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THE SPANISH ECONOMY

Monthly Report

THE DELEVERAGING OF HOUSEHOLDS AND FIRMS

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2010	2011	2012	2011				2012	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast					Forecast	
Gross domestic product									
United States	3.0	1.7	2.0	2.2	1.6	1.5	1.6	1.9	2.0
Japan	4.5	–0.7	1.7	–0.1	–1.7	–0.5	–0.6	1.7	2.5
United Kingdom	2.1	0.9	0.7	1.7	0.6	0.5	0.8	0.4	0.6
Euro area	1.8	1.5	–0.4	2.4	1.6	1.3	0.7	–0.3	–0.7
Germany	*3.6*	*3.1*	*0.5*	*4.6*	*2.9*	*2.7*	*2.0*	*0.8*	*0.6*
France	*1.4*	*1.7*	*0.1*	*2.3*	*1.7*	*1.6*	*1.3*	*0.3*	*0.4*
Consumer prices									
United States	1.6	3.1	2.3	2.1	3.3	3.8	3.3	2.8	2.2
Japan	–0.7	–0.3	0.2	–0.6	–0.4	0.2	–0.3	–0.2	0.2
United Kingdom	3.3	4.5	2.7	4.1	4.4	4.7	4.7	3.4	2.9
Euro area	1.6	2.7	2.0	2.5	2.8	2.7	2.9	2.6	2.0
Germany	*1.1*	*2.3*	*1.9*	*2.1*	*2.3*	*2.4*	*2.4*	*2.2*	*1.9*
France	*1.5*	*2.1*	*2.1*	*1.8*	*2.1*	*2.1*	*2.4*	*2.3*	*2.2*
SPANISH ECONOMY			Forecast					Forecast	
Macroeconomic figures									
Household consumption	0.7	–0.1	–1.5	0.4	–0.3	0.5	–1.1	–1.2	–1.7
Government consumption	0.2	–2.2	–6.2	0.6	–2.1	–3.6	–3.6	–6.8	–6.4
Gross fixed capital formation	–6.2	–5.1	–8.5	–4.9	–5.4	–4.0	–6.2	–8.8	–9.1
Machinery and capital equipment	*5.5*	*1.6*	*–5.3*	*5.7*	*1.1*	*2.2*	*–2.7*	*–6.2*	*–5.6*
Construction	*–10.1*	*–8.1*	*–10.0*	*–9.2*	*–8.1*	*–7.0*	*–8.2*	*–10.1*	*–10.9*
Domestic demand (contribution to GDP growth)	–1.0	–1.8	–4.0	–0.8	–1.9	–1.4	–2.9	–4.2	–4.4
Exports of goods and services	13.5	9.1	2.4	13.1	8.8	9.2	5.2	2.6	3.0
Imports of goods and services	8.9	–0.1	–7.4	6.0	–1.3	0.9	–5.9	–9.3	–8.1
Gross domestic product	**–0.1**	**0.7**	**–1.0**	**0.9**	**0.8**	**0.8**	**0.3**	**–0.4**	**–1.0**
Other variables									
Employment	–2.6	–1.9	–3.5	–1.4	–1.1	–1.9	–3.3	–3.3	–4.4
Unemployment (% labour force)	20.1	21.6	24.1	21.3	20.9	21.5	22.9	24.1	24.3
Consumer price index	1.8	3.2	1.8	3.5	3.5	3.1	2.8	1.9	1.8
Unit labour costs	–2.6	–1.9	0.1	–2.0	–1.7	–1.5	–2.5	–	–
Current account balance (% GDP)	–4.5	–3.9	–2.1	–6.6	–3.2	–2.9	–2.8	–2.6	–2.0
Net lending or net borrowing rest of the world (% GDP)	–4.0	–3.4	–1.6	–6.1	–2.7	–2.4	–2.3	–2.1	–1.5
General government financial balance (% GDP)	–9.3	–8.5	–5.5	–5.3	–9.9	–6.1	–12.8		
FINANCIAL MARKETS			Forecast					Forecast	
International interest rates									
Federal Funds	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	1.0	1.3	1.0	1.0	1.3	1.5	1.3	1.0	1.0
10-year US bonds	3.2	2.8	2.1	3.4	3.2	2.4	2.0	2.0	2.1
10-year German bonds	2.8	2.6	2.0	3.2	3.1	2.3	2.0	1.9	2.0
Exchange rate									
$/Euro	1.33	1.39	1.30	1.37	1.44	1.41	1.35	1.31	1.31

Contents

The deleveraging of households and firms

In the years prior to the recession that started in the last decade, in many countries the gradually increasing debt of the private sector allowed for much more intensive economic growth than would have been seen without it. The abrupt appearance of the crisis frustrated this expansion and revealed an excessive level of debt. This debt is now a heavy burden that can counteract the efforts made to exit economic lethargy. Without a significant reduction in this debt, it will be very difficult to get back to the growth rates of yesteryear.

The origins of mounting debt lie in a period of abundant liquidity and low interest rates which bring about a powerful expansion in credit. In the case of Europe, the creation of the euro represented, for some countries, a notable reduction in short and long-term interest rates, as well as an increase in their sources of financing, as exchange rate risk disappeared among participating states. In turn, the expansion in credit helped to push up asset prices (globalization prevented price rises in goods), in a spiral that caused speculative bubbles to appear.

The dynamics of the credit expansion are very different depending on the country, so there are other factors of a diverse nature (institutional, regulatory, structural) that, at any given time, can either make it difficult or encourage private actors to act. For example, in the case of the United States, the credit boom of the first decade was related to households and mortgage credit, while firms kept a relatively low level of leveraging, a very important factor when leaving the recessionary phase behind. In Spain, however, household debt tripled in the first decade of the century but corporate debt also rose significantly, going above the EU average.

Excessive leveraging represents a significant complication if the economy interrupts its growth and falls into recession. Under these conditions, it's clear that it's much more difficult to exit the crisis: prior experiences show that recovery is slower. To alleviate the problem, debt can be passed on from the private to the public sector (aid and subsidies for households, firms and banks) but, as we are finding out with the euro area's sovereign debt crisis, this is an extremely limited palliative action. The ideal solution is to boost growth but agents' little capacity for spending, resulting from the indebtedness itself, prevents this from happening spontaneously. Unless improvements are achieved in productivity and costs, which does not tend to happen overnight. It helps a lot to have an expansionary external environment to counteract the slump in domestic demand with demand for exports. Whenever possible, devaluating the country's currency helps to stimulate domestic production; inflation also helps, reducing the relative value of the debt in circulation. But devaluation and inflation are remedies with many side effects and, in any case, they are not within the scope of economies belonging to the euro.

The deleveraging phase therefore leads to slower and more fragile economic growth than is customary when exiting a conventional recession. In the case of Spain, the combination of high levels of leveraging, both in firms and households, and the requirement to slow up and reduce public sector leveraging augurs a prolonged period of below-potential growth. A period that can only be shortened by determined improvements in productivity, efficiency and competitiveness in all economic sectors.

EXECUTIVE SUMMARY

Signs of stabilization and large doses of prudence

The approval of a new bail-out for Greece reduces market tensions but oil is of concern.

The first indicators for international economic activity in the first quarter point to an encouraging improvement in the United States, a slowdown in the emerging countries and a slight recession in the euro area. In the latter, the resolution of the second adjustment programme for Greece has helped to reduce tensions in the markets. Investors perceive a certain shift towards improvement compared with the end of 2011, reflected in a gradual increase in the appetite for risk and the search for higher returns. Equity and corporate bonds have benefitted from this atmosphere, supported by the monetary relaxation applied by the central banks. However, we need to remain realistic and recognise that a large part of the areas of instability from previous months are still present, so that any bad news in this respect could spark off new episodes of downwards corrections. The price of crude oil is still a cause for concern, capable of destabilizing the fragile world recovery.

The United States is consolidating its recovery.

If we see the current economic crisis as being due to too much debt, and that an arduous deleveraging process is required to exit such a crisis, then the direction taken by the United States economy is the right one. The most indebted sector, households, has reduced its debt from 130% of disposable income in September 2007 to 113% in December 2011. A reduction that is only halfway if we consider a debt of 90% of disposable income as normal, the figure at the start of 2000. This sustained improvement, together with the steady progress being made in the labour market, seems to be motivating consumers, whose rise in spending could stand at 2% in real terms throughout this year. In investment, construction will continue to be the economy's worst performer, with an excess supply of housing that will continue until well into 2013. With an improved tone, capital goods investment should continue growing at more than 5% throughout 2012, after its strong progress in 2011.

In Japan, the results of the first quarter are positive thanks to the good performance by manufacturing exporters, traditionally the strong point of the Japanese economy. February's industrial production accumulated an increase of 6% since the start of the year, while the machinery orders of exporting firms, a leading indicator of capital goods investment, also picked up. Looking in more detail at the upward trends of the first quarter, February's trade balance was better than expected thanks to the good performance by exports, up by 2.9% compared with January, making the prospect of a current account deficit in 2012 more unlikely.

China sets a growth target lower than 8% year-on-year.

In China, it is worth noting the announcement of a reduction in the annual growth target for the first time in eight years. Prime Minister Wen Jiabao announced that, as from now, the Beijing government's target would go from 8.0% to 7.5%. This change involves the explicit proposal to redirect growth in investment and exports towards private

consumption, which in China only accounts for a third of the gross domestic product (GDP) and whose growth rates tend to be lower than those of investment.

For its part, the Brazilian economy grew by 2.7% in 2011, somewhat less than expected by most analysts and much less than the growth achieved in 2010 (up 7.5%). Although a greater impact was expected from the stimuli implemented since the summer, it has been confirmed that, in the final part of 2011, activity remained relatively weak, which should be attributed to the containment of net exports and the reduction in stock. By way of contrast, domestic expenditure once again demonstrated its resistance and picked up steam compared with the previous quarter. We expect this recovery in domestic demand to consolidate throughout 2012.

In the euro area, economic activity started the year with a weak pulse but is expected to liven up over the year. To date, most leading indicators that have been published point to the sharp deterioration in the last quarter of 2011 starting to slow up. Contemporary indicators point in the same direction. Consumer confidence has improved somewhat since the record low in December, helping retail sales in January to go from a 1.1% contraction year-on-year to zero growth. Industrial production for January shrank by 1.2% but this was less than the 1.8% drop reported in December, and an additional recovery can be glimpsed by way of the timid improvement in business sentiment indices in the euro area. The foreign sector remains the mainstay of this recovery, with a reduction in the trade deficit in January. However, the labour market still looks very weak, as shown by January's rise in the unemployment rate to 10.7%. Moreover, the fiscal adjustment that is being carried out, which is very intense in some countries, together with the deleveraging in the private sector, does not suggest that activity will recover quickly.

In the euro area, indicators point to the economic deterioration slowing up.

Meanwhile, the second adjustment programme for Greece has been given the green light, eliminating one of the factors of uncertainty that are still hovering over the euro area's economy. In fact, the decision regarding the restructuring of Greek public debt in the hands of the private sector was settled with a high degree of voluntary acceptance and a total participation of more than 95% of the debt in the hands of private creditors. The outcome of the debt write-down supposes a reduction of around 105 billion euros on Greece's debt, placing it at 245 billion euros or 114% of GDP, given the new injection of public funds.

The private sector's participation in the Greek adjustment is resolved with a high percentage of voluntary acceptance.

On the other hand, on the last day of February the European Central Bank (ECB) held the second of its two auctions for unlimited three-year loans to banks in the euro area. The central bank lent the 800 banks in question a total of 530 billion euros. This liquidity has helped to ease the nervousness regarding the credit crisis and has continued to have a favourable effect on the fall in risk premia for the sovereign bonds of Italy and, to a lesser extent, Spain. This circumstance has also been reinforced by the satisfactory issuances of public debt by both governments and by the structural measures that are being adopted. Given this reduction in tension, the ECB stopped buying up the bonds of both countries at the beginning of March. However, these tensions are far from having disappeared completely and actually resurfaced in Spain due to the revision of the public deficit targets for 2012.

The ECB injects a significant amount of liquidity.

Spain's budget for 2012, which will be presented at the end of March, will be the

In Spain, the new government is carrying out significant reforms...

cornerstone of the policy of the new government resulting from the elections last November. In these few months, the reformist drive of the new administration has become evident in three big initiatives: the labour reform, which aims to make the job market more flexible and has already come into force; the financial reform, which aims to sort out problematic assets and which is causing important movements in the sector; and the presentation of the bill for the budget stability and financial sustainability act, whose aim is to guarantee budget stability at all levels of the public administration.

...but the key lies in adjusting the public deficit.

In spite of this reformist drive, the deviation of 2011's public deficit from the targets set has created a lack of confidence regarding the Spanish economy's ability to sort out its public sector by eliminating the large imbalance between expenditure and revenue. Last year's public deficit reached 8.5% of GDP, 2.5 percentage points above the target set by the government and the European Commission. Obviously, the fiscal adjustment was clearly insufficient and redirecting this imbalance towards lower levels has become one of the main challenges for economic policy this year, particularly within a context of economic contraction.

The Spanish economy continues to obtain external savings to maintain its current level of expenditure.

Given this situation, the Spanish government revised its target deficit for 2012 from 4.4% of GDP to 5.8% of GDP, although the European Commission demanded that this should be lowered to 5.3%, maintaining the target to achieve a 3% deviation by 2013. This is a very severe challenge as the fiscal consolidation planned exceeds any adjustment in the fiscal balance recorded in Spain over the last few decades. Even more so when the Spanish economy has fallen back into a recession whose duration and extent is difficult to predict. Business indicators for the first quarter point to domestic demand still being depressed, although there are some signs of the decline stabilizing.

The mainstay that ensures the deterioration in activity will not be greater is the foreign sector. The slump in imports, due to weak domestic demand, together with the good performance by exports, has reduced the deficit for goods and services from 6.7% of GDP in 2007 to 0.6% in 2011. Of particular interest is the trade surplus with Spain's main trading partners, the euro area. However, this favourable trend has been partly offset by the deterioration in the income balance due to increasing payments for external debt. In short, in 2011 the Spanish economy needed external financing in the order of 35 billion euros, an amount that should fall substantially in 2012.

In any case, this means that, in spite of the recession in activity and the cutbacks in the spending of households, companies and the public sector, the Spanish economy still needs to attract external savings to finance an expenditure that continues to outstrip its own capacity to generate income and wealth. Within the aforementioned context of a lack of confidence among international investors when financing certain economies in the euro area, it is clear that maintaining a flow of financing towards the Spanish economy has become very complicated. This is why the application of the reforms undertaken and the thorough compliance of the adjustment in public budgets are crucial in order to stabilize the economy and thereby lay the foundations for a future recovery.

27 March 2012

CHRONOLOGY

2011

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

2012

January	25	Social agents sign a **wage moderation agreement** valid from 2012 to 2014.
February	3	The government approves a Decree-Law to **sort out the financial sector**.
	10	The government approves a Decree-Law of urgent measures to **reform the labour market.**
March	2	Twenty-five European Union countries sign the **Treaty on Stability, Coordination and Governance** to strengthen fiscal discipline.
	14	The Eurogroup approves the financing of **Greece's second adjustment programme**.

AGENDA

April

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

May

- **3** Governing Council European Central Bank.
- **4** Registration with Social Security and registered unemployment (April).
  Governing Council European Central Bank.
- **7** Industrial production index (March).
- **11** CPI (April).
- **15** EU GDP flash estimate (first quarter).
- **16** EU HICP (April).
- **17** Quarterly national accounts (first quarter).
- **18** International trade (March).
- **25** Producer prices (April).
- **29** Government revenue and expenditure (April).
- **30** CPI flash estimate (May).
- **31** Balance of payments (March).

INTERNATIONAL REVIEW

The United States: a little better, every day

The United States might grow by 2.0% in 2012, supported by domestic demand and stimulus measures.

Our growth forecast for the US economy for 2012 as a whole remains at 2.0% but the risks that might reduce this figure have also diminished slightly. Although the European debt crisis and oil prices are still considerable hazards, internal risks have lessened. Monetary and fiscal stimuli have helped to bring about a reduction in private debt and a recovery in the labour market that underpin the current levels of growth. Nevertheless, we should remember that there is still a long way to go and that private activity has yet to become totally self-sustainable, so stimuli will still be required.

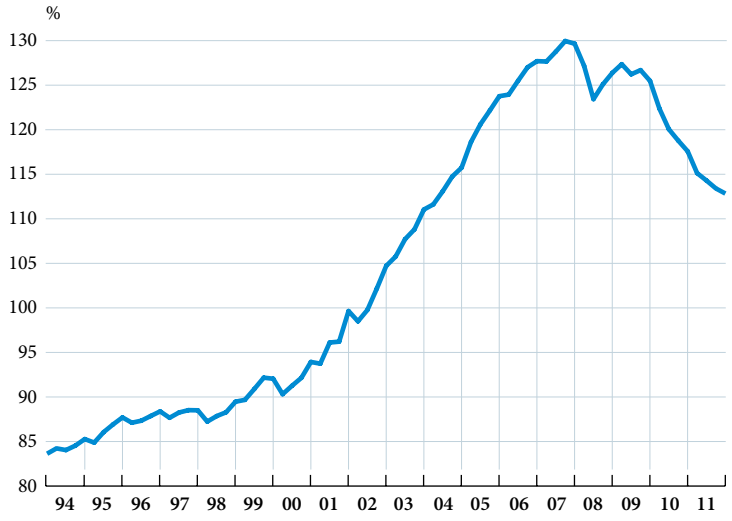
The US economy is at the head of developed economies in reducing debt.

If the current economic crisis is seen as a crisis of too much debt and that the exit to this crisis involves an arduous deleveraging process, then it can be said that the United States is leading the developed economies. From the peak of March 2009 to the end of 2011, private debt (individuals, financial and non-financial firms) fell from 303.1% to 250.9% of gross domestic product (GDP), a reduction of 52.3% in GDP terms that almost doubles the rise in debt taking place in the public sector since its minimum of June 2007, namely 32.5%.

Of the three private sectors, the one that must set the pace of debt reduction in the United States is households, which started

THE UNITED STATES: LESS DEBT, THE MEASURE OF RECOVERY

Gross household debt as percentage of disposable income



SOURCES: BEA, Federal Reserve and own calculations.

the crisis relatively more in debt than in other economies. The progress made is evident (see the Box «Household deleveraging: three countries, three stories»). The gross debt of households has gone from 130.0% of disposable income in September 2007 to 112.8% in December 2011. A reduction that is only halfway if we consider a debt of 90.2% of disposable income as normal, the figure at the start of 2000. This sustained improvement, together with the constant improvement in the labour market, seems to be motivating consumers.

Although private consumption slowed up at the end of 2011, after having experienced a sharp upswing, the first two months of 2012 show that there is a resistant base that should enable private consumption to grow by around 2.0% throughout this year in real terms. Along these lines, retail sales, without cars or petrol, grew by 3.1% year-on-year in real terms, somewhat above the pace at which it ended 2011, with a figure for January that was revised slightly upwards. Following this pattern, consumption expenditure for the national accounts in January advanced more than revenue, so we expect private consumption to grow by close to 2.0% in the first quarter in annual terms, quite a lot higher than the rate expected just two months ago. Similarly, the Conference Board Consumer Confidence index has started to rise again, clambering up to the level of 70.8 points, a level that is still lower than the historical average (around 100 points) but one which it hadn't reached since February 2008.

In spite of this improved situation, sustained growth in private consumption of much more than 2.0% looks difficult to achieve. Firstly, the reduction in debt has yet to pass its halfway mark and, in spite of the improvement in consumer credit,

Private consumption reveals a resistant base of growth around 2.0%.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	3.0	1.7	2.2	1.6	1.5	1.6	–	...	–
Retail sales	6.4	7.7	8.1	7.8	8.0	7.0	6.3	6.5	...
Consumer confidence (1)	54.5	58.1	66.9	61.8	50.3	53.6	61.5	70.8	...
Industrial production	5.3	4.2	5.4	3.8	3.7	3.8	3.6	4.0	...
Manufacturing (ISM) (1)	57.3	55.2	59.8	56.6	52.1	52.4	54.1	52.4	...
Housing construction	5.6	4.3	–5.3	–4.9	5.3	24.4	11.0	34.7	...
Unemployment rate (2)	9.6	9.0	9.0	9.0	9.1	8.7	8.3	8.3	...
Consumer prices	1.6	3.2	2.1	3.4	3.8	3.3	2.9	2.9	...
Trade balance (3)	–500.0	–560.0	–519.3	–534.0	–537.6	–560.0	–565.0	...	...
3-month interbank interest rate (1)	0.3	0.3	0.3	0.3	0.3	0.5	0.5	0.5	...
Nominal effective exchange rate (4)	75.4	70.9	71.9	69.6	69.8	72.4	73.4	72.3	73.0

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

The labour market is improving, with unemployment at 8.3%, but wages will take some time to rise.

a return to the situation before the crisis is not feasible, when private consumption was growing by 3.0% thanks partly to a continued erosion of the savings rate. Secondly, the current situation of the labour market, although it has improved, continues to limit the growth in household income.

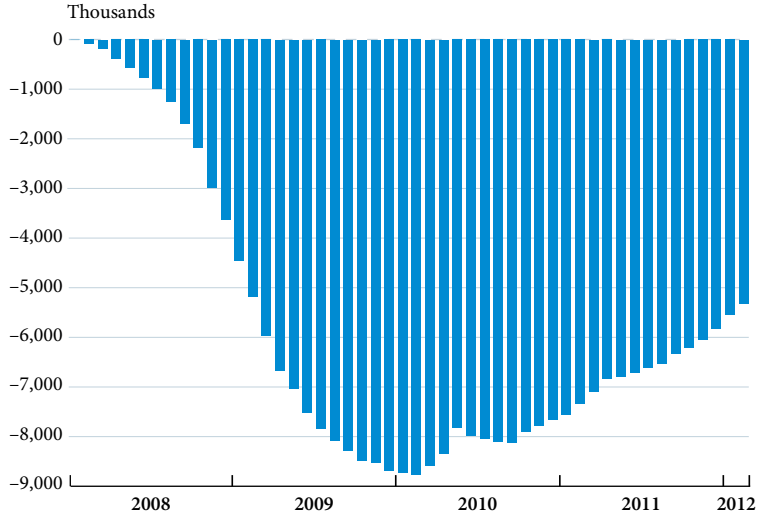
In this respect, although the trend in the labour market is one of the factors that has contributed the most to the improved prospects for the economy as a whole, the benefits that can be expected for 2012 will continue to be modest. After having bottomed out, the labour market's recovery should take place gradually, in three successive stages: firstly, there should be a greater use of the already employed workforce, followed by a rise in new contracts and, thirdly, a recovery in wages.

February's figures show that the recovery in hours worked and the number of new contracts continue to exceed expectations. 227,000 new jobs were created in February, bringing the total jobs recovered since March 2010 to 3.5 million. Nevertheless, there is still a long way to go before all the jobs lost during the crisis have been made up, namely a further 5.4 million. Similarly, the unemployment rate remained at 8.3% in February, way below the 10.0% of October 2010.

The recovery in employment is real but more modest that it appears, with three elements that will hinder wage recovery. Firstly, under-employment (workers who are working part-time involuntarily because of little demand) is still high. Although the improvement of the last few months is evident (between September 2011 and February 2012 the number of under-employed went from 9.1 million to 8.0 million), the real level is still much higher than the 4.5 million that might be considered normal. Secondly, the share of long-term unemployed, which are difficult to relocate, is still 42.6%, almost double the previous peak of 1983. Thirdly, the fall in the unemployment rate is due

THE UNITED STATES: EMPLOYMENT PICKS UP BUT STILL HAS A LONG WAY TO GO

Cumulative change in net jobs since the start of the recovery



SOURCES: US Census and own calculations.

both to job creation and also the reduction in the active workforce, suggesting that the situation is still far from buoyant.

In investment, construction will still be the economy's worst performer, with an excess supply of housing that will continue until well into 2013. One indicator of the slowness of the sector's recovery is that 698,000 new homes in annual terms were started in February, a figure which, although it is above the level of the same period the year before, extends to four months the persistence of a level that is 54.2% lower than the average for the period 1995-2000, prior to the bubble. The best prospects are still in the apartment block sector but prices continue to fall, with the Case-Shiller index for second-hand house prices falling again in December, down 4.0% for the whole of 2011.

With an improved tone, capital goods investment should continue growing at more than 5.0% throughout 2012, after its strong progress in 2011. Although the recovery in the manufacturing industry has faded somewhat over the last few months, business prospects for the services sector, which accounts for 86.2% of employment, continue to improve. The manufacturing activity index of the Institute for Supply Management (ISM) fell to 52.4 points, while the index for services continued to rise to 57.3 points, in line with a GDP growth rate higher than the current figure.

Improvements in housing are minimal. Prices continue to fall and construction is at a standstill.

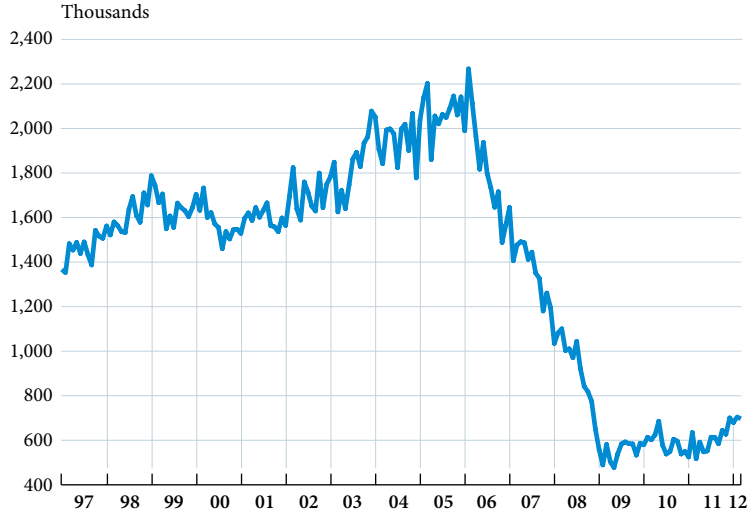
Capital goods investment will remain firm in 2012.

In the area of prices, persistently high oil prices could push up the consumer price index (CPI) close to 2.5%. These higher energy prices, which picked up in February, are preventing the expected drop in what is already a moderate inflation rate. While February's CPI held steady at 2.9% year-on-year, the decline is starting to be felt in the core CPI, which excludes energy and food prices, up 2.2% year-on-year. A minimal moderation that becomes more evident when we take into account the price variations between January and February. The sectors

The CPI rises by 2.9% and core inflation moderates by 2.2%.

THE UNITED STATES: CONSTRUCTION, A FAR-OFF RECOVERY

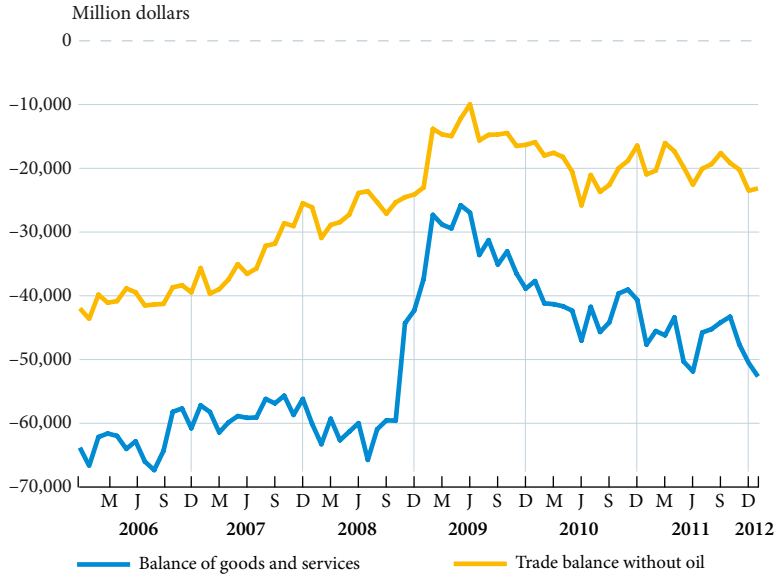
Homes started in annual terms



SOURCES: Department of Commerce and own calculations.

THE UNITED STATES: THINGS LOOK DIFFERENT WITHOUT OIL

Monthly balance of goods and services



SOURCES: Department of Commerce and own calculations.

Expensive oil stops the trade deficit from correcting and deducts growth for the economy as a whole.

pulling core inflation down the most were clothing, rent attributed to home owners and leisure.

The impact of higher oil prices is also being felt by the foreign sector, contributing to the net loss in growth entailed for the US economy. The trade balance for goods and services in January showed a deficit of 52.6 billion dollars. Of this amount, 29.7 billion were attributable to net imports of oil and its derivatives, which in annual terms represents 2.3% of GDP. Crude prices remaining at the current 125 dollars per barrel therefore involves a loss of around 0.5% in GDP terms compared with a hypothetical scenario in which oil prices fall to 100 dollars per barrel. This explains the interest being shown by Obama's administration in bringing down oil prices, applying measures such as releasing their own reserves. With regard to the balance excluding oil, of note is the good performance by exports, on the rise after several months of stagnation; a significant fact considering the general slowdown in world demand and particularly the weakness of its European trading partners.

Japan expects its economy to recover in the first quarter of 2012.

Japan: everything depends on industrial recovery

GDP ended 2011 with a drop in the fourth quarter and with a reconstruction effort that is encountering more difficulties than expected. Exporters have been hit hard by energy costs, aggravated by the effects of Thailand's floods, where Japanese firms had invested to ensure their supplies. This has eroded the current account surplus that, should it continue, would entail the need for external financing, making it more difficult to sustain the expansionary fiscal policies planned for 2012.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	January	February
Real GDP	4.5	–0.7	–0.1	–1.7	–0.5	–0.6	–	...
Retail sales	2.5	–1.2	–3.0	–1.7	–1.0	0.8	1.8	...
Industrial production	16.6	–3.5	–2.5	–7.0	–2.0	–2.3	–1.0	...
Tankan company Index (1)	0.0	–1.3	6.0	–9.0	2.0	–4.0	–	...
Housing construction	2.7	2.6	2.9	4.6	8.0	–4.8	–1.4	...
Unemployment rate (2)	5.1	4.6	4.8	4.6	4.4	4.5	4.6	...
Consumer prices	–0.7	–0.3	–0.5	–0.4	0.1	–0.3	0.1	...
Trade balance (3)	7.9	–1.6	6.5	3.4	1.3	–1.6	–2.7	...
3-month interbank interest rate (4)	0.39	0.34	0.34	0.34	0.3	0.3	0.3	0.3
Nominal effective exchange rate (5)	106.0	113.5	110.6	109.3	115.5	118.6	120.9	117.1

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

However, the outlook for the first quarter has improved precisely because of the good performance by manufacturing exporters, the traditional strength of Japan's economy. February's industrial production posted a cumulative increase of 5.8% since the start of the year, while the machinery orders of exporters, a

Industrial production stands at 2.8% below the level of February 2011.

JAPAN: INDUSTRIAL PRODUCTION PICKS UP

Industrial production index

SOURCES: Japanese Ministry of Communications, National Statistics Office and own calculations.

China modifies its growth target from 8.0% to 7.5%, with a contribution from consumption that needs to increase.

leading indicator for capital goods investment, also picked up. The only blot on this improved landscape is the important electronics and telecom sector which continued to decline, at a level that is still 18.0% below that of February 2011, the month prior to March's tragedy, while the general industrial production index still needs to improve just 2.8% to recover fully.

Looking in more detail at the upward trends of the first quarter, February's trade balance was better than expected thanks to the good performance by exports, which advanced 2.9% compared with January and reduce the likelihood of a current account deficit throughout 2012.

China: abandoning the eight

In March, the world's second economy lowered its annual growth target for the first time in eight years. Prime Minister Wen Jiabao announced that, as from now, the Beijing government's target would go from 8.0% to 7.5%. This change entails the explicit proposal to refocus growth in investment and exports towards private consumption, which in China accounts for just one third of GDP and whose growth rates are usually lower than those of investment.

The main scenario for 2012 is still one of a soft landing.

Our main scenario continues to be a soft landing for the economy, with growth that should come close to 8.0% for the whole of 2012. However, the risk of insufficient growth seems more likely than that of an increase in inflationary tensions. Although the trend in prices in the medium and long term points upwards, since China's demographic must continue to push up labour costs, inflationary tensions should not be a problem in 2012, especially when the latest figures confirm that the recovery in inflation in January was due to higher food prices because of the celebrations for the Chinese New Year.

In this respect, February's CPI was 3.2% year-on-year, while the CPI for food, which accounts for a third of the total in China, went from rising 10.5% in January to 6.2% in February. The greatest inflationary risk in the short term lies in energy prices, which are government

CHINA: MAIN ECONOMIC INDICATORS

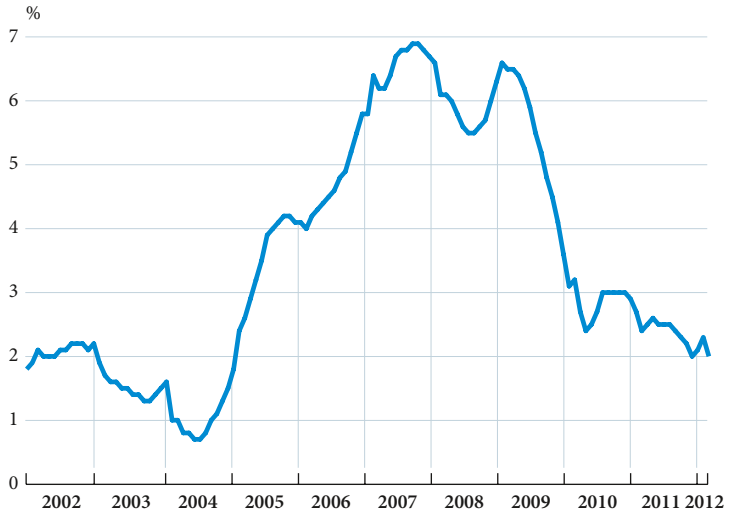
Percentage change over same period year before, unless otherwise indicated

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	January	February
Real GDP	10.4	9.2	9.7	9.5	9.1	8.9	–	...
Industrial production	15.3	13.8	14.5	13.9	13.8	12.8	...	...
Electrical power generation	14.7	11.0	12.1	12.0	10.8	8.9	–5.1	19.4
Consumer prices	3.3	5.4	5.1	5.7	6.3	4.6	4.5	3.2
Trade balance (*)	184.0	157.3	167.2	172.7	170.4	156.7	178.1	154.5
Reference rate (**)	5.39	6.35	6.06	6.31	6.56	6.56	6.56	6.56
Renminbi to dollar	6.8	6.5	6.6	6.5	6.5	6.3	6.3	6.3

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

CHINA: GOODBYE TO GROWTH VIA INTERNATIONAL TRADE

Trade balance for the last 12 months as percentage of GDP



SOURCES: Chinese Statistics Office and own calculations.

regulated in China. In March, the authorities raised fuel prices by 6% given the losses that the narrow margins were causing for Chinese refineries. However, the rise in the core CPI continued to be moderate, up 1.6% year-on-year in January.

Whereas the battle against inflation that began mid-2011 seems to have borne fruit, lower growth than expected is the greatest risk in the short term. Awaiting the publication of the industrial production figures for the first two months of 2012, which will show the extent of the robustness in industrial activity, electricity production picked up in February after its hiatus for the New Year celebrations. Similarly, house prices continued to fall in most of the country's cities in February, indicating that this sector, which represents 13% of GDP, continues to slow up. However, the soft landing is feasible as there is still a lot of room for stimulus policies, even more so if inflation is confirmed to be under control. The cash reserve ratio, in spite of the previous month's fall, is still at a high 20.5%, enabling further reductions, while government debt, even including that of local corporations, remains at a moderate level.

Inflation moderates to 3.2%.

For its part, the trade balance started to fall again. Calendar effects meant that, in February, there was a trade deficit of 31.5 billion dollars, the largest in China's recent history. Although this situation might correct itself in March, the cumulative surplus over the last twelve months is 154.5 billion dollars, very far from the situation prior to the financial crisis. In particular, while the trade surplus accounted for 5.7% of GDP on average in the period 2006-2008, the estimate for the twelve months up to February 2012 remains at 2.0%, suggesting that private consumption should not delay too long in taking over from exports and investment, if growth is to be bolstered.

Rapid slowdown in the real estate sector and exports.

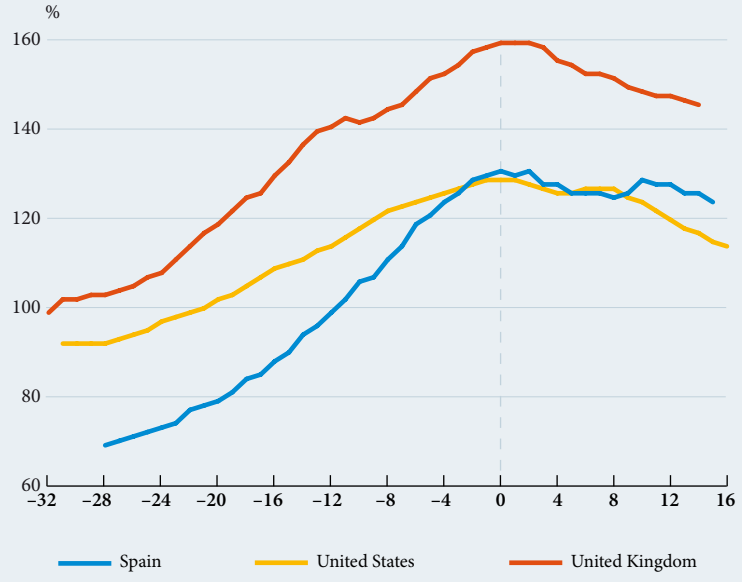
Household deleveraging: three countries, three stories

On the verge of 5 years since the subprime bubble sparked off the worst financial debacle in decades, households on both sides of the Atlantic are still attempting to reduce their excessive debt. This adjustment process promises to be long and arduous; even more so, if possible, in those countries that have yet to consolidate their recovery. Nonetheless, the slump in the economic cycle is not the only reason why the pace of household deleveraging varies substantially from country to country. The aim of this box is, precisely, to establish which factors lie behind this discordance and how this affects each country's growth prospects by comparing the United States, United Kingdom and Spain, three economies that share the regrettable need to overcome the ravages of a burst credit bubble.

During the long boom between the dot.com crisis and the subprime crisis, US, British and Spanish families took advantage of the large amount of low-cost liquidity to spend much more than they earned by considerably increasing their use of credit. Between 2001 and 2007, the level of household debt rose by 80% in the United States; by 87% in the United Kingdom and, in Spain, by 168%; almost doubling in the two Anglo-Saxon countries and tripling in Spain. Although the statistics in absolute terms are revealing in themselves, when considering their sustainability it is more appropriate to measure the indebtedness of households in relation to their earning capacity. So, during this intercrisis period, the household leverage ratio in the United States, measured as the ratio of debt to gross disposable income (GDI), rose by 30 percentage points (p.p.). In the United Kingdom this leverage ratio rose by 52 p.p. and, in Spain, by 58 p.p.

RATIO OF HOUSEHOLD DEBT TO GROSS DISPOSABLE INCOME

Number of quarters after the peak (period 0)



SOURCES: Thomson Reuters Datastream and own calculations.

The outbreak of the financial crisis in 2007 and its deterioration in 2008 with the Lehman Brothers bankruptcy marked the start of a deleveraging process that is slowly making progress in each of the economies analyzed. However, the statistics reveal perceptibly different adjustment rates between countries in this case as well. In the United States, the ratio of debt to GDI has fallen by 17 percentage points compared with its peak at the end of 2007. In the United Kingdom, the cumulative adjustment is 14 percentage points, also since its peak. In Spain, however, it has only adjusted by 7 p.p., in spite of having risen much more than in the United States or the United Kingdom over the eight years preceding the bursting of the bubble (see the above graph). According to a recent study by McKinsey,[1] which is based on the Nordic experience in the 1990s, US households should have carried out almost half their deleveraging while both the United Kingdom and especially Spain would be lagging behind.

So the question is why? Why is the deleveraging process progressing more slowly in the United Kingdom and why has the adjustment made in Spain been much less than in the other two countries? Before going into details regarding the causes, we should look at the forces that lie behind this correction and, to this end, we should break down these differences in the gross debt-to-income ratio into two parts: the variation due to the change in outstanding debt, the ratio's numerator, and that caused by the rise in disposable income, its denominator (see the table below). In the case of the United States and the United Kingdom, most of the reduction in the debt ratio during the deleveraging phase can be attributed to improved GDI. In both cases, household disposable income has grown by more than 10% in cumulative terms since the peak of indebtedness in 2007-2008. In clear contrast, Spain's GDI has only risen by 2% since 2008, which cannot account for more than three percentage points of its lag in the debt ratio.

BREAKDOWN OF DELEVERAGING RATIO DIFFERENCES

In percentage points of gross disposable income

	Peak of debt	Number of quarters Deleveraging	▼ debt/gross disposable income	Contribution from:	
				▼ debt	▲ gross disposable income
United States	2007Q4	16	–17	–5	–12
United Kingdom	2008Q1	14	–14	+3	–17
Spain	2008Q2	13	–7	–4	–3

NOTE: The latest data available correspond to the third quarter of 2011 for the United Kingdom and Spain and to the fourth quarter of 2011 for the United States.
SOURCES: Thomson Reuters Datastream and own calculations.

Employment trends are key to explaining the differences in terms of disposable income: while employment has fallen by around 2% since 2007 in the United Kingdom and by 4% in the United States, Spain has seen a 13% drop. However, the trend in wages in the three economies has not been so discordant (+7% in the United Kingdom, +9% in Spain and +10% in the United States). With regard to the numerator's contribution; i.e. the outstanding debt, in the United States and Spain this has fallen by 4% and 3% from the leveraging peaks respectively, while in the United Kingdom it has even risen by 2%. The burden of deleveraging in Spanish households has therefore fallen especially on adjusting the numerator and, in particular, on consumer credit, which has shorter maturities, as mortgage loans are still above the levels of mid-2008.

(1) See «*Debt and deleveraging: Uneven progress on the path to growth*», McKinsey Global Institute (2012).

Given this situation, the United States is bound to be more advanced in its household deleveraging process, both compared with Spain and the United Kingdom. So does this mean that US households have been more disciplined and responsible? Not necessarily. In part, the improved position of US households can be attributed to the higher level of defaults and mortgage foreclosures. These defaults account for almost two thirds of the household debt reduction, or 3 out of the 5 percentage points contributed by this fall to the correction in the leverage ratio.(2) In the United Kingdom and Spain, however, a slower drop in house prices, the reduction in the cost of mortgages, most linked to variable interest rates, and a greater use of refinancing or changes in bank loan conditions have slowed up the number of defaults but will prolong the deleveraging process.

On the other hand, in the United States deleveraging has been accompanied by a rise in public debt that has helped to more readily sustain the growth in income, thereby facilitating private deleveraging. In contrast, both Spain and the United Kingdom are combining private deleveraging with the consolidation of their national accounts. The simultaneous nature of public and private adjustment is another factor that will delay the completion of deleveraging in both countries, although having a central bank that can provide liquidity will help this process in the United Kingdom.

There are still several years of hard work ahead. Reducing debt in a recessionary context is very costly. That's why the faster we get back onto the path of growth, the less painful and shorter the process will be. In those economies, such as Spain, which are also forced to speed up the consolidation of their national accounts due to questions of external confidence, such growth can only come from the external sector. It is also fundamental, and even vital, to speed up the programme of structural reforms as well as the debt correction. Without this injection of oxygen, the deleveraging tunnel might end up being too murky and interminable.

(2) See *op. cit.* McKinsey Global Institute (2011).

This box was prepared by Marta Noguer
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Brazil: halting the slowdown

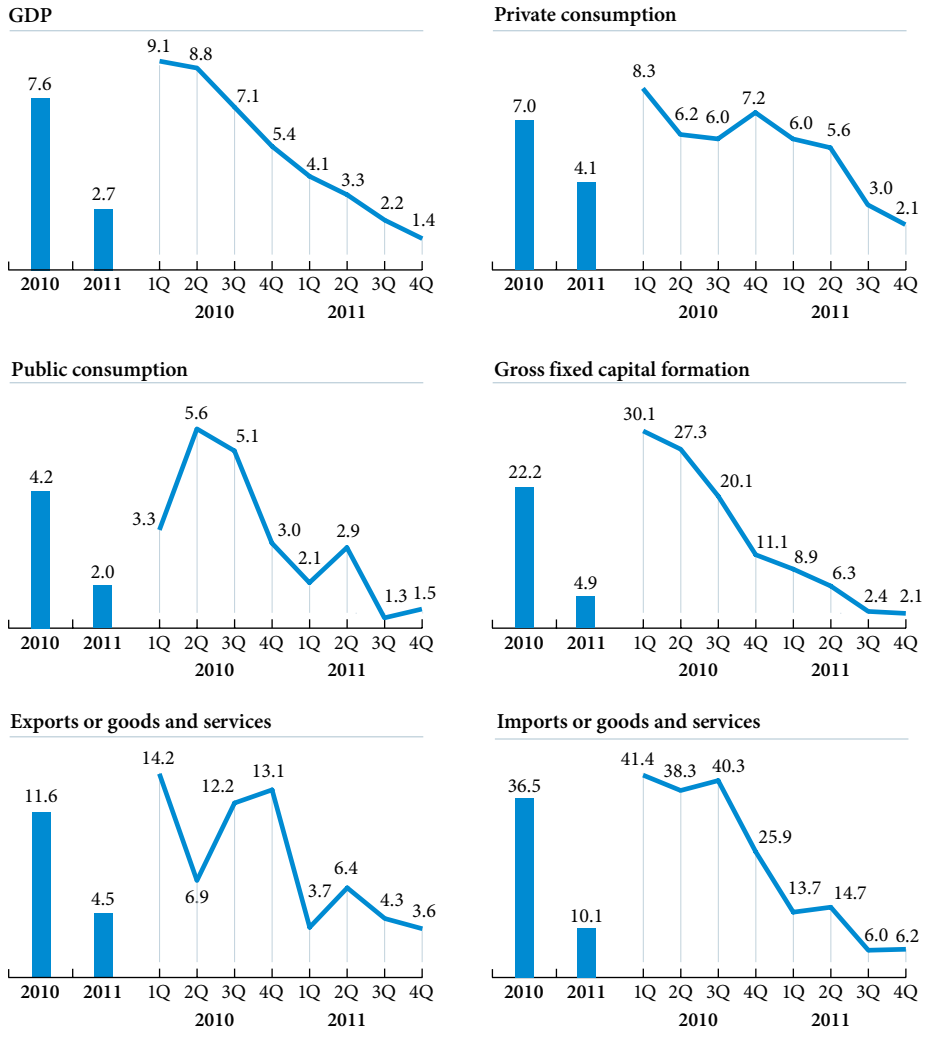
The economy grows by 2.7% in 2011, slowing up more than expected.

Brazil's economy grew by 2.7% in 2011, a little less than most analysts expected and much less than its growth in 2010 (+7.5%). Although a greater impact had been forecast from stimuli implemented since last summer, it has been confirmed that, in the final part of 2011, activity remained relatively weak, which should be put down to the sluggishness of net exports and the fall in stocks. In contrast, domestic expenditure once again proved to be resistant and livened up compared with the previous quarter.

We expect this upswing in domestic demand to consolidate throughout 2012, supported by a labour market with record low levels of unemployment; a rise in real wages; continuing inflows of capital; solid commodity prices; improved economic sentiment, not only in Brazil but also at a global level; and, of course, the impulse provided by the stimuli, which are fiscal, credit, macroprudential and monetary.

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

In this respect, the disappointing growth figures for the fourth quarter, added to the unexpected decline in industrial production in January and renewed upward pressure on the real, gave the Monetary Policy Committee (COPOM) enough justification to lower interest rates again. Nevertheless, the size of the last cut was quite surprising, namely 75 basis points, leaving the SELIC rate at 9.75%. Moreover, the minutes from the last Committee meeting hint at further cuts in the first half of the year, which could take the discount rate down to 9%.

Monetary lassitude, more aggressive than we expected, has forced us to revise our 2012 inflation scenario upwards, placing it at around 5.4% by the end of the year instead of the prior figure of 4.9%. In any case, prices started a gradual correction process in February, once the impact

The Monetary Policy Committee reduces the SELIC rate by a further 75 basis points, leaving it at 9.75%.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	January	February
Real GDP	7.6	2.7	4.1	3.3	2.2	1.4	–	...
Industrial production	10.6	0.3	2.4	0.7	0.1	–2.2	–3.2	...
Consumer confidence (*)	159.7	156.4	161.8	155.4	153.3	155.2	158.3	170.2
Unemployment rate (**)	6.7	6.0	6.3	6.3	6.0	5.2	5.5	5.7
Consumer prices	5.0	6.6	6.1	6.6	7.1	6.7	6.2	5.8
Trade balance (***)	20.1	29.8	22.4	25.2	30.5	29.8	28.1	28.6
Interest rate SELIC (%)	10.00	11.79	11.75	12.25	12.00	11.00	10.50	10.50
Reales to dollar (*)	1.78	1.63	1.63	1.56	1.88	1.86	1.75	1.72

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

Measures intensify to slow up the real's appreciation.

of transport tariff changes had been tempered, as well as other seasonal effects in January. However, this does not stop inflationary pressures from becoming significant again if the return to faster growth is confirmed as 2012 progresses, forcing the Monetary Policy Committee to turn around its interest rate policy, probably early in 2013.

For the time being, these interest rate reductions will boost efforts to halt the appreciation of the real, once again among the top priorities of Brazil's authorities, in their desire to reactivate an industrial sector that is going through a bad patch. In its last move, it extended the IOF (tax on financial transactions) of 6% to loans financed with foreign capital that mature in less than five years, while in March it had already extended this tax to loans maturing in less than three years.

Mexico: sticking to the script

The Mexican economy is increasingly supported by its domestic expenditure.

Prudential management of macroeconomic policy has helped the Mexican economy to remain solid in spite of the tensions affecting the world economy during the second half of 2011. The relative improvement in the United States' economic prospects has led us to forecast GDP growth of around 3.5%, but we also expect that the fourth quarter's tone of moderation will continue into 2012. Although it's improving, the United States' recovery in activity is still expected to be very gradual, so the volume of Mexico's exports is likely to remain paltry. On the other hand, domestic expenditure continues to provide increasingly solid support. Retail sales surprised by growing 4.4% year-on-year in January, while investment also posted notable growth in November and December.

Regarding the inflation scenario, this is still relatively benign, remaining within the target range. Moreover, the recent appreciation of the peso is helping to relax pressures on prices a little more. This makes the work of Banxico easier as, for the moment, it still doesn't need to move the official interest rate, which has stood at 4.5% for more than two years.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	January	February
Real GDP	5.5	4.0	3.9	3.9	4.4	3.7	–	–
Industrial production	6.1	3.9	4.9	3.7	3.6	3.4	3.8	...
Consumer confidence (*)	86.3	91.7	92.1	90.7	93.7	90.3	95.4	93.6
Leading business index (*)	116.5	116.5	119.6	120.4	122.3	122.8	123.8	...
Unemployment rate (**)	5.4	5.2	5.1	5.2	5.7	4.8	4.9	5.3
Consumer prices	3.9	3.2	3.5	3.3	3.4	3.5	4.0	3.9
Trade balance (***)	–3.0	–1.2	–1.5	0.0	–1.5	–1.2	–1.6	
Official Banxico rate (%)	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	12.33	11.90	11.90	11.72	13.78	13.94	13.02	12.81

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

What will move a little more in this first half of 2012 is the fiscal deficit. We must remember that this is an election year. For the time being, the balance has come down in favour of a change of government as polls point to Enrique Peña, the PRI candidate, as the favourite, ahead of Josefina Vázquez, from the incumbent party. In any case, the challenge facing the new President will be to boost the potential growth of an economy that still needs an ambitious programme of structural reforms to tackle historical obstacles, such as the tax revenue's excessive dependence on oil, and significant inefficiencies in the educational system.

Oil calls a halt, for the moment

Oil halted its upward trend and kept its price almost the same between 22 February and 22 March, falling by just 0.2% to 122.80 dollars per barrel (Brent quality, for one-month deliveries), 14.7% higher than the start of the year, equalling the rise for 2011 as a whole and 5.8% above the level of a year ago, when the Libyan crisis had reached its peak.

Saudi Arabia's decision to increase crude production to offset the fall in Iranian exports, backed by the release of US and UK reserves, is the main reason why prices have momentarily stabilized, highlighting the widespread interest in preventing rising oil prices from aggravating the slowdown in the world's aggregate demand.

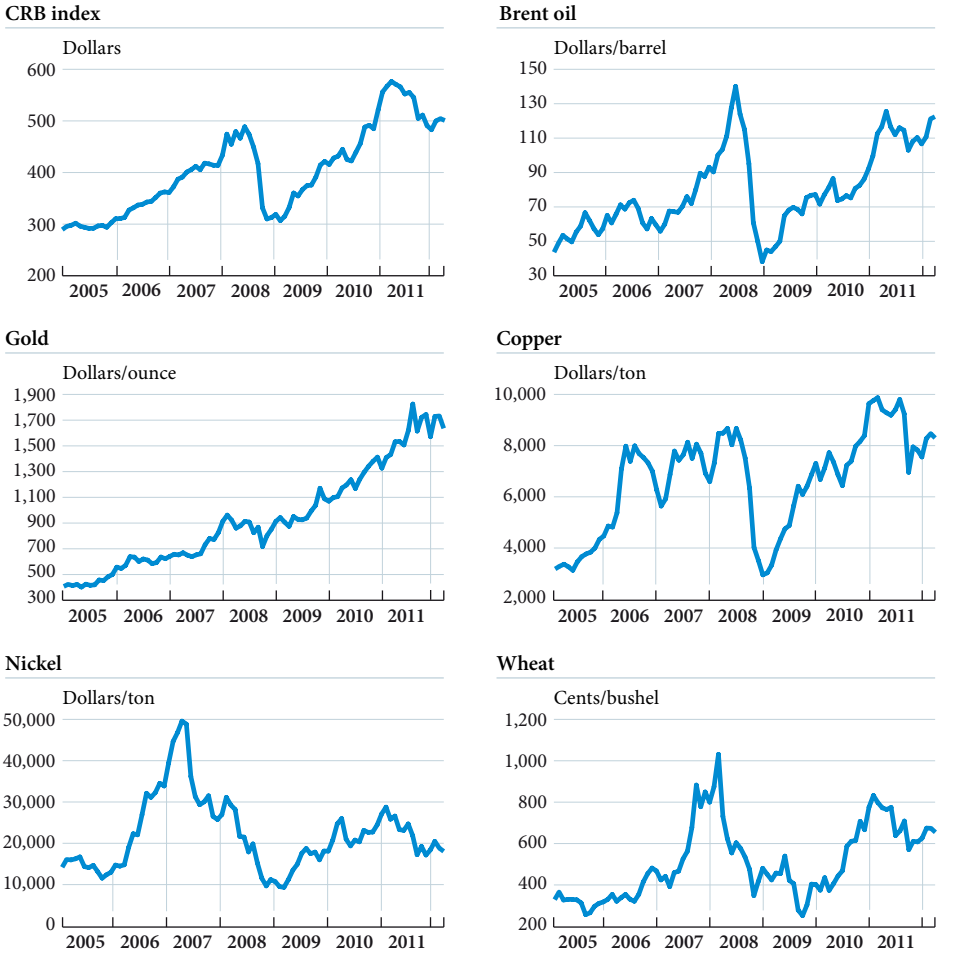
The rest of commodities performed unevenly, interrupting the upward trends of the start of the year. Such small decreases, however, make it difficult to speak of any change in trend. The CRB index grew by an imperceptible 0.2% between 22 February and 22 March but falls predominated among metals and foods, with the exception of iron, steel and rice. Among metals, of note were the falls in gold and nickel, namely 6.7% and the 8.2% respectively, while among foods the 10.4% fall in coffee prices was particularly significant.

Renewed strength in the peso relieves the pressure on prices.

Oil remains at 122.8 dollars, calling a halt to its upward trend.

Price rises are stalling but it's too soon to speak of any change in trend.

TREND IN VARIOUS COMMODITIES (*)



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

EUROPEAN UNION

The euro area: moving away from the precipice

In March, there were two significant changes in Greece's situation. Firstly, the exchange has been carried out of its sovereign debt in the hands of private creditors. The outcome of this write-down entails a reduction of around 105 billion euros in the Greek republic's stock of debt, leaving it at 245 billion euros, 113.9% of its gross domestic product (GDP).

This was precisely one of the basic requirements demanded by the troika to greenlight the second financial bail-out plan. This reduction in Greece's debt is key to reaching a debt stock level below 120.5% of GDP in 2020, a level considered to be crucial for guaranteeing the country's financial viability. The second vital factor has been the approval of a second bail-out plan by the euro area Finance Ministers and the International Monetary Fund.

In the European Union (EU), the political scenario will see two elections and a referendum over the next few months. Firstly, the French presidential elections of 2012, whose first round will take place on 22 April and the second round, between the two candidates with the most votes, on 6 May 2012. Secondly, the Greek legislative elections will probably take place in April. Lastly, Ireland will hold a referendum to decide whether to join the fiscal pact that 25 European Union countries, all excepting the United Kingdom and the Czech Republic, agreed to on 30 January and which is currently being ratified by each member state.

These decisions, which the citizens of these countries must take, are key points on the near horizon of the EU and could lead to an increase in uncertainty depending on how they are resolved. This background noise is occurring within a context of economic slowdown in the euro area, as highlighted by the breakdown in GDP data for the fourth quarter. The 0.7% year-on-year growth in GDP hides great disparity. While some countries such as Italy and the Netherlands have negative year-on-year growth of 0.5% and 0.7% respectively, the German engine has maintained year-on-year growth of 2%.

However, one of the components with the most worrying trend has been private consumption, with a negative year-on-year growth of 0.6%. Within such an environment of political and economic uncertainty, households decided to reduce their spending. This decision also resulted in lower growth in private investment, affected by sluggish demand and the difficulties in obtaining credit to finance business opportunities, while member states continue with their fiscal consolidation, leading to a 0.3% drop year-on-in public expenditure for the euro area as a whole. Fortunately, net exports offset this as the fall in imports was more pronounced than the slowdown in exports, with exports contributing three tenths of a

Greece and the new growth forecasts for the EU attract economic and political interest.

The troika approves the second financial bail-out plan for Greece.

The political agenda is centred on the elections to be held in France and Greece.

Leading indicators point to the economic deterioration probably slowing up.

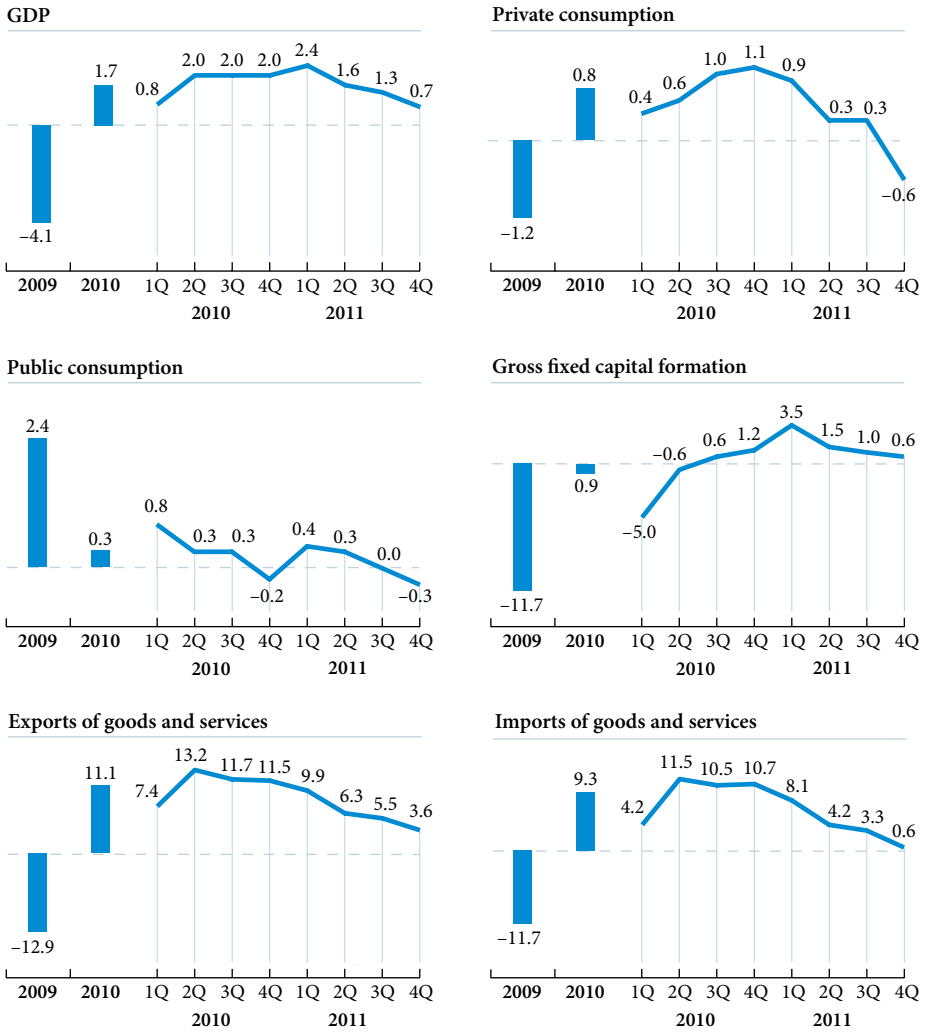
percentage point to GDP growth in the fourth quarter.

The data show that last year started with strong growth but this dwindled as time went on. The profile this year could be exactly the opposite; i.e. starting with a very weak level of economic activity but ending the year somewhat more strongly. Most leading indicators published to date indicate that the sharp economic deterioration in the last quarter last year should slow up.

From the point of view of demand, consumer confidence has improved a little since the minimum of –21.3 points recorded in December. This advance has not been substantial partly because it is limited by the weak labour market.

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCES: Eurostat and own calculations.

In January, the euro area's unemployment rate stood at 10.7%, two tenths of a percentage point above the average figure for the last quarter of 2011. In January, 185,000 people lost their job and, in total, there are 16.9 million people unemployed. This is a delayed indicator of economic activity but it is important to note that such a high figure has not been seen since October 1997. Although it's true that this figure masks a great disparity between countries, from Spain's unemployment rate of 23.3% to 4% in Austria.

The stabilization of the consumer confidence index has been translated into a month-on-month rise in January of 0.3% in retail and consumer goods, raising year-on-year growth from a contraction of 1.1% to zero growth. This figure is a good example of this slight improvement, as retail sales had recorded four consecutive month-on-month falls in the previous months.

The foreign sector is still the mainstay of the recovery. January's trade deficit fell to 7.6 billion euros, an improvement on December of 1.5 billion euros. And this is in spite of rising oil prices making crude imports considerably more expensive.

From the point of view of supply, January's industrial production shrank by 1.2% but less than the drop recorded in December of 1.8%. And an additional recovery can be glimpsed by way of the tentative improvement in business confidence indices in the euro area. This could reinforce the idea that the trend of economic decline has touched bottom. The industrial confidence index has improved from January's –7.0 points to –5.8 points in February. The index of economic sentiment, which represents an aggregate of business and consumer confidence, rose by one point compared with the previous month, up to 94.4 points.

The foreign sector remains the mainstay of the recovery.

EURO AREA: MAIN ECONOMIC INDICATORS

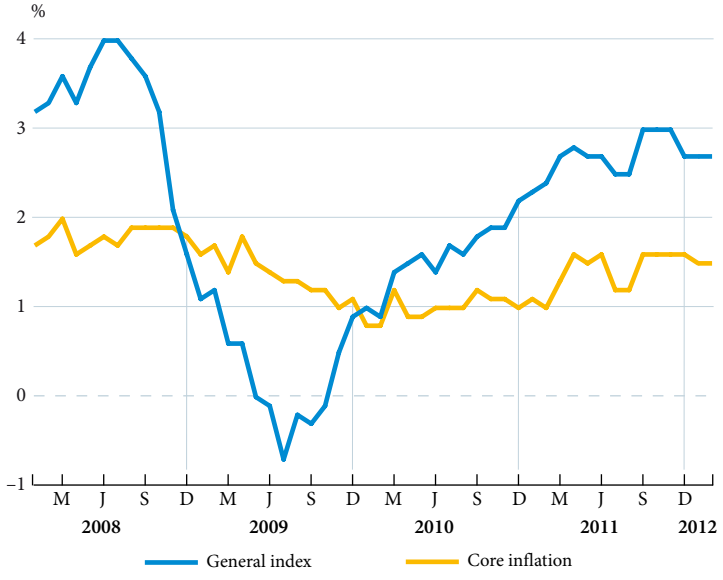
Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	January	February
GDP	1.8	1.5	2.4	1.6	1.3	0.7	–	...
Retail sales	0.9	–0.5	0.1	–0.5	–0.6	–1.1	0.0	...
Consumer confidence (1)	–14.2	–14.6	–11.0	–10.7	–15.9	–20.6	–20.7	–20.3
Industrial production	7.5	4.8	6.5	4.1	4.0	–0.1	–1.2	...
Economic sentiment indicator (1)	100.5	101.0	106.9	105.2	98.4	93.6	93.4	94.4
Unemployment rate (2)	10.1	10.2	10.0	10.0	10.2	10.5	10.7	...
Consumer prices	1.6	2.7	2.5	2.8	2.7	2.9	2.7	2.7
Trade balance (3)	4.6	–18.8	–10.0	–16.6	–21.7	–18.8	–1.3	...
3-month Euribor interest rate (%)	0.8	1.4	1.1	1.4	1.6	1.5	1.3	1.1
Nominal effective euro exchange rate (4)	103.7	103.4	102.7	105.2	103.5	102.1	98.9	99.6

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.

INFLATION REMAINS ANCHORED DUE TO RISING OIL PRICES

Year-on-year change in harmonized CPI



SOURCE: Eurostat.

Rising oil prices stop inflation from falling.

As we already mentioned in our last Monthly Report, one of the latent risks to economic recovery is the price of oil. For the moment, its rise has been keeping inflation at 2.7% since December while core inflation, excluding the most volatile elements of food and energy, has remained at 1.5% year-on-year.

Breaking down the inflation figures, we find that the most inflationary components for February compared with the previous month were petrol, transportation, electricity and tobacco.

These data have forced us to revise our inflation forecast for this year from 1.7% to 2.0%. This is slightly lower than the revision made by the European Central Bank, raising its forecast from 2.0% to 2.4%. The reserve bank attributes this rise to oil prices and the expected hikes in indirect taxes in some countries. In its note it explains that it has taken oil futures into account when calculating its oil price forecast. Our view of oil prices is less pessimistic, as we believe that it will not reach such a high level. The declaration made by Saudi Arabia's Petroleum Minister, Ali Naimi, stating that the price of black gold was not justified and announcing that his country would increase its production by up to 25%, if necessary, to push down the price, reinforces this idea. Evidently, oil producing countries want to maximize their revenue but they don't want to cause a world recession.

Although out estimate is more optimistic, this is no way reduces the concern shown by most central banks, including the European Central Bank, regarding the latent risk of further rises in inflation and the negative effect this would have on the disposable income of households, which we fully share.

In summary, European Union has successfully tackled a great obstacle in Greece, although the challenges facing the republic are still considerable. However, the debt swap has avoided a disorderly default, which would have had more serious destabilizing consequences, via contagion, for other EU member States. Moreover, economic indicators point to stabilization in the economic deterioration seen over the last few quarters. Nevertheless, the fiscal adjustment, which in some countries is intense, combined with private sector deleveraging should prevent economic activity from becoming dynamic. In short, whereas a few months ago economic agents were stricken with pessimism, it seems that this mood must have been altered somewhat by the latest economic figures, although this has not eliminated the fragile economic situation in the euro area.

Fiscal adjustment and private sector deleveraging impede a strong economic recovery.

Bank deleveraging in Europe: repercussions in the emerging world?

We tend to analyze the euro area's financial crisis from what we might call a Eurocentric perspective. We are concerned, for example, that the bank deleveraging occurring might hinder the Old Continent's growth by restricting credit. Although understandable, this view eclipses others resulting from the process. In particular, little is mentioned in the debate about the possible impact of the euro area's bank deleveraging on the financing of other regions in the world, in particular on the emerging economies. However, this is a relevant question as two issues are involved here that are not always taken into account.

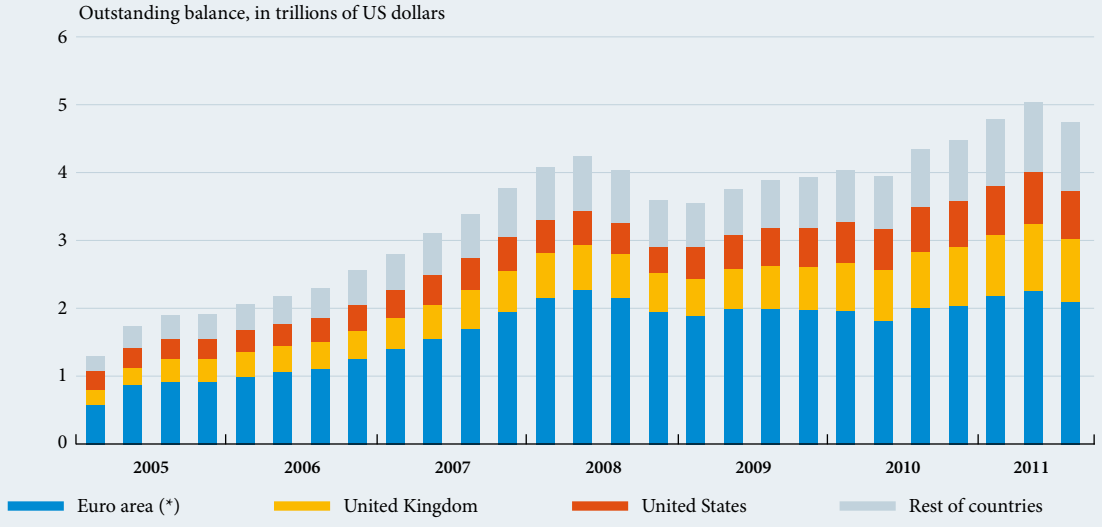
The first, the great importance of foreign credit in financing emerging economies. According to data from the Bank for International Settlements (BIS), between the first quarter of 2005 and the third of 2011, the last quarter with data available, foreign assets with regard to emerging economies in the hands of banks practically tripled, currently reaching 4.8 trillion dollars, an amount approximately equivalent to 25% of the emerging economies' national credit and 20% of their GDP. This is also a notably dynamic process as, in spite of the fact that four out of these seven years have been dominated by the global financial crisis, foreign credit has managed to grow by an average of 5% quarter-on-quarter. This dynamic context lessens the potential impact of the fall in external bank assets recorded in the third quarter of 2011 and the fact that this will probably continue in the fourth quarter.

A second issue, not always remembered, is the dominant role of European banks in this external financing. As can be seen in the graph below, approximately 44% of international bank financing comes from banks in the single currency area, followed by British banks in terms of importance (19% of the total). US banks would have a slightly lower share, in the order of 15% of the total. To complete this view, we should also mention the geographical distribution of European international bank financing. As might be expected, this is especially prevalent in emerging Europe (80% of external assets are in the hands of euro area banks) and, as a distant second, in Latin America (50%). Its importance is slightly less in emerging Asia and Africa.

Taking both facts together, namely that of the growing importance of foreign bank credit for emerging economies and the fact that Europe dominates this kind of financing (especially in emerging Europe), the concern expressed by some analysts is easy to comprehend: if European banks opted to reduce their leveraging in terms of their

EUROPEAN BANKS PLAY A DOMINANT ROLE IN THE EXTERNAL FINANCING OF THE EMERGING ECONOMIES

External assets related to emerging economies in the hands of banks from different countries



NOTE: (*) Sum of external assets held by banks in Germany, Austria, Belgium, Spain, Finland, France, Greece, Ireland, Italy, Netherlands and Portugal.
SOURCES: Bank for International Settlements and own calculations.

emerging counterparts in order to meet the new capitalization requirements, might credit suddenly flounder for the part of the globe that, so far, has managed to preserve growth?[1]

The answer, today, is that there are two significant factors that might help to reduce this risk we have just mentioned: i) the capacity of other zones to at least partly replace the role played by the euro area in emerging external financing, and ii) the fact that the true vulnerability of emerging Europe to handle the effects of a hypothetical deleveraging is actually more intricate.

When we analyze the trend in external credit to the emerging economies as a whole, we can see that the role of external financing coming from the euro area is being replaced by financing through banks in the United States, the United Kingdom and the rest of the world. In quantitative terms, the euro area's share has fallen by 10 percentage points since the fourth quarter of 2008 (when it was at its peak), with the US and British share increasing by four percentage points and that of other countries by the remaining two points. All this, as has been mentioned above, within a context of growth in the overall volume of external assets related to the emerging economies. Various analysts agree that there are reasons to believe the banks of China and the United Kingdom might

(1) A prior but distinct debate to the one that concerns us here is related to the scope this deleveraging process will ultimately have. As pointed out by a recent BIS study, this is an open discussion, with differing deleveraging calculations that range from 0.5 trillion dollars to 3 trillion dollars for the coming years; i.e. a figure of between 1% and 5% of the EU's total bank assets. See, in particular, Peter, G., M. Drehmann and V. Sushko, (2012), «European bank funding and deleveraging», BIS. Quarterly Review, March, and Morgan Stanley, (2011), «European Banks. What are the Risks of 1.5-2.5tr Deleveraging».

continue to play a compensatory role in the future, should European deleveraging be incredibly acute, especially in the critical region of emerging Asia.

With regard to the second of the factors mentioned above, the one related to emerging Europe, a recent BIS study suggests that this risk is less due to the composition and maturities of external bank credit.[2] So, although the BIS states that emerging Europe has weaknesses given the high share of foreign banks in the countries' total credit (approximately 50% of the total credit is held by euro area banks, with slightly higher rates in countries such as Hungary and Romania), the predominance of credit to their subsidiaries (compared with credit to firms, the public sector, etc.) partially limits Europe's financial vulnerability. This is due to the fact that the first of these types tends to be less volatile than the second, providing greater protection against any sudden changes in financial orientation on the part of foreign banks.

A second aspect related to the composition refers to the type of cross-border securities in question. If these are tradable debt securities (as opposed to non-tradable loans), the ease with which foreign creditors can get hold of their assets is greater (and, therefore, so is the vulnerability of the emerging economy in question). In accordance with the BIS figures, only 10% of the international assets held by euro area banks are in the form of tradable securities. Lastly, with regard to the maturity structure, this also helps to reduce the risk of any sudden reversal in external financing since, within the external assets portfolio of euro area banks, those whose counterparty is emerging Europe tend to be long-term (maturities longer than one year, accounting for two thirds of the total, compared with, for example, 50% from emerging Asia).

In short, we'll have to wait a while to be able to give a definitive judgement on this issue. Nonetheless, from the previous discussion we can conclude that the importance of European banks in the external financing of emerging countries, particularly in emerging Europe, means that attention should be paid to how Europe's deleveraging is progressing, albeit with the proviso that the international financial system could partly replace the role of European banks, using financing from banks in other zones and other types of financing, such as bonds, and also by reducing the concentration of risk in emerging Europe by means of the type and maturities of financing.

(2) See Avdjiev, S., (2011), «Evaluating the potential impact of deleveraging by euro area banks on emerging economies», BIS Quarterly Review, December.

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A modest tone for the German economy at the start of 2012

The economic indicators available point, on the whole, to a moderate expansion in Germany's economy in the first quarter of the year. The recovery underway would therefore avoid a technical recession after the slight decline recorded in the fourth quarter of 2011. However, it should be noted that some signs of weakness have appeared which can be partly put down to the high levels reached by oil prices.

Some signs of weakness mar the largely favourable outlook for the German economy.

Germany's industrial production grows more than expected in January but the short-term outlook is not encouraging.

Concerning demand, consumption appears lacklustre in the first few months of the year. Both retail sales and the industrial production of consumer goods, as well as passenger car registrations recorded drops year-on-year in January, although automobile sales stabilized in February. However, consumer confidence improved in the first two months, standing slightly above its historic average. Consumption should therefore continue to rise, boosted by the expectations of an increase in household disposable income.

With regard to investment, the outlook is quite favourable, supported by forecasts of growth in demand and by low interest rates. With regard to capital goods, investment demand will come both from replacement and also the enlargement of production capacity. In January, the industrial production of capital goods posted a strong trend and its annual rate of change reached 7.1%.

Foreign trade also started the year well. Exports of goods rose by 2.3% compared to the previous month, seasonally adjusted, and 9.3% compared with the same month in 2011. For their part, imports recorded a 2.4% rise month-on-month and a year-on-year increase of 6.3%. In this way, in January the trade surplus widened to 13.1 billion euros, up 29.7% on twelve months before.

From the point of view of supply, industrial production provided a pleasant surprise in the first month of 2012 by posting a month-on-month increase of 1.4%. However, the gradual fall in industrial orders suggests that the secondary sector will lose steam in the next period. This weakness might be offset by construction, which grew by 4.3% in January compared with the previous month. With regard to services, in January hotels and restaurants posted a year-on-year increase of 0.8% in their real turnover. In the first two months, tertiary sector confidence picked up compared with the last quarter of 2011, but scarcely reached its normal level.

The labour market, which usually lags behind the overall trend, continued to create jobs in January. However,

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	January	February
GDP	3.6	3.1	4.6	2.9	2.7	2.0	–	...
Retail sales	1.5	1.2	0.8	2.4	0.9	0.7	–1.5	...
Industrial production	10.0	8.1	12.8	8.1	8.2	3.4	2.1	...
Industrial activity index (Ifo) (*)	107.8	111.3	114.6	114.1	109.7	106.8	108.3	109.6
Unemployment rate (**)	7.1	6.0	6.3	6.0	5.8	5.7	5.8	...
Consumer prices	1.1	2.3	2.1	2.3	2.4	2.4	2.1	2.3
Trade balance (***)	154.9	158.1	157.9	158.7	159.0	158.1	161.1	...

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

in February the BA-X employment demand indicator fell to some extent, although still at a high level. The upward pressures of labour costs might have played a part in this. For its part, inflation rose by two tenths of a percentage point in February to 2.3% year-on-year, boosted by energy prices. It therefore interrupted its downward spiral started in October last year. Inflation is likely to fall although an unexpected rise in the price of crude cannot be ruled out.

Within this mixed scenario, we have kept our annual growth forecast for the German economy in 2012 at 0.5%. This modest growth contrasts with the more unfavourable rates expected for the rest of the largest economies in the euro area and is based on the competitiveness of the German economy. Nonetheless, if the situation of the rest of Europe's economies worsened, Germany would also be affected, in spite of its expansion being based on domestic demand.

Given this situation, at the start of spring the German government approved a programme of reforms for 2012. This includes the measures at a European level of the Euro Plus Pact. Moreover, in order to strengthen economic performance, the financial conditions for venture capital will be improved and qualified immigration will be easier, among other measures.

The German government approves a programme of reforms to stay in shape.

The French economy has a weak pulse

Problems of competitiveness, the delicate situation of some of its trading partners and the austerity measures implemented to redress its public accounts are hindering the French economy's performance. In the first few months of 2012, indicators point to economic stagnation in the first quarter, which represents a slowdown after the 0.2% quarter-on-quarter growth posted in the period October-December 2011.

For the year as a whole, we have not altered our previous forecast of an annual increase of 0.1%, as the above-mentioned factors are still going to persist. However, a pleasant surprise cannot be ruled out, if the global macroeconomic environment improves more than expected. Nevertheless, there are also downward risks, such as rising commodity prices or a worsening of

Indicators point to the French economy stagnating in the first quarter.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	January	February
GDP	1.4	1.7	2.2	1.6	1.5	1.4	–	...
Domestic consumption	1.7	0.8	3.6	1.2	–1.0	–0.4	–3.3	...
Industrial production	4.6	2.4	4.7	1.8	2.8	0.5	–1.5	...
Unemployment rate (*)	9.8	9.7	9.6	9.6	9.7	9.8	10.0	...
Consumer prices	1.5	2.1	1.8	2.1	2.1	2.4	2.3	2.3
Trade balance (**)	–51.8	–70.1	–59.6	–65.0	–69.3	–70.1	–69.2	...

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

France's external current account deficit widens in January.

the sovereign debt crisis in the peripheral countries of the euro area.

In any case, household consumption has been lacklustre at start of the year. The consumption of goods fell by 0.4% in January compared to the previous month, due particularly to the drop in cars. In February, passenger car sales reported a year-on-year decrease of 24.4%, although this rate has been affected by the end of purchase subsidies a year earlier. In the same month, retail sales dropped by 1.8% month-on-month. Consumer confidence is at a relatively low level because of concerns regarding rising unemployment and inflation. The unemployment rate reached 10.0% in January, 4 tenths of a percentage point more than twelve months before, and inflation held steady at 2.3% in February, 0.6 percentage points more than in February 2011, pressurized by energy and fresh food prices due to the month's bad weather. With regard to capital goods investment, the low level of production capacity utilization is failing to boost this in spite of low interest rates.

A bill to reduce corporate administrative charges in France.

With regard to the foreign sector, in January the current account deficit increased to 4.2 billion euros compared with 2.8 billion in December, seasonally adjusted. This was primarily due to the smaller surplus in services and, to a lesser extent, that of investment income. In any case, it highlights the fact that the French economy has competitiveness problems.

Italian consumer confidence picks up slightly in February but is still at a very low level.

A weak tone can also be observed in terms of supply. Industrial production grew by 0.3% in January compared with December, but less than expected. In February, surveys pointed to a slight decline due to cars and metallurgy. However, the normal level of orders suggests a slight expansion in the short term. On the other hand, new homes started rose by 2.6% in January compared with the previous month, seasonally adjusted. With regard to services, these stabilized in February, boosted partly by computing activities, offsetting a change in direction in hotels and restaurants.

The risk premium measured by the spread with German sovereign debt at ten years continued to improve, reaching 91 basis points by the middle of the fourth week in March, half the level recorded in November 2011. Similarly, in January corporate credit maintained an annual growth rate of 5.2%. On the other hand, the number of business insolvencies continued to fall, albeit losing steam in January, posting a year-on-year change rate of 0.7%. The underlying dynamism of the French economy could also be seen in the 4.3% rise year-on-year in start-ups in the period December-February.

To tackle the above-mentioned problems of competitiveness, at the end of February the French parliament adopted the bill for legal simplification and the reduction of administrative charges. The aim is to reduce the cost to firms of administrative forms, among other measures.

Italy: timid signs of improvement, given the seriousness of the situation

The revision of the National Accounts system's figures for the fourth quarter of 2011 for the third largest economy in the euro area confirmed that it had entered recession. However, the year-on-year drop in the last quarter was revised upwards by one tenth of a percentage

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	January	February
GDP	1.8	0.5	1.2	1.0	0.4	–0.4	–	...
Retail sales	0.1	–1.3	–0.2	–0.4	–1.8	–2.7	...	...
Industrial production	6.5	0.1	2.6	1.5	–0.3	–2.9	–4.1	...
Unemployment rate (*)	8.4	8.4	8.1	8.2	8.4	8.7	9.2	...
Consumer prices	1.5	2.7	2.3	2.6	2.8	3.4	3.2	3.3
Trade balance (**)	–30.0	–24.6	–34.2	–34.1	–32.1	–24.6	–22.7	...

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

point to –0.4%. The detailed figures showed that all the main components of domestic demand deducted from the quarterly growth in GDP, while the foreign sector contributed 0.7 percentage points. For the year as a whole, the GDP adjusted for calendar effects rose by 0.5% compared with a 2010.

Some signs of improvement have appeared in the last month. The index of economic sentiment posted a slight rise after two consecutive drops. However, it was still significantly below its historical average. Although the programme of reforms implemented by the new government will make greater growth possible in the long term, in the short term the Italian economy will continue to suffer from the effects of the necessary austerity measures and its cumulative loss of competitiveness. We therefore keep to our forecast of an annual decrease in GDP of 1.5% for this year.

Concerning demand, retail sales recorded a 0.7% growth month-on-month in January, seasonally adjusted, after two months of falls. However, in February vehicle registrations sharpened their year-on-year decline, posting a change of –18.9%. Consumer confidence picked up slightly in February but was at a very depressed level, affected by the expected contraction in disposable income and by the unfavourable trend in the labour market. The unemployment rate rose to 9.2% in January, 0.3 percentage points more than in December, and reached its highest level for the last few years. Inflation didn't cheer up consumers in February either, rising slightly to 3.3%.

With regard to the external situation, in January exports of goods fell by 2.5%, seasonally adjusted, while imports only dropped by 0.5%. The trade deficit totalled 4.35 billion euros, although the non-energy balance was positive, totalling 1.8 billion. However, compared with January 2010, the trend was better as exports rose by 4.3%, while purchases abroad fell by 2.6%, involving a correction of the deficit, albeit insufficient.

From the point of view of supply, industrial production continued its decline in the first month of the year, 2.5% down on December, and recorded a year-on-year drop of 5.0%. The short-term outlook is not good, judging by

The Italian government undertakes labour reforms to make the job market more flexible.

The Chancellor of the Exchequer reviews taxation in order to boost private investment.

January's 7.4% contraction month-on-month and 5.6% contraction year-on-year in orders. Things were no better for construction at the start of the year, when its production fell by 7.8% month-on-month, affected by the real estate crisis. With regard to services, their confidence index picked up slightly in February, albeit still at a low level.

On the other hand, the risk premium has narrowed slightly over the last period. The spread with German ten-year sovereign bonds, which had recorded a peak of 550 basis points last November, fell to around 300 basis points at the start of spring. The yield on Italian long-term sovereign bonds managed to fall below 5% by mid-March for the first time since August 2011.

This improvement is partly attributable to the support provided by the European Central Bank but the programmes of reforms underway may also have helped, as well as the redressing of the public deficit, which stood at 3.9% of GDP in 2011, compared with 4.6% in 2010. In this respect, after the packages of «Salva Italia», «Cresci Italia» and «Semplifica Italia» entered into force, towards the end of March the Italian government passed a bill to extensively reform the labour legislation, aiming to introduce more flexibility and efficiency in the labour market.

The United Kingdom: revising taxes to boost the economy

The fiscal consolidation efforts carried out by the United Kingdom over the last year have taken their toll with a sharp fall in economic activity, as shown by the growth in gross domestic product in 2011, which was just 0.8%. Moreover, the economic outlook is still not very optimistic.

Given this situation, the UK Chancellor of the Exchequer, George Osborne, has announced a reduction in the rate paid

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	January	February
GDP	2.1	0.8	1.6	0.5	0.4	0.7	–	...
Retail sales	–0.3	0.7	1.6	0.4	–0.5	1.2	1.3	1.0
Industrial production	1.9	–1.2	1.2	–1.4	–1.6	–2.9	–3.8	...
Unemployment rate (1)	4.7	4.8	4.5	4.7	4.9	5.0	5.0	5.0
Consumer prices	3.3	4.5	4.2	4.4	4.7	4.7	3.6	3.4
Trade balance (2)	–96.3	–101.1	–98.3	–98.7	–100.7	–101.1	–99.6	...
3-month Libor interest rate (3)	0.7	0.9	0.8	0.8	0.9	1.0	1.1	1.1
Nominal effective pound exchange rate (4)	80.4	78.4	78.4	78.6	77.1	79.4	80.4	80.8

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.

by the highest income bracket and also in corporation tax, whose aim is to boost private investment. The rate for incomes over 150,000 pounds per year is likely to decrease from 50% al 45%, as from April 2013. Although the more significant change in the short term is the downward revision of corporation tax, which will decrease from 26% to 24% as from April this year and is expected to stand at 22% in 2014.

George Osborne believes this will make the United Kingdom one of the most competitive countries in terms of attracting firms. However, he repeated his intention to offset these tax cuts to maintain the fiscal austerity plan. For this reason, he has decided to raise the taxes levied when buying a home valued at more than 2 million pounds sterling, by 5%. On the other hand, to stop the practice of avoiding stamp duty when buying a house through a company, he has passed a new 15% tax for such cases. To date, the stamp duty had been scaled, its highest level being 5% for houses worth more than one million pounds.

The Chancellor will also reinforce measures to combat tax evasion. And he has raised the tax levied on the assets of banks operating in the United Kingdom. Indirect taxes have also been raised, such as the tax on tobacco, up by 37 pence per box of cigarettes. In this way the Chancellor hopes to prevent the country losing its top credit rating, which is currently AAA. The target is to eliminate the fiscal deficit by the 2017 tax year, which is currently more than 8% of gross domestic product. And the challenge during the tax year beginning in April 2012 is huge, as the goal is to reduce the fiscal deficit to 5.9% of GDP by the end of March 2013.

This announcement was made within a context of lethargic aggregate demand. The weak labour market affected retail sales in February, down 0.8% month-on-month, the largest fall in the last nine months, and the figure for January has also been revised to 0.3% from 0.9%.

On the external side, the United Kingdom's trade balance in January posted a deficit of 7.5 billion pounds. This negative balance has deteriorated since December, although less than the months of October and November, so that, should it continue, the foreign sector would contribute positively to growth in the first quarter. Of note is the good performance by exports to countries outside the European Union, especially cars and oil, due to price rises.

In terms of supply, industrial production continues to deteriorate, posting a 0.4% drop month-on-month in January, while the year-on-year figure shows a contraction of 3.8%. Most items show contraction, almost without exception. Curiously, this figure contrasts with a slight improvement in the country's business sentiment surveys.

Inflation continues its downward trend, as shown by the figure for February with year-on-year growth of 3.4%, two tenths of a percentage point less than the previous month, although the rise in oil prices has slowed up February's decrease. Nonetheless, this is still the lowest level since November 2010 and reflects a significant fall since the 5.2% recorded in September last year. However, the Bank of England itself, in the minutes published for its monetary policy meeting in March, and regarding the preceding meeting, stressed its greater concern for inflation and its possible

Inflation continues to fall in the United Kingdom.

Financial tension has eased in emerging Europe.

effect on future wage pressures. It even announced that its 1.8% forecast for the end of 2012 does not totally reflect the risk supposed by the rise in oil prices seen over the last few months.

Emerging Europe: a recovery in the making

If we are to highlight the sources of uncertainty that have presided over the recent situation in emerging Europe, we should mention the financial repercussions of the euro area's sovereign debt crisis, Hungary's situation and the extent of the weak phase in activity. The financial tension front is apparently starting to be redressed, as shown by the appreciable relaxation in the risk premium of the sovereign bonds in emerging Europe and the successful sovereign debt issuances in foreign currency in Poland and Romania during the first quarter of the year. This is a change induced by developments outside the region but with important positive consequences, given these economies' dependence on external financing.

Hungary's situation is still one of waiting, with the government forced to make a move in terms of economic policy.

With regard to Hungary, public attention has been notoriously attracted by the decision of the European Union not to pay a third of the cohesion fund in 2013 if additional measures are not announced to cut structural expenditure before June. In spite of the media coverage, this is another step forward in the so-called excessive deficit procedure and had already been predicted by most analysts. The fundamental element that still dominates economic discussion concerns the need for financial aid from the International Monetary Fund (IMF) and the EU, and the likelihood of this happening soon. There is little news in this area but both the improvement in the international financial environment and the expectations that external credit will end up arriving have helped to reduce the interest rate charged on the government's debt.

Activity seems to have touched bottom in the last part of 2011.

With the financial storms temporarily abated and Hungary waiting expectantly, in the last few weeks attention has been focused on the strictly macroeconomic front. In particular, the main question is whether the slowdown in the economy has touched bottom or whether activity is likely to decline even further. Indicators that reflect cyclic nuances more finely, such as economic sentiment, seem to suggest that the first of these scenarios is the one that is actually happening.

In December 2011, the average economic sentiment for the five economies we usually cover in these pages (Poland, Romania, the Czech Republic, Hungary and Slovakia) posted its lowest value since December 2009. It arrived at this level after eight consecutive months of falls. Since then, the index has picked up over the last two months, outlining what looks like becoming a recovering trend. Different elements reinforce this conclusion. Firstly, several leading indicators (such as the one published by the Organization for Economic Cooperation and Development) point to the recovery in activity spreading over the next few months. Nonetheless, this same information shows that the pace of this recovery will be contained, for the time being, and will affect Poland more than the other economies in the region.

A second aspect that helps to substantiate the scenario of recovery is that this development goes beyond the strictly temporary and local framework. For the last few weeks, a process of moderate revision has been glimpsed in

expectations for global activity. After several months of better than expected activity indicators in key countries such as the United States and Germany, it is starting to be debated whether the contained growth forecasts employed since the end of 2011 are being surpassed, in a positive sense, by reality. For the time being, one example of this perception are the recent statements made by Christine Largarde, Director of the International Monetary Fund, affirming that the situation was slightly better than a few months ago and, even more significantly, that she believed the decisions taken in the last part of 2011 were having an effect. This is a valuable opinion that can be considered as increasingly widespread.

When are we likely to see this change in scenario confirmed? In emerging Europe, at the level of national accounts, a clear sign will be detected with the growth figures for the second quarter. We should remember that the latest figures available, referring to the fourth quarter of 2011, still showed the region's activity to be in decline. Given that monthly indicators are improving very gradually, in the first quarter we will most likely see positive but minimal quarter-on-quarter growth in most countries.

Leading indicators point to the incipient recovery becoming consolidated.

Although this recovery is still at a tentative stage, some people have wondered whether monetary policy is going to change its orientation soon. The answer is necessarily in the negative, as such a shift would be premature. No increase is expected in the official interest rate in 2012 in Poland, the Czech Republic, Slovakia or Romania. In the Hungarian case, there might even be a reduction in the official rate, which could go from the current 7% to levels of 6.5%-6.25% at the end of year, if international financial aid is finally confirmed. This is in spite of the fact that, in February, inflation was above the threshold of 4% year-on-year in most countries due to higher energy tensions (a component that grew in the order of 10% year-on-year, as an average for the region).

Inflation picks up thanks to energy but monetary policy is not going to shift.

FINANCIAL MARKETS

Monetary and capital markets

Progress is made towards exiting the European crisis but there's still a long way to go

The moderation in global risks boosts investor confidence.

Throughout March, various events have occurred of particular relevance for international financial markets and specifically for the European ones. We are referring to the successful injection of liquidity by the European Central Bank (ECB) and the fact that Greece will be able to avoid a disorderly default. Both events have brought a renewed dose of confidence regarding the possibility of advancing towards a definitive solution for the euro area's financial crisis. In addition, in the global sphere, the reactivation of economic growth in the United States and consolidation in the emerging countries has helped to improve investor expectations. This gradual increase in agents' appetite for risk and their search for profitability is in line with a change in preferences observed since the end of 2011, in accordance with the positive trend in risk assets, such as equity and corporate bonds. However, we need to remain realistic and recognise that a large part of the instability from previous months is still present, so that any bad news in this respect could spark off new episodes of downwards corrections.

Central banks pause the pace of expansionary measures.

Central banks in a position of «wait and see»

The Federal Reserve improves the economy's growth prospects.

The role played recently by central banks in this scenario is being decisive. Since 2008, they have demonstrated an extraordinary capacity to take decisions and act in response to the financial shocks occurring. Thanks to this sustained commitment they are achieving, at least in part, their desired goals of relaxing tension in the capital markets and boosting economic activity. As is usual, the outcomes of the measures that have been adopted require some time between their implementation to when their effects on the different economic and financial variables start to be felt. This is precisely the phase in which the main central banks of the developed countries now find themselves: a period of «wait and see» after the aggressive actions of the last few months.

In the United States, this was the implicit message given by the Federal Reserve (Fed) after its regular monetary policy meeting. As on previous occasions, the Fed Chairman, Ben Bernanke, highlighted the improvement seen since the summer in the indicators for household consumption and corporate investment. This trend has been accompanied by a gradual increase in the net creation of jobs. In spite of leading indicators, Bernanke pointed out that certain weaknesses continue in particularly relevant sectors, such as real estate. As a joint assessment, the Fed Committee declared that it expects the pace of economic growth to be «moderate» over the next few quarters. This marks a slight change in the terminology used («modest» was the term used up to now) that underlines, in the opinion of most observers, a more optimistic bias in the central bank's

message. In any case, the Fed decided to keep to its monetary policy strategy under the already familiar terms: exceptionally low interest rates (0%-0.25%) and the application of extraordinary measures already in force. Subtly, as he did not provide any more details regarding the deliberations of the Committee regarding extraordinary measures, Bernanke delayed one of the most debated issues in financial markets until the next meeting: the possible application of a third round of quantitative easing.

The Fed decides not to apply further monetary stimuli for the time being.

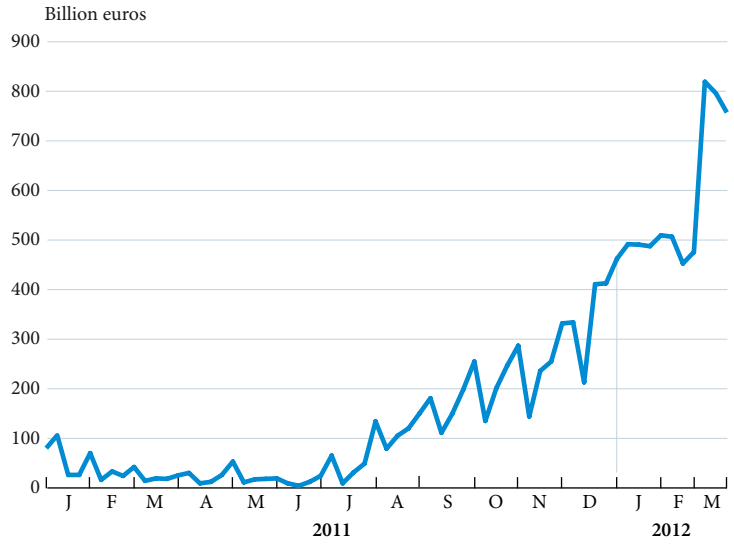
Regarding the ECB, the central bank's position has also transmitted the start of a waiting period after its latest actions in European financial markets. On the last day of February, the central bank carried out the second of the two auctions for unlimited three-year loans (LTRO) to banks in the euro area. On this occasion, the ECB granted a total of 530 billion euros to the 800 banks in question. According to its President, Mario Draghi, the tender was considered to be of «unquestionable success» as, on this occasion, among those applying for loans were medium and small-sized banks, auguring a more effective distribution of funds towards the real economy. As already suggested by Draghi himself, it is still too soon to calculate the impact of all the unconventional measures adopted by the central bank in the last few months. For the moment it can be stated that positive effects have been observed on credit markets and investor sentiment in the euro area. Similarly, the bank's executive body expects clear signs to be perceived of an increase in credit activity to the private sector over the coming months.

The ECB provides banks with more than half a trillion euros at three years.

Based on these funding facilities granted to the banking sector, and given that several signs have been observed of the euro area's economy stabilizing, the ECB decided to keep the official interest rate at 1%. However, the authority has warned that there are still risks that could push growth down. It is precisely because of this circumstance that it forecasts an

No statement from the ECB regarding the strategy it will applied to withdraw liquidity.

ECB DEPOSIT FACILITY



SOURCE: European Central Bank.

The ECB decides to keep the official interest rate at 1%.

average fall in GDP for the region this year of 0.1%. Similarly, Draghi referred to the existence of certain risks that might push up inflationary expectations over the coming months, including recent oil price rises and the hike in indirect taxes in several member countries. Draghi also applauded the progress made in the fiscal and labour areas being carried out by several governments in the euro area, principally Spain and Italy, and urged policymakers to implement new structural measures.

The monetary authorities of emerging countries are keeping a close eye on inflationary pressures.

In the case of the central banks of emerging countries, the pace of monetary policy decisions has also slowed up somewhat. Once the vast majority of emerging central banks had chosen a monetary strategy of relaxation to avoid a sharp slowdown in their economies, the appearance of a new source of instability is hindering their application. In fact, the rising price of a barrel of crude, caused by tensions in the Middle East, is increasing inflationary pressures at a global level. This circumstance has a greater impact on emerging economies, with substantially higher inflation rates than developed countries. Consequently, the pace of monetary relaxation has slowed

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									
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	1.47	2.04	0.25	0.53	0.20	0.50	1.04	0.77
December	1.00	1.36	1.95	0.25	0.58	0.20	0.50	1.08	0.92
2012									
January	1.00	1.13	1.75	0.25	0.54	0.20	0.50	1.08	0.47
February	1.00	0.98	1.61	0.25	0.48	0.20	0.50	1.06	0.57
March (1)	1.00	0.82	1.46	0.25	0.47	0.20	0.50	1.03	0.72

NOTES: (1) March 22.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 2-04-09 (1.25%), 7-05-09 (1.00%), 7-04-11 (1.25%), 7-07-11 (1.50%), 3-11-11 (1.25%), 8-12-11 (1.00%).

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

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

(5) Interbank rate.

SOURCES: National central banks, Bloomberg and own calculations.

up but in no way has stopped. For example, Brazil has cut its official interest rate to 9.75%, while China and India have reduced their reserve ratio for banks.

For their part, the interest rates of interbank markets in the United States and the euro area continued their downward slide started months ago. The relaxation of the Libor and Euribor interest rates is mainly a result of the forcefulness of the central banks' quantitative measures. However, dysfunctions in the European interbank market are still significant. This can be observed via the increase that has occurred in the already high level of overnight deposits made by European banks with the ECB after the 3-year loan auction.

The Euribor falls again as tensions ease in the interbank market.

Upswing in the yield on sovereign debt

In mid-March, the yield on public debt for the United States and Germany stopped the downward slide started five months ago. In the sovereign markets of these particularly solvent economies, the price of bonds has fallen as a consequence of the moderation in risks threatening global financial stability and European stability in particular. Factors such as monetary lassitude and the guarantee of liquidity have laid the foundations for what will probably be a new phase of investor flows returning to assets with a higher risk profile. In the United States this change in direction occurred in the second half of the month. The most evident sign is the sharp rise seen in the yield for 10-year bonds, reaching 2.37% in March.

In the euro area, the yield on German debt also rose appreciably throughout the month, even exceeding the threshold of 2% in some sessions. The successful injection of liquidity by the ECB and the approval of the second financial bail-out for Greece encouraged investors to sell the German bund in favour of other assets with higher yields, such as corporate bonds, shares and even the sovereign debt of some countries on the periphery of Europe. Less nervousness regarding the credit crisis has continued to act favourably on the reduction in risk premia for the sovereign bonds of Italy and, to a lesser extent, Spain. This circumstance has also been strengthened by the satisfactory sales of public debt by both governments and by the structural measures they have been adopting. Given this reduction in tension, the ECB stopped buying up the bonds of both countries at the beginning of March. However, these tensions have in no way disappeared entirely and, in fact, reappeared in Spain due to the expectation created around the announcement of the country's budget for 2012.

Yields rise on US and German debt.

The containment of risks in the euro area pushes down the risk premia for peripheral countries.

For its part, Greece managed to avoid the chaos of a disorderly default of its economy. Finally, most private bond holders accepted the conditions proposed by the Greek government regarding the exchange of debt and, at the European Summit, the approval was formalized for a second bail-out package (130 billion euros). Voluntary acceptance was high among creditors (85.7% of the total bonds issued under Greek law), although Greek policymakers made use of collective action clauses (CAC) to ensure the operation was a success. However, and given the international standards for

Greece manages to avoid the risk of disorderly default.

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								
February	3.2	3.5	5.4	4.8	3.4	1.3	3.6	1.9
March	3.4	3.7	5.3	4.8	3.5	1.3	3.7	2.0
April	3.3	3.6	5.5	4.7	3.4	1.2	3.6	2.1
May	3.0	3.4	5.4	4.8	3.1	1.2	3.3	1.8
June	3.0	3.4	5.4	4.9	3.2	1.1	3.4	1.7
July	2.5	3.2	6.1	5.9	2.8	1.1	2.9	1.4
August	2.2	2.9	5.0	5.1	2.2	1.0	2.6	1.1
September	1.9	2.6	5.1	5.5	1.9	1.0	2.4	0.9
October	2.0	3.1	5.5	6.1	2.1	1.0	2.4	1.0
November	2.3	3.4	6.2	7.0	2.1	1.1	2.3	0.9
December	1.8	3.1	5.1	7.1	1.9	1.0	2.0	0.7
2012								
January	1.79	3.05	4.97	5.95	1.80	0.97	1.97	0.72
February	1.82	2.88	4.99	5.19	1.97	0.96	2.15	0.72
March (*)	1.91	2.99	5.49	5.09	2.26	1.03	2.32	0.90

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

The exchange rate for the currencies of the emerging countries appreciates against the euro and dollar.

derivative markets, the restructuring was classified as a «credit event», entailing the activation of credit default swaps (CDS).

Appreciation in the currencies of the emerging countries

In March, the euro-dollar exchange rate maintained its trend of moderate fluctuations that has been the overall tone for the last few quarters. The ECB's LTRO auction and the favourable resolution of the Greek ultimatum in the European scenario, as well as the improved economic data for the United States ending up by with the American currency appreciating slightly. However, in spite of these short-term variations, the medium-term exchange rate looks increasingly stable, at around 1.30 dollars.

On the other hand, in the emerging countries as a whole there are signs of an incipient recovery in their currencies. Specifically, the recovery in investor confidence and the growing appetite for risk at a global level are boosting the already favourable perception of these countries' structural potential. The sum of these factors is encouraging the appreciation of the currencies of many of these economies, such as those of the Eastern European countries and the Brazilian real.

EXCHANGE RATES OF MAIN CURRENCIES

March 22, 12

	Exchange rate	% change (*)		
		Monthly	Over December 2012	Annual
Against US dollar				
Japanese yen	82.5	2.7	6.8	1.9
Pound sterling	0.633	0.9	1.7	–3.5
Swiss franc	0.914	0.4	–2.7	1.1
Canadian dollar	1.000	0.0	–2.1	1.9
Mexican peso	12.832	–0.1	–8.6	6.6
Against euro				
US dollar	1.320	0.4	–1.8	7.1
Japanese yen	108.9	2.3	8.5	–5.6
Swiss franc	1.205	–0.1	–0.9	–6.4
Pound sterling	0.835	–1.3	0.1	–3.9
Swedish krona	8.934	1.2	0.2	–0.3
Danish krone	7.435	0.0	0.0	–0.3
Polish zloty	4.168	–0.8	–7.1	3.3
Czech crown	24.73	–1.8	–3.5	1.3
Hungarian forint	294.1	1.7	–7.1	8.1

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

Large amounts of corporate bonds issued

In March, activity in the corporate bond markets continued to speed up. During the first few sessions, the combination of the ECB's extensive liquidity and doubts regarding Greece limited volumes in the primary and secondary markets. But the gradual improvement in the climate regarding sovereign and financial risks at a global level and the flow of good economic data boosted corporate bonds. This new upward trend is being characterized by the increase in bonds issued by companies, which are opting for financing in the market as opposed to other alternatives, and by investors looking for higher returns (prepared to take on more risk), finding an alternative in this kind of asset compared with sovereign debt and equity.

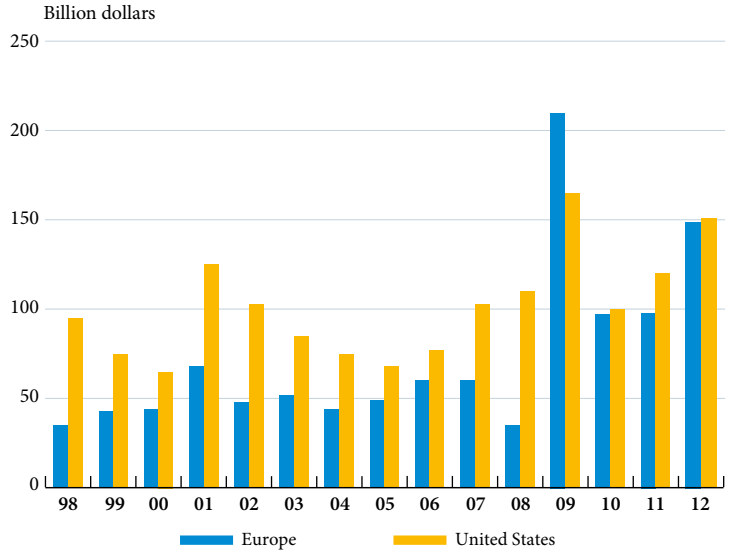
The reduction in sovereign risks has had the greatest effect on narrowing spreads between bonds in the euro area and particularly regarding the peripheral countries. This situation has encouraged European companies to issue investment degree bonds. Data such as the fact that the total number of bonds sold by non-financial companies since the start of the year double those for the same period last year, or that some solvent companies in Spain and Italy have sold their debt in North America, are proof of this market's resurgence. Europe's banking sector is experiencing a similar situation, although it's true that this sector's debt is mostly issued as covered bonds.

Credit markets benefit from the dissipation of international financial risks.

European companies take advantage of falling risk premia to issue more bonds.

CORPORATE BOND ISSUANCE IN EUROPE AND THE UNITED STATES

Data from 1 January to 21 March



SOURCE: Bloomberg.

The indices for high yield US bonds show very low interest rates.

In the United States, whose economic and financial situation is more encouraging than the European situation, corporate bond markets are at a more advanced stage of maturity. One fundamental aspect is the spectacular rise in flows of capital towards corporate debt funds since January. In the first three months of the year the amount received by these funds has doubled compared with the first quarter of 2011. Firms are taking full advantage of this circumstance, highly motivated by the low interest rates to finance themselves under conditions that have rarely been this favourable in history.

Emerging bond markets are also increasing considerably. The sustainability of the economic prospects for these economies, the favourable evaluation of their credit ratings and the reduction in risk at a global level are enough reason to attract international investors who are eager for yield.

A favourable wind is blowing for equity

Equity is the other asset that is clearly reflecting this change in global investor sentiment. In March, the main stock markets continued their upward trend of the last three months, consolidating this as the best start to the stock market year at a global level since the 1990s. However, the Spanish stock market is still hugely erratic with small volumes of trade. Among the aspects supporting this rally, of note is the improvement in global growth prospects; the reduction in the perception of risks; the acceleration in transferring liquidity from funds towards assets with a higher risk profile and yield; the positive trend in analysts' earnings estimates and the search for returns on investment via profit-sharing strategies (dividends).

Stock markets continue their upward trend, although the Spanish index is still lagging behind.

Precisely these last two aspects have been particularly relevant in the recent stock

market scenario. At a global level, and for the first time since last May, the upward revisions for corporate earnings carried out by analysts exceeded the downward revisions. These improved forecasts occurred mainly in the financial, industrial and consumer sectors. Such news suggests that analysts and investors are increasingly perceiving an imminent exit to the financial crisis compared with the uncertainty of the previous quarters. Meanwhile, investors keener on increasing the returns on their portfolios have opted to buy securities from companies that pay out high dividends, pushing their share prices up.

By geographical area, although the generalized trend was one of rises, the particularities of each economy were reflected in their stock markets. In the United States, the S&P 500 reached its highest value in four years, boosted by the improved economic forecasts and the successful outcome of the stress tests carried out by the Fed on the country's large banks. In the euro area, the stock market recovery was somewhat more tenuous. Once the Greek obstacle had been overcome, and with the reduction in the risk of funding for Europe's banks, investor optimism was mainly reflected in this sector's shares. However, in the last sessions peripheral sovereign risk has picked up, in particular for Spain, this being sufficient reason for its banks' shares to be penalized. Lastly, in the case of the stock markets of the emerging countries, revaluation lost some of its initial steam given the threat of a possible rise in inflation linked to the Middle East conflicts.

Analysts appear more optimistic regarding corporate earnings.

The S&P 500 is at its highest level for the last four years.

INDICES OF MAIN WORLD STOCK EXCHANGES

March 22, 2012

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*13,050.6*	*0.9*	*6.8*	*8.6*
Standard & Poor's	*1,392.7*	*2.6*	*10.7*	*7.6*
Nasdaq	*3,060.5*	*4.3*	*17.5*	*14.0*
Tokyo	10,127.1	6.0	19.8	5.4
London	5,842.7	–1.2	4.9	1.4
Euro area	2,525.7	0.3	9.0	–11.5
Frankfurt	*6,966.6*	*1.8*	*18.1*	*2.7*
Paris	*3,471.1*	*0.7*	*9.9*	*–10.8*
Amsterdam	*326.7*	*0.0*	*4.6*	*–8.3*
Milan	*16,395.3*	*–1.0*	*8.7*	*–23.9*
Madrid	*8,314.0*	*–4.0*	*–2.9*	*–21.4*
Zurich	6,249.4	0.9	5.3	0.4
Hong Kong	20,901.6	–3.0	13.4	–8.6
Buenos Aires	2,678.4	–5.6	8.8	–19.4
São Paulo	65,850.0	–0.4	16.0	–2.6

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.

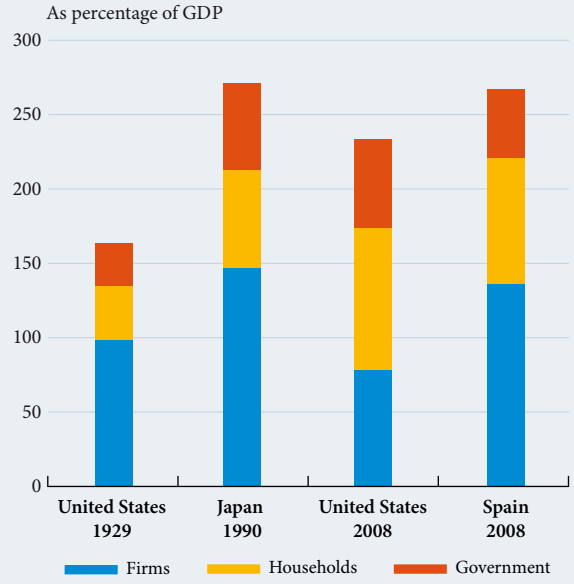
Corporate debt: first, prudence and ensuring liquidity

Credit booms that result in a financial crisis, subsequently giving way to a prolonged phase of debt reduction, have been repeated on many occasions throughout history. Several developed countries are now in the deleveraging phase of one of the most remarkable episodes of this kind. The United States and Spain are two leading exponents. Each case has its own particular features, both in terms of how it arose and also its consequences and the nature of the readjustment. These differences might be due to factors such as the institutional framework or the response provided by economic policy. This box looks at some issues related to the role played by non-financial companies.

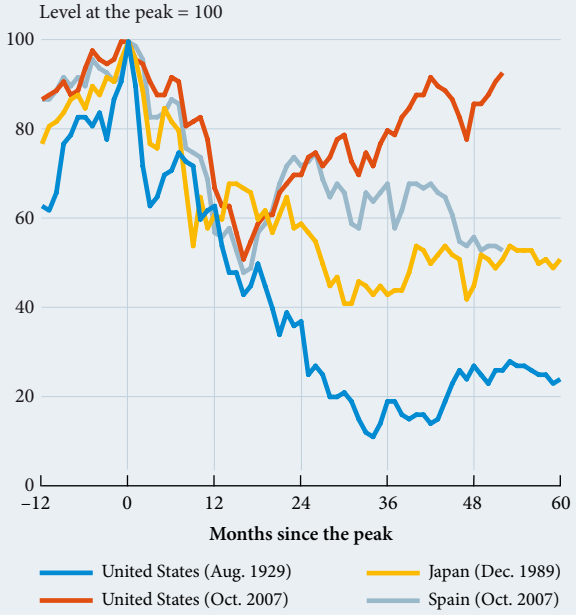
The outbreak of the subprime mortgage crisis put an end to a long, intense period of credit expansion in the United States. In 2008, the debt of non-financial institutional sectors was around 230% of GDP. At the same time, in Spain it had almost reached 270%. Surprised by the vulnerability shown by the system, analysts and economic authorities quickly looked to the past to find similar situations and pointers on how to handle the process successfully. The two most frequently mentioned cases are the United States in 1930 (the Great Depression) and Japan in 1990 (the Lost Decade). The graph below illustrates the size of the debt accumulated at the start of each adjustment phase.

NOTABLE CREDIT BOOMS THROUGHOUT HISTORY

Debt levels of institutional sectors



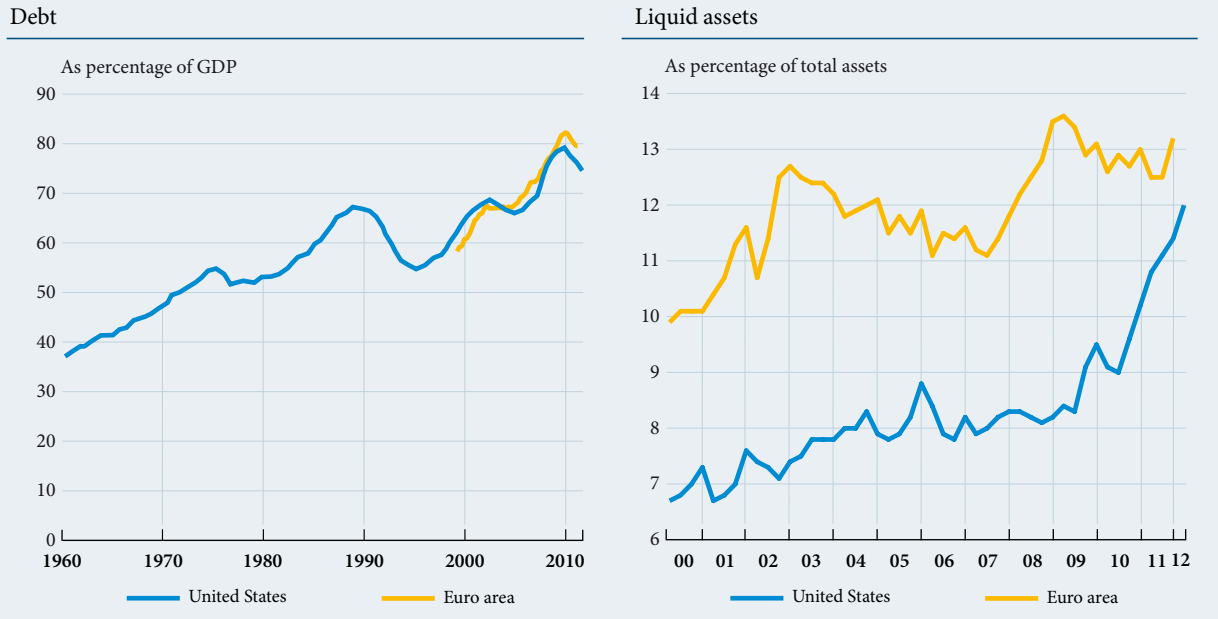
Post-boom stock market performance



SOURCES: McKinsey Global Institute and Bloomberg.

As can be seen, in 2008 the indebtedness of non-financial firms in the United States was lower than at the start of these two big benchmark episodes. However, it was as high in Spain. This observation is true both for the level of corporate debt compared with GDP and also its relative weight in the aggregate debt of the different institutional sectors. What implications might this have? Unfortunately, there have been few analyses of the macroeconomic effects of the level of corporate debt until very recently. Theoretically, there is no established consensus[1]. Empirically, most of the few studies carried out focus on countries' total debt or credit, if necessary distinguishing between public and private debt but without looking at the details of the latter.[2] One exception to this is the recent work by Cechetti et al. (2011),[3] which provides interesting findings. They identify a stronger negative influence of corporate debt than household debt on GDP growth. Both have an effect when they go beyond a similar threshold (90% of GDP for corporate and 84% for household, in the historical experience accumulated to date) but, from this point onwards, the impact in terms of a drag on economic growth is more significant when it's corporate debt that inflates.

TRENDS IN DEBT AND LIQUIDITY OF NON-FINANCIAL FIRMS



SOURCES: European Central Bank and IIF.

(1) The contributions provided by H. Minsky constitute the most frequently mentioned background. Points on the Japanese experience have been made by R. Koo. Among the most recent studies is the one by G. Eggertsson and P. Krugman, «*Debt, Deleveraging and the Liquidity Trap*», mimeograph, (2010).
(2) For a general view, see C. Reinhart and K. Rogoff, «*Growth in a time of Debt*», AER, May 2010, as well as O. Jordà, M. Schularick and A. M. Taylor, «*When Credit Bites Back: Leverage, Business Cycles and Crises*», NBER Working Paper 17621, (2011). For an application to the Spanish case, see O. Aspachs, S. Jódar and J. Gual, «*Perspectivas de desapalancamiento en España*», Documento de Economía no. 23 of "la Caixa", (2011).
(3) S. Cechetti, M. S. Mohanty and F. Zampolli, «*The Real Effects of Debt*», BIS. Working Paper no. 352, (2011).

According to this finding, we could attribute the better macroeconomic performance of the post-2008 United States in comparison to its performance during the Great Recession and Japan's Lost Decade to the more moderate situation of corporate debt, as the boom had been dominated by households and the financial sector. But other factors are also included in the fray, especially the fast, aggressive response of economic policy since 2008, so that this claim cannot be categorical, particularly when the authors admit that, due to a lack of data, the estimated size of these effects is somewhat imprecise. Whatever the case, another area where the relative strong equity position of US companies appears to have a favourable effect is in stock market trends. Since 2008 there has not been anything resembling a wave of company bankruptcies; quite the opposite, in fact: they have reinforced their balance sheets and quickly improved their income statements. Consequently, the stock market recovery has been notably fast, in contrast with the situation after United States-1929 and Japan-1990.

In short, US companies arrived at 2008 with a high but tolerable level of debt: without exceeding the harmful 90% threshold and in line with the long-term trend (the main reason for a secular upward trend is financial deepening, associated with economic progress and increasing wealth). One of the reasons why firms acted relatively moderately during the 2003-2007 credit boom is they had already gone through an expansionary cycle of debt and investment just a few years earlier (related to the internet bubble), with its subsequent purge. Consequently, companies did not need any huge investment and self-financing was also abundant, thanks to healthy income statements.

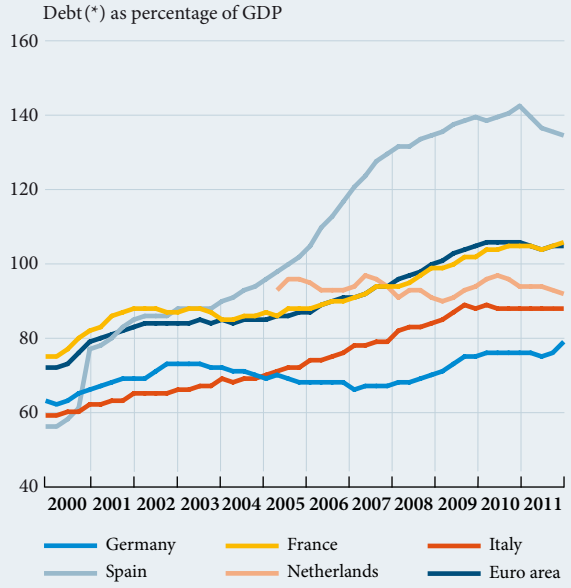
After the crisis erupted in 2008, this prudential behaviour has continued and even intensified. Gross debt as a percentage of GDP has fallen. In fact, a notably conservative approach can be seen in the overall balance sheet. For example, in the trend of the debt to asset ratio, in longer debt maturities and, above all, in the large and increasing proportion of liquid assets in the overall asset composition. Some have compared the behaviour of firms over the last few years with that of the emerging countries: prioritizing caution and ensuring liquidity. In the case of emerging countries, this attitude is due to their traumatic experiences after the Asian and Latin American crises at the end of the 1990s. For firms, their shock came in 2001 when the internet bubble burst and with the sudden paralysis in 2008, both in access to bank financing and to the bond market.

US companies have strengthened their equity position in the system's last four years of deleveraging. Profits are high, so self-financing has played an important part. Moreover, the bond markets have quickly reopened and firms have taken advantage of this to issue bonds and build up liquidity. In the opinion of some observers, this behaviour on the part of firms is counterproductive for the US economy as a whole, as it does not help to offset the recessionary effects of the inevitable deleveraging of the rest of the institutional sectors. In this respect, it would be preferable for companies to reduce their savings, distributing more funds to their shareholders or, even better, expanding investment and creating jobs.

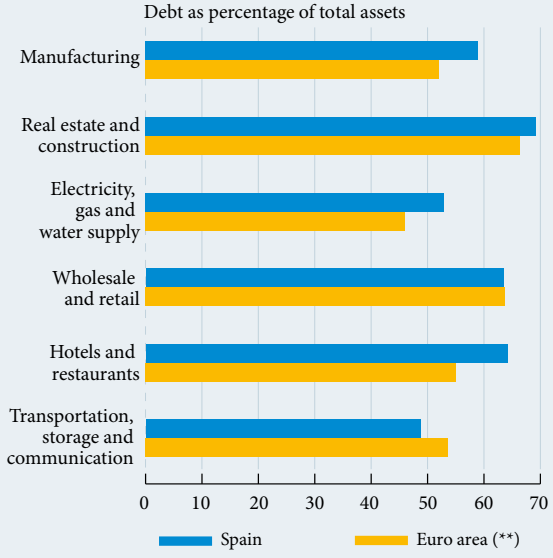
The situation in Europe has a lot in common with that of the United States. The equity position of firms was reasonably solid at the start of the 2008 crisis and has remained stable over the last few years, with European companies also behaving conservatively. Ultimately, on the Old Continent the deleveraging being carried out is associated, as in the United States, with financial institutions, with households in some countries and, more recently, with governments, but not with the corporate world. However, Spain is an exception, given that its level of corporate debt is clearly higher than the norm. A large part of this phenomenon can be put down to the sectoral

SPAIN'S CORPORATE DEBT STANDS OUT IN THE EURO AREA

Trend by country



Comparison by activity sector in 2008



NOTES: (*) Includes items not included in the measurement of «Debt» in previous graphs.
(**) Weighted by GDP average of the ratios of Germany, France, Italy, Portugal and Belgium.
SOURCES: ECB and Bank of Spain.

composition of economic activity and, in particular, the excessively high volume represented by the real estate and construction secto.[4] As is well-known, an accumulation of debt in this sector interacts negatively with the balance sheets of financial institutions and is acting as a drag on the country's economic recovery.

(4) See the box *«The excessive debt of Spanish firms: a matter of many or just a few?»* in this volume.

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

SPAIN: OVERALL ANALYSIS

Economic activity

The green shoots of spring?

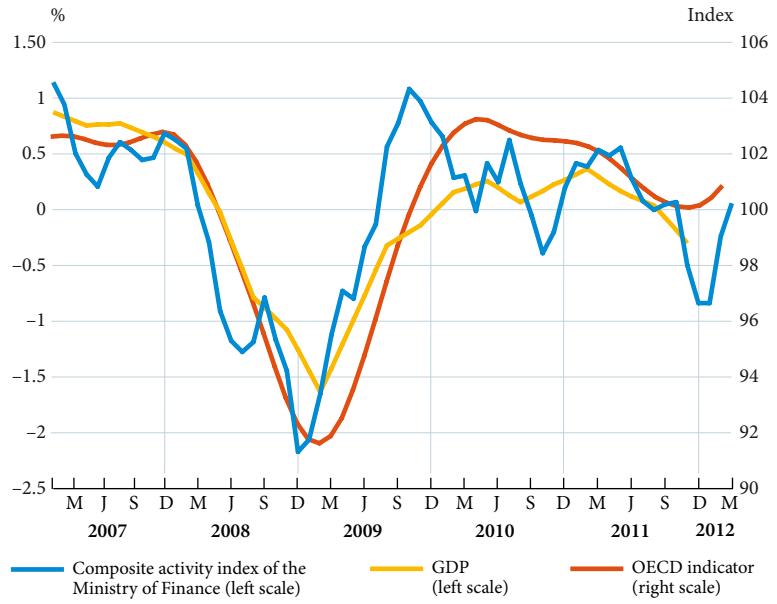
Some leading indicators point to recovery.

Spring has brought the first green shoots, as least so it appears. Last month we already announced that a significant number of leading indicators had stabilized and some of them had even started to pick up. This, now, has become a recovery in composite activity indicators. Nevertheless, the market's overall perception regarding the Spanish economy's ability to recover has worsened. One sign of this is that the risk premium for Spain's public debt has risen significantly instead of improving, as is the case of Italy and France. One of two things: either the upswing in leading indicators is transitory or the markets are being guided by the wrong signs. Which is right?

A good example of the general improvement in leading indicators is the good performance of the composite activity index (ISA in Spanish), produced by the Ministry of Finance, and the leading indicator of the Organization for Economic Cooperation and Development (OECD). As can be seen in the graph below, their trend is closely related to that of gross domestic product (GDP) and consequently these are good leading indicators of its performance. The Ministry of Finance ISA index saw a large

SIGNIFICANT IMPROVEMENT IN LEADING INDICATORS

Quarter-on-quarter change



SOURCES: OECD, Ministry of the Economy and own calculations.

decline in the last quarter of the year but its quarter-on-quarter rate of change has picked up significantly this year so far. The performance of the OECD indicator is similar. According to this, the drop in GDP of the first quarter of 2012 should be very modest. However, it's very important to remember that the predictive capacity of these indicators improves as the different indicators for the first quarter are published. For example, the latest data available for industrial production are the figures from January. These indices will therefore change once February and March's figures are announced.

To be able to evaluate just how far these composite indicators might end up changing, we need to look at the main indicators that comprise them in more detail. Regarding demand, the data are actually far from encouraging. The consumer confidence index, far from stabilizing, has once again posted a sharp drop after the large decline it suffered in January. The level it's at now is equivalent to the minimum it reached in 2010. The data for non-energy imports in January reinforce the idea that consumption does not seem to be picking up in the first quarter of this year. The decline in year-on-year terms was 6.8%, more than double the drop that occurred in the last quarter of 2011. The data for car and industrial vehicle registrations don't point to any change in trend either.

But we must add a significant proviso to this battery of negative indicators. The sales of large consumer firms did see notable improvement in January. While they had fallen by 4.8% year-on-year in December, in January their percentage change stood at 1.3%. However, it is still too soon to evaluate whether this figure is the result of the volatility inherent to the series or whether, on the other hand, it's the first indication of a possible

Demand indicators are not encouraging.

DEMAND INDICATORS

Percentage change over same period year before

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	January	February
Consumption								
Production of consumer goods (*)	0.8	–1.0	–1.5	–0.8	0.7	–2.2	–1.6	...
Imports of consumer goods (**)	–9.5	–2.2	–1.1	–8.7	1.2	0.4	–2.2	...
Car registrations	3.1	–17.7	–27.3	–26.4	–0.7	–5.5	2.5	–2.1
Credit for consumer durables	–12.3	–9.9	–13.9	–10.1	–4.4	–10.4	–	...
Consumer confidence index (***)	–20.9	–17.1	–19.6	–16.1	–15.8	–16.8	–20.2	–24.7
Investment								
Capital goods production (*)	–3.3	0.8	3.0	2.5	2.6	–4.8	–6.0	...
Imports of capital goods (**)	6.5	–3.1	2.3	–4.9	–1.5	–7.2	–11.3	...
Commercial vehicle registrations	7.0	–6.6	–2.2	–11.2	5.8	–15.1	–17.4	–18.1
Foreign trade (**)								
Non-energy imports	10.3	1.0	7.4	–0.7	0.8	–3.1	–6.8	...
Exports	15.6	10.1	16.0	9.0	10.9	5.4	1.9	...

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

The push is coming from supply.

change in trend. In general, what can be stated is that we cannot find any indicators on the side of demand to justify the improvement in the composite indicators. Quite the opposite, in fact.

The push is coming from the supply side. Electricity consumption is still showing clear signs of stabilizing. Whereas, in the last quarter, this fell by 4.2%, in February the drop in year-on-year terms had decreased to 1.2%. Industrial production also seems to be showing signs of stabilizing. A trend that is reflected in the slow improvement in the industrial confidence index.

One possible explanation for the better performance by supply indicators could be the good performance by the foreign sector. In the last quarter of 2011, the drop in exports in quarter-on-quarter terms was much less than the fall in imports, –1.6% and –6.5% respectively. This meant that the foreign sector's contribution to economic growth was clearly positive, namely 1.3 percentage points. The export figures for January, however, have not been so positive. It's true that the year-on-year change is still in clearly positive terrain, i.e. 3.9%, but the downward slide shown by the figures over the last few months has not only not

SUPPLY INDICATORS

Percentage change over same period year before

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	January	February
Industry								
Electricity consumption (1)	2.9	–1.1	0.5	0.5	–1.1	–4.2	–2.6	–1.2
Industrial production index (2)	0.8	–1.4	1.8	–1.1	–1.4	–5.0	–4.2	...
Confidence indicator for industry (3)	–13.8	–12.5	–8.6	–10.7	–14.4	–16.5	–14.8	–14.2
Utilization of production capacity (4)	72.0	73.3	72.6	74.7	73.3	72.7	72.5	–
Imports of non-energy intermediate goods (5)	24.6	3.1	12.2	3.8	0.9	–4.0	–8.0	...
Construction								
Cement consumption	–15.4	–16.9	–1.5	–16.6	–21.0	–26.8	–23.3	–32.0
Confidence indicator for construction (3)	–29.7	–55.4	–54.1	–55.4	–58.6	–53.6	–58.4	–45.3
Housing (new construction approvals)	–17.3	–14.6	–6.8	–19.5	–5.3	–26.1	...	...
Government tendering	–38.0	–46.1	–45.4	–34.8	–45.3	–59.3	...	...
Services								
Retail sales (6)	–1.0	–5.4	–5.9	–5.1	–4.2	–6.5	–5.9	...
Foreign tourists	1.0	7.6	2.8	10.4	8.5	6.1	4.6	...
Tourist revenue inflows	3.9	8.6	6.7	12.2	8.8	5.7	...	...
Goods carried by rail (ton-km)	6.4	2.0	8.2	1.8	7.7	–9.8	–8.1	...
Air passenger traffic	2.9	6.0	5.0	10.6	6.2	1.5	–3.0	–5.7
Motor vehicle diesel fuel consumption	–1.2	–3.7	–1.6	–4.5	–2.7	–5.7	...	...

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.

stabilized but has speeded up. This contrasts with the economic activity figures for the main countries in the euro area, where the signs of stabilization do seem to be sturdier. This suggests that, although January's export figures were not very good, the downward slide should hit bottom over the coming months.

Having reviewed the main supply and demand indicators, it seems clear that the recovery shown by the main composite indicators for activity should be taken with a great deal of caution, as they might change tone a little as more data are announced. The markets' loss of confidence in the Spanish economy's ability to recover, however, is difficult to justify with the figures commented so far.

A detailed analysis of the different indicators does not show such a robust recovery as that shown by the composite indices, but neither have they got much worse. The increase in the lack of confidence is surely the result of the uncertainty that still surrounds the fiscal consolidation process and the restructuring of the financial sector. By the end of 2011, the public deficit had risen to 8.5%, 3.5 percentage points above the target set by the European Commission. This means that this year's target has had to be revised, finally being set at 5.3% of GDP. The adjustment that will have to be made is huge, around 50 billion euros. The approval of the central government budget for this year is fundamental to being able to evaluate the probability of success. Similarly, in April we will also know the strategies of the different financial institutions to tackle the new requirements imposed on the sector.

So April will be a crucial month. The information we will gradually obtain about the first quarter performance will be much more solid, as will be the position taken by the market regarding the country's capacity to adjust its public accounts and successfully restructure its financial sector.

The support from exports weakens.

The central government budget and restructuring of the financial sector are crucial to restore confidence.

Labour market

Unemployment: unevenly spread

The crisis almost equals the male and female unemployment rate.

In February, the state employment register posted 112,269 more people unemployed than the previous month, bringing the total number of registered unemployed to 4,712,098. Seasonally adjusted, February's rise in unemployment is the second highest since September 2009. For their part, the number of Social Security registrations fell by 2.6% year-on-year, resulting in 49,710 fewer contributors than in January. However, these job losses are not evenly spread among the population or different regions.

Since the summer of 2007, the increase in male unemployment has doubled that of the female rate. A detailed analysis of the labour force survey (LFS) reveals why this has happened. The crisis has destroyed 13% of the employment posted by the Spanish economy in the summer of 2007. The bursting of the property bubble has destroyed more than half the jobs in construction, while the overall drop in activity has eliminated, so far, 22% and 9% of the jobs in the industrial and agricultural sectors, respectively. Given that men hold most of the jobs in these sectors (more than 90% of those employed in construction are male, in

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

February 2012

	No. of unemployed	Change over December 2011		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	163,462	17,501	12.0	25,729	18.7	3.5
Industry	534,844	25,374	5.0	31,381	6.2	11.4
Construction	807,931	32,003	4.1	47,039	6.2	17.1
Services	2,804,340	191,811	7.3	287,752	11.4	59.5
First job	401,521	23,050	6.1	20,934	5.5	8.5
By sex						
Males	2,353,264	143,526	6.5	218,652	10.2	49.9
Females	2,358,834	146,213	6.6	194,183	9.0	50.1
By age						
Under 25 years	501,842	41,281	9.0	31,421	6.7	10.7
All other ages	4,210,256	248,458	6.3	381,414	10.0	89.3
TOTAL	**4,712,098**	**289,739**	**6.6**	**412,835**	**9.6**	**100.0**

SOURCES: Public State Employment Service and own calculations.

addition to the 75% in industry and agriculture), the male unemployment rate has risen to a much greater extent than the female, now almost equalling the latter.

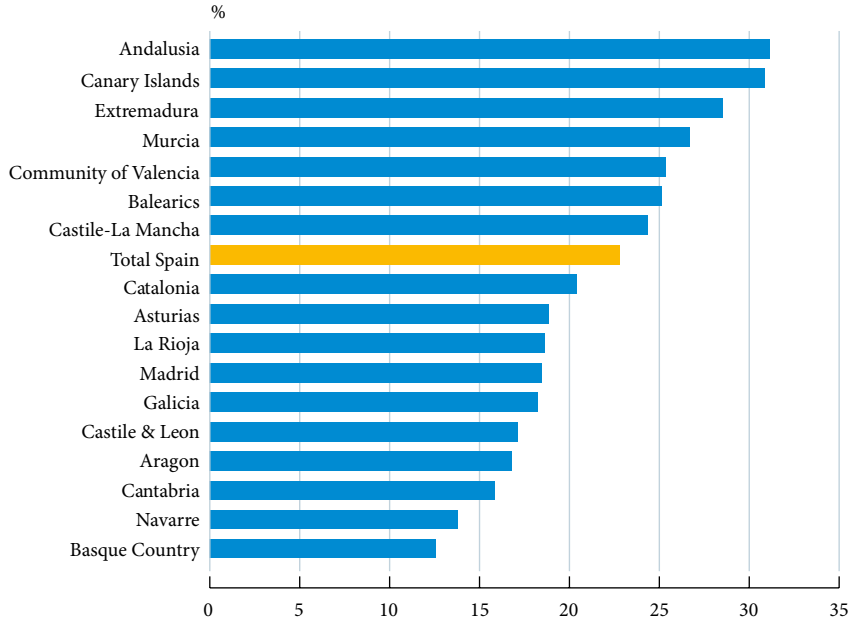
Whereas, in the third quarter of 2007, the male unemployment rate stood at 6.2%, the female rate was 10.5%. Today the difference between both is just 9 tenths of a percentage point, standing at 22.5% and 23.3% respectively. The crisis has been comparatively more benevolent to women. Almost 90% of women work in the services sector, whose employment has hardly dropped by 5% since its historic peak in summer 2008. However, after a positive performance in 2010, employment in the services sector was responsible for 35% of the total job losses in 2011. Should this trend continue, and the figures for registered unemployment in February show a greater increase on December in the number of female unemployed compared with male, the situation won't be very encouraging for women either.

Regarding nationality, one out of every four workers in the sector hardest hit by the crisis, namely construction, was foreign and, given that the number of foreigners in this sector has fallen by 69% in three years, many immigrants have ended up unemployed, have moved over to agriculture or have opted to emigrate. According to the LFS, since the start of 2008, the number of foreign unemployed workers has risen by 721,000 and their unemployment rate comes to 35%, compared with 21% for those of Spanish nationality; while, in the same period, the number of foreigners in the agricultural sector has increased by 20%. The lack of employment options has also resulted in a net exit of foreign population in 2011, and this for the first time, totalling almost 30,000 people.

Even young people with doctorates have an unemployment rate of 26%.

THE DIVERSITY BETWEEN DIFFERENT PRODUCTION ACTIVITIES LIES BEHIND THE DIFFERENT UNEMPLOYMENT RATES

Unemployment rate in the autonomous communities



SOURCE: National Institute of Statistics.

Andalusia and the Canary Islands lead unemployment with a rate of 30%.

Better education seems to be one way to ensure a greater chance of finding work, as the higher the qualifications, the lower the unemployment rate. However, the difficulty in finding a job has meant that one in two of all those aged under 25 who want to work can't find one, and even with higher qualifications their unemployment rate doesn't fall below 39%. Should they get a doctorate before they're 30, young people face an unemployment rate of 26%.

From a geographical point of view, Andalusia and the Canary Islands lead unemployment in Spain and are among the five regions with the highest unemployment in Europe. According to the latest data from Eurostat, referring to 2010, eight of the twelve European regions with the highest unemployment are Spanish. The other four regions are French overseas territories. The explanation for this regional disparity in Spain lies in the activities carried out in the different areas. Those regions such as the Basque Country, Navarre or Aragon whose workforce (compared with the rest of Spain) was employed more extensively in the industrial sector and less in construction at the start of 2008 have seen a smaller increase in their unemployment rate. On the other hand, those regions with more jobs in construction or agriculture, as well as less industrial weight, have seen their unemployment rocket to levels close to 30%. Hence the differences between autonomous communities range from 12.6% in the Basque Country to 31.2% in Andalusia.

Labour costs remain below inflation.

On the other hand, as a consequence of the rise in unemployment and the need to regain competitiveness, companies' labour costs are increasing at a slower pace than historically. The crisis seems to have put an end to wages being linked to

WAGE INDICATORS

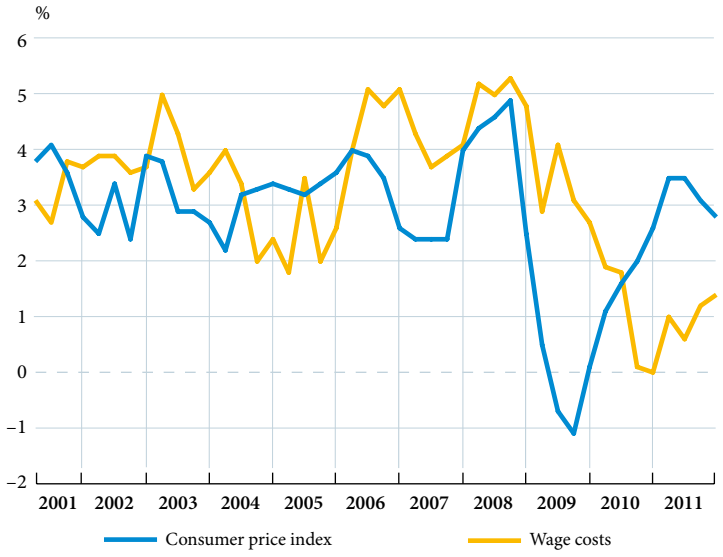
Percentage rate of change over same period year before

	2010	2011	2011			
			1Q	2Q	3Q	4Q
Increase under general wage agreements (*)	**1.5**	**2.4**	**3.1**	**2.7**	**2.6**	**2.4**
Wage per job equivalent to full-time work (**)	**–0.1**	**0.8**	**0.6**	**0.5**	**1.4**	**0.8**
Quarterly labour cost survey						
Wage costs						
Total	0.9	1.0	1.0	0.6	1.2	1.4
Industry	*2.9*	*2.8*	*3.0*	*3.1*	*2.8*	*2.3*
Construction	*0.8*	*2.5*	*2.3*	*3.2*	*1.9*	*2.4*
Services	*0.5*	*0.5*	*0.3*	*–0.2*	*0.8*	*1.1*
Average wages per hour worked	1.1	2.1	0.2	1.3	4.5	2.2
Other labour costs	–1.1	1.6	0.4	1.5	2.2	2.2
Work day (***)	–0.3	–0.9	0.8	–0.6	–3.2	–0.8
Farm wages	**2.9**	**...**	**1.7**	**1.9**	**1.7**	**...**
Labour cost in construction	**1.0**	**0.9**	**1.3**	**2.0**	**2.0**	**2.0**

NOTES: (*) Does not include wage revision clauses. Cumulative figures.
(**) Quarterly National Accounts: data adjusted for seasons and public holidays.
(***) Effective hours worked per worker per month.
SOURCES: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fisheries and Food, Ministry of Public Works and own calculations.

WAGE COSTS CONTINUE TO GROW BELOW INFLATION

Annual change in wage costs per worker and month and in inflation



SOURCE: National Institute of Statistics.

inflation and the agreement signed between trade unions and employers in this respect appears to ensure that this trend will continue in the future.

The wage cost per worker and month grew by 1.4% year-on-year in the fourth quarter of 2011 while inflation stood at 3.1% during the same period. The fact that the number of hours worked fell by 0.8% compared with the same quarter the previous year meant that the wage cost per hour actually worked rose by 2.2%. Nonetheless, wage costs per hour have remained below the historical average.

Redundancy costs pushed up the year-on-year variation in total labour costs, standing at 1.6%. The labour cost per worker and month totalled 2,684 euros, of which 2,020 euros correspond to wages, 573 to Social Security contributions and the rest to compensation, company benefits and other costs.

In short, unemployment has risen asymmetrically throughout the last four and a half years. The sector of activity in which people were employed in 2007 has been crucial to understanding how unemployment has affected different groups and regions, while the lack of employment has become a greater barrier to young people joining the job market, to those with fewer qualifications and also the long-term unemployed. On the other hand, the lower increase in wages is helping to ease the rise in labour costs for firms, which should ultimately improve their competitiveness.

Unemployment is uneven depending on the population segment and region.

Prices

Inflation remains constant in spite of the drop in consumption

Food prices stabilize inflation at 2.0%.

After four consecutive months of falls, in February the consumer price index kept its year-on-year rate of change at 2.0%. The reason? The rise seen in the price of food and non-alcoholic beverages offset the stability or slight fall seen in the rest of the shopping basket.

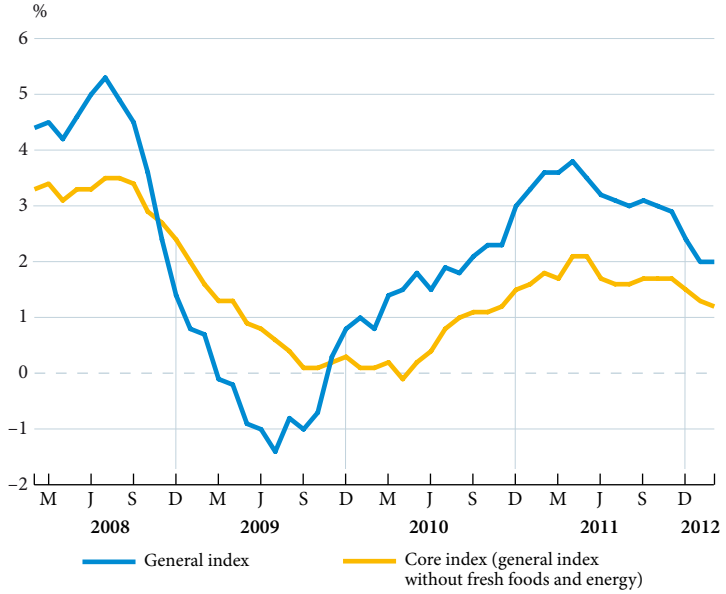
Weak consumption pushes down the core CPI.

The upward pressure exercised by food and non-alcoholic beverages, whose inflation rate increased by 0.3 percentage points compared with January and stood at 2.6% year-on-year, boosted by pulses, fresh vegetables and milk, was offset by the fall in the year-on-year rate of change for insurance (which did not rise this year, unlike last year), in addition to the decreases in leisure and culture, housing, hotels, cafés and restaurants and also clothing and footwear. Hence the general consumer price index remained unaltered compared with January.

This stability in inflation does not mean that consumption is stronger; in fact, it is still very weak in the Spanish economy. February's consumer confidence index reached the levels of 2010; retail sales fell in January to 5.9% year-on-year, while sales of large firms dropped by 5.0% in the same period. In other words, the

INFLATION HALTS ITS DOWNWARD PATH

Annual variation in the consumer price index



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

February

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2011	2012	2011	2012	2011	2012
By type of spending							
Food and non-alcoholic beverages	101.5	–0.2	0.1	–0.1	0.4	1.5	2.6
Alcoholic beverages and tobacco	102.6	0.2	0.3	2.4	0.5	14.5	2.2
Clothing and footwear	91.6	–1.6	–1.7	–15.6	–15.9	0.3	0.0
Housing	101.9	0.3	0.2	3.1	0.7	8.0	3.3
Furnishings and household equipment	100.1	0.0	–0.1	–0.9	–1.0	0.9	1.1
Health	97.7	0.0	0.1	0.0	–0.1	–1.5	–2.9
Transport	103.5	0.8	0.8	2.3	2.7	10.0	5.3
Communications	97.0	0.0	0.1	–0.1	–2.0	–0.7	–3.5
Recreation and culture	99.1	0.6	0.2	–1.3	–2.2	–0.2	0.4
Education	102.1	0.0	0.0	0.1	0.1	2.3	2.8
Restaurants and hotels	100.0	0.1	0.1	0.2	0.0	1.7	0.9
Other goods and services	101.5	0.6	0.3	1.2	0.8	3.1	2.3
By group							
Processed food, beverages and tobacco	101.9	0.2	0.2	0.8	0.5	3.4	2.8
Unprocessed food	101.0	–0.9	0.0	–0.9	0.2	2.9	1.8
Non-food products	100.0	0.2	0.1	–0.8	–1.4	3.7	1.8
Industrial goods	99.7	0.1	0.0	–2.0	–2.6	5.6	2.4
Energy products	*104.9*	*1.2*	*1.1*	*5.8*	*3.5*	*19.0*	*7.9*
Fuels and oils	*106.5*	*1.6*	*1.5*	*4.9*	*4.8*	*20.4*	*10.4*
Industrial goods excluding energy products	*97.5*	*–0.4*	*–0.4*	*–4.9*	*–5.1*	*0.8*	*0.1*
Services	100.4	0.3	0.1	0.3	–0.1	1.8	1.3
Underlying inflation (**)	99.7	0.1	0.0	–1.4	–1.7	1.8	1.2
GENERAL INDEX	**100.4**	**0.1**	**0.1**	**–0.6**	**–1.0**	**3.6**	**2.0**

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

expected lethargy in consumption in the first quarter is taking place and is reflected in prices via core inflation, which excludes fresh foods and energy. The core consumer price index did fall in February, by one tenth of a percentage point, bringing its year-on-year rate of change to 1.2%.

Which elements will push up inflation in the coming months? Firstly, oil. The price of Brent quality oil in euros has set records in the last few weeks of March, coming close to 96 euros per barrel. This rise is due to the higher price of Brent quality oil in dollars, accumulating a 16% increase since the start of the year, mainly as a result of instability in the Middle East, together with the euro's gradual depreciation, which has lost 7% against the US currency in the last year.

Brent quality oil in euros is at a record high.

In order to stop this rise in oil prices accentuating the contraction in Europe and limiting global recovery, Saudi Arabia, the world's largest oil producer, has announced that it is ready to increase its production. At the same time, the United States and the United Kingdom seem to be prepared to release part of their strategic reserves and thereby help to avert an even greater rise in prices. For the moment, in Spain, the price of 95 petrol before tax has risen by 22% since December and, including tax, has reached 1.50 euros a litre, a record high. Given the currently high levels, we have raised our inflation forecast for 2012 by two tenths of a percentage point, whose average is now at 1.8%.

The second source of tension for inflation comes from electricity prices, which will rise in April. The electricity tariff has remained frozen since last July and, unlike January 2011, when the tariff rose by 8.2%, this year the price of electricity has remained untouched.

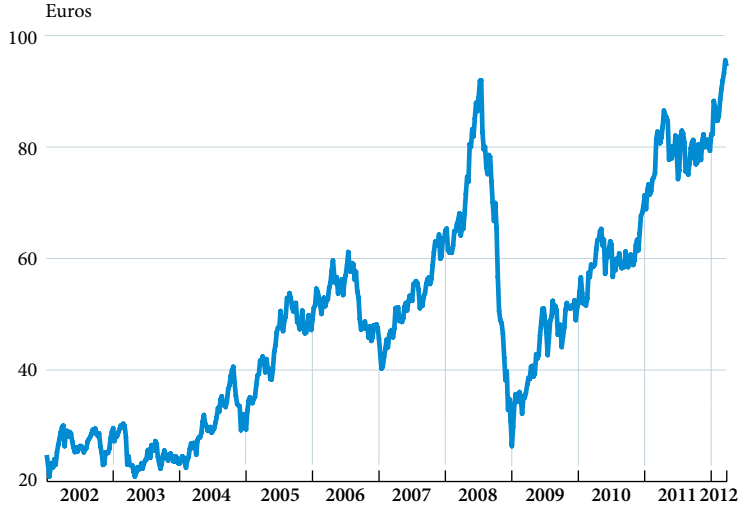
However, a ruling by the Supreme Court has forced the Ministry of Industry to backdate an increase in electricity tolls (the regulated part of the electricity bill, accounting for almost half the final electricity bill). The origin of the problem lies in the fact that the gap between the electricity system's revenue and costs has generated, up to March this year, a debt of 21.8 billion euros and the system still has a tariff deficit.

According to calculations by the electricity industry, tolls should increase by almost 35% to comply with the court ruling and, given that the cost of energy in the last auction fell by 7%, the increase in the electricity bill would be in the region of 14%. To mitigate such a rise, the government could raise the energy deficit ceiling or take other kinds of additional measures.

The third element that, under normal circumstances, could result in inflationary pressure is the injection of liquidity

OIL PRICES THREATEN THE ECONOMIC RECOVERY

Price of a barrel of Brent quality oil in euros



SOURCE: Reuters Datastream.

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 (**)	
2011											
January	3.7	6.8	1.5	1.0	6.8	17.3	11.7	7.3	2.0	12.2	–
February	1.3	7.6	1.9	0.9	7.9	18.5	11.1	6.2	1.4	13.1	1.3
March	–5.2	7.8	2.1	1.2	8.0	18.6	10.8	5.4	1.5	11.6	–
April	–4.7	7.3	2.5	1.3	7.1	17.1	10.0	4.0	1.6	10.3	–
May	–8.1	6.7	2.6	1.3	6.5	15.4	8.7	2.9	0.8	8.2	1.6
June	6.7	6.7	2.6	1.3	6.4	15.4	7.8	2.5	0.6	7.0	–
July	5.1	7.5	2.8	1.4	6.8	17.9	9.1	3.3	1.0	8.0	–
August	4.2	7.1	2.7	1.3	6.2	17.2	8.9	2.4	1.0	7.2	1.4
September	5.2	7.1	2.5	1.2	5.5	18.8	9.6	3.2	1.3	6.6	–
October	2.6	6.5	2.4	1.3	5.0	17.0	9.7	3.8	1.4	5.8	–
November		6.3	2.6	1.2	4.1	17.0	8.7	2.6	1.2	4.8	1.2
December		5.2	2.4	1.1	3.0	14.0	6.9	2.5	1.0	3.4	–
2012											
January		3.6	2.2	1.0	1.7	9.2	5.5	2.7	1.6	2.4	–

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

carried out by the European Central Bank. However, the contraction in activity, the lack of solvent demand and the deleveraging of the economy make any recovery in credit unlikely in the short term. In fact, in January the number of credits and loans fell by 1.4% year-on-year. Any inflationary pressures via credit will therefore be very small.

In summary, inflation will continue to fall over the coming months, although the price of oil and electricity might lessen this drop. Given the recessionary tone of the current situation, the second-round effects produced by the rise in energy costs on the rest of goods should be very limited.

The price of electricity will go up in April.

Foreign sector

Export performance will be crucial to determining the path of the Spanish economy's recovery.

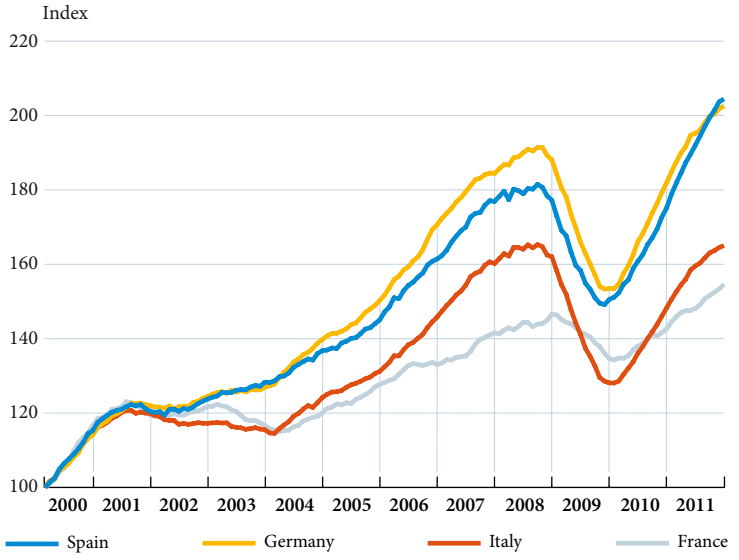
Growth in exports is slowing up

The foreign sector has become the driving force behind the Spanish economy over the last few years. The acute shrinkage in imports in 2009 and, subsequently, the greater recovery in exports cushioned weak domestic demand. However, the latest data available show a slowdown in the growth of foreign demand for Spanish goods. How this develops over the next few months will be crucial to determining the path of recovery for the Spanish economy. All this within a context of shrinking imports, which will help to continue correcting the trade deficit in 2012.

In fact, the value of exports of Spanish goods increased by 35.8% between 2009 and 2011. As can be seen in the graph below, this growth exceeds that recorded in the main European economies. Even in Germany, the second largest exporting country in the world, growth in nominal exports during this period was less, namely 32.0%. The relative improvement in Spain's competitiveness compared with the rest of the euro area, measured in unit labour costs, and the gradual penetration of exports in the main emerging markets lie behind this trend. This helped to significantly reduce the trade deficit, which went from representing 9.7% of the gross domestic product in the second quarter of 2008 to 4.3% in December 2011.

INTENSE GROWTH IN THE VALUE OF SPANISH EXPORTS OVER THE LAST FEW YEARS

Moving average 12 months (February 2000 = 100)



SOURCE: Bank of Spain.

However, a clear slowdown can be seen in the growth of exports, in particular as from the second half of 2011. This trend continued in January 2012, a month in which exports rose by 3.9% year-on-year. Although this is quite an appreciable advance, it is the smallest in the last two years. Weak demand in the euro area, which in 2011 was the destination for 53% of these exports, explains this slowdown. Demand for Spanish goods on the part of the rest of the monetary union members fell by 1.3% year-on-year in January. This figure contrasts with the trend in exports towards emerging markets such as Russia, the countries of Latin America and China, which grew by 37.1%, 20.3% and 14.6% year-on-year respectively in the same month.
We expect the less dynamic European economy to keep export growth weak, particularly during the first half of 2012.

Exports grow by 3.9% year-on-year in January, the smallest increase in the last two years.

In spite of this slowdown, the trade deficit shrank again in January, down 25.8% year-on-year, boosted by the squeeze in imports, namely 3.1% year-on-year. Of note is the improvement both in the non-energy balance, with a surplus of 225 million euros, and the energy balance. The latter, however, will continue high over the next few months due to oil prices remaining at relatively high levels.

The trade deficit shrinks by 25.8% in January 2012.

FOREIGN TRADE

January 2012

	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	4,941	0.4	24	1,060.2	12.4	6.4	–3,880	21.5
Consumer goods	4,602	4.5	23	5,432.8	–0.5	32.8	831	118.1
Food	*1,162*	*2.1*	*6*	*2,342.8*	*7.0*	*14.1*	*1,181*	*201.6*
Non-foods	*3,440*	*5.3*	*17*	*3,090.0*	*–5.5*	*18.6*	*–350*	*89.8*
Capital goods	1,189	–13.5	6	1,245.4	8.9	7.5	56	104.7
Non-energy intermediate goods	9,503	–6.7	47	8,840.9	5.1	53.3	–662	93.0
By geographical area								
European Union	10,050	–4.9	50	10,949.7	0.8	66.0	900	109.0
Euro area	*8,181*	*–4.4*	*40*	*8,766.5*	*–1.3*	*52.9*	*586*	*107.2*
Other countries	10,185	–1.3	50	5,629.5	10.6	34.0	–4,555	55.3
Russia	*495*	*–38.7*	*2*	*210.5*	*37.1*	*1.3*	*–285*	*42.5*
United States	*694*	*–18.9*	*3*	*609.0*	*6.4*	*3.7*	*–85*	*87.8*
Japan	*287*	*3.2*	*1*	*152.4*	*6.2*	*0.9*	*–134*	*53.2*
Latin America	*1,544*	*30.6*	*8*	*896.8*	*20.3*	*5.4*	*–647*	*58.1*
OPEC	*2,854*	*21.3*	*14*	*645.4*	*42.5*	*3.9*	*–2,209*	*22.6*
Rest	*4,311*	*–10.9*	*21*	*3,115.5*	*3.1*	*18.8*	*–1,195*	*72.3*
TOTAL	**20,234**	**–3.1**	**100**	**16,579.2**	**3.9**	**100.0**	**–3,655**	**81.9**

SOURCES: Ministry of the Economy and own calculations.

Financing needs reach the levels of 2003

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

This improvement in the trade balance led the correction of the external imbalance in 2011, namely 9 tenths of a percentage point, to 3.7% of GDP. This level is close to those of 2003. The improvement in the services balance, boosted by the good performance of tourism, also helped to reduce the current deficit. For its part, the deterioration in the income balance prevented any larger correction, due to the increase in the cost of financing debt.

Use of European Central Bank facilities rises to 124 billion euros in 2011.

We expect the current deficit to continue adjusting in 2012, coming close to 2% of GDP. This improvement will be mainly due to the reduction in the goods deficit.

On the other hand, the surplus of the services balance and the deterioration in the income balance will slow up their growth rates this year.

With regard to the financial account, the Spanish economy's reduced need for external capital was accompanied, at the same time, by a change in the composition of financing. The only source of net capital inflows in 2011 was the European Central Bank (ECB), which rose to 124,056 million euros. This increase contrasts with the trend in portfolio and direct investments, which posted net outflows. We expect this trend to continue over the next few months, taking into account the significant liquidity auction held by the ECB in February 2012.

BALANCE OF PAYMENTS

December 2011

	Last 12 months		
	Balance in million euros	Annual change	
		Absolute	%
Current account balance			
Trade balance	–39,954	7,188	–15.2
Services			
Tourism	*30,611*	*3,653*	*13.6*
Other services	*4,700*	*3,861*	*460.1*
Total	35,311	7,514	27.0
Income	–29,186	–7,245	33.0
Transfers	–5,948	1,168	–16.4
Total	**–39,778**	**8,626**	**–17.8**
Capital account	**5,334**	**–962**	**–15.3**
Financial balance			
Direct investment	–7,202	–9,428	–
Portfolio investment	–11,494	–41,233	–
Other investment	–49,603	–46,504	–
Total	**–68,299**	**–97,165**	**–**
Errors and omissions	–6,410	–3,956	161.2
Change in assets of Bank of Spain	109,153	93,457	–

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

Public sector

The challenge of severe fiscal consolidation

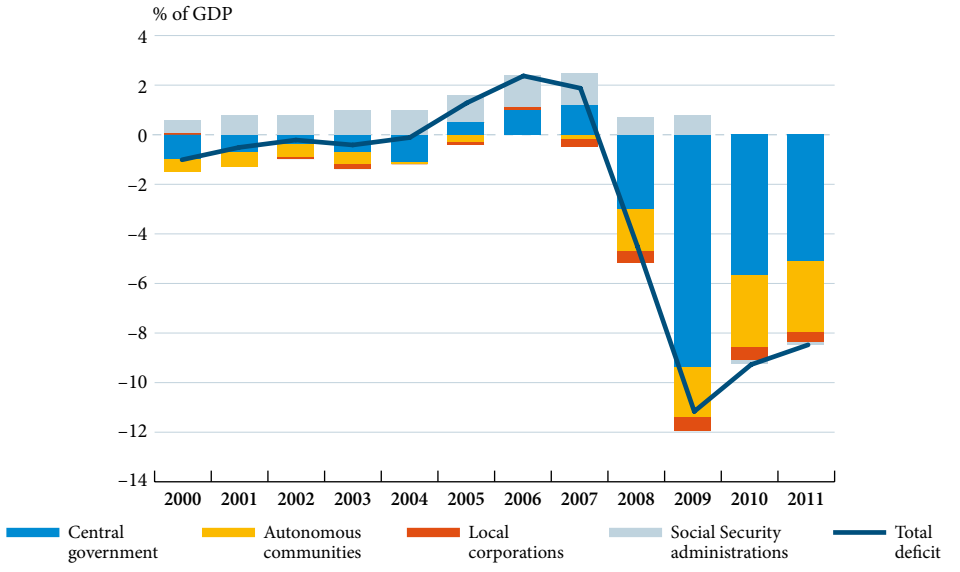
2011's public deficit reached 8.5% of gross domestic product (GDP). This figure, which is 2.5 percentage points away from the target set by the government and the European Commission for last year, certifies that the fiscal adjustment carried out was not enough. Redirecting this imbalance downwards has become one of the main challenges facing the general government this year, particularly in a context of economic contraction. Should this be achieved, it would reduce the upward path of public debt and restore confidence in the sustainability of Spain's national accounts.

In fact, the fall of 8 tenths of a percentage point in 2011's public deficit represented just a quarter of the adjustment contained in the stability programme. The zero fall in the deficit of the autonomous communities, which held steady at 2.9% of GDP compared with the 1.3% required, lies behind a large part of this deviation. The improvement in the central government balance of 0.6 percentage points, to 5.1% of GDP, wasn't enough either, 0.3 percentage points above target. The deficits of Social Security and local government corporations deviated from the limits established by 5 and 1 tenths of a percentage point, respectively.

The public deficit reaches 8.5% of GDP in 2011.

THE REDUCTION IN THE PUBLIC DEFICIT IN 2011 WAS NOT ENOUGH

Breakdown of the public deficit by administration



SOURCE: Ministry of the Treasury and Public Administrations.

The economy's deterioration in the second half of 2011 contributes to the deficit deviation.

The weakness of the economy during the second half of 2011 contributed to this insufficient correction in the national accounts. Available cash accounting data confirm this statement. Revenue of the central government and the autonomous communities between July and December last year fell by 1.4 billion euros compared with the same period in 2010. This fall was particularly sharp in terms of indirect taxes, more sensitive to changes in consumption, with a 9.9% drop year-on-year. The sharp deterioration in the labour market during the same period also affected the Social Security accounts, whose revenue from contributions were down by 1.9 billion euros, a fall of 3.6% year-on-year.

With regard to 2012, January's figures do not point towards any change in trend. The deterioration in employment and consumption continued to push tax revenue down, with a 12.2% decrease year-on-year. This includes the higher volume of rebates compared to January 2010, mainly with regard to corporation tax. According to the Tax Ministry, an adjustment of this tax would place the fall in tax revenue at 4.0% year-on-year. A similar decrease, of 3.7% year-on-year, can be seen in Social Security revenue during the first month of the year.

The largest adjustment in the last 50 years needs to be carried out to bring the deficit down to 5.3%.

This trend in budget flows is in line with the macroeconomic scenario presented by the government for 2012. According to this, GDP will shrink by 1.7% year-on-year, while the unemployment rate will reach 24.3%. Given this situation, the Spanish government raised its target deficit for 2012 by 1.4 percentage points to 5.8% of GDP. A level that the European Commission reduced to 5.3%. This means a correction in the public deficit of 3.2 percentage points in one year, taken on, almost equally, by the central government and the autonomous communities.

The government approves a new measure to reduce the accounts payable of public administrations.

But, in spite of revising this limit, meeting the new target is still a challenge that requires considerable effort. The planned fiscal consolidation exceeds any adjustment in the public balance recorded over the last five decades. In fact, the increase in interest payments due to higher financing costs for the debt and the economic contraction place the adjustment required to meet this target at around 50 billion euros. New adjustment measures are therefore likely to be adopted in addition to the 15 billion euros announced by the central government and to the consolidation plans presented by the autonomous communities.

This statement has boosted expectation regarding the content of the central government budget, which will be announced at the end of March. This will reveal the government's strategy to achieve the new deficit target. It is vital that the measures adopted help to dissipate uncertainty regarding the sustainability of Spain's public accounts. In March, the differential between 10-year Spanish and German bonds widened to 350 basis points. The increase in public debt last year, of 8.4 percentage points to 68.5% of GDP, contributed to this higher financing cost. A level, however, that is still relative comfortable when compared with the average debt of other euro area countries, which is above 87% of GDP.

Another measure that could help to restore confidence in the public accounts is the supplier payment plan passed by the government. This will grant up to 35 billion euros in loans to the autonomous communities and local government corporations to settle their debts with suppliers, which total 49.4 billion euros between them.

Savings and financing

Regulators join forces to bolster the banking sector

The measures taken over the last few months reflect the fact that the reinforcement of the banking system has been placed towards the top of political agendas, both at a European and state level. The three-year loans from the European Central Bank (ECB) to financial institutions have helped to ease liquidity tensions. At the same time, the Spanish government approved a Royal Decree-Law to sort out the financial system. The presentation by financial institutions of their plans to comply with the new law will help to dissipate questions regarding the evolution of Spain's banking map. These measures are expected to help strengthen bank solvency, particularly given the weakness of the Spanish economy predicted for 2012, which will keep the bank non-performing loans (NPL) ratio high.

February's approval of the new financial reform will require banks to increase cover for their property-related assets. An effort the government estimates at around 50 billion euros. This estimate takes as its reference the value of problematic property assets held by banks at June 2011, which the Bank of Spain estimated at 176 billion euros. However,

Political efforts are focused on the recovery of the banking sector at the level of Europe and Spain.

CREDIT TO PRIVATE SECTOR BY PURPOSE

Fourth quarter of 2011

	Balance (*)	Change this year	
	Million euros	Million euros	%
Financing of production activities			
Agriculture, livestock raising and fishing	21,757	–1,371	–5.9
Industry	143,231	–9,145	–6.0
Construction	98,505	–16,014	–14.0
Services	680,213	–14,921	–2.1
Total	**943,706**	**–41,451**	**–4.2**
Financing to individuals			
Acquisition and renovation of own home	656,503	–6,295	–0.9
Acquisition of consumer durables	37,686	–4,382	–10.4
Other financing	99,498	–8,418	–7.8
Total	**793,687**	**–19,095**	**–2.3**
Other	**45,156**	**–858**	**–1.9**
TOTAL	**1,782,548**	**–61,404**	**–3.3**
Acquisition of housing and real estate activities	***924,868***	***–23,364***	***–2.5***

NOTE: (*) By credit institutions as a whole: banking system, loan finance establishments and official credit.
SOURCES: Bank of Spain and own calculations.

The NPL ratio for property credit rises to 9.3%.

the almost 12 billion euro increase in doubtful loans between June and December last year will push this effort even higher.

The larger volume of doubtful assets and the 1.8% fall in the outstanding balance for property credit over the same period pushed up the property NPL ratio to 9.3% at the end of 2011. This figure is 1.2 percentage points higher than the level recorded in June. There are significant differences between the different items that make up property credit. While the NPL ratio for developers and constructors stood at 20.9% and 17.7% respectively in December, late mortgage payments for households reached 2.8%. This last ratio, however, has increased almost non-stop since 2004.

The government approves a Royal Decree to ease evictions for households facing the greatest difficulties.

Given this rise, the new government approved a Royal Decree to ease the problem of eviction for those at risk of marginalisation. This includes a code of good practice which banks can voluntarily join, helping to renegotiate mortgages and even deciding to repossess the property in lieu of payment. The households that can benefit from this are those without any employment-related income and where the mortgage exceeds 60% of their total income. Moreover, they must not have any guarantors and the price paid for the housing must have been under certain levels established according to the size of the municipality. All these restrictions substantially limit the people who can benefit from this law.

An analysis of the rest of the production sectors shows similar trends in terms of credit and non-payment. It can also be seen that those sectors with a higher NPL ratio in 2011 were the ones recording the highest fall in credit. Credit to the construction sector, with an NPL ratio of

FINANCING OF NON-FINANCIAL SECTORS (1)

January 2012

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,121,914	–9,490	–2.6	73.9
Non-financial corporations	1,255,675	–4,691	–2.6	43.7
Resident credit institution loans (3)	*836,189*	*–5,645*	*–5.1*	*29.1*
Securities other than shares	*65,715*	*349*	*8.8*	*2.3*
External loans	*353,771*	*605*	*1.7*	*12.3*
Households (4)	866,239	–4,799	–2.5	30.2
Housing loans (3)	*663,749*	*–3,090*	*–1.8*	*23.1*
Other (3)	*199,402*	*–1,721*	*–4.6*	*6.9*
External loans	*3,088*	*12*	*4.5*	*0.1*
General government (5)	750,572	15,611	13.7	26.1
TOTAL	**2,872,486**	**6,121**	**1.4**	**100.0**

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

17.7% in December, fell by 14.0% year-on-year. Less intense were the reductions in credit to the primary sector and industry, namely 5.9% and the 6.0% year-on-year, respectively. Their NPL ratios in December reached 6.5% and 5.4%. Lastly, credit to services, with an NPL ratio of 4.7%, fell by 2.1% year-on-year.

The data available for 2012 show that this rate of credit squeeze is also the case for other resident sectors. In January, this fell by 3.1% year-on-year. The NPL ratio, for its part, increased by 29 basis points, reaching 7.91% of the outstanding balance of credit. This fall in credit helped to reduce private sector debt by 9.5 billion euros in January, contrasting with the further increase in public sector financing, up by 15.6 billion euros in the same month.

We expect the predicted weakness of the economy, especially during the first half of 2012, and private sector deleveraging will maintain the credit squeeze throughout the year. Interest rates for new credit operations, which are at their highest for the last three years, will also contribute to this trend. The increase in interest rates contrasts with the monetary policy applied by the ECB over the last few months. In fact, maintaining the interest rate at 1%, a historically low level, and the liquidity injections will have reduced the cost of funding for Europe's banks. A reduction that has not been passed on to retail interest rates, reflecting the rise in the risk premium for bank operations.

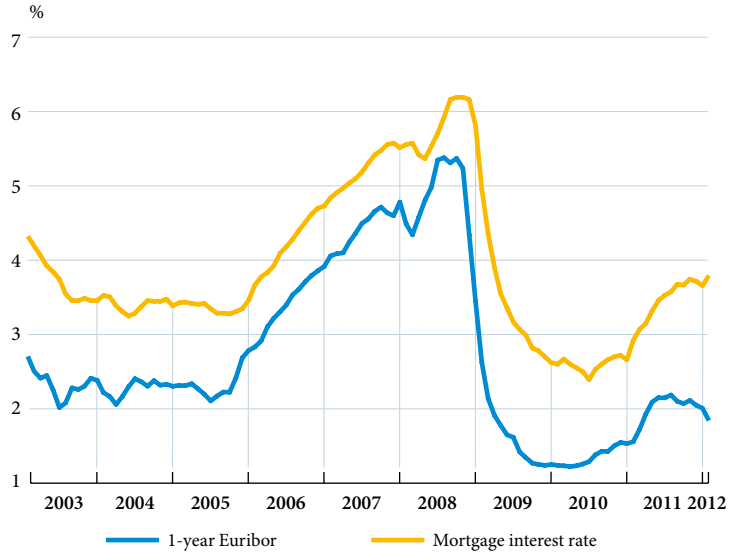
In this respect, of note is the sharp upswing in the interest rate applied for buying housing, up 14 basis points in January compared with the previous month. This trend contrasts with the fall in the main reference rate for these products, the one-year Euribor, down 16 basis points over the same period. As can be seen in the graph below, the spread between both series came close to 2 percentage points that month, much higher than the 36 basis points recorded in June 2008.

Credit falls by 3.1% year-on-year and the NPL ratio reaches 7.91% in January 2012.

The interest rate for new credit operations reaches its highest level for the last three years.

THE SPREAD WIDENS BETWEEN THE EURIBOR AND THE MORTGAGE INTEREST RATE

Interest rate for new mortgage operations and 1-year Euribor



SOURCE: Bank of Spain.

Spanish banks resort more to the Eurosystem in February, up by 152.4 billion euros.

The volume of commercial paper issued by banks almost doubles between September and January 2012.

Bank deposits keep shrinking

ECB loans to Spanish banks via the Eurosystem rose by 152.4 billion euros in February. This has improved banks' liquidity position. As a consequence, funding from new retail deposits has fallen dramatically, keeping the interest rates for new deposit operations almost at a standstill.

Within this context, the deposits of firms and households were down significantly in January, with a fall of 4.2% year-on-year. This shrinkage is mainly due to the decrease in term deposits, down 42.7 billion euros in this period. Is this trend in deposits due to a reduction in household savings?

In principle, when economic activity deteriorates and the unemployment rate rises, household savings tend to grow ostensibly. This is what happened during the last recession, when the savings rate, measured by the percentage of the gross disposable income of households, rose by more than 8 percentage points in two years. During this period, total bank deposits recorded a significant increase, particularly in long-term deposits.

However, the fall in bank deposits over the last few months also reflects a change in composition in the financial assets held by families and firms. The rise in the yield on sovereign debt and other instruments such as bank commercial paper will have been a contributing factor. In fact, in this last example, it can be seen that the volume of commercial paper issued by financial institutions in circulation almost doubled between September 2011 and January 2012. Given this scenario, we expect the savings rate to reduce its rate of contraction and even come to a standstill during the first months of the year.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

January 2012

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	261,965	–7,746	–2.9	7,037	2.8	19.3
Savings deposits	197,452	–5,498	–2.7	–11,203	–5.4	14.6
Term deposits	696,688	–1,048	–0.2	–42,713	–5.8	51.4
Deposits in foreign currency	17,631	–87	–0.5	–464	–2.6	1.3
Total deposits	**1,173,735**	**–14,380**	**–1.2**	**–47,344**	**–3.9**	**86.6**
Other liabilities (*)	**181,270**	**–3,694**	**–2.0**	**–11,528**	**–6.0**	**13.4**
TOTAL	**1,355,005**	**–18,074**	**–1.3**	**–58,872**	**–4.2**	**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.

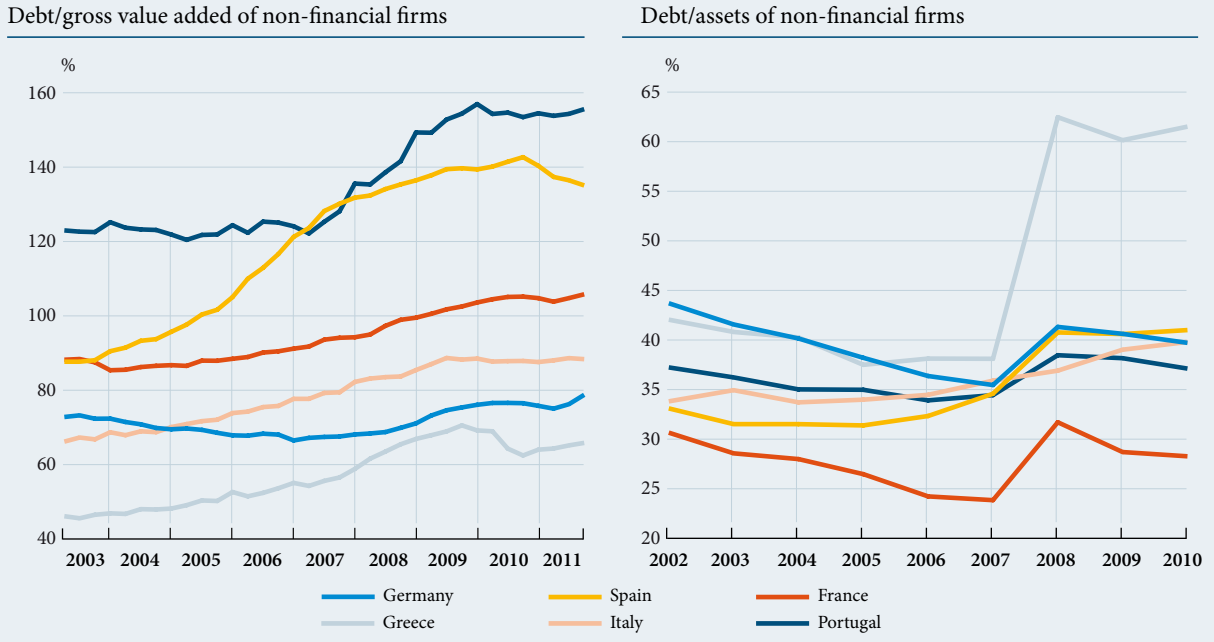
The excessive debt of Spanish firms: a matter of many or just a few?

The growth in indebtedness of non-financial firms during the 1990s and up to 2007 was a widespread phenomenon in most European countries and particularly intense in Spain. That is why it is usually claimed that our companies have too much debt and urgently need to deleverage.

We can use a range of indicators to measure the levels of debt. The most frequently used ratios are those of debt to assets (the percentage of the balance sheet financed by external funds); debt to gross operating profit (which measures the capacity to return debt with the earnings being made), and the financial burden on profit (percentage of earnings allocated to pay interest on debt taken out). High ratios indicate that companies are vulnerable, suggesting too much dependence on external funds or large proportions of the profits going to pay for debts.

As can be seen in the graph, the conclusions regarding the debt of Spanish firms vary depending on the indicator used. Their balance sheet structure does not appear to show signs of excessive debt in aggregate terms: the percentage financed with equity is in line with that of other countries in the euro area. On the other hand, indicators related to earnings or gross value added show a significantly high level of indebtedness compared with other euro area countries, indicating the need to increase profitability of the companies' assets. The deterioration in our economy has made this problem more acute, drying up earnings in a large number of sectors and raising debt ratios that take this variable as their reference.

DEBT INDICATORS FOR NON-FINANCIAL COMPANIES IN EUROPEAN COUNTRIES



SOURCES: European Central Bank and IIF.

The problem of these aggregate ratios is that they do not show whether a country's higher debt is due to a larger specialization in sectors that, given their characteristics, require higher debt or whether there is a widespread problem of excessive debt in all sectors. One illustrative example is the construction and real estate development sectors. In most of the countries analyzed, these are the sectors with the highest debt ratios, so their greater relative weight in our economy would partly explain our higher ratios. However, we can indeed talk of excessive debt when, in addition, this sector in Spain has a debt ratio that is 27 times its annual profit, compared with a ratio of 10 in the rest of the European countries. As we will see, this is not the only sector in Spain suffering from such an ailment.

A company's sustainable level of debt depends on many factors. Some are specific to the branch of activity it operates in. A sector whose production process requires a lot of intangible assets will have fewer tangible assets to act as a guarantee for a loan, compared with another sector that is more machinery-intensive, for example. Other factors are determined by characteristics of the firm itself, such as its management's ability to achieve greater profitability or to provide additional guarantees. In this respect, size is also important, as markets have little information on small firms: their contracts are not usually public and they don't issue listed securities, due to the relatively high costs this entails. Given this fact, small firms tend to rely more on self-financing or bank credit. In any case, their behaviour differs from that of large firms.

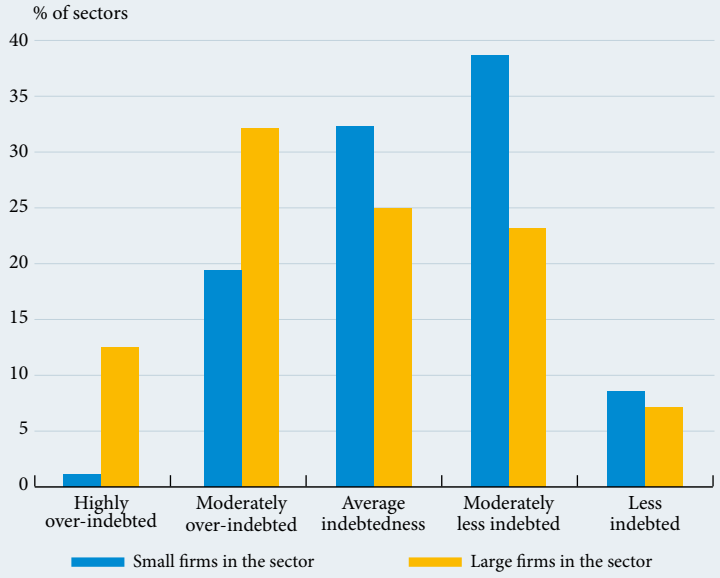
Therefore, in order to judge whether a company's level of debt is excessive, we need to take all these factors into account. One way of doing so is to compare the levels of indebtedness of Spanish firms with similar firms from other countries in the euro area that operate within the same branch of activity. In this way, by comparing firms from the same branch, we minimize those differences that might arise due to sector-specific features. If, moreover, we compare firms of the same size, those differences that might arise from having more or less access to markets are also reduced. The remaining differential should be attributable to differences in management ability or other specific circumstances. This kind of analysis has been carried out in a recent study[1] whose key findings we summarise here.

Firstly, the analysis shows how large and small firms do, in fact, behave very differently. Their debt ratios are highly disparate, although which type of company has a larger level of debt depends on the branch of activity.

The second of the findings comes from comparing the debt levels of Spanish firms with the average levels for the main countries in the euro area, within each branch of activity and company size. The graph below shows that, in 2010, large Spanish firms were on average more heavily indebted when compared with their European peers than small firms. In fact, large firms had debt ratios above the European average in 45% of the sectors; a figure that falls to 20% for small firms. In addition, for a high proportion of these overly indebted sectors, their relative debt has become more acute since 2007 (either because their leverage has increased or because their debt has fallen less than in other countries).[2]

(1) Jódar-Rosell, S. and Martínez Carrascal, I. (2012), El sobreendeudamiento de las empresas españolas: ¿problema común o de unas pocas?, "la Caixa" Documento de Trabajo 01/2012.
(2) It was only possible to carry out the analysis for 2010 with data from the aggregate balance sheet for each sector and company type. Consequently, the debt ratio calculated in this way could be affected by the values presented by the larger firms in each group (the larger small firms and the larger large firms). However, quartiles of the debt distribution ratios are available for 2009 and the conclusions for the representative company of each group remain the same.

DEBT COMPARED TO EUROPEAN AVERAGE BY SIZE OF COMPANY, 2010



NOTES: (*) Small firms: turnover <10 million euros; large firms: turnover > 50 million euros.
(**) Average calculated with data from Germany, Belgium, Spain, France, Italy and Portugal.
SOURCE: Own calculations based on BACH-ESD data.

Lastly, the analysis shows how the lower relative debt of small firms seems to result from their greater effort to reduce this debt since the end of 2007. In fact, the financial burden for small firms grew by around 15% between 2007 and 2009, while it only increased slightly for large firms. We could conclude that, given the lower interest rates during 2009, the greater financial burden for small firms reflects a larger drop in their earnings. Given this situation, these firms probably tried to reduce their reliance on external funds, concentrating on meeting their debt commitments that were consuming a large proportion of their earnings. Similarly, this fall in earnings would also increase the risk perceived by creditors that these firms would not be able to meet their debts. This makes it difficult to renew short-term credit and accentuates the deleveraging process, particularly within a context of less appetite for risk. In line with this situation, the data show how indebtedness has tended to fall further in those sectors whose over-indebtedness with respect the European average was larger in 2007.

In short, although the aggregate data show a proportion of external funds on the balance sheets of Spanish firms that is similar to other countries, a breakdown by sector reveals the need for adjustment in many of them. This adjustment has already started and has been particularly acute in small firms, although there are still numerous sectors with excessive debt. Moreover, it is vital to increase the productivity of our firms to bring our levels of financial burden and debt to earnings closer to those of the rest of Europe. Increasing profitability is a challenge that is as or even more important that reducing debt.

This box was prepared by Sandra Jódar Rosell and Inmaculada Martínez Carrascal
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As of December 31, 2011

FINANCIAL ACTIVITY	Million euros
Total customer funds	248,326
Receivable from customers	182,661
Profit attributable to Group	975

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	28,529
Branches	5,196
Self-service terminals	8,011
Cards (million)	10.3

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2012	Million euros
Social	331
Science and environmental	68
Cultural	69
Educational and research	32
TOTAL BUDGET	**500**

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