JULY-AUGUST 2009

THE SPANISH ECONOMY

Monthly Report

NUMBER 326

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2007	2008	2009	2008				2009	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast						Forecast
Gross domestic product									
United States	2.0	1.1	–2.9	2.5	2.1	0.7	–0.8	–2.6	–3.7
Japan	2.3	–0.7	–6.9	1.2	0.6	–0.3	–4.4	–8.4	–8.2
United Kingdom	3.0	0.7	–4.6	2.6	1.7	0.3	–1.8	–4.1	–5.3
Euro area	2.6	0.7	–4.5	2.2	1.5	0.5	–1.7	–4.8	–5.0
Germany	*2.6*	*1.0*	*–5.6*	*2.8*	*2.0*	*0.8*	*–1.6*	*–6.9*	*–6.5*
France	*2.1*	*0.7*	*–3.0*	*2.0*	*1.2*	*0.6*	*–1.7*	*–3.2*	*–3.3*
Consumer prices									
United States	2.9	3.8	–1.0	4.2	4.3	5.2	1.5	–0.2	–1.4
Japan	0.1	1.4	–1.0	1.0	1.4	2.2	1.0	–0.1	–0.5
United Kingdom	2.1	3.6	1.8	2.4	3.3	4.9	3.9	3.0	1.8
Euro area	2.1	3.3	0.3	3.4	3.6	3.8	2.3	1.0	0.1
Germany	*2.3*	*2.6*	*0.4*	*2.9*	*2.9*	*3.1*	*1.6*	*0.8*	*0.2*
France	*1.5*	*2.8*	*0.4*	*2.9*	*3.3*	*3.3*	*1.8*	*0.6*	*0.0*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	3.4	0.1	–3.1	2.0	0.8	–0.2	–2.3	–4.1	–3.9
Government consumption	4.9	5.3	4.3	3.7	5.0	6.1	6.3	5.4	4.5
Gross fixed capital formation	5.3	–3.0	–15.4	2.4	–0.8	–4.1	–9.3	–13.1	–15.4
Capital goods	*10.0*	*–1.1*	*–22.2*	*5.2*	*1.8*	*–1.3*	*–9.7*	*–18.6*	*–25.0*
Construction	*3.8*	*–5.3*	*–14.2*	*0.2*	*–3.1*	*–7.3*	*–10.9*	*–12.4*	*–12.7*
Domestic demand (contribution to GDP growth)	4.4	0.1	–5.4	2.6	1.2	–0.2	–3.0	–5.3	–5.8
Exports of goods and services	4.9	0.7	–14.4	4.8	4.4	1.5	–7.9	–19.0	–16.7
Imports of goods and services	6.2	–2.5	–17.0	3.6	1.8	–2.0	–13.2	–22.3	–18.8
Gross domestic product	**3.7**	**1.2**	**–3.7**	**2.7**	**1.8**	**0.9**	**–0.7**	**–3.0**	**–4.2**
Other variables									
Employment	2.9	–0.6	–6.6	1.6	0.1	–0.9	–3.1	–6.0	–7.5
Unemployment (% labour force)	8.3	11.3	18.4	9.6	10.4	11.3	13.9	17.4	18.7
Consumer price index	2.8	4.1	–0.2	4.4	4.6	4.9	2.5	0.5	–0.8
Unit labour costs	2.9	3.4	–0.5	4.2	3.6	3.4	2.6	0.8	
Current account balance (% GDP)	–10.1	–9.5	–6.1	–12.1	–9.5	–8.7	–7.9	–8.7	
Net lending or net borrowing rest of the world (% GDP)	–9.7	–9.1	–5.5	–11.2	–9.0	–8.4	–7.6	–8.5	
Government balance (% GDP)	2.2	–3.8	–9.5						
FINANCIAL MARKETS			Forecast						Forecast
Interest rates									
Federal Funds	5.0	2.1	0.3	3.2	2.1	2.0	0.9	0.3	0.3
ECB repo	3.8	3.9	1.2	4.0	4.0	4.2	3.4	1.8	1.1
10-year US bonds	4.6	3.6	3.2	3.6	3.9	3.8	3.2	2.7	3.3
10-year German bonds	4.2	4.0	3.0	3.9	4.3	4.3	3.5	3.1	3.1
Exchange rate									
$/Euro	1.37	1.48	1.34	1.50	1.56	1.51	1.34	1.30	1.36

Contents

From subprime mortgages to a world recession: two anxious years

In the summer of 2007, just two years ago, it became clear that a small segment of the US mortgage market, subprime mortgages, was presenting a disturbing anomaly. With the real estate recession already under way and interest rates that had gone up relatively fast, it was no wonder there was a notable increase in default of such mortgages that had been granted to customers of doubtful solvency. The most troubling was that this phenomenon quickly set off a chain reaction in terms of risk aversion, a collapse of liquidity and widespread distrust that put the financial system on the edge of an abyss. This affected not only the United States but also Europe and Asia.

As the public has become aware of the series of errors, incompetence and even rather unethical behaviour that led to the present financial crisis, it has become possible to understand the phenomenon and move on to the design of mechanisms to avoid any repetition. To some extent, the origin of the disaster has a lot to do with the dynamic of bubbles, both real and financial. A very long period of easy monetary policies, which sharpened with the dot-com crisis in 2000 and the terrorist attacks in 2001, set the bases for a liquidity bubble along with an expansionist credit bubble that led to exceptional world growth in the period 2003-2007. This growth rested on very weak bases and was boosted by low interest rates and over-leveraging of the private sector along with persistent world imbalances. Prudence was greatly eased and investors ignored risk more and more. It was claimed that economic cycles had passed into history and it seemed that the good times would last forever.

As often happens in times of excessive speculative euphoria, a quite banal event, on this occasion the matter of subprime mortgages, suddenly turned around the trend, emphasizing the fragility of the financial system and the excesses that had taken place. It was only a relative surprise. Year after year, the Bank for International Settlements had been warning of the risks facing the international economy. Nearer home, the Bank of Spain had repeatedly warned of the excesses in the real estate sector. However, if *a posteriori* it is tempting to point to possible culprits and lay blame, when a bubble is in full swing and irrational exuberance is the order of the day, going against the current becomes a thankless task.

The crisis puts in question many important principles that up until now have been considered as givens as, for example, the degree of regulation and supervision that should be applied to the financial system or, on the other hand, the degree of self-regulation that is acceptable. The paradigm of the efficiency of the markets, the standard of inversion models based on pure rationalism, stands in doubt. The response to the financial crisis also raises major questions. The initial reaction of economic policies, the massive injection of government funds into the economy, is not without its risks. The rapid worsening of the public sector accounts threatens the stability of the economy and could mean a serious problem if recovery is not rapid. International coordination, both in the financial sphere and the real economy, could be greatly improved. Meanwhile, the crisis continues. The worst is probably behind us but one has to be very optimistic to believe that the road ahead is clear. The times of anxiety may perhaps be over but the days of tranquillity are not yet in sight.

EXECUTIVE SUMMARY

Will the green shoots die off in summer?

Worst of crisis may have passed according to economic sentiment indices.

Last month we obtained growth figures for the first quarter in most of the developed countries. These figures confirmed, should there still be any doubt, the extent of the current recession. The drop noted in the economies of many countries was clearly and simply historic. But, perhaps carried away by Spring fever, many analysts emphasized the appearance of «green shoots» or signs that could indicate that the worst of the recession was now behind us. Now that Summer is here with all its heat, will those green shoots die off? Or will they be able to resist a number of months that promise to be very hot with a high risk of fires?

Gradual process of recovery in financial markets also pointing in this direction.

Up to this date, the most convincing signs of a coming recovery are those offered by the economic sentiment indices. In the United States, the consumer confidence index for May published by the Conference Board and the index for business sentiment put out by the Institute of Supply Management continue to recover ground lost last Autumn. The situation was similar in the Euro Area. Both the economic sentiment index prepared by the European Commission and the Purchasing Managers Index continued to improve. All the indices however are still at levels noting economic recession.

Some real economy indicators beginning to show change in trend.

The gradual recovery taking place in international financial markets is another factor supporting those who claim there are «green shoots». Over the past month the differentials in the interbank market have continued to decrease. The cumulative revaluations of the S&P 500 and the Eurostoxx 50 from the lows recorded in March have held close to the level of 40%. In the United States, secondary markets, closed since the beginning of the crisis, have begun to operate again. This process of recovery has been aided by the financial reforms being proposed on both sides of the Atlantic. Furthermore, the European Central Bank has successfully carried out its first unlimited injection of liquidity for a 12-month term. This should ease tensions and contribute to a gradual reduction of differentials in coming weeks.

The big unknown to show up in coming months is whether the improvement in the economic sentiment indices and financial terms are turning into a more moderate drop in consumption, production and the labour market. For the moment, news on various fronts is not conclusive. Retail sales have continued to drop both in the United States and the Euro Area as a whole but they have done so in a more moderate way so that the drop in consumption could be hitting bottom. Industrial production, on the other hand, is continuing to collapse in both economies. The labour market, which out of the three indicators is the slowest to respond, is also continuing to worsen sharply and everything indicates that this trend will last for the rest of this year.

While it is by no means clear in which the quarter the recession will hit bottom, uncertainty about the way out is even greater. No doubt, the heavy leverage of households in the main developed economies, along with the sharp increase in unemployment, will limit the ability to recover.

We should take into consideration the ability to resist the recession being shown by many developing countries. In this respect, the strength of the Chinese economy is notable. It grew by 6.1% in the first quarter and recent indicators show the settling down of recovery. Another case shows up in the countries of Central and Eastern Europe. While until very recently it seemed they were facing an almost catastrophic scenario, now financial conditions have turned around. Starting out at annual lows, stock markets in this area have grown by around 60%, the main currencies have recovered part of the ground lost and the cost of insuring against default of sovereign debt has dropped by nearly half. If the countries of Central and Eastern Europe manage to come out of the depression without giving any last-minute surprises and, especially, if the Chinese market again moves ahead, the picture will offer much more peace of mind.

Another factor that will set the way out of the recession is the future course of inflation. For the moment, most developed countries are showing decreases marking up all-time lows. In May, the year-on-year rate in the United States was –1.3%, Japan also reported a drop of 0.1% while in Germany the rate held at 0.1% and in the Euro Area as a whole the rate dropped to 0%. The weakness of demand, and especially the drop in oil prices, was responsible for these developments. Nevertheless, we expect that the rates will turn around in the second half of the year. The base effect of oil prices and other commodity prices on the year-on-year rate should disappear in coming months. Furthermore, we should note that there is concern about whether the central banks will withdraw the huge amount of liquidity injected into the markets, which poses a potential risk for future inflation.

Ability of some developing countries to resist crisis could act as support.

The situation in Spain's economy is similar to that in the main advanced economies. Following the results in the first quarter, analysts are closely examining all indicators to check if, in fact, moderation in the contraction in activity in the second quarter has actually taken place.

As in most developed countries, economic sentiment indicators and financial terms are improving. The consumer confidence index, for example, rose in March and April although it still stands at very low levels.

In Spain, economic sentiment indices and financial terms also improving.

With regard to financial terms, the 1-year Euribor marked up at new all-time low in June when it stood a slightly above 1.50%. Furthermore, in recent months we note some moderation in the drop in the growth rate of credit granted to the private sector, in keeping with the improved state of liquidity of financial institutions. Approval of the Fund for Orderly Restructuring of Banks will help financial terms to keep improving. This fund has an initial backing of 9 billion euros but it can borrow up to 90 billion euros to finance recapitalization or mergers of financial institutions. What is more, it will increase confidence in Spain's financial sector which in April saw the default rate for credit institutions as a whole rise to 4.5% and Moody's rating agency reduce the ratings of some 30 Spanish banks.

Measures to reactivate economy also beginning to take effect.

Some real economy indicators seem to have hit bottom...

The effects of these economic regeneration plans introduced by governments have now begun to show up. The plan for government investment at the muncipal level, approved at the end of last year, has already shown its effects in figures for employment and unemployment in May. The recovery in car sales in May and June came as a result of aids for car purchase. Having less immediate effects, the central government is carrying out structural reforms in the services sector through introduction of the relative EC directive. This involves encouraging competition in the sector, eliminating bureaucratic rigidities and liberalizing various activities. It is estimated that the boost to competition in the sector will have a positive impact of 1.2% on the GDP and on employment to the extent of between 150,000 and 200,000 jobs.

...and labour market beginning to show slight change in trend.

The plans to stimulate the economy, the improvement of economic sentiment indices and the changes in financial terms are turning into some moderation in the rate of contraction in demand and overall activity. Retail sales, for example, slowed their drop in May, the decrease in production of consumer goods in April was lower than in the first quarter and the collapse in the industrial production index eased slightly.

The labour market is also beginning to show a change in trend. For the second month in a row there was a slowdown in the process of job loss and the rise of unemployment. Nevertheless, labour costs continued to increase in the first quarter of 2009 in spite of the sharp worsening seen in the labour market. The wage component rose by 2.8% year-on-year given that many wage reviews are indexed to past inflation.

As in other developed countries, the future trend in inflation in Spain will be key for determining the profile for coming out of the current recession. For the moment, consumer prices in May continued their downturn marking up a negative year-on-year change rate for the third consecutive month. This now stands at 0.9%, a bigger than expected decrease which reflects the downward pressures on prices as a result of the sharp contraction of private consumption. Underlying inflation was down to 0.9%, the lowest level in recent decades.

Another factor that will determine the potential growth of Spain's economy over the longer term is the growing imbalance in the public sector. Revenues continue to drop whereas spending is increasing notably due to the increase in unemployment benefits and the plan to stimulate the economy. In this respect, the central government has revised the deficits forecast for 2009 and 2010 putting them at 9.5% and 8.4% of gross domestic product respectively.

Immediate prospects still recessive at least until well into 2010.

The central government has also revised its macroecomic forecasts for 2009-2012 with the prospect of a drop in gross domestic product of 3.6% in 2009 and 0.3% in 2010. According to these forecasts, the recession will keep easing in coming quarters and next year we shall begin to see positive quarter-on-quarter growth rates. Nevertheless, the Organization for Economic Cooperation and Development does not see things quite as clearly as it is expecting a drop of 4.2% this year and a further decrease of 0.9% in 2010. It is to be hoped that the green shoots survive the summer but their future growth could be slower than desired.

June 26, 2009

CHRONOLOGY

2008

September	**19**	US government presents **bailout plan for country's banking system** amounting to 700 billion dollars.
October	**7**	Spanish government announces creation of **fund for purchase of financial assets** of financial institutions up to maximum of 50 billion euros and raises guarantee on deposits and investments to 100,000 euros.
	8	**European Central Bank**, **Federal Reserve** and **Bank of England** cut official interest rates by 50 basis points in joint move with other central banks.
	12	Euro Area countries agree on **joint action** to strengthen financial system up to end of 2009.
	13	Government authorizes granting of **government guarantees** up to 100 billion euros in 2008 on new financial transactions of financial institutions with possible extension to 2009.
	28	IBEX 35 index for **Spanish stock exchange** marks up lowest level (7,905.4) since 2004.
	29	**Federal Reserve** cuts reference rate to 1.00%.
November	**6**	**European Central Bank** lowers official interest rate to 3.25%.
	15	Meeting of G-20 in Washington to **reform international financial system**.
	20	Dow Jones index for **New York stock exchange** records lowest level since 2003 (7,552.3).
	28	Government announces 8 billion-euro **public works plan** for municipalities and 3 billion-euro plan for investment in various sectors and economic spheres.
December	**4**	**European Central Bank** lowers official interest rate to 2.50%.
	16	**Federal Reserve** reduces reference rate to band between 0%-0.25%.
	24	Brent quality **oil** price drops to lowest level since July 2004 (37.23 dollars a barrel).

2009

January	**1**	Further enlargement of **Euro Area** with entry of Slovakia making total of 16 member states.
	15	**European Central Bank** lowers official interest rate to 2.00%.
	20	Barack Obama sworn in as **President of the United States**.
March	**5**	**European Central Bank** lowers official interest rate to 1.50%.
	6	Central government announces measures to **facilitate financing of working capital for medium-sized companies** and to **revive employment** and ease effects of **unemployment**.
	27	Government approves series of **measures to boost economic activity**: reform of law on meetings of creditors, revival of credit insurance and introduction of EU directive on services.
April	**2**	**European Central Bank** lowers official interest rate to 1.25%. G-20 meeting in London aimed at **reform of international financial system**.
May	**7**	**European Central Bank** lowers official interest rate to 1.00% and announces measures to facilitate liquidity in banking system.
	12	Government announces **new economic policy measures**: partial removal of tax deduction for buying normal residence as of 2011, aids for buying cars, reduced taxes for some small and medium-size businesses and self-employed persons, etc.
June	**12**	Government **increases taxes** on tobacco, petrol and diesel fuel for motor vehicles.
	26	Government establishes **Fund for Orderly Restructuring of Banks**.

AGENDA

July

- **2** Registrations with Social Security and registered unemployment (June). Governing Council of European Central Bank.
- **3** Industrial production index (May).
- **10** CPI (June).
- **15** Harmonized CPI (June).
- **22** Foreign trade (May).
- **23** Producer prices (June).
- **24** Labour Force Survey (2nd Quarter).
- **28** Central government revenue and spending (June).
- **30** Flash estimate HCPI (July).
- **31** Balance of payments (May). US GDP (2nd Quarter).

August

- **4** Registrations with Social Security and registered unemployment (July).
- **5** Industrial production index (June).
- **6** Governing Council of European Central Bank.
- **13** CPI (July).
- **14** Flash estimate GDP (2nd Quarter). CPI harmonized with EU (July).
- **19** Foreign trade (June).
- **25** Producer prices (July).
- **27** Quarterly National Accounts (2nd Quarter).
- **28** Flash estimate HCPI (August).
- **31** Central government revenues and spending (July).

INTERNATIONAL REVIEW

United States: has it hit bottom?

United States: economy down 5.7% because of collapse in investment.

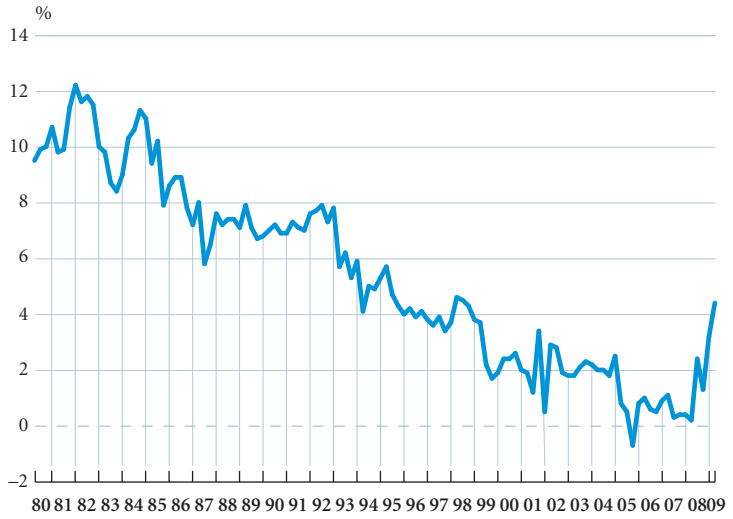
The US economy could be very close to hitting bottom. Following an initial upward revision of previously published figures, the gross domestic product (GDP) for the first quarter of 2009 dropped by 2.5% year-on-year, or 5.7% quarter-to-quarter annualized. Nevertheless, the stabilization of these decreases is going to be accompanied by a rather languid recovery. Proof of this is that private consumption dropped in April for the second consecutive month following a slight rise at the beginning of 2009, because of the higher savings rate of households which in the same month rose to 5.7% of disposable income, something that had not happened since February 1995.

Economy may hit bottom in second quarter but household debt is making recovery difficult.

Why is the recovery going to be weaker than in previous cycles? Simply because private consumption (70% of GDP) will be unable to grow the way it had in the years prior to the recession when it was based on household borrowing with a savings rate that was constantly moving down. Between the end of 2000 and the end of 2007 gross household debt went from 95.9% to 133.0% of disposable income. According to the Fed, the return of debt to the reasonable level of 100% of disposable income, with loan interest rates considered normal, would reduce private consumption by 0.75% per annum during the entire process (ten years) in a situation with a stable saving rate. If we add to this the reduction in wealth because of the depreciation of

UNITED STATES: NEED TO REMOUNT SAVINGS

Household savings as percentage of disposable income



SOURCE: Bureau of Economic Analysis and own calculations.

assets, the burden to be faced by recovery is considerable.

Latest demand indicators confirm that consumption has hit bottom but still shows no signs of recovery. Retail consumption in May reported a meagre improvement after two months of drops in a row. Excluding cars and petrol, retail sales dropped by 5.4% year-on-year in real terms, although durable goods left behind the downward pressure seen in previous months. In a tone of moderate optimism, the Conference Board consumer confidence index continued to show a recovery more based on prospects than on the perception of the present situation, recovering the level in September 2008 when the mortgage loan insurers Freddie Mac and Fannie Mae were intervened and Lehman Brothers went bankrupt.

Consumer confidence improving and retail sales hit bottom.

On the supply side, the index of economic activity and business sentiment published by the Institute for Supply Management for May continued to gradually approach the 50 points barrier considered the threshold marking the beginning of expansionist stages. New orders held close to the point of balance but employment, while also easing its rate of downturn, was the weakest component. Industrial production remained the most negative among supply indicators with a decrease of 13.1% year-on-year in May whereas the utilization of production capacity continued to mark up new all-time lows going down to 68.3%.

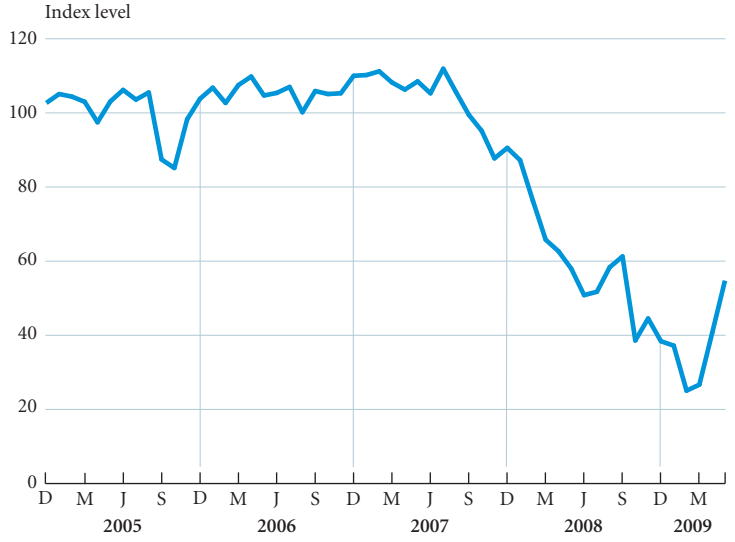
Business executives less pessimistic but industry still stalled.

Housing still gave no signs of hitting bottom, both in terms of demand and supply. Real estate prices continue to worsen the property situation of households and the Case-Shiller index for March showed a cumulative drop of 33.1% compared with June 2006. Sales of existing housing, with a drop of 3.5% year-on-year, continued to seek a point of resistance. But the recovery in the housing market will have

Real estate prices still dropping and unoccupied units prevent housing from hitting bottom.

UNITED STATES: GREEN SHOOTS BASED ON EXPECTATIONS NOT SO GREEN

Consumer confidence index



SOURCE: Conference Board and own calculations.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
Real GDP	2.0	1.1	2.1	0.7	–0.8	–2.5	–	...
Retail sales	3.3	–0.7	2.4	0.4	–8.0	–8.9	–10.0	–9.6
Consumer confidence (1)	103.4	58.0	57.3	57.3	40.7	29.9	40.8	54.9
Industrial production	1.5	–2.2	–0.4	–3.2	–6.7	–11.6	–12.7	–13.4
Manufacturing (ISM) (1)	51.1	45.5	49.1	47.4	36.1	35.9	40.1	42.8
Sales of single-family homes	–26.7	–37.4	–39.3	–36.2	–41.0	–38.5	–34.0	...
Unemployment rate (2)	4.6	5.8	5.4	6.1	6.9	8.1	8.9	9.4
Consumer prices	2.9	3.8	4.4	5.3	1.6	0.0	–0.7	–1.3
Trade balance (3)	–701.4	–695.9	–711.3	–725.8	–695.9	–604.5	–571.5	...
3-month interbank interest rate (1)	5.3	2.8	2.8	3.2	2.2	1.2	1.0	0.7
Nominal effective exchange rate (4)	77.9	74.4	70.9	73.5	81.3	82.7	82.3	81.2

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

Unemployment hits 9.4% and is expected to continue growing in coming months.

to wait for a reduction in the stock of unoccupied housing units on sale now being increased by a growing number of foreclosures. Because of this, the increase in housing starts in May (reported at 532,000 in annual terms) must be interpreted with caution.

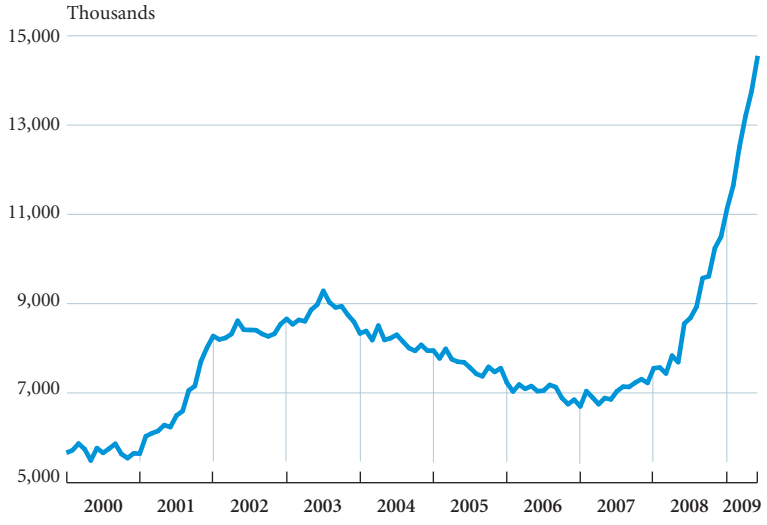
One difficulty for recovering housing demand is the weakness of the labour market. Unemployment, which rose to 9.4% of the labour force in May, will continue to increase going above 10.0% in spite of the fact that the 345,000 non-farm jobs lost were much less than the average loss in the previous six months. As opposed to recent recessions, the lower proportion of temporary workers laid off in terms of total lay-offs and the large number of workers that have involuntarily been working part-time indicates that there will be a higher proportion of long-term unemployment. As a result, the number of unemployed in May went above 14.5 million workers, twice that in 2007.

CPI drops by 1.3% while upward trend in underlying index moderates.

The general index of consumer prices (CPI) dropped by 1.3% year-on-year in May and the underlying CPI (the general rate less food and energy) eased off the increases seen in recent months to increase by a relatively moderate 1.8% year-on-year which, excluding housing rentals, went to 2.1%. Inflationary risks have been more important than deflationary risks and the increase in oil prices and the performance of the underlying index in recent months indicate upward price pressures, reinforced by the Fed's expansionist monetary policies. More costly oil means lower disposable incomes for households and puts impediments in the way of the already precarious recovery. Furthermore, higher price pressures could raise mortgage loan rates thus holding back recovery of the real estate

UNITED STATES: ABSOLUTE RECORD NUMBER OF UNEMPLOYED

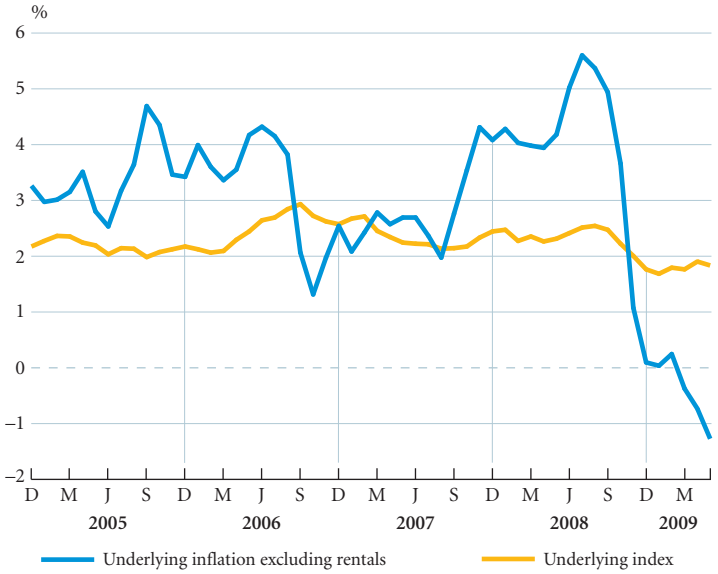
Number of unemployed over 16 years of age



SOURCE: Department of Labour and own calculations.

UNITED STATES: UNDERLYING STABILITY

Year-on-year change in components of underlying consumer price index (*)



NOTES: (*) Underlying index excludes food and energy.
SOURCE: Department of Labour and own calculations.

Trade deficit seems farther and farther from stabilizing correction.

market. For this reason, the stability of underlying inflation in May means a considerable relief.

In the foreign sector, the prospect of a sustained correction in the deficit seems somewhat farther off following the figure for April. The trade deficit rose for the second consecutive month and went to 29.16 billion dollars while the reduction in trade figures continued although at a lower rate. Since October 2008, when the volume of trade began to drop, the deficit has been reduced by more than 30 billion dollars although of this figure nearly 19 billion dollars resulted from cheaper oil. With current domestic consumption not dropping as it was at the end of 2008, with world demand seemingly unable to absorb exports from the United States and oil on the rise, far from constant correction, the US trade imbalance is pointing toward new increases.

Japan down by 8.4% because of drop in exports.

Japan: toward stabilization of losses

In the first quarter of 2009, the Japanese economy contracted by 8.4% year-on-year, 14.2% quarter-on-quarter annualized rate. This was a record drop since 1945 which may be explained almost entirely by the decrease in exports which were down 36.8% year-on-year. Also notable on the negative side was investment in capital goods which dropped 22.4%. The bigger decrease in private consumption, which was down 2.7% year-on-year, and its greater inertia and weight in the economy will make an early recovery more difficult.

Japan saw a bigger drop in overall activity because its exports (17.4% of its economy) collapsed as a result of reduced world demand (including in Japanese goods), because of the distortion in world trade on the supply side from the increase in credit insurance

JAPAN: MAIN ECONOMIC INDICATORS

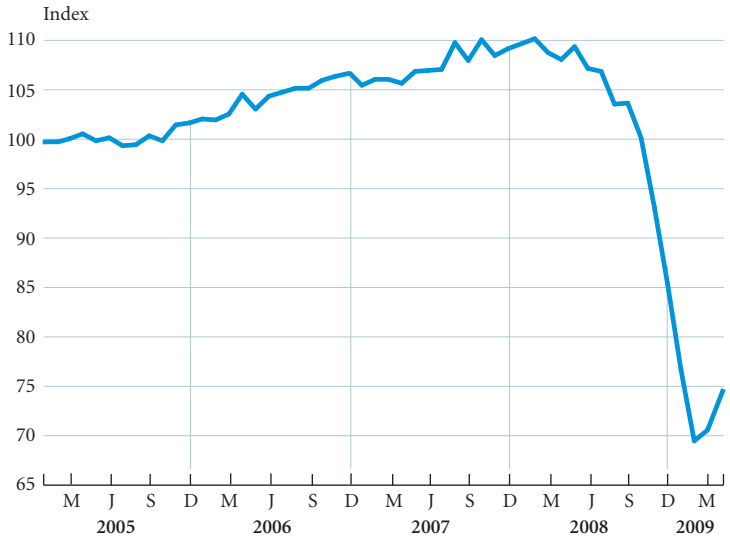
Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
Real GDP	2.3	–0.7	0.6	–0.3	–4.4	–8.4	–	...
Industrial production	2.9	–3.4	1.6	–3.3	–15.0	–34.0	–30.7	...
Tankan company Index (1)	22.0	–2.8	5.0	–3.0	–24.0	–58.0	–	...
Housing construction	–17.2	2.4	–11.1	40.3	3.9	–21.4	–32.6	...
Unemployment rate (2)	3.9	4.0	4.0	4.0	4.0	4.4	5.0	...
Consumer prices	0.1	1.4	1.4	2.2	1.0	–0.1	–0.1	...
Trade balance (3)	12.6	4.0	10.3	7.5	4.0	1.4	1.0	...
3-month interbank interest rate (4)	0.7	0.8	0.8	0.9	0.8	0.7	0.6	0.6
Nominal effective exchange rate (5)	77.1	86.6	82.6	81.9	98.5	102.1	95.9	96.3

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

JAPAN: INDUSTRIAL PRODUCTION BEGINS TO RECOVER

Industrial production index



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

and guarantee costs, which has brought breakdowns in supply chains, as well as because Japan's exports are more intensive than many others in capital goods, these being of a more fluctuating nature than consumer products and have high value added.

Nevertheless, figures for the trade balance in April confirm that the worst is over. From the end of September 2008 to February 2009 Japan's exports dropped 49.4% but since then as of April they grew by 12.9% showing something of a better rate. This recovery also took place on the import side but at much lower rates. According to figures for the balance of payment, the surplus in the goods balance of 263 billion yen in April was the best figure in the past seven months following a series of deficits unknown since 1945. Given the weight of exports in growth, it is likely that in the second quarter the economy will show much lower decreases than in the first quarter, although the weakness in consumption and investment does not indicate any definite recovery.

High intensity of capital goods in exports amplifies the drop...

In Japan, producers set the tone more than consumers and the most recent supply indicators also show the end of sharp decreases. Industrial production shows a pattern very similar to exports. After having dropped by 32.9% between September 2008 and February 2009, the April figure confirmed an incipient recovery although it should be remembered that the index stands 28% below the level last September. Nevertheless, these improvements were less evident in machinery orders which are an early indicator of investment.

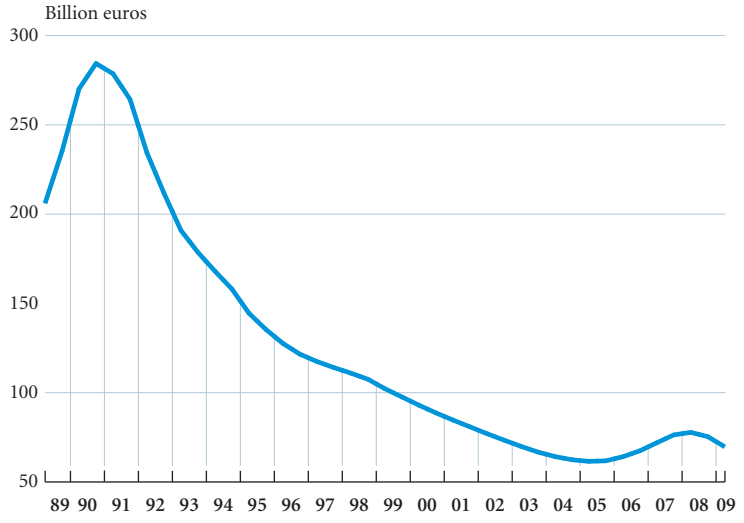
...but exports begin to recover.

On the demand side, the weakness of retail sales continued and in April showed a drop of 2.8% year-on-year. In spite of a slight rise, car sales in May failed to escape its downturn, thus confirming the weakness of private consumption.

Industrial production beginning to recover.

JAPAN: HOW TO HIT BOTTOM WITHOUT RECOVERING

Land prices in six main cities (*)



NOTES: March 2000 = 100.
SOURCE: Japan Real Estate Institute and own calculations.

Consumption dropping, CPI down 0.1% and unemployment hits 5%.

The housing market points in the same direction with sales in the Tokyo area dropping 19.8% year-on-year in May while land prices in the six largest cities were down 9.6% year-on-year in the first quarter of 2009. In turn, housing starts in April showed a sharper decrease.

China slows down and grows at 6,1%, with lower exports but more investment.

In line with the weakness of domestic demand, prices in April dropped by 0.1% year-on-year. Still more significant was the drop in the underlying CPI (the general index less energy and food) which also dropped for the fourth month in a row (down 0.4% year-on-year) leaving Japan again immersed in a deflationary dynamic. The Tokyo CPI in May was down 0.8% year-on-year pointing to further price drops. In this situation, the labour market continues on a downward trend. The unemployment rate has reached 5.0% of the labour force, the worst figure since November 2003 while the employment situation continues to get worse with 1,910,000 jobs lost in the past 12 months.

Industrial production up 8.9% but electrical energy generation continues to drop.

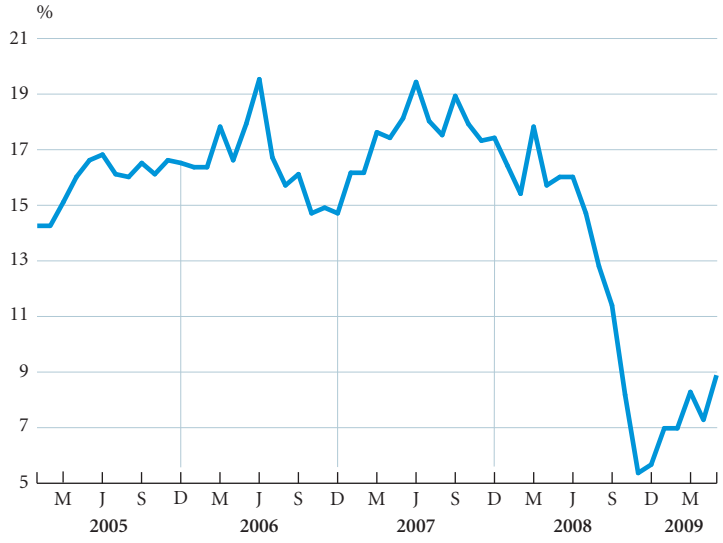
China: heavily dependent on government stimulus

The economy is growing by 6.1%, well above any other large world economy. The reduction in trade has affected China less than other export economies but there still remains the task of revitalizing private domestic demand, especially consumption, in order to reduce dependence on the fiscal stimulus package which includes spending on infrastructures amounting to 4.5% of GDP both in 2009 and 2010.

Recent indicators show that recovery is settling in. Industrial production in May grew by 8.9% year-on-year, an increasing rate, although still far from the 15%-16% that has been the norm in

CHINA: RECOVERY CONTINUEING

Year-on-year change in industrial production (*)



NOTES: (*) Figures adjusted for calendar effects related to Chinese Lunar New Year.
SOURCE: Chinese National Statistics Office and own calculations.

recent years. Retail sales have also increased while prices have stopped dropping compared with the previous month, with a general CPI that decreased by 1.4% year-on-year in May while food was down by just 0.6%. Nevertheless, there are some doubts about China's growth. National electrical power generation was down 3.2% year-on-year in May, which is in contrast to the growth rate of 15% that has been normal in recent years. Similarly, cement production, while more volatile, held at levels low than those usual in previous years.

The weakness of world trade is hurting China's economy less than expected but, on the other hand, the recovery in the foreign sector (less intensive in capital goods) will also be slower. The trade surplus for the past 12 months ending in May held close to the all-time high of 307.31 billion dollars, with exports dropping by 26.4% year-on-year and imports down 25.2%, in both cases somewhat more than in the previous month, which was clearly the opposite of Japan's exports which began a path of recovery after a drop that was also sharper.

Exports continue to drop but trade surplus holding up.

China's growth needs to be concentrated on domestic demand. Foreign surpluses have brought an accumulation of reserves in dollars that makes China vulnerable to an expansionist monetary policy of the US Federal Reserve. As a result, news of stabilization of inflation in the United States is welcome. But domestic growth will come through an increase in propensity to consumption and for this to happen there is a need for government spending on health which will reduce the necessity of households to save.

Implementation of health care should activate private consumption.

CHINA: MAIN ECONOMIC INDICATORS

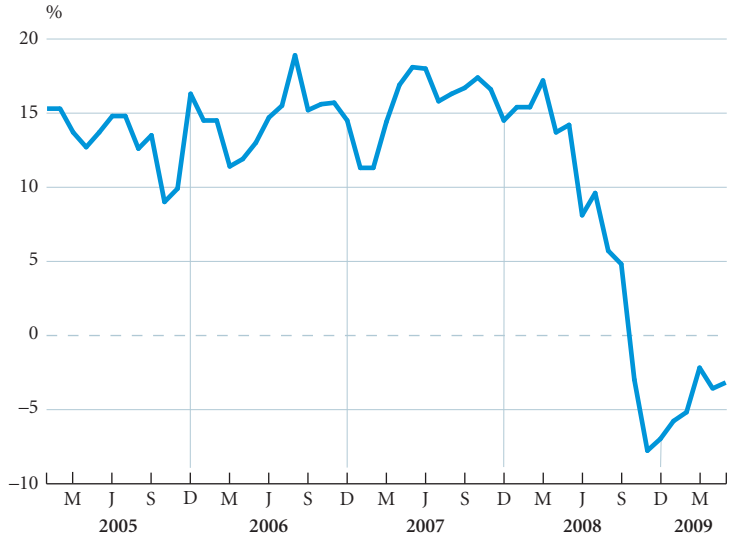
Percentage change over same period year before, unless otherwise indicated

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
Real GDP	13.0	9.1	10.1	9.0	6.8	6.1	–	...
Industrial production	17.1	13.0	15.9	13.0	6.4	9.2	7.3	8.9
Electrical power generation	15.7	6.7	11.9	6.7	–6.0	–4.3	–3.6	–3.2
Consumer prices	4.8	5.9	7.8	5.3	2.5	–0.6	–1.5	–1.4
Trade balance (*)	262.4	295.3	247.5	257.1	295.3	317.1	313.8	307.3
3-month interbank interest rate (**)	3.6	4.2	4.6	4.4	3.2	1.8	1.7	1.4
Renminbi to dollar	7.6	6.9	6.9	6.8	6.8	6.8	6.8	6.8

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

CHINA: RECOVERY APART FROM ELECTRICAL ENERGY

Year-on-year change in electrical energy generation (*)



NOTES: (*) Figures adjusted for effects of Chinese Lunar New Year.
SOURCE: Chinese National Statistics Office and own calculations.

Brazil: fears of a long recession are vanishing

Economy contracts by 1.6% in first quarter...

In the first quarter of 2009, the gross domestic product (GDP) contracted by 1.6% year-on-year. While this figure is negative, it hides positives aspects. On the one hand, the drop is mainly the result of the sharp contraction in investment but consumption continued to record positive growth rates. In addition, in spite of the fact that the world economic situation is still recessive, in net terms the foreign sector also contributed positively to the Brazilian economy.

Specifically, investment in the first quarter collapsed by 13.7% year-on-year, the biggest drop since September 1992. As we stated earlier, the positive note on the demand side came from household consumption which was able to grow 1.5% year-on-year in the January-March period. With regard to the foreign sector, it made a slightly positive contribution to the change in GDP thanks to a greater contraction in imports (drop of 21.6% year-on-year) than in exports (year-on-year decrease of 18.3%).

Above mentioned trends related to national accounting in the first quarter continued in the early months of the second quarter. Short-term prospects for investment are therefore not good. The low level of the economy's utilization of installed production capacity, along with a considerable margin for decrease in inventories, suggests that recovery of investment will be slow.

Also in line with the trend in the first quarter, the most recent indicators for retail sales and consumer confidence suggest that the trend is remaining positive so far in the second quarter. Retail sales grew by 6.6% year-on-year in April, practically twice the average for the first three months (3.5%).

...and figure could be worse but for consumption that is surviving the blow.

If this is what may be seen from the demand perspective, the supply indicators suggest that the worst of the recession may have been left behind. While industrial production in April was down 12.3% year-on-year, there has been a notable rise from the lows reached in December 2008. Production of intermediate goods has moved up by 4.3% while production of non-durables has risen by 3.0%. Production of durable goods rose by 58% under the effect of measures adopted by the government to aid the motor-vehicle sector.

Inflation in turn has continued to moderate. Weakness in demand has contributed to keep under control inflationary pressures that arose from the sharp depreciation of the real since last summer. Furthermore, since mid-April the real has gone back onto a path of

Lower rate of monetary easing in view of moderate inflation and some improvement in growth prospects.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
Real GDP	5.6	5.1	6.4	6.8	1.1	–1.6	...	...
Industrial production	5.9	2.9	5.2	6.4	–6.2	–13.9	–12.3	...
Consumer confidence (1)	132.3	140.4	146.5	136.3	132.9	128.5	124.9	125.7
Unemployment rate São Paulo (2)	15.0	13.0	13.7	12.7	11.6	12.6	14.6	...
Consumer prices	3.6	5.7	5.6	6.3	6.2	5.8	5.5	5.2
Trade balance (3)	40.0	24.8	30.7	28.7	24.8	25.0	27.0	25.6
Interest rate SELIC (%) (4)	12.75	11.25	12.25	13.75	13.75	11.25	10.25	10.25
Reales to dollar (1)	2.1	1.8	1.6	1.9	2.3	2.3	2.2	2.0

NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Billion dollars.
(4) On June 12 the Banco Central do Brasil lowered the SELIC rate to 9.25%.
SOURCE: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil own calculations.

Mexico suffering worst crisis since 1995.

appreciation to stand at around 1.95 reales per dollar. This has allowed inflation to drop to 5.2% in May, three decimals less than in April. Underlying inflation held stable at 4.7%. In a context of moderate inflationary pressures and prospects of gradual recovery, it is expected that the Banco Central do Brasil will continue reducing the SELIC rate from the present 9.25% to 8.5% in the course of 2009.

Mexico: elections and structural reforms

Mexico is immersed in an economic recession comparable to the «Tequila» crisis in 1995. The 8.6% year-on-year drop in GDP in the first quarter of 2009 was of an intensity similar to that of 1995 which would indicate that for 2009 as a whole the contraction will not be far from the 6.2% reached in 1995. One difference between the current crisis and the «Tequila» crisis is that the triggers were not local but from outside. Furthermore, the macroeconomic improvements made in the past 15 years have made it possible for the adjustment process to be orderly and from a relatively solid financial position. Nevertheless, the impact of the recession is sharper in Mexico than in other Latin American countries due to heavy dependence on the US economy.

This situation is reflected in latest available economic activity indicators. The collapse of consumer confidence, which was down by more than three points in May, is indicative of the lack of tone in household spending which will weaken domestic demand in the second quarter. At the same time, supply indicators suggest that cyclical weakness will scarcely improve during this period given that industrial production in April stood at 9.1% below levels one year earlier. During this stage of extreme weakness in economic activity unemployment continues to rise and in April reached to 5.3%.

Up-coming elections could determine government's margin for carrying out structural reforms.

In this context, the governor of the Banco de México, Guillermo Ortiz, has repeated the need to undertake deep reforms that would raise the potential

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
Real GDP	3.3	1.4	2.5	1.5	–1.7	–8.6	...	...
Industrial production	2.4	–1.0	0.1	–1.4	–4.4	–9.9	–9.1	...
Consumer confidence (1)	104.9	92.2	94.2	88.9	83.3	80.1	82.1	78.3
General unemployment rate (2)	3.7	4.0	3.5	4.2	4.3	5.0	5.3	...
Consumer prices	–22.7	–11.8	4.9	5.5	6.2	6.2	6.2	6.0
Trade balance (3)	–10.1	–17.3	–7.8	–11.9	–17.3	–17.5	–16.2	...
Official Banxico rate (%) (4)	7.00	7.50	7.75	8.25	8.25	6.75	6.00	5.25
Mexican pesos to dollar (1)	11.0	10.6	10.3	11.0	13.9	14.2	13.8	13.2

NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Billion dollars.
(4) On June 19 the Banco Central de México lowered the intervention rate to 4.25%.
SOURCE: Banco de México and own calculations.

growth of the economy. These measures must be aimed at adding to human capital through investment on education and health and by strengthening the fiscal position (including the pension scheme) and, because of their profound nature, such measures will require a very broad political consensus. It is not by chance that Ortiz made this statement close to the elections set for July 5.

The July elections were of great importance to President Calderón given that they renewed all 500 deputies and half the 356 senators. Polls indicated that neither the government nor the opposition would obtain a majority but the new political map will be fundamental for determining what alliances will make it possible to undertake the necessary reforms.

From subprime mortgage crisis to global recession: the transmission to emerging economies

One of the surprises of the current financial crisis has been its global scope. According to the forecasts of the International Monetary Fund (IMF), a total of 69 countries, equivalent to 75% of the world economy, will see their gross domestic product (GDP) drop in 2009. Of the remaining 25% that can avoid a drop in GDP approximately half is due to just one country, namely China. Furthermore, it spread very rapidly seeing that up until practically the end of Summer 2008 it seemed that the crisis was confined to the centre of the world economic system, that is, to the industrialized countries. In order to understand how the crisis has been able to affect practically the whole world it is necessary to explore its international transmission channels.

One initial means for this shift is of a financial kind. There is some agreement, that a characteristic factor of the current crisis is the extreme financial stress it has brought about, especially notable as of September 2008. As of that moment, at least four aspects of financial stress substantially worsened. There were sharp price drops on the stock market, risk aversion shot up, doubts increased about the state of banking institutions and foreign exchange pressures grew worse. In an attempt to quantify this phenomenon and bring it together in a single indicator, the International Monetary Fund (IMF) recently prepared an index that includes the various areas of financial stress related to the emerging economies.[1]

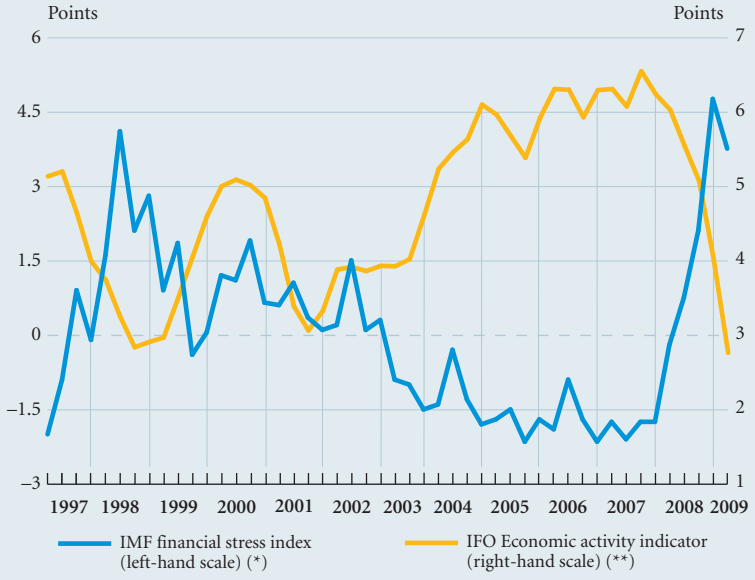
According to this indicator, these economies underwent a drastic increase in financial stress in the third and fourth quarters of 2008, a situation that began to ease (although holding at historically high levels) in the first quarter of 2009. This stress, always according to this indicator, began earlier in the industrialized countries and also began to undergo correction in these economies earlier than in the emerging markets. By area, the trend in the emerging economies shows some differences. Financial stress was greater in emerging Asia than in Latin America or Emerging Europe. Nevertheless, the latter (as distinct from what happened in the rest of the world) is not showing any appreciable remission of financial stress in the first quarter of 2009.

What have been the appreciable effects of this financial tension? Two notable developments are the repatriation of capital and the lowering of credit to the private sector. With regard to the former, according to the forecasts of the Institute of International Finance, private flows of credit from the industrialized countries went from net inflows of 200 billion dollars in 2008 to a net outflow of 100 billion dollars. More than half of this change

(1) See International Monetary Fund «How Linkages Fuel the Fire: The Transmission of Financial Stress from Advanced to Emerging Economies», *World Economic Outlook*, Chapter 4, April 2009.

FINANCIAL STRESS HAVE SUBSTANTIAL EFFECT ON ACTIVITY IN EMERGING ECONOMIES

Indicators of financial stress and world economic activity



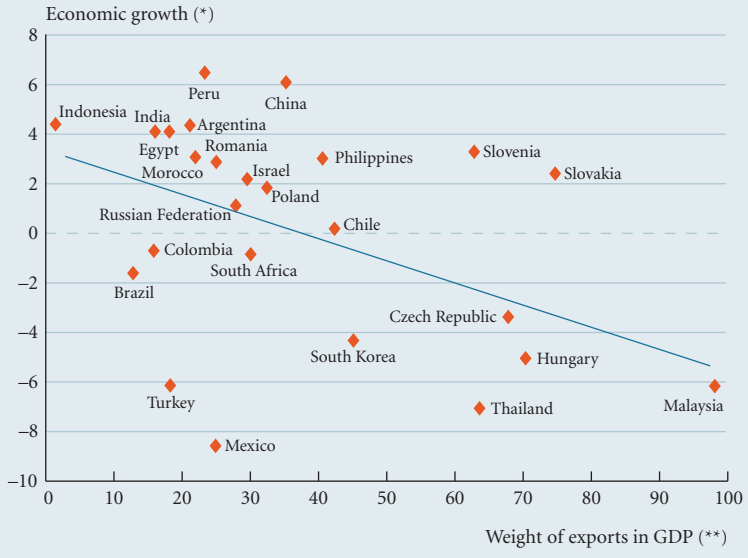
NOTES: (*) IMF financial stress index made up of 18 economies in Asia, Latin America and Emerging Europe.
(**) Own calculations based on economic activity indices for Latin America, Asia and Central and Eastern Europe prepared by IFO Institute.
SOURCE: IMF, IFO Institute and own calculations.

was due to the turnaround in financial flows of commercial banks. This movement will be sharper in Emerging Europe than in Asia or Latin America. Domestic private credit, in turn, underwent a sharp slowdown in year-on-year growth rates in the three areas, although the slowdown was greatest in Latin America.

As well as this channel for passing on financial stress, a second way is through world trade. The reduction in world trade has been unexpectedly steep in recent months. According to IMF figures, world exports of goods last January stood at levels 26% lower than one year earlier. The emerging countries and those still developing have not escaped the tendency mentioned earlier while their exports of goods fell by 25% year-on-year in January.

The sharp contraction in world trade arises not only from the drop in domestic demand in the industrialized countries but also from the fact that there was a blockage on world commercial credit. While the financing of international trade is of relatively low risk, as it is well collateralized, it has shown to be very sensitive to financial problems of a global nature. This was the case during the Asian crisis although on that occasion it was restricted only to those countries affected but now it has had a bigger impact. According to some estimates, around 80% of world trade depends on credit to a greater or lesser degree. It is also normally a matter of short-term financing. In addition, the difficulty in having access to credit in various countries at the same time has affected world supply chains. All of this has meant that the world credit crisis has had a rapid and sharp impact on world exports.

CRISIS DEPRESSING EXPORT-BASED ECONOMIES



NOTES: (*) Real year-on-year change, latest quarter available.
(**) Exports of goods as percentage of GDP (2008).
SOURCE: IMF, Eurostat, national statistical institutes and own calculations.

From the above we must deduce that the crisis became a global one because financial and trade flows are global in nature. And, if we are tempted to look back to periods of lesser economic and financial integration as a remedy to avoid such developments, we should not forget that it is precisely this integration that has made it possible that over the past 20 years, for the first time in centuries, three-quarters of the world has had reasonable prospects of escaping from poverty.

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

Oil slightly moderating upward trend

Oil raised again although not as sharply as the month before. Between May 20 and June 22 crude oil moved up by 11.1% to stand at 66.82 dollars a barrel (one-month delivery Brent quality) after having come close to 73 dollars. The cumulative rise for the current year has been 70.9%.

The price of oil continued to bet on a scenario of economic recovery on the optimistic side, the weakness of the dollar and the continuation of easy monetary policies by the central banks. Uncertainty about Iran, one of the main world producers, for now does not seem to be affecting the price of oil. With a world demand of 83.3 million barrels a day, Iran produces 3.65 million barrels and exports 2.2 million while Saudi

Price of oil rising again making 71% total increase for year.

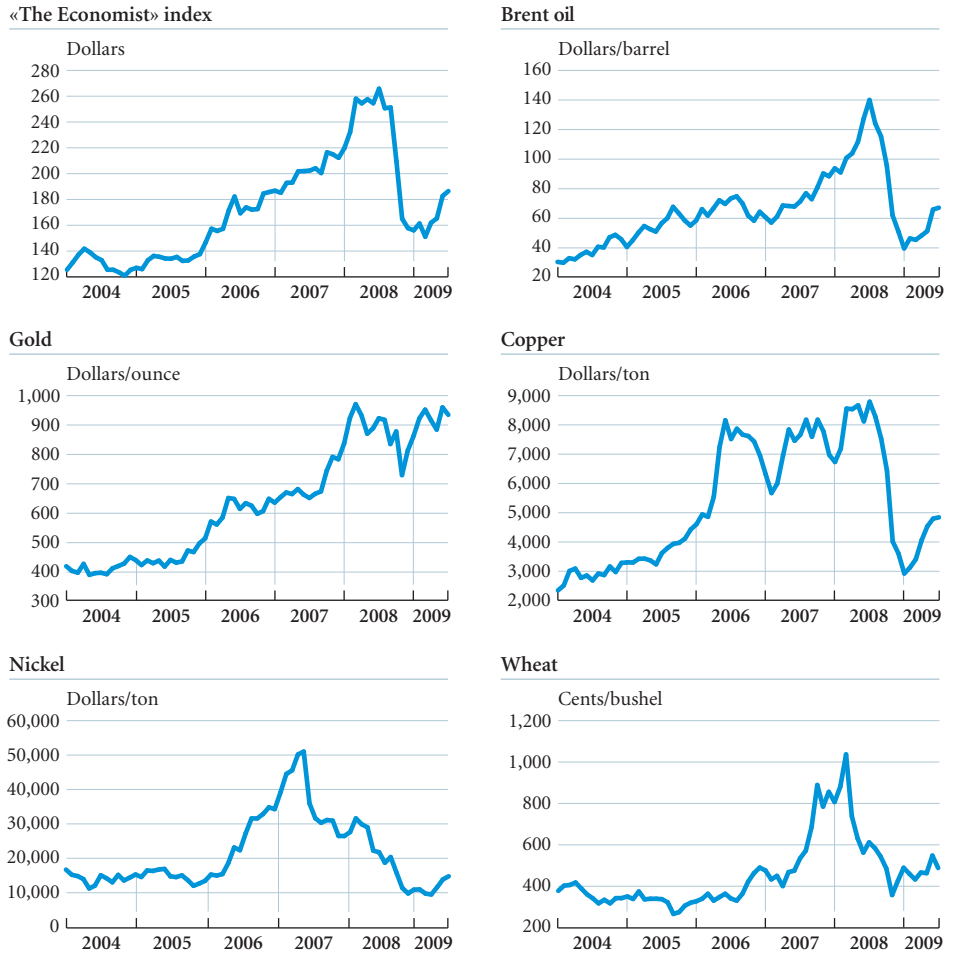
Oil price betting on continuation of easy monetary policies but ignores uncertainty about Iran.

Commodities remain high led by base metals but rate of increase easing.

Arabia's production is estimated at 3.0 million barrels a day so that it could compensate for possible deficiencies in Iran's supply.

Commodity prices generally followed in the wake of oil with continuing increases which, however, are losing strength. *The Economist* commodities index rose by 2.4% between May 20 and June 22, with a cumulative increase of 19.7% for the current year. By sector, gold maintained its increases while wheat lost part of the gains made the previous month. It was base metals that showed the biggest increases. The downturn in the industrial economies have reduced the production of scrap from which comes a large part of industrial supply. The reduction in scrap supplies is contributing to the co-existence of an upward trend in base metal prices alongside the weakness of world industrial production.

TREND IN VARIOUS COMMODITIES (*)



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

EUROPEAN UNION

Euro Area: looking for a change in the trend

In the *Monthly Report* for June we underlined the sharp contraction undergone by the European economy in the first quarter of 2009. This, together figures obtained from regular indicators, led us to substantially revise downward our growth forecast for 2009 putting it at 4.5%. In any case, we noted that the rate of contraction of the economy should gradually decrease. The unknowns at the time of closing off the June *Monthly Report* which have become clear during the past month show the extent of the contraction in the first quarter of the various components and sectors of the economy and the change in trend in the rate of economic contraction.

Let us look at the components. With regard to the trend in the various GDP components, in the first quarter practically all of these continued to sharply contract, one more example of the current recessive process. There was a notable drop in investment which went to 4.2% compared with the previous quarter and contributed 0.9 percentage points to the total drop in GDP. Exports also continued to decrease sharply (8.1% compared with the previous quarter) but, given that imports also underwent a major contraction (down 7.2%), the total contribution of the foreign sector to the overall drop in the gross domestic product (GDP) was only 0.3 percentage points.

Recession being felt in all components of GDP.

A breakdown of economic contraction by sector shows that, while the recession is affecting all sectors, the industrial sector and retail trade transportation are being hurt most. The industrial sector contracted by 8.8% compared with the previous quarter and contributed 1.5 percentage points to the contraction of the economy. Retail trade and transportation contracted by 2.6% compared with the previous quarter and added another 0.5 percentage points to the total contraction of the economy.

Industrial sector, retail trade and transportation most affected.

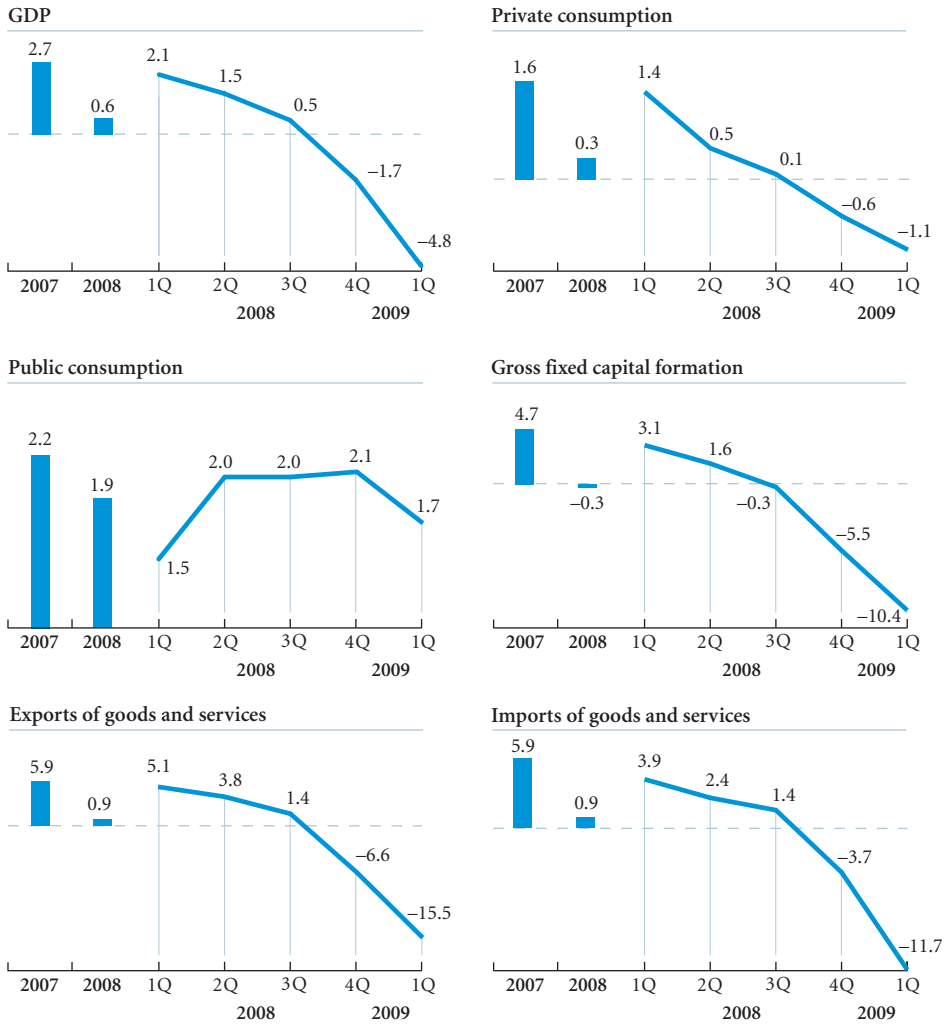
According to our estimates, economic activity continued to contract in the second quarter but at a lower rate than that reached in the first quarter. There are two main factors supporting this forecast. On the one hand, there is the improvement in economic sentiment indicators. That prepared by the European Commission in May continued to recover for the second consecutive month. The Purchasing Managers Index (PMI) that reflects changes in production, orders, inventories and employment, again improved in June for the fourth month in a row. In any case, both confidence indicators still stand at levels consistent with economic contraction.

Economic activity to keep contracting although at lower rate.

On the other hand, financial markets are continuing a gradual process of easing. The 1-year Euribor, for example, continues to mark up all-time lows due to the effect of the 1-year liquidity auctions being carried out by the European Central Bank. Another good example is the growing financing

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCE: Eurostat and own calculations.

of large companies in the wholesale market, a fact reflected in the spectacular recovery of the bond issues market in recent months.

The effects of the improvement in confidence and financial terms will very gradually show up in increased economic activity. For the moment, the trend in retail sales, an indicator of the trend in private consumption, and in industrial production, a good indicator of investment, has still not shown any clear change.

End of recession will be slow and not without risks.

It is important to emphasize that, while there may be a change in trend in the rate of contraction in coming quarters, the exit from the recession will be slow and not without its risks. The worsening of the labour market is one of the main factors that will mean that economic growth holds below potential over the medium term. The unemployment rate

stood at 9.2% in April and stands a long way from the 7.2% reached in March 2008. This has meant that the total number of persons unemployed has now gone above 14.5 million persons.

With regard to risks, the future trend in inflation remains a key unknown. For the moment, it is surprising how fast and how sharp it is slowing down. The Euro Area harmonized consumer price index (HCPI) for May stood at 0%, setting a new all-time low, but underlying inflation dropped by only two decimals and held at 1.5%. This would indicate that the drop in inflation is mainly due to the decrease in commodity prices. We therefore expect that in coming months it will reach figures slightly below zero but in the fourth quarter could rapidly recover and end the year at rates close to 1%.

Another major question is why the recession remains sharper in the Old Continent than in the United States, the country where the financial crisis began. In the *Monthly Report* for June we stated that the collapse in world trade was one of the main factors, given that the Euro Area, especially Germany, is much more dependent on the good state of the foreign market than the United States. In the present issue we underline another factor – the growth potential of both economies. A very simple way of estimating this is to calculate the average growth over a reasonably long period of time. As shown in the accompanying graph, those countries with lower growth potential are expected to suffer more during the current year. Among these, we should mention Japan, Germany and Italy. Greece and Poland stand in an opposite situation. The Baltic countries

Unemployment affecting 14.6 million persons.

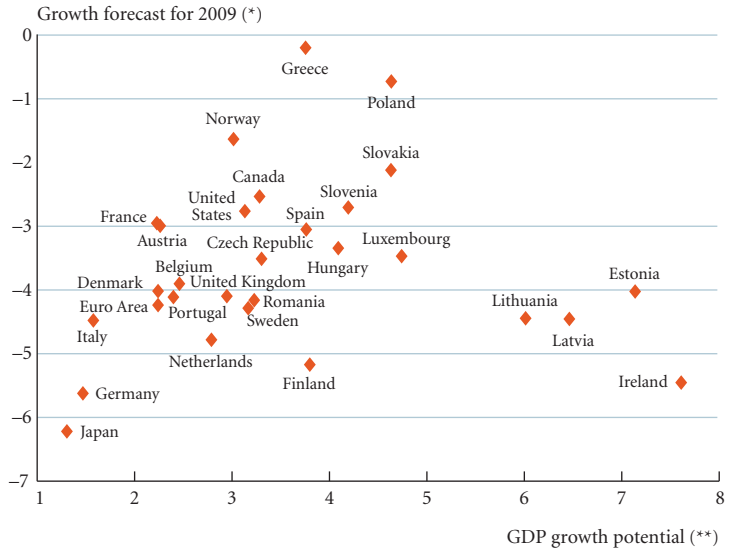
EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
GDP	2.7	0.6	1.5	0.5	–1.7	–4.8	...	–
Retail sales	1.3	–0.2	–0.3	–1.0	–1.9	–3.4	–2.2	...
Consumer confidence (1)	–4.9	–17.9	–14.6	–19.2	–26.1	–32.2	–31.3	–31.1
Industrial production	3.5	–1.7	1.1	–1.5	–9.0	–18.3	–20.7	...
Economic sentiment indicator (1)	108.9	91.1	97.5	89.9	75.8	65.7	67.2	69.3
Unemployment rate (2)	7.4	7.5	7.3	7.5	8.0	8.7	9.2	...
Consumer prices	2.1	3.3	3.6	3.8	2.3	1.0	0.6	0.0
Trade balance (3)	20.1	–1.2	13.8	–11.4	–31.7	–35.2	–34.6	...
3-month Euribor interest rate	4.3	4.6	4.9	5.0	4.2	2.0	1.5	1.4
Nominal effective euro exchange rate (4)	107.9	113.0	116.0	114.0	109.1	111.9	112.5	...

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.
SOURCE: Eurostat, European Central Bank, European Commission and own calculations.

RECESSION ESPECIALLY SEVERE IN COUNTRIES WITY LOW GROWTH POTENTIAL



NOTES: (*) IMF forecasts.
(**) Average GDP growth between 1995 and 2006.
SOURCE: IMF and own calculations.

Lower growth potential of Euro Area showing effects.

and Ireland do not seem to follow this relation but this is due to the fact that in recent years they have been growing above their potential, which leads to an overestimation of their growth potential. The Euro Area as a whole has a growth potential lower than that of the United States and therefore expected growth for this year is also lower.

Germany: recovery could come in the second half of the year

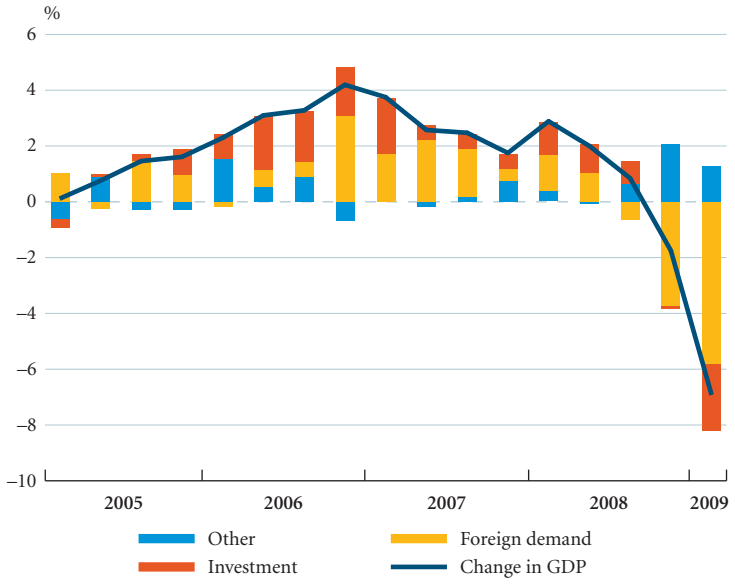
Germany was one of the developed countries to show the biggest drop in the economy in the first quarter of 2009, reporting a reduction in GDP of 3.8% quarter-on-quarter (6.9% year-on-year), the biggest drop since World War II. As shown by regular indicators, a breakdown of the GDP by component confirms that the worsening of Germany's economy was the result of the collapse of investment and exports, with year-on-year reductions of 11.4% and 17.5% respectively. Hence, the two engines driving the economy in the recent growth period are now those pulling it down into a deep recession.

Germany's GDP down 6.9% year-on-year due to drop in investment and exports.

This situation is made clear in the following graph. Whereas in 2006 the contribution of these two components amounted to 2.6 percentage points of the 3.2% growth of the German economy, the worsening over the last two quarters (especially in exports) fully explains the reduction in Germany's GDP. Only the increase in stocks and maintenance of public and private consumption (aided by economic stimulus plans) has avoided a bigger contraction of GDP. As a result, the recovery of the German economy will have to be preceded by the stabilization of investment and the foreign sector, which will mean that the exit from the recession will be slower than that of its trading partners so that the first signs of

INVESTMENT AND FOREIGN DEMAND PULL DOWN GERMAN DEMAND

Contribution of various components to change in GDP



SOURCE: Deutsche Bundesbank and own calculations.

recovery are not expected to show up until the second half of 2009.

An analysis of the main economic indicators confirms this view. In spite of the month-on-month rise these showed in March, the figures for April show slight decreases compared with the month before. On the demand side, retail sales showed reduced growth while exports reported a month-on-month drop of 4.8%, more than that recorded in the past two months, thus, reaching a historical year-on-year minimun with a reduction of 25.6%. This meant that the trade surplus continued to drop going to 28.6% lower than one year earlier.

In view of demand still not stable and the accumulation of inventories over recent months, industrial production and orders were down by 1.1% and 1.9% month-on-month respectively, thus maintaining year-on-year changes close to all-time lows and bringing about a further reduction in production capacity utilization, especially in manufacturing industry. The IFO business activity index for June continued to improve, aided by the state of the future component, while leaving behind the low reached in March.

Trade surplus continues severe drop.

In spite of this rapid worsening of the economy, the effect on the unemployment rate up until now has been fairly limited even showing a drop in May. This was largely due to employment adjustment plans (kurzarbeit) which, according to the Federal Employment Agency, involved 1.2 million workers in the first four months of the year and brought about a drastic reduction in hours worked in the early months of the year.

The cost of economic stimulus plans, along with tax cuts announced by the government for 2010 (amounting to 13 billion euros) has increased forecasts for the public deficit. According to the

Worsening of economy still not affecting labour market.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009			
			2Q	3Q	4Q	1Q	April	May	June
GDP	2.6	1.0	2.0	0.8	–1.8	–6.9	–	...	–
Retail sales	–3.0	–0.5	–0.8	0.1	–0.5	–2.8	–0.3	...	...
Industrial production	5.8	0.0	2.8	0.0	–7.5	–19.6	–21.6	...	...
Industrial activity index (IFO) (*)	106.2	96.8	102.1	94.8	86.2	82.6	83.7	84.3	85.9
Unemployment rate (**)	9.0	7.8	7.9	7.7	7.6	8.0	8.3	8.2	...
Consumer prices	2.3	2.6	3.0	3.1	1.6	0.8	0.6	0.1	...
Trade balance (***)	181.5	195.3	202.3	196.3	183.0	159.6	144.6	...	...

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

Germany's deficit expected to reach 6% in 2010.

Bundesbank, this will go above 3% this year and will come close to 6% in 2010 while raising Germany's debt to 80% of GDP. In view of this situation, the German parliament has approved a law under which the central government and *land* governments will have their borrowing capacity reduced over coming years.

France: on the way to end of recession?

Business survey indicators on rise.

The latest surveys indicate that economic activity in France is easing the recession. According to a report on the economic situation published by the Bank of France on June 9, the index for the industrial business climate rose in May to stand at 81 points. Another index of business opinion, the synthetic index of economic climate, rose in June for the third month in a row. This would indicate that the drop in French industrial production should ease in coming months. Even so, the French institute of Statistics (INSEE) is estimating a major decrease in industrial production in 2009 (15.7%) following the drop in 2008.

Among all the negative news, there was a notable rise in the number of car registrations in May (14.5% year-on-year) the result of measures taken to aid the motor vehicle sector. This increase is in contrast to the drops reported in previous months.

Inflation down 0.3% year-on-year in May.

On the demand side, private consumption is likely progressing gradually in 2009 given that the purchasing power of households will rise thanks to the decrease in prices. In fact, the consumer price index was down by 0.3% year-on-year in May, partly due to the sharp drop in oil prices, given that underlying inflation was down but still held positive. A negative inflation figure has not been recorded sine 1957. In spite of the drop in prices, the risk of deflation remains small and generally it is expected that this downward trend will be halted by the end of summer.

With regard to investment, the figures indicate that this will drop

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
GDP	2.3	0.3	1.0	0.1	–1.7	–3.2	–	...
Domestic consumption	4.8	–0.6	–0.1	–0.9	–2.5	–1.0	0.5	–1.6
Industrial production	1.5	–2.5	–0.3	–2.2	–9.0	–15.8	–18.8	...
Unemployment rate (*)	8.3	7.8	7.6	7.8	8.2	8.6	8.9	...
Consumer prices	1.5	2.8	3.3	3.3	1.8	0.6	0.1	–0.3
Trade balance (**)	–33.5	–48.6	–46.1	–50.9	–55.3	–55.4	–56.0	...

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

notably in 2009 especially in the first two quarters.

On the other hand, the fact that other countries are showing a more favourable profile should help ease the sharp drop in French exports from the beginning of 2009. Following the sharp decrease of 6.0% quarter-on-quarter in the first quarter of 2009, the INSEE estimates decreases of 3.8%, 1.8% and 0.8% respectively in the following quarters of 2009.

In this context, the INSEE is forecasting a decrease in economic activity that is progressively more moderate. As a result, following the quarter-on-quarter drop of 1.5% in the fourth quarter of 2008 and 1.2% in the first quarter of 2009, the French GDP should not drop by more than 0.6% and 0.2% in the second and third quarters of 2009 stabilizing in the final quarter of the year. All this adds up to a drop of 3.0% in GDP in 2009.

The recession is also weighing heavily on the French labour market. According to INSEE, close to 600,000 jobs will likely be lost. At the same time, the unemployment rate will continue the upward trend begun in the second quarter of 2008 going to around 10% at the end of 2009. This would mean an increase of close to 3 points over this period.

INSEE predicting 3.0% drop in GDP in 2009.

Italy's lost decade

In the first quarter of 2009, Italy's economy suffered its biggest drop in recent decades with a year-on-year decrease of 6.0%. As well as the expected drop in investment and exports, the breakdown of the trend in GDP shows a reduction of 1.1% quarter-on-quarter in private consumption which underlines the weakness in Italy's domestic demand. Prospects for coming months are not more hopeful so that everything suggests that in 2010 Italy's GDP will stand at a level similar to that of 2001.

An analysis of regular economic indicators shows some disparity in statistical trends which may be a sign of some easing of the recession. While exports reported a quarter-on-quarter reduction of 7.2% after two consecutive months of recovery, causing the biggest year-on-year drop since 1986, industrial orders in May and industrial production in April show a slight rise. As a result, it is possible that investment in the second

Italy's GDP in 2010 expected to stand at levels similar to 2001.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
GDP	1.5	–1.0	–0.3	–1.3	–3.0	–6.0	–	...
Retail sales	1.3	–0.3	–0.7	0.1	–1.7	–3.1	...	...
Industrial production	2.1	–3.3	0.1	–3.9	–10.6	–21.1	–24.5	...
Unemployment rate (*)	6.2	6.8	6.8	6.7	7.0	7.3	–	...
Consumer prices	1.8	3.3	3.6	4.0	2.8	1.5	1.2	0.9
Trade balance (**)	–12.8	–10.0	–8.6	–10.8	–12.3	–11.1	–10.1	...

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

Italy's heavy debt load prevents adoption of new economic measures.

quarter will show a less pronounced drop.

On the other hand, the unemployment rate in March 2009 was 7.3%, a level relatively low if we compare it with other European countries. Nevertheless, the rapid worsening of the Italian labour market, with the loss of 204,000 jobs in the first quarter of 2009, brought about a further reduction in consumer confidence which leads us to expect that private consumption will continue to drop in spite of a lower inflation rate.

In this situation, Italy's public debt reached a new all-time high in April going to close to 110% of the country's GDP and with forecasts putting it up to 115% at the end of the year. This situation is dissuading the Berlusconi government from adopting economic stimulus measures that would raise debt even higher so that there exists little margin for manoeuvre to ease the recession.

United Kingdom: slowdown easing

Industrial production down 12.3% in April 2009.

The British economy has offered some less negative news in the past two months. This makes it possible to foresee that the drop in the GDP in the previous two quarters, largely due to the collapse in world demand and adjustment in inventories, will be difficult to repeat. Industrial production dropped by 12.3% year-on-year in April, a dip slightly less than that recorded the month before. Other early indicators, such as the economic sentiment index, suggest that economic activity is probably slowing the rate of downturn.

Nevertheless, the return to a stage of sustainable growth is still very uncertain as various factors exist which put the British economy in a quite vulnerable position. Among these factors, the banking system depends largely on support from the government, unemployment is increasing, world demand remains dormant and households have very high debt levels.

With regard to the labour market, various figures confirm that the process of worsening has continued although at a slower rate. The number of registered unemployed has increased putting the May unemployment rate at 4.8%, two decimals above the figure recorded in April. The increase in wages (2.7%

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
GDP	3.0	0.7	1.8	0.4	–2.0	–4.1	–	...
Retail sales	4.2	2.7	3.4	1.2	1.9	0.6	2.7	–1.7
Industrial production	0.1	–2.6	–1.0	–2.5	–7.6	–12.6	–12.3	...
Unemployment rate (*)	2.7	2.8	2.5	2.8	3.4	4.2	4.6	4.8
Consumer prices	2.3	3.6	3.3	4.9	3.9	3.0	2.3	2.2
Trade balance (**)	–83.1	–93.3	–93.6	–94.9	–93.6	–91.3	–89.3	...
3-month Libor interest rate	5.3	6.0	6.0	5.9	6.3	2.8	1.6	1.4
Nominal effective pound exchange rate (***)	103.9	97.6	92.6	92.8	89.4	73.7	76.9	78.8

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion pounds.
(***) Change weighted for foreign trade flows. Higher values imply currency appreciation.
SOURCE: OECD, Bank of England, ONS, European Commission and own calculations.

year-on-year in the three months ending in April) has slowed. There was also a drop in the number of hours worked. In this context, retail sales were down 1.7% in May although part of this drop may be explained by base effects given that the figure for May 2008 was unusually high.

To some extent, this was in contrast to the trend in inflation which stood at 2.2% in May after showing 2.3% in April, an index somewhat above that expected and slightly above the Bank of England target. The fact that the decrease in inflation was not bigger, as in other countries, may be attributed to the fact that depreciation of the pound has exercised upward pressure on prices.

Inflation stands at 2.2%, in the United Kingdom higher than expected.

Emerging Europe: from collapse to euphoria. Where are we headed?

In the first half of 2009 events in Central and Eastern Europe passed with lightning speed. At the beginning of the year both the trend in financial variables and in economic activity indicators suggested that the problems in the region had become excessive. The stock markets were clearly dropping, currencies were subject to heavy depreciatory pressures and country-risk indicators shot sky-high.

The collapse of national currencies worsened the pressure on debts of companies and households, much of which were expressed in foreign currencies and of notable volume following the credit boom experienced in previous years. Industrial activity, oriented toward manufacturing exports to the Euro Area, collapsed as a result of the serious recession in Germany and other key markets. The drop in inflows of international capital raised the fear that one of these countries was going to be unable to meet its foreign commitments. The process of bank deleveraging led to fears about the subsidiaries that Western European banks maintained in the region.

After start to 2009 with major tensions in financial markets of Emerging Europe...

Nevertheless, as of the end of February and the beginning of March the

...situation improves appreciably as of March.

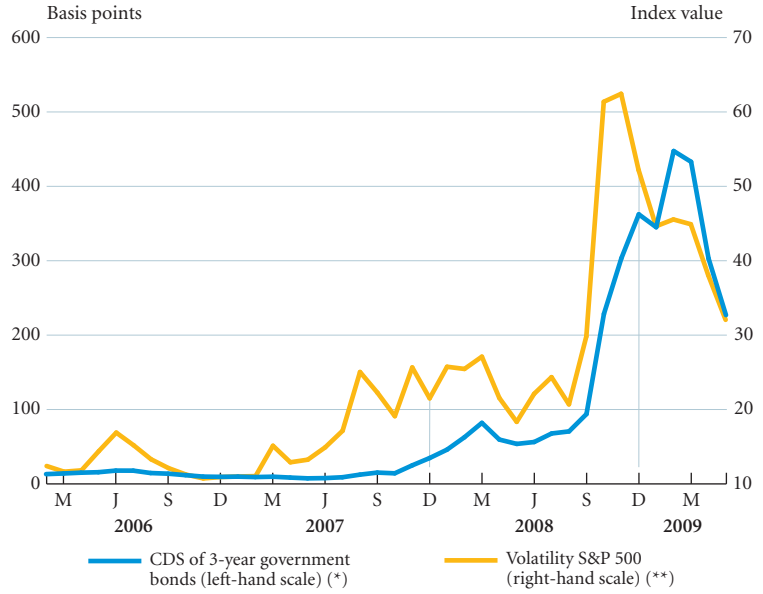
financial situation has had a turnaround. Starting from annual lows, stock markets in the region have gone up by around 60%, the main currencies have recovered lost ground (for example, the zloty has appreciated 7% against the euro) and the cost of insuring against default on sovereign bonds has gone down close to half in most of these countries.

What happened in the region in such a short time that would explain this turnaround in the markets? Was this a move based on changes in macroeconomic prospects or, on the other hand, was it a matter of a financial correction? Was this a strictly regional development or does it arise from a global improvement? It is essential to properly understand what lies behind this radical change because this understanding is needed to be able to anticipate the immediate future with some success.

With regard to the matter of a change in macroeconomic fundamentals versus strictly financial factors, the figures suggest that the latter are determining issues. Economic activity indicators, such as economic sentiment or industrial production, have tended to confirm the scenario of deep recession in 2009 which was especially sharp in the first quarter. The incipient improvement in certain areas of economic activity is basically due to the fact that the cycle of industrial adjustment has been so intense that the rebuilding of inventories is making it possible to undo part of the slump in manufacturing. Nevertheless, the lack of foreign demand and the restriction of credit remain serious.

DROP IN WORLD RISK AVERSION REDUCES FINANCIAL TENSIONS IN EMERGING EUROPE

Indicators of financial tensions



NOTES: (*) Weighted average of CDS for 3-year bonds of Poland, Czech Republic, Slovakia, Hungary, Romania, Bulgaria, Estonia, Latvia and Lithuania on monthly average.
(**) VIX index on monthly average.
SOURCE: Thomson Reuters Datastream and own calculations.

As a result, it does not seem that the improvement in the markets is due to a stronger scenario of cyclical recovery than anticipated. On the other hand, what has happened is that the sharp drop in asset prices between October and February had put them at attractive values, especially in the case of the stock markets. In terms of price/benefit ratio at the beginning of 2009, Emerging European shares were substantially cheaper than those of Asia or Latin America. If regional quotations were at attractive levels, a reduction in risk aversion would set off a definite recovery in the markets, something that has indeed taken place since the end of February.

Here we may pose a second related question. Are we seeing here a world or regional phenomenon? The figures suggest that the global factor has predominated. In spite of being relatively more undervalued, the stock markets in Emerging Europe have recovered to a lesser extent than those of Latin America and scarcely more than those of Asia. A similar trend has been repeated in other financial assets, such as currencies.

This does not imply that some specific regional developments have not played a part. In particular, financial aid from the International Monetary Fund (IMF) to Romania and Poland had its impact on financial developments. But it seems that the reduction of world risk aversion was a dominant factor benefiting financial assets of Emerging Europe as against a hypothetical differential reduction in regional risk aversion or a potential improvement in macroeconomic prospects.

Main boost to financial recovery is reduction in world risk aversion...

From a macroeconomic point of view the region is still facing a complex situation. While the global industrial cycle, undergoing tenuous recovery in the second quarter, will likely shift to exports and industrial production in the region it is doubtful whether this movement will be able to compensate for the forces depressing domestic demand (excessive borrowing, little margin for fiscal expansion, end of the process of lowering official interest rates, etc.).

At the same time, the breech in international financing, while it appears adequately covered in 2009, is going to be a problem in 2010 due, for example, to renewal of debt planned for this year. A third front, along with the cycle and international financing, concerns possible regional «contagion». While in Emerging Europe some countries coexist with clearly differentiated situations, the delicate situation in the Baltic states (especially market pressure for Latvia to devalue its currency) could end up affecting the region as a whole.

A final risk factor is of a political nature. A good part of the bid to survive the crisis demands that the economic adjustment under way in these countries does not flounder, something that in turn depends on the ability to bear the political and social cost that adjustment involves. In view of the electoral blow meted out to governments in Hungary and Latvia in the recent European elections, this cannot be dismissed. Overall, the risks of and hindrances to recovery are substantial and it does not seem possible to avoid Emerging Europe ending up in a deep recession in 2009 and, in the best of cases, with a return to minimal growth in 2010.

...and not so much to change in macroeconomic prospects which remain very slim.

FINANCIAL MARKETS

Monetary and capital markets

United States and Europe proposing reforms in financial regulation systems

Proposals for financial reform put forward in United States and Europe.

As a result of the current crisis, those responsible for economic policy have a unique opportunity to carry out reforms in the international financial system. Following an initial period when efforts were concentrated on containing the damage arising from the financial upsets, June brought various forward-looking proposals for financial reforms by governments on both sides of the Atlantic.

In United States, it is proposed to create a regulatory agency to improve coordination along with a new consumer protection agency.

In the United States, the government presented its plan that still has to be approved by Congress. This process could be long drawn out and take the best part of this year given that the depth of the reforms implies complex negotiations between the Democratic and Republican parties. The plan has five objectives. First, it aims to promote firm supervision and regulation of financial institutions. An agency of financial regulators would be created to identify system risks and improve cooperation between the various regulatory bodies. An important change included in the proposal is the concession of new powers to the Federal Reserve in order to supervise even institutions that are not banks but which could put financial stability at risk.

European Union suggests creation of European System of Financial Supervisors.

The second aim is to establish full supervision of financial markets, strengthening the regulation of titularization markets, making this the authority enabled to supervise the payments system handed over to the Federal Reserve. A third key element is the protection of consumers and investors from financial abuses. Inspired by the European system, a new consumer protection agency would be created to increase the transparency of financial products and services. The fourth basic pillar of the proposal is the establishing of a new system for closing down financial institutions that present system risks. Finally, the proposal includes measures for establishing international regulation standards and improving international cooperation.

In turn, the European Union Council, held on June 18-19, recommended the creation of a European System of Financial Supervisors aimed at improving quality, coordination of financial regulation and establishment of a trans-border framework to prevent and manage financial crises. At the same time, it charged the Commission with a legislative proposal aimed at establishing the new framework of financial supervision in the European Union by Autumn this year with the aim of having the new regulations come into force in 2010.

At its monetary policy meeting on June 24, the Federal Reserve maintained the reference rate within the range of 0.00% and 0.25%. In its press release issued at the end of the meeting, it indicated that, while the severity of the drop in the economy of various countries had eased, there were still prospects of

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						
2008									
June	4.00	4.95	5.39	2.00	2.78	0.93	5.00	5.95	2.73
July	4.25	4.97	5.37	2.00	2.79	0.90	5.00	5.78	2.78
August	4.25	4.96	5.34	2.00	2.81	0.88	5.00	5.75	2.70
September	4.25	5.27	5.50	2.00	4.05	1.02	5.00	6.30	3.00
October	3.75	4.76	4.87	1.00	3.03	0.94	4.50	5.84	2.43
November	3.25	3.85	3.95	1.00	2.22	0.93	3.00	3.91	1.23
December	2.50	2.89	3.05	0.25	1.43	0.10	2.00	2.77	0.75
2009									
January	2.00	2.09	2.27	0.25	1.18	0.10	1.50	2.17	0.70
February	2.00	1.83	2.03	0.25	1.26	0.10	1.00	2.05	0.75
March	1.50	1.52	1.81	0.25	1.19	0.10	0.50	1.65	0.63
April	1.25	1.37	1.73	0.25	1.02	0.10	0.50	1.45	0.66
May	1.00	1.27	1.63	0.25	0.66	0.10	0.50	1.28	0.60
June (1)	1.00	1.22	1.60	0.25	0.61	0.10	0.50	1.23	0.38

NOTES: (1) June 23.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-10-08 (3.75%), 6-11-08 (3.25%), 4-12-08 (2.50%), 5-03-09 (1.50%), 2-04-09 (1.25%), 7-05-09 (1.00%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).
(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 04-12-08 (2.0%), 7-01-09 (1.5%), 05-02-09 (1.0%), 5-03-09 (0.50%).
(5) Interbank rate.
SOURCE: National central banks, Bloomberg and own calculations.

weakness in economic activity. For this reason, it stated that it would maintain the official interest rate within its present framework for a long time to come.

The European Central Bank, at its meeting on June 4, also decided to maintain its reference rate at 1%. It took advantage of the following press conference to announce its forecasts for the Euro Area in 2009. It lowered economic growth to –4.6%, with scarcely any change in harmonized inflation which would go down one decimal to 0.3%.

On June 24, the ECB carried out its first unlimited injection of 12-month liquidity at the intervention rate of 1% without the inclusion of any premium. In subsequent auctions, injections of liquidity will be carried out at the reference rate plus a differential according to market conditions. There was strong demand for liquidity for a total of 442.42 billion euros granted to 1,121 institutions. This injection by the ECB should ease tensions and contribute to a gradual reduction of differentials over coming weeks. In fact, as may be seen in the above table, the tendency to a reduction in interbank market differentials is being maintained. While the 3-month Euribor is quoted at 1.22%, the 1-year Euribor stands at 1.60%.

Federal Reserve and ECB maintain reference rate unchanged.

ECB holds first unlimited 12-month liquidity auction and contributes to unblocking of interbank market.

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
2008								
June	4.62	4.81	4.90	5.17	3.97	1.60	5.13	3.29
July	4.36	4.53	4.67	4.90	3.95	1.54	4.81	3.05
August	4.18	4.38	4.55	4.82	3.81	1.42	4.48	2.89
September	4.02	4.35	4.60	4.90	3.82	1.47	4.45	2.61
October	3.90	4.30	4.61	5.15	3.95	1.48	4.52	2.84
November	3.26	3.68	3.89	4.46	2.92	1.40	3.77	2.28
December	2.95	3.41	3.81	4.38	2.21	1.17	3.02	2.10
2009								
January	3.30	3.81	4.39	4.71	2.84	1.30	3.70	2.18
February	3.11	3.66	4.28	4.68	3.01	1.28	3.62	2.24
March	3.00	3.55	4.05	4.39	2.66	1.35	3.17	2.10
April	3.18	3.59	3.92	4.28	3.12	1.43	3.50	2.14
May	3.59	3.95	4.29	4.48	3.46	1.49	3.75	2.41
June (*)	3.48	3.85	4.26	4.63	3.68	1.42	3.76	2.32

NOTES: (*) June 23.
SOURCE: Bloomberg.

Yield on government bonds begins rising in June then undoes upward move.

The same thing happened in the United States with the 3-month Libor showing an all-time low of 0.61%. This reflects the improvement in the US interbank market which was helped by news that various institutions that had received funds from the government had repaid those support amounts.

The performance of the yield on government bonds in June had two quite different periods. In the first two weeks in June, the improved economic expectations sent the yield on government bonds up so that it went to highs for the year. For example, US 10-year bonds reached a quote of 3.95% while the German *bund* of similar term showed 3.72%. This brought about an increase in real interest rates that was not motivated by an increase in inflation expectations, which held at low levels, nor by a rise in sovereign bond risk, but rather reflected an improvement in confidence about the economic situation on the part of investors.

Downward revision of growth forecasts moderates investor optimism.

Nevertheless, once this period had passed and with help from the drop in shares and downward revisions of growth forecasts by various international bodies, the optimism of investors began to moderate. They felt that the yields being offered by government bonds represented an interesting investment proposal keeping in mind that, although the drop in the economy had slowed down, most large companies were still in recession. For this reason, heavy buying of government bonds reduced the yield these offered. This took place except in two countries, seeing that both in the United States and Italy bond rates held to the trend in the past three months when they showed an increase in yields.

Foreign exchange rates: much activity amounting to little

If we compare exchange rates of the major currencies at the end of May with those at the end of June, we note that they are very similar. For example, a dollar would buy 95.4 yen on May 27 whereas on June 23 it would buy 95.6 yen. On the same dates, the euro rate against the dollar went from 1.397 to 1.395 respectively. It seems that the markets are showing that quotes have been reached that reflect the present situation and that, for the moment, while waiting for new economic figures, foreign exchange rates can well run within a narrow range.

On the other hand, uncertainty has increased about the possible trend in the dollar over coming months. This increased uncertainty about which way the dollar will go is reflected in regular surveys among leading experts on the currency markets who work in various financial institutions, both public and private. The consensus indicates a widening in the range of the various forecasts. While arguments in favour or against involve many factors, three of the most important stand out.

The first is that there is a consensus regarding the end of the recession in the United States. This will come about before it happens in the Euro Area or Japan and should favour the tendency to a stronger dollar. What is more, if there are sharp ups and downs in stock market quotes in coming months, at those times when there is an increase in risk aversion, investors will take refuge in the dollar so that the tendency for the greenback to appreciate will be increased.

Quotations for dollar, yen and euro remain at same levels as last month, all running within narrow range.

Experts divided on forecasts for coming quarters.

EXCHANGE RATES OF MAIN CURRENCIES

June 23, 2009

	Exchange rate	% change (*)		
		Monthly	Over December 2008	Annual
Against US dollar				
Japanese yen	95.6	0.8	5.1	–12.9
Pound sterling	0.613	–2.5	–11.6	17.1
Swiss franc	1.076	–0.6	0.7	2.9
Canadian dollar	1.153	2.5	–5.7	11.9
Mexican peso	13.311	1.2	–2.7	22.4
Against euro				
US dollar	1.397	–0.4	0.0	–11.1
Japanese yen	133.5	0.4	5.1	–25.4
Swiss franc	1.503	–0.9	0.7	–8.0
Pound sterling	0.857	–2.8	–11.5	7.8
Swedish krona	11.113	5.6	1.5	15.4
Danish krone	7.444	0.0	0.0	–0.2
Polish zloty	4.544	3.0	8.7	26.0
Czech crown	26.15	–2.0	–2.7	8.0
Hungarian forint	282.0	0.6	5.8	15.3

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

Likelihood United States will come out of recession before Europe and Japan helps appreciation of dollar...

On the other hand, there is another factor that actually goes in favour of dollar depreciation. This is related to the huge issue of government bonds necessary to finance the public deficit and the limit that large borrowers of US Treasury bonds can carry in their investment portfolios, among these being China and the OPEC countries. The difficulty lies in being able to evaluate the sensitivity of the dollar to the various factors and especially at what moment in time one or the other factor will be involved.

...while huge issue of government bonds to finance US public deficit favours depreciation of dollar.

Pause in recovery of shares

Following three months of sharp rises, the share markets showed an uneven performance in June. In the first half of the month, the tendency of the stock market indices continued the upward trend begun in March only to later become negative in final sessions. In spite of this movement, the cumulative revaluation of the S&P 500 and the Eurostoxx 50 from the lows recorded in March held at around the level of 40%.

Stock market shows irregular performance in June with constant changes of trend.

The sentiment dominating the markets remains one of expecting a gradual reduction of economic risks at the global level. But the appearance of certain unfavourable factors set off a call for caution among investors. In any case, the figures on the flow of funds continued to show a notable move of money toward share markets with preference being given to the financial sector and cyclical sectors, such as cars and natural resources.

Economic figures still showing weak global scenario far from confidence surveys of various economic agents.

The most relevant aspects of the trend in stock market indices in this period were the publication of figures on the international macroeconomic situation and certain important events related to listed companies in the United States. On both fronts, there was both positive and negative news, thus bringing about an uneven performance on the stock market.

With regard to the economic figures, June saw further disparity between some indicators that were clearly upward in terms of prospects and some still very weak figures on the real economy. The latter showed a reality still farther off in the future than expected, which created doubts among investors about the timing and strength of the hoped-for recovery. A clear example of this was shown by the indicators for the US real estate sector with very poor sales figures and high statistics for default and foreclosures. The most important obstacle, however, was the higher mortgage loan rates for 15-30 years which caused unease for their possible negative impact on the purchasing power of households and consumption. Industrial production was another indicator of economic activity showing even worse and one not in agreement with the forecasts of improvement coming from business executives.

Another determining factor in the performance of markets was certain news and events relating to listed companies from which some important implications for the global scenario may be drawn. On the one hand, there was a rise in capital increases by companies, both financial and non-financial, aimed at obtaining resources and avoiding reductions in their ratings. This means an increase in the supply of shares in circulation and therefore will tend to push down quotes. In addition, the US Treasury announced the names of the ten national banks it would allow to return government funds received as aid some months ago. Institutions such as

INDICES OF MAIN WORLD STOCK EXCHANGES

June 25, 2009

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*8,299.9*	*0.3*	*–5.4*	*–29.7*
Standard & Poor's	*900.9*	*1.6*	*–0.3*	*–31.8*
Nasdaq	*1,792.3*	*5.9*	*13.7*	*–25.4*
Tokyo	9,796.1	4.8	10.6	–29.2
London	4,285.9	–1.8	–3.3	–24.4
Euro Area	2,418.2	–0.9	–1.2	–30.1
Frankfurt	*4,825.4*	*–1.9*	*0.3*	*–27.1*
Paris	*3,184.5*	*–1.6*	*–1.0*	*–29.8*
Amsterdam	*254.3*	*–2.4*	*3.4*	*–42.1*
Milan	*18,992.7*	*–4.9*	*–2.4*	*–36.7*
Madrid	*9,706.4*	*3.8*	*5.6*	*–22.0*
Zurich	5,434.5	–0.2	–1.8	–23.3
Hong Kong	18,275.0	6.7	27.0	–19.3
Buenos Aires	1,545.8	–1.1	43.2	–26.1
São Paulo	49,672.1	–2.3	32.3	–24.6

NOTES: (*) 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.

Goldman Sachs, Morgan Stanley, JP Morgan and American Express will be able to break their link with government funding that limited their normal operations, something that was received favourably by the markets as it was seen as a sign of the solidity of these institutions and the system as a whole.

Another positive factor was the improvement noted in the revised estimates of corporate profits made by analysts. Following several months of constant downward revisions, in recent weeks it seems that an upward process may have begun. For now, this is weak and located in the most cyclical sectors of the stock market but, if an overall improvement in economic growth is confirmed, it is possible that the upward revisions in estimates will become general and grow stronger.

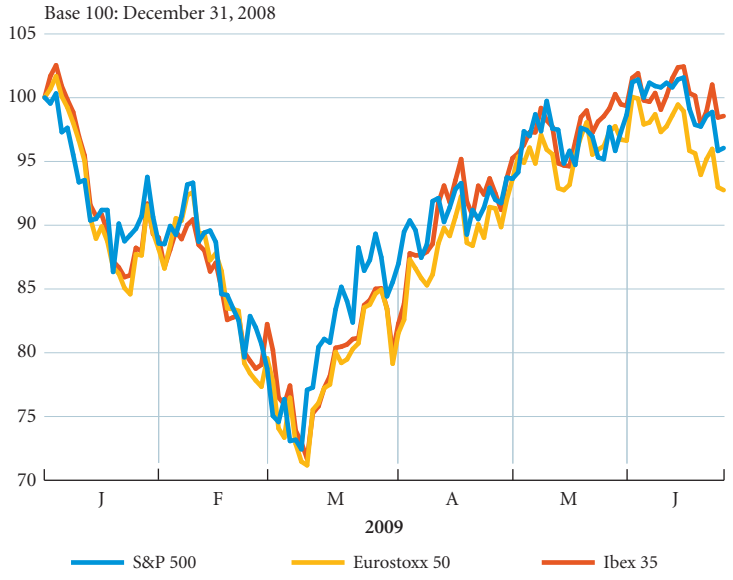
Coming weeks will witness some important events that will help determine if, as seems most likely, the upward trend on the stock markets is renewed, showing that the recession has been beaten, or if, on the contrary, it shows that these three months have only been an oasis in the middle of the global economy desert and quotes go back to showing weak again. First of all, corporate results for the second quarter will be published and companies will make known their business prospects. Secondly, we shall see if the improvement in confidence indices are consolidated as well as the recovery of figures for the real economy. Thirdly, the reduction of risk aversion as markets and agents (which have been a focus of instability) try to recovery normal operations, will be put to the test, as, for example, in the case of

News on companies improves confirming world situation with lower risk.

Estimates of corporate profits begin to improve.

MAIN STOCK EXCHANGES SHOW MODERATE RISE IN JUNE

Main stock market indices



SOURCE: Bloomberg and own calculations.

Coming weeks key for determining trend in share markets.

banks in the United States and some emerging countries.

Reduction of corporate credit risk also slows

Halt to reduction in risk premiums on corporate bonds but investor flows toward sector continue.

Corporate bond markets continued to improve in all segments up to the middle of June. The positive trend was based on the same group of fundamental factors affecting the financial markets in general. The most important was the sharp drop in risk premiums due to the success of the fiscal and monetary measures adopted by economic authorities world-wide. Another key factor, on the demand side, was the increase in flows of investment of various kinds toward corporate bonds. Investors have been attracted by the higher yields offered by these instruments, both those of highest solvency and those bearing greater risk. We should point out the role of institutional investors, such as pension funds and insurance companies, which have taken up the opportunity for some all-time high spreads to be included in their corporate bond portfolios. In addition, the central banks are continuing to open their balance sheets to instruments which finally favour the valuation of corporate bonds.

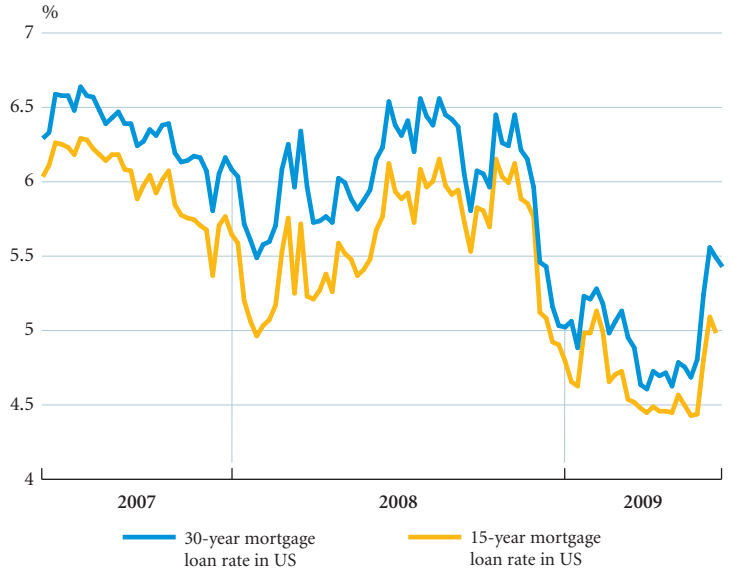
Companies somewhat reduce bonds issues although European banks issuing bonds under shelter of ECB buying programme.

On the supply side, companies reduced their issue activity in terms of the very high figures seen at the start of the year although some issuers in Europe (mainly financial institutions) took advantage of the situation to issue bonds under the shelter of the ECB announcement of its programme to acquire covered bonds.

In the United States there has been a notable recovery of secondary markets, which have been practically closed since the beginning of the financial crisis, as a result of the increased flows toward this type of asset in recent months. In this scenario, some high-yield companies

MORTGAGE LOANS COSTING MORE

Mortgage loan rates in United States



SOURCE: Bloomberg.

have also taken the opportunity to go to the market with operations not so important in terms of amount as for what they symbolically mean for the recovery of normalcy in the market.

In fact, this gradual normalization of the credit market is taking place by sectors and segments. Those closest to the liquidity programmes of the Federal Reserve and other central banks have now been practically normalized. At the opposite end of the scale we find the «covered loans» market which has begun to show signs of recovery only in recent weeks (issues in May came to 35 billion dollars in the United States whereas in the early months of the year this market had disappeared).

Toward the middle of June, a series of factors came together which cooled down and moderated the boom climate being experienced in loan markets. One of the most influential was the sudden increase in government bond interest rates which brought about upward pressure on rates of all types of bonds, putting up the cost of credit, especially mortgage loans.

High risk companies taking advantage of market recovery to issue bonds.

Publication of the ECB's Report on Financial Stability, warning of the risks to the European Financial System, also had an impact. According to its estimates, some significant figures show that there exists the potential for risks of 283 billion euros up to the year 2010, a good part of these taking place in the corporate sector. In turn, in the United States new legislation is being drawn up dealing with the financial system that in principle requires more demanding levels of solvency and supervision of financial institutions.

Liquidity now becoming available for syndicated loans and leveraged debt.

Coinciding with these facts, the credit rating agencies have revised the ratings of many institutions downward. This has brought a rapid response from many

Rise in interest rates on mortgage loans.

Credit rating agencies revise many company ratings downward.

companies, hastening the search for financing in capital markets or recurring to capital increases in order to avoid a reduction in credit ratings.

While the markets have stopped the trend to the better begun in March, it may be expected that, once the impact of these factors has been absorbed, risk premiums and differentials will keep dropping to the extent that the flow of capital from private and institutional investors continues.

The Fed's made-to-order programmes to deal with the crisis

In the introduction to his book on the Great Depression,[1] Ben S. Bernanke, chairman of the Fed, attributes a good part of his research interest in this historic event to the fascination he had for the unfortunate individuals responsible for economic policy at the time, those who unsuccessfully tried to manage totally new and dramatic situations. When he began this field of research, Bernanke could not have known that years later he would be the leading monetary authority in the United States. But, what could have been better preparation for a central banker faced with the biggest economic and financial crisis in the past 70 years?

In fact, the present managers of monetary policy have the experience of history and the teachings of economic research over decades and this has provided them with a route map which, in spite of some nebulous aspects, has made it possible to design a strategy that seems to have avoided a new world depression.

At the beginning of the crisis, the Federal Reserve (Fed) had no hesitation in using its conventional instruments to the limit. Official interest rates were sharply and rapidly reduced while at the same time loans to financial institutions were widened and made more flexible. But, as the crisis developed, the central bank realized it had to put non-conventional monetary policy measures into effect.

The interest rate reached its possible limit of 0% without there being any signs of improvement in the economy and with important inflation risks still showing, the result of high household debt, the fragile situation of the banks and the paralysis of a large part of capital markets. In view of this, the Fed decided to put into practice a wide range of new measures that have spectacularly changed the size and composition of its balance sheet and are finally aimed at reviving the flow of credit in the economy as a whole.

Bernanke had called this policy one of credit easing, showing his conviction that it was essential to create specific programmes for each segment of the credit market that got into difficulties (commercial paper or titularizations, for example). The Fed has thus adapted itself to the special institutional and functional characteristics of the US financial system, which in recent decades had reduced its degree as «banker» in favour of a disintermediated model based on the capital markets. In this model, buyers and sellers of funds directly interact or go through structured financing.

In the design of its new arsenal of instruments, the Fed took into account two other considerations. First, that this crisis was of world scale and therefore it was necessary to coordinate its monetary policy with the other

(1) Bernanke, Ben (2000), «Essays on the Great Depression». Princeton University Press, pp. viii-ix.

central banks. Secondly, that it had to be pro-active and work in a decisive way and, if too much liquidity may have been injected, working out how to withdraw it without great difficulty.

The best comparison of the Fed's non-conventional monetary policy is the heart surgery procedure known as a by-pass. The aim of this procedure is to resolve an obstruction in the arteries that irrigate the heart. The technique consists of by-passing the partially blocked arteries and thus restoring the blood flow to the circulatory system (or, in this case, the flow of credit in the financial system).

The various programmes introduced by the Fed may be set out in four large groups according to the immediate purpose for which they have been designed. The accompanying graph shows their relationship with the credit markets at which they are aimed.

The first group of measures is intended to provide liquidity to the financial institutions. Here we note the swap lines with central banks of other countries to which dollars are provided in view of the strong demand for this currency from financial entities outside the United States, thus managing to avoid added tensions in currency markets. Also included here are the liquidity facilities the Fed is making available to banks and other financial operators such as investment banks with very easy access terms. This takes us up to conventional banking channels.

The second group of measures is aimed at granting direct loans to borrowers and final investors. This deals with intervention in the commercial paper market, which is important for the financing of many financial and non-financial companies. The direct granting of liquidity to investment funds that invest in this type of security prevented massive sales of promissory notes from increasing the cost of short-term financing of companies. This is also the case of the crucial asset-backed securities market which for some months was practically paralyzed for lack of takers and thanks to a specific programme of purchases between the Fed and the Treasury has been recovering its activity.

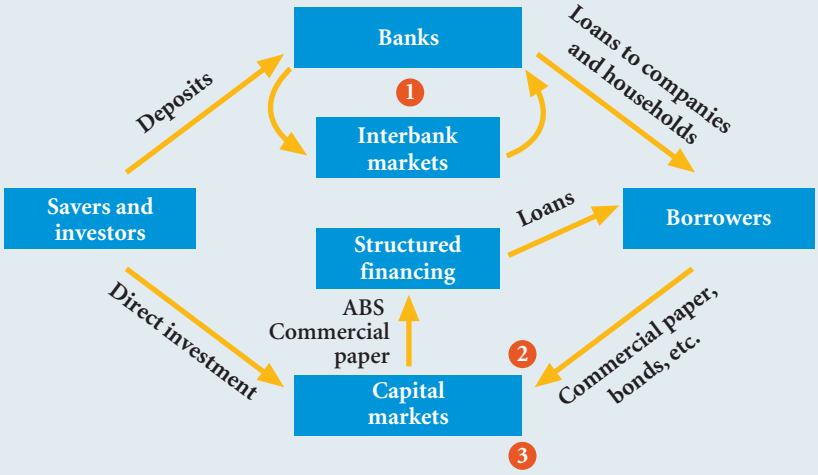
The third package of measures involves the buying of quality assets, such as government bonds or bonds issued or guaranteed by government mortgage bodies (Fannie Mae and Freddie Mac). This is aimed at a reduction in government bond interest curves and aids the mortgage bond market and finally provides for supporting the real estate market through the reduction of reference interest rates used for mortgage loans.

Finally, the Fed designed a programme to support specific institutions. We could point out the aid given to the largest lender in the country (AIG) for an amount of 85 billion dollars and the aid granted to JP Morgan for it to acquire the bankrupt investment bank Bear Stearns. It also provided aid to Bank of America for the acquisition of Merrill Lynch. These programmes, with an obvious impact on the liquidity of the system, go much farther and enter the sphere of the solvency and structure of the financial system as a whole.

The impact of the various programmes on stabilizing the financial system has been very great. Among the results of the various programmes introduced by the Fed we may underline the normalization of the interbank market, which reflects an improvement in the state of liquidity of the financial institutions. Furthermore, the results have been very positive in the various credit markets with a renewal of issues in the commercial paper market and a reduction of differentials. Finally, the purchase of high quality assets has made it possible to improve interest rate terms and the availability of credit in the economy as a whole.

It is still too early to judge the final success of the various Fed programmes and it may be necessary for some years to pass to be able, with the perspective of time, to analyze this non-conventional monetary policy. Even Bernanke himself, as a good academic, in a speech given on June 4, emphasized the need to go deeper into economic research under the stimulus of the present crisis which began in August 2007. What is certain is that up-coming books on monetary policy will include a special chapter explaining the body of measures taken by the US central bank in the current crisis. Chairman Bernanke wrote his book on the Great Depression. Now he is making history with the programmes the Fed has put into practice to deal with a crisis of a size similar to the one before.

AREAS OF IMPACT OF FED PROGRAMMES



1. Provision of liquidity to financial institutions
2. Concession of direct loans to borrowers and final investors
3. Purchase of high quality assets
4. Aid to specific institutions

SOURCE: Federal Reserve and own calculations.

This box was prepared by Alejandro Gisbert
Financial Markets Department, "la Caixa" Research Department

SPAIN: OVERALL ANALYSIS

Economic activity

Recession losing its bite

Following three quarters of deep recession, the few indicators available for the second quarter of 2009 point to a continuation of the drop in economic activity. Nevertheless, we feel that the overall worsening of the situation has somewhat eased partly due to the effect of the government measures to stimulate the economy and to some improvement in the international picture. In any case, the May economic sentiment index showed a slight worsening because of the unfavourable trend in the services confidence index.

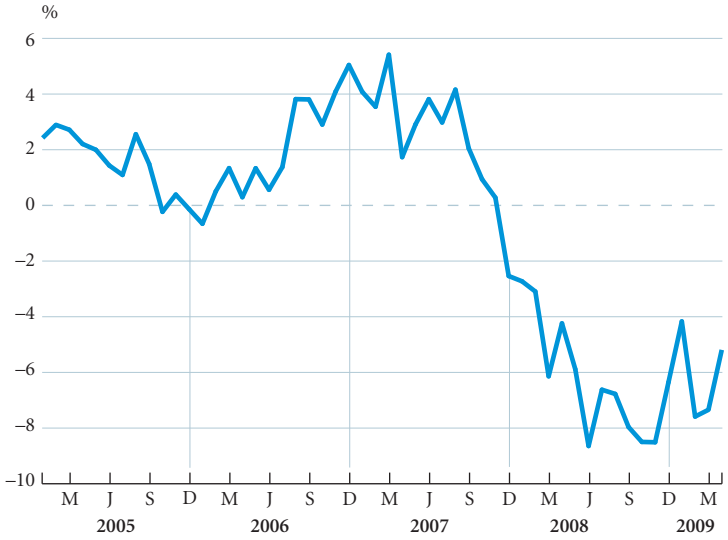
The drop in consumption has eased in keeping with the consumer confidence index in March and April although it remains at very low levels. The year-on-year decrease in production of consumer goods in April was 11.9% although this was nearly one point less than in the first quarter. Retail sales also slowed their contraction trend at the beginning of the second quarter. Nevertheless, all components showed year-on-year drops in real terms.

The biggest dip came in home goods. In the period January-May the sale of white-goods appliances were down 25.8% compared with the same period the year before in terms of units, according to figures supplied by Anfel, the manufacturers association, largely due to the recession in the construction sector.

Drop in consumption eases at beginning of second quarter.

DROP IN RETAIL SALES EASES SLIGHTLY

Year-on-year change in general retail trade index at constant prices (*)



NOTES: (*) Index (without service seasons) deflated and adjusted for calendar effects.
SOURCE: National Institute of Statistics and own calculations.

New 2000E direct aid plan for car purchase slows sharp drop in sales.

With regard to car registrations, the new 2000E plan providing direct aid for buying that came into force in the second half of May began to show its effect and halted the drop in sales of less polluting cars. In this way, passenger car registrations were down 38.7% for the month as a whole compared with May 2008, four points less than the cumulative drop in the first five months of the year. With the start of the new plan prospects for passenger car sales in coming months have improved. In addition, the index for retail sales prospects was also up in May.

In addition, in April domestic sales of large companies slightly eased their drop in annual terms. This was due to sales of goods because sales of services slipped down with an annual drop of 15.7%. On the foreign front, exports by large companies also showed a slight easing in the collapse which stood at 18.0% year-on-year in April.

With regard to investment, the downward trend is continuing although there are some hopeful signs. Capital goods production was down by 22.7% in April compared with 12 months earlier although this was 7.7 points less than in the first quarter. On the other hand, registrations of commercial vehicles, which were severely affected by the recession in transport, were down by 53.4% in May compared with one year earlier.

Housing construction still adjusting to real estate recession.

The other major component of investment, construction, is still adjusting to the real estate recession. In mid-June, the Ministry of Housing published a report putting the figure for non-subsidized homes unsold at the end of 2008 at 613,512. Home sales remain

DEMAND INDICATORS

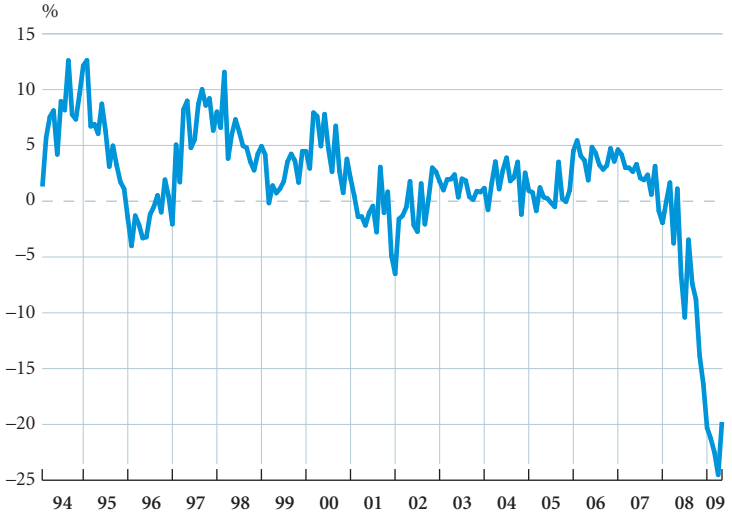
Percentage change over same period year before

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
Consumption								
Production of consumer goods (*)	1.7	–4.7	–4.4	–4.5	–10.3	–12.8	–11.9	...
Imports of consumer goods (**)	5.1	–7.7	–6.9	–4.1	–17.2	–9.4	...	...
Car registrations	–1.2	–28.1	–19.6	–32.5	–46.6	–43.1	–45.6	–38.7
Credit for consumer durables	10.0	3.6	7.1	3.4	–4.2	–12.0	–	...
Consumer confidence index (***)	–13.3	–33.6	–31.3	–38.3	–44.7	–45.0	–39.0	...
Investment								
Capital goods production (*)	4.6	–8.8	–6.1	–8.0	–20.8	–30.4	–22.7	...
Imports of capital goods (**)	9.8	–19.6	–16.4	–15.9	–28.8	–31.3	...	...
Commercial vehicle registrations	0.3	–43.6	–34.1	–50.1	–61.3	–52.4	–58.5	–53.4
Foreign trade (**)								
Non-energy imports	7.3	–4.9	0.2	–4.1	–19.0	–26.0	...	...
Exports	4.2	1.9	6.6	7.8	–8.4	–17.9	...	...

NOTES: (*) Adjusted for difference in number of working days.
(**) By volume.
(***) European Commission survey: difference between percentage of positive and negative replies.
SOURCE: ANFAC, National Institute of Statistics, Bank of Spain, Ministry of Economy and Finance, European Commission and own calculations.

COLLAPSE IN INDUSTRIAL PRODUCTION EASES SLIGHTLY

Year-on-year change in industrial production index



NOTES: Statistical series corrected for calendar differences.
SOURCE: National Institute of Statistics.

depressed. In this context, an early indicator, go-aheads for new housing construction, showed a year-on-year drop of 64.1% in the first quarter. Nevertheless, the drop in cement consumption showed some let-up in May as a result of the municipal public works plan introduced by the central government. In any case, government tendering faltered in the first quarter of 2009. Nevertheless, the construction confidence index for May reached its highest level in the past six months.

On the supply side, there has been a severe depression in industry, brought about by the sharp contraction in demand, both domestic and foreign. To this must be added structural factors involving the cumulative loss of competitiveness in recent years. As a result, industrial production continued to show sharp decreases although the rate of the collapse eased somewhat in April. The biggest drops came in consumer durables and intermediate goods. The decrease of 30.6% in new industry orders in the first four months of the year compared with the same period in 2008 would indicate a continuation of the weakness in industry in coming months. In any case, confidence in the secondary sector in April and May rose slightly above the low in March.

Contraction in demand and cumulative loss of competitiveness slow down industrial sector.

With regard to services, the volume of business corrected for calendar effects was down 17.3% in April compared with the same month the year before. Nevertheless, this decrease was slightly lower than that recorded in the first four months of the year. All sub-sectors reported year-on-year drops. The smallest decreases showed up in information technology while the biggest came in retail trade.

In view of this situation, the central government revised downward its macroeconomic forecasts for 2009-2012 in which it expected a drop in gross domestic product (GDP) of 3.6% in 2009 and 0.3% in 2010. Nevertheless,

Tertiary sector also down.

Government revises growth forecasts downward but OECD more pessimistic putting drop in 2009 GDP at 4.2%.

the Organization for Economic Cooperation and Development (OECD) announced a downward revision of its growth forecasts for Spain's economy, putting them at a drop of 4.2% in 2009 and 0.9% in 2010.

In addition, in mid-June the government approved a plan to replace buses. Furthermore, the government gave impetus to a structural reform of the services sector taking advantage of the introduction of the corresponding EC directive. The bill approved by the government attempts to improve competition in the sector, removing bureaucratic rigidities and liberalizing certain activities. As a result, it is estimated there will be a positive impact on the GDP of 1.2% and an impact on employment of between 150,000 and 200,000 jobs.

SUPPLY INDICATORS

Percentage change over same period year before

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
Industry								
Electricity consumption (1)	5.2	1.0	3.9	0.7	–5.1	–8.9	–11.0	–8.2
Industrial production index (2)	2.0	–7.3	–5.4	–6.3	–16.6	–22.7	–19.7	...
Confidence indicator for industry (3)	–0.3	–18.0	–13.7	–18.7	–32.7	–36.7	–36.0	–35.0
Utilization of production capacity (4)	81.3	79.5	80.3	79.3	76.9	68.8	–	69.5
Imports of non-energy intermediate goods (5)	8.0	–0.7	6.9	–2.1	–18.2	–32.9	...	...
Construction								
Cement consumption	0.2	–23.5	–19.6	–25.2	–37.2	–44.7	–45.2	–39.1
Confidence indicator for construction (3)	9.3	–22.6	–17.3	–23.7	–34.7	–36.7	–40.0	–31.0
Housing (new construction approvals)	–24.7	–59.4	–56.0	–62.4	–60.2	–64.1	...	...
Government tendering	–15.0	3.0	–29.9	6.4	12.4	–5.7	...	...
Services								
Retail sales (6)	2.3	–6.3	–6.3	–7.1	–7.7	–6.3	–5.2	...
Foreign tourists	1.1	–2.4	1.3	–5.1	–9.0	–16.3	–1.7	...
Tourist revenue inflows	3.3	–0.4	1.3	0.2	–8.0	–17.2	...	...
Goods carried by rail (ton-km)	–3.7	–7.7	–3.5	–1.7	–23.0	–34.1	–43.1	...
Air passenger traffic	9.0	–3.1	–0.6	–4.9	–12.7	–18.2	–5.0	–11.9
Motor vehicle diesel fuel consumption	4.9	–3.8	–2.8	–3.7	–9.6	...	...	...

NOTES: (1) Adjusted for number of working days and temperature.
(2) Adjusted for difference in number of working days.
(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 deflated and corrected for calendar effects.
SOURCE: 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 Economy and Finances and own calculations.

Labour market

Labour market shows some easing of downturn

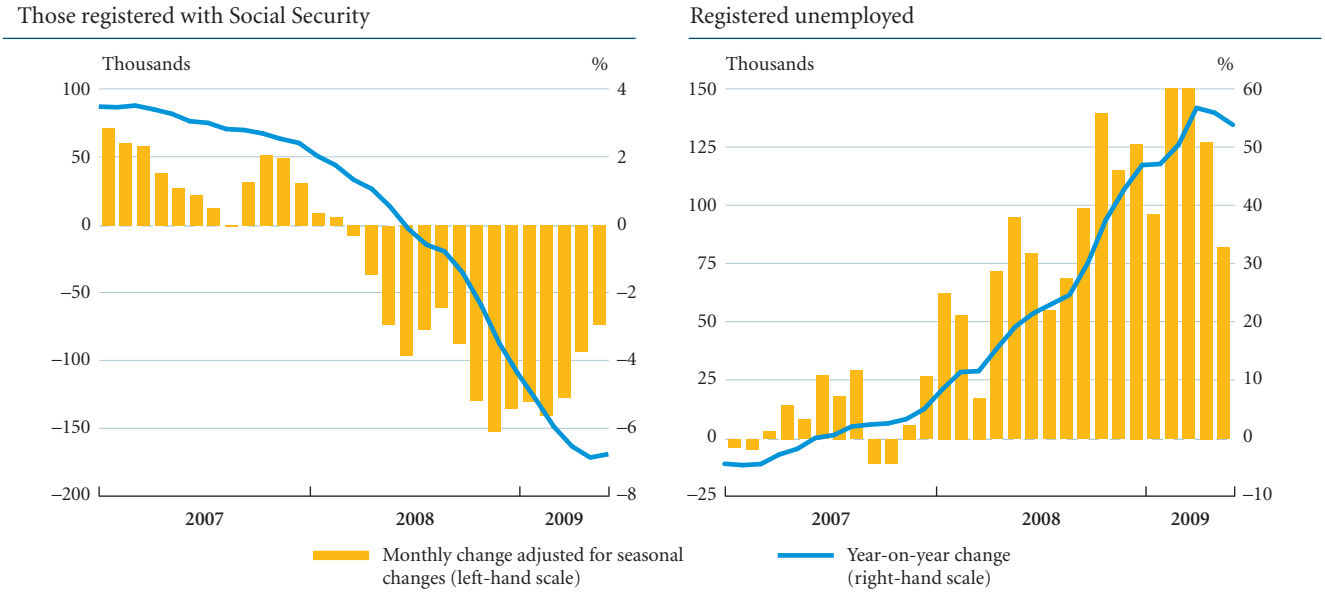
The loss of jobs slowed down in May given that those registered with Social Security as working showed a decrease of 72,930 in seasonally-adjusted terms (an increase of 69,307 in gross figures), a lower decrease than that recorded in previous months. At the same time, the increase in registered unemployment adjusted for seasonal changes slowed in May, reporting an increase of 82,340 (a drop of 24,741 in gross figures).

For the second month in a row, the figures showed some easing in the process of job loss and the increase in unemployment and this would partly suggest the beginning of a stage with less worsening in the labour market. Having an influence on this trend was the civil works programme introduced by the central government. The fact it was the construction sector that showed a drop in unemployment would indicate that the E Plan measures have had some effect. Nevertheless, it is possible that unemployment will go up again when those measures end.

Figures for those registered with Social Security show that in the past 12 months ending in May the drop in employment was substantially higher among foreign workers who reported a year-on-year drop of 10.6% as against 6.2% for Spanish nationals. Among foreign workers, those from the European Union were down 7.9% while those from outside the EU recorded a drop of 11.7%. With regard to type of hiring contract, the increase in those registered in gross figures was

Number of those registered with Social Security down 6.7% year-on-year.

DECLINE IN LABOUR MARKET EASING



SOURCE: Ministry of Labour and Social Affairs, INEM and own calculations.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	April	May
Persons registered with Social Security (1)								
Sectors of activity								
Industry	*2.4*	*–2.1*	*–1.1*	*–2.6*	*–5.6*	*–9.3*	*–10.1*	*–10.2*
Construction	*3.6*	*–10.3*	*–7.0*	*–12.4*	*–19.6*	*–25.3*	*–22.6*	*–21.4*
Services	*3.4*	*1.5*	*2.2*	*1.4*	*–0.4*	*–2.3*	*–3.8*	*–4.0*
Job situation								
Wage-earners	*3.1*	*–0.7*	*0.3*	*–1.1*	*–3.7*	*–6.3*	*–7.3*	*–7.1*
Non-wage-earners	*2.8*	*0.4*	*1.3*	*–0.1*	*–1.9*	*–3.9*	*–4.9*	*–5.0*
Total	**3.0**	**–0.5**	**0.5**	**–0.9**	**–3.4**	**–5.8**	**–6.8**	**–6.7**
Persons employed (2)	**3.1**	**–0.5**	**0.3**	**–0.8**	**–3.0**	**–6.4**	**–**	**–**
Jobs (3)	**2.9**	**–0.6**	**0.1**	**–0.9**	**–3.1**	**–6.0**	**–**	**–**
Hiring contracts registered (4)								
Permanent	2.0	–14.3	–5.6	–13.8	–26.0	–35.4	–41.1	–33.7
Temporary	0.3	–10.4	–7.4	–9.4	–17.9	–23.9	–27.6	–18.0
Total	**0.5**	**–10.9**	**–7.2**	**–9.9**	**–18.9**	**–25.4**	**–29.3**	**–19.8**

NOTES: (1) Average monthly figures.
(2) Estimate by Labour Force Survey.
(3) Equivalent to full-time work. National Accounting estimate; figures adjusted for seasonal effects and number of working days.
(4) At INEM.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Services, Employment Institute and own calculations.

Drop in employment sharper in small and medium-size businesses than in large companies.

exclusively concentrated in temporary work contracts given the fact that those on permanent contract continued to drop. Spain's production fabric based largely on construction, tourism and agriculture contributes to the fact that temporary work contracts hold such an important role, both in job creation and job losses.

In addition, according to the Labour Force Survey for the first quarter of 2009, job loss was sharper in small and medium-sized companies (operations with less than 250 employees), with a year-on-year drop of 10.4% in the number of workers. The decrease in large companies stood at 4.5%.

Labour costs continue to increase although at slower rate

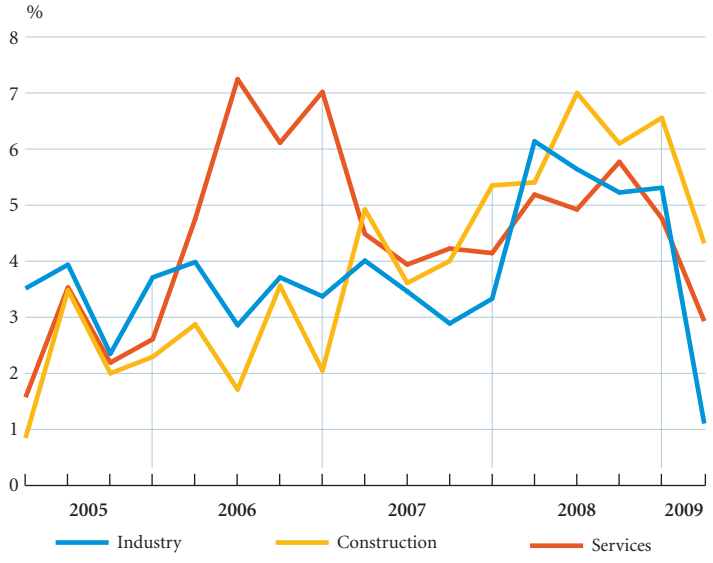
Decrease in inflation being passed through to wage costs.

In the first quarter of 2009, labour costs rose by 3.9% year-on-year, lower than the 5.8% reported in the previous quarter. The decrease in inflation is being passed through to labour costs. As a result, the drop is largely due to the wage component that increased by 2.8% year-on-year given that many wage revisions are indexed to inflation. The non-wage cost, which includes indemnities for firing, eased the drop in labour cost. If the worsening in the labour market slows down in the second quarter of 2009, non-wage costs should show some easing off.

By economic sector, construction is showing the biggest increase in overall wage cost, especially because of wage increases and termination indemnities. On the other hand, industry is showing lower growth in total wage costs due to the decrease in overtime and back-pay, along with indemnities for layoffs.

INDUSTRY LEADS EASING IN WAGE COSTS

Year-on-year change in ordinary wage costs per worker



SOURCE: National Institute of Statistics.

WAGE INDICATORS

Percentage change over same period year before

	2007	2008	2008			2009
			2Q	3Q	4Q	1Q
Increase under general wage agreements (*)	**3.1**	**3.6**	**3.5**	**3.5**	**3.6**	**2.7**
Wage per job equivalent to full-time work (**)	**3.7**	**5.3**	**5.4**	**5.3**	**5.2**	**4.0**
Quarterly labour cost survey						
Wage costs						
Total	4.0	5.4	5.4	5.8	5.1	2.8
Industry	*3.4*	*5.6*	*5.6*	*5.2*	*5.3*	*1.1*
Construction	*4.5*	*6.3*	*7.0*	*6.1*	*6.6*	*4.3*
Services	*4.2*	*5.1*	*4.9*	*5.8*	*4.8*	*2.9*
Average wages per hour worked	4.6	5.1	2.3	6.3	3.0	2.5
Other labour costs	4.1	4.5	4.4	3.9	6.0	6.8
Work day (***)	–0.5	0.2	3.0	–0.6	2.1	0.4
Farm wages	**3.1**	**5.1**	**5.2**	**6.1**	**4.5**	**3.2**
Labour cost in construction	**2.4**	**5.7**	**6.4**	**7.6**	**7.9**	**7.5**

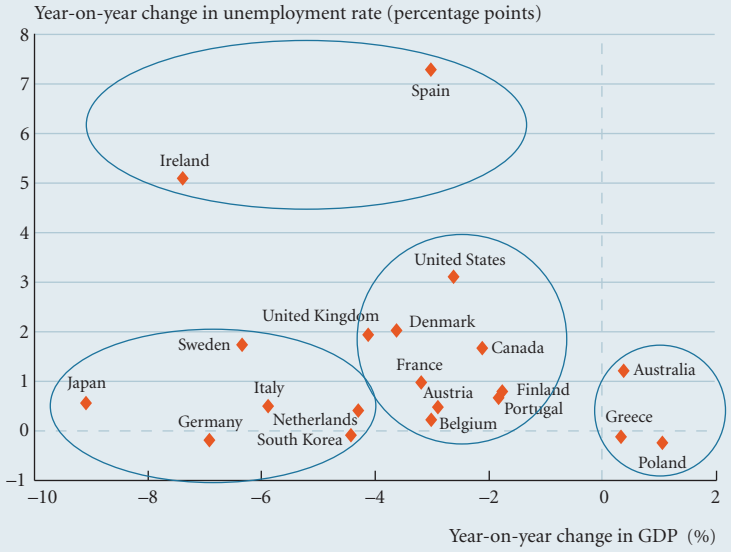
NOTES: (*) Does not include wage revision clauses. Cumulative figures.
(**) Quarterly National Accounts: figures adjusted for seasonal and calendar differences.
(***) Effective hours worked per worker per month.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fishing and Food, Ministry of Public Works and own calculations.

The recession and the labour market: comparative prospects of various countries

The world financial crisis, that began with subprime mortgages in the United States in the summer of 2007, has shifted to the real economy and this has generated a recession in the labour market. Nevertheless, the loss of jobs has been very uneven in the various economies. Let us see how and why.

The graph below includes most of the main countries in the Organization for Economic Cooperation and Development (OECD) according to the sharpness of the economic slowdown and the increase in the unemployment rate over the past year. We should point out that it is possible that the various countries included may stand at different stages of their economic cycle and that, for this reason, the comparison may be somewhat biased, so that the graph should be interpreted with due caution.

NOTABLE CONTRAST BETWEEN COUNTRIES IN THEIR ABILITY TO PREVENT UNEMPLOYMENT



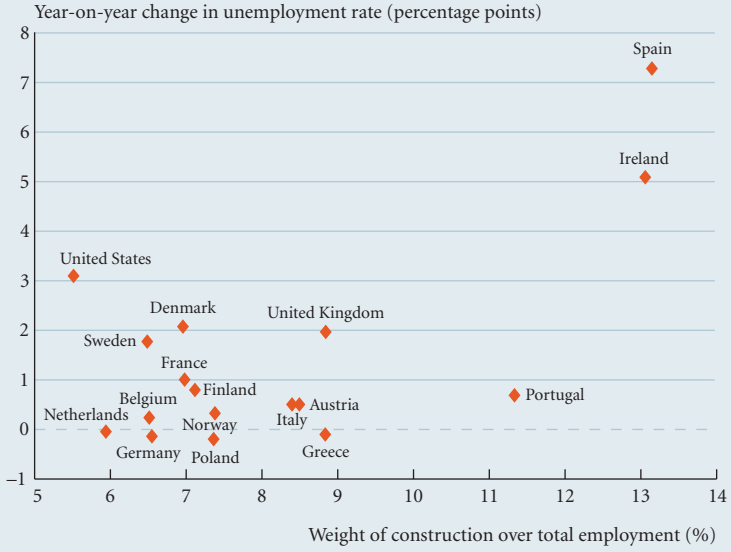
NOTES: Figures for the first quarter of 2009. In Denmark, Portugal and Finland, the year-on-year change in GDP is for the fourth quarter of 2008. In Italy and Greece, the year-on-year change in unemployment rate is for the fourth quarter of 2008.
SOURCE: OECD and own calculations.

Grosso modo, the countries break down into four groups. The first group is made up of Greece, Poland and Australia which, for the moment, have not seen drops in gross domestic product (GDP). The second group, characterized by a major slowdown in economic activity and a relatively slight increase in unemployment, is made up of Austria, France, Finland, Portugal, Canada, United States, United Kingdom and Belgium. The third group includes those economies that have undergone the worst drops in GDP but whose unemployment has risen very little (Netherlands, Italy, Germany, Sweden, South Korea and Japan). Finally, Spain and Ireland are the most extreme cases as they are characterized by a significant drop in GDP accompanied by a notable worsening of the labour market. While there is the possibility that in some of these cases the transmission of the economic recession to the labour market may take place later, the prospects for 2009 maintain the same pattern.

The varied response of the labour market is thus evident. Some of the factors explaining this are the differences in the weight of the construction sector and the importance of the real estate bubble, the nature of government regulation of employment and the ability of the labour market to adapt to the ups and downs of the real economy.

First of all, we note the variations in the contribution of the construction sector to total employment. We can expect a worse performance in the labour market in those countries showing a combination of a relatively higher volume of workers in construction and a real estate bubble. The following graph indeed shows a positive association between the relative importance of employment in construction and an increase in the unemployment rate, something especially notable in Spain and Ireland. Both countries, according to the Bank for International Settlements, also reported very notable increases in real estate prices from 2000 on and up to the economic recession (86% and 63% respectively).

CONSTRUCTION SECTOR HOLDS HEAVY WEIGHT IN SPAIN AND IRELAND



NOTES: Figures for unemployment in first quarter of 2009. In Italy, Norway and Greece, the year-on-year change in unemployment rate corresponds to the fourth quarter of 2008. The weight of construction is calculated for the final quarter of 2007.
SOURCE: Eurostat, Bureau of Labor Statistics (BLS) and own calculations.

The weight of construction over total employment is less in the United States, Denmark, United Kingdom and Sweden because their economies are more diversified. Nevertheless, the increase in unemployment is not to be dismissed and it is probable that real estate bubble in these economies played an important role (in all these countries prices rose by more than 60%). In the other countries, with the exception of France and Belgium, real estate price increases were more moderate. In these two economies, however, the role of construction employment over the total volume of the labour force is lower, which would explain the slight impact on unemployment.

A second element creating variations in the performance of unemployment are the different government regulations on labour relations. We should especially mention the fact that some governments allow companies in difficulties to reduce the working day and wages of their workers, with the lost wages being compensated by payments from the public sector. In this way, they avoid dismissals in sectors affected by the recession.

The most notable case is the German system of reducing the working day with government help (Kurzarbeit). In March, some 1,246,618 workers were in this situation as against 3.398,000 persons unemployed. If this mechanism did not exist, the total number of unemployed would likely be much higher in Germany. Other countries, such as Belgium, France, Austria and the Netherlands also have programmes similar to that of Germany. As a result, those countries with generous plans of this type are managing to ease, at least in terms of current figures, the state of recession in the labour sphere. In the case of Spain, this plan would be similar to those offering the suspension or reduction of the work day. This programme has less coverage and in March involved only 49,220 workers, a relatively insignificant figure compared with the four million unemployed.

Regarding this partial unemployment schemes, the European Central Bank recognizes that they may be efficient in protecting the human capital of companies in short-term recessive stages. Nevertheless, it advises against them over the long term given that they may reduce the incentive of companies and workers to carry out reconversions or investments.

In addition, government regulation may affect the ability of the labour market to adapt to changes in the economy. The system of trade training, labour organizations and methods of determining wages have an influence on this ability to adjust.

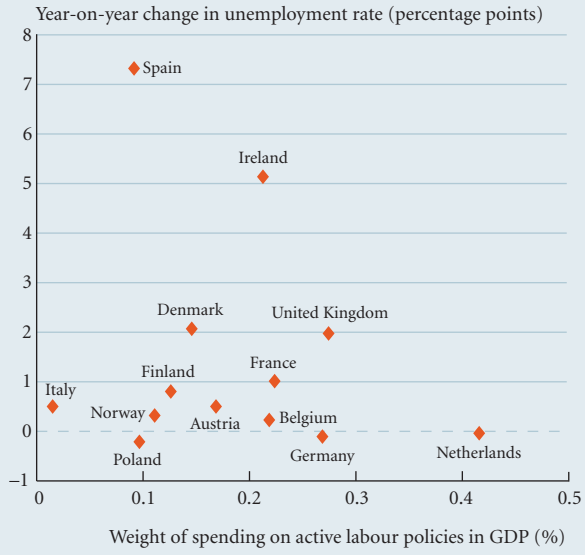
With regard to training, studies show that shifts to unemployment within a country are greater in the group with a low level of education (see, for example, Labour Recession Observatory for last April published by FEDEA regarding the case of Spain). In this context, it would seem reasonable that this relation would persist at a more broken-down level. Those economies based on low-skill jobs or with a high rate of school drop-out probably have a higher risk of showing a sharp increase in the number of unemployed. In Spain, this factor may have contributed to the rise in unemployment. In 2008, for example, Spain led in ranking of low-skilled jobs in the EU-15 (14.4%), five points above Germany and France. It also headed the list for school drop-out, standing lower only than Portugal.

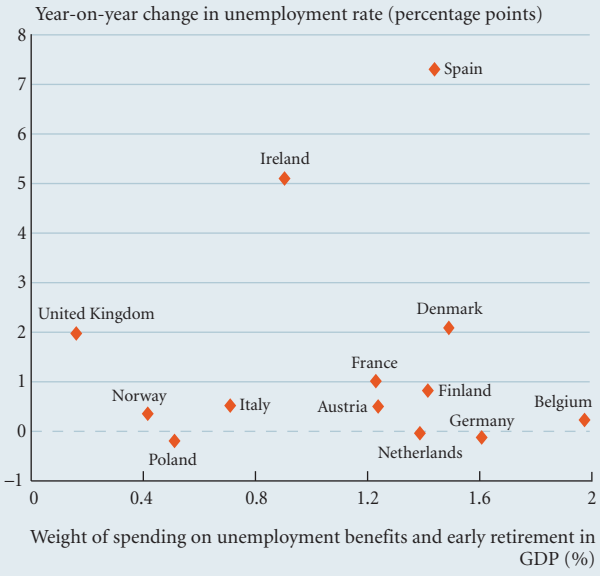
On the other hand, training received during a lifetime means that workers (especially for those who are older) are better prepared to deal with change and are more mobile. In this respect, the differences between countries are also notable. For example, whereas in Sweden some 62% of workers between 55-64 years had some training in 2007, the figure in Spain was 14%.

With regard to the role of labour bodies, their effect on the overall unemployment picture is not clear. While generally it is felt that the so-called active market policies (training, incentives for starting a business, etc.) are more effective in preventing unemployment that unemployment benefits and early retirement, the empirical evidence is complex. For example, as shown in the accompanying graph, the increase in unemployment is generally lower in those countries that spend more on active labour market policies. On the other hand, there is a positive correlation, although weak, between spending on unemployment subsidies and the increase in unemployment.

Finally, it is logical to believe that those countries with greater rigidity in wage determination would show more pronounced increases in unemployment in periods of recession. This is so because, if companies cannot adjust to weakness in demand through wage moderation, they will do so through lay-offs. This would suggest that in the past year we should have seen bigger wage increases in those economies where unemployment has grown relatively higher. Nevertheless, figures available up to this date do not make it possible to clearly confirm the expected positive correlation between wage increases and higher unemployment.

DOUBTFUL CORRELATION BETWEEN ACTIVE AND PASSIVE LABOUR MARKET POLICIES AND TREND IN UNEMPLOYMENT





NOTES: Unemployment figures for first quarter of 2009. In Italy and Norway year-on-year change in unemployment rate corresponds to fourth quarter of 2008. Spending on active labour market policies in 2007.
SOURCE: Eurostat and own calculations.

To sum up, the rate of increase in unemployment varies considerably between countries and does not necessarily correspond to the sharpness of the downturn in economic activity. The sector structure, government regulations and active and passive labour market policies, among other factors, have an influence on the trend in the labour market to a greater or lesser extent.

This box was prepared by Maria Gutiérrez-Domènech
European Economy Department, "la Caixa" Research Department

Prices

Third month in row to show year-on-year drop in CPI

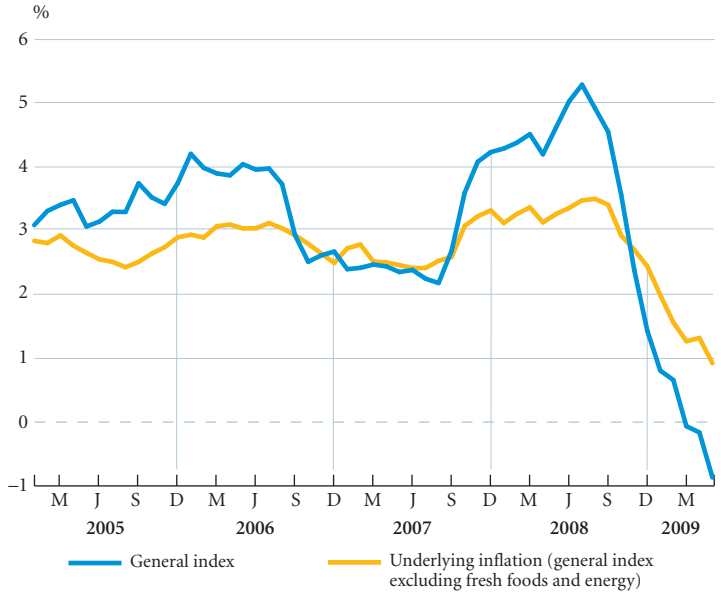
Historic decrease in consumer prices.

In May consumer prices continued the downturn that began in August 2008 with the halt to the rise in commodity prices, especially in oil prices. As a result, toward the end of Spring the year-on-year change rate in the consumer price index (CPI) was negative for the third month in a row recording a decrease of 0.9% compared with May 2008, the biggest in recent decades. This year-on-year drop was higher than expected and reflects deflationary pressures arising from the sharp contraction in consumption. In fact, in order to compete in this environment, many companies have had to allow price discounts or to lower them noticeably.

The general level of prices dropped very slightly in May and the year-on-year change rate of the GDP went down 7 decimals compared with the month before. This reduction was largely due (by 4 decimals) to fuels and fuel-oils, given that in May prices rose less than in the same month of 2008 with a year-on-year change rate at –22.8%, the lowest level in recent decades. Unprocessed foods also contributed to the decrease in prices, although to a much lesser extent, thanks to moderation in the prices of chicken and fresh fruit.

UNDERLYING INFLATION BELOW 1%

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

The stable core of inflation, so-called underlying inflation, which excludes energy products and unprocessed foods, contributed 3 decimals to the year-on-year drop in inflation in May. Underlying inflation was down to 0.9%, some 4 decimals less than in April, and thus showed the lowest level in recent decades. This is an indicator of the deflationary pressures to which the economy has been subject in the deepest recession in recent times.

Underlying inflation also marks up lowest level in recent decades, reflecting deflationary pressures arising from contraction in consumption.

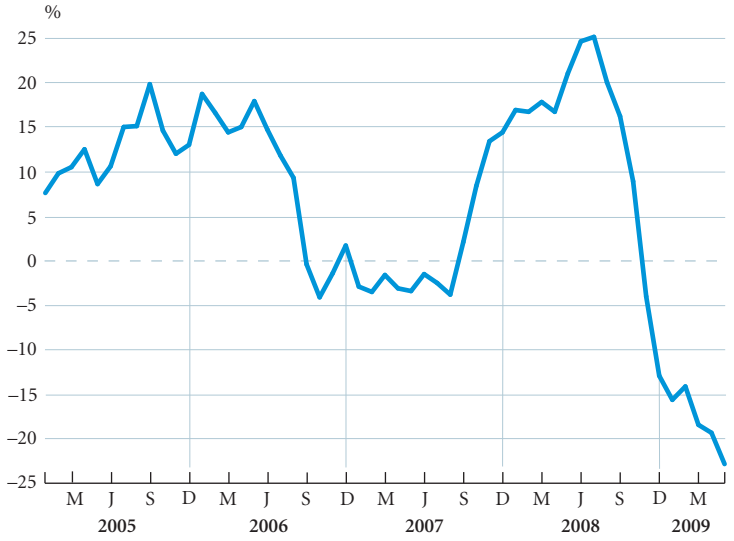
CONSUMER PRICE INDEX

	2008			2009		
	% monthly change	% change over December 2007	% annual change	% monthly change	% change over December 2008	% annual change
January	–0.6	–0.6	4.3	–1.2	–1.2	0.8
February	0.2	–0.5	4.4	0.0	–1.2	0.7
March	0.9	0.4	4.5	0.2	–1.1	–0.1
April	1.1	1.5	4.2	1.0	–0.1	–0.2
May	0.7	2.2	4.6	0.0	–0.1	–0.9
June	0.6	2.8	5.0			
July	–0.5	2.3	5.3			
August	–0.2	2.1	4.9			
September	0.0	2.0	4.5			
October	0.3	2.4	3.6			
November	–0.4	2.0	2.4			
December	–0.5	1.4	1.4			

SOURCE: National Institute of Statistics.

FUELS AND FUEL-OILS PUSH INFLATION DOWN IN MAY

Year-on-year change in price of fuels and fuel-oils



SOURCE: National Institute of Statistics.

Food prices drop in last 12 months.

Looking at underlying inflation, prices of processed foods stood at the same level as 12 months earlier and contributed one decimal to the reduction of year-on-year inflation. Also notable was the 8.8% year-on-year drop in the price of milk, some 2.3 points more than in the previous month. In turn, prices of industrial goods, excluding energy products, sharpened their decrease to 0.8% due to strong competition in international markets. Services also showed the contraction in demand and, in spite of being more sheltered from foreign competition, their year-on-year change rate went down a half-point to 2.6%, the lowest level in recent decades.

Inflation differential with Euro Area reaches new negative record of –0.9%.

The consumer price index harmonized with the European Union also recorded a year-on-year drop of 0.9%. As a result, the negative differential with the Euro Area rose to 0.9 percentage points, a new record. This may partly be attributed to the greater weight of energy products and foods in the Spanish index although the differential in terms of underlying inflation was also negative.

CONSUMER PRICE INDEX BY COMPONENT GROUP

May

	Indices (*)	% monthly change		% change over previous December		% monthly change	
		2008	2009	2008	2009	2008	2009
By type of spending							
Food and non-alcoholic beverages	108.5	0.2	–0.5	1.2	–2.0	6.7	–0.8
Alcoholic beverages and tobacco	115.6	0.1	0.0	3.5	3.5	4.1	3.9
Clothing and footwear	106.2	1.3	1.6	–0.4	–2.4	0.8	–1.5
Housing	111.0	0.7	–0.1	4.4	–0.6	6.6	0.8
Furnishings and household equipment	107.2	0.5	0.3	1.6	0.6	2.5	1.6
Health	97.3	–0.6	–2.1	–0.4	–1.5	0.4	–0.9
Transport	100.9	2.5	0.8	5.3	1.4	8.4	–9.1
Communications	99.5	0.0	–0.2	0.3	–0.1	0.1	–0.7
Recreation and culture	98.6	0.1	–1.5	–0.9	–1.2	–0.6	0.0
Education	111.7	0.0	0.0	0.3	0.2	3.9	3.9
Restaurants and hotels	111.7	0.2	–0.1	3.1	1.1	4.8	2.1
Other goods and services	109.4	0.1	0.0	2.6	1.7	3.2	2.7
By group							
Processed food, beverages and tobacco	110.3	0.2	–0.4	2.3	–0.7	7.5	0.0
Unprocessed food	107.3	0.1	–0.5	–0.4	–2.6	4.1	–0.6
Non-food products	105.9	0.8	0.1	2.4	0.2	4.0	–1.1
Industrial goods	101.8	1.4	0.4	2.5	–0.7	4.2	–4.6
Energy products	*100.4*	*4.3*	*0.9*	*10.1*	*0.6*	*16.5*	*–15.3*
Fuels and oils	*94.5*	*5.7*	*1.2*	*12.4*	*–0.4*	*21.0*	*–22.8*
Industrial goods excluding energy products	*102.0*	*0.3*	*0.3*	*0.0*	*–1.2*	*0.2*	*–0.8*
Services	110.2	0.2	–0.3	2.3	1.1	3.8	2.6
Underlying inflation (**)	107.3	0.3	–0.1	1.5	0.0	3.3	0.9
GENERAL INDEX	**106.8**	**0.7**	**0.0**	**2.2**	**–0.1**	**4.6**	**–0.9**

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

From our analysis it would appear that the fact that inflation was negative was mainly due to the trend in commodity prices in recent months. Given that these prices reached their peak in July 2008, forecasts suggest further decreases in inflation in coming months. Nevertheless, as of mid-summer it is likely that there will be a rise in inflation that will put the end of the year on positive ground.

Producer prices report biggest drop in recent decades

The trend to deflation in wholesale prices continued in April. The year-on-year change rate in producer prices was –3.4%, reporting the lowest level in recent decades. This drop was a reflection of the collapse in commodity prices in the past year, in spite of the rise seen in recent months and of the weakness in demand. All the main components of producer prices showed a downward trend, with the year-on-year decreases in energy and intermediate goods being most notable.

The annual decrease in import prices stood at 7.4%. All components, with the exception of capital goods, eased in a situation of fierce competition in international markets. The change rate for capital goods rose by one decimal to 3.2% under the effect of the depreciation of the euro over the past 12 months.

Prospects for bigger drops in inflation in coming months but with an upturn as of mid-summer.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflator (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2008											
April	7.8	6.6	5.1	2.5	5.8	13.3	6.9	0.6	–0.4	2.3	–
May	16.3	7.4	5.1	2.3	5.9	17.4	9.2	0.7	–0.1	2.5	3.1
June	9.2	8.4	5.2	2.3	6.2	21.1	10.4	1.1	–0.2	2.6	–
July	12.6	10.2	5.1	2.5	7.3	27.4	10.4	0.5	–0.2	3.7	–
August	6.0	9.2	4.8	2.5	7.6	23.2	9.6	1.3	0.3	5.0	3.4
September	–0.8	8.3	4.1	2.4	7.1	19.9	8.5	1.9	0.6	5.9	–
October	–7.6	6.1	2.8	2.4	5.3	14.9	5.2	3.2	1.3	5.1	–
November	–10.5	2.9	2.2	2.3	2.9	4.3	0.9	4.3	1.9	5.0	2.5
December	–10.3	0.4	1.6	2.3	1.0	–3.4	–3.9	2.6	1.6	2.0	–
2009											
January	–7.2	–0.5	0.9	1.9	–1.6	–2.2	–4.9	2.8	2.0	0.4	–
February	–5.4	–1.1	0.4	1.5	–3.2	–1.9	–5.6	3.1	2.6	–1.2	1.3
March	–7.1	–2.5	–0.4	1.3	–4.4	–4.9	–6.9	2.7	3.1	–2.7	–
April	...	–3.4	–0.8	1.2	–5.5	–6.7	–7.4	2.4	3.2	–3.6	–

NOTES: (*) Figures adjusted for seasonal and working days effects.
(**) Except energy.
SOURCE: National Institute of Statistics, Ministry of Economy and own calculations.

Foreign sector

Current account deficit down to 8.8% of GDP in March.

Current account deficit keeps being reduced

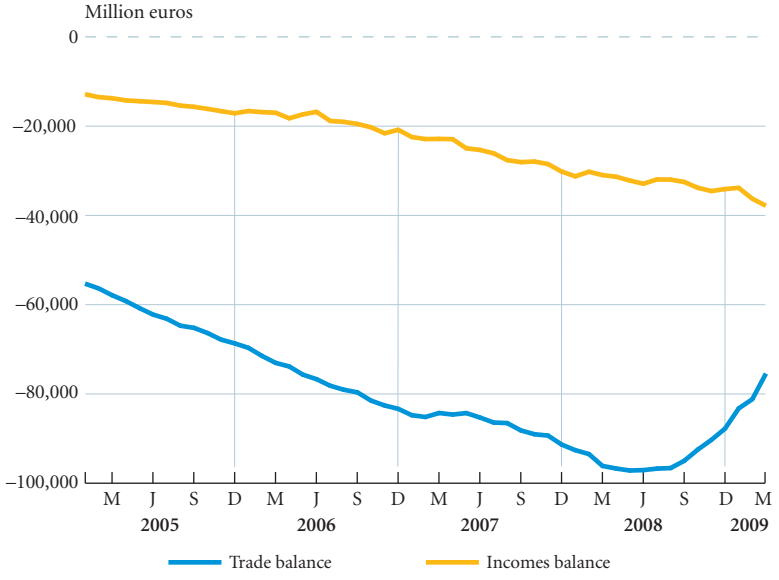
As is the case in most developed economies, Spain's exports have undergone a major contraction in recent months. Nevertheless, the bigger drop in imports in the first quarter, fostered by the decrease in domestic demand and the contraction in energy product prices, made possible a 47.7% reduction in the trade deficit compared with the same period in 2008, thus maintaining the trend begun in recent months.

This improvement in Spain's trade deficit is the main reason for the improvement in the current account imbalance. The monthly figures show that Spain's current account deficit was 42.1% lower than in the same month in 2008, making this the ninth year-on-year decrease in ten months. This meant that the cumulative deficit for the past year was down to 8.8% of gross domestic product (GDP) in March. While this figure is 1.7 percentage points lower than the high recorded one year ago, it remains on very high level and we expect that the same trend will be maintained in 2009 putting it below 7% of GDP.

The improvement in current account deficit in the past year was almost entirely due to the performance in the goods balance, which showed a reduction in deficit of more than 20 billion euros, as may be seen in the graph

TRADE AND INCOMES BALANCES: HEADING FOR A COLLISION?

Cumulative balance in past 12 months



SOURCE: Bank of Spain Balance of Payments and own calculations.

BALANCE OF PAYMENTS

March 2009

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–12,835	–49.0	–75,342	20,683	–21.5
Services					
Tourism	*4,081*	*–15.5*	*27,318*	*–613*	*–2.2*
Other services	*–613*	*–40.2*	*–1,151*	*3,122*	*–73.1*
Total	3,467	–8.9	26,167	2,510	10.6
Income	–10,322	56.8	–37,794	–6,855	22.2
Transfers	–3,601	–17.9	–8,467	302	–3.4
Total	**–23,290**	**–27.9**	**–95,436**	**16,639**	**–14.8**
Capital account	**660**	**–70.5**	**3,982**	**–1,707**	**–30.0**
Financial balance					
Direct investment	–7,813	–	–20,877	17,340	–45.4
Portfolio investment	9,261	–	43,033	20,564	91.5
Other investment	19,858	–63.6	33,922	–68,094	–66.7
Total	**21,305**	**–29.0**	**56,078**	**–30,191**	**–35.0**
Errors and omissions	1,842	32.9	4,444	3,145	242.0
Change in assets of Bank of Spain	–517	–60.6	30,932	12,113	64.4

NOTES: 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.
SOURCE: Bank of Spain and own calculations.

on the previous page. This positive contribution, however, was partly reduced by the increase in the deficit in the incomes balance which was up by 6.85 billion euros compared with March 2008. The worsening of the figure for the incomes balance was the result of the increased indebtedness of Spain's economy to the rest of the world in recent years, with the increase in interest payments this involves. As a result, the weight of the deficit in the incomes balance in terms of the current account deficit in the first quarter of 2009 was very similar to that of the trade deficit.

High leveraging continues to increase deficit in incomes balance.

In spite of the contraction in the still positive capital account balance, the improvement in the current account deficit reduced the financing need of Spain's economy by 14.0% putting it at levels similar to those in 2006 (8.4% of GDP). From the perspective of institutional sectors, this reduction came about as a result of the trend in net savings of households and companies which counteracted the higher leverage of general government in the past year.

The cover for Spain's still high deficit came from two alternative sources – the increase in net liabilities of the Bank of Spain and the attraction of foreign funds by resident sectors. The increase in net liabilities of the Bank of Spain was due to the change in the coverage of deficits of financial institutions, especially to greater recourse to Eurosystem liquidity auctions. Nevertheless, the size of this recourse dropped in the first quarter of

Financing need is being reduced.

Short-term borrowing beginning to lose importance.

2009 due to the easing of borrowing restrictions for financial institutions. This may be seen in the increase in net assets of the Bank of Spain (517 million euros in this period), a trend expected to be maintained in coming months.

Funds obtained by resident sectors also showed a significant change with a reduction of more than 30 billion euros. Furthermore, this reduction was accompanied by a change in the composition of borrowing obtained over the past 12 months. As a result, short-term financing, which in March last year became the main source of foreign funds, showed less importance with a reduction of 70 billion euros. On the other hand, net foreign portfolio investment continued to increase and again became the main source of foreign financing. This increase, however, was mainly due to lower Spanish portfolio investment abroad. Direct investment, both Spanish and foreign, held at very low levels in March, similar to those in 2005. Nevertheless, Spain's net direct investment abroad continued to increase.

Public sector

Sharp reduction in central government revenues in first four months of year

The recessive situation is continuing to have an unfavourable impact on central government accounts. On the one hand, revenues keep going down, not only because of lower taxable incomes but also because of regulatory changes aimed at raising liquidity of households and companies. Furthermore, spending has gone up substantially, partly due to the increase in unemployment benefits following the spectacular increase in the number of unemployed and the government plan to stimulate the economy.

In the first four months of the year total central government non-financial revenue, including those segments ceded to autonomous communities and local government under current financial arrangements, was down 12.6% compared with the same period in 2008. Direct taxes were down 4.7% compared with the same period last year. Collections under the main heading, personal income tax, were down 11.7% largely due to a decrease in worker pay hold-backs which were affected by a notable drop in employment, moderation in wages and the impact of the early tax deduction of up to 400 euros. Furthermore, tax postponements were on the increase. While hold-backs

Recessive situation continues to have unfavourable impact on central government accounts.

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

April 2009

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**14,613**	**–19.1**	**45,882**	**–18.4**
Non-financial revenue adjusted (*)				
Personal income tax	7,797	–16.4	26,800	–11.7
Corporate tax	4,086	140.1	5,109	59.0
VAT	3,696	–52.3	17,970	–33.6
Special taxes	1,565	1.2	6,111	–3.8
Other	2,230	–1.0	8,934	23.0
Total	**19,374**	**–14.2**	**64,924**	**–12.6**
Non-financial spending	**11,735**	**7.1**	**54,349**	**13.5**
Treasury balance	**2,878**	**–59.5**	**–8,467**	**–**
Surplus (+) or deficit (–) (**)	***1,033***	***–82.0***	***–6,553***	**–**

NOTES: (*) Includes tax segments ceded to regional and local governments under current financing system.
(**) In terms of National Accounting.
SOURCE: Ministry of Economy and Finance and own calculations.

Collections for company tax down 28% in homogeneous terms, reflecting drop in corporate profits.

on capital earnings were up, those on leasing and investment funds gains showed a decrease.

Collections for company tax were up by 59.0% but this was largely due to the fact that in 2008 companies were allowed to postpone the first instalment and to other regulatory changes. In homogeneous terms, company tax collections were down 27.7%, reflecting the decrease in corporate profits.

Indirect taxes dropped by 27.5%. The most important heading, value added tax (VAT), showed a year-on-year drop of 33.6%. This decrease was due to the contraction in consumption and imports but also was a result of earlier rebates, of a broadening of the right to request monthly rebates and longer postponement periods. In turn, special taxes showed a more moderate decrease (down to 3.8%), thanks to taxes on tobacco and petroleum products.

Public deficit increasing.

Other revenues were up 23.0%. Commissions collected on guarantees granted for bond issues of financial institutions under the Concerted Action Plan of the Euro Area Countries contributed to this increase.

On the other side of the account, total non-financial spending was up 13.5% in the first four months of the year compared with the same period in 2008. Current spending rose by 4.8%. Under this heading personnel costs rose by 2.9%. Purchases of goods and services were down 0.4% while financial costs rose by 2.2%. The biggest heading, current transfers, were up by 6.2%. There was a notable payment of 2 billion euros to the Public Employment Service with no outlay the year before.

Government raises special taxes on tobacco and petroleum products.

Capital spending was up 79.6%, putting the figure at 10.03 billion euros in the first four months of the year. Real investments rose by 7.8% while the largest heading, capital transfers, went up by 178.2% to reach 6.54 billion euros. This extraordinary increase was largely due to payments under the State Fund for Local Government Investments as part of the central government plan to stimulate the economy.

As a result of the trend in government revenue and spending, there was a non-financial deficit of 8.47 billion euros, in contrast to a surplus of 8.38 billion euros recorded in the January-April period last year. In terms of National Accounting, that is to say, taking into account rights and obligations due, there was a deficit of 6.55 billion euros, equivalent to 0.6% of gross domestic product.

In this environment, at the end of the second week of June the central government adopted a new series of fiscal and budgetary measures. It approved extraordinary credits of close to 20 billion euros to meet commitments related to unemployment benefits, job promotion, health, safety and reactivation of economic activity. Furthermore, the Autonomous Communities were compensated for the removal of property taxes to the extent of 1.8 billion euros. On the other hand, taxes were increased on tobacco as a contribution to the sustainability of the public accounts and to foster health. At the same time, taxes on petroleum products were raised by 2.9 cents per litre except on diesel fuel for transport, farming and heating purposes. On the other hand, under a new revision of the aims of budgetary stability for the next three years, the central government raised the forecast for the public deficit in 2010 to 7.9% of GDP although with the prospect of putting it at 3.0% in 2012.

Savings and financing

Deleveraging of private sector continuing

The 1-year Euribor, an interest rate widely used as a reference for loans, marked up a new all-time low going to 1.64% on monthly average, some 335 basis points below the same month in 2008. At the end of June, the Euribor again broke its all-time low going to 1.53%.

One-year Euribor marks up new all-time low in June...

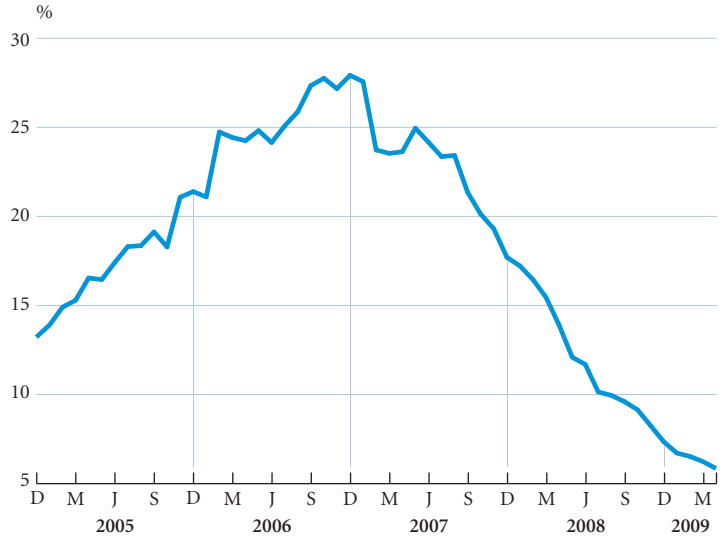
In turn, interest rates on new private sector transactions at credit institutions have also dropped appreciably since October 2008. The average interest rate went down to 3.88% in April, some 213 basis points less than 12 months earlier. The lower reduction than that in the interbank rate may be explained by the increase in the risk premium arising from the sharp increase in default. On the other hand, given that in the same period the inflation rate fell more, in effect real interest rates rose.

This, along with weakness in demand for funding due to the contraction in consumption and investment, meant that financing granted to the private sector continued on a downward track. In April, the year-on-year change rate stood at 4.1%, some 2 points less than in December. Nevertheless, in recent months we note something of a slowdown in growth rate in line with the improved situation in the liquidity of financial institutions.

...and interest rates on private sector loans also down in spite of increase in risk premiums.

SLOWDOWN EASING IN PRIVATE SECTOR FINANCING

Year-on-year change rate in private sector financing



SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

April 2009

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	58,201	–16,014	–21.6	–27,239	–31.9	3.1
Secured loans (*)	1,104,539	–4,258	–0.4	13,347	1.2	59.5
Other term loans	522,219	–7,238	–1.4	10,390	2.0	28.1
Demand loans	46,508	–2,621	–5.3	4,043	9.5	2.5
Leasing	42,399	–2,830	–6.3	–4,533	–9.7	2.3
Doubtful loans	83,658	20,601	32.7	58,751	235.9	4.5
TOTAL	**1,857,522**	**–12,359**	**–0.7**	**54,759**	**3.0**	**100.0**

NOTES : (*) Greater part made up of secured mortgage loans.
SOURCE: Bank of Spain and own calculations.

Notable slowdown in credit granted to private sector.

On the other hand, the growth of credit granted to the private sector in the past 12 months was slightly higher than that for the Euro Area as a whole and even more so in real terms as the inflation differential was negative.

In the first four months of the year, the slowdown in funding was not as sharp in companies as it was in households. The total for companies rose by 5.8% at the end of April compared with the same month last year, 1.5 points less than in December 2008. Commercial credit, used to finance working capital, continued to contract and showed a year-on-year decrease of 31.9%. Nevertheless, funding obtained by large companies through bond issues was up 24.1% over the past year.

Large companies increase bond issues.

The slowdown in credit granted to companies was mainly in the construction sector. In fact, total loans going to this sector was down 8.4% at the end of the first quarter compared with the same period last year. The total for the primary sector (agriculture, livestock raising and fishing) was lower than the figure for one year ago. With regard to services, here also we note some easing although the year-on-year change rate rose by 8.0%. Among these, credit granted for real estate activities moderated slightly with year-on-year growth of 3.8%. With regard to industry, this held to an annual increase slightly above 10.0%.

Total funding granted to households up in April following four months of decreases in a row.

Growth of funding granted to households in the past 12 months ending in April was 1.7%. We should point out that in April the total for this type of funding rose following four months of decreases in a row. Loans for housing purposes continued to ease going to a year-on-year increase of 1.8% in April. In turn, credit for purchase of consumer durables slowed much more, to the point that at the end of the first quarter it showed a drop of 12.0% compared with 12 months earlier.

This trend was in keeping with the sharp rise in default in this type of credit to 7.3% at the end of March, as against an average rate of 4.3%. In turn, default in loans for home buying with mortgage collateral stood at 2.8%, well below average. At the same time, the doubtful loan rate in the case of real estate developers stood at 7.6%. In April, the

CREDIT TO PRIVATE SECTOR BY PURPOSE

First quarter of 2009

	Balance (*)	Change this year		Change over 12 months	
	Million euros	Million euros	%	Million euros	%
Financing of production activities					
Agriculture, livestock raising and fishing	24,492	–1,751	–6.7	–511	–2.0
Industry	158,707	2,566	1.6	14,891	10.4
Construction	141,308	–10,540	–6.9	–12,929	–8.4
Services	690,161	7,446	1.1	50,886	8.0
Total	**1,014,668**	**–2,279**	**–0.2**	**52,338**	**5.4**
Financing to individuals					
Acquisition and renovation of own home	645,979	–3,871	–0.6	15,818	2.5
Acquisition of consumer durables	50,493	–3,683	–6.8	–6,864	–12.0
Other financing	110,523	–4,863	–4.2	–4,217	–3.7
Total	**806,995**	**–12,417**	**–1.5**	**4,736**	**0.6**
Financing to private non-profit institutions	**5,125**	**–966**	**–15.9**	**–679**	**–11.7**
Other unclassified	**34,958**	**7,527**	**27.4**	**11,996**	**52.2**
TOTAL	**1,861,747**	**–8,135**	**–0.4**	**68,391**	**3.8**

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

default rate for lending institutions as a whole continued to rise going to 4.5%. In this context of increasing default, around the middle of June, Moody's rating agency lowered its figures for 30 Spanish banking institutions.

In environment of increasing default Moody's agency cuts ratings of 30 Spanish banking institutions.

In this situation, the Minister for Economy and Finance, Elena Salgado, let it be known that she was planning a bank reconstruction fund with the backing of 9 billion euros. This fund could borrow up to 90 billion euros in order to finance recapitalization and mergers of financial institutions in case of need. This measure is in line with those adopted in other European countries and on the other side of the Atlantic.

In turn, net funding of general government continued to rise sharply in April to show a figure 26.9% above one year earlier. Nevertheless, a substantial part of the new financial resources available during the month went to increase bank deposits. As a result, government borrowing counteracted the trend to deleveraging in the private sector so that total funding in April maintained an annual rate of increase of 6.7%.

Deposits easing off but less than loans

Returns on bank deposits have also tended to drop since October 2008. Nevertheless, in the past 12 months ending in April on average deposits were down less than loans (137 basis points) and went to 1.59%.

In this context, growth of bank deposits eased slightly to show year-on-year growth of 11.0%, substantially higher

Fund for restructuring banking system in the offing.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

April 2009

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	243,415	–1,397	–0.6	5,565	2.3	17.2
Savings deposits	184,636	4,859	2.7	12,764	7.4	13.1
Term deposits	737,327	8,055	1.1	104,598	16.5	52.2
Deposits in foreign currency	26,902	–2,415	–8.2	–4,734	–15.0	1.9
Total deposits	**1,192,280**	**9,102**	**0.8**	**118,193**	**11.0**	**84.5**
Other liabilities (*)	**219,523**	**–29,107**	**–11.7**	**–44,894**	**–17.0**	**15.5**
TOTAL	**1,411,803**	**–20,005**	**–1.4**	**73,300**	**5.5**	**100.0**

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

Financial institutions strengthening equity through preferred stock issues.

than in the case of credit, so that the gap between the two tended to narrow.

By type of deposit, time deposit accounts showed the biggest annual growth (16.5%) although with a tendency to slow down. On the other hand, savings deposits continued to show an increased growth rate in keeping with the desire of individuals to add to their savings in a context of reduced returns on time deposits.

In recent months, financial institutions have also attracted liabilities from among savers through the issue of preferred stock. This instrument is of mixed type (fixed and variable returns) in order to strengthen equity of financial institutions.

Improved return on mutual fund participations.

In this situation of competition between deposits and other products, mutual funds continued to mark up net withdrawals amounting to 1.08 billion euros in May. Nevertheless, the biggest withdrawals took place in conservative funds such as money-market funds, short-term bond-based funds and guaranteed variable-yield funds. As a result, fund assets again dropped going to 161.82 billion euros in spite of the capital gains noted during the month.

The favourable trend in financial markets in May made possible an average monthly return on funds of 0.62% while the increase over December was 1.44%. In the first five months of the year there were notable capital gains of 36.0% on international share-based funds in emerging markets with positive gains in all types of mutual funds. In any case, average annual yield was negative at –2.7% although for the past 18 years it stood at 4.1% annual, higher than inflation during that period.

What kind of medicines exist to detoxify the financial system?

Since the beginning of the financial crisis two years ago, the government of various countries coincided that, in order to move forward into the recovery of their financial systems and the economy in general, it was necessary to put the balance sheets of banks in order. The first government interventions, in October 2008, came through massive recapitalization of the balance sheets of various institutions, either indiscriminately (United States and France) or of specific entities (United Kingdom: Northern Rock, RBS, Lloyds; Netherlands: Dexia; Belgium: Fortis). Nevertheless, as well as being costly, this intervention turned out to be ineffective because, as it was not a focussed one or that discriminated between entities, it would have needed too much capital to be effective. Governments, then, decided not to act on balance sheets in a general way but to take specific actions on the root of the problem: «toxic assets».[1] And the fact is that the global restriction of credit («credit crunch») that has become evident since the outbreak of the subprime mortgage crisis is largely caused by the uncertainty about the real value of those toxic assets. This uncertainty has meant that many entities around the world prefer to be prudent, that is, preserving their capital to the maximum by raising the exigencies for credit granting. In view of the harm this may mean for the real economy, governments have developed various plans, all of them based on one of the two major methods for taking action on toxic assets: the guarantee and the purchase (see the following table). However, as we shall see, in practice most of the plans involve elements of the two models.

SCHEME OF DIFFERENT ALTERNATIVES TO ACT AGAINST TOXIC ASSETS

Method	Brief description	Maintenance of toxic assets in balance sheet	Government outlay	Critical aspects
Guarantee on toxic assets	Government coverage of losses above a fixed limit	Yes	In case that potential losses occur	Defining the first loss and the premium to be paid for the guarantee
Purchase of toxic assets («bad bank»)	Segregation of «good» and «bad» assets for focussed management	No. Generally, the «bad bank» is managed by the State	High, although in their design some plans try to reduce the impact on tax-payers to the minimum	Valuation of toxic assets in order to fix the transaction price

The first method consists of limiting potential losses through a public insurance. It has been done in the United States and the United Kingdom with some of their leading entities: Bank of America, Citigroup, Royal Bank of Scotland, Lloyds. The big advantage of this solution is that the uncertainty about the value of the toxic asset is reduced by an instrument that covers the risk while does not require an immediate outlay by the government. As a consequence, the tax-payer is protected (at least initially). Nevertheless, the setting of the first loss (limit above which the State is the one that assumes the losses) and the premium (a payment the entity must make in exchange of the guarantee) is complex and may hide the cost of the insurance for the State.

In the case of a «bad bank», the complexity shows up in the difficulty of valuating the toxic assets. As it was done in Sweden in the 90s, creating a «bad bank» involves transferring the toxic assets to a new segregated entity so that the original bank may continue working without the initial uncertainty. In the current crisis, this

(1) By toxic asset is understood a kind of asset linked to subprime mortgages in the United States.

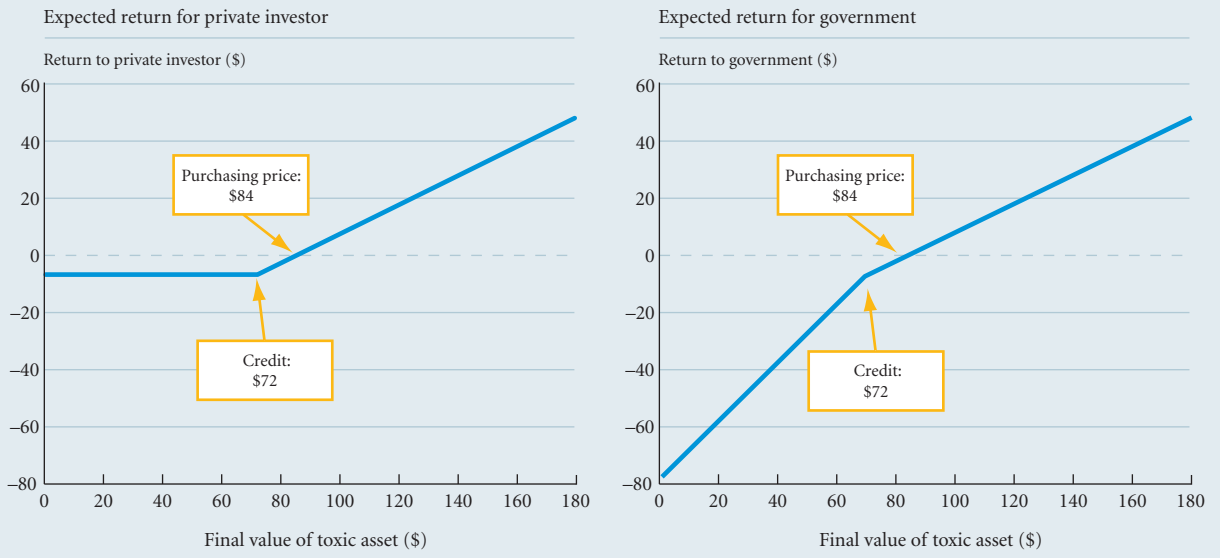
has already been done in Switzerland with UBS, although in this case there were also elements of a State guarantee. In addition, in other countries there are other plans, currently in design and implementation stage, that try to solve the setting of a transaction price in different ways.

The European Commission deals with the matter of a «bad bank» in *Treatment of Impaired Assets in the Community Banking Sector*, a document published in February 2009. It urges to fix the transaction price according to the projection of the future cash flows from the toxic asset (real economic value), under homogeneous suppositions for the entire European Union that still remain to be defined.

Another way of dealing with the matter of valuation is proposed in the Geithner Plan in the United States which promotes the participation of the private sector in the *Public-Private Investment Program (PPIP)*. In principle, this plan is appealing because it offers a high leverage to the private investor. For every dollar he invests, the FDIC[2] guarantees the debt for another $6 in the case of the «legacy loan program» or offers up to $5 of financing from TARP[3] in the «legacy securities program». Furthermore, the State invests 50% of the capital, completing the capital participation of the private investor. The leverage puts a downward limit on the losses of the private investor. On the other hand, he continues to participate in the potential gains without any limit. With regard to the government/State, it fully assumes the downward risks related to the final value of the toxic asset and, therefore, may have to carry heavy losses. But thanks to its capital contribution it may also participate in potential gains. As may be seen in the following graph, if we bought a toxic asset at $84 we would need $12 of capital ($6 from the State and $6 from the private investor) while the remaining $72 would come

EXPECTED BENEFITS OF GEITHNER PLAN

Investment with leverage (6 to 1) and 50/50 participation in capital by State and private investor (without taking into consideration cost of leverage and guarantee)



SOURCE: Public-Private Investment Program and own calculations.

(2) FDIC: Federal Deposit Insurance Corporation – U.S. agency in charge of preserving and promoting public confidence in the U.S. financial system.
(3) TARP: Troubled Asset Relief Program – Program created in the U.S. to repurchase assets and/ or capital from those banks most affected by the crisis.

from a credit guaranteed by the FDIC. The maximum a private investor could lose would be $6 (the amount invested in as capital). The government could end up losing the entire amount invested in ($72 + $6). For values above $72, the State would recover the entire part of the credit and would start the recovering of the capital invested in. Finally, for final values of the toxic asset above $84, both State and private investor would share the profit 50/50. To sum up, thanks to the leverage, the expected value for the private investor is higher (he only participates in profits) and he will be willing to pay a higher price than in a situation without leverage. On the other hand, the government will practically assume the entire risk.

Nevertheless, from the point of view of the supply the advantages of the Geithner Plan are in doubt. At first, those banks with toxic assets in their balance sheets should have to participate in the plan in order to remove uncertainty from their balance sheets and be able to continue normal operations. But reality has led the FDIC to postpone the legacy loans program. In practice, banks ask for higher prices than those that private investors are willing to pay, even counting with the leverage.

To sum up, various countries have shown they are ready to act on those toxic assets that financial institutions are holding in their balance sheets so that credit will flow again to companies and households. However, we still have to wait to evaluate those plans at a practical level because of the lack of interest in participating shown by financial institutions. The fact that they are not interested in participating could be a sign of recovery but it is also an expression of their lack of interest in recognizing the losses right now when there still exists uncertainty about their extent and accounting principles allow them to spread losses over time. Finally, after two years of subprime mortgage crisis and serious events in the international financial system, the question of toxic assets has still not been fully resolved. The US stress test and the commitment of governments to give stability to their financial systems have reduced the risk premium in the sector although the strength of bank balance sheets still remains to be solved. If this is not done, it will make recovery of the real economy much more difficult.

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"la Caixa" GROUP: KEY FIGURES

As of December 31, 2008

FINANCIAL ACTIVITY	Million euros
Total customer funds	238,407
Receivable from customers	176,100
Profit attributable to Group	1,802

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	27,818
Branches	5,530
Self-service terminals	8,113
Cards (thousands)	10,344

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2009	Million euros
Social	310
Science and environmental	81
Cultural	79
Educational	30
TOTAL BUDGET	**500**

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