crisis such as the present. These shortcomings come as no surprise. Since it was conceived, it has been common knowledge that the countries comprising the EMU did not constitute an optimal monetary area and that, in the long term, the institutional structure given to the single currency would not be enough, particularly when the time came to handle its first big crisis. An optimal design would have required one of three things: a highly mobile labour factor, greater price and wage flexibility or, in the absence of both of these, a degree of fiscal integration that would partly make up for the lack of the exchange rate as a means of adjustment when faced with an external shock that affects

(1) See «La crisis del euro: causas últimas y soluciones duraderas». Jordi Gual. Revista de Occidente no. 367, December 2011. Fundación José Ortega y Gasset.

different members of the union to differing degrees. However, none of these three conditions has occurred in the EMU.

The mechanisms aimed at alleviating such lacks in terms of preventing imbalances within the union, essentially established in the Stability and Growth Pact, did not work. Neither did the markets fulfil their disciplinary role until the crisis occurred (Greek 10-year bonds enjoyed a spread of barely 0.1% compared with German bonds in 2005, in spite of huge differences in fundamentals). We're only too aware of the upshot of this concoction of faults: the single currency widened the union's external imbalances to excessive levels and deficit countries accumulated unprecedented levels of debt; the recession arrived and governments resorted to their public coffers to lessen its impact, increasing their economies' external liabilities; a change in government in Greece revealed a bigger hole than had been acknowledged... and all the alarm bells started ringing. The rest can be included largely in what might be called the local causes or urgent problems of the crisis.

These local causes come from the difficulty in interrupting the following vicious circle: the austerity measures required from countries whose sovereign solvency is arousing mistrust due to the critical state of their public accounts hinder both their growth prospects and the solvency of their private sector. This makes fiscal adjustment even more difficult, feeding back into a perverse spiral that, if not halted, can lead to such a high level of mistrust and turbulence that it ends up infecting other, fundamentally solvent economies.

Armed with this diagnosis, the time has come to prescribe a treatment which will naturally differ depending on the objective. If our aim is to make the system more robust in order to avoid any future outbreaks, then we have to attack the problem at source, in other words, correct the union's deficient institutional system, achieving greater common governance which would, in all probability, be a long, complex process. If, at the same time, we need to put a stop to the increasing ills of affected countries (in other words, keep their risk premia within sustainable limits) or, should this be contagious (and it is), avoid an epidemic (i.e. stop the sovereign risk premia of the rest of the member states from rocketing), the right remedy will require a sufficiently powerful shock treatment to break the vicious circle described previously.

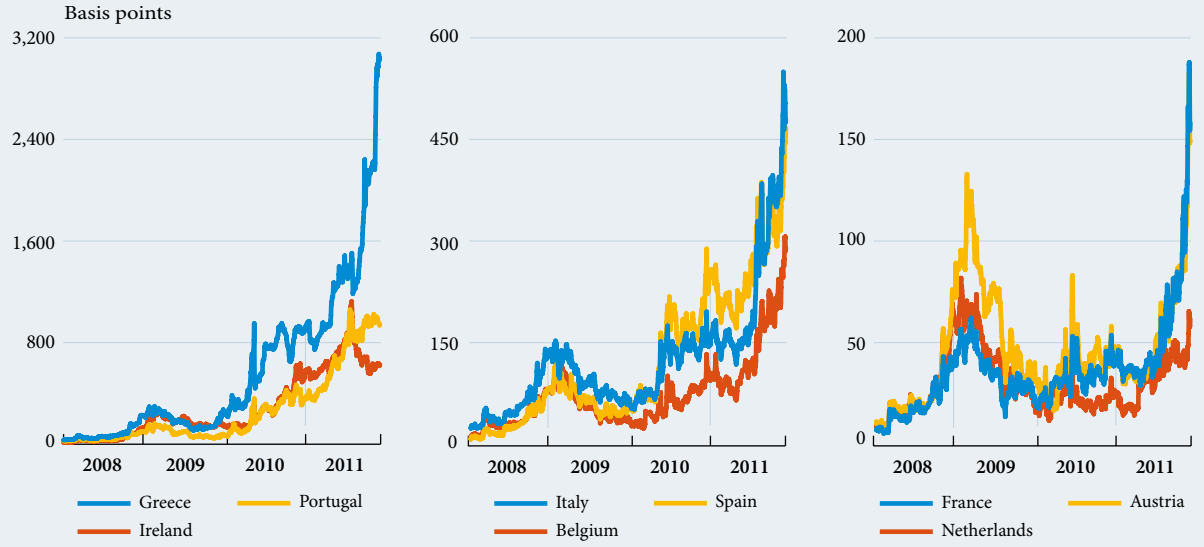
The increasing tension in the financial markets shows that, for the time being, this spiral is still in operation and that the measures adopted to date have not been enough to slow up the contagion (and some of them have even been counterproductive). The soothing effect of the last euro area summit, which agreed a voluntary restructuring of Greek debt with a 50% write-down, the recapitalization of the main European banks, the enlargement and flexibilization of the European Financial Stability Fund and to advance towards more robust pan-European governance, hardly lasted twenty-four hours. Not only did tensions not abate, they even intensified: they swallowed up Italy, showed no mercy to Spain and Belgium and reached the very heart of the euro area when the risk premia of France, Austria and even the Netherlands started to dance to the song of doubt (see the graph below).

In some sectors, deficient institutional management is being blamed for the steady deterioration of the crisis, as much lacking in resources as resolve. Repeated deferment of an inevitable restructuring of Greek debt and the opposition of countries in the north of Europe, and particularly Germany, to shock treatments to soothe the tension (such as creating a common bond, the so-called Eurobond, which would set up a single risk premium, or more aggressive intervention by the ECB in buying up sovereign debt) are exasperating markets that want fast solutions that can sweep away the uncertainty hovering over the euro area's sovereign risk at one fell swoop.

However, albeit risky, the strategic line followed by the EMU leaders in handling the crisis is consistent with a long-term view, prioritizing the union's greater solidity above its short-term stability. In the absence of an

TENSIONS REACH THE HEART OF THE EURO AREA

Spread relative to the German bund



SOURCES: Thomson Reuters Datastream and own calculations.

integrated, flexible labour market, the imbalances threatening the euro can only be corrected via institutional changes, be they on a national scale, with reforms that allow a flexible downward adjustment to prices and costs, i.e. by arranging an internal devaluation given that monetary devaluation is impossible; or be it on a pan-European scale, advancing towards greater fiscal and, possibly, political integration.

Any institutional reform requires resolve and time, and this might help to explain why the European authorities have taken the steps they have taken. Delaying the restructuring of Greek debt would have been to slow up contagion to other economies that are solvent but have liquidity problems, giving them time to do their homework and thereby verify their solvency. Similarly, rejecting any proposal that ends the recently restored disciplinary function of the markets (such as Eurobonds) aims to pressurize countries forced to correct internal imbalances to continue with their adjustments (avoiding the moral risk entailed in returning to a single risk premium).

In short, the scale achieved by the crisis might be the only way to convince governments and citizens that both adjustments and greater fiscal integration are inevitable requirements to guarantee the survival of the single currency; the only way to generate the necessary resolve to advance along these lines. Nonetheless, the markets have not relented and resorting to some kind of shock treatment therefore seems inevitable in order to achieve this long-term goal (probably via the massive intervention of the ECB), to stop emergencies from breaking out or simply to gain time... in case there's anyone left who still needs to be persuaded that the future of Europe, without the euro, looks very bleak indeed.

This box was prepared by Marta Noguer
International Unit, Research Department, "la Caixa"

Notable German economic growth in the third quarter

In the third quarter, Germany's GDP is 0.5% up on the previous quarter but looks to slow down.

The level of economic activity speeded up in the third quarter, in line with expectations. The initial estimate for GDP growth predicted a quarter-on-quarter rise of 0.5% and that of the second quarter was revised upwards by 2 tenths of a percentage point to 0.3%. Year-on-year growth therefore rose to 2.6% in calendar adjusted terms. In spite of supposing a notable increase, there are indications that the slowing up trend predicted is continuing, as GDP rose by 4.7% in the first quarter compared with the same period the previous year, while in the second quarter this rise was just 2.9%.

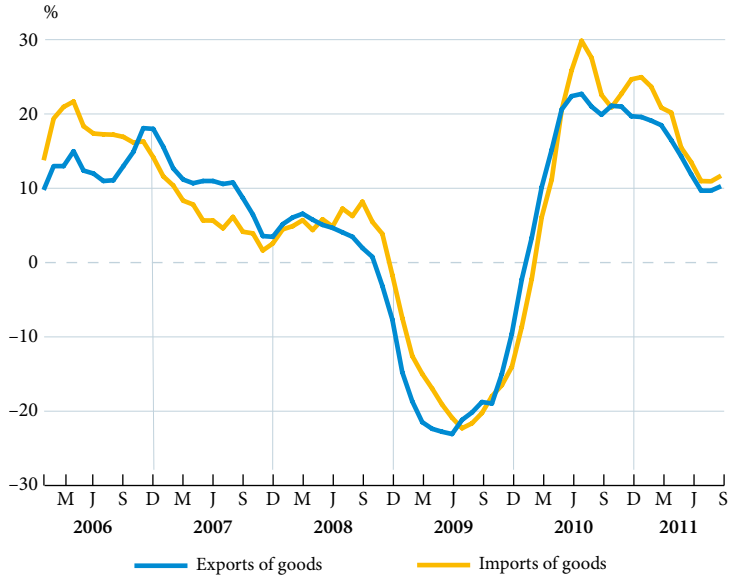
Employment increases by 1.2% compared with the third quarter of 2010 and reaches its highest level since reunification in 1990.

The increase in GDP in the third quarter can be put down especially to domestic demand. Of note within this is household consumption. This was boosted by appreciable wage rises and an increase in the number of employed. In fact, employment rose by 1.2% compared with the third quarter of 2010, up to 41.2 million people, the highest level since reunification in 1990. The number of hours worked also rose by 1.4% year-on-year. Corporate investment in capital equipment also posted a positive contribution to economic growth. However, foreign demand barely made a contribution to the rise in GDP in the third quarter, as the dynamism in exports was largely offset by the increase in imports.

With regard to the fourth quarter, the favourable development of the labour market should continue to support consumption. However, in October the BA-X indicator for employment demand fell slightly, albeit remaining at a high level. For its part, unemployment rose a little in seasonally adjusted terms but the trend is still downward. Vehicle registrations slowed up in the same month, recording a year-on-year increase of 0.6%. At the same time, consumer

THE FOREIGN SECTOR LOSES DRIVE AS THE ENGINE FOR GERMAN GROWTH

Year-on-year change in the three-month moving average



SOURCES: Statistisches Bundesamt Deutschland and own calculations.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011			
			4Q	1Q	2Q	3Q	October
GDP	–5.1	3.6	3.8	4.6	2.9	2.6	–
Retail sales	–3.2	1.5	1.2	0.7	2.4	0.5	...
Industrial production	–15.5	10.0	11.7	12.8	8.1	8.1	...
Industrial activity index (IFO) (*)	90.7	107.8	113.4	114.7	114.2	109.6	106.4
Unemployment rate (**)	7.8	7.0	6.6	6.3	6.0	5.9	...
Consumer prices	0.4	1.1	1.5	2.1	2.3	2.4	2.5
Trade balance (***)	138.7	154.9	154.9	157.9	159.0	159.9	...

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

confidence fell for the fourth consecutive month, affected by higher uncertainty, although it was appreciably above its normal level.

With regard to investment, there will probably be a slowdown judging by the slight decline in the expectations components of business sentiment indices over the last few months, such as the Ifo and the ZEW. Moreover, in the fourth quarter the degree of production capacity utilization relaxed somewhat, although still above the long-term average.

From the point of view of supply, in September industrial production fell by 3.0% compared with the previous month, but rose by 2.0% for the third quarter as a whole, compared with the preceding quarter, and in August-September rose by 8.0% compared to the same two months in 2010. With regard to the near future, industrial orders were down again, by 4.3% month-on-month in September, although in the period August-September they were 3.2% higher than in the same two months the previous year. The diminishing trend in orders and the drop in the PMI indicator to below the neutral level in October for the first time in twenty-five months suggests a moderate increase in production in industry over the coming months. Neither can we expect any great push from construction.

On the other hand, budgetary revenue is exceeding forecasts, so the coalition government believed it had some leeway in this area. Accordingly, on 6 November it announced a plan to reduce the personal income tax burden in 2013 and 2014 to the tune of around 6 billion euros, which would especially benefit low and medium income brackets, in line with electoral promises. However, the opposition has criticized the project as it believes it jeopardizes the budgetary consolidation required by the constitution. On the other hand, by the middle of the same month the government decided that, as from January 2012, it will lower the obligatory Social Security pension contribution by 0.3 percentage points to 19.6%. This reduces labour costs and reinforces the competitiveness of the economy.

The German government announces its plan to reduce the tax burden on income as from 2013.

Regarding the economic outlook, the fourth quarter will probably see very modest growth or even shrinkage due

We are revising our German growth forecast for 2012 to 0.7%.

French GDP grows a little more than expected in the third quarter but is likely to stand still or shrink in the next few quarters.

to the slowdown in the global economy and especially that of the euro area members. This weakness might continue in the early days of 2012. We have therefore revised our 2012 growth forecast downwards, from 1.8% to 0.7%, reflecting the presence of significant risks within a context of financial turbulence.

New package of measures from the French government to meet its public deficit target

French GDP was expected to pick up in the third quarter and, in fact, the initial estimate exceeded expectations, posting a quarter-on-quarter rise of 0.4%. However, the stagnation of the second quarter was revised slightly downwards to –0.1%. Year-on-year growth in GDP therefore held steady at 1.6%.

Unlike in the second quarter, this advance was particularly driven by domestic demand, contributing 0.3 percentage points to the change in GDP. The biggest contribution came from household consumption, picking up again after a 0.8% drop quarter-on-quarter in the second quarter, posting a quarterly increase of 0.3%. On the other hand, investment slowed up to a 0.4% quarter-on-quarter rise. With regard to stock variations, these had zero effect on GDP in the third quarter after having deducted 2 tenths of a percentage point in the second.

New record for the risk premium of French sovereign debt since the euro was launched.

With regard to exports, these provided a positive contribution of one tenth of a percentage point to GDP growth, but 4 tenths of a percentage point less than in the second quarter. Exports of goods and services revived slightly and rose by 0.7% on the previous quarter. For their part, imports picked up and pushed forward with a 0.3% rise after the drop recorded in the previous three months.

In spite of the favourable trend in GDP in the third quarter, available indicators generally point to a slowdown in the coming quarters. In October, vehicle registrations were down 0.4%, seasonally adjusted, compared with the preceding month. Consumer confidence improved a little in October but was appreciably below the long-term average and this figure is unlikely to imply any change in the downward trend of the last few months.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011			
			4Q	1Q	2Q	3Q	October
GDP	–2.6	1.4	1.4	2.2	1.6	1.6	–
Domestic consumption	–0.4	1.7	0.9	3.5	1.1	–1.0	...
Industrial production	–12.6	4.6	4.2	4.7	2.0	3.4	...
Unemployment rate (*)	9.5	9.8	9.7	9.7	9.7	9.9	...
Consumer prices	0.1	1.5	1.7	1.8	2.1	2.1	2.3
Trade balance (**)	–44.8	–51.3	–51.3	–59.1	–64.0	–67.7	...

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

With regard to investment, this is likely to continue moderating as the degree of production capacity utilization remained below its historical average and uncertainty increased. In fact, in the manufacturing sector, the latest survey of entrepreneurs shows that they expect an increase in investment in capital goods of 4% year-on-year in terms of value in 2012, after a forecast increase of 11% in 2011. The main reasons they gave are the renewal of equipment, improvements in safety, the environment and working conditions and energy savings; and, to a lesser extent, the enlargement of production capacity and automation.

Looking at supply, the panorama is similar. Industrial production rose by 3.4% year-on-year in the third quarter, although it fell by 1.7% month-on-month in September. It should be noted that its level is slightly below the one reached before the great recession of 2008-2009. On the other hand, the order portfolio in the period June-August was 10.7% above its level in the same months in 2010, but a loss of dynamism can be observed which will affect the level of activity in the short term. With regard to services, confidence fell a little in October, widening its differential compared with the historic average. For construction, building permits rose year-on-year by 13.4% in September but the climate showed signs of deterioration in October.

In this environment, after having revised downwards its 2012 economic growth forecast from 1.75% to 1%, the French government presented a new adjustment plan on 7 November to be able to meet its budget targets, namely to reduce the public deficit from 5.7% of GDP in 2011 to 4.5% in 2012, 3.0% in 2013 and balanced in 2016. The new package entails supplementary savings of 17.4 billion euros up to 2016, of which 7 billion correspond to 2012. This plan is in addition to the one from last August. Among other measures, tax deductions are reduced, the rise in the legal retirement age to 62 has been brought forward by one year, to 2017, corporate tax has been increased by 5% for large firms, an intermediate rate of 7% has been created for value added tax for restaurants and the reconditioning of buildings, which had applied a rate of 5.5% up to 2011, the scale for personal income tax will not be updated by inflation in 2012 and 2013 and withholdings on dividends and interest will be increased from 19% to 24%.

These decisions were taken in spite of the impending presidential elections in spring 2012. The desire to defend France's top debt rating seems to have also played a part. However, financial markets did not reduce their pressure. On 16 November the spread with German ten-year bonds reached 189 basis points, a new record since the euro was launched. For their part, the exposure of France's large banks to peripheral public debt, especially Italian, has hit the stock market hard throughout 2011. However, in the last twelve months up to September, bank credit to French firms rose by 5.3%. Nevertheless, the quarterly increase in SMEs stood still, for the first time in two years.

The 25.0% year-on-year drop in new firms in October confirms that the economic climate has got worse, and the index was below its normal level that same month. Given this situation, economic activity is likely to stagnate or even decline in the coming quarters. We have therefore cut our GDP growth forecast for 2012 as a whole to 0.5%.

France's industrial order portfolio loses steam.

Cut in our 2012 GDP growth forecast for France to 0.5%.

The Italian economy, in a critical state

Infected by the Greek crisis, the risk premium for Italy's sovereign debt reaches unsustainable levels and forces political changes.

The combination of contagion from the Greek crisis, growth deficiencies due to structural competitiveness problems and high levels of debt has been an explosive one for the Italian economy, placing it firmly in the eye of the hurricane of the euro crisis. At the end of October, pressure from the markets and international authorities led the Italian government to ask for supervision of the reforms promised to the European Union, carried out by the EU bodies themselves and the International Monetary Fund. But events took them by surprise.

The new government of the euro area's third economy, presided over by Mario Monti, is facing the challenge of simultaneously adjusting its budgets and encouraging economic growth.

After starting the approval procedure for the reforms requested by the European Union, the Italian prime minister, Silvio Berlusconi, was forced to resign due to political pressure, both internal and external, given his loss of credibility. The president of the central government, Giorgio Napolitano, appointed the former EU commissioner for competition, Mario Monti, as the new prime minister. He designated an essentially technocrat government to get the country out of the financial emergency in which it finds itself, securing parliamentary support for his programme.

The new government announced that it would comprehensively apply the reforms approved in mid-November, which included reserve duty for surplus civil servants, receiving 80% of their salary up to a maximum of two years, the liberalization of professional services as well as those offered by local administrations, the disposal of public properties to reduce central government debt and an increase in the retirement age to 67 as from 2026. It also stated that its governing actions would be based on the three pillars of budgetary strictness, economic growth and equity.

Mario Monti also announced new measures to be specified over the coming weeks. He said that he would consider the return of a tax on housing, would amend employment legislation, boost the employment of women and young people, simplify public administration and combat tax evasion and the black economy.

A new adjustment package is required to offset the recently increased financing costs and reverse the rise in public debt.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011			
			4Q	1Q	2Q	3Q	October
GDP	–5.2	1.2	1.5	1.0	0.8	...	–
Retail sales	–1.7	0.0	0.1	–0.3	–0.2	...	...
Industrial production	–18.7	6.5	5.3	2.2	1.8	0.2	...
Unemployment rate (*)	7.8	8.4	8.3	8.2	8.1	8.2	...
Consumer prices	0.8	1.5	1.7	2.3	2.6	2.8	3.4
Trade balance (**)	–5.9	–29.3	–29.3	–34.9	–36.0	–33.9	...

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

The key lies in securing the confidence of the financial markets to reduce the risk premium and avoid the danger of embarking on a negative spiral. To this end, economic growth also needs to be encouraged. The structural measures are focused on this aim. However, their effect is not short-term and one risk for the new government, which in principle should govern until the end of the legislature in 2013, is the proverbial political instability of Italy, which might raise its head once the corrective decisions have been specified, as we must not forget that the government depends on parliamentary support.

And what does this all mean for the economic situation as a whole? The Italian statistics institute did not publish the GDP flash estimate for the third quarter in November, as would have been usual, since the historical series were being revised, so we will have to wait until 21 December for the definitive figures. However, available indicators point to a slight shrinkage due to weak domestic demand, which would mean the first decline in a year and a half. Leading indicators for the fourth quarter also point to a drop in the level of activity.

With regard to the outlook for 2012, the constricting effects of the adjustment plan will probably prevail over the potential increase in GDP. For its part, the push provided by the foreign sector will be limited by the little growth predicted for members of the euro area next year. Italy is therefore likely to undergo a slight recession in 2012 as a whole.

We expect Italian GDP to shrink slightly in the second half of 2011, with this continuing in 2012.

The United Kingdom: growth forecasts are revised downwards

The slowdown in the UK economy is gradually being confirmed with growth in gross domestic product (GDP) for the third quarter remaining at 0.5%, one tenth of a percentage point below that of the second quarter. Although a breakdown for this figure is still not available, some details are known. The GDP flash estimate was supported

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011			
			4Q	1Q	2Q	3Q	October
GDP	–4.9	1.4	1.3	1.6	0.6	0.5	–
Retail sales	1.0	0.4	–0.9	1.5	0.5	–0.3	0.9
Industrial production	–10.1	2.2	3.0	1.5	–0.9	–0.9	...
Unemployment rate (1)	4.7	4.7	4.5	4.5	4.7	4.9	5.0
Consumer prices	2.1	3.3	3.4	4.2	4.4	4.7	5.0
Trade balance (2)	–82.4	–96.2	–96.2	–98.1	–98.5	–100.5	...
3-month Libor interest rate (3)	1.2	0.7	0.7	0.8	0.8	0.9	1.0
Nominal effective pound exchange rate (4)	73.9	80.4	79.3	78.4	78.6	77.1	79.4

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

The tendency for economic activity to slow up is continuing.

by industry and services, which grew by 0.5% and 0.7% respectively.

These figures are quite respectable and warrant certain optimism after quite a poor second quarter, although it's true that this was due to an additional bank holiday because of the royal wedding and also to March's earthquake in Japan, which affected the logistics chains of industrial production. When we look at its trend over the last few quarters, we can see a moderate slowdown. On the other hand, the construction industry decreased by 0.6% and has yet to show any convincing signs of stabilization.

Our GDP growth forecast for next year is cut from 1.7% to 0.7%.

The latest macroeconomic indicators suggest the continuation of the slowdown of the economy. For example, industrial production for September fell by 0.7% year-on-year and has posted negative figures for the last seven months in a row. In addition, consumer confidence has fallen to a level lower than in February 2009. This drop in confidence has been affected by the bad figures for the labour market, reflected in the 5% rise in the unemployment rate in October.

Emerging Europe, having so far escaped the repercussions of the debt crisis, is starting to be affected.

Given this panorama, the Bank of England acknowledged that the economic outlook had worsened and reduced its growth forecast for 2012 from 2.0% to approximately 1.0%, and expects inflation to fall quickly, especially in the first part of next year. Given this situation, next year the reserve bank might decide to extend its non-standard monetary policy of quantitative easing.

We have also included the latest economic variables in our forecasts and have reduced GDP growth for the coming year from 1.7% to 0.7%, and we also think that inflation will fall quickly from its current level, reaching an average of 2.7% for the whole of the year.

Country-risk indicators reflect greater uncertainty.

Our GDP growth estimate is three tenths of a percentage point lower than the official forecast by the Bank of England because we believe that the country's swift consolidation of its public accounts, the deleveraging of households that are severely in debt, a dysfunctional banking system and a drop in world growth will be obstacles that are difficult to overcome and will prevent higher growth for the economy of the United Kingdom.

It's important to note that the quarterly growth rates presented by the United Kingdom in 2012 will probably be erratic due to several unique factors, such as the holding of the Olympic Games in London in the third quarter and some fiscal adjustment measures that will be concentrated in certain quarters. In other words, it's difficult to define a clear picture for GDP growth in 2012.

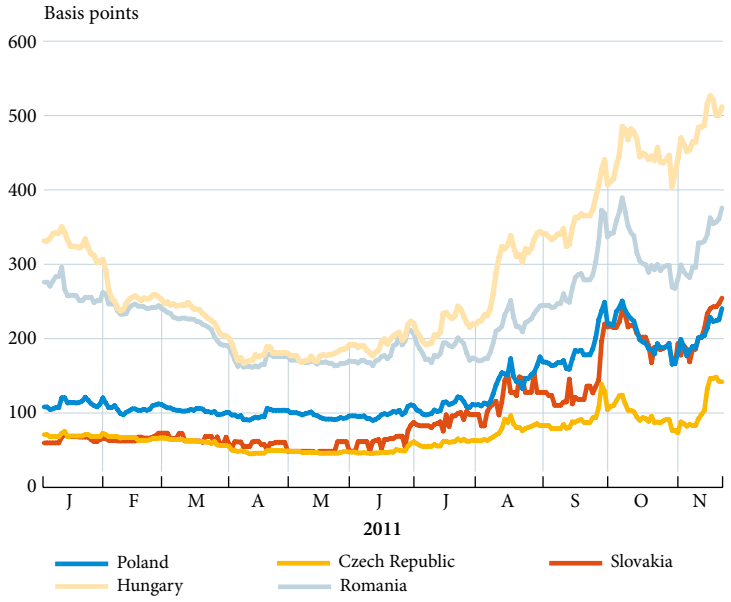
In addition to the deterioration in economic prospects, the level of uncertainty regarding the forecast has also increased significantly. Resolving the sovereign debt crisis in the euro area is a key element for the UK economy and, therefore, the outcome will have a notable impact on its economic activity.

Emerging Europe: global crisis, local risks

The worsening of the sovereign debt crisis in the euro area over the last few weeks has ended up affecting emerging Europe, a region that, to date, had escaped the worst repercussions of this episode. Country-risk indicators, the clearest sign of loss of investor confidence in an economy, have simultaneously shifted upwards since mid-October in Poland, Hungary, the Czech Republic, Slovakia and Romania, the five countries we usually track in this report.

THE EUROPEAN DEBT CRISIS AFFECTS THE COUNTRY-RISK OF EMERGING EUROPE

Credit Default Swap prices for sovereign debt at 3 years



SOURCE: Thomson Reuters Datastream.

The increase in the cost of hedging sovereign debt against hypothetical default, reflected in the levels of Credit Default Swaps for three-year bonds, has differed depending on the starting level (see the graph above). Hungary and Romania have suffered an increase of more than 100 basis points in just over one month. In the remaining three cases (Poland, the Czech Republic and Slovakia), the rise has been in the order of 70-80 basis points.

Greater investor sensitivity to possible financial risks has also been passed on to other areas. What has caught most attention in this episode is the exchange rate. Although the four currencies of the aforementioned countries have suffered from downward pressures (Slovakia obviously shares the single currency), at the worst moments of last month the Czech koruna and the Hungarian florin were hit the hardest. At the episode's peak, between 10 and 14 November, the Hungarian currency had fallen cumulatively by about 8% against the euro, while the Czech currency had dropped by 4% (in both cases compared with their value one month earlier). In the case of the Polish zloty, during this period it depreciated by around 3% and the Romanian leu by 1%.

The currencies of Hungary and the Czech Republic are under pressure.

A third source of tension that might help us to understand what lies behind financial investors' diagnosis is the trend in the stock markets. During the long month between mid-October to the penultimate week of November, the stock market of the Czech Republic fell by more than 8%, while Slovakia's dropped by 5%.

With these figures we are in a position to understand what has happened over the last few weeks. The widespread increase in risk aversion has highlighted the fact that two countries are of particular concern at the moment.

Investors still have doubts regarding the fiscal path taken by Hungary.

In the case of the Czech Republic, its high dependence on international banks is of some concern.

The first, which was already under close watch by investors, is Hungary. In this case, the country's main weakness lies in its delicate fiscal position. In spite of slightly improving its fiscal balance in 2011, the country still has the highest level of public debt in the region (in the order of 80% in 2010). Moreover, the adjustment this year has been carried out via rather unorthodox measures that wear away both the credibility of the country's economic policy and its growth potential.

The second country affected by the episode of financial stress has been the Czech Republic (Slovakia would also be included in this category but, as it belongs to the euro, it has been slightly less affected by financial ups and downs). In the Czech Republic, the main source of risk does not lie with its public finances at all (which are notably rigorous) but with the possible repercussions for its economy of the international banking situation getting worse. It should be noted that a significant part of the Czech banking system is made up of subsidiaries of foreign banks (specifically, 80% of bank assets are in the hands of these subsidiaries, mostly of banks whose parent company is located in the euro area).

This trait, which is neutral per se, becomes a weakness when the parent banks suffer liquidity tensions and need to improve their solvency ratio. If, hypothetically, the foreign banks reduced the funding for their subsidiaries, the macroeconomic outcome could be a credit squeeze at a delicate time in the economic cycle. In this respect, it should be noted that the Czech Republic has posted disappointing national accounts figures for the third quarter, with zero growth in GDP for this period.

Beyond the present situation, the immediate prospects in terms of risks are not limited to the effects caused by the European debt crisis. Although activity figures for the third quarter show economies that are still growing at an acceptable rate (with the exception of the Czech Republic), October's business indicators, such as the one for economic sentiment, point to the economic pulse being weak in the last part of 2011. This explains why Romania's central bank unexpectedly lowered its reference interest rate on 2 November, from 6.25% al 6.0%. This path might soon be followed by those countries that have borne less financial pressure and can relax a little the support provided for their currencies through high interest rates, an obvious candidate being Poland.

FINANCIAL MARKETS

Monetary and capital markets

A road full of potholes

In this final stretch of the year, the financial scenario has worsened due to the uncertain trend in some of the essential factors for global markets. Firstly, the activity figures for the world's main economies are suffering a greater decline than expected. Secondly, the euro area's sovereign debt crisis is going through a series of new and unexpected bad patches that are hindering the decision-making process required to put a stop to the crisis. This situation is also feeding fears of the crisis spreading to other economies. And lastly, the negotiations to reduce the fiscal deficit in the United States do not seem to be achieving the desired outcome, suggesting a less than brilliant future for the growth of its economy. On the whole, developments in these factors are increasing, if indeed this is possible, the risk aversion of investors and the volatility of the main risk asset indices.

The central banks are starting to be less restrictive

Over the last few months we have seen the rate of growth in the world economy slow up. The reasons for this still ongoing process, as well as its implications, differ depending on the geographical area, although the following can be included among the common elements in most cases: a drop in aggregate demand, rising commodity prices and greater financing difficulties. According to the opinion of the consensus of economists, the risk of a double dip recession for the world's economy has lessened thanks to the crucial action taken by central banks. As is logical, the decisions taken by monetary authorities vary depending on the country and each institution's chosen goal for its monetary policy, but we can state with all certainty that most central banks have started to shift their policies towards a more expansionary focus in order to avoid any risk of a double dip recession.

The global financial scenario is facing the end of the year with several risks hovering over it.

In the United States, the Federal Reserve (Fed), after its Monetary Policy Committee meeting in November, presented the conclusions of its analysis of the state of the economy. In the words of its chairman, Ben Bernanke, and based on the information obtained from various indicators for activity, there was some improvement in the economy's growth in the third quarter. This change in trend, observed in household consumption and capital goods investment, has largely been boosted by the reduction of some obstacles of a temporary nature that, since the beginning of the year, were stopping growth from developing normally. However, and in spite of this advance, the chairman acknowledged that the US rate of growth was still showing clear signs of weakness. It's because of this, and because significant risks of a downturn still exist for the economy, that the Fed has modified its growth prospects for 2012, reducing the

Central banks are attempting to avoid recession in their economies.

The US economy is growing very slowly.

The Fed keeps to an expansionary monetary strategy in order to boost the economy.

estimates made in June (3.3%-3.7%) to a more adjusted range of 2.5%-2.9%. Similarly, the expectations for the labour market, already not very optimistic in the short term, have also been rectified along the lines of a more modest growth scenario. It predicts that the unemployment rate might improve slightly from its current level of 9%, reaching between 8.5% and 8.7% by the end of 2012.

The ECB cuts the official interest rate to 1.25%...

Given this situation, the Federal Reserve, continuing with its dual proposal to encourage sustained growth of the economy and keep prices stable, has repeated its commitment to keep interest rates within the minimum range of 0%-0.25% and has confirmed that its programme of exceptional monetary policy measures will continue. Among these measures, of note is the programme to lengthen the average maturity of the debt it holds (Operation Twist) and the reinvestment of the principal and of the interest on public debt and mortgage-backed securities, also in its portfolio. In the last few months, financial forums have speculated whether the Fed might carry out another bond purchase programme within the previous rounds of quantitative easing. In this respect, the institution, far from refuting any kind of rumour, specified that it is constantly on the alert and ready to modify its assets portfolio whenever necessary.

...although confirming that inflation will remain higher than it wishes.

In the euro area, the European Central Bank cut the official interest rate by 25 basis points to 1.25% at its November meeting. According to the institution's new president, the Italian Mario Draghi, this turnabout in monetary policy was decided unanimously, this being the first cut in interest rates since May 2009.

The top monetary authority maintains liquidity facilities for banks.

He also said that this decision was taken due to continued pressure in financial markets that is affecting the stability of the euro area, as well as the persistence of the current risks related to the delicate financial situation of the peripheral countries and the slowdown in global activity. He also suggested that this situation might lead to a slight recession in the region's economy for the last part of the year. However, the decision to cut the official rates has been taken within a scenario where the euro area's harmonized inflation rate is at 3%, the highest level for the last three years. Due to these changes in the region's economic context, the ECB stated that it might revise downwards its growth forecast for the euro area and that it would provide more information on this point at the next meeting on 8 December.

Regarding the action taken by the ECB in the sovereign debt crisis of the region's periphery, the institution has always appeared willing to act in order to resolve the tensions in financial markets, restore agent confidence and especially try to lessen the disastrous effects on nations of the lack of financing in international capital markets. In this area, the ECB has started to implement quite significant unconventional measures over the last few quarters. Specifically, these are the wide range of unlimited liquidity auctions at different maturities (1, 3 and 6 months) at a fixed interest rate, the long-term refinancing operations (LTRO) at 12 and 13 months, with the same characteristics as the liquidity facilities, and finally the purchase of covered bonds. By using these instruments, the monetary authority hopes to help banks in the euro area to access funding, as they are encountering greater difficulties in the capital markets as a consequence of the credit crisis.

The ECB's participation is also crucial in aspects related to negotiations between the euro area members affected by the crisis, to supervision (together with the European Commission and the IMF), and to regulation in creating the European Financial Stability Fund (EFSF). But where it's truly playing a decisive role is in buying up the public bonds of countries in difficulty. By making purchases in secondary bond markets, the ECB is trying to lessen the effects of investor nervousness, which are unjustifiably pushing up the yields for bonds from these countries, specifically Italian and Spanish bonds. Moreover, in the last few weeks there has been open debate among euro area countries as to whether the ECB should be the lender of last resort for the member states or whether there should be other ways of resolving credit tensions.

The ECB buys up the public debt of Spain and Italy with the aim of reducing tension in the bond markets.

For their part, the framework of the emerging countries' monetary policies is currently shifting towards less restrictive strategies. Although, in the first part of the year, these countries' central banks were battling to avoid the effects of high levels of growth, in the second half of the year a slowdown in activity indicators has highlighted the fact that their restrictive

Emerging countries' monetary policies are starting to be less restrictive.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2010									
November	1.00	1.03	1.53	0.25	0.30	0.19	0.50	0.74	0.20
December	1.00	1.01	1.51	0.25	0.30	0.19	0.50	0.76	0.20
2011									
January	1.00	1.07	1.64	0.25	0.30	0.19	0.50	0.78	0.26
February	1.00	1.09	1.77	0.25	0.31	0.19	0.50	0.80	0.10
March	1.00	1.24	2.00	0.25	0.30	0.20	0.50	0.82	0.28
April	1.25	1.35	2.12	0.25	0.27	0.20	0.50	0.82	0.24
May	1.25	1.43	2.14	0.25	0.25	0.20	0.50	0.83	0.26
June	1.25	1.55	2.16	0.25	0.25	0.20	0.50	0.83	0.28
July	1.50	1.61	2.18	0.25	0.26	0.20	0.50	0.83	0.24
August	1.50	1.54	2.09	0.25	0.33	0.19	0.50	0.89	0.10
September	1.50	1.55	2.08	0.25	0.37	0.19	0.50	0.95	0.15
October	1.50	1.59	2.12	0.25	0.43	0.20	0.50	0.99	0.57
November (1)	1.25	1.48	2.04	0.25	0.52	0.20	0.50	1.03	1.00

NOTES: (1) November 28.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 5-03-09 (1.50%), 2-04-09 (1.25%), 7-05-09 (1.00%), 7-04-11 (1.25%), 7-07-11 (1.50%), 3-11-11 (1.25%).

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

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

(5) Interbank rate.

SOURCES: National central banks, Bloomberg and own calculations.

Interbank markets reflect the tensions generated by the European crisis.

interest rates were out of synch with the moderation in the rates of economic growth. Since then, many central banks have modified their lines of action to avoid a sharp decrease in growth expectations. The main instrument used to make the shift towards a more expansionary policy has been cuts in official interest rates. The most representative example of this situation is occurring in Brazil, where the central bank has adopted a policy of gradual interest rate cuts (currently at 11.0%) to boost economic growth, relegating the inflation target to second place, currently at 7%. It has also started to withdraw some quantitative measures of a restrictive nature.

Yields on high quality debt remain low.

Another environment where interest rates are gaining in importance is in the interbank markets. It is precisely through interest rates where agents' expectations are expressed regarding the possible decisions of central banks. But, moreover, in situations of financial adversity such as the present, interest rates reflect the degree of tension and mistrust between some credit institutions and others when competing in the capital markets. In the case of the United States, the reference for the interbank market is the Libor interest rate (in dollars). As has been happening since the summer, the overall trend in the Libor interest rates throughout November has remained upward. Far from being a reflection of tougher monetary policies by the Federal Reserve (which has confirmed that its lax monetary policy will continue), the rise in interest rate seems to be more related to the increase in uncertainty caused by developments in Europe's sovereign debt crisis. On the other hand, in the euro area the Euribor interest rate references have fallen slightly due to the lowering of the official interest rate for the region and the action taken by the ECB to buy debt from Spain and Italy.

The Fed's actions in secondary markets encourage a drop in long-term yields.

US debt heads investor preferences

The internal return rates (IRR or yield) for the public debt of the two main developed economies, the United States and Germany, have once again fallen slightly throughout November, placing them back at historically low levels. The main reason for this movement is investors valuing this kind of asset as a safe haven given the high volatility generated by the sovereign crisis in the euro area. Specifically, in the United States, this could be seen in the yield for 10-year bonds, which broke through the barrier of 2% while the IRR of 2-year bonds remained stable. In addition to the effect of abundant capital flows in search of quality, the rise in price (and fall in yield) of long-term debt also occurred due to two reasons. The first, because of the Fed's intervention in the debt markets via the Operation Twist, leading to a drop in long-term interest rates and more flexible financing conditions for the private sector. And the second, because of the pessimism regarding negotiations for an effective plan to reduce the US deficit in terms of GDP over the coming decade. The absence of agreement would lead to an automatic programme of fiscal cuts being activated that would hinder future growth prospects for the economy.

In the case of the euro area, the yield for German public debt also fell both for 2-year and 10-year maturities (0.37% and 2%, respectively) in November. It should be noted that, since the start of

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								
November	2.67	3.15	5.50	4.67	2.80	1.19	3.23	1.56
December	2.96	3.36	5.45	4.82	3.29	1.13	3.40	1.72
2011								
January	3.16	3.53	5.37	4.72	3.37	1.22	3.66	1.87
February	3.17	3.55	5.39	4.84	3.43	1.26	3.60	1.90
March	3.35	3.71	5.30	4.82	3.47	1.26	3.69	1.96
April	3.31	3.64	5.47	4.74	3.41	1.24	3.58	2.06
May	3.02	3.39	5.36	4.78	3.06	1.17	3.29	1.82
June	3.03	3.41	5.45	4.88	3.16	1.14	3.38	1.73
July	2.54	3.23	6.08	5.87	2.80	1.08	2.86	1.36
August	2.15	2.83	5.04	5.13	2.18	1.02	2.50	1.08
September	1.89	2.60	5.14	5.54	1.92	1.03	2.43	0.94
October	2.03	3.10	5.54	6.09	2.11	1.05	2.44	1.00
November (*)	2.26	3.68	6.69	7.25	2.00	1.06	2.29	0.89

NOTE: (*) November 28.
SOURCE: Bloomberg.

the sovereign crisis, the value of these bonds has been related to the different episodes in the crisis. But fear of contagion to other countries (such as Italy, Spain, France and Belgium) and the rapid political changes occurring in Italy and Greece after the agreements adopted in October at the Euro Summit have, if anything, made German bonds even more of a safe haven compared with the sovereign bonds of the rest of the member states. However, towards the end of November this circumstance altered after the bad results of the auction for German 10-year bonds.

With regard to the European countries in difficulty, the month of November has been marked by a strong upswing in the risk premia of most of the economies, particularly for Italy and Spain. Although to a lesser extent, the spread of French debt compared with the German bund also widened due to the doubts of some rating agencies regarding France's capacity to meet its deficit targets and the high exposure of the country's banks to debt from other countries in the firing line. Within this context of growing instability, the ECB's purchases of Italian and Spanish debt barely calmed the nerves of investors, witnesses of how market pressure was forcing political changes in Greece and Italy. This situation has now been reflected in the recently issued Italian and Spanish bonds, whose yields rocketed due to greater risk aversion. It is expected that, in addition to the advances being made in the area of governance of the European Union and ECB, the new political leaders of the periphery will quickly implement effective austerity packages to ensure a certain level of financial stability and the achievement of the targets imposed by the Euro group. As these premises come

The price of German bonds reflects the advances made towards solving the European crisis.

Investors' fears push up the debt yields of countries in difficulty.

The euro's exchange rate is highly volatile due to the sovereign crisis.

about and a greater degree of stabilization is achieved within the euro area, tension in the debt markets should ease and we should see an improvement in investor confidence.

Volatility dominates the currency markets

Within the current economic and financial context, the currency markets are going through a phase of high volatility. Most analysts agree that this situation might continue over the coming months due to the uncertainty in the financial markets and the slowdown in the world's growth prospects. Of note among those factors causing the most movement in these markets are the actions taken by central banks on the exchange rate for their currencies (for protectionist purposes), the change in expectations regarding economic growth and incidents related to the European crisis. This is precisely one of the variables with the most significance for the dollar-euro exchange rate. The unsteady political scenario in southern Europe, fear of the crisis spreading to other countries such as Spain and France and the lack of resolve and speed in implementing austerity measures are sufficient reason for the euro to have lost close to 3% in November against the US currency.

EXCHANGE RATES OF MAIN CURRENCIES

November 28, 2011

	Exchange rate	% change (*)		
		Monthly	Over December 2010	Annual
Against US dollar				
Japanese yen	77.7	2.4	–4.4	–8.5
Pound sterling	0.642	–3.5	–0.2	0.0
Swiss franc	0.918	6.0	–1.8	–8.9
Canadian dollar	1.033	4.0	3.4	1.5
Mexican peso	13.995	7.1	11.8	10.7
Against euro				
US dollar	1.338	5.4	0.0	–1.9
Japanese yen	103.9	–3.2	–4.4	–6.4
Swiss franc	1.229	0.6	–1.8	–6.8
Pound sterling	0.859	–2.1	0.2	1.9
Swedish krona	9.253	2.4	2.9	0.9
Danish krone	7.438	–0.1	–0.2	–0.2
Polish zloty	4.518	4.1	12.3	9.5
Czech crown	25.76	4.2	2.9	3.2
Hungarian forint	308.9	1.8	9.8	8.2

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

Corporate bonds suffer from the euro area crisis

To date, corporate bond markets have performed relatively well within the context of the recent financial crisis. Corporate income indices have shown notable resistance to the slowdown in global economic activity and the sovereign debt crisis of the euro area. Thanks to this situation, part of these assets (investment grade bonds) has been chosen by investors as a stable safe haven, together with gold and US long-term debt. But over the last few weeks, political upset in the periphery of the euro area and its effect on the sovereign crisis have unbalanced the risk premia of corporate bonds, mainly in Europe. In the investment grade segment, this situation has merely aggravated the credit risk spreads between the US and European market, making investment in the former more appealing and safer in the eyes of agents. The main signs of the deterioration in risk premia can be found in the bonds of the euro area's financial institutions, under a lot of pressure due to the worsening of the peripheral sovereign debt crisis. In an attempt to ease tension in the market and help banks to access funding, the ECB has restarted its programme to purchase covered bonds. With regard to the high risk and high yield sector, and after the indices had improved in October, uncertainty regarding the European crisis and its implications for global economic growth prospects have made this kind of asset less attractive.

The euro area's financial upsets are starting to affect corporate credit markets.

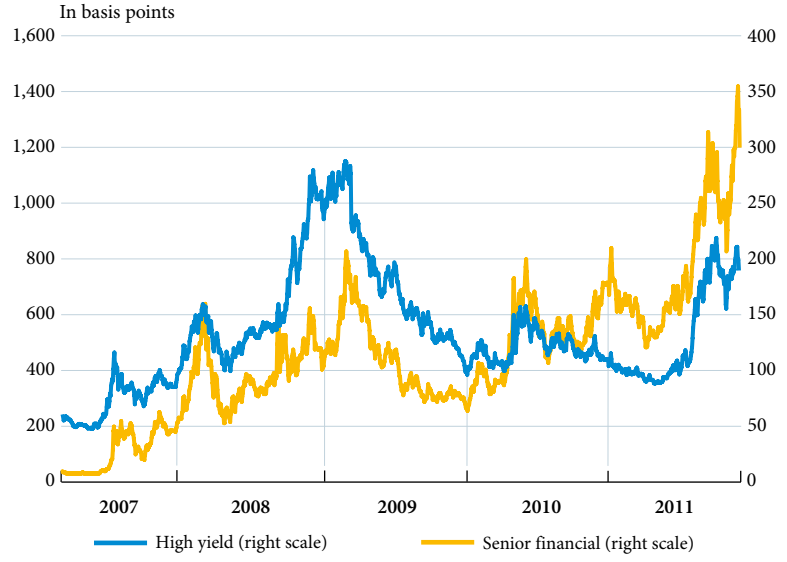
In the current scenario, investors still see investment grade bonds as an attractive safe option.

In spite of this, international investors continue to prefer the public debt and corporate bonds of emerging countries. The continual arrival of investor flows to these markets is pushing down yields, both in public and private bonds, to historically low levels. The gradual

High yield bonds lose ground due to the slowdown in the world's growth prospects.

RISK PREMIA REFLECT THE UNCERTAINTY REGARDING THE FINANCIAL SECTOR

5-year Markit Itraxx indices



SOURCE: Bloomberg.

Current financial risks are penalizing stock market returns.

increase in the amount of capital to these markets is due to the relaxation of the monetary policies in these countries and the improvement in the credit rating of local companies.

Stock markets have yet to perk up

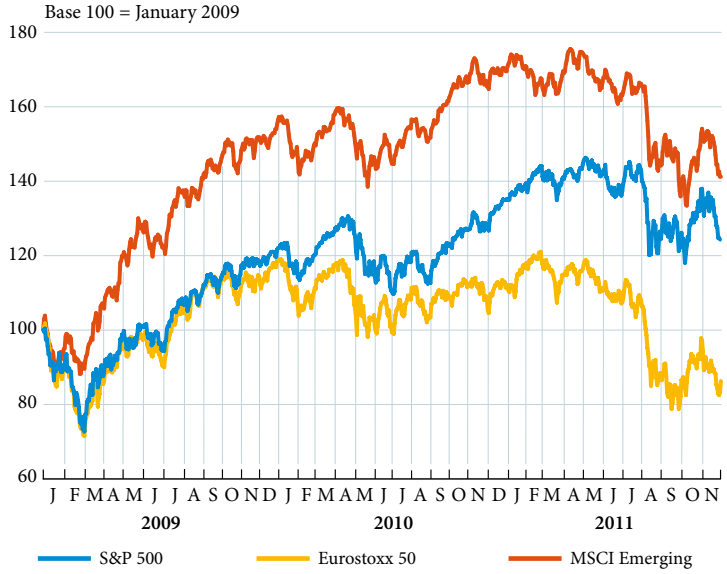
For yet another month, the main international stock markets have been characterised by their weak performance and continually high volatility. The main fears damping the enthusiasm of investors have been the pessimism regarding politicians' ability to negotiate efficient fiscal plans in the United States and, in the euro area, the growing fear that the European sovereign debt crisis will spread to the rest of the world, as well as doubts regarding the rate of growth of the global economy. In fact this has been one of the aspects that have pushed down stock markets the most during November, given the disappointing industrial figures from China and the moderation in growth figures from the United States. Regarding the capacity of political leaders to take resolute decisions in the area of fiscal policy, financial markets and specifically equity markets, for some time now investor decisions have been accompanied by a feeling of exhaustion regarding the slowness of these decisions and their implementation.

Rising risk premia in the euro area are pushing down stock prices in the banking sector.

But the factor that is perhaps causing the greatest degree of risk aversion among investors is the delicate situation of the sovereign debt crisis in the euro area. The perception that the measures being adopted are not very effective and too slow, as well as the widening spread between the countries affected and Germany and, above all, the consequent

DOWNWARD PRESSURE CONTINUES IN THE MAIN INTERNATIONAL STOCK MARKETS

Stock market indices



SOURCE: Bloomberg.

INDICES OF MAIN WORLD STOCK EXCHANGES

November 28, 2011

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*11,231.8*	*–8.2*	*–3.0*	*1.3*
Standard & Poor's	*1,158.7*	*–9.8*	*–7.9*	*–2.6*
Nasdaq	*2,441.5*	*–10.8*	*–8.0*	*–3.7*
Tokyo	8,287.5	–8.4	–19.0	–17.5
London	5,277.6	–7.4	–10.5	–6.9
Euro area	2,186.9	–11.2	–21.7	–20.1
Frankfurt	*5,660.4*	*–10.8*	*–18.1*	*–17.4*
Paris	*2,962.7*	*–11.5*	*–22.1*	*–20.5*
Amsterdam	*281.5*	*–10.1*	*–20.6*	*–16.3*
Milan	*14,409.2*	*–13.5*	*–28.6*	*–27.4*
Madrid	*8,027.7*	*–13.0*	*–18.6*	*–15.9*
Zurich	5,504.2	–6.0	–14.5	–15.1
Hong Kong	18,037.8	–9.9	–21.7	–21.2
Buenos Aires	2,426.0	–19.5	–31.1	–26.5
São Paulo	54,894.5	–7.8	–20.8	–19.5

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.

fear of the crisis infecting the rest of the euro area and countries lending funds to Europe are the main arguments weighing heavy on European indices. The sector hardest hit by investors is banking, due to its high exposure to the region's sovereign debt and the limited prospects of gains in the new, more restrictive regulatory environment.

However, the medium-term forecasts for stock markets are more encouraging. Assuming that the risk of a global economic recession will be avoided and that political and monetary leaders will manage to lay the foundations for recovery from the European crisis, risk assets might possibly gain in value. The main arguments supporting this scenario would be, on the one hand, an extension of the corporate earnings cycle and, on the other, a reduction in global credit risk.

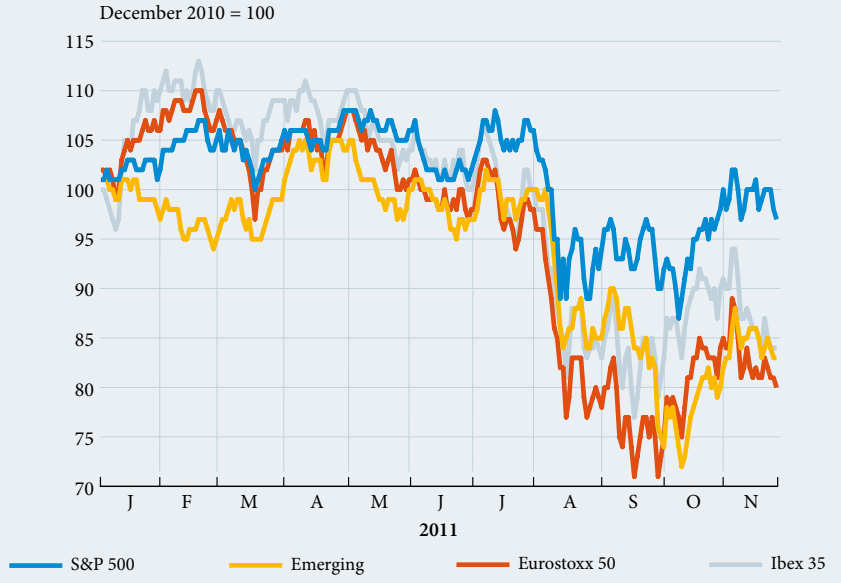
The medium-term outlook for stock markets is more encouraging.

The stock market panorama is bleak; a good time to buy?

In the final days of 2011, four years after the subprime crisis broke out, the conditions under which financial markets are operating are once again looking sombre, especially in Europe. On the one hand, the macroeconomic environment is plagued with hazards and beset by uncertainty. The deleveraging process of numerous agents (be they households, banks or governments) is incomplete, so that there are many threats that could still lead to recession, in particular the debt crisis that's punishing the euro area. Unfortunately, the capacity to act of political and economic authorities is not inspiring enough confidence and the effects of the measures adopted and those that might be adopted are doubtful. On the other hand, and to a large extent as a result of this situation, investors' appetite for risk has decreased while their preference for liquidity has increased.

In the stock market arena, performance in 2011 has been poor in the United States, bad in the emerging countries and very negative in the euro area, particularly in its financial sector. This has merely lengthened the prolonged period of stagnation and the high volatility experienced by the West's stock markets for several years now. The question is whether, as from the coming year, conditions will tend to improve and thereby boost share prices, or whether the opposite will happen and this downward slide will continue or even get worse.

STOCK MARKET TRENDS IN 2011



SOURCE: Datastream.

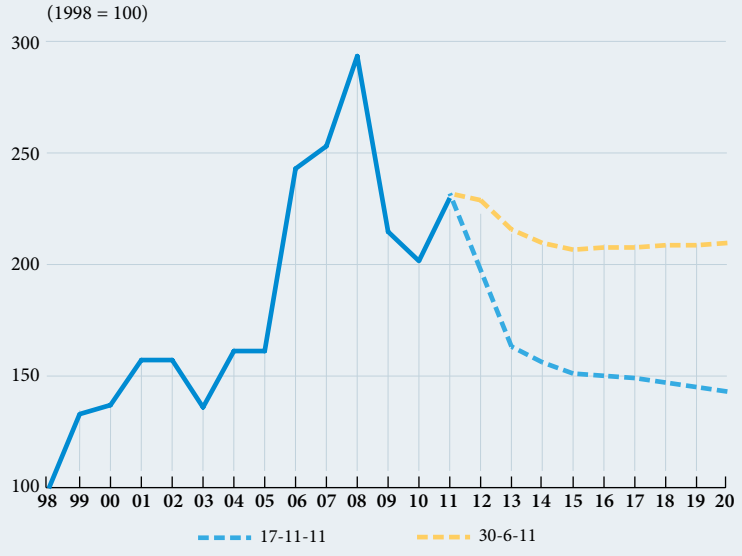
In the first instance, the key factors can be found in the world's macroeconomic trends, in the outcome of the European sovereign debt and banking system crises and, for Spain, in its ability to correct its budget and reform the economy. These issues are dealt with in more detail by other sections in this report.[1] However, we should point out here that, with the appropriate provisos, there's good reason to predict a moderately positive scenario on these

(1) See, in particular, the other three Boxes, which review the key elements for each of these issues.

three fronts, provided the political forces have enough sense, courage and technical know-how. If this is actually what happens throughout 2012, the implications will be favourable for the fundamental decisive factors underlying stock market prices: corporate earnings and the risk premium. Certainly, the contribution of both variables will be significant but, in the singular state of affairs today, with exceptionally high uncertainty, the latter has become particularly relevant.

Investors' expectations for corporate earnings and dividends have fallen in the second half of 2011, due to the slowdown in the world's economy and the worsening of the European debt crisis. In fact, as can be seen in the graph below, this decline in expectations[2] has been particularly severe in the euro area, a circumstance attributable to the relative weight of the banking sector in its stock markets (almost 25% in the index selected). In fact, repeated messages that the region's banks need to improve their solvency, if necessary resorting to increasing their capital and curbing the payment of dividends, have been a vital element in this sharp change in prospects.

DIVIDENDS PER SHARE IN THE EURO AREA: PAST TREND AND EXPECTATIONS



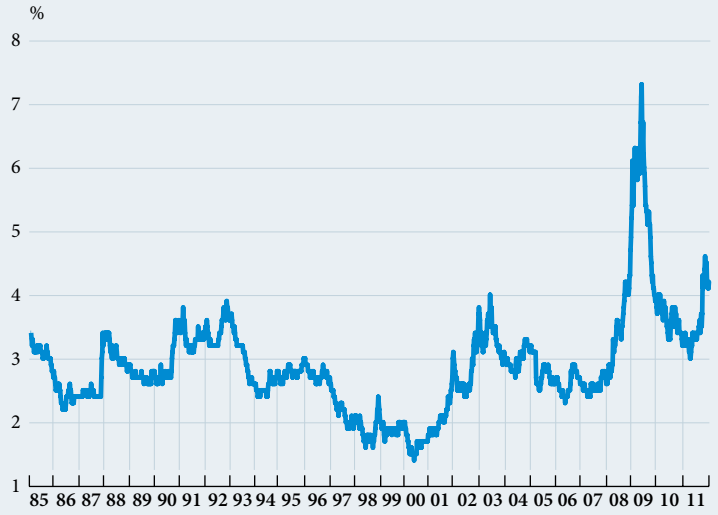
SOURCE: Bloomberg.

In any case, the expectation of a level of dividends per share over the next four years that is around the same size as the figure fifteen years ago is unlikely to be called optimistic or inflated, unless we expect disaster for the euro project, the collapse of banks and a far-reaching and long recession. Insofar as a non-catastrophic scenario is expected for the euro area, earnings and dividends are likely to surprise us and exceed the figures expected by the markets. The situation is different for the United States, however, where investor expectations, although not exaggerated, are more generous and therefore more vulnerable to unexpected setbacks in the economic cycle.

(2) The graph refers to futures contracts for dividends per share of the companies on the Index Eurostoxx 50, interpreting them as representative of investor expectations as a whole. Estimates by the consensus of professional analysts have also decreased but, in this case, from and to higher levels, given these agents' traditional tendency to overestimate, as well as their inertia.

What should be noted is that this projection for the euro area assumes, at the index's current levels, a dividend yield in the order of 4%, a level in the upper range of those observed over the last few decades. Once again, the situation is different in the United States, as valuation there is much more demanding, offering only a moderate appeal. Other stock market valuation indicators also show the same for both regions, such as the cyclically adjusted Price/Earnings ratio (CAPE) and Tobin's q.

DIVIDEND YIELD IN THE EURO AREA



SOURCE: Datastream.

The factor underlying the euro area's relatively high dividend yield is, presumably, a rise in the stock market risk premium.(3) This interpretation is in line with the information provided by other indicators, such as sentiment surveys on investors of all types, the level of risk premia for sovereign and corporate bonds, the volatility implicit in stock options, the high correlation between different assets, etc. On the other hand, various academic studies(4) have highlighted that, historically, increases in the dividend yield ratio have mostly been due to rises in the risk premium and, consequently, have generally led to a subsequent improvement in returns in the medium term (through dividend pay-outs and/or stock revaluations).

Several theoretical explanations have been offered for the causes that increase or decrease the risk premium. Some are based on arguments that assume investors do not behave completely rationally but suffer from cognitive limitations in appreciating the fundamental value of assets, making them succumb to fads, panics(5) and other kinds of psychological bias.(6) Others uphold the paradigm of rationality and even the capacity of agents to appreciate fundamental value, but argue that investors lose their tolerance for risk when, at times of economic

(3) This can also be applied to other ratios, such as the P/E ratio or the PBV ratio.
(4) See J. Cochrane, «Discount Rates», The Journal of Finance, Vol. LXVI, No. 4 2011, and John Campbell, S. Giglio and Ch. Polk, «Hard Times», Harvard University Working Papers, 2011.
(5) For example, Andrew Haldane, «Risk Off», Bank of England, Speeches, 2011.
(6) For example, U. Malmendier and S. Nagel, «Depression Babies: Do Macroeconomic Experiences Affect Risk-Taking?», Quarterly Journal of Economics, Vol. 126 (1), 2011.

crisis and growing unemployment, they feel their income and consumption are threatened.[7] The risk premium has also been related conceptually with the existence of financial frictions (such as liquidity crises) and with imperfect information. Whatever the case, the situation currently being experienced by the euro area contains the whole gamut of these elements.

Correctly identifying the causes of fluctuations in the risk premium is important for economic policymakers when designing measures of financial stability, as well as for investors, particularly those operating in the short term and who therefore depend critically on its performance. For those with a more medium or long-term approach, it's important to bear in mind what we have already mentioned: whatever the cause, an increase in the dividend yield associated with an increase in the risk premium ultimately means potentially more attractive returns in the future. Under this premise, and given the events of recent times, investing in a diversified portfolio of European shares is an option that has notably gained in appeal over the medium term; even though there's a small likelihood of 2012 still being disappointing.

(7) For example, Cochrane (2011) op.cit.

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

SPAIN: OVERALL ANALYSIS

Economic activity

The green shoots wither in winter

Greater risk of a double dip recession.

The deterioration in the growth of gross domestic product (GDP) is being confirmed and, consequently, the Spanish economy is increasingly likely to enter a recession in the coming quarters. So a double dip recession appears to be a given. Now the big question is how extensive and how long the recession will be. In principle, the bulk of the evidence suggests that it will be temporary and not very far-reaching but uncertainty is still very high.

For the moment, the third quarter's growth figures were not very encouraging. As in the last few quarters, domestic demand continued to adjust. This time, one of the main causes was the performance by private consumption, down 0.1% in quarter-on-quarter terms and thereby losing the ground it had gained in the second quarter. The re-estimation of the historic series also brought about a significant change. The positive trend it exhibited, with quarter-on-quarter growth averaging 0.4% between the last quarter of 2009 and the second quarter of 2011, has now become 0.1%.

Public consumption also failed to contribute positively to the GDP flash

DEMAND INDICATORS

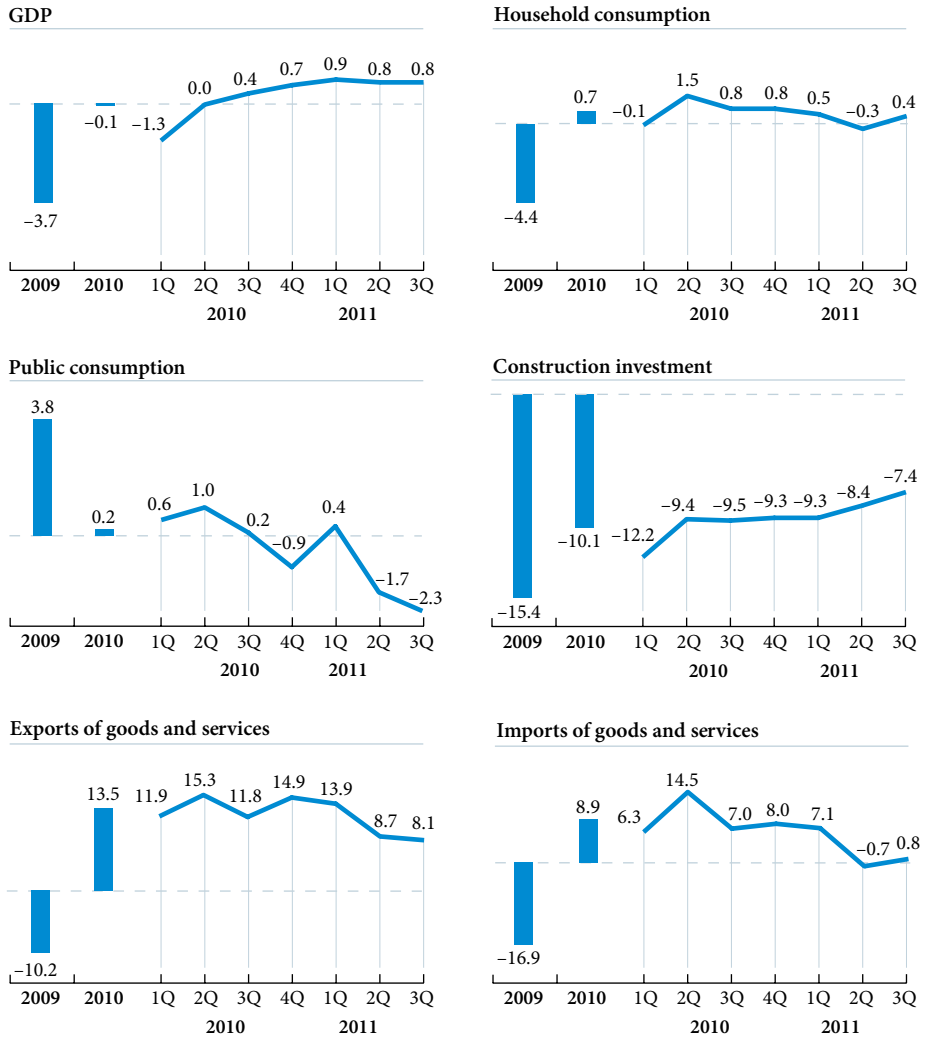
Percentage change over same period year before

	2010	2011	2010	2011				
			4Q	1Q	2Q	3Q	September	October
Consumption								
Production of consumer goods (*)	0.8	–0.6	0.1	–1.5	–0.8	0.7	0.6	...
Imports of consumer goods (**)	–9.5	–3.0	–13.7	–1.1	–8.7	1.2	2.9	...
Car registrations	3.1	–19.7	–29.3	–27.3	–26.4	–0.7	–1.3	–6.7
Credit for consumer durables	–12.3	–12.1	–14.6	–13.9	–10.1	...	–	–
Consumer confidence index (***)	–20.9	–17.4	–21.0	–19.6	–16.1	–15.8	–17.0	–19.6
Investment								
Capital goods production (*)	–3.3	2.6	–3.2	3.0	2.5	2.3	0.5	...
Imports of capital goods (**)	6.5	–1.5	4.8	2.3	–4.9	–1.5	3.1	...
Commercial vehicle registrations	7.0	–3.9	1.4	–2.2	–11.2	5.8	9.4	–7.0
Foreign trade (**)								
Non-energy imports	10.3	2.4	5.4	7.4	–0.7	0.8	2.1	...
Exports	15.6	11.9	15.3	16.0	9.0	10.9	7.8	...

NOTES: (*) Adjusted for public holidays.
(**) By volume.
(***) European Commission survey: difference between percentage of positive and negative replies.
SOURCES: ANFAC, National Institute of Statistics, Bank of Spain, Ministry of the Treasury, European Commission and own calculations.

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



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

estimate; quite the opposite, in fact. Severe public spending cuts are starting to result in significant declines in public consumption. Specifically, in the third quarter this fell by 1.1%, placing the year-on-year rate of change at –2.3%, five tenths of a percentage point below the figure posted for the previous quarter.

Investment figures were slightly better thanks to the trend in investment in capital goods and transportation. After a significant drop of 1.3% in the second quarter, this grew by 2.3% in the third quarter, bringing the year-on-year rate of change to 2.5%. However, investment in construction took a step backwards. We already expected this to continue deteriorating but the extent of the reduction, namely 1.9% in quarter-on-quarter terms, was greater than expected.

Public and private consumption are down on the previous quarter.

SUPPLY INDICATORS

Percentage change over same period year before

	2010	2011	2010	2011				
			4Q	1Q	2Q	3Q	September	October
Industry								
Electricity consumption (1)	2.9	–0.5	2.2	0.4	0.4	–1.2	–1.3	–3.7
Industrial production index (2)	0.8	–0.3	0.4	1.8	–1.1	–1.5	–1.8	...
Confidence indicator for industry (3)	–13.8	–11.5	–9.2	–8.6	–10.9	–14.4	–16.0	–13.8
Utilization of production capacity (4)	72.0	73.3	72.9	72.6	74.7	73.3	–	72.7
Imports of non-energy intermediate goods (5)	24.6	5.6	18.2	12.2	3.8	0.9	1.6	...
Construction								
Cement consumption	–15.4	–15.6	–17.3	–2.4	–16.6	–21.0	–19.8	–28.4
Confidence indicator for construction (3)	–29.7	–55.3	–41.5	–54.1	–55.4	–58.6	–64.2	–49.0
Housing (new construction approvals)	–17.3	–13.1	–20.3	–6.8	–19.4	...	...	...
Government tendering	–37.9	–35.0	–34.9	–37.9	–24.7	...	...	...
Services								
Retail sales (6)	–1.0	–5.1	–1.9	–5.9	–5.1	–4.3	–5.6	...
Foreign tourists	1.0	8.0	1.5	2.9	10.4	8.5	9.2	8.0
Tourist revenue inflows	3.9	9.6	5.4	6.7	12.2	...	...	...
Goods carried by rail (ton-km)	6.4	5.8	–4.2	8.2	1.8	7.7	16.4	...
Air passenger traffic	2.9	6.8	4.3	5.0	10.6	6.2	7.6	2.3
Motor vehicle diesel fuel consumption	–1.2	–3.1	–1.6	–1.6	–4.6	...	...	...

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

The change in the savings rate will be key to the consumption trend.

As a whole, domestic demand therefore fell by 0.4% compared with the previous quarter and, according to leading indicators for the fourth quarter, it will continue this clearly downward trend. The consumer confidence index, for example, fell by 2.6 points, totalling –19.6 points, a level it has not reached since April this year. The automobile sector is also having a hard time again, with registrations dropping by 6.7% in October in year-on-year terms, 5.4 percentage points lower than in September.

The supply indicators for the fourth quarter don't warrant much optimism either. In October, electricity consumption posted a large decrease of 3.7% in year-on-year terms and the confidence index for industry, although slightly better than in September, has remained at a relatively low level.

Nonetheless, one of the most worrying factors in the short term is how private consumption and investment will respond, faced with increased tensions in the sovereign debt markets and the significant upswing in unemployment

in the third quarter. Both factors increase uncertainty regarding the economic prospects of households and firms and, in such a situation, both usually increase their savings as a precautionary measure. This is precisely what happened in 2009, when the savings rate picked up suddenly from 13.6% of households' disposable income to 18.5% in one year. Such a trend is not in evidence for the moment but, in order to make sure it doesn't happen, it's vitally important for the main European leaders to speed up reforms and the implementation of the measures approved at the last summit, such as the start-up of the European Financial Stability Fund (EFSF). Given that the European Central Bank's capacity to intervene in the public debt markets seems to be limited, it's very important for the EFSF to act quickly, effectively and decisively.

Within this context of weaker domestic demand, all the cards for the Spanish economy's recovery are held by a single hand: the contribution of the foreign sector. This became decisive again in the third quarter this year and, in quarter-on-quarter terms, its contribution to GDP growth was 2.0%. This was possible particularly thanks to the strong progress made by exports, up by 3.1% in quarter-on-quarter terms, one percentage point above their average growth during the last year. Imports, however, remained weak and only advanced by 1.6%, largely reflecting the weakness of the Spanish economy's domestic demand as a whole.

Another big risk hovering over the Spanish economy is therefore a decline in the foreign sector. And this, given the circumstances facing the main European countries, does not seem to be a remote possibility. Quite the opposite, in fact. In spite of the good GDP figures for the third quarter offered by Germany and France, both countries have seen the main leading indicators for their respective economies deteriorate significantly over the last few months. The same thing is happening for the euro area as a whole. The consensus of economists, which in June forecast 1.7% growth in GDP in 2012, is now expecting 0.4%, a level similar to the one forecast by the Research Department of "la Caixa", specifically 0.3%.

Under such circumstances, the foreign sector is unlikely to continue boosting the recovery of Spain's economy with the same vigour. We have therefore appreciably reduced our GDP growth forecast for the whole of 2012, from 1.1% to 0.2%. We expect the foreign sector's contribution to continue being positive, specifically 1.2%, 0.9 percentage points less than in 2011. As we have already mentioned, domestic demand will more than likely fall moderately by 1.0%.

Although we believe that the risks facing this new forecast have been suitably balanced upwards and downwards, it's important to note that the degree of uncertainty surrounding such forecasts is very high. Given the nature of the economic situation, there are many different factors that might substantially alter the course of economic activity over the coming quarters. Among these, and as we have already mentioned, of particular importance is the capacity to resolve the sovereign debt crisis. The Spanish economy's growth prospects could notably improve should this resolution be faster than expected.

The possible deterioration in the foreign sector casts a shadow over the recovery.

Labour market

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

A return to the 1990s?

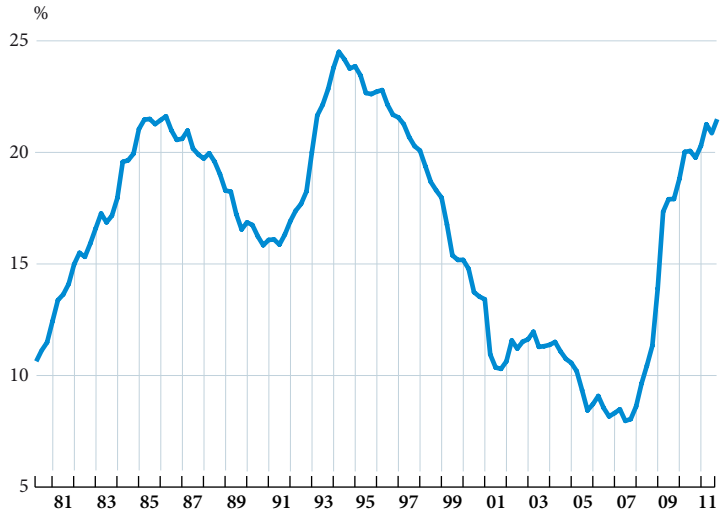
The labour force survey (LFS) for the third quarter has been unambiguous in its confirmation of the progressive deterioration in our labour market. The number of unemployed rose by 144,700 people, reaching a total of 4,978,300, very close to the psychological figure of 5 million unemployed. The unemployment rate therefore increased by just over 0.6 percentage points compared with the previous quarter, reaching 21.5%. We have to go back to the mid-1990s to find a similar rate. But are these two periods really comparable?

The last time the unemployment rate went above 20%, the economy needed more than five years to recover. Today, Spain's labour market has been above this figure for almost two years and, according to our forecasts, will need at least three more years, up to 2014, for more than 80% of the people looking for work to find employment. Within the current context of an economic slowdown, the short-term outlook does not look at all promising.

The data from the quarterly National Accounts system showed that gross domestic product (GDP) stood still in the third quarter and, according to our forecasts, activity will shrink and eventually reach negative figures by the start of next year. Within this context, data for the labour market will continue to worsen throughout 2012, reaching an unemployment rate of close to 22.5% by the end of next year.

THE UNEMPLOYMENT RATE RISES TO RECORD HIGHS

Unemployment as % of labour force



SOURCE: National Institute of Statistics (INE).

ESTIMATED EMPLOYMENT

Third quarter 2011

	No. of employees (thousands)	Quarterly change		Accumulated change		Annual change		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	707.7	–33.5	–4.5	–96.8	–12.0	–46.3	–6.1	3.9
Non-farm	17,448.5	–113.3	–0.6	–155.1	–0.9	–344.3	–1.9	96.1
Industry	*2,576.3*	*–1.4*	*–0.1*	*–46.5*	*–1.8*	*–24.3*	*–0.9*	*14.2*
Construction	*1,370.7*	*–59.5*	*–4.2*	*–201.8*	*–12.8*	*–297.4*	*–17.8*	*7.5*
Services	*13,501.5*	*–52.4*	*–0.4*	*93.2*	*0.7*	*–22.6*	*–0.2*	*74.4*
By type of employer								
Private sector	14,935.7	–149.8	–1.0	–304.0	–2.0	–435.2	–2.8	82.3
Public sector	3,220.6	3.1	0.1	52.1	1.6	44.7	1.4	17.7
By work situation								
Wage-earners	15,179.4	–113.0	–0.7	–134.8	–0.9	–276.9	–1.8	83.6
Permanent contract	*11,228.9*	*–160.7*	*–1.4*	*–285.0*	*–2.5*	*–277.6*	*–2.4*	*61.8*
Temporary contract	*3,950.4*	*47.5*	*1.2*	*150.1*	*3.9*	*0.5*	*0.0*	*21.8*
Non-wage-earners	2,968.9	–33.3	–1.1	–115.2	–3.7	–116.5	–3.8	16.4
Entrepreneurs with employees	*935.5*	*–17.2*	*–1.8*	*–77.7*	*–7.7*	*–72.5*	*–7.2*	*5.2*
Entrepreneurs without employees	*1,909.7*	*4.0*	*0.2*	*–23.6*	*–1.2*	*–17.9*	*–0.9*	*10.5*
Family help	*123.7*	*–20.1*	*–14.0*	*–13.9*	*–10.1*	*–26.1*	*–17.4*	*0.7*
Other	8.0	–0.4	–4.8	–1.9	–19.2	2.9	56.9	0.0
By time worked								
Full-time	15,757.7	42.7	0.3	–176.0	–1.1	–417.1	–2.6	86.8
Part-time	2,398.5	–189.5	–7.3	–76.0	–3.1	26.6	1.1	13.2
By sex								
Males	10,034.0	–32.8	–0.3	–175.7	–1.7	–342.2	–3.3	55.3
Females	8,122.2	–114.0	–1.4	–76.3	–0.9	–48.4	–0.6	44.7
TOTAL	**18,156.3**	**–146.7**	**–0.8**	**–251.9**	**–1.4**	**–390.5**	**–2.1**	**100.0**

SOURCES: National Institute of Statistics and own calculations.

Evidence of the worsening of the outlook is provided by the 144,700 rise in the unemployment figures for the third quarter, so that 403,600 people have already swelled the ranks of the unemployed in the last 12 months. This figure is unusual as the summer usually provides positive data and the summer season this year has been exceptionally good for the tourism industry. Nonetheless, the services sector lost 45,900 jobs and, together with construction, which lost 26,000 people, accounts for almost 50% of the rise in unemployment. Whereas the industrial sector reduced its number of unemployed (23,400) and agriculture only rose slightly, the other big cause of the higher unemployment rate was among those looking for their first job, a group that increased by 48,000 people, as well as those who had lost their job more than one year ago (up by 40,700).

It is precisely this last group that causes most concern, since the long-term unemployed account for more than 48% of the total figure and these people tend

Construction and services account for 50% of the rise in unemployment.

ESTIMATED UNEMPLOYMENT

Third quarter 2011

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	2,674.0	65.9	2.5	193.8	7.8	53.7	21.0
Females	2,304.4	78.8	3.5	209.8	10.0	46.3	22.1
By age							
Under 25 years	917.9	31.3	3.5	57.2	6.6	18.4	45.8
Other	4,060.4	113.3	2.9	346.4	9.3	81.6	19.2
By personal situation							
Long-term unemployment	2,398.5	88.4	3.8	428.2	21.7	48.2	–
Seeking first job	458.2	48.1	11.7	79.8	21.1	9.2	–
Other	2,121.6	8.1	0.4	–104.4	–4.7	42.6	–
TOTAL	**4,978.3**	**144.6**	**3.0**	**403.6**	**8.8**	**100.0**	**21.5**

SOURCES: National Institute of Statistics and own calculations.

The public sector is creating jobs while the private sector is destroying them apace.

to have greater problems in finding employment. Similarly, the number of households with all their members unemployed has risen by 10.3% compared with the previous year, reaching a total of 1,425,200. Moreover, in the third quarter of 2011, and for the first time in the last decade, fewer than 70% of households with people of working age have all their members employed. These figures don't only have social consequences but also economic ones, as the number of households going bust increases and households' capacity to consume decreases. Moreover, the deterioration in the labour market could result in many individuals increasing their savings as a precautionary measure, which would limit the recovery in consumption even further.

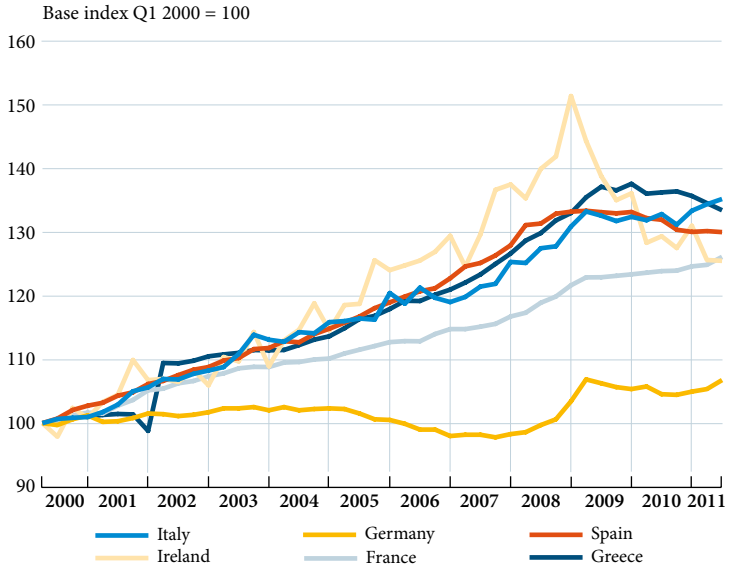
One of the most surprising figures from the latest LFS is the fact that the public sector has continued to increase its relative weight of salaried workers. In the third quarter of 2011, 21.2% of all salaried workers were public employees, four points more than at the start of the crisis in 2007. The public sector boosted its number of employees by 3,100 in the last quarter compared with the previous quarter, and has already seen 347,400 additional public employees since the beginning of 2008. On the other hand, during the same period the private sector destroyed 1,985,400 salaried jobs, 116,100 just in the last quarter.

Along the same lines, employment posted a year-on-year drop of 2.1% (146,800 fewer people in the last quarter), so that the total number of employed in Spain is now 18,156,300. The most worrying is the ongoing decline in entrepreneurs with workers and the self-employed, falling by 7.2% and 3.8% respectively in the last year, as these constitute a very significant proportion of our economy's economic fabric and employment.

The only positive interpretation of these job losses is that employment is falling at a faster rate than GDP growth is slowing up, so that apparent productivity is improving. Worker productivity grew

OUR EUROPEAN RIVALS ALSO IMPROVE THEIR COMPETITIVENESS

Unit labour costs



SOURCES: Eurostat and own calculations.

by 2.7% in the last quarter, 8 tenths of a percentage point more than in the previous quarter. For their part, unit labour costs fell by 2.1% so that, in 2011, the economy has maintained the trend of the last few years and continues to improve its competitiveness. The adjustment is even greater if we carry out this analysis in real terms, as the real unit labour cost fell by 3.6% in 2010, and the improvement will be even bigger in 2011. Given that this phenomenon of improved productivity is not limited to our economy, Spain will have to persevere to regain its competitiveness compared with its closest European rivals.

The encouraging competitiveness indices are proof of our economy's capacity to recover, although the question of exactly how long employment will take to pick up brings us back to our first question. Although the crisis in the 1990s and the current crisis have similarities regarding the labour market, they cannot be compared directly. Whereas the crisis was mostly one of supply in the 1990s and there was a huge reconversion in industry, the present crisis is fundamentally one of demand, burdened by the turbulences still present in the euro area, the economy's deleveraging as a whole and the re-assimilation of those employed in the real estate bubble (mainly the construction sector). Although the recovery may be slow and the outlook may get worse in the short term, we do seem to be on the right track.

The economy regains its competitiveness and lays the foundations for recovery.

Prices

Inflation persists, but not for long

The CPI falls by one tenth of a percentage point and reaches 3.0% in October.

Inflation should be the last thing on our minds right now. Although the year-on-year rate of change in the consumer price index (CPI) stood at 3.0% in October, with a fall of barely one tenth of a percentage point compared with the previous month, the almost flat trend over the last four months looks like it's about to disappear. Given the current state of affairs, our forecast is that inflation will reach around 2.4% by the end of the year and that this trend will continue in 2012, with the annual average rate being around 1.4%.

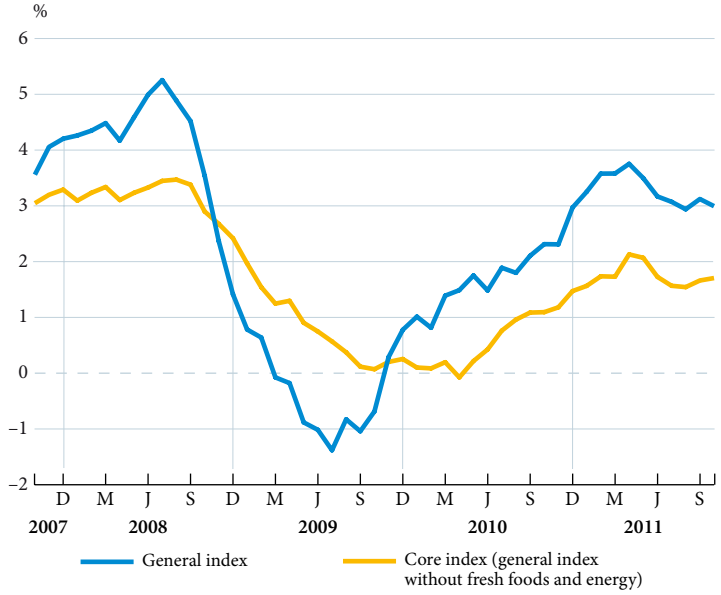
Annual average inflation in 2012 will be around 1.4%.

What is this forecast based on? Leading economic indicators are not exactly encouraging. Consumer confidence fell in October for the third consecutive month (as did the indicator for economic sentiment) and is now almost 5 points below its historical average. For their part, retail sales have seen negative year-on-year rates all year, while industrial production has gradually got worse throughout the year and, in September, posted a 1.5% drop. The figures provided by the National Accounts system for the third quarter show meagre growth in consumption of 0.4% and a public consumption in evident decline.

Inflationary pressures might fall even further if uncertainty remains high and the various economic agents end up increasing their savings rates as a

INFLATION IS STILL ALMOST FLAT, FOR THE TIME BEING

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

precautionary measure, which would reduce consumption. The harsh side of this deterioration in expectations can already be seen in the 1.9% fall in employment in the third quarter. The loss of 327,000 net jobs, an unemployment rate of 21.52% and the fact that wages are down by 1.2% (and with this rate being negative for almost three years) does not encourage optimism regarding the performance of consumption in the short term.

Proof of the deterioration in expectations at an international level is the European Commission's downward revision of Europe's growth. Even the European Central Bank (ECB), led by the recently invested president Mario Draghi, reduced interest rates to 1.25% at the beginning of November although inflation in the euro area remained stable at 3.0% in October, far from the 2% target set by the ECB itself.

This change in interest rates is very unlikely to generate inflationary pressure as the extraordinary liquidity measures present in the system over the last few months have had very little effect on the real economy, a symptom that the vehicles transmitting monetary policy are not well oiled. Moreover, France has presented its most austere budget for the last 50 years, with the aim of maintaining its maximum credit rating, and the expansionary fiscal measures presented in Germany are not big enough to generate inflationary pressure in the euro area. Inflation in the euro area is therefore likely to fall.

The year-on-year rate of change in the harmonized index of consumer prices (HICP) for the euro area, standing at 3.0%, can be explained both by the methodological change as well as the inflation in the energy component which, together with alcohol and tobacco, prevented the rate from falling in Europe. Proof of energy's significant contribution and relative weight is that core inflation, which excludes unprocessed food and energy products, remained constant in October at 2.0%.

Inflationary pressures lessen both in Spain and Europe.

CONSUMER PRICE INDEX

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

SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

October

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2010	2011	2010	2011	2010	2011
By type of spending							
Food and non-alcoholic beverages	110.6	0.1	0.1	0.1	1.6	0.4	2.2
Alcoholic beverages and tobacco	150.9	0.0	1.0	8.6	4.0	8.5	10.4
Clothing and footwear	105.2	9.8	10.3	–2.8	–3.1	0.3	0.3
Housing	125.6	1.4	0.4	5.0	5.5	5.4	6.3
Furnishings and household equipment	109.2	0.5	0.5	0.6	0.6	0.9	1.0
Health	96.0	–0.4	0.2	–1.1	–0.3	–1.0	–0.5
Transport	118.1	0.2	–0.2	6.3	4.7	6.9	7.6
Communications	97.1	–0.2	–0.6	–0.7	–1.5	–0.8	–1.6
Recreation and culture	97.2	–0.8	–0.8	–1.4	–0.3	–0.8	0.0
Education	120.3	1.4	2.0	2.1	2.7	2.3	2.9
Restaurants and hotels	115.2	–0.2	–0.3	1.7	1.3	1.5	1.3
Other goods and services	115.6	0.3	0.1	2.5	2.4	2.7	2.7
By group							
Processed food, beverages and tobacco	117.8	0.1	0.3	0.9	2.7	1.1	4.4
Unprocessed food	109.8	0.3	–0.1	1.9	0.2	2.1	0.9
Non-food products	112.2	1.1	0.9	2.0	1.8	2.6	2.9
Industrial goods	110.4	2.5	2.1	2.6	2.2	3.7	4.3
Energy products	*136.4*	*1.3*	*0.1*	*11.1*	*10.1*	*12.6*	*14.5*
Fuels and oils	*133.5*	*0.3*	*0.2*	*12.3*	*10.2*	*14.3*	*16.2*
Industrial goods excluding energy products	*101.6*	*2.9*	*3.0*	*–0.4*	*–0.7*	*0.6*	*0.6*
Services	114.1	–0.2	–0.2	1.3	1.4	1.5	1.6
Underlying inflation (**)	110.3	0.9	1.0	0.7	0.9	1.1	1.7
GENERAL INDEX	**113.0**	**0.9**	**0.8**	**1.8**	**1.8**	**2.3**	**3.0**

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

The winter season pushes up prices compared with September.

If the situation is so bad and might even get worse, why have prices not already started to fall in Spain? Spanish inflation posted a 3.0% year-on-year change in October, very close to the levels reached in the previous three months. This figure represents a drop of one tenth of a percentage point compared with the year-on-year change of the previous month, due to the lower inflationary pressure of housing and transportation, up by 6.3% and 7.6% respectively.

This was possible thanks to October's stable electricity prices compared with price hikes in 2010, and also to the falling price of fuels and oils, down in October in clear contrast to the rise in the same month the previous year. The greatest upward pressure came from alcoholic beverages and tobacco, due to the big rise last month that still affects the calculation of inflation. Given that core inflation excludes unprocessed food and energy products, this remained stable at 1.7%.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2010											
September	8.0	3.4	0.2	0.5	4.0	9.1	9.2	6.9	1.8	10.6	–
October	10.3	4.1	0.6	0.5	4.3	10.5	8.6	6.4	1.7	10.5	–
November	10.3	4.4	0.9	0.6	5.1	10.7	9.2	7.7	2.1	11.0	1.4
December	8.5	5.3	1.3	0.7	5.7	13.5	10.4	8.1	2.5	11.8	–
2011											
January	3.7	6.8	1.5	1.0	6.8	17.3	11.7	7.3	2.0	12.2	–
February	1.3	7.6	1.9	0.9	7.9	18.5	11.1	6.2	1.4	13.1	1.8
March	–5.2	7.8	2.1	1.2	8.0	18.6	10.8	5.4	1.5	11.6	–
April	–4.7	7.3	2.5	1.3	7.1	17.1	10.0	4.0	1.6	10.3	–
May	–8.1	6.7	2.6	1.3	6.6	15.4	8.7	2.9	0.8	8.2	2.0
June	6.7	6.7	2.6	1.2	6.5	15.4	7.8	2.6	0.6	6.9	–
July	5.1	7.5	2.8	1.4	6.8	17.9	9.1	3.3	1.0	8.0	–
August		7.1	2.7	1.3	6.2	17.2	8.9	2.4	0.9	7.3	1.5
September		7.1	2.5	1.2	5.6	18.4	9.6	3.2	1.2	6.6	–

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

In terms of the monthly change, the CPI was up by 0.8 tenths of a percentage point compared with the previous month, the third consecutive month of monthly increases. On this occasion, it was due to the start of the winter season, which upped the price of clothing and footwear by 10.3%. And the winter is also partly responsible for the rise in heating fuel and gas, applying upward pressure, quite the opposite to leisure and culture, as well as hotels and travel, affected in the opposite direction due to the seasonal component.

In short, the year-on-year inflation rates of around 3.0% for the last few periods will disappear over the coming months and embark on a clearly downward trend. The lethargy of demand, together with an uncertain immediate future, will restrict consumption even further and push inflation down, which will remain below 2% in 2012.

These forecasts assume that oil prices will remain stable over the coming months. In the case of fluctuations in this heading, we might see both inflation in the euro area and especially in Spain vary by a few tenths of a percentage point, the latter because it is particularly sensitive to variations in energy prices.

Fluctuations in oil prices might affect our forecasts.

Foreign sector

The foreign sector maintains its positive contribution to growth in the third quarter.

The energy deficit continues to widen

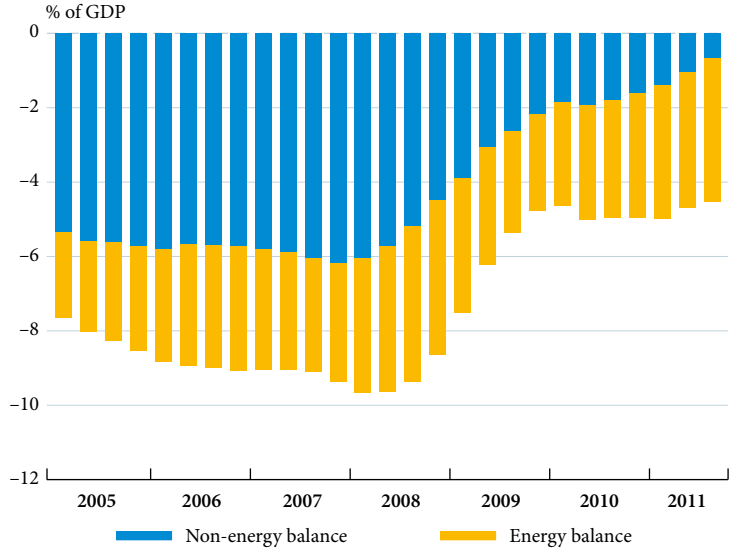
The Spanish economy came to a standstill between July and September 2011. As had already happened in the previous quarters, the dynamism of foreign demand, contributing four tenths of a percentage point to growth in this period, offset the weakness in domestic demand. This good performance comes from the real growth in exports, practically double that of imports. Over the coming quarters, the lower boost from world trade and slower growth in Europe's economy suggest a deceleration in the pace of exports. However, the lethargy of domestic demand, with the consequent slowdown in imports, will keep foreign demand's contribution positive during 2012. Within this context, it's important to reflect on the future trend in the trade balance.

The data available for September show a further increase in the trade deficit, for the second month in a row. In cumulative terms over the last twelve months, this reached 48.43 billion euros, 1 billion higher than the balance recorded two months ago. The slight upswing in imports during these summer months lies behind this deterioration.

However, a breakdown of imports shows that most of its year-on-year increase was down to higher prices. This situation differs from the one seen in exports and the main reason is the greater relative weight of the energy component in the case of the former. As a consequence, the rise

THE ENERGY DEFICIT SLOWS UP THE CORRECTION IN THE TRADE IMBALANCE

Cumulative balance over the last four quarters compared with the GDP of the same period



SOURCES: Ministry of the Economy and own calculations.

in prices of energy products, more than 25% that month, had a greater effect on the value of foreign goods entering the country.

Given this situation, the cumulative energy deficit for the last twelve months continued to widen, reaching 3.8% of gross domestic product (GDP) in September. This figure is half a point above the rate for December 2010. Nevertheless, the good performance by the non-energy component, falling by 1.6% to 0.7% of GDP in this period, helped to reduce the total deficit by four tenths of a percentage point to 4.5% of GDP. In accordance with our expectation that oil prices will remain at their current level, the energy deficit will continue to widen up to the first quarter of 2012, albeit at an increasingly slower rate.

In addition to the pressure exercised by energy prices on the deficit in the short term, this trend will also depend on how the European market performs, which accounts for around 65% of Spain's exports. The slowdown in growth expected for member states of the European Union points towards a slower rate of growth in exports in the first half of 2012. In fact, September's figures already show some indication of this deceleration, with 4.8% growth in exports to Europe year-on-year compared with 19.3% the previous month. However, the extent of its effect on the trade balance will depend on the decrease in imports. In this respect, if Spanish demand for foreign goods drops off more than exports, the trade deficit will be able to narrow in 2012.

The rise in energy prices intensifies the growth in imports.

The trade deficit falls to 4.5% of GDP, boosted by the non-energy component.

Oil prices and the slowdown in Europe's economy will determine the trade balance in 2012.

FOREIGN TRADE

January-September 2011

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	41,688	29.0	22	9,780.3	57.3	6.2	–31,908	23.5
Consumer goods	44,616	2.4	23	51,198.4	12.3	32.4	6,582	114.8
Food	*11,883*	*5.5*	*6*	*18,636.4*	*8.7*	*11.8*	*6,754*	*156.8*
Non-foods	*32,733*	*1.3*	*17*	*32,562.0*	*14.5*	*20.6*	*–171*	*99.5*
Capital goods	12,547	–2.8	6	13,765.6	21.5	8.7	1,219	109.7
Non-energy intermediate goods	94,854	11.0	49	83,477.3	16.3	52.8	–11,377	88.0
By geographical area								
European Union	101,089	5.5	52	104,263.0	14.0	65.9	3,174	103.1
Euro area	*81,879*	*6.2*	*42*	*83,136.9*	*10.6*	*52.5*	*1,258*	*101.5*
Other countries	92,616	18.1	48	53,958.6	24.1	34.1	–38,658	58.3
Russia	*6,838*	*53.8*	*4*	*1,864.9*	*33.3*	*1.2*	*–4,973*	*27.3*
United States	*7,831*	*16.9*	*4*	*6,079.5*	*28.1*	*3.8*	*–1,751*	*77.6*
Japan	*2,424*	*–7.2*	*1*	*1,345.5*	*29.0*	*0.9*	*–1,078*	*55.5*
Latin America	*12,467*	*20.9*	*6*	*9,048.2*	*25.1*	*5.7*	*–3,419*	*72.6*
OPEC	*20,580*	*23.2*	*11*	*6,103.3*	*24.8*	*3.9*	*–14,476*	*29.7*
Rest	*42,476*	*12.8*	*22*	*29,517.2*	*22.1*	*18.7*	*–12,959*	*69.5*
TOTAL	**193,705**	**11.2**	**100**	**158,221.6**	**17.3**	**100.0**	**–35,483**	**81.7**

SOURCES: Ministry of the Economy and own calculations.

Tourism accelerates the current deficit's rate of contraction

The current deficit speeds up its rate of contraction in August...

In spite of a slight deterioration in the balance of goods, the cumulative current deficit for the last twelve months speeded up its rate of contraction in August, with a fall of 18.0% year-on-year. This correction is due to the good performance of the balances of services and transfers, higher than the increase in the deficit recorded in the balances of goods and income.

...and comes close to our forecast of 4% of GDP for 2011.

On the other hand, we expect the income balance deficit accumulated over twelve months to continue growing until the end of the year. Between December 2010 and August 2011, this has increased by more than 5 billion euros up to 27.11 billion, due to higher financing costs for Spain's private and public debt. Nonetheless, we expect the correction in the current imbalance to slow up over the last few months of the year, coming close to a deficit of 4.0% of GDP in 2011.

BALANCE OF PAYMENTS

August 2011

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–27,544	–13.7	–42,769	5,861	–12.1
Services					
Tourism	*21,525*	*14.2*	*29,639*	*3,110*	*11.7*
Other services	*2,235*	–	*2,761*	*2,689*	–
Total	23,761	24.0	32,400	5,799	21.8
Income	–20,340	34.0	–27,106	–3,593	15.3
Transfers	–6,247	–8.5	–6,540	1,625	–19.9
Total	**–30,370**	**–12.6**	**–44,015**	**9,691**	**–18.0**
Capital account	**3,960**	**–10.3**	**5,838**	**137**	**2.4**
Financial balance					
Direct investment	–7,091	–	–4,675	–2,819	152.0
Portfolio investment	–5,651	–	19,872	–15,471	–43.8
Other investment	21,860	–	39,872	66,143	–
Total	**9,117**	**–**	**55,069**	**47,853**	**–**
Errors and omissions	–6,296	77.4	–5,201	263	–4.8
Change in assets of Bank of Spain	23,590	–53.7	–11,692	–57,545	–

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

Tension intensifies in the public debt markets

Tensions have got worse in the European public debt markets during the last few months of 2011. Moreover, this is no longer a problem affecting basically the peripheral countries, as tension has spread to most countries in the euro area. In the case of Spain, this has led to an even higher financing cost for public debt in November, now at levels similar to those before the euro was adopted. The correction over the coming year will depend, on the one hand, on whether disturbances at a European level calm down and, on the other, whether the fiscal targets set by the stability plan are achieved.

Tension in the sovereign debt markets intensifies...

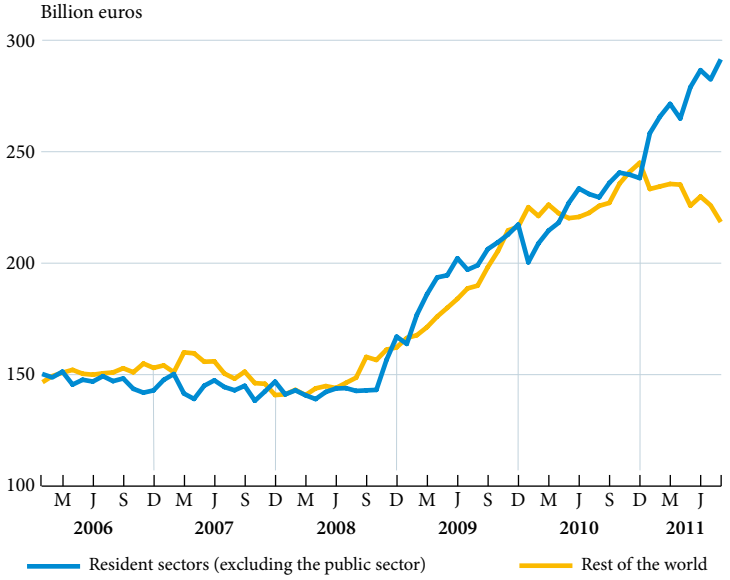
To date, the reforms in Italy and changes in government in both Italy and Greece have not managed to stop investors' doubts from spreading to other economies. Spain has been one of the main countries affected. Its interest rate spread for ten-year sovereign bonds came close to 500 basis points compared with similar German bonds, reaching 6.8%. Only intervention by the European Central Bank (ECB), buying up Italian and Spanish bonds, managed to temporarily ease the tension.

...pushing financing costs for Spain's public debt up to their highest level since the euro began.

Volatility in the secondary market has affected the debt recently issued by the Treasury. Recently auctioned 12 and 18-month bills were sold at interest rates of 5.0% and 5.2% respectively, one and a

LESS GOVERNMENT DEBT IN THE HANDS OF FOREIGN INVESTORS

Public debt by counterparty sector



SOURCE: Bank of Spain.

The public cash deficit reaches 31.08 billion euros.

half points higher than the rates a month earlier. This increase was even greater for 10-year bonds, reaching 6.98%. Levels that have not been seen since 1997.

Within this uncertain context regarding the trend in sovereign debt market tension, significant divestment can be seen on the part of foreign investors. This has been confirmed by the reduction in their portfolios of Spanish public debt. As can be seen in the graph above, debt owned by non-residents decreased by 26,762 million euros during the first eight months of the year; a phenomenon that has more than likely intensified over the last few turbulent months.

Revenue from direct and indirect taxation decreases in September.

With regards to the future, it is of the utmost importance to reduce the financing costs of public debt, particularly considering the large number of public sector bonds that mature next year, close to 120 billion euros. Otherwise, higher interest payments and the weakness of Spain's economic recovery in the first half of the year will make it difficult to adjust the high fiscal imbalances recorded to date.

In fact, the central government's cash budget for September reveals a certain slowdown in the deficit correction. While the deficit accumulated over the first half of 2011 was 23.7% lower than in the same period a year earlier, figures up to September show a smaller adjustment of 18.1%, placing the deficit at 31.08 billion euros.

The European Commission predicts that the public deficit will represent 6.6% of GDP in 2011.

The reasons for this slower rate of reduction can be found mainly in central government revenue. The application of the new financing system for the autonomous communities means that figures cannot be compared with data from 2010. Nevertheless, if we take the aggregate data for the central government and the communities, there was a significant reduction in September of 6.5% year-on-year. The decreases in revenue from Value Added Tax (VAT) and Company Tax, amounting to 298 and 775 million euros respectively, are the main causes.

With regard to payments, we can see less spending on real public investment compared with the first nine months of 2010, offsetting the rises in spending on personnel and interest payments over the same period.

The public deficit is therefore unlikely to fall below the target set by the stability programme, namely 4.8% of Spanish GDP. As a consequence, there will be no margin to absorb the deficit deviations expected from the rest of the organizations, mainly from the autonomous communities, unlike the situation in 2010. The new forecasts by the European Commission are along the same lines, placing the public deficit for 2011 at 6.6% of GDP, 0.6 percentage points above the government's target.

Should this deviation come about, tension regarding Spain's sovereign debt will remain high over the coming months. Given this possibility, it would be better if the new government chosen in November could act quickly in order to maintain investor confidence.

The sovereign debt crisis takes its toll

Tension in Europe's sovereign debt markets is not diminishing; quite the opposite, in fact. Increasingly more countries are being asked to pay higher interest rates on their public debt by the market. This phenomenon is no longer restricted to the so-called peripheral countries but others such as Austria, Belgium and France have also seen their risk premium go up considerably throughout November. Spain has not been left out of this phenomenon and has also seen a significant rise in the yields demanded for its debt. Consequently, this has made it difficult to adjust public expenditure at a particularly critical time. Reducing the public deficit must be a top priority to stop public debt from entering an expansionary cycle but, at the same time, higher risk premia make this goal difficult to achieve. Within such a situation, two questions become especially relevant: what is the impact of rising risk premia on Spain's public treasury? And, particularly, how much leeway does the Spanish economy have?

This rise in interest rates has been general for all maturities of Spanish public debt, reaching levels similar to 1997. The interest rate for one-year bills, in particular, has risen by 435 basis points (b.p.) since the summer of 2009, standing at 5.1% in November. The increase for 5 and 10-year bills has been less severe, namely 287 b.p. and 256 b.p. respectively. In this last case, of note is the different trend for their German counterparts, whose yield has fallen by 156 b.p. since August 2009. This fall is because German bonds (the bund) are seen as a safe haven, perceived as being risk-free assets. Consequently, they're more in demand at times of greater uncertainty in the markets, making them more expensive in exchange for greater stability. As a result of these different trends, the spread between both yields (commonly known as the risk premium) has increased by 412 b.p. over the last two years.

Given this situation, it's no surprise that the cost of debt due to interest payments is rising. In the first half of 2011, for example, this increased by 26.3% compared with the same period a year ago, partly due to the higher financing costs for debt issues. Another important factor has been the rise in the volume of debt over the last few years: between 2007 and 2010, public debt as a percentage of GDP rose by 25 percentage points, up to 61.0% of GDP.

However, it's important to note that, in spite of this significant increase, debt is still at a relatively moderate level. The average for euro area countries in 2010 was equivalent to 85.6% of GDP. This means that, to date, Spain's cost of public debt has been smaller than in other countries. In 2010, this cost remained stabled at 1.9% of GDP, only above Denmark and at the same level as the Netherlands. Even Germany, with lower financing costs, had a higher interest burden, namely 2.5% of GDP that same year.

However, according to European Commission forecasts, Spain will be one of the countries where this figure will rise the most between 2010 and 2013, specifically by seven tenths of a percentage point of GDP. Only Italy and the three countries bailed out by the European Union (Greece, Ireland and Portugal) will see a higher increase. Given that public deficit adjustment will be progressive, public debt will continue to rise until stabilizing, very probably, at around 75% of GDP.[1] The increase in public debt will therefore be much less than the one seen between 2007 and 2010, but it will continue to push up expenditure due to interest payments.

On the other hand, the interest rate demanded for Spanish public debt is unlikely to fall very quickly to pre-crisis levels and will consequently continue to put pressure on the cost of the debt. In order to determine how much

(1) For more information see Pina J. D.: «Perspectivas de la deuda pública española». "la Caixa" Working Papers.

THE BURDEN OF INTEREST PAYMENTS CONTINUES TO BE ONE OF THE SMALLEST IN EUROPE

Interest payments as percentage of GDP. 2010

SOURCE: European Commission.

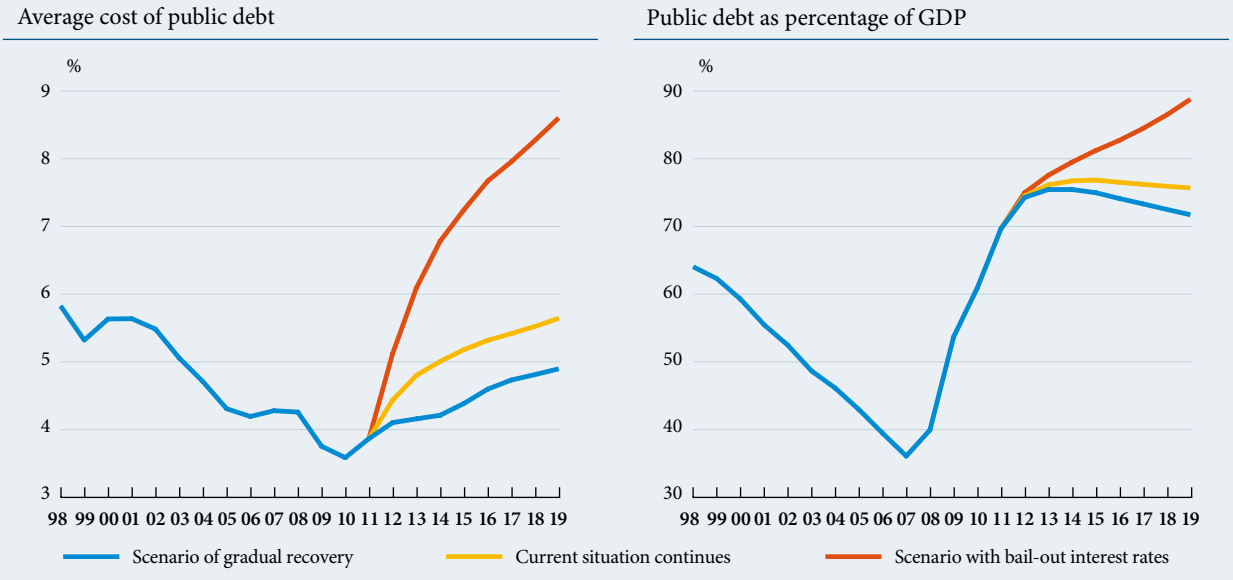
leeway the Spanish economy has, we will analyze three different scenarios.(2) The first assumes that tension in the public debt markets will gradually dissipate throughout 2012 and that, as from 2013, the consolidation of Europe's economic revival will lead the European Central Bank (ECB) to gradually raise the official interest rate. The interest rate for public bonds and bills would therefore fall slightly over the next two years due to the lower risk premium, and would rise again as from 2014 due to the higher ECB reference rate. Within this scenario of gradual recovery, in the long term the yield on 1, 5 and 10-year bonds would be 4.2%, 4.8% and 5.2% respectively, gradually pushing up the average cost to 5.0%, and the interest burden would stabilize at around 3.4% of GDP, a similar level to the one recorded at the end of the last century. Although far above the figure for 2010, this would allow public debt to start to adjust as from 2015.

In our second scenario, we analyze what would happen if the interest rate for public debt remained at today's levels. These are 5.1% for 1-year bills, 5.6% for 5-year bonds and 6.3% for 10-year bonds. Within this context, the average financing rate would be higher than 5.5% and the interest burden would be 7 tenths of a percentage point higher than in the previous scenario, reaching 4.1% of GDP. In this case the public debt does not increase much more than in the first scenario but the higher interest burden makes it more difficult to correct over the long term.

Lastly, we have also analyzed the performance of these variables within a much more adverse context. We therefore assume financing costs for public debt at similar levels to those for Ireland, Greece and Portugal when they were bailed out, with yields of around 6.7%, 11.0% and 10.2% for short, medium and long-term maturities, respectively. Within this scenario, the average cost of public debt would rise rapidly to 9.0% and would lead to an explosion of debt, which would quickly exceed 90% of GDP.

(2) In these three scenarios, we assume that real GDP growth increases gradually, going above 2.0% as from 2014, and that the ECB's reference rate starts to rise as from January 2013, reaching an equilibrium level of 4.0% by 2015.

EXCESSIVELY HIGH YIELDS COULD LEAD TO A SHARP RISE IN PUBLIC DEBT



SOURCES: Ministry of the Economy and own calculations.

This last scenario is obviously less likely but it serves to illustrate just how fast public accounts can deteriorate on encountering rough seas. Both the level of Spain's public debt and its costs are lower than most developed countries. This gives the Spanish economy significant leeway but that doesn't mean it is all plain sailing from now on. The utmost discipline is required in terms of the economy.

This box was prepared by Joan Daniel Pina
European Unit, Research Department, "la Caixa"

Savings and financing

The credit squeeze deepens in the second half of the year

The financial sector faces 2012 in a healthier state and with more capital.

During this year that is now coming to an end, Spain's financial sector has extensively transformed itself. As a result, the banking system is facing 2012 in a healthier state and with a higher level of capital. This achievement should have dismissed investors' doubts regarding the sector's solvency and should have made it easier to access wholesale funding. However, the worsening of tensions in debt markets over the last few months has prevented this from happening. This fact, within a context of weaker economic recovery and private sector deleveraging, has furthered the credit squeeze during the second half of the year.

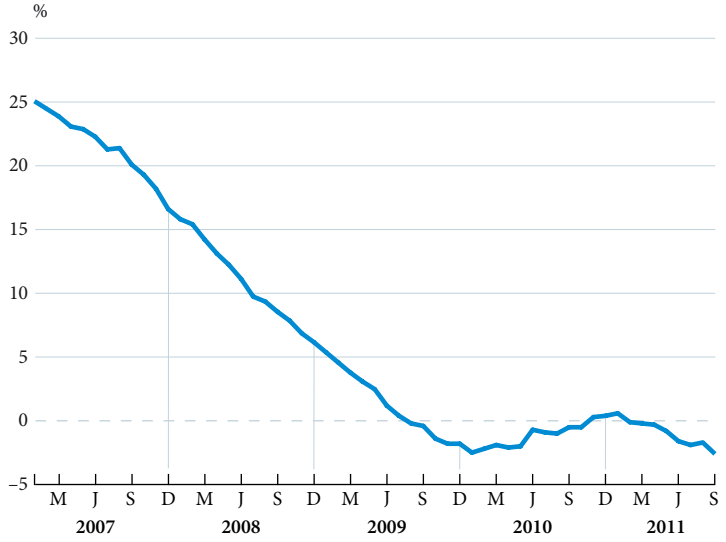
In September, credit to other resident sectors falls by 2.6% year-on-year.

In fact, the standstill in the outstanding balance of credit to other resident sectors in September, a month that typically sees large increases, speeded up the year-on-year drop in credit by 9 tenths of a percentage point, to 2.6%. As can be seen in the graph below, this is the biggest drop since the start of the last economic recession. This credit squeeze is partly due to demand for mortgages being brought forward by households in 2010, resulting from the end of tax incentives to purchase housing.

The bank loan survey published by the Bank of Spain highlights the different factors underlying the credit squeeze in the third quarter of the year. According to the responses from the ten institutions

CREDIT SPEEDS UP ITS RATE OF CONTRACTION IN SEPTEMBER

Year-on-year change in credit to other resident sectors



SOURCE: Bank of Spain.

that take part in the survey, both supply and, principally, demand factors were involved. In the first case, the greater difficulty in accessing wholesale funding and deteriorating prospects of economic growth meant that the criteria applied to grant loans became slightly tougher in the third quarter. But the main reason came from the side of demand. The fall in credit applications between July and September was very big, particularly in the case of households.

As a consequence, private sector financing decreased by 54.77 billion euros in the first nine months of the year, consolidating the deleveraging started in 2010. This trend contrasts with the performance of public sector debt, which grew by 63.7 billion euros over the same period.

Looking to the future, we expect the underlying factors applying downward pressure to credit will continue for the remainder of the year and this will bring the year-on-year drop in credit to almost 4.0% by December 2011. If the economic pulse remains weak and problems in the economic and financial arena do not improve next year, credit will continue to fall significantly.

We expect credit squeezes in 2011 and 2012.

Within this context of a drop in credit and the slight deterioration in the labour market, many are now looking to the trend in the doubtful debt ratio. This remained practically stable in September at 7.16%. However, our forecasts point to further rises over the coming months due to the deterioration in the real estate portfolio.

In fact, Spanish banks' high and problematic exposure to the real estate sector represents the main risk they must face. According to the Bank of Spain's Financial Stability Report, in June 2011

The doubtful debt rate remains stable at 7.2%.

FINANCING OF NON-FINANCIAL SECTORS (1)

September 2011

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,153,800	–54,765	–1.7	75.3
Non-financial corporations	1,274,184	–35,817	–1.9	44.6
Resident credit institution loans (3)	*854,522*	*–42,953*	*–4.2*	*29.9*
Securities other than shares	*64,869*	*3,882*	*7.9*	*2.3*
External loans	*354,793*	*3,254*	*2.4*	*12.4*
Households (4)	879,616	–18,948	–1.4	30.8
Housing loans (3)	*671,799*	*–8,160*	*–0.7*	*23.5*
Other (3)	*204,404*	*–10,881*	*–3.5*	*7.1*
External loans	*3,413*	*93*	*6.2*	*0.1*
General government (5)	705,504	63,702	13.7	24.7
TOTAL	**2,859,304**	**8,937**	**1.9**	**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 main risks to banks' solvency are their high exposure to the real estate sector and to public debt.

doubtful, foreclosed and standard assets under supervision related to property development totalled 176 billion euros. Certainly a high figure, but it's important to bear in mind that provision coverage (specific and general) accounts for 33% of these assets. This ratio would be enough to cover any hypothetical losses resulting from the standard scenario of July's stress tests, although not a more adverse scenario.

Along the same lines is the exposure of Spain's banks to peripheral sovereign debt (Italian, Greek, Portuguese and Irish) that, at December 2010, was equivalent to 0.4% of all assets. Unlike what has happened in other banking systems, this figure does not seem to entail any significant risk to the strength of Spain's financial system. Only a reduction in the value associated with Spain's public debt, accounting for 6.9% of banking assets, would actually affect their solvency.

With regard to liquidity tensions, the closure of wholesale funding markets might make it difficult to renew the more than 120 billion euros of bank debt that matures in 2012. In this respect, the one-year liquidity auction of the European Central Bank (ECB) to be held this December will help to ease this risk.

In short, Spain's banking sector is saying goodbye to 2011 in a stronger state. Nevertheless, market tensions and less economic activity are the main risks that could affect the sector in the coming year. All this within a situation of private sector deleveraging that will continue to restrict credit.

Deposits fall in September

Deposits of firms and households fall by 1.1% year-on-year in September.

Within this context of tension in wholesale funding markets, deposit institutions are modifying their liability structure. This has led to greater appeal for private deposits, increasing the fixed-term deposits attracted. However, the data available up to September show a 1.1% reduction in the deposits of Spanish households and firms compared with the same month a year ago. An analysis of the different bank liabilities show that this drop has occurred in both short-term instruments (including sight and savings deposits) as well as long-term. The reasons for this fall are mostly due to bank deposits being replaced with

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

September 2011

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	262,154	388	0.1	5,815	2.3	18.8
Savings deposits	199,648	–11,639	–5.5	–8,870	–4.3	14.3
Term deposits	724,843	–18,806	–2.5	–9,810	–1.3	52.0
Deposits in foreign currency	18,403	–979	–5.1	–360	–1.9	1.3
Total deposits	**1,205,049**	**–31,036**	**–2.5**	**–13,225**	**–1.1**	**86.5**
Other liabilities (*)	**187,588**	**–15,424**	**–7.6**	**–9,011**	**–4.6**	**13.5**
TOTAL	**1,392,637**	**–46,459**	**–3.2**	**–22,236**	**–1.6**	**100.0**

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

another kind of financial instrument offering a higher yield.

In fact, the higher risk premium associated with Spain's public debt has pushed up yield on issues carried out over the last few months. This has diverted funds from households and firms towards these instruments and has turned the Spanish public sector into a tough competitor for banks.

Given this situation and the need to secure funding, Spain's banks are being forced to increase the yield offered by their products. An increase that, in the case of deposits, is limited by the decree law that, since July, has regulated the interest rates that can be offered by financial institutions. This can be seen in the trend in interest rates of banks' new liabilities operations. In September, this stood at 1.7%, one tenth of a percentage point above the figure recorded the previous month.

July's decree law curbs rising interest rates.

Moreover, the cut in the ECB reference rate has reduced the margin to increase the yield on liabilities over the coming months. As a consequence, banks themselves are designing new products that do not come under this directive, allowing them to secure resources from firms and households, as is the case of commercial paper.

For their part, mutual funds are maintaining the trend started in April 2011, with net new withdrawals totalling 891 million euros.

The higher yield on Spain's public debt represents tough competition for banks.

"la Caixa" Research Department

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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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