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THE SPANISH ECONOMY

Monthly Report

NEW FISCAL RULES FOR THE EURO

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2010	2011	2012	2010		2011			
				3Q	4Q	1Q	2Q	3Q	4Q
INTERNATIONAL ECONOMY		Forecast							Forecast
Gross domestic product									
United States	3.0	1.7	2.0	3.5	3.1	2.2	1.6	1.5	1.6
Japan	4.5	–0.8	1.6	5.2	3.3	0.0	–1.7	–0.8	–0.7
United Kingdom	2.1	0.9	0.7	3.0	1.7	1.7	0.6	0.5	0.8
Euro area	1.8	1.5	–0.4	2.0	2.0	2.4	1.7	1.4	0.8
Germany	*3.6*	*3.0*	*0.5*	*4.0*	*3.8*	*4.6*	*2.9*	*2.6*	*1.8*
France	*1.4*	*1.6*	*0.1*	*1.6*	*1.4*	*2.2*	*1.7*	*1.5*	*0.8*
Consumer prices									
United States	1.6	3.1	1.9	1.2	1.2	2.2	3.3	3.8	3.3
Japan	–0.7	–0.3	0.2	–1.0	–0.3	–0.5	–0.4	0.2	–0.3
United Kingdom	3.3	4.5	2.7	3.1	3.4	4.1	4.4	4.7	4.7
Euro area	1.6	2.7	1.6	1.7	2.0	2.5	2.8	2.7	2.9
Germany	*1.1*	*2.3*	*1.7*	*1.2*	*1.5*	*2.1*	*2.3*	*2.4*	*2.4*
France	*1.5*	*2.1*	*1.8*	*1.5*	*1.6*	*1.8*	*2.1*	*2.1*	*2.4*
SPANISH ECONOMY		Forecast							Forecast
Macroeconomic figures									
Household consumption	0.7	0.0	–0.9	0.8	0.8	0.5	–0.3	0.4	–0.7
Government consumption	0.2	–1.5	–5.5	0.2	–0.9	0.4	–1.7	–2.3	–2.3
Gross fixed capital formation	–6.2	–4.8	–7.2	–5.5	–5.4	–4.9	–5.5	–4.2	–4.5
Machinery and capital equipment	*5.5*	*2.1*	*–4.7*	*7.5*	*5.8*	*5.8*	*1.6*	*2.5*	*–1.6*
Construction	*–10.1*	*–7.8*	*–8.3*	*–9.5*	*–9.3*	*–9.3*	*–8.4*	*–7.4*	*–6.0*
Domestic demand (contribution to GDP growth)	–1.0	–1.4	–3.2	–0.7	–0.9	–0.7	–1.7	–1.2	–1.9
Exports of goods and services	13.5	9.0	1.5	11.8	14.9	13.9	8.7	8.1	5.4
Imports of goods and services	8.9	1.3	–5.9	7.0	8.0	7.1	–0.7	0.8	–2.0
Gross domestic product	**–0.1**	**0.7**	**–1.0**	**0.4**	**0.7**	**0.9**	**0.8**	**0.8**	**0.3**
Other variables									
Employment	–2.6	–1.9	–3.6	–2.0	–1.4	–1.4	–1.1	–1.9	–3.3
Unemployment (% labour force)	20.1	21.6	24.1	19.8	20.3	21.3	20.9	21.5	22.9
Consumer price index	1.8	3.2	1.4	1.9	2.5	3.5	3.5	3.1	2.8
Unit labour costs	–1.5	–1.0	0.1	–1.9	–2.3	–1.5	–1.5		
Current account balance (% GDP)	–4.5	–4.0	–2.5	–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	–2.0	–3.1	–2.6	–5.9	–2.4	–2.2	–2.6
General government financial balance (% GDP)	–9.3	–8.2	–5.5	–7.9	–13.4	–5.3	–9.9	–6.1	
FINANCIAL MARKETS		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	2.0	2.8	2.8	3.4	3.2	2.4	2.0
10-year German bonds	2.8	2.6	2.2	2.4	2.6	3.2	3.1	2.3	2.0
Exchange rate									
$/Euro	1.33	1.39	1.26	1.29	1.36	1.37	1.44	1.41	1.35

Contents

New fiscal rules for the euro

At the end of the 1950s, the core of what is now the European Union embarked on the path towards creating a common market. From that it went on to a single market and, in the 1990s, the construction of Economic and Monetary Union took shape: closely linked economic integration emphasising the coordination of economic and, most particularly, fiscal policy. The ultimate aim was the creation of a single currency. The start-up of the euro and the founding of the European Central Bank represented the culmination of this singular process of supranational integration.

The euro worked normally during its first decade and even largely protected its members from the turbulences of the 2008-2009 crisis. But, contrary to what some people had expected, it did not help economies converge in terms of productivity or external competitiveness, for example. It even widened some imbalances, such as the external deficit and asset bubbles.

The basic component of monetary union, as it had been designed in Maastricht, also failed: fiscal discipline. The survival of the single currency relied on support from healthy public finances in each and every one of the countries in the euro. To this end, the Stability and Growth Pact was agreed, a fiscal rule that was to ensure excessive public deficits would be a thing of the past. The Member states of the euro kept control of their fiscal policy but with perfectly demarcated limits and accountability.

Or perhaps not. In practice, the Pact's supposed discipline had already become diluted in 2003 and, in retrospect, the rule's effectiveness was deficient. Structural public deficits continued in many countries so that, when the global crisis hit their economies, the deficits scaled unexpected heights. The little leeway gained during the boom years quickly ran out due to the action of automatic stabilizers, the emergency aid given to the banking sector and fiscal stimuli provided to offset the fall in aggregate demand. Once financing markets closed their doors and there was no last resort provider of liquidity, the serious state of public finances in some euro area countries became critical. Bail-outs for Greece, Ireland and Portugal attempted to avoid bankruptcy and the collapse of the euro area.

But, although extremely important, resolving the immediate problem of countries with liquidity or solvency problems is not the only dilemma. The question is what must be done to stop this from happening again. The European Union's initial response has been to remodel the mechanisms of economic and budget coordination: a reinforced Stability and Growth Pact together with stricter and more forceful corrective and preventative measures. Moreover, at December's summit, the Council decided to raise the fiscal rules to the status of a treaty, firmly entrenching the principle of budget stability. This is an important step but it is not enough. The institution or process to provide liquidity in the last resort still needs to be defined within the monetary union. The current bail-out fund and the one that will come into force this year are insufficient as they currently stand. The «communitarization» of debt or transferring this function to the European Central Bank are options that arouse controversy. Real progress towards greater fiscal integration would require a parallel advance in political integration, a challenge that must be faced by the European Union.

EXECUTIVE SUMMARY

Does fiscal adjustment jeopardize growth?

The sovereign debt crisis is leading the euro area into another recession.

The world economy is going through quite a weak period in terms of growth, which might continue until the middle of the year. However, economic indicators for the United States point to a reasonably energetic domestic demand, Japan is embarking on its recovery after a complicated 2011 and the emerging countries are suffering a less pronounced slowdown than had been feared. The most delicate situation is still in Europe. The European authorities have yet to satisfactorily tackle the sovereign debt crisis, which is leading the euro area into another recession. For their part, financial markets seemed to be pointing to a slight recovery in January, although the predominant tone is still one of uncertainty.

The United States grows moderately while the emerging economies slow up less than feared.

Less vigorous activity in the second half of 2011 and deteriorating expectations have led the International Monetary Fund (IMF) to cut back its growth forecasts for 2012 compared with the ones announced in September. But not for the United States, which it still expects to grow by 1.8%. In the case of the emerging economies, the downward revision is 0.7 percentage points, to 5.4%, but with appreciable growth from China (8.2%), India (7.0%) and Brazil (3.0%). The sharpest revision is in the euro area with a slight recession predicted for 2012 (–0.5%). The reasons given for this development are the rise in and persistence of high risk premia for sovereign debt, the effects of bank deleveraging on the real economy and the impact of the fiscal consolidation announced for some Member states. In this respect, Olivier Blanchard, chief economist at the IMF, has warned, referring to Europe, that «excessive fiscal adjustment will undermine activity even further, will diminish citizens' support for adjustment and reduce market confidence».

In the United States, expansionary policies are not completely withdrawn...

The dilemma of whether to reduce the public deficit or keep to a minimally expansionary policy in order to consolidate recovery is much less pressing in the United States. Its fiscal leniency, which in 2010 and 2011 supported the recovery in activity, will continue to fall in intensity due to the levels of debt reached. But the possible approval, in February, of an extension to tax exemptions for contributions paid by companies for their employees and in unemployment insurance will help to underpin a growth that still needs some assistance. In any case, it is estimated that growth in gross domestic product (GDP) for the fourth quarter reached 0.7% quarter-on-quarter and 1.6% year-on-year, which would leave the total growth for 2011 at 1.7%. This performance is supported by the improved labour market, outstripping the expectations of just two months ago. It has made an appreciable contribution to the rise in the sentiment of consumers, who account for 71% of GDP.

However, consumer and business confidence remains low in the euro area due to the high uncertainty, leading to decisions on expenditure being postponed. The main problem lies in the lack of a resolution for the euro area's sovereign debt crisis. Fiscal pact

negotiations started at December's summit made slow progress in January. The president of France, Nicolas Sarkozy, and the German chancellor, Angela Merkel, have said they are satisfied with the advances being made but the details are unknown. On the other hand, private creditors and the Greek government have yet to reach an agreement regarding the size of the write-down for Greek debt, although some progress does seem to have been made.

In this uncertain atmosphere, the credit rating agency Standard & Poor's (S&P) downgraded its rating for nine countries. Among these, France and Austria have fallen by one notch, from the maximum of AAA to AA+. Due to the loss of the top credit rating for several member states of euro area, the agency has also reduced to AA+ the rating for the bail-out fund, the European Financial Stability Facility. This resulted in an irate response from the Eurogroup and the European Central Bank (ECB), believing this decision to be arbitrary and damaging to the current efforts to stabilize unrest in the euro area.

Paradoxically, this rise in the euro area's risk profile has not affected these countries' sovereign debt issuances, managing to sell their assets at lower interest rates than in issuances prior to S&P's announcement. The reason for this probably lies in the fact that the market had already incorporated these decisions in the price of financial assets.

Things have also been made easier by the policy applied by the ECB, the agent that is providing most support to stabilize the euro area. This assistance is given via a series of unconventional measures whose aim is to reduce the problems encountered by Europe's banks in securing funding and consequently the problems for the real economy. Among these measures, of note are unlimited liquidity lines at a fixed interest rate, provided by the ECB since last year. The two liquidity auctions approved at the last meeting in December are a good example of this, with a three-year maturity. According to the ECB, the result of the first tender, held towards the end of 2011, was a success in terms of demand from Europe's banking sector and its effects are helping to improve banks' funding conditions and to restore investor confidence. These results will probably be reinforced by the next three-year liquidity injection, planned for February.

...while confidence remains at a minimum in the euro area.

But this momentary revival in the government bond market does not resolve the fundamental question, which is whether the countries of the euro area will be able to consolidate their national accounts in a context of lower growth or even recession. In other words, there is the risk that the additional cuts announced in countries such as Italy and Spain, among others, might damage economic activity and set off a negative spiral. To make matters more complicated, the need of Europe's banking system to recapitalize in such a context might mean that the credit squeeze for the private sector will continue for more months than would be desired, making it difficult to exit the crisis. This places the euro area in a decidedly complex situation that will have to be tackled by policymakers sooner rather than later, perhaps by relaxing the requirements for fiscal adjustment and bank recapitalization, as well as providing measures to boost activity.

The ECB provides liquidity, improving the financing terms for sovereign debt and banks.

Within this context, the evolution of the dollar-euro exchange rate has once again come down in favour of the US currency over the last few weeks. The dollar's cumulative appreciation since its record low in May 2011 (1.482 dollars per euro) has risen to almost 13%. The euro has also lost value against other currencies. This is the case of the euro exchange rate with the

The question is whether the euro area countries can eliminate public deficit in a context of lower growth and even recession.

The Spanish economy is facing another recession, with unemployment and public deficit at very high levels.

Japanese yen, which reached 99.65 yen per euro, this being the highest value for Japan's currency in twelve years.

With regard to the Spanish economy, available business indicators, especially for the end of 2011, confirm that the recession is underway and the question is now how long it will last and how deep it will go. The rapid deterioration in the economic situation during the second part of last year has led to a slight correction in forecasts for 2012 and 2013. Both the IMF and the Bank of Spain agree that the scenario will be recessionary in 2012, although not as intense as the one in 2009. It should be noted that, in that year, GDP fell by 3.7%, stabilized at –0.1% in 2010 and managed to grow by 0.7% in 2011. The seriousness of the current relapse stems from the fact that it is occurring at a time when unemployment is at a peak and the public deficit is too high, unlike the situation at the start of the 2008-2009 recession.

The new government has adopted measures to cut spending and raise taxes.

The reasons behind the sombre outlook for the current year lie firstly in the slowdown in European growth, the main export market for Spanish goods and services. Moreover, the uncertainty of financial markets regarding the resolution of the euro area crisis and the need to sort out financial institutions will make it difficult for credit to circulate. Lastly, the requirement to correct the excessive public deficit means that budgets are squeezing spending.

In this respect, it should be noted that the new government formed after November's elections has confirmed a significant deviation of 2011's public deficit compared with the target set. Specifically, forecasts by the new government place the deficit at around 8% of GDP, while the target was 6.0%. Should this figure be confirmed, it would mean that a greater effort will have to be made in 2012 in order to meet the target set by Brussels, which is 4.4%. The government has stated that it is totally committed to the budget stabilization programme and has therefore already presented a battery of measures. These particularly include a hike in personal income tax and in the tax on housing, in addition to spending cuts.

The measures announced represent a saving of 15 billion euros. But in order to reduce the deficit from 8% of GDP to 4.4% in 2012, this correction must exceed 40 billion euros. New, far-reaching measures will therefore be announced over the coming weeks and, particularly, in the approval of the 2012 budget, which will take place in March. Unless the European authorities realize that, in the current recessionary environment, undertaking intense fiscal adjustment makes it more complicated to resolve the crisis. It could even have the opposite effect because, as we have already mentioned, the short-term impact of these actions on growth could be clearly negative.

Wage moderation and advances in structural reforms will boost firms' competitiveness and flexibility.

However, we should remember that, in the medium and long term, these measures will have a positive effect on growth. Not only because a healthy economy is better able to undertake sizeable projects but also due to the improved credibility this would produce in international markets. The commitment to wage moderation reached at the end of January by unions and firms is also along these lines. An agreement that should encourage greater corporate competitiveness and greater flexibility to adapt to the currently complicated environment. The government is also contemplating far-reaching structural reforms that will come to light over the coming months and are also along these lines.

26 January 2012

CHRONOLOGY

2011

January	**1**	Estonia joins the **euro area**, which grows to seventeen member states.
	14	Ben Ali's regime in Tunisia falls, the first in a chain of **political changes** in North Africa and the Middle East, with repercussions for oil prices.
February	**2**	Signing of the **Social and Economic Agreement** by the government, trade unions and employers, including pension reform.
	18	The government passes a Decree-Law to reinforce the solvency of **financial institutions**.
March	**25**	The **Euro Plus Pact** is approved and the foundations are laid to set up the **European Stability Mechanism** in the European Council.
April	**7**	The **European Central Bank** raises the official interest rate to 1.25%.
May	**17**	The Council of Economic and Finance Ministers of the European Union approves the **financial bail-out plan for Portugal**, totalling 78 billion euros.
	22	**Elections** are held in thirteen autonomous communities and in the municipalities.
June	**10**	The government approves a Decree Law that **reforms collective bargaining**.
July	**7**	The **European Central Bank** raises the official interest rate to 1.50%.
	21	The countries of the euro area approve a second **bail-out plan for Greece** among other measures to tackle the sovereign debt crisis.
August	**16**	The leaders of Germany and France, Angela Merkel and Nicolas Sarkozy, propose that **the euro area's institutions should be reinforced** by a series of mechanisms to improve coordination of economic policy.
	19	The government approves a package of **economic policy measures**, advancing the payment of corporate tax for large firms, rationalizing pharmaceutical expenditure and a temporary reduction in VAT for new housing.
	30	The Congress agrees to reform the Constitution to introduce the principle of **budgetary stability**.
September	**22**	The Spanish government ratifies Royal Decree Law 13/2011, which re-establishes **wealth tax** for 2011 and 2012.
October	**26**	The euro summit agrees to launch a **new aid programme for Greece**, with a write-down of 50% of the debt for private investors, to substantially enlarge the lending capacity of the EFSF and to raise the Core Tier 1 **capital ratio of banks** to 9%.
November	**3**	The **European Central Bank** lowers its official interest rate to 1.25%.
	20	The Partido Popular wins the **general elections** with an absolute majority.
December	**8**	The **European Central Bank** lowers the official interest rate to 1.00% and announces two extraordinary auctions of liquidity at 36 months, a widening of the assets accepted as collateral and a reduction in the reserve ratio.
	9	The **European summit** seals a pact to ensure **greater fiscal discipline** by means of a treaty that would involve the 17 members of the euro area plus other EU states that wish to join the agreement.
	30	The government approves a package of **economic policy measures** that includes spending cuts and tax hikes.

2012

January	**25**	Social agents sign a **wage moderation agreement** valid from 2012 to 2014.

AGENDA

February

- **2** Registration with Social Security and registered unemployment (January).
- **8** Industrial production index (December).
- **9** Governing Council of the European Central Bank.
- **15** CPI (January). EU GDP flash estimate (fourth quarter).
- **16** Quarterly National Accounts (fourth quarter).
- **21** International trade (December).
- **24** Producer prices (January).
- **29** GDP flash estimate (February).
  Balance of payments (December).
  EU HICP (January).

March

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

INTERNATIONAL REVIEW

The United States: better and with a modest 2012

The United States grows by 0.7% in the fourth quarter.

The US economy is consolidating its recovery and stands at the head of the advanced economies. As this report goes to press, the Department of Trade announced that growth in gross domestic product (GDP) for the fourth quarter picked up to 0.7% quarter-on-quarter, 1.6% year-on-year, leaving the growth figure for the whole of 2011 at 1.7%. This consolidation is supported by an improved labour market, which is exceeding the expectations held just two months ago and has contributed greatly to the improvement in the sentiment of consumers, who account for 71.0% of GDP. But consolidation does not mean abundance. The strength of the fourth quarter, based on a low savings rate and an upward cycle of stock, should give way to growth with a more modest tone. The advance for the whole of 2012 is therefore unlikely to exceed 2.0%. There are various reasons for this low profile. Most importantly, household income continues to increase unhurriedly, so that consumer spending should return to the fold in the first quarter of 2012.

The deleveraging of household debt will also continue, whose gross debt stood at 114.1% of disposable income in the third quarter of 2011, lower than the peak of 129.9% of September 2007 but still above

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	–3.5	3.0	3.1	2.2	1.6	1.5	–	1.6	–
Retail sales	–7.0	6.4	7.6	8.2	7.8	8.0	7.5	7.0	6.5
Consumer confidence (1)	45.2	54.5	57.0	66.9	61.8	50.3	40.9	55.2	64.5
Industrial production	–11.2	5.3	6.2	5.4	3.8	3.7	4.4	3.8	2.9
Manufacturing (ISM) (1)	46.3	57.3	57.9	61.1	56.4	51.0	50.8	52.7	53.9
Housing construction	–38.4	5.6	–5.1	–5.3	–4.9	5.3	16.3	24.3	24.9
Unemployment rate (2)	9.3	9.6	9.6	9.0	9.0	9.1	8.9	8.7	8.5
Consumer prices	–0.4	1.6	1.3	2.1	3.4	3.8	3.5	3.4	3.0
Trade balance (3)	–381.3	–500.0	–500.0	–520.4	–536.0	–540.5	–544.3	–553.2	...
3-month interbank interest rate (%)	0.7	0.3	0.3	0.3	0.3	0.3	0.4	0.5	0.6
Nominal effective exchange rate (4)	77.7	75.4	73.0	71.9	69.6	69.8	71.6	72.2	73.2

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

the range of 90-100 for the long-term trend. The cost of oil, whose price is refusing to fall, won't help to relieve consumer budgets either. Thirdly, Europe's debt crisis will also be a burden on growth by deteriorating the trade balance and financial conditions. Lastly, fiscal expansion, which supported activity in 2010 and 2011, will continue to lose steam due to the levels of debt reached. But the possible approval, in February, of an extension to the tax exemptions for contributions paid by companies for their employees and in unemployment insurance will help to underpin a growth that still needs some assistance.

For 2012, advances will moderate due to stagnation in revenue and the European crisis.

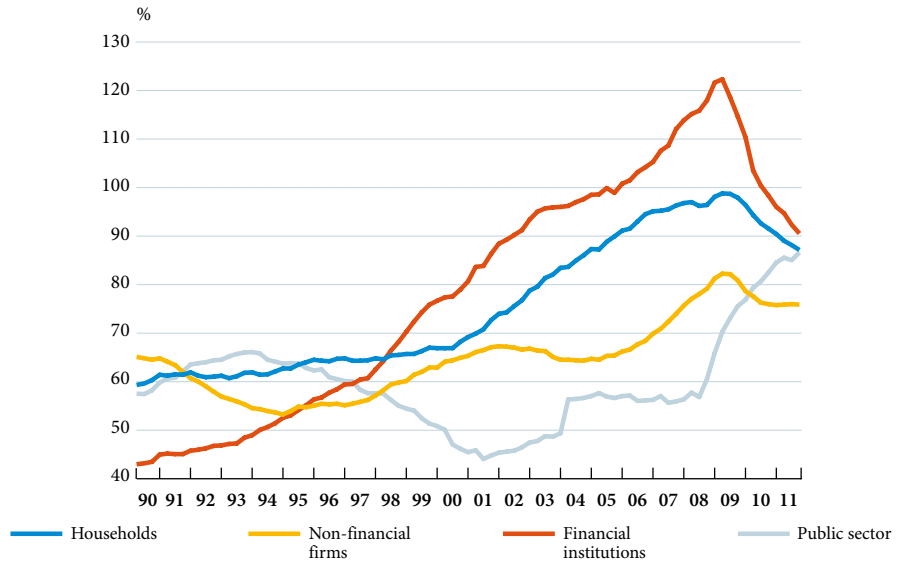
The latest indicators for economic activity show the upswing in private consumption slowing down. The first sign of this came from national accounts. Household income came to a standstill in November at the same time as private consumption grew by a meagre 0.1% compared with October. With this, the savings rate fell to 3.5% of disposable income, the lowest level since December 2007. The Christmas campaign was also worse than Thanksgiving, with retail sales without cars or petrol falling by 0.1% in December compared with November's figures. On the plus side for consumption, the incipient improvement in the labour market continues to encourage more optimistic sentiment among consumers. The Conference Board Consumer Confidence index advanced in December to 64.5 points, the highest since April 2011 and far above the 40.9 points of October, although it's true that today's level is still more typical of recession than expansion.

Beyond the ups and downs of private consumption, the labour market is where the most significant improvement is taking place in the economy. The true measure of how 2012 will turn out will be whether employment continues to

The upswing in consumption slackens but consumer confidence continues to improve.

THE UNITED STATES: TAKING OVER FROM THE PUBLIC SECTOR BUT WITH AN UNCERTAIN FUTURE

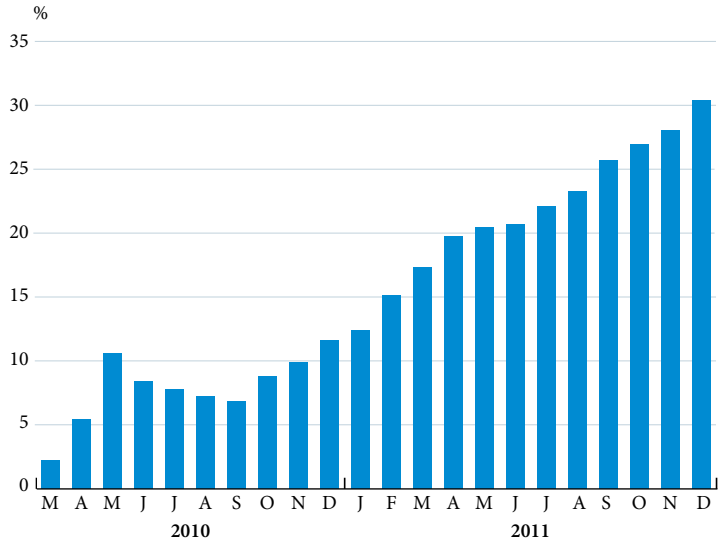
Credit debt as percentage of nominal GDP



SOURCES: Federal Reserve and own calculations.

THE UNITED STATES: EMPLOYMENT CONTINUES TO IMPROVE BUT STILL HAS A LONG WAY TO GO

Net jobs created, cumulative since the start of the recovery (*)



NOTE: (*) As a percentage of the total jobs lost during the crisis.
SOURCES: US Census and own calculations.

The labour market improves, with unemployment down to 8.5% and under-employment falling.

improve. The unemployment rate fell again in December, ending the year at 8.5%, a level clearly lower than the one expected in summer. Although this drop in unemployment is partly due to a reduction in the labour force, 1.64 million net jobs were created in 2011 and more than two million since the start of the recovery. The rapid drop in under-employment is also significant; i.e. those workers who are working part-time involuntarily, which went from 9.1 million in September to ending the year slightly below 8 million, the lowest since January 2009. The rise in the number of hours worked, a leading indicator of the fall in under-employment, also rose slightly, suggesting this trend will continue. Nonetheless, the job market still has a long way to go before it recovers completely. The jobs created in 22 months of recovery represent just 30.3% of the 8.75 million jobs lost during the crisis, while the purchasing power of wages ended 2011 below the level reached at the end of 2010.

Business sentiment is in line with growth slightly above 2%.

The business climate is in line with this situation of growth that, although moderate, is becoming firmer. The business sentiment indices of the Institute of Supply Management (ISM) for manufacturers and services continued to improve, although still not far from the reference level of 50 points. The respective levels of 53.9 points in manufacturers and 56.2 in services are typical of relatively modest growth, close to 2.5%. Industrial production, which livened up a little in December, is enjoying a slight recovery that is somewhat more robust than the one in 2002-2007 but far below the boom in the 1990s. With a similar profile, industrial capacity utilization continued to improve up to 78.1%, although this also reveals that a large amount of resources are still idle.

The oversupply that is still affecting the housing market is stopping it from reaping the benefits of this incipient improvement in the job market. The price of real estate is close to bottoming out.

The relationship between median housing prices and household income shows a return to normality, so that real estate prices can be considered as reasonable. However, it's one thing to be close to bottoming out but a very different thing to move away from this bottom. Surplus supply and credit conditions are hindering recovery. The Case-Shiller index for second-hand housing continued to slide downwards in October, while new homes started in December, at a lower level than half the average for the period 1995-2000, prior to the bubble, disappointed by falling compared to November. Even if the unemployment rate continues to fall throughout 2012, which should eventually result in a fall in non-performing loans and, consequently, in the surplus supply of housing, we are unlikely to see any signs of improvement in the sector before 2013.

For its part, inflation continues to fall slightly due to the persistent low utilization of production resources. This trend should become sharper over the coming months due to the base effects of oil prices that, should they remain at their present level, will go from year-on-year increases of 28.0% and 16.9% in November and December 2011, respectively, to a drop of close to 5% in March 2012. This should curb the rise in the consumer price index (CPI). This process has already started, with December's CPI rising by 3.0% compared with 3.4% in November. Similarly core inflation, which excludes energy and food prices, also rose by 2.2% year-on-year. But the trend is downwards, with an end to the boost provided by imputed rent and the upswing in durables due to the effects of Japan's tsunami. All this leaves space for new expansionary policies by the Federal Reserve in the case of a decline in demand's growth.

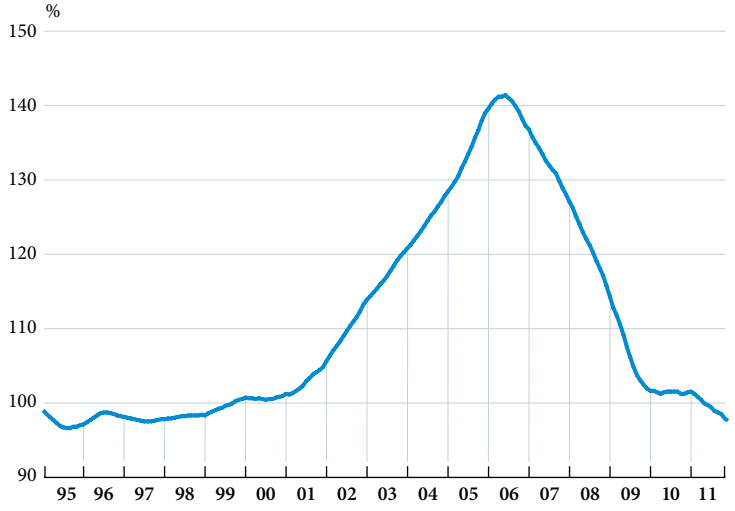
Housing prices almost touch bottom but their recovery will have to wait until 2013.

In the foreign sector, the correction in the trade imbalance has halted due to a slowdown in world demand. The trade balance for goods and services in

The CPI is up 3.0% and core inflation by 2.2%, but 2012's trend will be one of moderation.

THE UNITED STATES: HOUSING RETURNS TO REASONABLE PRICES

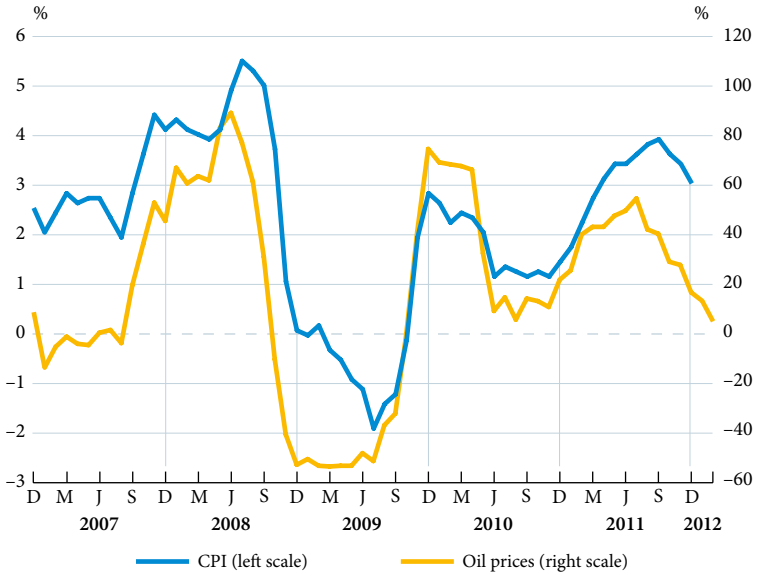
Median second-hand house prices divided by median household income (*)



NOTE: (*) Average last 12 months. Base 100 = average 1980-2000.
SOURCES: National Association of Realtors, Thomson Datastream and own calculations.

THE UNITED STATES: OIL WILL PULL THE CPI DOWN

Year-on-year change in CPI and oil prices (*)



NOTE: (*) One-month Brent contracts.
SOURCES: Department of Trade, Thomson Reuters Datastream and own calculations.

The trade deficit widens due to a decline in exports.

November was 47.8 billion dollars, 10.4% above the figure for October. This deterioration was mainly due to the drop in exports, down for the second month in a row. Weak global demand will mean that, in 2012, the foreign sector's contribution to growth will be negative, or zero in the best case scenario. Growth will therefore have to depend on domestic demand, which will look for support from the confirmation of recovery in employment.

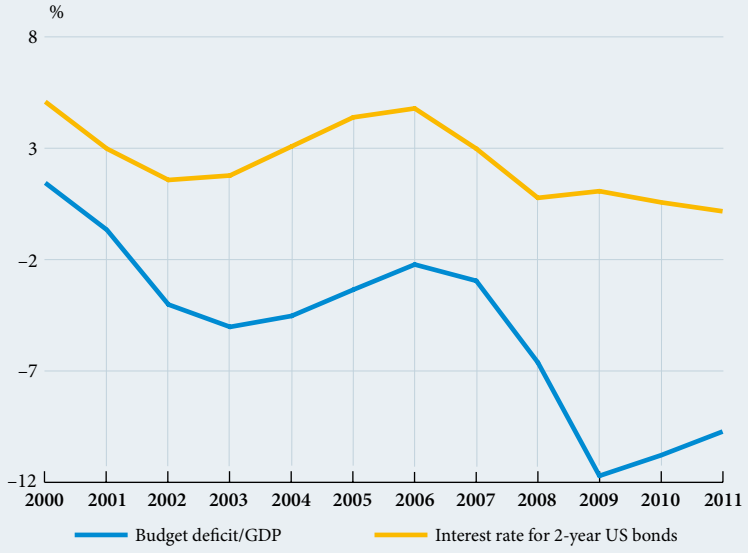
The case of debt in the United States: a movie with a happy ending?

While all the spotlights have been turned on the European sovereign debt crisis, behind the scenes the United States has been trying to establish a fiscal policy that ensures its public debt is sustainable. Although the actors in the drama are the same on both sides of the Atlantic, namely a large deficit and the debt ratio, the United States' commitment to growth represents quite a different strategy to the paradigm of austerity prevailing on the Old Continent. For the moment, the European script has moved the US plot into the background. It might, however, soon get a bigger audience.

According to IMF estimates, the United States ended 2011 with a deficit close to 10% and a debt that is dangerously near 100% of GDP. At the other extreme, Germany is trying to gradually reduce its debt nowadays close to 83%,

THE UNITED STATES HAS BECOME A SAFE HAVEN AGAINST FINANCIAL STORMS

Budget deficits and interest rates in the United States



SOURCES: Bloomberg and Thomson Reuters Datastream.

in spite of having a deficit estimated at 1.7%. Meanwhile, in Spain, the current government is justifying its adjustment programmes after estimating 2011's deficit at close to 8% and its debt around 70% of GDP.

The US libretto is hoping to use debt to set up an expansionary policy and thereby return to the path of growth. Such growth would mean that the future interest on debt could be paid. In Europe the strategy is the opposite; reducing deficit and controlling debt so that the economy can grow again once it is no longer burdened.

For the present, the markets are rewarding the US approach and the consensus of analysts expects the United States to grow by close to 1.8% in 2012 while the euro area will enter into recession (with an estimated fall of 0.3%). For investors, the United States has become a safe haven as, since the start of the crisis, yields on US bonds have fallen to record lows, even paying out negative returns. Apart from the liquidity injection carried out by the Federal Reserve, global uncertainty has acted as a balm on the United States' national accounts.

Unlike the countries in the euro area whose solvency is being questioned (Greece, Portugal, Ireland, etc.), the United States enjoys enough political credibility to adjust its national accounts when necessary and, at present, few doubt its capacity to grow, based on its greater dynamism and flexibility; although its position is weakening on both fronts.

On the one hand, the United States' growth potential might have been harmed. The bursting of the real estate bubble, the deleveraging of the economy and also less spending on infrastructures, which the country will have to tackle at some point, precisely because of the reduction in the deficit, will damage its capacity to grow. In fact, the Congressional Budget Office, the government body that provides Congress with objective budgetary information, places US growth at around 2.5% as from 2016. This is lower than the growth rate for the last 30 years, specifically 3.0%.

On the other hand, as time passes the United States is running out of leeway to adjust its national accounts. Already in 2010, a Congressional Committee[1] warned that «Our nation is on an unsustainable fiscal path», and recommended to start extensive adjustments to achieve a public deficit of 2.3% by 2015. The Congressional Budget Office estimates that, should the current fiscal policy be continued, federal debt (which accounts for almost 70% of US public debt and is legislated directly by Congress) would reach almost 100% of GDP in 2020 and interest would total a trillion dollars the same year (equivalent to 4.1% of GDP in 2020). The graph below shows in yellow (alternative scenario) the path that debt would take if no measures were implemented.

Moreover, one of the pillars that might sustain the credibility of fiscal policy is seriously in doubt. The United States has a debt ceiling (the maximum amount that can be reached every year by the central government's debt, known as Federal debt in the United States) which needs Congress's approval to be raised. However, this ceiling does not represent any effective limit as it has been increased without any major complications almost every time this has been necessary.

In addition to being far from an instrument to control public finances, the debt ceiling is actually making it difficult to define a fiscal adjustment plan. This was highlighted last summer when another raise was necessary to be able to finance the debt maturing. This time, however, differences between Democrats and Republicans delayed approval for the increase up to one day before the debt came due, thereby fuelling rumours of a possible default. The reason behind these differences: the lack of agreement between the two large parties regarding how and when fiscal consolidation should be carried out.

These signs of political paralysis, almost unheard of in the United States, justified the agency Standard & Poor's withdrawing the country's triple A rating, the highest possible. The agency also believes that the agreement reached between Republicans and Democrats «falls short of what... would be necessary to stabilize the government's medium-term debt dynamics».[2] In particular, the Budget Control Act passed last summer authorizes an increase in the debt ceiling of 2.1 trillion dollars (14% of US GDP in 2011) in 10 years. This rise is gradual and provides enough leeway so that the ceiling is not expected to be raised again until after November's presidential elections.

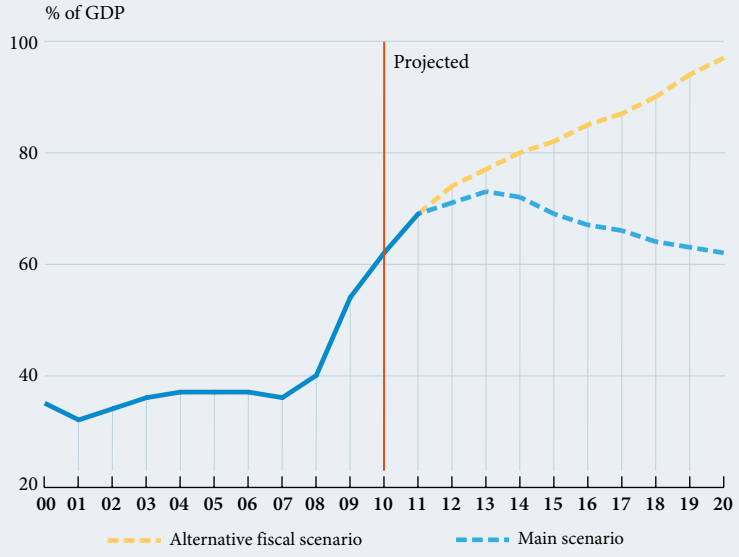
In exchange, a reduction in current expenditure has been established totalling 917 billion dollars over the next 10 years, which immediately came into effect, and a two-party commission was set up called the «Supercommittee», with the aim of identifying a further 1.5 trillion of structural adjustment, also over the next 10 years. The Act also stipulates that, if the Supercommittee did not reach an agreement by 23 November, there would be an automatic adjustment of 1.2 trillion, whose cost would be shared equally between domestic and defence spending.

Finally, the Supercommittee did not reach an agreement and the automatic adjustments will therefore begin in January 2013. Consequently, the aim is to stabilize debt and place the United States on the blue line shown in the graph below (main scenario). Both defence cuts and also the cuts in domestic spending are not detailed and Social Security, Medicaid (healthcare for low income people) and other programmes for people on low incomes are exempt. This lack of precision will perhaps give rise to further rounds of negotiation after November's elections.

(1) National Commission on Fiscal Responsibility and Reform (December 2010), «The Moment of Truth».
(2) Standard & Poor's (August 2011), «United States of America long-term rating lowered to 'AA+' on political risks and rising debt burden; outlook negative».

THE AIM IS TO REDIRECT THE GROWING DEBT SO THAT IT IS SUSTAINABLE

Federal debt held by the public



NOTE: Both scenarios are projections from the Congressional Budget Office. The main scenario (extended-baseline scenario) adheres closely to the cuts contained in the Budget Control Act, which establishes a deficit reduction framework up to 2021. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period.(3)
SOURCES: Congressional Budget Office and own calculations.

Although there are no signs that a tragedy is probable or imminent, the higher the debt, the greater the risk, as well as the greater likelihood of further rating downgrades. The public is fickle and Europe's experience has shown that adjustments are more painful the later they occur, and it's not the same to make adjustments during a boom as during a time of uncertainty. The United States has chosen to wait until things improve and, for the moment, it seems to be doing well.

(3) Series of assumptions established by the Congressional Budget Office in «The Long-Term Budget Outlook» (2011).

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Japan: recovery in jeopardy

Pending confirmation of the recovery in 2012, after the tsunami in March and the nuclear crisis of Fukushima, the latest indicators show a downward bias, particularly in manufacturing industry and exports, the traditional drivers for Japan's economy. On 26 December last year, the prohibition was lifted to export weapons, a law dating from 1967 that was highly symbolic.

Japan sees the steam go out of its recovery.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	–5.5	4.5	3.3	0.0	–1.7	–0.8	–	...	–
Retail sales	–2.3	2.5	–0.4	–3.0	–1.7	–1.0	1.9	–2.2	...
Industrial production	–21.8	16.6	6.8	–2.5	–7.0	–2.0	0.1	–4.2	...
Tankan company Index (1)	–40.8	0.0	5.0	6.0	–9.0	2.0	–	–4.0	–
Housing construction	–27.7	2.7	6.8	3.2	4.3	7.8	–5.7	–0.2	...
Unemployment rate (2)	5.1	5.1	5.0	4.7	4.6	4.4	4.5	4.5	...
Consumer prices	–1.3	–0.7	–0.3	–0.5	–0.4	0.1	–0.2	–0.5	...
Trade balance (3)	4.0	7.9	7.9	6.5	3.4	1.3	0.2	–0.7	...
3-month interbank interest rate (%)	0.58	0.39	0.34	0.34	0.34	0.3	0.3	0.3	0.3
Nominal effective exchange rate (4)	98.6	106.0	111.0	110.6	109.3	115.5	118.8	118.0	118.8

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

Industrial production falls, hit by the yen's appreciation and rising electricity costs.

The end of this tradition will allow Japanese companies to take part in high tech projects such as the F-35 combat fighter jet. However, the fact is that any amount of aid falls short for the beleaguered manufacturing industry of a country where dedicating yourself to «monozukuri» (making things) really counts for something.

Exports are affected by the global slowdown and the trade deficit hits a record high.

Industrial production is losing steam after an initially robust recovery from its minimum levels last March. November's decline compared with October was 2.7%, 17.5% below the average for the first five months of 2008, the period prior to the world trade crisis. The yen's appreciation and rising electricity costs, which are 2.5 times those of South Korea due to the tsunami, continue to hinder the recovery. The Tankan sentiment index for large manufacturing firms shows a downward trend, indicating that this pattern will continue in the first half of 2012.

The slowdown in world demand has come on top of these domestic woes. Exports contributed four fifths of the growth in the economy as a whole in the third quarter but this contribution will be drastically cut in the fourth quarter of 2011 and the first half of 2012. After a strong push in May and June, exports slowed up and then fell in October and November. The consequence of this is that the trade deficit for the last 12 months reached 1.7 trillion yen, the highest since 1963.

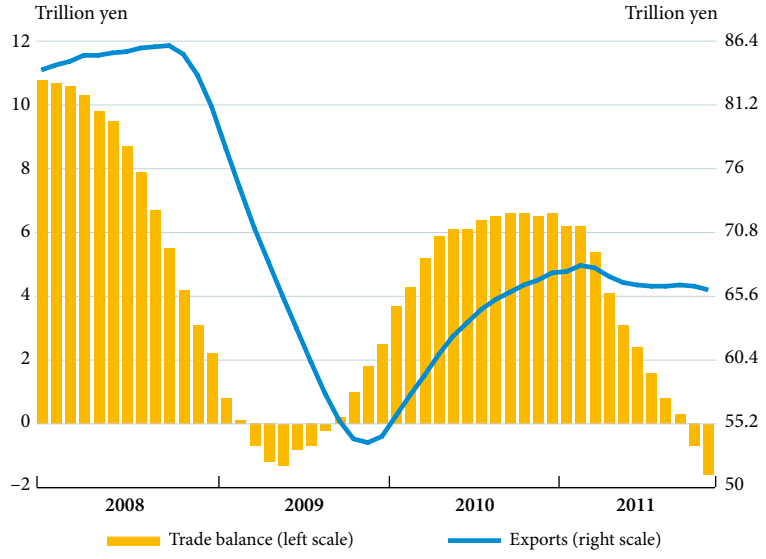
Fiscal policy will be expansionary, with the CPI falling by 0.5%.

Because of these difficulties in the private sector, fiscal policy for 2012 will continue to be expansionary. Of the 90 trillion yen budgeted for expenditure, 68.4 trillion excluding interest payments, only 42.3 trillion will come from tax revenue, the rest coming from issuing debt, swelling a figure that exceeds 200% of GDP.

In this respect, the 5% hike in tax on consumption continues to encounter political difficulties in an economy that

JAPAN: THE RECOVERY IN TRADE COMES OFF THE RAILS

Trade balance and exports (*)



NOTE: (*) Sum of the last 12 months.
SOURCES: Japanese Ministry of the Economy, Trade and Industry and own calculations.

is still deflating. The CPI fell by 0.5% year-on-year in November while the core CPI, the general index without energy or food, fell by 1.1%.

China: towards a soft landing

China is underpinning its soft landing with 8.9% growth year-on-year in GDP for the fourth quarter, so that the economy will have grown by 9.2% for the whole of 2011. This rate should fall in 2012 down to 8.4% for the whole of the year, a rate that, although high in comparison with all advanced economies, is close to the limit of 8% which, according to the Chinese government, guarantees stability and peace in society. That's why the authorities' top priority is to ensure growth.

Controlling inflation, which had been the main aim up to September, has been relegated to second place. December's CPI rose by 4.1% year-on-year, almost the same as last November and far from July's figure of 6.5%. However, this does not mean that inflationary pressure has been averted. The price of labour continues to rise due to the social changes occurring in the country and the CPI for food, which accounts for half of the general index in China, picked up slightly to 9.1%. Nonetheless, December's figures leave room for expansionary policies.

China is slowing up, growing by 8.9% in the fourth quarter.

Inflation moderates to 4.1% but food prices rise by 9.1%.

The main scenario is one of a soft landing supported by the underlying trends in China's economy. But the risks tilt downwards, with a brusque halt for two of the pillars to growth over the last few years: housing and exports. The housing sector, which accounts for 13.0% of the total economy, is at a standstill. Prices have stopped rising and falls have been posted in significant zones such as Whenzhou, in the dynamic province of Zhejiang. Land under construction has fallen by 25% and December's sales were

The brusque halt in housing is the biggest risk to the main scenario of a soft landing.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	9.2	10.4	9.8	9.7	9.5	9.1	–	8.9	...
Industrial production	12.5	14.5	13.3	14.5	13.9	13.8	13.2	12.4	12.8
Electrical power generation	6.8	14.0	6.2	12.1	12.0	10.8	9.4	7.5	9.8
Consumer prices	–0.7	3.3	4.7	5.1	5.7	6.3	5.5	4.2	4.1
Trade balance (*)	196.4	184.0	184.0	176.1	173.8	171.5	161.7	153.9	157.9
Reference rate (**)	5.31	5.31	5.81	6.06	6.31	6.56	6.56	6.56	6.56
Renminbi to dollar	6.8	6.8	6.7	6.6	6.5	6.5	6.4	6.4	6.3

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

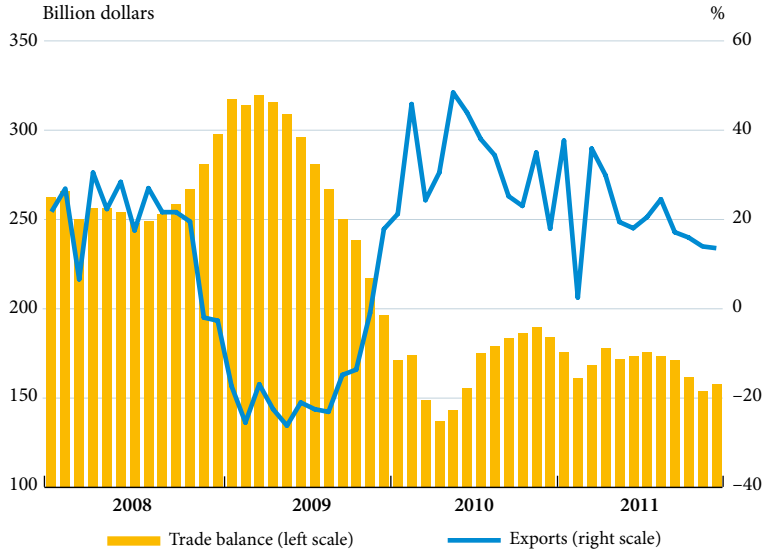
The foreign sector continues to lose steam but metal imports grow.

down 8.4% year-on-year, when in the third quarter they had grown by 12.9%. The positive side to this lies in the fact that lower inflation will allow monetary policies to stimulate the sector, such as reducing the cash reserve ratio. Meanwhile the exodus from rural areas continues. In December, the urban population exceeded the rural population for the first time in China's history. This movement also supposes a strong source of demand that should help to bolster the sector.

For its part, the foreign sector continues to decline. December's trade balance

CHINA: EXPORTS SLOW DOWN AND THE TRADE SURPLUS SHRINKS

Trade balance (*) and year-on-year change in exports



NOTE: (*) Sum of the last 12 months.
SOURCES: China's Official Statistics Office, Economists Intelligence Unit and own calculations.

totalled 16.5 billion dollars, somewhat higher than the figure for November but without changing its downward trend. Exports grew by 13.4% year-on-year, a very low rate for the Chinese economy. In the case of imports, the signs of a slowdown are more ambiguous. Although year-on-year growth was 11.2%, within a lower range, this was partly due to strong base effects. Basic metal imports such as copper, which in China is an indicator of industrial activity, were definitely on the up, supporting the main scenario of growth in excess of 8%.

Following a similar pattern, industrial production picked up slightly in December, up by 12.8%, proof that there is underlying resistance in the Asian giant's activity. Another positive factor was provided by the retail sales of consumer goods, up 18.1% year-on-year in December. Private consumption, which continues to be the one big element missing from the growth equation, with a relative weight in the economy that hardly reaches 35%, has great potential for growth. The problem is whether it will liven up quickly enough to offset the decline in exports and a possible halt in the housing sector.

Industrial production and retail sales indicate an underlying resistance to growth.

Brazil: slowdown under siege

Towards the end of 2011, inflation provided a welcome break for Brazil's economy and closed the year at 6.5%, just enough to be within the target range of 4.5% ± 2.0%. Supported by this change in trend, the Monetary Policy Committee stuck to its script and reduced the SELIC rate by 50 basis points at the end of January. The official interest rate is therefore back to 10.50%, a level that is still high compared with other emerging economies but which we expect will continue to fall over the coming months.

This forecast assumes a scenario in which Brazil's economic growth will remain at around 3.0% in 2012, below its potential, and in which price rises will continue to converge towards their central target (4.5%). Should tensions in Europe abate more quickly than expected or the rate of economic activity at a global level pick up substantially, the economic outlook for

In Brazil, inflation moderates towards the end of 2011 and ends the year within the target range.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	–0.3	7.6	5.4	4.2	3.2	2.2	–	...	–
Industrial production	–7.3	10.5	4.2	2.5	0.6	0.1	–2.7	–2.2	...
Consumer confidence (*)	138.3	159.7	159.9	161.8	155.4	153.3	151.9	155.4	...
Unemployment rate (**)	8.1	6.7	5.7	6.3	6.3	6.0	5.8	5.2	...
Consumer prices	4.9	5.0	5.6	6.1	6.6	7.1	7.0	6.6	6.5
Trade balance (***)	25.3	20.2	20.2	22.5	25.3	30.5	31.1	31.3	29.8
Interest rate SELIC (%)	9.92	10.00	10.75	11.75	12.25	12.00	11.50	11.50	11.00
Reales to dollar (*)	2.32	1.78	1.66	1.63	1.56	1.88	1.72	1.81	1.86

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

The economic policies are expected to remain countercyclical in tone.

Brazil would also be more buoyant, as well as tempering the need to intensify the expansionary tone of its monetary policy. However, for the moment and after the sharp slowdown in the third quarter, Brazil's economic authorities are still prepared to use all the weapons in their arsenal to ensure the economy has a soft landing.

For the moment, the countercyclical shift taken by economic policies at the end of the summer seems to be having an effect. Since mid-November, macroeconomic indicators have been showing a tepid upswing in the rate of activity and the bulk of the evidence available suggests that Latin America's leading economy will have grown again in the last quarter of 2011. Retail sales continued to rise, once more revealing the resistant appetite of Brazilian consumers, while industrial production increased by 0.3% in month-on-month terms after three previous months of falls.

Nonetheless, some moderation could also be seen in the correction of prices. This is a figure that calls for caution, as there is still the risk that, if the current course of official interest rate cuts goes on too long, the production fabric and prices will be put under pressure again, compromising the use of further interest rate cuts as a countercyclical policy instrument. This risk becomes greater if we take into account the fact that the recent weakness in the real doesn't help to control prices either, or that fiscal policy has also taken on an expansionary air in the first few months of 2012; to begin with, the 14% rise in the minimum wage led to rises both in pensions and other social benefits indexed to this wage.

On the other hand, the Brazilian authorities' desire to preserve the tone of economic activity can also be seen in its current handling of commercial policy. Over the last few weeks, a greater effort has been made to stifle competition from foreign products in the domestic market, at the same time as tensions have worsened with Argentina due to the intensification of protectionist measures by its neighbour to the south. Nevertheless, we should praise the reaction of Brazil's authorities, avoiding reprisals and giving themselves until February to evaluate the impact of these measures on its exports.

In short, Brazil is facing a 2012 that will require a firm hand on the rudder. The bridge of the ship has made it clear that its main aim is to ensure comfortable growth without any surprises but this does not mean it can let down its guard with prices.

Mexico: prices speed up while growth moderates

In Mexico, inflation ends 2011 at an annual high but within its target range.

In December, inflation rose for the third consecutive month in Mexico, ending 2011 at an annual high of 3.8%. This acceleration in prices reflects the rise in tobacco, food, transport and clothes but also the impact of the peso's recent depreciation, which hit the cost of imported goods but, for the moment, has not led to any second-round effects. Although we expect this trend to continue in the first few months of 2012, it is a temporary rather than an underlying trend, so we have kept to our forecast that the inflation rate will remain within its target range throughout 2012. The output gap will remain in negative terrain, which should stop domestic demand from putting too much pressure on prices – in fact, core inflation for services, which best reflects the domestic influence on inflation, seems to be staying at a relatively low level for the moment.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	–6.2	5.4	4.2	4.3	3.6	4.4	–	...	–
Industrial production	–7.3	6.0	4.7	4.9	3.8	3.4	3.3	2.8	...
Consumer confidence (*)	80.5	86.3	89.6	92.1	90.7	93.7	90.6	89.5	90.8
Leading business index (*)	110.5	116.6	118.1	119.9	120.8	122.2	122.0	...	...
Unemployment rate (**)	5.5	5.4	5.3	5.1	5.2	5.7	5.0	5.0	4.5
Consumer prices	5.0	3.9	4.2	3.5	3.3	3.4	3.2	3.5	3.8
Trade balance (***)	–4.7	–3.0	–3.0	–1.5	0.0	–1.5	–1.2	–1.3	...
Official Banxico rate (%)	6.75	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	14.18	12.33	12.35	11.90	11.72	13.78	13.21	13.60	13.94

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

In any case, the renewed vigour of inflation and perceptible economic improvement in the United States are tempering the temptation to give an expansionary shift to monetary policy. Nevertheless, Mexico's economic authorities have made it clear that they are prepared to introduce new stimuli should global economic conditions deteriorate more than expected and have a negative impact on the outlook for the local economy.

For now, macroeconomic indicators suggested that Mexican production continued to expand during the last part of 2011, although more slowly than in previous quarters. Although it's true that this slowdown could be attributed largely to a more sluggish foreign demand, a certain deceleration is also starting to be perceived in some components of domestic demand, which would impose additional downward risks on our main scenario in which the Mexican economy would grow by around 3.5% in 2012.

Metals react upwards while oil remains the same

The price of crude remained practically unchanged between 22 November and 23 December, gaining 2.5%, taking it to 110.70 dollars per barrel (Brent quality, for one-month deliveries), 3.3% higher than the start of the year and 13.7% higher than last year's level.

Oil prices are following the same trend due to geopolitical uncertainties in the Strait of Hormuz, through which 35% of the world's trade passes every day, and due to a global demand that has not eased up. Should prices remain close to the level of 110 dollars per barrel, as from March 2012 oil should contribute towards a reduction in the inflation rates of most countries due to base effects since, between March and June 2011, crude far exceeded the reference price of 120 dollars per barrel because of the Libyan crisis.

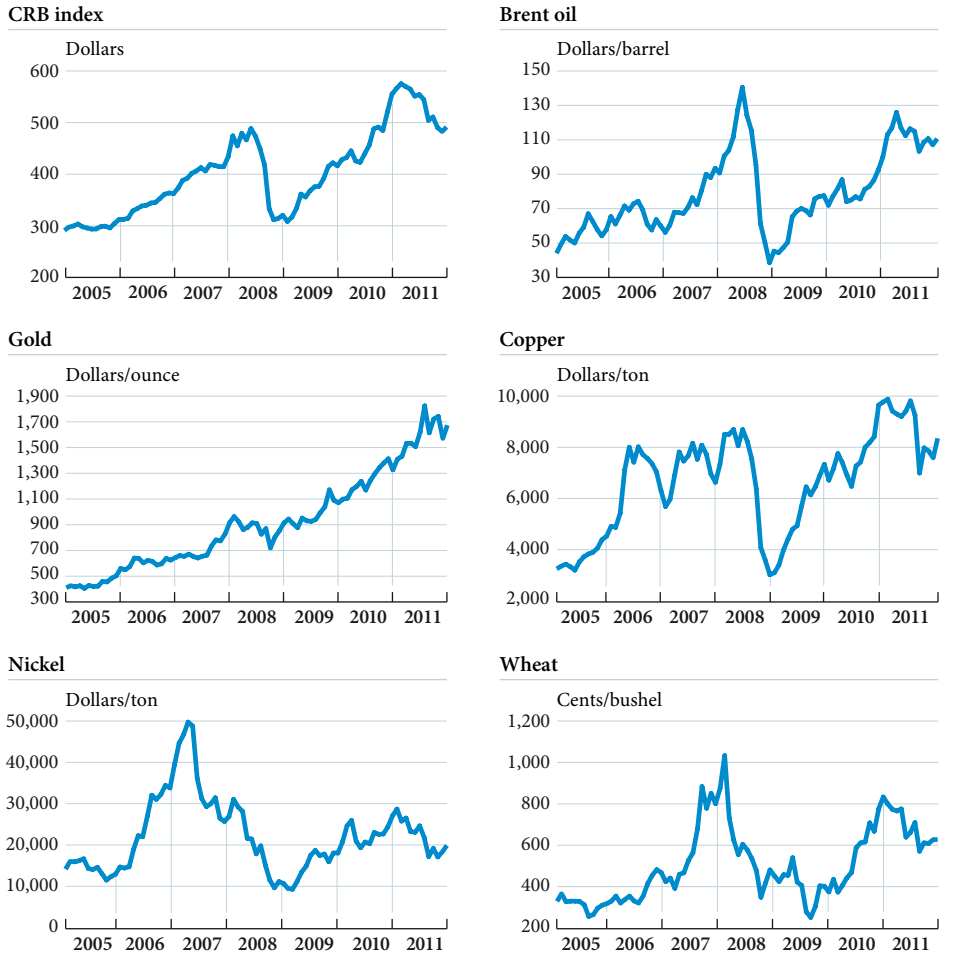
The upswing in prices and perceptible economic improvement in the United States delay any expansionary shift in monetary policy.

Oil reaches 110.7 dollars, following a largely stable trend.

Metals pick up while food prices remain sluggish.

There was a possible upward change in trend in the rest of commodities, led by metals, due to China's import figures, which is the world's main buyer. While the CRB Index gained 3.0% between 22 December and 23 January, copper, aluminium and nickel grew by 10.9%, 9.9% and 8.6%, respectively. In general, precious metals also followed the path taken by basic metals, with the exception of gold, whose more modest rise of 4.5% took it to 1,677 dollars per ounce. Food, nevertheless, continued to fall, which should ease China's inflation to some extent, as well as that of other emerging economies.

TREND IN VARIOUS COMMODITIES (*)



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

EUROPEAN UNION

Too many loose ends in the euro area to reduce uncertainty

Economic expectations in the euro area have worsened over the last few months. One of the reasons for this deterioration comes from the political sphere. The sovereign debt crisis has highlighted the urgent need to reform the foundations of the monetary union. However, the long negotiation process is affecting its credibility. On the other hand, macroeconomic indicators continue their declining trend.

Focusing on the first aspect, the negotiations on the euro area's fiscal pact are progressing slowly. However, in a joint statement the president of France, Nicolas Sarkozy, and the German chancellor, Angela Merkel, stated that they were satisfied with the progress being made. The details, however, are still not known.

The second focus of negotiation lies between private creditors and the Greek government on the extent of the write-down for Greece's debt. The latest news indicates that an agreement will be reached to finally proceed towards an exchange of the bonds affected by a new issuance of Greek public debt. However, the terms are still being negotiated and the percentage of creditors that might accept this exchange is not clear.

It's evident that, while sweeping projects are being negotiated, such as the new fiscal pact, combined with new proposals for regulatory changes, the level of uncertainty is unlikely to diminish. This has led the credit rating agency S&P to downgrade nine countries, including France and Austria, down one notch from AAA to AA+. Due to the loss of the top credit rating for several member states of the euro area, S&P has also reduced to AA+ the rating for the European Financial Stability Facility.

While the euro area's political negotiations are taking their time, economic expectations are deteriorating.

Paradoxically, this rise in the risk profile for the euro area has not affected the sovereign debt issuances of these countries, which have managed to sell their assets at lower interest rates than in issuances prior to S&P's announcement. This is probably because the market had already incorporated these decisions in the price of financial assets. Nevertheless, now Portugal has a rating of BB by S&P. This level on the credit rating scale is known as a speculative grade or junk bonds. S&P has currently assigned a BB rating to countries such as Cost Rica, Serbia, Guatemala and the Philippines.

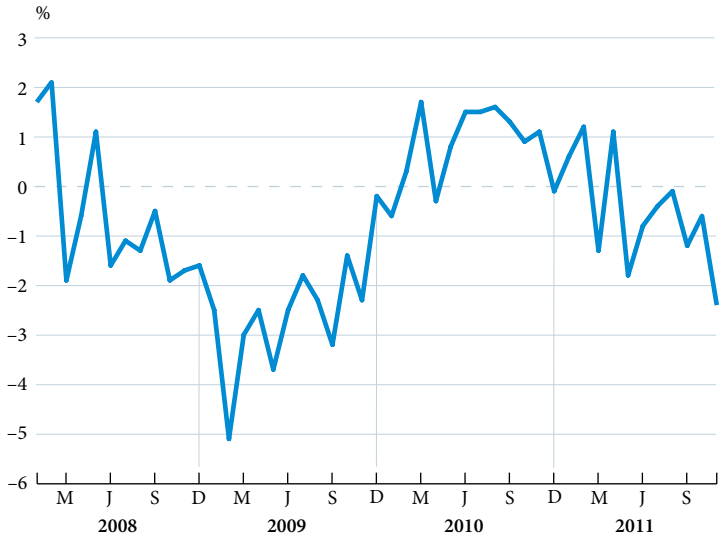
S&P downgrades its credit rating for several member countries of the European Union.

This high level of uncertainty has harmed the expectations of economic agents and they are showing their scepticism by being highly prudent in their spending and investment decisions. In fact, with regard to demand, household consumption can be seen to be advancing weakly. This lethargy is reflected very clearly in November's retail sales figures, down 2.4% year-on-year, accelerating the trend of the last few months, as can be seen in the graph below. And the short-term outlook seems to be worse as

Economic agents show great caution in their spending and investment decisions.

CONSUMERS MISTRUST THE ECONOMIC SITUATION

Year-on-year change in retail and consumer goods except cars and motorbikes



SOURCE: Bloomberg.

The foreign sector posts a surplus of 6.9 billion euros in November.

December's consumer confidence index was at a record low of –21.1, a level not seen since August 2009.

With regard to the foreign sector, the slowdown in domestic demand in the euro area is being offset by an improvement in the trade balance with other countries. In November 2011 this posted a surplus of 6.9 billion euros compared with a deficit of 2.3 billion in the same month of 2010. Seasonally adjusted, exports grew by 3.9% compared with October, while imports stabilized.

Industrial production continues to deteriorate.

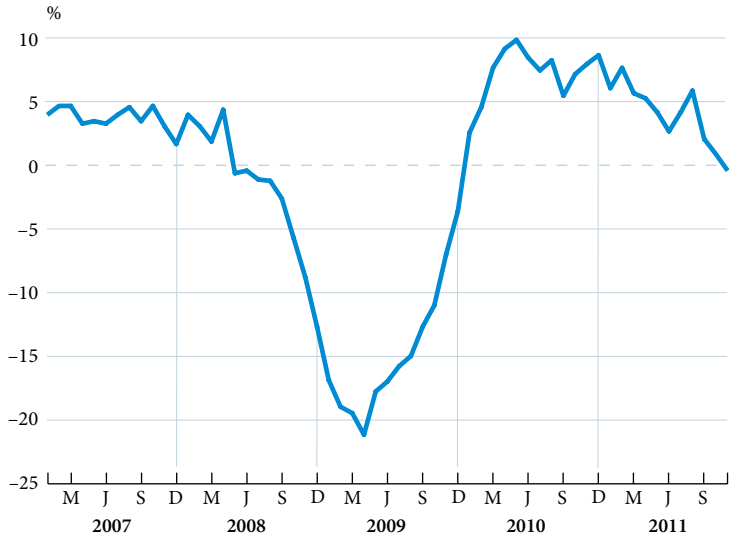
From the point of view of supply, a widespread deterioration can also be seen in short-term expectations. In November, the euro area's industrial production fell by 0.1% month-on-month while year-on-year growth decreased to –0.3%. Looking at a breakdown of the industrial production index, durables and non-durables both fell month-on-month by 0.8%, which could not be offset by the rise in energy (0.5%). Geographically, the pleasant surprise of France posting 1.1% growth month-on-month could not offset the falls in Germany (1%) and Spain (1%).

Not all the news is bad, though, and we should point out two positive aspects of the indicators for the economic situation. Firstly, political uncertainty has depreciated the euro and this should have an impact on foreign trade in the coming quarters. Although, on the other hand, it also entails a potential risk of oil imports becoming more expensive.

However, the latest inflation figures for December in the euro area were down from the 3.0% of November to 2.7% year-on-year. The weak aggregate demand which supposes a loss of price-setting power by firms, in combination with stable oil prices, has led to a reduction in the consumer price index. The expected downward slide in the harmonized CPI will have a positive impact as households' real disposable income won't deteriorate so much.

SHARP DROP IN THE EURO AREA'S INDUSTRIAL PRODUCTION

Year-on-year change in industrial production



SOURCE: Eurostat.

A series of factors has altered the forecast for growth this year in the euro area. Firstly, the World Bank has cut its world growth forecast from 3.6% to 2.4% for 2012. This decrease will hit European exports, as four of the eight countries that export the most in the world are members of the euro area. Secondly, the additional

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
GDP	–4.2	1.7	2.0	2.4	1.6	1.3	–	...	–
Retail sales	–2.5	0.8	0.6	0.1	–0.5	–0.5	–0.6	–2.4	...
Consumer confidence (1)	–24.8	–14.0	–10.4	–10.6	–10.4	–15.6	–19.9	–20.4	–21.1
Industrial production	–14.7	7.5	8.0	6.6	4.2	4.0	1.0	–0.3	...
Economic sentiment indicator (1)	80.7	100.9	105.7	107.4	105.7	98.8	94.8	93.8	93.3
Unemployment rate (2)	9.5	10.1	10.0	10.0	10.0	10.1	10.3	10.3	...
Consumer prices	0.3	1.6	2.0	2.5	2.8	2.7	3.0	3.0	2.7
Trade balance (3)	10.7	4.6	4.6	–10.0	–16.4	–20.5	–24.1	–15.6	...
3-month Euribor interest rate (%)	1.2	0.8	1.0	1.1	1.4	1.6	1.6	1.6	1.5
Nominal effective euro exchange rate (4)	111.7	104.7	104.4	103.7	106.4	104.6	104.0	103.5	101.7

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.

Lower world growth, political uncertainty and the state of the financial system force a downward revision of economic growth.

deterioration during the last month in macroeconomic indicators augurs several quarters of negative growth.

Moreover, doubts have arisen as to whether euro area countries will be able to consolidate their national accounts in a context of lower growth. In other words, there is the risk that the additional cuts announced in countries such as Italy and Spain, among others, might harm economic activity. Lastly, it's very likely that the uncertainty regarding the European banking system's capacity to recapitalize will keep the squeeze on credit for the private sector for a few more months.

All these elements have led us to revise downwards our forecast for growth in the euro area's gross domestic product for this year, down six tenths of a percentage point from 0.3% to –0.4%. There's no doubt that the deteriorating economic expectations for the euro area are resulting in more prudent behaviour on the part of economic agents in their decisions to consume and invest.

No-one said it would be plain sailing

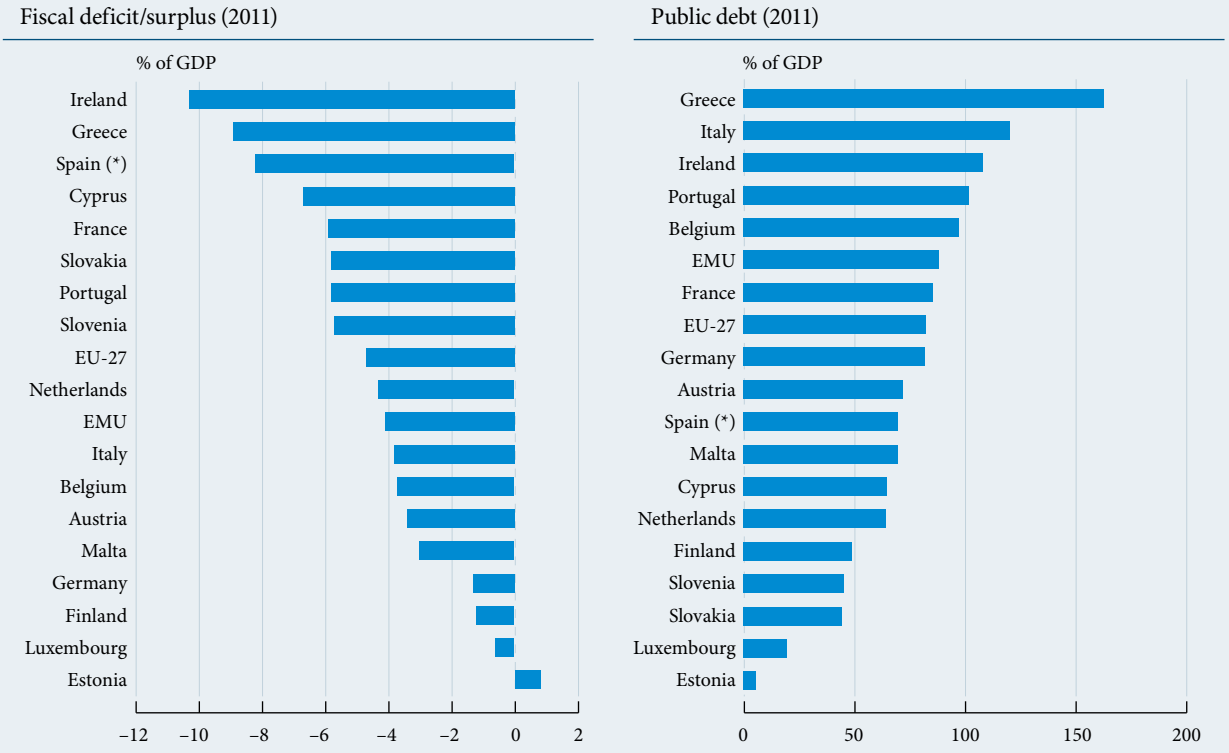
The international financial crisis and its sequel in Europe, the sovereign debt crisis, uncovered structural deficiencies in the euro area's institutional framework that were ignored for too long. Specifically, the European Monetary Union (EMU) lacks effective mechanisms to avoid the accumulation of excessive fiscal imbalances – the Stability and Growth Pact has been proven insufficient – or to offset giving up the nominal interest rate as an instrument to adjust external imbalances within the union. These deficiencies were known to exist since the union was created, just like it was known that, sooner or later, they would have to be amended. However, it is very human to put off tough decisions until circumstances force our hand; this explains why large confederations have tended to make the biggest advances after a traumatic episode and the euro area will be no exception.[1] In Europe, this unavoidable situation arrived together with the worst crisis seen since the Second World War; a challenging rough patch but one that is, unfortunately, necessary for the euro area to take a giant step towards its final destination: a union with a greater degree of fiscal and economic integration.

At this stage, few doubt that the euro area's future demands more Europe, this being understood as greater fiscal, economic and probably, in the long run, political integration. This necessity does not come merely from the immediate need to sort out the sovereign debt crisis, which is one reason, but also from the aim to underpin the very foundations of the EMU which, no matter how you look at it, are incomplete to ensure the viability of the single currency in the long term. The goal is therefore highly ambitious and the process to achieve it, highly complex: taking a definite step forward towards fiscal union requires changes in European treaties and a drastic reform of economic governance which, at present, have yet to materialize with enough forcefulness or precision.

Since the bankruptcy of Lehman Brothers in 2008, 22 European Council summits and an endless number of bilateral meetings have been held and yet, although it's true that measures have gradually been taken to establish

(1) See, for example, Bordo, M., Agnieszka, M. and Jonung, L. (2011), *A Fiscal Union for the Euro: Some Lessons from History*, NBER W.P. #17380.

THE EMU LACKS EFFECTIVE MECHANISMS TO PREVENT INTERNAL IMBALANCES



NOTE: (*) Own forecasts.
SOURCES: AMECO, own forecasts for Spain and own calculations.

greater fiscal coordination between member states at successive summits, it is also true that, initially, these measures were too spineless. So much so that, instead of tackling the crisis, they hinted at a lack of resolve and an inadequacy in the institutional framework that swept away the confidence of investors and economic agents. It was not until the last part of 2011, when the crisis became systemic and financial tensions engulfed non-periphery economies such as France and Austria, that greater consensus was reached regarding the need to progress along these lines and measures undertaken became more far-reaching.

To date, the most decisive step in this direction was taken in December. On the one hand, with a new fiscal agreement for budgetary discipline in the euro area (christened the fiscal compact); on the other, the commencement of the 6-pack or stability pact, which includes a new directive and 5 new regulations and is the most important reform of economic governance mechanisms for the European Union since the EMU was created 20 years ago. This stability pact was proposed by the European Commission in September 2010 and approved by the 27 members of the European Union and the European Parliament in October 2011. In practice, it establishes that, as from 13 December 2011, euro area countries that are subject to an excessive deficit procedure (higher than 3% of GDP) and that do not comply with the specific recommendations to correct this excess can be penalized with almost automatic fines (of up to 0.2% of GDP), if this is recommended by the European Commission and unless a qualified majority of the group opposes it. It also reinforces the debt target, requiring countries with too much debt to reduce it progressively at the rate of one twentieth per year of the difference between the current level and 60% of

GDP. On the other hand, it also introduces an excessive imbalance procedure to prevent divergences in competitiveness, unsustainable current account deficits, asset bubbles and other macroeconomic imbalances. This procedure will result in recommendations from the Commission to member states that, should they not be complied with, can also lead to financial penalties (of up to 0.1% of GDP).

The imminence of the 6-pack coming into force paved the way for the European Council to approve the principles of the new fiscal compact at its December summit. The German authorities arrived at the meeting with one objective: to incorporate fiscal rules in the primary legislation of the European Union and of the different member states that would set in stone the goal of a balanced budget under the penalty of automatic sanctions. Although they did not manage to convince all their European partners to modify the union's treaties (the United Kingdom flatly refused), they did manage to get the commitment of the EMU member states (and the backing of their European Union partners, apart from the United Kingdom and the Czech Republic) to incorporate a «golden rule» of a balanced budget in their respective main national legislation (preferably in the Constitution). This rule will restrict the public sector's structural deficit to 0.5% of GDP and failure to comply will result in automatic penalties. They also agreed that it should be the European Union Court of Justice that supervises the transposition of this fiscal rule into national legislation and that both the details of this rule and also the rest of the measures agreed in the pact (reducing excessive debt or renouncing unanimity in terms of applying automatic penalties or payments from the European Stability Mechanism) should be sealed by means of an intergovernmental agreement, which is already being drafted and is expected to be ratified before March 2012.

The new fiscal pact therefore reinforces what was established in the 6-pack. As a whole, these agreements lay the foundations for greater progress towards fiscal and economic integration. To start with, they give more leeway to the European Central Bank to acquire the public debt of peripheral countries. They also force countries with larger imbalances into greater discipline and to subject their budgets to the European Union's supervision. In turn, this will help to establish mutual trust within the union, also aiding the work of authorities from the more financially solid countries to convince their citizens that, eventually, a broader mandate for the ECB and the greater sharing of risk through some sort of stability bond would serve the general interest, as these measures would provide the single currency with a significant amount of solidity.

A common sovereign debt issuance would particularly help towards financial stability and economic efficiency in the euro area. Firstly, it would be a powerful instrument to tackle the liquidity problems currently facing some member states (allowing them to benefit from the greater credit quality of other members) and would minimize the risk of a sudden loss of market access in the future. As a considerable reserve of secure, liquid assets would be created, it would also provide the euro area's banks with a source of more solid guarantees and would help to pass on the ECB's monetary policy. On the other hand, this bond market's large size, liquidity and credit quality would lead to a relatively low interest rate, reducing financing costs both for the public and private sector in the euro area.

Europe chose its destiny years ago. Right from the start, it was assumed that the journey towards this destiny would be long, complex and stormy; that there would be a political price to pay for making progress, a price that could only be paid when there was no other choice. In order to get through the present storm we have to start paying that political price and move on towards the next port of call: European Fiscal Union. The alternative is to sink without trace as, at this stage, going back is not actually an option.

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

Prospect of a slight slowdown in the German economy in 2012

Initial estimates confirm that Germany's GDP grew by 3.0% last year. The German economy therefore exceeded its highest level prior to the Great Recession of 2008-2009 after two years of recovery. In 2011, growth came particularly from domestic demand, both consumption and investment. On the other hand, the foreign sector, in spite of dynamic exports, only contributed 0.8 percentage points to GDP growth.

However, although the details of this development in the fourth quarter are still not available, it can be assumed that GDP shrank by about two tenths of a percentage point compared to the third quarter. This can be explained by the sharp upswing in July-September on the one hand and, on the other, by the cooling off in economic sentiment due mainly to the debt crisis in the periphery of the euro area.

Nevertheless, the last few months have seen a reversal in the worsening business climate so that, although economic weakness will probably continue throughout the winter, we expect it to be temporary and not very extensive. We forecast 0.5% growth in GDP for 2012. Nonetheless, it should be noted that there are downward risks should the European sovereign debt crisis get worse, given the importance of trade with its partners in the euro area.

We forecast growth of 0.5% for German GDP, with a risk of this being less.

This increase in economic activity will be supported by lax monetary policy and the expansion of the global economy, and also especially by the energy of private consumption. Consumer confidence improved in November and December 2011 and consolidated at a level slightly above its historical average. This optimism is based on the rise in disposable income. In fact, in the third quarter the real wage rose by 0.6% compared with the same period a year ago, although a slowdown can be observed.

Good performance by the labour market also made a positive contribution. The number of employed reached a new record in 2011 and rose by 1.3% compared with the previous year. In December, unemployment continued to fall in seasonally adjusted terms and the

The rise in disposable income and the advances being made by the job market boost German consumers' optimism.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
GDP	–5.1	3.6	3.8	4.6	2.9	2.6	–	...	–
Retail sales	–3.2	1.4	1.1	0.8	2.4	0.8	1.4	0.9	...
Industrial production	–15.5	10.0	11.7	12.9	8.2	8.2	4.1	3.6	...
Industrial activity index (Ifo) (*)	90.7	107.8	113.4	114.7	114.2	109.6	106.4	106.6	107.2
Unemployment rate (**)	7.8	7.1	6.7	6.3	6.0	5.8	5.6	5.5	...
Consumer prices	0.4	1.1	1.5	2.1	2.3	2.4	2.5	2.4	2.1
Trade balance (***)	138.7	154.9	154.9	157.9	159.0	159.7	156.7	159.0	...

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.

Germany's public deficit falls to 1% of GDP in 2011 and the government is determined to continue budget discipline in 2012.

BA-X index for employment demand continued to rise. In fact, a deficit of specialised workers has been registered in numerous branches of activity.

The downward trend of inflation over the last few months is another reason for consumers to be motivated. In fact, after having reached 2.6% in September, it closed the year at 2.1%. We expect inflation to continue falling in 2012, if energy prices don't provide any nasty surprises. In any case, in 2011 productivity per worker continued to increase, posting a 1.6% rise year-on-year, helping the year-on-year change in CPI without energy products to be just 1.3% in December.

With regard to investment, the improvement in the economic climate also points to some vigour throughout 2012. The ZEW index rose sharply in January, a second consecutive month of increases. On the other hand, the low interest rates should encourage investment in construction.

From the point of view of supply, after the decline in industrial production in October-November compared with the previous 2-month period, the diminishing trend in industrial orders augurs only modest growth in the coming winter months. However, the production of construction rose by 3.1% in October-November compared to the previous two months and, although a slowdown is expected, it remains essentially strong.

The economy's good performance in 2011 helped Germany's public deficit to fall to 1.0% of GDP after being above the 3% limit established in the European Union Treaty during the previous two years. The public deficit has also been easier to control thanks to the very low interest rates on German debt, benefitted by investors' flight to quality. In 2012 the German government is determined to continue with its policy of budget discipline.

On the other hand, the gradual reform of the pension system has started this year, which will raise the retirement age by two years, up to 67, in 2030. This will also boost the sustainability of Germany's national accounts.

The French economy, going through a bad patch

After posting 0.3% quarter-on-quarter growth in the period July-September, revised downwards by 0.1 points, the French economy probably shrank slightly in the fourth quarter according to available indicators, and might continue to shrink during the first few months of this year. In a context in which the economic climate indicator is still slightly below the normal level and in which there are still problems of competitiveness, and also because of a certain slowdown in the global economy, we have revised downwards our growth forecast for French GDP to 0.1% for 2012. The risks are mostly downwards, given the notable interrelation with countries on the periphery of the euro area, affected in turn by the sovereign debt crisis.

Our growth forecast for French GDP in 2012 is downgraded to 0.1%.

From the point of view of demand, consumption is weakening. Consumer confidence stabilized in December but at a very low level. This pessimism is partly due to the bad performance by the labour market. The unemployment rate shows a slightly upward trend and is approaching 10%. The inflation rate isn't any cause for joy either as, in December, this stood at its highest level for the year, namely 2.5%.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
GDP	–2.6	1.4	1.4	2.2	1.7	1.5	–	...	–
Domestic consumption	–0.4	1.7	0.9	3.5	1.1	–1.3	0.3	–1.9	...
Industrial production	–12.6	4.6	4.3	4.7	1.9	2.9	1.7	0.9	...
Unemployment rate (*)	9.5	9.8	9.7	9.6	9.6	9.6	9.7	9.8	...
Consumer prices	0.1	1.5	1.7	1.8	2.1	2.1	2.3	2.5	2.5
Trade balance (**)	–44.9	–51.5	–51.5	–59.0	–64.2	–68.3	–71.0	–70.5	...

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

However, it is likely to take a downward turn in 2012.

Supply also seems to be going through a bad patch. In the period September-November, industrial production fell by 1.0% compared with the previous three months, posting a year-on-year rise of 1.1% on the same period the previous year. Although, in December, the activity of the secondary sector improved slightly, the short-term outlook is not too favourable as industrial orders decreased by 2.3% in terms of value in September-November compared to the previous three months.

Services picked up slightly in December. Tourism also posted a year-on-year rise in October thanks to French visitors. However, the indicator for the economic climate of the tertiary sector was appreciably below its historical average in December.

Within this context, the credit rating agency Standard & Poor's downgraded France's sovereign debt rating together with a further eight European countries at the end of the second week in January. In the case of France, the cut was just one notch, to AA+. This measure had already been assumed by the market and the risk premium for France's long-term sovereign debt compared with its German equivalent remained at around 129 basis points at the start of the third week in January, far from the peak of 189 basis points since the euro was launched, reached in mid-November. On the other hand, agencies Moody's and Fitch have kept the top rating for French sovereign debt.

The ratings agency, Standard & Poor's, withdraws its top rating for long-term French sovereign debt.

The tensions in financial markets are gradually affecting credit to the private sector. In the fourth quarter, while the demand for financing in industry grew more sharply than in the previous quarter, the financing obtained rose more moderately than the demand for credit. Credit to the private sector also slowed up in November. Credit to non-financial firms advanced by 4.5% in the last twelve months, 0.9 points less than in October, while credit for households rose by 6.8%, half a point below the previous rate.

In this context, and three months from the presidential elections, the government adopted urgent measures to tackle the deterioration in the labour market. It will therefore be easier for companies

The French government adopts urgent measures to tackle deterioration in the labour market.

Italy enters recession in the second half of 2011 and looks likely to shrink in 2012.

to reduce working hours when they are in difficulty, the employment of young people by microfirms will be encouraged and training will be improved for the long-term unemployed. Moreover, a reform is being prepared for professional training in line with the economy's needs in order to improve competitiveness.

Readjusting the Italian economy

After a quarter-on-quarter drop in GDP of 0.2% in the third quarter, although the official figures are still not available, a higher drop will probably be posted in the fourth quarter, so that the Italian economy will have returned to recession without having returned to its level prior to the Great Recession of 2008-2009. This seems to be suggested by indicators, such as the 4.1% year-on-year fall in industrial production in November and 8.1% for construction in October.

Hikes in indirect taxation will make it difficult for Italian inflation to be redirected this year, ending 2011 at 3.3%.

This trend is due to the effect of restrictive economic policy measures adopted last year and also the slowdown in the world economy, apart from problems of competitiveness. The foreign sector's contribution to growth, although positive, has been insufficient.

Judging by leading indicators and by the expected results of the austerity measures currently underway, with rises in taxes and cuts in public spending, the outlook for 2012 is for the recession to continue, at least in the first few quarters, so we have forecast the change in GDP for the whole of the year at –1.5%. The package of structural reforms called «Cresci Italia», which is discussed in more detail below, will have a positive effect on the enlargement of potential growth but their impact will be particularly medium and long-term.

Household consumption is showing signs of weakness due to wages' loss of purchasing power, to the drop in employment and the rise in unemployment over the last few months, as well as rising uncertainty. The rate of change in consumer prices ended with a year-on-year increase of 3.3% in December, due partly to the hike in indirect taxes. This will continue in 2012, making it difficult to redirect inflation. We therefore predict that, this year, household consumption will continue to fall, whose level of confidence has dropped to its lowest level since at least the mid-1970s. Investment is also likely to decrease this year, given the low

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
GDP	–5.1	1.4	1.6	0.8	0.7	0.2	–	...	–
Retail sales	–1.7	0.1	0.1	–0.4	–0.3	–1.3	–1.1	–1.4	...
Industrial production	–18.6	6.4	5.7	2.3	1.5	–0.1	–3.3	–3.6	...
Unemployment rate (*)	7.8	8.4	8.3	8.2	8.1	8.1	8.5	8.6	...
Consumer prices	0.8	1.5	1.7	2.3	2.6	2.8	3.4	3.3	3.3
Trade balance (**)	–5.9	–30.0	–30.0	–34.2	–34.1	–32.1	–30.6	–28.8	...

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

utilization of production capacity on the one hand and the persistence of the real estate crisis on the other.

Although the public sector deficit fell by 5.5 billion euros in 2011 compared with the previous year, which was more than expected, at the end of the second week in January the agency Standard & Poor's downgraded Italian sovereign debt to BBB+, while Fitch kept it at A+ but with a negative outlook, and Moody's at A2; all these ratings are investment grade, unlike Greece, Portugal and Ireland. However, its risk premium stood at around 485 basis points, slightly below the record of 550 posted in the second week of November.

It is very important for confidence to recover and the risk premium to fall for the sustainability of the country's national accounts. Within this context, on 20 January the government presided over by Mario Monti approved a new package of measures, focusing this time on liberalizing several sectors such as energy, transport, finance and insurance, local public services and professional services, including pharmacies and notaries. This package also includes measures to boost infrastructures and construction. Moreover, to tackle high youth unemployment, those aged under 35 can set up a new «simplified limited company» with capital as little as one euro. The last two years of university training can also be taken in combination with work experience.

These measures have led to a wave of protests by the groups affected but the government is determined to apply them, although there might be amendments to some measures during the two month period to validate them in parliament. With regard to the structural reform of the labour market, the government is talking to social agents but plans to go ahead with the reform in a few weeks.

The «Cresci Italia» decree boosts competition and infrastructures to regain lost competitiveness.

The United Kingdom: the train has yet to leave the station

The economy of the United Kingdom resembles a train stopped at a station while the loudspeaker announces that a power cut is preventing it from leaving but the problem will soon be resolved. Certainly, the British economy is immersed in the midst of the fiscal consolidation programme announced two years ago. The fiscal austerity programme implemented to date in a combination of spending cuts and tax hikes already totals 42 billion pounds sterling. A level of adjustment that represents 2.9% of GDP of the United Kingdom.

The Italian government is preparing its labour reform.

And the latest figures indicate a lack of dynamism in economic activity. From the point of view of demand, retail sales are flagging, posting 0.7% year-on-year in November, while new car registrations fell in December by 3.7% year-on-year. However, it is necessary to stress that the weakness shown by economic indicators related to consumption are actually pointing more towards a halt in economic growth than the start of an economic slowdown which could result in a long-lasting recession. Fortunately, December's inflation figures fell from 4.8% to 4.2%, which is good news for the net income of households. This slowdown in inflation was led by the components of energy and clothing.

The latest figures for the foreign sector aren't very encouraging either. In November, while imports rose, exports fell, widening the trade deficit and increasing the risk of the foreign sector's

The economy in the United Kingdom is flagging due to weak aggregate demand.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
GDP	–4.4	2.1	1.7	1.7	0.6	0.5	–	...	–
Retail sales	0.5	–0.2	–1.0	1.5	0.5	–0.3	1.2	0.7	...
Industrial production	–9.0	1.9	2.9	1.3	–1.3	–1.4	–2.0	–3.1	...
Unemployment rate (1)	4.7	4.7	4.5	4.5	4.7	4.9	5.0	5.0	5.0
Consumer prices	2.1	3.3	3.4	4.2	4.4	4.7	5.0	4.8	4.2
Trade balance (2)	–87.3	–89.4	–89.4	–98.4	–98.7	–100.8	–101.7	–101.6	...
3-month Libor interest rate (3)	1.2	0.7	0.7	0.8	0.8	0.9	1.0	1.0	1.1
Nominal effective pound exchange rate (4)	73.9	80.4	79.3	78.4	78.6	77.1	79.4	80.1	79.6

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.

This weakness can be seen in manufacturing production and the construction industry.

contribution to growth becoming more negative.

From the point of view of supply, manufacturing production decreased by 0.2% month-on-month in November, while in year-on-year terms it posted a fall of 0.6%. This is the first year-on-year drop since January 2010. This figure means that manufacturing production very probably shrank in the fourth quarter last year. And the figure is not insignificant, as this economic sector accounts for approximately 10% of the country's GDP. In December, the purchasing managers' index (PMI) for manufacturing stood at 49.6 points, slightly below the 50 points that constitute the boundary between expansion and shrinkage but improving on the figure posted in November, namely 47.7 points. Fortunately, the Purchasing Managers' Index for the services sector presented a level of 54 points in December, up by 1.9 points on the previous month's figure.

Hungary suffers significant financial upset in the last few weeks.

Nonetheless, the construction industry continues to suffer from the weakness in house prices that, depending on the index used, ranges from 0.4% to –1.3% year-on-year. This is quite understandable as households are being cautious given the uncertainty hovering over the economy's future in the coming months.

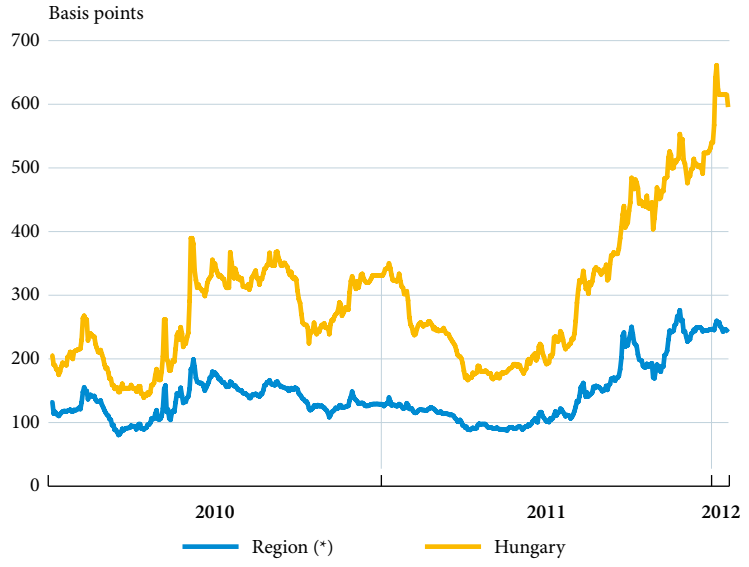
In short, the train's passengers are impatient to restart their journey but it seems that the power won't be on again until the middle of this year, as leading economic indicators suggest an absence of any significant growth during the first six months.

Emerging Europe: Hungary causes concern

Hungary has grabbed public attention over the last few weeks. Between 6 December and 5 January, its country-risk premium shot up 176 basis points, going above 600 points, and the Hungarian florin lost 6% of its value against the euro. The Budapest stock market also fell by 9% in this period. What has been happening in the country? Although the

HUNGARY'S SOLVENCY RISK, GREATER THAN THE REGION'S

CDS prices for 3-year sovereign bonds



NOTES: (*) Average for Poland, Czech Republic, Slovakia and Romania.
SOURCE: Thomson Reuters Datastream.

immediate cause was the negative outcome of negotiations with the International Monetary Fund (IMF) and the European Union (EU) concerning the significant financial aid requested by the Hungarian government last November, it's also true that the country's problems come from further back in time. As can be seen in the graph above, since May 2010, when the new centre-right government led by Viktor Orban took over, the doubts regarding Hungary's public solvency have tended to grow, a dynamic that has become more exaggerated since last September, intensifying even further at the end of 2011.

The essential factor underlying the stance taken by international investors is the government's inadequate response to problems with its national accounts. Although it's true that the situation inherited regarding public debt was complicated, with a cumulative public debt of around 80% of GDP (the highest in emerging Europe), what has caused most uncertainty is the perception that the budget adjustment policy followed was too short-term and lacked clear guidelines. First of all, the strategy employed to improve the fiscal balance in 2011 focused primarily on exceptional and not recurrent measures: transferring to the public system for pensions the system's private pillar (representing an extraordinary revenue of around 8% of GDP) and levying a series of duties to different sectors (banks, distribution chains, etc.) that generated an amount equivalent to approximately 2% of GDP.

Although this certainly helped to convert a public deficit that, in 2010, had reached the equivalent of 4.2% of GDP, into a surplus of 3.5% in 2011, the lack of any structural actions will mean that the country's accounts will become imbalanced again in 2012. The European Commission, for example, predicts a deficit of 3.2%. In addition to the harmful effects for long-term growth, the way in

Investors are concerned not only about the state of its public finances...

...but also the method used to improve the fiscal balance, excessively based on exceptional measures.

Also a cause for concern are the constitutional changes that might limit the central bank's independence.

which these measures have been adopted (with a communication strategy that has tended to disconcert economic agents and with little predisposition to negotiate with the groups affected) has damaged the country's credibility.

To complete the picture of rather unorthodox economic policy, the government decided to attack, not very aptly, another of its inherited problems namely the relative weight of private debt in foreign currencies (which totals 60% of the total mortgage credit, for example). Attempting to mitigate the effects of the florin's sharp depreciation since 2010 (greater than 14% against the euro), in September a plan was adopted for the early settlement of mortgages in foreign currencies at a subsidized exchange rate compared with the market rate, with financial institutions making up the shortfall.

Within this context of diminishing credibility of economic policy, external developments have ended up making the financial situation tenser. The worsening of world's financial uncertainty associated with the euro area debt crisis since last November and the deterioration of economic activity in Hungary, linked to the weakness in the euro area, have resulted in a worrying financial dynamic since mid-November. Specifically, the unlikelihood of the economy being able to meet its significant external refinancing needs in 2012 forced the government, in November, to look to multilateral bodies in search of a loan of around 15 to 20 billion euros.

This makes it more unlikely that the IMF will grant a loan and causes a reaction from the European Commission.

However, the fact that these conversations coincided with constitutional changes that could damage the autonomy of Hungary's central bank has led to negotiations being suspended and a worsening of the financial tensions suffered by the country. Beyond its economic content, other aspects of the new constitution, such as the limitations to judicial independence or changes in the rights of minorities, have been considered as potentially incompatible with different aspects of European cultural heritage. All this has led to different actions on the part of EU institutions.

Particularly relevant is the Report by the European Commission last 11 January, highly critical of the fiscal adjustment efforts carried out in 2011 and those planned in the budget for 2012. This means that the so-called «Excessive Deficit Procedure» will continue its course and, should no corrective measures be taken by the Hungarian government, it might end up with significant economic sanctions (such as the loss of structural funds). Similarly, on 17 January, the Commission filed three cases of European rights violations (related to the independence of the central bank and judiciary and also data protection). Although the most likely scenario is that Hungary, albeit reluctantly, will reverse the most controversial aspects and will end up accepting the terms under which the IMF and European Union will provide credit, the unorthodox bias of economic policy is more unlikely to be corrected completely.

FINANCIAL MARKETS

Monetary and capital markets

A new year, the same old problems

The year has started with investors keeping an eye on the same issues that had set the tone for financial markets last year. Top of the list are the familiar fiscal imbalances of the main western economies, particularly the euro area where these problems are occurring within a far-reaching institutional crisis. Second is the threat of a slowdown in economic growth in the emerging countries. Third is the still weak pulse of the United States' economy and the doubts raised by its economic policy in an electoral year. Fortunately, since the last few weeks of December signs have been glimpsed of a possible change in the European scenario which might give rise to a more stable phase in global financial markets. Should the measures adopted by the ECB and the euro area's fiscal treat agreements actually turn out to be successful, investor confidence would recover, making it easier for higher risk assets to appreciate in the medium term. But in the meantime, and pending the results of the different actions taken by the world's central banks and government leaders, the dominant sentiment in financial markets continues to record a high degree of uncertainty and confusion.

Central banks make an effort to boost economic growth

The slowdown in the pace of growth for the world economy is a fact that has been gradually confirmed since the second half of last year. The delicate financial situation affecting the main developed economies is combined with a progressive slowdown in production in the emerging countries, as well as lower foreign investor flows to these economies. All this has hampered international growth prospects. An examination of the latest data shows an economic scenario in which, while the euro area appears to be entering a period of recession, in the United States growth is stabilising at a moderate rate, as well as signs of a gentle deceleration in the growth of the large emerging economies. Within this context, monetary authorities play a crucial role. Most central banks have adopted strategies that prioritize economic growth over price stability, aiming to restore the confidence of financial markets in their actions.

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

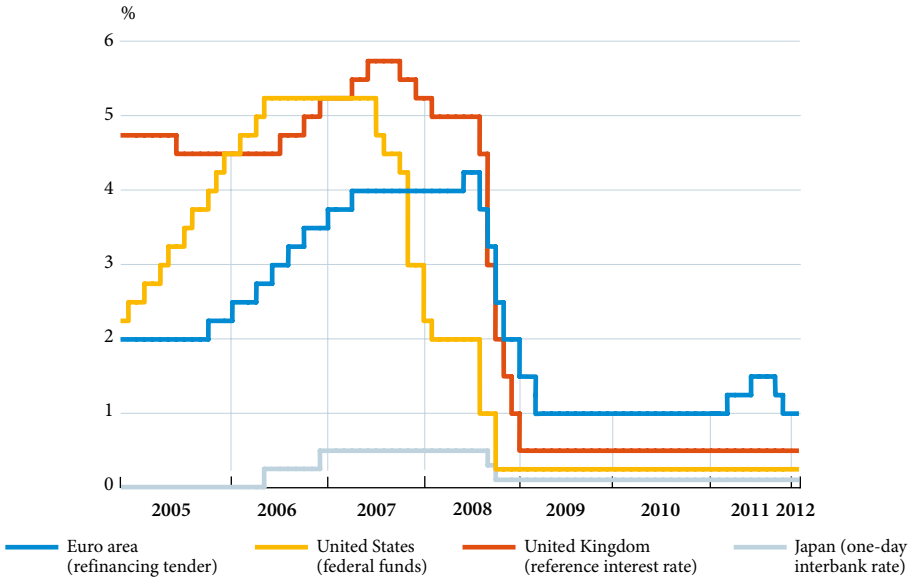
Monetary authorities attempt to safeguard growth in their economies.

In the case of the United States, the Federal Reserve (Fed) has once again decided to extend the expansionary profile of its monetary strategy in order to underpin a recovery that is still slow. As has been the case since the third quarter last year, the main economic indicators are gradually improving. Specifically, household consumption and corporate investment are progressing well, giving some hope of the economic recovery continuing. However, as emphasized time and time again by the Federal Reserve Chairman himself, Ben Bernanke, the economic situation is still looking very vulnerable, as suggested by the lack of activity in some key production areas,

The Fed believes that activity is progressing well, although there are still risks.

EXPANSIONARY MONETARY POLICIES DOMINATE THE FINANCIAL SCENARIO

Official interest rates of the central banks



SOURCES: Federal Reserve and own calculations.

The Fed's monetary measures are having the desired effect on long-term interest rates.

particularly the housing sector. Bernanke also stressed the persistence of a high number of risks hovering over the economic recovery, a large proportion of these originating in the euro area's sovereign debt crisis. The monetary authority also pointed out the favourable trend in the net creation of jobs which, although upward, is still at a level that historically corresponds to economic situations dominated by fragility. Based on these data, the Fed has repeated its proposal to boost job creation, albeit without threatening price stability, and to this end it is defending the maintenance of interest rates at their currently minimal levels (0%-0.25%), as well as continuing with exceptional monetary measures. Of note among these measures is the reinvestment of the accrued interest and principal from notes and mortgage-backed securities that have matured, as well as its programme to extend the maturity of government bonds on the Federal Reserve's balance sheet. This action, known as Operation Twist, is actually having the desired effect on long-term interest rates. Specifically, the Fed purchasing bonds with long maturities while selling short-term bonds is pushing down interest rates and thereby reducing financing costs for the private sector (particularly mortgages). Although the Fed authorities have not given any firm announcement regarding the possibility of implementing a new package of quantitative measures (which would be a third round of quantitative easing), the authority is at great pains to stress its total flexibility in adopting decisions that facilitate sustained economic growth.

In the euro area, the European Central Bank (ECB) kept its official interest rate at 1% at its meeting in January. According to the bank's president, Mario Draghi, this decision was taken based on the data obtained from surveys that have

started to show some signs of the region's activity stabilizing. However, this evidence is tenuous and set within a highly uncertain context, where there is a still a high risk of the economy performing less well than expected. This risk has two facets. On the one hand are the financial risks resulting from worsening tension in the euro area's credit markets. And, on the other, there are economic risks, closely related to the slowdown in world economic growth and structural imbalances (the need for fiscal adjustment). However, although it is true that the risks to growth and inflation for the area as a whole are markedly downward, the possibility of further cuts in the official interest rates by the central bank might come up against the relatively good tone of the German economy.

Moreover, the ECB is basing its aid on a series of unconventional measures whose aim is to reduce the difficulty of Europe's banks in securing funding, and consequently the difficulties for the real economy. Among these measures, of note are the unlimited liquidity lines at a fixed interest rate provided by the ECB since last year. The two liquidity tenders approved at the last meeting in December are an outstanding example, with a three-year maturity. According to the ECB, the result of the first tender, held towards the end of 2011, was a success in terms of demand from Europe's banking sector, and its effects are helping to improve banks' funding conditions and to restore investor confidence. These results will probably be reinforced by the next injection of liquidity at three years, planned for February.

In terms of the ECB's direct involvement in stabilizing and resolving the euro area's sovereign crisis, the authority is still firmly committed to ensuring the debt markets function correctly, thereby restoring investor confidence. In order to carry this out, the ECB has continued to resort to purchasing the bonds of euro area countries in difficulties. Purchases made to date total 217 billion euros, with this process speeding up over the last few months due to rising credit tensions related to Italy and Spain.

The ECB sees some signs of economic stabilization in the euro area.

Looking at the monetary scenario for the emerging countries, of note is the shift that most authorities have started to make in their monetary policies. The gradual slowdown in global business indicators, which started in the summer, has led to the restrictive tone of their monetary policies being severely out of synch with the trends in the real economy. Given this situation, and with the aim of avoiding a sharp slowdown in real growth rates, the central banks of these economies have decided to change the direction of their policies towards a less restrictive profile. For example, in January, and continuing the sequence of interest rate cuts starting in August 2011, Brazil's central bank approved a new cut in the official interest rate to 10.5%. China and India have also applied less restrictive measures, among others.

The three-year liquidity tender eases funding conditions for Europe's banks.

In such an environment, interbank market rates have continued to reflect, in the form of fluctuations, the variations in the financial and monetary scenario on both sides of the Atlantic. Interest rate movements were downwards in January. In the United States, the Libor interest rate in dollars halted its upward trend started in the summer thanks to the tentative easing of uncertainty in Europe's financial situation. While, for its part, the Euribor interest rate accumulated another drop for all maturities. In addition to

The central banks of the emerging countries try to save their economies from a sharp deceleration.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2011									
January	1.00	1.07	1.64	0.25	0.30	0.19	0.50	0.78	0.26
February	1.00	1.09	1.77	0.25	0.31	0.19	0.50	0.80	0.10
March	1.00	1.24	2.00	0.25	0.30	0.20	0.50	0.82	0.28
April	1.25	1.35	2.12	0.25	0.27	0.20	0.50	0.82	0.24
May	1.25	1.43	2.14	0.25	0.25	0.20	0.50	0.83	0.26
June	1.25	1.55	2.16	0.25	0.25	0.20	0.50	0.83	0.28
July	1.50	1.61	2.18	0.25	0.26	0.20	0.50	0.83	0.24
August	1.50	1.54	2.09	0.25	0.33	0.19	0.50	0.89	0.10
September	1.50	1.55	2.08	0.25	0.37	0.19	0.50	0.95	0.15
October	1.50	1.59	2.12	0.25	0.43	0.20	0.50	0.99	0.57
November	1.25	1.48	2.04	0.25	0.52	0.20	0.50	1.03	1.00
December	1.00	1.36	1.95	0.25	0.58	0.20	0.50	1.08	0.92
2012									
January (1)	1.00	1.18	1.80	0.25	0.56	0.20	0.50	1.09	0.62

NOTES: (1) January 23.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 2-04-09 (1.25%), 7-05-09 (1.00%), 7-04-11 (1.25%), 7-07-11 (1.50%), 3-11-11 (1.25%), 8-12-11 (1.00%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).
(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 4-12-08 (2.0%), 7-01-09 (1.5%), 5-02-09 (1.0%), 5-03-09 (0.50%).
(5) Interbank rate.
SOURCES: National central banks, Bloomberg and own calculations.

The Euribor falls due to increased liquidity in Europe's financial system.

the effect of the ECB's cut in the official interest rate in December, there is also the impact of the large liquidity tender held by the European authority with a three-year maturity, significantly reducing tensions in this market.

Stability reigns supreme in the government bond markets

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

Continuing the tone of the last few months, the internal rate of return (IRR or yield) for the public debt of the main economies – the United States and Germany – has been stable, therefore remaining at historically low levels.

This debt market performance is the result of the attitude shown by investors given the highly uncertain scenario still being perceived in the euro area, pushing up demand for low risk assets in detriment of other riskier options. In the case of the United States, this can be seen in the trend of the yield on 10-year bonds. For the third consecutive month, their yield has been below 2%, the result of several aspects. In addition to the aforementioned unstable financial situation in the euro area is the overwhelming presence of the Fed in secondary debt markets (buying up bonds via Operation Twist), as well as the perception that, in this election year, the

political bodies will be forced to tackle medium and long-term budget adjustment.

In the case of the euro area, German debt has performed in a similar way to that of the United States, albeit with some nuances. The yields on 2 and 10-year maturities (0.21% and 1.86% respectively) have continued to fall due to the abundant liquidity injected by the ECB and the downgrading suffered by various countries in the region; specifically the downgrade in the credit rating carried out by Standard & Poor's for several economies, of note being France, Italy and Spain. Although this action had already been partly assumed by investors, the change in rating has strengthened the leadership of German debt as the best quality European asset. Evidence of this is that, for several sessions, German one-year bonds offered negative interest rates for the first time in their history.

Investors see German debt as the safest European asset.

Investor sentiment is divided when it comes to those countries negatively affected by the sovereign debt crisis. On the one hand, the advances made in creating a fiscal pact for the euro area, the promise of rigorous action by the new governments in Italy and Spain and the satisfactory outcome of the ECB's big liquidity tender (LTRO) are factors that have helped to cheer up many investors. The relative improvement in the uncertain environment has allowed Italy and Spain's risk premia to relax, also contributing to the success of recent long-term debt tenders carried out by both countries. But, on the other hand, incessant doubts regarding Greece's capacity to meet its commitments with its creditors and the declared incapacity

Advances in the euro area are facilitating new bond issuances from countries in southern Europe.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2011								
January	3.16	3.53	5.37	4.72	3.37	1.22	3.66	1.87
February	3.17	3.55	5.39	4.84	3.43	1.26	3.60	1.90
March	3.35	3.71	5.30	4.82	3.47	1.26	3.69	1.96
April	3.31	3.64	5.47	4.74	3.41	1.24	3.58	2.06
May	3.02	3.39	5.36	4.78	3.06	1.17	3.29	1.82
June	3.03	3.41	5.45	4.88	3.16	1.14	3.38	1.73
July	2.54	3.23	6.08	5.87	2.80	1.08	2.86	1.36
August	2.15	2.83	5.04	5.13	2.18	1.02	2.50	1.08
September	1.89	2.60	5.14	5.54	1.92	1.03	2.43	0.94
October	2.03	3.10	5.54	6.09	2.11	1.05	2.44	1.00
November	2.26	3.68	6.69	7.25	2.00	1.06	2.29	0.89
December	1.83	3.15	5.09	7.11	1.88	0.99	1.98	0.66
2012								
January (*)	1.90	3.07	5.47	6.20	2.00	1.00	2.10	0.78

NOTE: (*) January 23.
SOURCE: Bloomberg.

Several factors weaken the euro's exchange rate against other currencies.

of Portugal to achieve its fiscal deficit targets have once again heightened scepticism among another large group of investors. As a result, the risk premia of these two countries have risen.

The euro's exchange rate continues to fall

One of the consequences of the economic and financial scenario over the last few months is the high degree of volatility seen in the foreign exchange markets. Although the range of fluctuations in the short term is tending to narrow, there are several factors that point to this trend perhaps continuing throughout the first part of 2012. Particularly the repercussions from the euro area crisis, the aggressiveness of the monetary measures taken by some central banks and the disparate macroeconomic data between different countries and regions. It is precisely the conjuncture of these elements that has helped the dollar-euro exchange rate to rise, once again, in favour of the US currency over the last few weeks. The dollar's cumulative appreciation since the record low in May 2011 (1.482 dollars per euro) has risen to almost 13%.

The euro has also lost value against other currencies. This is the case of its exchange rate with the Japanese yen, which reached 99.65 yen per euro, this being the highest value for Japan's currency in twelve years.

EXCHANGE RATES OF MAIN CURRENCIES

January 23, 2012

	Exchange rate	% change (*)		
		Monthly	Over December 2011	Annual
Against US dollar				
Japanese yen	76.9	–1.5	0.0	–7.3
Pound sterling	0.642	–0.1	0.2	–2.7
Swiss franc	0.929	–0.8	–1.0	–2.2
Canadian dollar	1.009	–1.1	–1.2	1.6
Mexican peso	13.133	–5.4	–6.1	8.2
Against euro				
US dollar	1.300	0.4	–0.3	4.7
Japanese yen	100.0	–1.9	0.3	–12.6
Swiss franc	1.207	–1.2	–0.8	–7.2
Pound sterling	0.835	–0.3	0.2	–2.2
Swedish krona	8.782	–2.2	–1.6	–2.2
Danish krone	7.436	0.0	0.0	–0.2
Polish zloty	4.296	–3.4	–4.0	9.8
Czech crown	25.43	–1.3	–0.6	4.8
Hungarian forint	302.6	–1.6	–4.1	9.2

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

The credit wheel is starting to turn again

With the start of the year, credit markets have recovered part of their rhythm lost towards the end of 2011 due to rising tensions regarding Europe's sovereign crisis. The ECB's huge three-year liquidity tender at a fixed interest rate and the fiscal agreements reached at the European summit on 9 December marked a turning point in the evolution of the risk premia for the large countries on the periphery of the euro area (Italy and Spain). This situation has meant that the interest rates of the main issuing countries have continued to fall during January, a circumstance that has also been passed on to the rest of the corporate bond sectors. The fall in spreads has been relatively significant, both in the investment degree tranche and also in high yield. Technical factors related to portfolio recomposition have had a favourable effect on the value of investment grade corporate bonds. The downgrade experienced by various sovereign issuers has merely reduced the supply of top quality securities. The expansion in the balance sheets of central banks has also led to a fall in the securities available for institutional investors. This situation has also meant that many of these investors have opted to move their funds towards other issuers providing larger returns and greater risk, such as high yield.

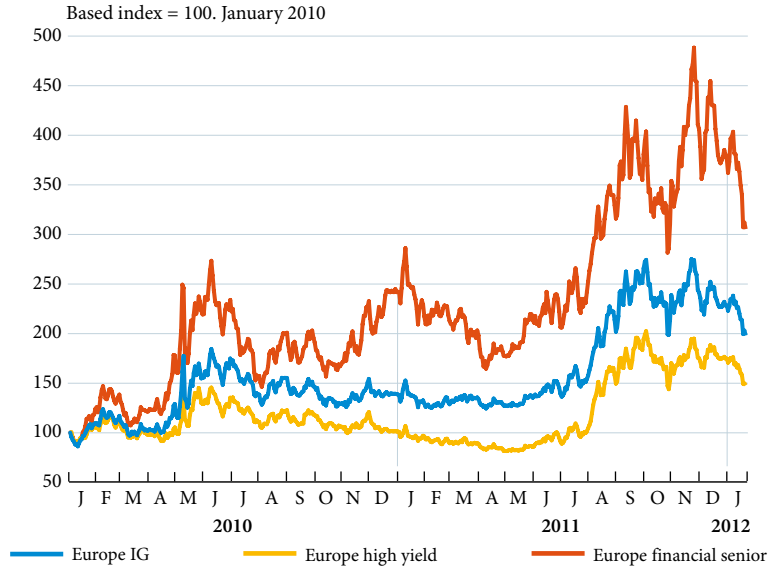
The relatively improved outlook for the euro area's crisis reactivates corporate credit markets.

The area that has benefitted the most from the incipient situation is the private debt of Europe's banking sector. After the sector had been penalized for the last two years with a sharp rise in its risk premia, the liquidity facilities provided by the ECB, the relative improvement in the outlook of the crisis and the effort being made by financial institutions to strengthen their solvency have led to an increase in issuances of senior debt and covered bonds (mortgage-backed securities) by institutions in countries from the central core of the euro area.

Corporate bond markets continue to offer attractive yields.

TREND IN RISK PREMIA OF EUROPEAN CORPORATE BONDS

Credit spreads. iTraxx Europe indices



SOURCE: Bloomberg.

Global stock markets start the year with gains.

For their part, the emerging markets' corporate bonds have remained very active in spite of the uncertainty related to Europe. Efficient management by the monetary authorities in order to avoid a sharp slowdown in economy, as well as the improvement in the credit rating of government and corporate bonds for some of these economies, are boosting the flow of foreign capital and thereby increasing corporate bond issuances.

New stimuli for equity

The stock market year has started with gains for most international stock markets. The relative improvement in the risk of systemic contagion of the European crisis, the favourable economic growth figures for the United States and the measured expansion of monetary policy in developing countries have been the main aspects dominating investor mood in January. Although it's true that investor sentiment indicators in these markets, as well as capital flows towards equity, are still at levels typical of situations of high economic and financial instability, it is still the case that risk aversion has fallen relatively since the last few weeks of December.

Corporate earnings in the United States are boosting the main stock market indices.

But in addition to these factors of great relevance for developments in the stock markets, from a sector and company point of view another series of equally relevant aspects is also converging. We are referring, firstly, to the corporate earnings season for the fourth quarter of 2011 in the United States. To date, 14% of the S&P 500 companies have published their earnings figures. Although the consensus of analysts estimates that there might be some reduction in the number of pleasant surprises (companies that report higher than expected earnings) as a consequence of the US economic slump in 2011, key indicators such as earnings per share are beating the record for the

THE SOVEREIGN DEBT CRISIS HAS PENALIZED EUROPE'S BANKING SECTOR

Trends in share prices of the banking sector in the United States and Europe (S&P 500 and Eurostoxx 50)

SOURCE: Bloomberg.

same quarter the previous year. The technology sector is key in this respect. This situation, together with the improved economic data for the United States, has made the US stock markets more stable. Secondly, from a sector point of view, it's worth noting the flow of news regarding Europe's banking sector. In the last two years, Europe's banks have been most heavily penalized by investors due to the high exposure of their balance sheets to the region's sovereign debt. But recent events have become somewhat more favourable. The increase in liquidity provided by the ECB and the acceptance of a wider range of assets as collateral for loans, the request by Germany and France to make the sector's accounting regulations more flexible and the advances being made in the euro area in the fiscal area are, as a whole, having a positive effect on the share prices of European banks, even offsetting the impact of the rating downgrade of various euro member states.

In the medium term, the consolidation of these factors and the continuity of current trends should help pave the way for a new phase marked by higher yields and a return of investment. Nevertheless, in the short term, aspects such as threats to the private sector's participation in restructuring Greek debt and possible new episodes of contagion continue to make the outlook for the stock markets highly uncertain.

Share prices for Europe's banking sector take a break.

INDICES OF MAIN WORLD STOCK EXCHANGES

January 23, 2012

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,720.5*	*3.5*	*4.1*	*7.1*
Standard & Poor's	*1,315.4*	*4.0*	*4.6*	*2.5*
Nasdaq	*2,786.7*	*6.4*	*7.0*	*3.6*
Tokyo	8,765.9	4.4	3.7	–14.7
London	5,774.4	4.7	3.6	–2.1
Euro area	2,445.8	6.8	5.6	–17.7
Frankfurt	*6,444.3*	*9.6*	*9.3*	*–8.8*
Paris	*3,342.7*	*7.8*	*5.8*	*–16.8*
Amsterdam	*323.0*	*4.9*	*3.4*	*–10.5*
Milan	*15,850.2*	*5.1*	*5.0*	*–28.3*
Madrid	*8,618.0*	*0.9*	*0.6*	*–20.4*
Zurich	6,139.6	4.2	3.4	–6.5
Hong Kong	20,110.4	8.0	9.1	–15.8
Buenos Aires	2,867.6	16.3	16.4	–21.4
São Paulo	62,312.1	8.0	9.8	–9.9

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

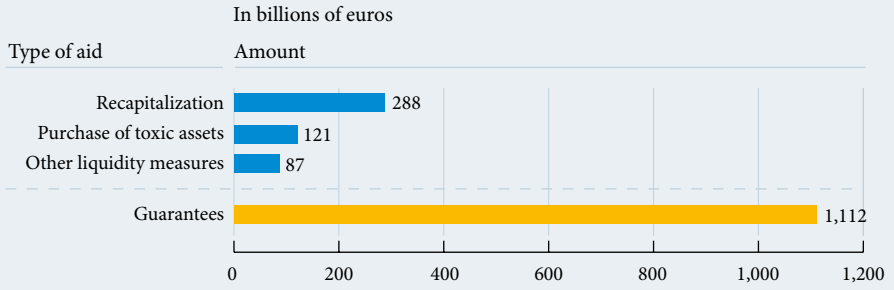
The impact of bank bail-outs on national accounts

Since the financial crisis started in 2007, there have been numerous and varied interventions by countries to bail out or restructure their financial systems. Some of the bankruptcies have also been significant, such as that of Lehman Brothers in the United States in September 2008 or the Danish Amagerbanken and Fjord-bank Mors in 2011. However, due to the risk of contagion and the role played by banks in the payment system and flow of credit to the economy, countries have allocated large amounts of public money to bail out and restructure banks in difficulty.

To safeguard competition, all aid programmes offered to a sector or to a company by any European country must first be approved by the Directorate General for Competition of the European Commission. Since 2007, the number of approval applications for aid programmes for financial systems has rocketed. Between 2007 and 2010, European countries allocated 0.5 trillion euros in capital and liquidity aid (4% of Europe's GDP). This aid includes a wide range of measures: direct capital injections, with or without political rights; buying back toxic assets to get rid of balance sheet uncertainty or granting loans to boost liquidity. Banks have also been able to issue up to 1.1 trillion euros (9% of GDP) of debt with a government guarantee. In addition to this aid, there is also the macroeconomic policy of the European Central Bank, with its injections of liquidity and purchases of mortgage-backed securities.

AID GRANTED TO THE FINANCIAL SYSTEM BY EUROPEAN COUNTRIES

Cumulative 2007-2010



SOURCE: European Commission (State Aid Scoreboard; Autumn 2011 update).

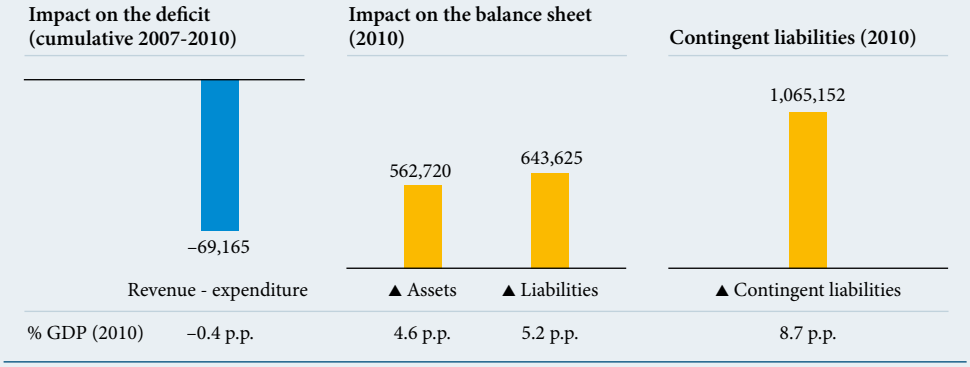
Depending on their characteristics and scope, the impact of the measures adopted in different countries has varied, both in terms of sorting out the financial system and the national accounts of the respective countries. In this respect, giving a guarantee is not the same as offering credit or injecting capital. Neither is doing this directly the same as doing it through a society set up for this purpose, as is the case of the National Asset Management Agency (NAMA) in Ireland.

So, what has been the impact on national accounts of the state aid packages adopted over the last few years? Firstly, on countries' indebtedness. Injecting capital, buying up assets or granting credit all require large payouts by the central government which they have had to finance with more debt. According to Eurostat figures, countries' liabilities have grown by almost 644 billion euros (5.2 percentage points of GDP) as a consequence of state intervention in the financial sector. Of these liabilities, 70% are debt issues. But little of the aid has been non-

refundable. That's why public assets have also grown, by nearly 563 billion euros (4.6 percentage points of GDP). Of these financial assets, 40% are shares in financial institutions.

IMPACT ON NATIONAL ACCOUNTS OF THE AID GRANTED TO THE FINANCIAL SYSTEM IN EUROPEAN COUNTRIES

In billions of euros



SOURCE: Eurostat (Eurostat supplementary table for the financial crisis; April 2011).

One initial impact is therefore on the debt to acquire assets or shares in entities, whose net figure has grown by 0.6 percentage points of GDP. Depending on how the assets acquired perform and their potential to deteriorate, the public impact of this bail-out could be greater in the future.

But not all public aid is reflected on national balances. When this aid is given via guarantees, the impact on national accounts is different. Over the last few years, guarantees for issues of new debt have emerged as a key support measure but, to date, this has not led to any countries having to pay out money. Consequently, unlike capital measures or liquidity injections, they do not increase a country's debt. However, they do lead to contingent risks; i.e. potential risks for the future.

Ireland is a case in point. With the first symptoms of deterioration in its financial institutions, the decision was taken to nationalize and inject capital into them. The Irish government injected 4 billion euros and 2.7 billion euros (4% of GDP), respectively, in the Anglo Irish Bank (Anglo) and the Irish Nationwide (INBS). The country's debt rocketed. After Ireland was bailed out by the International Monetary Fund and the European Union, it decided to set up NAMA to continue to sort out the system. How does NAMA work? Financial institutions sell their riskiest loans to the agency in exchange for state-backed bonds. It is NAMA that issues the bonds granted to financial institutions in exchange for assets and, consequently, no public debt needs to be issued, which would increase debt. But the country's contingent risks increase due to the state guaranteeing the bonds.

Lastly, we should also note that countries might see a profit or loss resulting from all this aid, which would affect the country's deficit. Included under profit are payments for guarantees, commissions on loans, etc. And under losses are those of financing loans, deterioration in the assets acquired and, if applicable, the need to call on a guarantee. In this case, in the cumulative figure for 2007 to 2010, European countries have lost over 69 billion euros, increasing the public deficit by 0.4 percentage points. But the situation differs widely depending on the country. Ireland (–35.7 billion euros), Germany (–16.6 billion euros) and the United Kingdom (–15.0 billion euros)

have accumulated the highest losses. However, between 2007 and 2010, France achieved a profit of 2.4 billion euros and Spain of 1.5 billion euros, in both cases slightly improving their deficit figures.

In a nutshell, the difficult economic and financial situation that has been going on since 2007 has led many countries to bail out their banks with tax revenue. But not all measures have the same impact on national accounts, nor do they entail the same potential income or future risks, considerations which, ultimately, are also being taken into account when designing bail-out schemes.

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

SPAIN: OVERALL ANALYSIS

Economic activity

Severe adjustment in growth prospects

2012 has not got off to a good start. The latest indicators for economic activity confirm that the recession is underway and no analyst doubts this now. The only significant doubts that remain are the duration of the recession and its extent. In January, the consensus of economists once again revised downwards their growth forecasts for Spain's gross domestic product (GDP) in 2012 and, on average, now expects a reduction of 0.3% for the whole of the year. However, the economy is expected to get back on the path of growth next year and advance by 0.9% year-on-year.

The divergence between the forecasts from the main research centres is very big, highlighting the great uncertainty surrounding the performance of economic activity at present. Among these, of note is the severe revision carried out by the International Monetary Fund (IMF), going from predicting 1.2% growth for this year to a decline of 1.7%. The IMF doesn't hold out much hope for the coming year either as, according to its latest forecasts, GDP will also record a slight drop for 2013 as a whole, specifically 0.3%.

To a large extent, the size and duration of the fall in GDP will be determined by three factors: the resolution of the sovereign debt crisis, the extent and manner of the adjustment for Spain's fiscal deficit and the trend in oil prices. These three factors will largely depend on political rather than strictly economic factors. Hence the great uncertainty surrounding the current economic slowdown.

Oil prices have picked up again slightly as a result of tensions in the Strait of Hormuz. A further rise in crude would make recovery even more difficult, as it would push up general inflation and reduce the level of activity. In the European area, negotiations for the new fiscal pact are progressing as expected; i.e. slowly. A positive note is provided by the growing credibility afforded the negotiation process by the strength of the French-German tandem made up of President Nicolas Sarkozy and the German chancellor, Angela Merkel.

Looking to Spain, the new government has confirmed that the actual public deficit for 2011 will deviate notably from the target set by the previous government. Specifically, the new government's forecasts place the deficit at around 8% of GDP, while the target was 6.0%. Should this figure be confirmed, it would mean that a greater effort would have to be made in 2012 in order to meet the 4.4% target set by Brussels. The new government has affirmed that it is totally committed to the fiscal stability pact and has therefore already presented a battery of reforms, including an increase in income tax and house rates (for a more detailed explanation, see the section on the public sector).

The measures announced represent a saving of 15 billion euros but savings

Early figures for 2012 seem to confirm the recession.

The consensus estimates a 0.3% fall in GDP year-on-year.

DEMAND INDICATORS

Percentage change over same period year before

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
Consumption									
Production of consumer goods (*)	–8.2	0.8	0.1	–1.5	–0.8	0.7	–2.2	–4.4	...
Imports of consumer goods (**)	–5.8	–9.5	–13.7	–1.1	–8.7	1.2	24.6	–10.0	...
Car registrations	–17.9	3.1	–29.3	–27.3	–26.4	–0.7	–6.7	–6.4	–3.6
Credit for consumer durables	–11.5	–12.3	–14.6	–13.9	–10.1	–4.4	–	...	–
Consumer confidence index (***)	–28.3	–20.9	–21.0	–19.6	–16.1	–15.8	–19.6	–15.4	–15.3
Investment									
Capital goods production (*)	–22.1	–3.3	–3.2	3.0	2.5	2.6	–1.6	–7.4	...
Imports of capital goods (**)	–26.3	6.5	4.8	2.3	–4.9	–1.5	–8.7	–4.2	...
Commercial vehicle registrations	–40.0	7.0	1.4	–2.2	–11.2	5.8	–7.0	–23.8	–14.1
Foreign trade (**)									
Non-energy imports	–16.9	10.3	5.4	7.4	–0.7	0.8	2.3	–6.0	...
Exports	–9.8	15.6	15.3	16.0	9.0	10.9	5.1	8.7	...

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.

More than 40 billion euros will need to be saved to cut the deficit to 4.4% of GDP.

this year will have to exceed 40 billion in order to reduce the deficit from 8.0% of GDP to 4.4%. New, far-reaching measures will therefore be announced over the coming weeks and particularly when the 2012 budget is approved, which will take place in March. In any case, the impact this will have on growth in the short term will be clearly negative, partly explaining the reduction in forecasts. However, it is very important to note that, in the medium and long term, these measures might have a positive effect on growth, not only because a healthier economy is better able to undertake substantial projects but also due to the improved credibility this would entail in international markets.

Both supply and demand indicators warn of a decline.

For the moment, the macroeconomic indicators are not at all encouraging. We shall look more closely at two of these: retail sales and industrial production. The former recorded a sharp contraction in November of 7.1% in year-on-year terms. This indicator reflects the situation affecting demand, which has fallen back again as it did in 2009, threatened by rising uncertainty. The consumer confidence index, which fell again in December, and electricity consumption, down by 4.9% in the same month, are further signs of rising uncertainty.

The situation is similar for supply. The industrial production index fell by 7.0% in November in year-on-year terms and the trend is not at all reassuring. The purchasing managers' index or PMI, still at very low levels indicative of a recession, and the industrial confidence index both reinforce the downward outlook of economic activity in Spain.

SUPPLY INDICATORS

Percentage change over same period year before

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
Industry									
Electricity consumption (1)	–4.9	2.9	2.2	0.5	0.5	–1.2	–4.0	–3.9	–4.9
Industrial production index (2)	–15.8	0.8	0.4	1.8	–1.1	–1.4	–4.2	–7.0	...
Confidence indicator for industry (3)	–30.8	–13.8	–9.2	–8.6	–10.9	–14.4	–13.8	–16.9	–18.8
Utilization of production capacity (4)	71.2	72.0	72.9	72.6	74.7	73.3	72.7	–	–
Imports of non-energy intermediate goods (5)	–20.9	24.6	18.2	12.2	3.8	0.9	–6.2	–4.4	...
Construction									
Cement consumption	–32.3	–15.5	–17.7	–3.1	–16.6	–21.0	–28.4	–28.9	–21.9
Confidence indicator for construction (3)	–32.3	–29.7	–41.5	–54.1	–55.4	–58.6	–49.0	–52.7	–59.1
Housing (new construction approvals)	–58.1	–17.3	–20.3	–6.8	–19.5	–5.3	0.4	...	...
Government tendering	–8.2	–37.9	–34.9	–45.5	–34.0	–45.4	–67.6	...	...
Services									
Retail sales (6)	–5.4	–1.0	–1.9	–5.9	–5.1	–4.2	–7.0	–7.1	...
Foreign tourists	–8.8	1.0	1.4	2.9	10.4	8.5	8.0	3.6	...
Tourist revenue inflows	–9.0	3.9	5.4	6.7	12.2	8.8	7.9	...	...
Goods carried by rail (ton-km)	–28.4	6.4	–4.2	8.2	1.8	7.7	–5.0	–8.6	...
Air passenger traffic	–7.9	2.9	4.3	5.0	10.6	6.2	2.3	–2.0	4.1
Motor vehicle diesel fuel consumption	–5.1	–1.2	–1.6	–1.6	–4.5	–2.8	–5.3	...	...

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.

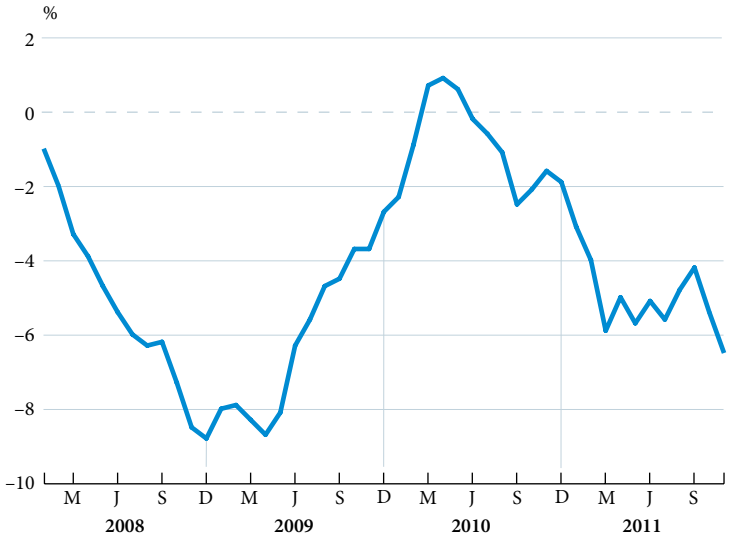
The job market's weak development, the tendency of prices to moderate and the timid pace of imports, all commented on in their respective sections, have led us to also considerably revise our scenario of forecasts for the year as a whole. In line with the evolution of these indicators, we expect GDP to shrink by 1.0%. For the coming year we expect growth of 0.6%. For this to happen, it will be fundamental for the course set by the new government to continue without delay, for the sovereign debt crisis to gradually be resolved over the first half of the year and, ultimately, for the vacillation of oil prices to remain just that; vacillation.

The recession the Spanish economy is entering is particularly the result of high political uncertainty and not of structural problems in the economy, although these do exist and measures will have to be taken to revive growth in the medium term. The nature of the recession therefore means that short-term risks are high. A new upswing in financial tension due to negotiations breaking down between holders of Greek debt and the

The nature of this second recession is particularly political.

RETAIL SALES REVEAL THE WEAKNESS OF DEMAND

Year-on-year rate of change of the three-month moving average



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

Greek government on how to restructure its debt, or doubts regarding Portugal and Ireland's capacity to comply with their respective fiscal adjustment programmes might delay the Spanish economy's recovery. At the same time, if all this is resolved favourably, confidence might return faster than expected. 2012 has not started well but this does not mean it is going to end badly.

Labour market

In search of an aegis

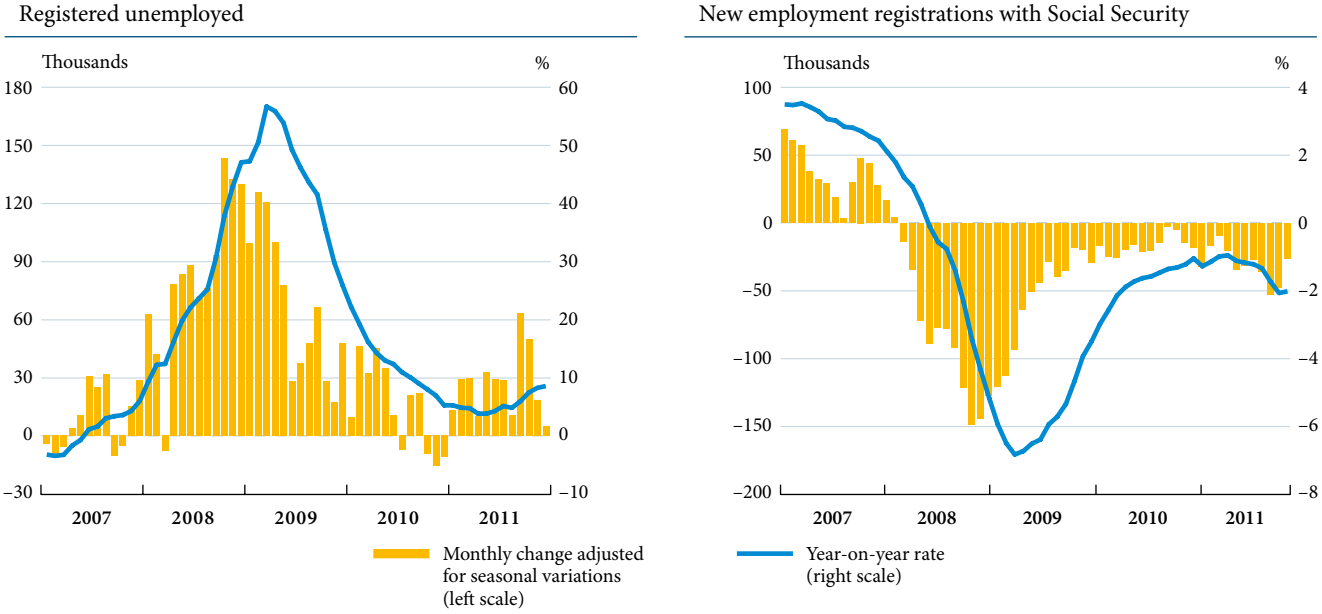
In Greek mythology, the aegis is Athena's shield, used by Perseus to help him decapitate Medusa, whose head is then incorporated into the goddess's shield. The task faced by the current government is no less titanic than that of Perseus: decapitating the monster of unemployment, without comparison in Europe, and protecting the labour market so that, in future crises, the unemployment rate will not go above 20% again.

This will be the umpteenth reform of the job market since democracy began in Spain, the last one taking place just eight months ago. The expected reform has been preceded by an announcement by the President of the government, Mariano Rajoy, anticipating that the next labour force survey (LFS) will provide an unemployment figure of 5.4 million people. This takes the unemployment rate to 23.3% so that, given the current situation, the historical maximum of 24.6% could be exceeded, reached at the start of 1994.

For 2011 as a whole, the State Employment Service recorded an increase of 322,286 people in the number of unemployed; i.e. 7.9% more than in 2010. This annual figure hides the extensive decline suffered by the labour market in the second half of the year, when the number of unemployed rose by more than 300,558 people, more than double

In 2011, the number of unemployed increases by 322,286 people compared with 2010.

THE JOB MARKET FIGURES REFLECT THE WORSENING SITUATION



SOURCES: Ministry of Labour, Public Employment Offices and own calculations.

the figure for the same period in 2010. According to the latest figures published, in December the number of unemployed increased by 1,897 people, while the number of workers registered with Social Security fell by 18,608, a drop of 2.0% compared with the figure for the previous December.

Various organisations, both national and supranational in scope, have recommended that the new government carry out labour reform to improve the high unemployment figures. In this respect, the government indicated that it would start to take measures early in January. However, the conversations and subsequent agreement between social agents, employers and trade unions have, for the time being, postponed the government's initiative until February.

The main issues around which conversations revolve and on which the reform might be based are: collective bargaining, internal flexibility, conditions for hiring and firing workers, wage moderation and a last block made up of a combination of training, public employment policies and absenteeism control.

The discussions on the current collective bargaining procedure focus on how to synchronize wage rises and activity throughout the economic cycle. Agreements lasting over several years and ultra-activity (the automatic extension of an agreement when a new one can't be reached), together with the prevalence of many different areas of negotiation, including at a sector and province level, are slowing up the process of adjusting

EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2009	2010	2010	2011					
			4Q	1Q	2Q	3Q	October	November	December
Persons registered with Social Security (1)									
Sectors of activity									
Industry	*–10.6*	*–4.8*	*–3.2*	*–2.8*	*–2.4*	*–2.4*	*–3.0*	*–3.4*	*–3.5*
Construction	*–23.1*	*–13.4*	*–11.3*	*–9.6*	*–11.4*	*–13.0*	*–14.0*	*–15.3*	*–15.4*
Services	*–2.6*	*0.0*	*0.4*	*0.3*	*0.5*	*0.3*	*0.0*	*–0.4*	*–0.4*
Job situation									
Wage-earners	*–6.0*	*–1.8*	*–1.2*	*–1.1*	*–0.9*	*–1.3*	*–1.9*	*–2.3*	*–2.2*
Non-wage-earners	*–4.8*	*–2.8*	*–1.9*	*–1.6*	*–1.2*	*–1.0*	*–1.0*	*–1.0*	*–1.1*
Total	**–5.8**	**–2.0**	**–1.3**	**–1.2**	**–1.0**	**–1.2**	**–1.7**	**–2.1**	**–2.0**
Persons employed (2)	**–6.8**	**–2.3**	**–1.3**	**–1.3**	**–0.9**	**–2.1**	**–**	**–**	**–**
Jobs (3)	**–6.6**	**–2.4**	**–1.4**	**–1.4**	**–1.0**	**–1.9**	**–**	**–**	**–**
Hiring contracts registered (4)									
Permanent	–31.0	–6.4	0.0	–1.8	–5.0	–8.4	–17.9	–22.4	–29.5
Temporary	–13.5	3.8	2.8	0.7	3.9	0.9	–2.5	–1.3	0.3
Total	**–15.5**	**2.8**	**2.5**	**0.4**	**3.1**	**0.2**	**–3.8**	**–3.2**	**–2.0**

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

the labour framework to the situation of the company. One example of how collective bargaining can be out of synch occurred in 2009, when the economy declined by 3.7% and the country was on the brink of deflation but real wages grew by 2.5%. That's why employers and trade unions have declared that they want to help separate company agreements from sector ones at the same time as encouraging the former.

Another agreement reached by social agents is the increase in the minimum hours of irregular distribution from 5% to 10%. The aim is to make companies more flexible and to help labour market adjustments be carried out more readily via prices (wages) instead of quantities (dismissals).

Simplifying the amalgam of contracts established by legislation is also on the government's agenda. The current labour framework is defined by its dual nature, with a large proportion of workers enjoying permanent contract conditions that are very different from those of temporary workers. Of note is the prevalence of temporary contracts in December, accounting for 94% of all new contracts given.

With regard to wage moderation, employers and trade unions seem to have reached an agreement regarding wage trends over the coming years. This agreement contains a maximum wage increase of 0.5% in 2012 and 0.6% in 2013 and 2014, with a specific clause for this last year. If the rise in GDP for 2013 is between 1% and 2%, the maximum wage increase in 2014 will be 1%; if the rise in GDP in 2013 is greater than 2%, wage increases will be 1.5%. This agreement also modifies the year-end wage revision clause and establishes the following: if inflation is above 2%, wages will only be increased by the difference to this 2%; if inflation in the euro area is less than in

94% of new contracts in December are temporary.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

December 2011

	No. of unemployed	Change over December 2010		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	145,961	19,132	15.1	19,132	15.1	3.3
Industry	509,470	17,832	3.6	17,832	3.6	11.5
Construction	775,928	22,861	3.0	22,861	3.0	17.5
Services	2,612,529	240,590	10.1	240,590	10.1	59.1
First job	378,471	21,871	6.1	21,871	6.1	8.6
By sex						
Males	2,209,738	156,550	7.6	156,550	7.6	50.0
Females	2,212,621	165,736	8.1	165,736	8.1	50.0
By age						
Under 25 years	460,561	26,787	6.2	26,787	6.2	10.4
All other ages	3,961,798	295,499	8.1	295,499	8.1	89.6
TOTAL	**4,422,359**	**322,286**	**7.9**	**322,286**	**7.9**	**100.0**

SOURCES: Public State Employment Service and own calculations.

The reform must put a stop to job losses.

Spain, the former will be used as a reference; if the rise in fuel and oil prices is greater than 10%, this component will be removed from the inflation calculation.

The aim of this agreement is for firms to improve their competitiveness abroad and for workers not to lose so much purchasing power. The clauses serve to separate wages from inflation in the case of sudden increases in oil prices or indirect tax hikes (hence the use of Europe's inflation rate as a reference). Apart from these agreements, and in an attempt to contain wages, the government has also frozen the official minimum wage used to establish payment concepts in many agreements, setting this at 641 euros.

Lastly, making greater use of the available resources is also being studied for labour reform, in terms of redefining training and public employment policies to ensure these focus on those groups hardest hit by unemployment, namely the long-term unemployed, who account for 42.5% of all unemployed, and also young people, who double the unemployment rate with a rate of 45.8%.

Other measures being considered are a greater control of absenteeism and moving public holidays to Mondays to reduce costs.

These five areas are interrelated and form part of a whole. Like the sides of a shield, they must be perfectly balanced to achieve a legal framework that protects the rights of all workers at the same time as helping firms become more competitive.

The monster of unemployment is rising up and it has more than five million heads. To put a stop to the constant job losses, a labour reform is required that lays the foundations to create employment that are rooted in productivity. At the same time, this reform must also protect workers to ensure that, come the next economic dilemma, we do not return to the same high levels of unemployment.

Prices

Inflation falls and the outlook darkens

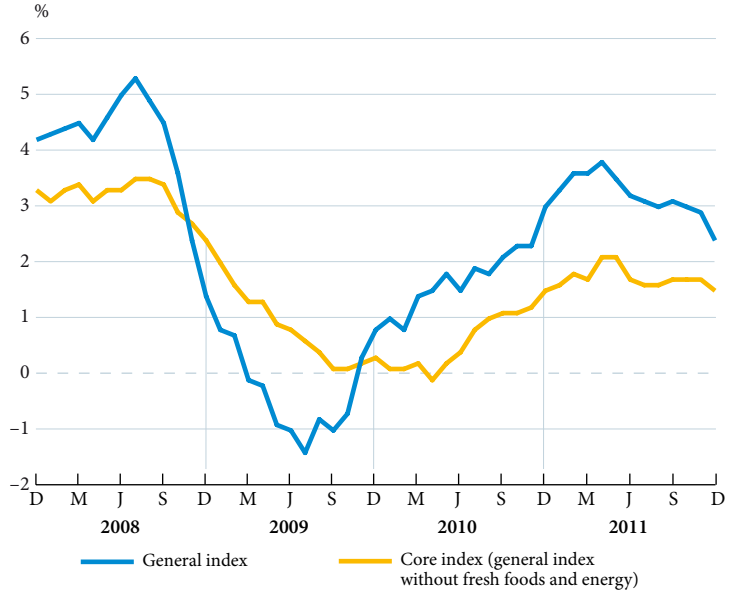
December served up what had been promised. The year-on-year rate for the consumer price index (CPI) fell by 5 tenths of a percentage point compared with November, placing its year-on-year change at 2.4%. This increase masks the change in trend undergone by prices in April after reaching a peak with a 3.8% year-on-year change and their practically unabated drop since then. The extent of this fall will be determined both by the severity of aggregate demand's lethargy and also the performance of energy products.

In spite of the squeeze in activity in the fourth quarter, indicated by the Bank of Spain, the explanation for December's fall in inflation does not lie so much in the recessionary tone of consumption but rather in the disappearance of last year's base effects. In December 2010, inflation rose by 7 tenths of a percentage point due essentially to rises in the price of tobacco and fuels and oils. On the other hand, this year tobacco has remained stable over the last three months and fuels and oils even decreased slightly in December. These effects have caused the year-on-year rate of change for tobacco and fuels and oils to alternate from 13.6% and 14.0% in November to 4.9% and 8.6% in December.

Inflation falls by 5 tenths of a percentage point to 2.4%.

SHARP FALL IN INFLATION IN LINE WITH WHAT WAS EXPECTED

Year-on-year change in the CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

December

	Indices (*)	% monthly change		% change over previous December	
		2010	2011	2010	2011
By type of spending					
Food and non-alcoholic beverages	111.1	0.4	0.3	0.7	2.1
Alcoholic beverages and tobacco	151.2	6.1	0.0	15.2	4.2
Clothing and footwear	108.9	–1.2	–1.4	0.6	0.3
Housing	125.8	0.3	0.1	5.7	5.8
Furnishings and household equipment	109.7	0.2	0.1	1.0	1.1
Health	93.6	0.0	0.1	–1.2	–2.8
Transport	118.4	1.9	–0.2	9.2	4.9
Communications	97.0	0.0	0.0	–0.7	–1.6
Recreation and culture	98.8	1.3	2.2	–1.1	1.3
Education	120.3	0.0	0.0	2.3	2.8
Restaurants and hotels	115.1	0.2	0.2	1.7	1.2
Other goods and services	115.9	0.2	0.2	2.8	2.7
By group					
Processed food, beverages and tobacco	118.3	1.4	0.2	2.6	3.1
Unprocessed food	110.3	0.6	0.5	2.6	0.7
Non-food products	112.8	0.5	0.1	3.1	2.4
Industrial goods	111.2	0.6	–0.3	4.7	3.0
Energy products	*136.8*	*2.8*	*–0.3*	*15.6*	*10.3*
Fuels and oils	*134.0*	*3.8*	*–0.4*	*18.4*	*10.6*
Industrial goods excluding energy products	*102.6*	*–0.3*	*–0.3*	*0.9*	*0.3*
Services	114.5	0.4	0.5	1.6	1.7
Underlying inflation (**)	110.9	0.3	0.2	1.5	1.5
GENERAL INDEX	**113.6**	**0.6**	**0.1**	**3.0**	**2.4**

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

International tensions push up oil prices.

In fact, the performance of fuels and oils is precisely one of the unknown factors for this year. The geopolitical tensions generated regarding the Strait of Hormuz, a marine corridor of just 60 kilometres at its narrowest point through which approximately 40% of the world's crude travels, has helped to momentarily push up oil prices in January. Oil products constitute 54% of final energy consumption and Spain imports 98% of these so, in this case, our country is totally dependent on others. Any distortion in the trade of fuels and oils will have an immediate effect on prices and therefore on the CPI, of which it accounts for 7.7%.

In fact, this dispute is already having an impact on energy supply policy via European sanctions, which will force a reorientation regarding Iranian crude imports. This country is the largest supplier for Spain, contributing 15% of the total. It is unknown whether this lower supply will push up fuel prices.

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	1.3	6.5	15.4	7.7	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	4.2	7.1	2.7	1.3	6.2	17.2	8.9	2.4	1.0	7.3	1.5
September	5.2	7.1	2.5	1.2	5.5	18.8	9.6	3.2	1.3	6.5	–
October	...	6.5	2.4	1.3	5.0	17.3	9.8	3.8	1.4	6.0	–
November	...	6.3	2.6	1.2	4.0	17.1	8.8	2.6	1.2	5.2	...

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

Another factor increasing the risk of higher oil prices is the appreciation of the dollar. Given that barrels of Brent quality oil are traded in dollars, the more the euro depreciates against the dollar, the more expensive it is to buy. A rise in price in this commodity is then passed on to the economy as a whole, pushing up inflation. This is a common phenomenon throughout all euro area countries.

If we compare the price of fuels in Spain, not including taxation, with our largest trading partner, namely the euro area, they are above the average, according to the latest report on this area by the Ministry of Industry. However, if we include taxation, petrol and diesel are 14% and 7% below the average for the 17 countries that share the euro. Even so, Spain's taxes add more than 40% to the final price.

This high level duty can be explained by the difficulty in replacing oil with another kind of input. This phenomenon makes fuel prices inelastic and means that, when they rise, there is less variation in the amount consumed. As a result, autonomous communities have used fuels to impose the so-called «health cent». This duty on the price of petrol and diesel is passed on almost entirely to consumers. That's why a large proportion of the differences between prices in the different autonomous communities were in the region of 3.7 and 4.2 cents per litre, respectively, in November.

In spite of the aforementioned risk of prices rising, the slump in activity will become a decisive factor in pushing inflation down. The measures adopted to reduce the deficit will have a notable

The euro's depreciation makes imports more expensive.

CONSUMER PRICE INDEX

	2010			2011		
	% monthly change	% change over December 2009	% annual change	% monthly change	% change over December 2010	% annual change
January	–1.0	–1.0	1.0	–0.7	–0.7	3.3
February	–0.2	–1.2	0.8	0.1	–0.6	3.6
March	0.7	–0.5	1.4	0.7	0.1	3.6
April	1.1	0.6	1.5	1.2	1.4	3.8
May	0.2	0.8	1.8	0.0	1.4	3.5
June	0.2	1.0	1.5	–0.1	1.2	3.2
July	–0.5	0.6	1.9	–0.5	0.7	3.1
August	0.3	0.8	1.8	0.1	0.8	3.0
September	0.1	0.9	2.1	0.3	1.0	3.1
October	0.9	1.8	2.3	0.8	1.8	3.0
November	0.5	2.4	2.3	0.4	2.2	2.9
December	0.6	3.0	3.0	0.1	2.4	2.4

SOURCE: National Institute of Statistics.

Inflation will fall towards 1.4% but there are risks that might push it up.

effect on aggregate demand and, according to our forecasts, will reduce growth prospects for 2012, placing the fall in GDP at 0.5% year-on-year. For this reason, our inflation forecast for 2012 is around 1.4%. The extension of the extra low VAT rate and a return to tax deductions for a primary residence will hardly have any effect on the CPI.

This core scenario assumes an average price of Brent quality oil for the whole of the year at around 104 dollars; i.e. reflecting a context where the problems in the Persian Gulf are contained. These forecasts also assume a dollar-euro exchange rate above 1.30 for the year as a whole. Any deviation from these two assumptions will push up inflation in 2012. Moreover, our forecasts do not include any modifications in indirect taxation that might occur, which would also increase the inflation forecast. In short, the downward slide will continue in 2012, although the euro's devaluation and oil prices might lessen its fall.

Foreign sector

Exports boost the correction in the trade balance

Since 2008, the foreign sector has become the main source of growth for the Spanish economy. This good performance is due to the sharp shrinkage in imports at first and then the good pace of exports and particularly to tourism picking up in 2011. As a consequence, the foreign component's contribution to gross domestic product (GDP) was slightly lower than the annual average of 2 percentage points during these four years. With regard to 2012, we expect the foreign sector to continue contributing positively. However, there are several factors that might affect the intensity of the latter. These are: the evolution of Europe's economy, the euro's exchange rate and oil prices.

In fact, the data available for the fourth quarter of 2011 show clear signs of weakness in the country's domestic demand. Within this context, the pace of growth of imports fell sharply. In November, the consumption of foreign goods grew by 5.3% year-on-year compared with the average 11.2% rise during the first nine months of last year. This contrasts with the faster pace of growth in exports that, in November, stood at 13.4% year-on-year.

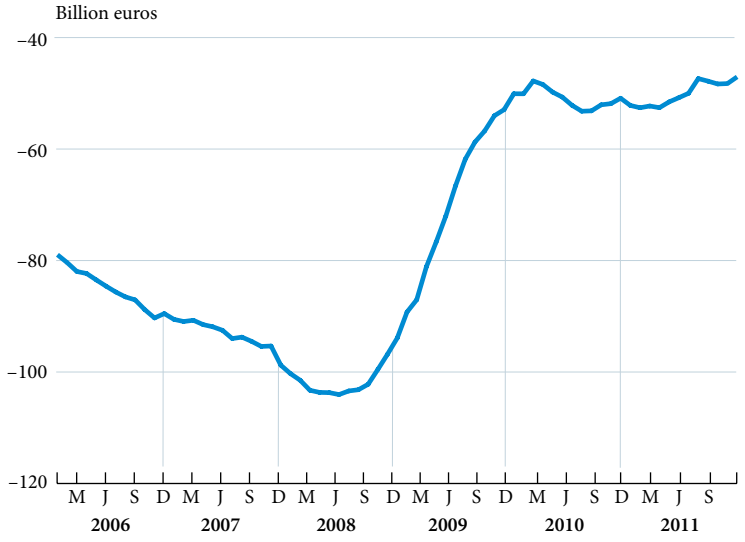
This disparate trend is accentuated if we analyze the real evolution of trade flows; i.e. net of the price effect. Of note is the

The foreign sector's good performance will soften the economic squeeze in 2012.

The fall in the volume of imports reflects the slowing up of domestic demand.

THE TRADE DEFICIT REACHES ITS LOWEST LEVEL SINCE THE CRISIS ERUPTED

Trade balance



SOURCE: Ministry of Industry, Tourism and Trade.

The trade deficit reduces by 31.1% year-on-year in November.

fall in real imports in the month of November, 4.9% year-on-year, compared with the 8.7% rise in the volume of exports over the same period.

As a result, the trade deficit fell by 31.1% year-on-year in November and the cumulative imbalance for the last twelve months stood at 47.2 billion euros. This improvement is mainly due to the evolution in the non-energy component, with a surplus of 192 million euros. The surplus with the European Union lies behind this good performance.

We expect the trade balance to continue adjusting in 2012.

Looking to the future, we expect the recession in Europe's economy in 2012 to reduce the rate of growth of Spanish exports. However, this effect will be partly offset by the slight depreciation expected in the euro over the first half of this year, which will boost exports to the rest of the world. At the same time, weak domestic demand will also affect the consumption of foreign goods, which will more than likely lead to a fall in Spain's imports in 2012.

In short, Spain's trade balance will maintain its path of adjustment throughout this year thanks mainly to the reduction in the non-energy deficit. All this in a context where oil prices will gradually converge towards levels slightly lower than the present, reducing the pressure of the energy balance on the total deficit.

FOREIGN TRADE

January-November 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	50,974	27.6	21	14,086.6	74.0	7.1	–36,888	27.6
Consumer goods	56,425	4.3	24	63,359.9	10.6	32.1	6,935	112.3
Food	*14,869*	*5.3*	*6*	*23,277.2*	*8.2*	*11.8*	*8,408*	*156.5*
Non-foods	*41,556*	*4.0*	*17*	*40,082.7*	*12.1*	*20.3*	*–1,473*	*96.5*
Capital goods	16,003	–3.2	7	16,975.8	18.3	8.6	973	106.1
Non-energy intermediate goods	115,869	9.1	48	103,059.5	14.3	52.2	–12,809	88.9
By geographical area								
European Union	126,378	6.4	53	131,073.7	13.9	66.4	4,696	103.7
Euro area	*102,518*	*7.2*	*43*	*104,925.9*	*10.9*	*53.1*	*2,408*	*102.3*
Other countries	112,893	15.2	47	66,408.1	21.3	33.6	–46,485	58.8
Russia	*8,085*	*45.4*	*3*	*2,336.5*	*28.1*	*1.2*	*–5,749*	*28.9*
United States	*9,776*	*15.6*	*4*	*7,242.5*	*21.4*	*3.7*	*–2,533*	*74.1*
Japan	*2,977*	*–6.8*	*1*	*1,724.3*	*33.0*	*0.9*	*–1,253*	*57.9*
Latin America	*15,552*	*19.3*	*6*	*11,070.1*	*19.1*	*5.6*	*–4,482*	*71.2*
OPEC	*25,110*	*21.2*	*10*	*7,617.7*	*22.0*	*3.9*	*–17,492*	*30.3*
Rest	*51,393*	*9.3*	*21*	*36,416.9*	*21.0*	*18.4*	*–14,977*	*70.9*
TOTAL	**239,271**	**10.4**	**100**	**197,481.7**	**16.3**	**100.0**	**–41,789**	**82.5**

SOURCES: Ministry of the Economy and own calculations.

The current balance records its first surplus since 1998

If we widen our analysis to the whole of the current balance we can see that, in October 2011, this totalled 456 million euros. This figure, the first surplus recorded since August 1998, represents an improvement in the current balance of 3.1 billion euros compared with the same month last year. However, a breakdown shows that close to two thirds of this adjustment correspond to the good performance by the transfer balance, reflecting a transfer from the European Union to the public administrations.

Another component that played an important part in this improvement was the services balance, boosted by the good performance of tourism revenue, in October growing by 7.9% year-on-year. However, the slowdown in the growth of tourist visits to Spain over the last two months of the year suggests that revenue will have less room for improvement in the remainder of 2011. In our opinion, the weakness of the European economy in 2012 will ensure this trend continues in 2012.

The transfer and services balances permit a current surplus in October.

In addition to less dynamism in the services balance is the increase in the income balance deficit, resulting from the rising cost of financing Spanish debt. Nevertheless, we expect that the improvement in the balance of goods will help to reduce the current deficit to below 3% of Spanish GDP in 2012, compared with the 4.0% we estimate for 2011.

The trade deficit will fall below 3% of GDP in 2012.

BALANCE OF PAYMENTS

November 2011

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–34,043	–13.2	–41,986	5,564	–11.7
Services					
Tourism	*27,920*	*14.2*	*30,437*	*3,560*	*13.2*
Other services	*3,342*	*321.1*	*3,388*	*2,382*	*237.0*
Total	31,262	23.9	33,825	5,943	21.3
Income	–23,726	28.0	–27,130	–3,615	15.4
Transfers	–5,577	–37.6	–3,752	4,100	–52.2
Total	**–32,083**	**–22.6**	**–39,043**	**11,991**	**–23.5**
Capital account	**4,281**	**–16.0**	**5,477**	**–812**	**–12.9**
Financial balance					
Direct investment	–4,288	167.0	–456	4,602	–91.0
Portfolio investment	–6,715	–	–12,748	–64,101	–
Other investment	–4,408	317.5	–6,451	–1,830	39.6
Total	**–15,411**	**–**	**–19,655**	**–61,328**	**–**
Errors and omissions	–9,487	61.5	–6,065	–618	11.3
Change in assets of Bank of Spain	52,699	478.5	59,287	50,768	–

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

Spain's deficit exceeds 8% of GDP in 2011 according to a government announcement.

Fiscal consolidation: a long road to travel

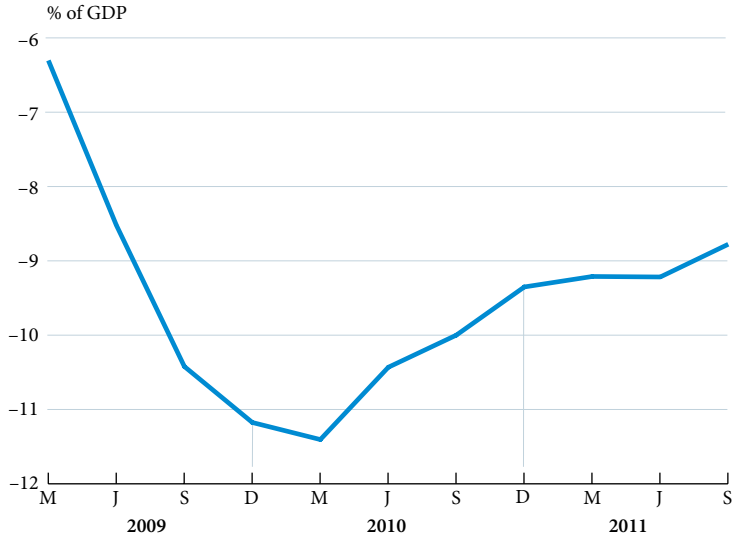
«The beginning of the beginning». The government's Vice-President used these words to introduce the new package of fiscal measures to redirect Spain's public deficit. The message is clear: the consolidation process promises to be laborious. Particularly after announcing that 2011's public deficit would be around 8.0% of the country's gross domestic product (GDP). A figure that is varies significantly from the 6.0% target contained in the stability programme.

In fact, the figures for public administration net borrowing in the third quarter of 2011 have confirmed suspicions that last year's fiscal adjustments were not enough. As shown in the graph below, the cumulative deficit between October 2010 and September 2011 represented 8.8% of GDP for the same period. This means a reduction of just 5 tenths of a percentage point compared with the 2010 balance.

In fact, during the first three quarters of 2011, the general government only adjusted its deficit by 4.4 billion euros, far from the 34 billion required to meet the target set for the whole of the year. An analysis of budget flows during this period shows a fall in primary spending of 11 billion euros; i.e. expenditure without taking into account interest

PUBLIC SECTOR NET BORROWING IS NOT ADJUSTING QUICKLY ENOUGH

Public sector net lending (+) / net borrowing (–)



SOURCE: National Institute of Statistics.

payments. But the deteriorating macroeconomic situation wiped out part of this improvement as interest payments rose and revenue fell.

With regard to the fourth quarter, we expect that the economic squeeze won't favour fiscal adjustment either. Available cash accounting figures confirm this. Tax revenue for the central government and autonomous communities in November 2011 was down by 11.3% compared with the same period a year ago. In the case of the central government, it achieved its deficit target for 2011 as a whole, namely 4.8% of GDP, one month before the end of the year, so that it probably exceeded this figure by year-end.

But the central government wasn't the only one not to meet its targets. According to the government, the Social Security accounts had a deficit in 2011 compared with the target surplus of 0.4% of GDP. Similarly, the autonomous communities reached an imbalance of close to 2.5% of Spanish GDP, far from the figure of 1.3% set at the beginning of year. As a consequence, we estimate that public sector net borrowing stood at 8.2% of GDP in 2011, more than 2 percentage points higher than the target.

Undoubtedly, this deviation makes it more difficult to consolidate Spain's public finances in 2012. An adjustment of approximately 40 billion euros is required in order to meet the target set for this year of 4.4% of GDP. Given this situation, the new government announced another adjustment plan that includes measures both to cut spending and increase public revenue. Among the former, of note are the freezing of civil service wages and of the filling of vacancies for most staff, a 20% reduction in grants to political parties and unions, as well as cuts in research and development, in loans to motorway licensees and the budgets for RENFE (railways) and RTVE (broadcasting). Public spending is expected to fall by 8.9 billion euros with these measures.

We must also add to this figure the 6.3 billion euro rise in revenue the government hopes to achieve. This will be done via tax hikes in 2012 and 2013 that affect housing rates (IBI in Spanish), taxes on savings and also income tax (IRPF in Spanish). The latter will see an increase of between 0.75 percentage points for the lowest incomes to 7 percentage points for the highest.

In addition to these measures, throughout January the new executive also announced further advances regarding the drafting of the Budget Stability Act. As well as introducing a new fiscal rule that limits Spain's deficit, this also aims to establish measures to increase control of the public accounts of autonomous communities. It was also agreed to close 400 public corporations at the end of the year. In exchange, the government is providing a new line of credit through the Official Credit Institute (ICO in Spanish) to resolve any liquidity problems encountered by the communities.

All these measures have been welcomed by the financing markets. This, together with the European Central Bank's injection of liquidity into the banking sector, meant that new debt issuances could be placed at lower interest rates than those recorded in the preceding months. However, an additional adjustment in the order of 25 billion euros is still required to achieve the deficit target set for 2012. This means the introduction of further measures that won't help to boost Spain's economy in a year of recession.

Higher financing costs and falling revenue hinder the correction of expenditure in 2011.

The deficit needs to be adjusted by around 40 billion euros in 2012.

According to the government, its new measures will reduce the deficit by 15 billion.

Fiscal rules: tied to the mast?

Homer told how, so as not to succumb to the Sirens' song, Ulysses decided to tie himself to the mast of his ship, ordering his crew to plug their ears with wax. Thanks to this decision, the Greek hero managed to avoid wrecking the ship against the reefs and was able to continue his long journey home. In a similar way, the Spanish government approved two new rules in 2011 that restrict fiscal policymaking by introducing limits to public spending and deficit. In exchange, they hope to be able to achieve fiscal consolidation and ensure the long-term sustainability of their public finances. Will these new fiscal rules help them to achieve this aim?

In addition to exercising a redistributive function and ensuring the provision of public goods, fiscal policy might also be used to cushion the fluctuations inherent in economic cycles. For example, an increase in public spending can prevent a larger fall in economic activity during recessionary periods. This can be offset in boom times with reductions in spending that, in turn, slow up the pace of growth. However, there are some factors that push public spending too high in structural terms. This is the case, for example, of greater spending for electoral purposes or due to excessive optimism regarding how the economy will perform in the future. The adoption of fiscal rules is an attempt to correct these deviations to ensure the long-term sustainability of national accounts and give the fiscal policy decisions taken by public administrations more coherence over time and credibility.

The economic literature points to Sweden, already in the 1930s, as the pioneer in designing a fiscal framework centred on achieving long-term sustainability for its national accounts without affecting the stabilizing nature of fiscal policy. Since then, numerous countries have adopted new rules. According to a report by the International Monetary Fund (IMF), in 2009 there were 57 countries with at least an explicit limit for their public deficit or debt and/or some budgetary items.[1] Among these we find member states of the European Union that, on signing the Stability and Growth Pact (SGP) in 1992, introduced a public deficit limit of 3% of the gross domestic product (GDP). But the credibility and effectiveness of this rule have been seriously damaged as it was not capable of boosting fiscal consolidation during the last expansionary cycle or of preventing the fast deterioration in national accounts after the crisis erupted. The laxness of the deficit rule in expansionary times and the practical absence of mechanisms to encourage the correction of imbalances when limits are exceeded explain its little success. Given this situation, euro area countries have started to design a new fiscal pact that can redirect public debt to more sustainable levels.

According to the same IMF report, the empirical evidence available seems to confirm, in general, that fiscal rules are effective in achieving budgetary discipline and increase the chances of success for fiscal consolidation processes. However, the European case highlights the importance of the details in these rules in order for them to work well. A badly defined rule can divest fiscal policy of the necessary flexibility to dampen economic cycles, intensifying recessions (becoming procyclical) and reducing the public administration's capacity to react to the crisis. But as well as being flexible, an effective fiscal rule must also be precise, easy to implement and must be directly related to the desired final outcome, generally the sustainability of national accounts. It is also essential to define a corrective procedure in the case of non-compliance.

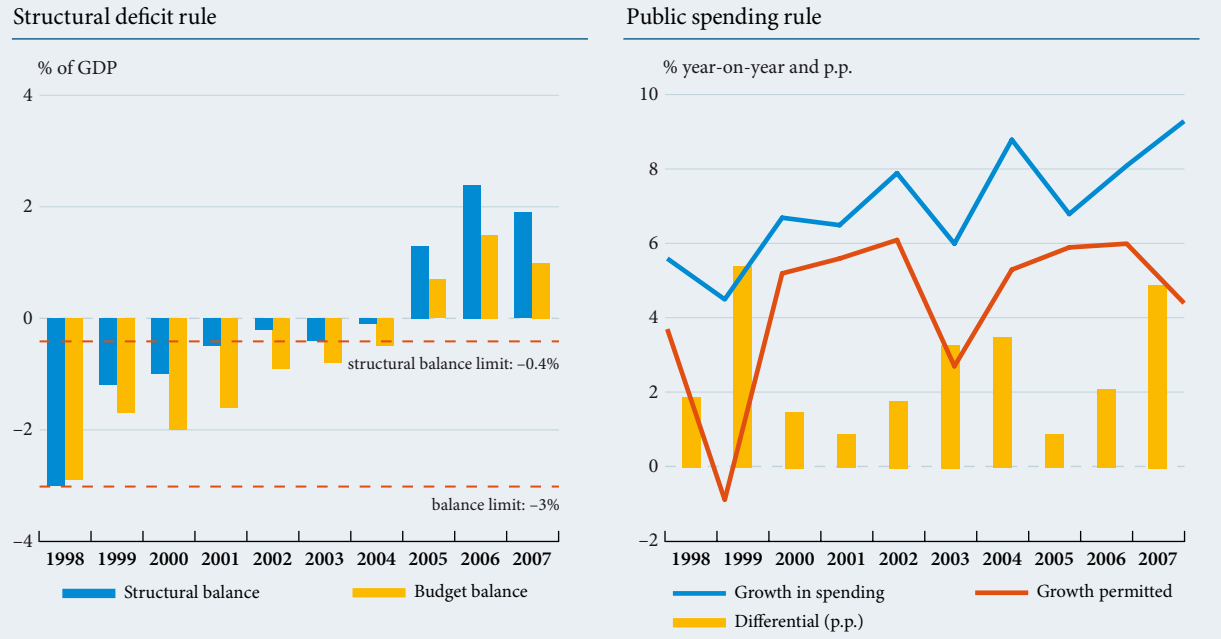
In the case of Spain, the two reforms approved in 2011 regulate public spending and deficit. In the case of public spending, this cannot be higher than the medium-term rise in nominal GDP unless it is accompanied

(1) See IMF (2009), *Fiscal rules – Anchoring expectations for sustainable public finances.*

by discretional rises in public revenue. Excluded from this expenditure are interest payments on debt and non-discretional spending on unemployment benefit. With regard to the second rule, in September 2011 a reform of the Constitution was passed that limits the structural deficit of the public sector – i.e. the total deficit once corrected for the effect of the economic cycle. The structural deficit will not be able to exceed the margins defined by the European Union, in the case these are specified. Similarly, the limit to the structural deficit contained in the Constitution will be established in an organic law pending approval and that will probably be around 0.4% of GDP as from 2020. Of this figure, 0.26 points of GDP will correspond to the structural deficit of the central government and the remaining 0.14 percentage points will correspond to the autonomous communities.[2] These restrictions can only be exceeded in the case of economic recession or in exceptional situations.

A priori, both rules comply with most of the conditions indicated previously as propitious for them to function correctly. Both the use of the structural deficit and medium-term growth in GDP to calculate public spending allow the series' cyclical component to be adjusted, making the rules more flexible. In boom periods, the effort to comply with these rules is greater than if both variables were not cycle-adjusted. Similarly, the deterioration in budget flows associated with economic contractions, due for example to greater spending on unemployment benefit, does not affect the deficit's structural component and reduces the need to adjust the budget. Moreover, elevating the deficit limit to a constitutional level might improve the rule's effectiveness as it makes it difficult to

THE NEW FISCAL RULES WOULD HAVE DEMANDED GREATER BUDGETARY BALANCE BETWEEN 1998 AND 2007



SOURCES: IGAE, International Monetary Fund, Bank of Spain and own calculations.

(2) This means that the accounts of local corporations and of the Social Security Administration must be in equilibrium. However, in the case of the latter, the implementing organic law might detail a budget stability target according to the medium and long-term demographic and economic evolution forecasts.

modify. However, the correct design of both measures will have to be evaluated after the European fiscal pact and the state budget stability law have been concluded. The details of their wording will determine their efficacy, as that is where the corrective mechanisms will be established that will be followed in the case of non-compliance of the rules. On the other hand, lack of specificity when defining the exceptions that allow the structural deficit limit to be exceeded and delaying its commencement until 2020 hint at some unknown factors regarding its good functioning.

An interesting exercise that attempts to analyze the effectiveness of the new fiscal rules consists of estimating their effect if they had been in force during the last expansionary cycle. In the graph on the left we can see the evolution of Spain's fiscal balance between 1998 and 2007. As can be seen, this did not exceed the limit of 3% of GDP contained in the SGP and large surpluses were recorded during the last three years. In contrast, the new rule defined for the structural deficit would have only been complied with between 2005 and 2007, which would have forced the public administrations to make a greater effort so as not to exceed the structural deficit of 0.4% of GDP. Similarly, as shown by the graph on the right, the spending limit introduced in the budget framework would have been exceeded throughout these years. According to the Bank of Spain, during that period the average growth in public spending was 7.0% year-on-year compared with the 4.6% that would have been permitted by this fiscal rule.[3]

The use of both rules would have brought about less public spending between 1998 and 2007 and would have forced public administrations to take advantage of expansionary periods to sort out their accounts. The table shows the annual budget balance required to comply with the new fiscal rules during the period analyzed. As can be seen, the structural deficit limit would have been the more restrictive rule during the first few years. In 2001, this rule would have demanded a structural surplus of 0.7% of GDP compared with the deficit of 0.5% observed.

WHAT WOULD HAVE HAPPENED BETWEEN 1998 AND 2007 WITH THE NEW FISCAL RULES?

	Fiscal balance observed	Balance necessary to comply with the rule (*)	
		According to the structural deficit limit	According to the public spending limit
1998	–3.0	**–0.5**	–2.3
1999	–1.2	0.1	**0.8**
2000	–1.0	**0.6**	–0.4
2001	–0.5	**0.7**	–0.2
2002	–0.2	0.3	**0.4**
2003	–0.4	0.0	**0.8**
2004	–0.1	0.0	**1.1**
2005	1.3	0.2	**1.6**
2006	2.4	0.5	**3.1**
2007	1.9	0.5	**3.7**

NOTE: (*) The rule that requires greater adjustment in the fiscal balance to ensure compliance is in bold.
SOURCES: Bank of Spain and own calculations.

(3) See Banco de España (2011), «La reforma del marco fiscal en España: los límites constitucionales y la nueva regla de crecimiento del gasto público». *Boletín Económico*. September 2011.

From that time on, the spending rule would have been the one that would have forced greater budget containment. The effect that the implementation of these rules would have had on public debt cannot be underestimated. This would have been close to 25% of GDP at the start of the economic crisis. A figure, by 9.1 percentage points, lower than the minimum of 2007, which would have given public administrations much more leeway to tackle the sovereign debt crisis.

In short, both from the theoretical point of view and via a hypothetical exercise, it seems that the design of Spain's new fiscal rules is on the right course in its aim to ensure the long-term sustainability of national accounts without losing the stabilizing nature of fiscal policy. To this end, it is of the utmost importance that both the European fiscal pact and Spain's budget stability law to be approved in the next few months end up defining the aspects that are important for them to function correctly. This would strengthen the ties to the mast of fiscal coherence and would allow the journey to continue towards the consolidation of Spain's national accounts.

This box was prepared by Joan Daniel Pina
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Savings and financing

Deleveraging continues in the private sector

The non-financial private sector reduces its debt by 50 billion euros.

In Spain, resident private sector financing fell in 2011. This decline was largely due to the weakness of economic activity and the far-reaching restructuring process carried out by Spain's banking system. All this in a context of huge tension in Europe's financing markets. 2012 started with these turbulences easing thanks basically to the injection of liquidity by the European Central Bank (ECB) last December. However, forecasts for 2012 do not augur any recovery in credit.

In fact, during the first three quarters of 2011, the non-financial private sector accelerated its deleveraging that had started in mid-2010, reducing its debt by more than 50 billion euros. Nevertheless, the ratio of private debt to gross domestic product (GDP) was still at a very high level, namely 217.3%. As a consequence, this imbalance is expected to continue to adjust over the coming years. This is quite the opposite to what will happen with public sector debt which, due to its net borrowing, will continue to gradually rise.

The data for November 2011 showed a trend in line with these predictions. Private sector financing was 2.1% below its level recorded a year ago. This reduction affected both households and

FINANCING OF NON-FINANCIAL SECTORS (1)

November 2011

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,147,183	–61,342	–2.1	75.0
Non-financial corporations	1,268,985	–40,976	–2.2	44.3
Resident credit institution loans (3)	*850,784*	*–46,691*	*–4.5*	*29.7*
Securities other than shares	*65,467*	*4,520*	*6.0*	*2.3*
External loans	*352,734*	*1,195*	*2.5*	*12.3*
Households (4)	878,197	–20,366	–2.1	30.7
Housing loans (3)	*667,935*	*–12,024*	*–1.2*	*23.3*
Other (3)	*207,194*	*–8,091*	*–5.0*	*7.2*
External loans	*3,068*	*–252*	*4.4*	*0.1*
General government (5)	715,875	73,992	13.7	25.0
TOTAL	**2,863,057**	**12,649**	**1.2**	**100.0**

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

non-financial firms in a similar way. On the other hand, if we look only at the change in the outstanding credit balance for other resident sectors, this shrank by 2.9% year-on-year in November.

Albeit to a lesser extent, the weakness of credit over the last few months of 2011 could also be seen in the euro area as a whole, growing only slightly by 1.0% in November. Given this situation, the ECB decided to provide Europe's banking sector with enough liquidity to encourage credit to flow again to the different economic agents. In the case of Spain, and as can be seen in the graph below, this led to the banking system resorting more to the Eurosystem, up to nearly 119 billion euros and coming close to the peak reached in July 2010.

Although this intervention by Europe's top monetary authority helped to ease tension in the financing markets, there are doubts as to whether it will boost Spain's credit balance in 2012. The reasons for this lie mainly in the weaker dynamism of the Spanish economy and the new reform of the banking sector which is very likely to be approved in February. With regard to the first factor, the squeeze in economic activity, and the consequent deterioration in Spain's job market, will reduce the solvent demand for credit this year. This will also push up the non-performing loan rate, which in November already accounted for 7.51% of the total credit portfolios in Spain, nine basis points above the previous month's ratio.

As in previous months, real estate credit is the main culprit for this rise in non-performing loans. Given that this component accounts for 22.8% of the total credit in September, it is no surprise that real estate risk is considered to be the main threat to the solvency of Spain's banking system. Given this situation, the new government is preparing a new plan that aims to remove any doubt regarding the soundness of banks' balance sheets

Credit to the non-financial private sector falls by 2.9% year-on-year in December.

The economic squeeze and the new reform of the financial sector will weaken credit's performance in 2012.

ECB LOANS TO THE SPANISH FINANCIAL SYSTEM COME CLOSE TO THE PEAKS OF 2010

Eurosystem financing requested by Spain's banking system

SOURCE: Bank of Spain.

The government will force an increase in provisions to cover losses from real estate portfolios.

in Spain. The latest information rules out the creation of a «bad bank» to group together the financial sector's toxic real estate assets. In exchange, it seems that the government will toughen up the provisions that have to be made by financial institutions to cover any losses from their real estate portfolios, especially those related to foreclosed land. These provisions will reduce any profit made in 2011 and 2012.

In the long term, this measure might improve the solvency of Spain's banking sector without requiring any significant intervention by the public administration. However, excessively strict conditions might also affect their lending capacity. Moreover, those institutions with a larger proportion of real estate assets on their balance sheets might find it difficult to extend their provisions. This could result in further restructuring of Spain's banking sector.

The household savings rate falls again, to 12.0%.

Bank deposits speed up their rate of descent

The deposits of firms and households fall by 3% year-on-year in November.

In the third quarter of 2011, the household savings rate maintained its downward slide started a year and a half ago, reaching 12.0% of disposable income in cumulative terms for four quarters. This figure is moving away from the peak of 2009, when households' precautionary savings rose by more than five percentage points, reaching 18.5%. In fact, this increase intensified the reduction in private consumption that year and, by extension, helped to shrink the economy further. Given the new deterioration in economic activity predicted for 2012, the performance of the savings rate has become one of the key questions to be answered.

According to our forecasts, the savings rate will continue to fall over the coming quarters, albeit at a significantly slower rate. This will ease the fall in private consumption. The data for bank liabilities are in line with this forecast. Bank liabilities held by households and firms recorded a year-on-year decrease of 3.0% in November, driven by the fall in term deposits.

An analysis of the trend in deposits of households and firms shows a fast deterioration as from June 2011. There are three reasons for this decline: firstly, the stagnation and subsequent shrinkage of the Spanish economy as from

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

November 2011

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	263,937	2,171	0.8	11,891	4.7	19.3
Savings deposits	198,708	–12,580	–6.0	–7,533	–3.7	14.6
Term deposits	707,764	–35,884	–4.8	–29,994	–4.1	51.8
Deposits in foreign currency	16,882	–2,500	–12.9	–4,901	–22.5	1.2
Total deposits	**1,187,291**	**–48,793**	**–3.9**	**–30,537**	**–2.5**	**87.0**
Other liabilities (*)	**178,156**	**–24,856**	**–12.2**	**–11,500**	**–6.1**	**13.0**
TOTAL	**1,365,448**	**–73,649**	**–5.1**	**–42,037**	**–3.0**	**100.0**

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

the third quarter last year. Secondly, the introduction of a decree law that limited the return on deposits offered by financial institutions. As a consequence, these have used other financial instruments that are exempt from this limitation, such as commercial paper, to attract retail funds. And lastly, of note is the sharp rise in interest rates for sovereign debt which attracted a significant number of small investors during the last few months of 2011.

Looking to the future, the ECB's 3-year tenders are expected to meet the liquidity needs of Europe's banks and, in particular, of Spain's. This will reduce the need for finance via retail deposits and will avoid another period of sharp interest rate rises. Moreover, the hike in the duty levied on income from savings, of between 2 and 7 percentage points, which is introduced in the new plan to adjust Spain's public deficit, won't help deposits to recover in the coming quarters either.

The hike in duty levied on income from savings will not help deposits to recover.

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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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