

Monthly Report



SECTORS OF THE FUTURE

Towards tomorrow's economy [Page 18](#)

Demographics, emerging economies' development and natural resources will redraw the sector map of our economies

Innovation performance: cross-country comparison [Page 34](#)

Innovative capacity - a means of overcoming the crisis?

Venture capital, a step forward [Page 46](#)

Historically the venture capital industry has been involved in the most dynamic sectors. Will this continue to be the case?

Beyond bricks and mortar: the medium-term outlook for sectors [Page 53](#)

Which sectors can drive business in a future cycle of growth?

Forecast

% change over same period year before unless otherwise noted

	2008	2009	2010	2009				2010	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY	Forecast								
Gross domestic product									
United States	0.4	-2.4	3.0	-3.3	-3.8	-2.6	0.1	2.5	3.3
Japan	-1.2	-5.2	2.5	-8.6	-6.0	-4.8	-1.4	4.2	2.4
United Kingdom	0.5	-4.9	1.4	-5.3	-5.9	-5.3	-3.1	-0.2	1.1
Euro area	0.5	-4.0	1.0	-5.0	-4.9	-4.1	-2.1	0.5	1.0
Germany	1.0	-4.9	1.3	-6.7	-5.8	-4.8	-2.2	1.5	1.4
France	0.3	-2.2	1.4	-3.9	-3.2	-2.6	-0.4	1.2	1.4
Consumer prices									
United States	3.8	-0.3	1.9	-0.2	-1.0	-1.6	1.5	2.4	2.0
Japan	1.4	-1.4	-0.6	-0.1	-1.0	-2.3	-2.0	-1.1	-0.9
United Kingdom	3.6	2.2	2.8	3.0	2.1	1.5	2.1	3.3	3.4
Euro area	3.3	0.3	1.2	1.0	0.2	-0.4	0.4	1.1	1.3
Germany	2.6	0.3	1.0	0.8	0.3	-0.2	0.4	0.8	1.0
France	2.8	0.1	1.5	0.7	-0.2	-0.4	0.4	1.4	1.6
SPANISH ECONOMY	Forecast								
Macroeconomic figures									
Household consumption	-0.6	-5.0	0.1	-5.5	-6.0	-5.0	-3.5	-0.6	1.3
Government consumption	5.5	3.8	-0.2	6.0	4.7	4.1	0.8	1.5	-0.4
Gross fixed capital formation	-4.4	-15.3	-6.7	-14.9	-17.0	-16.0	-12.9	-9.9	-6.9
Capital goods	-1.8	-23.1	0.4	-24.0	-28.3	-23.8	-15.3	-2.5	-0.0
Construction	-5.5	-11.2	-9.7	-11.3	-11.6	-11.4	-10.2	-10.6	-10.1
Domestic demand (contribution to GDP growth)	-0.5	-6.4	-1.6	-6.3	-7.4	-6.6	-5.3	-2.5	-1.1
Exports of goods and services	-1.0	-11.5	8.1	-16.6	-14.7	-10.8	-2.9	8.0	8.2
Imports of goods and services	-4.9	-17.9	2.6	-22.3	-21.7	-17.0	-9.6	2.6	4.2
Gross domestic product	0.9	-3.6	-0.4	-3.3	-4.2	-4.0	-3.1	-1.3	-0.2
Other variables									
Employment	-0.6	-6.7	-2.1	-6.3	-7.2	-7.2	-6.1	-3.6	-2.2
Unemployment (% labour force)	11.3	18.0	19.4	17.4	17.9	17.9	18.8	20.0	19.3
Consumer price index	4.1	-0.3	1.5	0.5	-0.7	-1.1	0.1	1.1	1.5
Unit labour costs	4.6	0.4	-0.5	0.9	0.9	-0.1	-0.1	0.1	
Current account balance (% GDP)	-9.5	-5.1	-4.1	-7.9	-4.5	-3.8	-4.2	-6.8	
Net lending or net borrowing rest of the world (% GDP)	-9.1	-4.7	-3.7	-7.6	-4.0	-3.6	-3.7	-6.1	
General government financial balance (% GDP)	-4.1	-11.2	-9.5						
FINANCIAL MARKETS	Forecast								
International interest rates									
Federal Funds	2.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	3.9	1.2	1.0	1.8	1.1	1.0	1.0	1.0	1.0
10-year US bonds	3.6	3.2	3.7	2.7	3.3	3.5	3.4	3.7	3.6
10-year German bonds	4.0	3.3	3.1	3.1	3.4	3.3	3.2	3.2	2.9
Exchange rate									
\$/Euro	1.48	1.39	1.30	1.30	1.36	1.43	1.48	1.38	1.29

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Sectors of the future

A diagnosis leaves little to discuss. After the boom that started in the mid-1990s, which enabled a considerable increase in income per capita and employment, the worldwide economic crisis has had the dubious virtue of highlighting the serious weaknesses underlying the high growth in Spanish gross domestic product. Specifically, the private sector's excessive debt has become evident, as well as its subordination to external financing. This dependency has also revealed significant lacks in terms of international competitiveness. Descending to the level of the productive economy, this expansion was overly dependent on the construction of housing, which emerged as the engine for activity. Meanwhile, the industrial sector was constantly being eroded away, particularly in more labour-intensive activities, in its tough battle against relocation towards lower wage countries.

The worldwide economic and financial crisis did not only halt the brilliant expansionary phase of the Spanish economy and doom it to the worst recession in half a century. The crisis also put an end to an unrepeatable period. The drop in interest rates due to the integration of the euro is not going to happen again. Further debt for companies and households is no longer feasible. It will be a long time before we see the same financial facilities being offered by foreign investors and savers. The questions then arise that are the most difficult to answer: What will be the engines behind Spain's future economic growth? What will the new production model be like?

Several lines of thought are offered in this Monthly Report: the ability of countries to convert technological knowledge into growth; how socioeconomic, demographic and cultural changes are going to generate new opportunities for growth; which sectors can withstand the decline of the property market and how to finance the most dynamic sectors or firms. These are complementary views that attempt to throw some light on the paths that might be taken by the economy in the coming years, in the belief that bringing forward the right actions to facilitate this journey might be key to recovering the levels of activity and employment that have been lost.

It is widely believed that the future lies in innovation, but the question is how to translate scientific, technological and organisational advances into marketable products that generate value added. Here there are significant differences between countries and there's a lot of room for improvement in the case of Spain. Moreover, the economic situation has led to firms cutting their expenditure on innovation, raising serious doubts regarding this means of improvement. In any case, innovation must be adapted to the changes in consumption patterns and production structure: the ageing population in developed countries, the new middle classes in emerging countries, a new awareness of issues related to energy, the environment and the sustainability of the ecosystem. So, should we conclude that we must focus on developing these new sectors? Not by a long shot. There is a wealth of evidence that firms in sectors considered as traditional can be successful, and these firms often contain the seed that germinates into new activities that continually transform the production fabric. Recovering the capacity to innovate by taking advantage of the rich, diversified industrial and service base of the Spanish economy will be crucial in order to return to a normal situation of expansion that once again generates employment and wealth.

EXECUTIVE SUMMARY

The world's economy and trade grow strongly again...

The European sovereign debt crisis erupts

The recovery of the world's economy is progressing at a faster pace than was expected a few months ago. The Organization for Economic Cooperation and Development predicts that the planet's gross domestic product (GDP) will grow at an annual rate of approximately 4.5% in 2010 and 2011. Moreover, it expects the volume of world trade, after plummeting 11% in 2009, to make up for this slump in 2010 by growing by 10.6%, with this expansion continuing in 2011 at a rate of 8.4%. Employment rates are still lagging behind and monetary policies have yet to get back to normal, but the Great Recession of 2008-2009 is becoming a thing of the past.

...but a public debt storm hits Europe, due to uncertainty in the markets regarding the ability of governments to meet their obligations.

However, the public debt storm that broke out in Europe in May reminds us that the road to recovery is still not completely clear and that the financial instability starting in mid-2007 has not yet come to an end. Uncertainty has arisen as a result of a relatively minor event, the imbalance of the public accounts of a country that accounts for less than 3% of the euro area's GDP. Public accounts whose correspondence with reality was already increasingly being doubted towards the end of 2009. Hence fears grew that the Greek government would not be able to meet its obligations with the holders of its bonds. Risk premia and the cost of hedging the debt rocketed as investors fled from Greek bonds, leaving the country at a dead end. This uncertainty did not limit

itself to the Greek case but spread to the rest of sovereign debt, particularly taking it out on the debt of countries with the greatest financial weakness, forcing the euro down in value.

Given the risk of systemic crisis, on 2 May the euro area's finance ministers agreed to set in motion a bailout plan to support Greece that involves funding totalling 110 billion euros. The euro area member states are contributing 80 billion, while the International Monetary Fund (IMF) is covering the rest. In exchange for stabilizing its financial situation over the next three years, Athens agreed to implement a tough adjustment plan that has already led to several general strikes. The measures include a hike in value added tax (VAT) and other indirect taxes, cuts in civil service wages and personnel, pension cuts and combating tax fraud. These cuts in expenditure will help its public deficit to go from 13.6% of GDP in 2009 to under 5% in 2013, but they will not stop public debt from rising to 150% of GDP in 2012.

Such support for Greece was not enough to appease the turbulence in the markets. The risk of non-payment of the Greek debt remained high and fuelled fears that other countries in the euro area, such as Portugal, Ireland, Spain and Italy, might follow suit. Given this scenario, the Council held an urgent meeting and, in the early hours of Monday, 10 May, came to a far-reaching agreement to stop the panic from spreading. Consequently, a European stabilization mechanism has been set up, provided with 750 billion euros, in which the IMF also takes part

The European Union reacts decisively, approving a European stabilization mechanism provided with 750 billion euros.

by providing half the total national contributions. These funds are available for those countries in the euro area that have to tackle problems of liquidity and take the form of loans or lines of credit. At the same time, a firm commitment to fiscal stability was adopted and, in particular, Spain and Portugal undertook to take measures to reduce public debt in addition to those announced for 2010 and 2011. At the same time, the European Central Bank (ECB) announced that it would buy up government and private bonds should their respective markets suffer from problems of liquidity, as it has actually done. Since the aim of this measure is to get these markets back to normal, these operations are «sterilized» or offset by reverse operations so that monetary policy is not affected. The ECB also announced a return to the fixed-rate tender procedure with full allotment for 3-month tenders and that it would revive its swap line with the Federal Reserve of the United States to facilitate dollar liquidity.

The extent and decisiveness of these measures managed to inject some calm into the markets, slightly reducing the interest rate differentials between the public debt of periphery countries of the euro area and those of Germany, although these are still higher than the pre-crisis levels. Thanks to its status as an asset safe haven, German debt with 10-year maturity has slipped below 3%, offering a yield of 2.74% at the end of May.

Government bond markets are still highly volatile and the next few weeks will be crucial to regaining stability after the significant measures announced, both for the euro area as a whole and in the various countries that are adjusting their budgets. We cannot rule out some moments of tension during this period but, in the medium term and as the economic data continue to confirm global economic growth, the differentials between Germany

and the periphery countries will tend to stabilize and even fall within a context of a slightly upward trend in the yields offered by sovereign debt.

Another financial asset that has suffered severely from market volatility has been the stock market. Equity investors have shown themselves to be much more concerned than the financial sector, only comparable with the situation experienced in 2008 with the Lehman Brothers, due both to the European sovereign crisis and also to the announcements made in the United States concerning the regulation of the financial system.

The euro has also been hit by its share of the tension. In the midst of extreme statements by numerous international economists and investors, who were even setting a date for the disappearance of the single currency, the European Union has decided, in the words of the EU Commissioner for Economic and Monetary Policy, Olli Rehn, that «we shall defend the euro whatever it takes». In any case, the euro has accelerated its depreciation against the dollar, started at the end of November last year when one euro was worth 1.50 dollars. One euro is currently worth 1.23 dollars, depreciating approximately 8% in the last month.

Nonetheless, a weak euro is not such bad news as it will help the foreign sector to continue boosting economic recovery. In May Eurostat announced its estimate for GDP growth in the euro area for the first quarter of 2010, namely 0.2% compared with the previous quarter, so that the year-on-year rate of change has now reached positive figures and is at 0.5%. Although the progress being made by the European economy seems somewhat weak, particularly when compared with the figures presented by the United States, it's good to see it clearly in positive terrain again. We must

The ECB accepts to buy public and private debt to unblock markets with liquidity problems.

The markets still have not completely calmed down and the euro is suffering from a notable slump compared with the dollar...

...which is good news for the euro area's growth prospects.

However, the early withdrawal of fiscal stimuli is of some concern.

remember that the quarter-on-quarter change in the last period of 2009 stood at a modest 0.0%.

The solidity of Europe's recovery is of some concern due to the early withdrawal of the fiscal stimuli implemented to slow up the effects of the recession. In addition to Greece, Portugal and Spain have also presented detailed plans to speed up the reduction of their public deficit and other countries such as France and Italy will also act along the same lines. Germany, for example, has already announced that it will not carry out the tax cuts promised by its chancellor, Angela Merkel. Outside the euro area, the recently elected British prime minister, David Cameron, has already stated that reducing the public deficit is one of his priorities.

Spain presents an ambitious assortment of measures aimed at speeding up the planned reduction in its public deficit...

In the case of Spain, the president of the government has announced a new package of extraordinary measures to speed up the reduction in the public deficit contained in the 2010-2013 Stability Programme that was approved in January. The 2010 deficit would therefore be cut by an additional half a point compared with the initial plan, to 9.3% of GDP, and that of 2011 would be 1.5 points lower, at 6%. In order to achieve these targets, 5% will be cut off the wages of most public sector employees, pensions will be frozen in 2011 (except non-contributory and minimum pensions), some conditions will be modified regarding eligibility for dependency benefit and partial retirement, the «baby cheque» will be repealed (2,500 euros per birth), Social Security expenditure on drugs will be cut, external development aid will be reduced, public investment will be less and expenditure to autonomous communities and councils will also be cut.

...which will help to restore confidence and leave the recession behind once and for all.

As a complement to these measures, it has also been announced that the government is studying a new tax aimed at large fortunes. Moreover, social, trade union and employer representatives are negotiating labour reforms that will help to create more jobs once the recovery becomes consolidated.

In fact, in the middle of the month the National Institute of Statistics confirmed that, in the first quarter of 2010, GDP had grown quarter-on-quarter for the first time in seven quarters. In other words, the recession has ended, although the year-on-year rate of change in GDP was still -1.3% in the first quarter of 2010. So the Spanish economy is now seeing the end of its worst recession in the last few decades, as this has been longer than the previous recession of 1992-1993, which lasted five quarters, and has also been slightly more severe, as the accumulated drop in GDP has been 4.6% compared with 1.7% in the previous recession.

In spite of everything, we do not rule out a possible drop in GDP over the coming quarters. Domestic demand is still very sluggish and the measures to correct the deficit adopted in May might affect consumer confidence, as well as cutting back the capacity to spend. It should be remembered that, midway through the year, there will be a hike in VAT that might also alter households' consumption profile. However, should the improvement in the public imbalances become consolidated and the financial markets stabilize, as expected, business confidence will improve within an environment of international expansion and with clearer economic and financial expectations that will help to leave the worst recession in half a century well behind us.

27 May 2010

CHRONOLOGY

2009

- June** **12** Government **increases taxes** on tobacco, petrol and diesel fuel for motor vehicles.
26 Government establishes **Fund for Orderly Restructuring of Banks**.
- September** **26** The Spanish government passes the **2010 State General Budget**, which eliminates the deduction of 400 euros from income tax, raises the duty on capital income and also the general and low VAT rates as from July 2010.
- November** **27** The central government presents its draft bill for the **Sustainable Economy Act**.
- December** **1** The **Lisbon Treaty** comes into force, reforming certain aspects of the European Union.

2010

- January** **29** The government passes a package of **budget austerity measures** and proposes to raise **the retirement age** to 67.
- February** **9** Agreement for employment and **collective bargaining 2010, 2011 and 2012** between representatives of employers and trade unions.
- April** **7** The government presents its **extraordinary Infrastructure Plan**, which will involve 17 billion euros in the coming two years.
9 The government passes a **new package of measures to boost economic activity**.
10 The Finance Ministers of the euro area announce the **conditions for helping Greece**.
12 The government proposes a **new plan to reform the labour market**, to be discussed within the context of social dialogue.
- May** **2** Countries in the euro area **approve financial aid for Greece**, totalling 110 billion euros.
10 The European Union adopts a **European Stabilization Mechanism**, provided with 750 billion euros, with the involvement of the International Monetary Fund.
20 The government approves a Decree-Law to adopt **extraordinary measures to speed up the planned reduction in its public deficit**.

AGENDA

June

- 2** Registration with Social Security and registered unemployment (May).
EU industrial production index (April).
- 4** Industrial production index (April).
EU GDP (first quarter).
- 10** Governing Council of the European Central Bank.
- 11** CPI (May).
- 16** Labour costs (first quarter).
EU inflation (May).
- 22** Foreign trade (April).
Fed Open Market Committee.
Government revenue and expenditure (May).
- 25** Producer prices (May).
- 29** Retail sales (May).
HCPI flash estimate (June).
- 30** Balance of payments (April).

July

- 2** Registration with Social Security and registered unemployment (June).
EU industrial production index (May).
Industrial production index (May).
- 8** Governing Council of the European Central Bank.
- 13** CPI (June).
- 14** EU inflation (June).
- 20** Foreign trade (May).
- 23** Producer prices (June).
- 27** Government revenue and expenditure (June).
- 28** Retail sales (June).
- 29** HCPI flash estimate (July).
- 30** Labour force survey (second quarter).
Balance of payments (May).
US GDP (second quarter).

INTERNATIONAL REVIEW

The United States grows by 3.0% thanks to private consumption and capital goods investment...

...but the savings rate is falling while debt has yet to be reduced.

The United States: consumers lose their fear

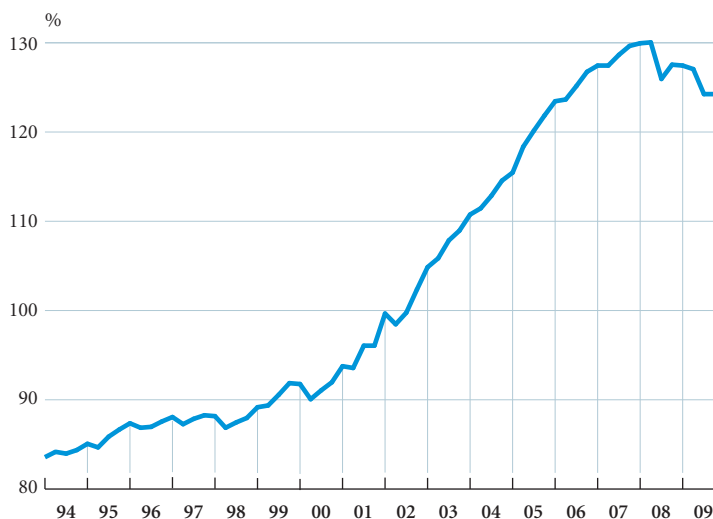
Less risk aversion on the part of consumers is bolstering the recovery. For the first quarter of 2010, gross domestic product (GDP) grew by 3.0% annualized quarter-on-quarter, 2.5% compared with the same period a year ago. This stronger GDP was due to private consumption, on its own accounting for four fifths of the total growth for the quarter. The other pillar to the recovery is capital goods investment, boosted by good business confidence indicators and profits. Residential investment continues to be among the weaker components, although it is showing some signs of

a slow recovery. The foreign sector also weakened growth because of a slowdown in exports and the upward pressure on imports due to domestic demand.

Public consumption faltered again and, given the latest disturbances in debt markets, is unlikely to contribute much to growth in the coming quarters. The upward trend for 2010 has therefore been reinforced, although there are doubts as to whether the recovery will continue at its current pace. In this respect, the upswing in consumption, although resulting from a positive reversal of the risk aversion, is not so much due to greater income but rather a return to low savings rates, less than 3%

THE UNITED STATES: NECESSARY SAVINGS TO REDUCE OUTSTANDING DEBTS

Gross household debt as percentage of disposable income

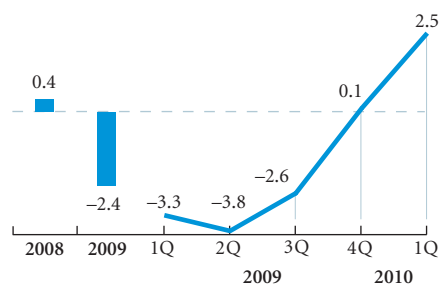


SOURCES: BEA, Federal Reserve and own calculations.

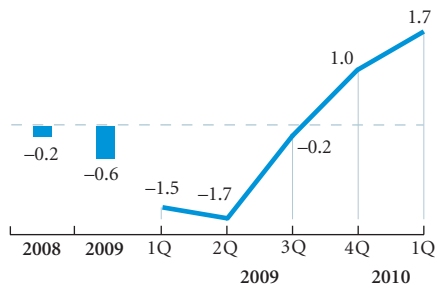
TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms

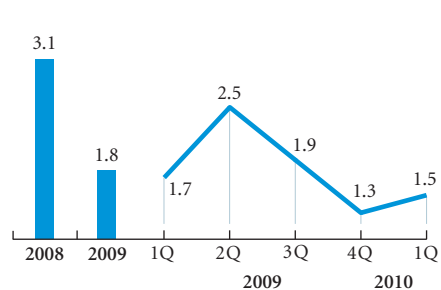
GDP



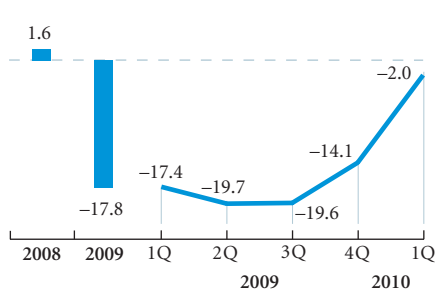
Private consumption



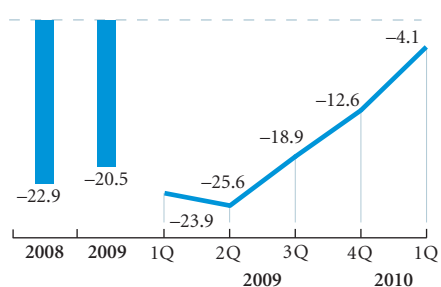
Public consumption



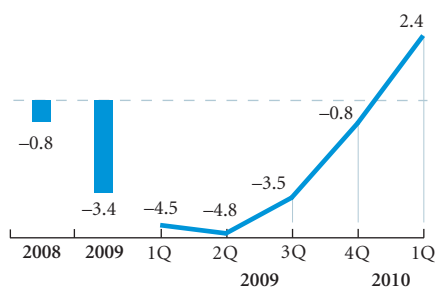
Non-housing investment



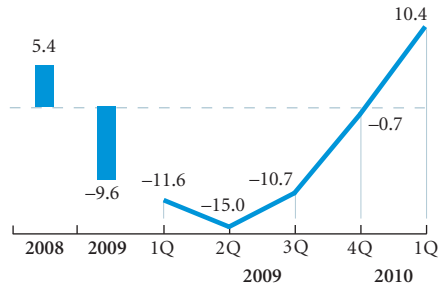
Housing investment



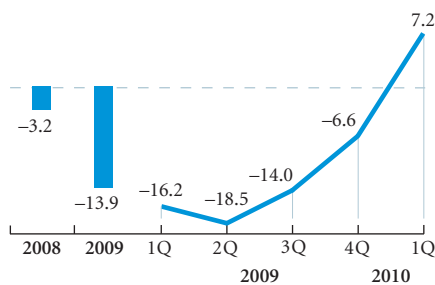
Domestic demand



Exports of goods and services



Imports of goods and services



SOURCES: Bureau of Economic Analysis and own calculations.

Retail sales accelerate while consumer pessimism falls.

of disposable income, after having exceeded 5% at the beginning of 2009. A low savings rate that makes it difficult for households to continue reducing their debt. Between March 2008 and December 2009, total household debt went from 130.1% to 122.7% of disposable income, a slightly higher level than might be considered normal, given the long-term trend. Additionally, with growth close to 3% it will be difficult to quickly reduce the high unemployment rate, in spite of the fact that the US economy has been creating jobs since early 2010.

The latest demand indicators reinforce the pattern of a recovery led by private consumption. Retail sales, without cars or petrol, continued their upswing of the first quarter by advancing 5.5% year-on-year, 4.5% discounting the effect of price variations, close to their pre-crisis level. Although less convincing than retail sales, the Conference Board Consumer Confidence index, which is a delayed

indicator in recoveries, advanced in April to its highest level since September 2008, the month before Lehman Brothers went bankrupt.

On the supply side, non-financial firms have been showing themselves to be one of the strong points throughout this crisis, at first thanks to their lower levels of debt compared with banks and households and, afterwards, to their rise in profits. Consequently, the business sentiment index of the Institute for Supply Management rose slightly to the level of 60.4 points in manufacturing and 60.3 points in services, in both cases consistent with the economy's strong expansion. Also on the path to recovery, albeit with a lower profile, industrial production enjoyed an upswing in April, growing 5.1% year-on-year, although the indicator is still 9% below its level of December 2007, before the crisis. Similar behaviour could be seen from industrial capacity utilization, close to 74.0% of the total, its highest percentage since the end

Entrepreneurs are optimistic and industry continues its slow recovery.

THE UNITED STATES: THE REACTION OF CONSUMERS

Real retail sales without vehicles or petrol, year-on-year change (*)



NOTE: (*) Data deflated by the consumer price index without energy or food.

SOURCES: Department of Trade and own calculations.

of 2008 but still far from the historical average of 81.0%.

The housing market is still weak but timid signs of recovery on the supply side suggest that, in the coming quarters, it will no longer be a burden on GDP growth, although it's starting from a very low level. 672,000 homes were started in April, in annual terms, 40.9% higher than the same period one year ago but far from the typical figure for the years before the bubble, namely 1,600,000 new homes. The end of government aid for first-home buyers in April and the high number of foreclosed mortgages, both of which encourage oversupply, will continue to hinder the recovery in house prices. The Case-Shiller index for second-hand house prices had practically stagnated in February, with a rise of 0.1% compared with the month before, seasonally adjusted, and 29.9% below the maximums of 2006.

The labour market continues to pick up. 290,000 net jobs were created in April, a sharp rise that takes the total gain since the beginning of the year to 573,000 jobs. However, the unemployment rate increased slightly from 9.7% to 9.9% and will only fall very slowly. Firstly, the share of long-term unemployed, who are more difficult to relocate, accounts for 45.9% of the total unemployed, double the figure in the 1983 recession when unemployment reached similar levels to the present. Secondly, the large number of discouraged workers, and of workers doing part-time work involuntarily, might absorb the growth in demand for labour as the recovery progresses.

Inflationary tensions are fading further into the distance. Prices are thereby helping policies to boost demand but are also a warning that the recovery in demand may be more fragile than it seems. In April, the fall in energy prices meant that the general consumer price

Construction is showing a timid recovery but prices are still rock bottom.

The labour market is now creating jobs but unemployment is still close to 10%.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010	
			2Q	3Q	4Q	1Q	April
Real GDP	0.4	-2.4	-3.8	-2.6	0.1	2.5	-
Retail sales	-1.0	-6.3	-9.9	-7.1	1.9	5.7	8.8
Consumer confidence (1)	58.0	45.2	48.3	51.8	51.0	51.7	57.9
Industrial production	-2.2	-9.7	-12.9	-9.4	-4.7	2.3	5.2
Manufacturing (ISM) (1)	45.5	46.2	43.0	51.4	54.6	58.2	60.4
Sales of single-family homes	-37.4	-22.7	-27.1	-11.7	-4.9	5.7	...
Unemployment rate (2)	5.8	9.3	9.3	9.6	10.0	9.7	9.9
Consumer prices	3.8	-0.4	-1.2	-1.6	1.4	2.4	2.2
Trade balance (3)	-695.9	-378.6	-503.7	-414.2	-378.6	-403.2	...
3-month interbank interest rate (1)	2.8	0.7	0.8	0.4	0.3	0.3	0.3
Nominal effective exchange rate (4)	74.4	77.8	79.4	75.4	73.6	75.5	76.0

NOTES: (1) Value.

(2) Percentage of labour force.

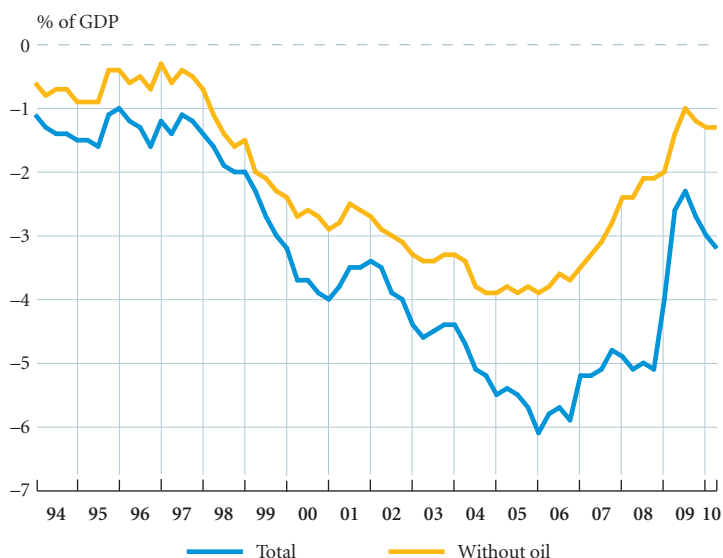
(3) Cumulative figure for 12 months in goods and services balance. Billion dollars.

(4) Exchange rate index weighted for foreign trade movements. Higher values imply currency appreciation.

SOURCES: OECD, national statistical bodies and own calculations.

THE UNITED STATES: THE GAP IS CLOSING, WITH THE PERMISSION OF OIL

Trade balance of the United States, quarterly data



SOURCES: Department of Trade and own calculations.

The CPI is up 2.2% while core inflation slows up to 1.0%.

index (CPI) was lower than March's figure, seasonally adjusted, with a year-on-year change of 2.2%. Persistently low production capacity utilization continued to ensure that any rises in core inflation would also be moderate, up 1.0% year-on-year. Core inflation without the estimated equivalent of rent for owners also slowed up its progress, from 2.4% to 2.2% year-on-year.

The trade deficit increases due to oil prices but continues to adjust.

The foreign sector is very unlikely to make a positive contribution to the economy's growth over the coming months, given the recovery in domestic demand and the relative strength of the dollar. But on the plus side, the tendency towards adjustment appears more solid than at the start of the year. The trade deficit for goods and services in March was 40.423 billion dollars, around 1 billion above the previous month's total due to fluctuations in oil prices. However, the deficit excluding oil and derivatives fell by 0.8 billion dollars, thanks to dynamic exports, which grew

Thanks to exports, Japan grows 4.9% but consumption is slowing up.

faster than imports in March. This good result for the non-oil balance points towards a continuation of the adjustment starting in the first quarter of 2006, when the non-oil deficit reached 3.9% of nominal GDP. After the ups and downs caused by the worldwide trade crisis, in the first quarter of 2010 the deficit fell to 1.3% of GDP.

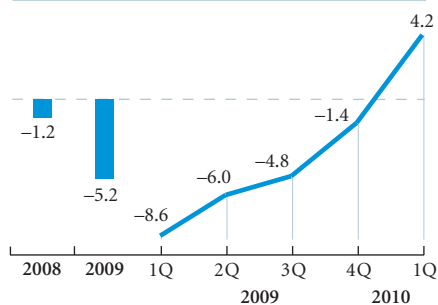
Japan: exports catapult the economy

The Japanese economy grew 4.9% annualized quarter-on-quarter in the first quarter, 4.2% year-on-year. This figure means that there is less danger of a relapse in activity in 2010. The main player in this upswing was exports, up 35.2% compared with the same period a year ago and accounting for four fifths of the growth of the economy as a whole. So the pattern is being of the last few years repeated, albeit with greater intensity, namely a strong inclination towards the foreign sector. This time

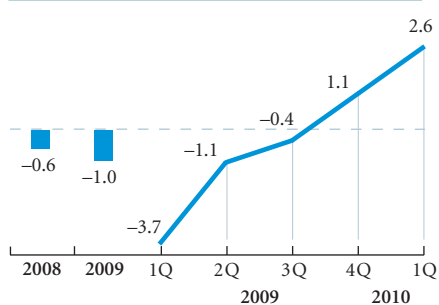
TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms

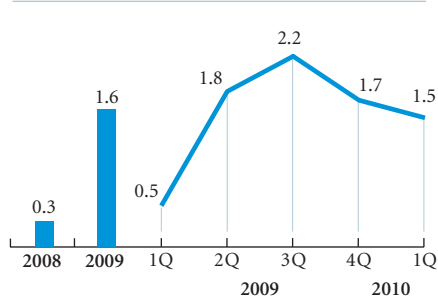
GDP



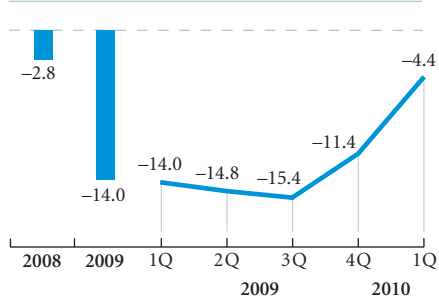
Private consumption



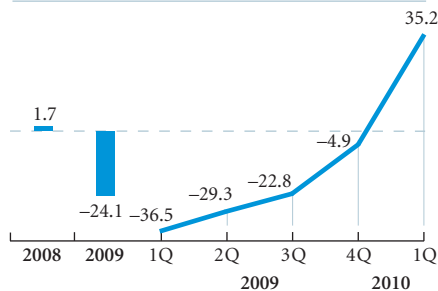
Public consumption



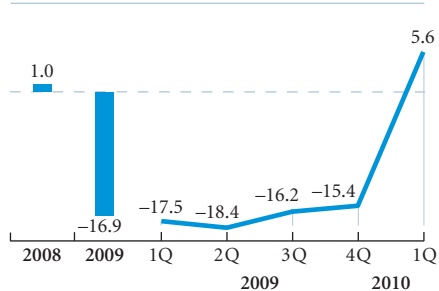
Gross fixed capital formation



Exports or goods and services



Imports or goods and services



SOURCES: Japanese Ministry of Communications and own calculations.

domestic demand also rose, assisted by the good performance of capital goods investment and construction, which is coming out of a trough. But, and this is more of the same, private consumption was disappointing and grew less than forecast, placing a shadow of doubt over this recovery continuing. So the boost provided by exports means that 2010 is better than expected but caution must continue to dominate the outlook for 2011.

The Japanese economy is suffering from weak domestic demand within a deflationary context. The debt of the Japanese government's coffers is the highest of all rich economies. The main buyers of this debt are the Japanese. Although this protects Japanese bonds from a lot of financial unrest, it also means that being able to place debt depends on a high household savings rate. A sustained recovery in private consumption would reduce savings

Deflation and weak domestic demand continue.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010	
			2Q	3Q	4Q	1Q	April
Real GDP	-1.2	-5.2	-6.0	-4.8	-1.4	4.2	-
Retail sales	0.3	-2.3	-2.8	-1.9	-0.7	3.8	...
Industrial production	-3.4	-21.8	-26.9	-20.5	-5.1	27.1	...
Tankan company Index (1)	-2.8	-40.8	-48.0	-33.0	-24.0	-14.0	-
Housing construction	2.5	-27.6	-31.9	-35.9	-20.7	-6.7	...
Unemployment rate (2)	4.0	5.1	5.1	5.4	5.2	4.9	...
Consumer prices	1.4	-1.4	-1.0	-2.2	-2.0	-1.1	...
Trade balance (3)	4.2	4.0	1.0	1.8	4.0	6.7	...
3-month interbank interest rate (4)	0.8	0.6	0.6	0.5	0.5	0.4	0.4
Nominal effective exchange rate (5)	86.6	98.6	95.7	97.0	99.6	101.1	99.0

NOTES: (1) Index value.

(2) Percentage of labour force.

(3) Cumulative balance for 12 months. Trillion yen.

(4) Percentage.

(5) Index weighted for foreign trade movements. Higher values imply currency appreciation. Average in 2000 = 100.

SOURCES: OECD, national statistical bodies and own calculations.

Industry and investment continue to recover.

and would leave public debt without buyers, consequently pushing up interest rates.

The latest supply indicators show that improvement is limited to the industrial and export sectors. Industrial production in March recovered from its hiatus in February but its upward trend is less energetic than at the start of the recovery and it is still 13.3% below the figure of May 2008. Investment perspectives also continued to improve in March, with machinery orders increasing both in purchases for the domestic market and also in the demand for investment on the part of exporters.

The housing market saw a rise in new homes started in March but it would still be premature to talk of any recovery. The price of land in the six main cities fell again in the fourth quarter of 2009, accumulating a drop of 14.9% compared with the level of March 2008. In the

labour market, the unemployment rate for March picked up slightly to 5.0%, although the gain in jobs in manufacturing offset what had been lost in February.

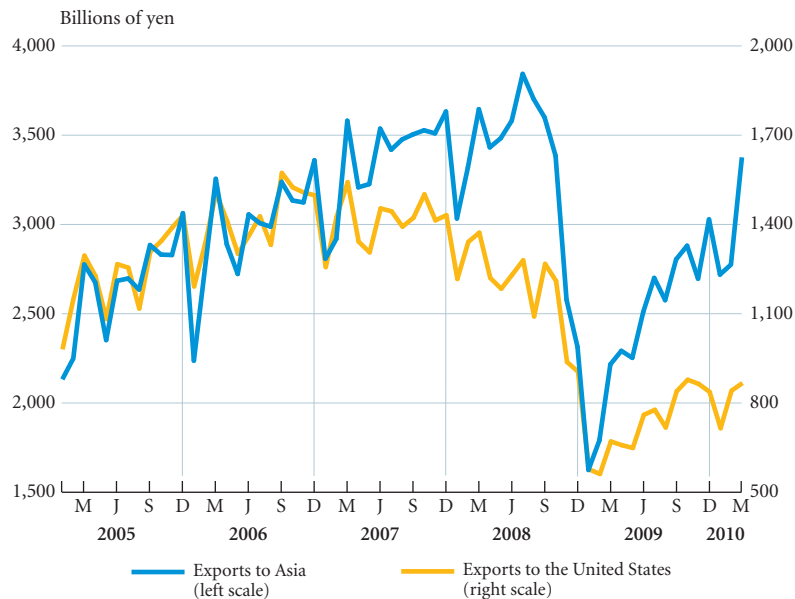
In prices, weak demand continued to encourage deflationary trends, which should continue throughout 2010. Consequently, March's CPI posted a drop of 1.0% year-on-year and core inflation, the general index without energy or food, dropped 1.1% year-on-year, reaching the level of April 1992.

It's in the foreign sector where the recovery shines the brightest. March's trade surplus increased, supported more by the decline in imports than by strong exports. Japan's export recovery is based mainly on sales to the rest of the Asian continent, which between the end of 2008 and March 2010 went from 47.8% of the total to 56.3%. Within this context, while

Housing continues weak and unemployment reaches 5%.

JAPAN: THE RECOVERY IS SUPPORTED BY ASIA

Japanese exports to Asia and to the United States



SOURCES: Japanese Ministry of Communications and own calculations.

exports to the Asian continent reached pre-crisis levels in March, exports to the United States and Europe continued at 40% below this level.

China: overheating in sight?

The risk of overheating is hovering over the Asian giant in spite of the different measures taken by the government. The acceleration in inflation, standing at 2.8% year-on-year in April, above the 2.4% of March and consensus forecasts, might be a symptom of this overheating although, for now, food prices are the main component behind this upswing. Housing prices also continued to rise, reaching 12.8% year-on-year in April and revealing a possible bubble in the real estate market.

Within this context, the Chinese authorities have adopted various

measures to drain the abundant liquidity from the economy and cool off the real estate sector. For the third time this year, the People's Bank of China announced a rise of 50 basis points in the cash reserve ratio, setting it at 17% for large banks. This was in addition to the rise in mortgage interest rates and in the initial down-payment required to acquire a second home. Nonetheless, bank credit, which seemed to have moderated in March, livened up again in April, reviving doubts as to the effectiveness of some of the policies implemented. Specifically, new bank lending in April rose to 771 billion yuan from a little more than 500 billion in March. We therefore expect the monetary authority to raise interest rates and to make the exchange rate scheme more flexible in the second half of the year, although this latter measure does not seem so urgent now, after the appreciation of the dollar and the renminbi against the euro.

Japan's CPI falls by 1% but the foreign sector picks up thanks to exports to Asia.

The risk of overheating is once again hovering over the Chinese economy.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2008	2009	2009			2010	
			2Q	3Q	4Q	1Q	April
Real GDP	9.6	8.7	7.9	9.1	10.7	11.9	–
Industrial production	12.6	12.5	9.0	12.3	17.9	19.5	17.8
Electrical power generation	6.7	6.7	–0.4	8.0	24.3	22.6	22.2
Consumer prices (*)	5.9	–0.7	–1.5	–1.3	0.7	2.2	2.8
Trade balance (**)	298	198	296	251	198	150	139
Reference rate (***)	5.31	5.31	5.31	5.31	5.31	5.31	5.31
Renminbi to dollar (*)	6.9	6.8	6.8	6.8	6.8	6.8	6.8

NOTES: (*) Average.

(**) Cumulative balance for 12 months. Billion dollars.

(***) Percentage at end of period.

SOURCES: National Statistics Office, Thomson Reuters Datastream and own calculations.

Business indicators are still improving.

Business indicators continue to denote the vitality of the Chinese economy. Domestic demand continues its pace of growth, both in consumption and investment. Retail sales were up 15.3% year-on-year in April in real terms, while the investment in fixed assets continued to advance strongly, 26.0% in April compared with 26.1% in March. The latter hardly show any signs of slowing up due to the new regulations that restrict the approval of new investment projects and limit, in theory, the granting of loans.

On the supply side, industrial production grew by a solid 17.8% year-on-year in April, in line with the strength the industrial sector appears to be enjoying globally in this second quarter. Things are getting back to normal in the foreign sector. The trade balance has returned to positive figures with a surplus of 1.682 billion dollars after a modest deficit in March. Exports enjoyed a 30.5% rise year-on-year in April compared with 24.3% in March, and imports continue to grow strongly, up nearly 50% year-on-year.

The stock market falls within a context of changes in monetary policy.

Lastly, various Asian stock markets have suffered considerable losses in the last few weeks, coinciding with the tightening up of monetary conditions in several countries. The Composite index of the Shanghai stock exchange has been no exception, sustaining drops in the order of 15% in the last month.

Brazil: at a dragon's pace

When visiting Madrid in mid-May, Luiz Inácio Lula da Silva took his leave of those attending the event, entitled «Brazil: Alliance for a new global economy», with a laconic «Brazil's time has come!». And he undoubtedly knew exactly what he was talking about. Hours later, his country's central bank announced that the Brazilian economy had posted, in the first quarter of 2010, its highest year-on-year growth in 15 years. The new index of economic activity, produced by the bank itself, indicates 9.8% growth compared with the same quarter a year ago, and 2.4% compared with the last quarter of 2009. If the data from the National Accounts system, which will be published in June,

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010	
			2Q	3Q	4Q	1Q	April
Real GDP	5.1	-0.2	-1.7	-1.4	4.3	...	-
Industrial production	2.9	-7.3	-11.6	-8.7	6.3	17.3	...
Consumer confidence (*)	140.4	138.3	128.4	141.9	154.2	158.1	...
Unemployment rate São Paulo (**)	13.0	12.8	13.9	13.1	11.8	11.7	...
Consumer prices	5.7	4.9	5.2	4.4	4.2	4.9	5.3
Trade balance (***)	24.8	25.3	27.5	26.4	25.3	23.3	20.8
Interest rate SELIC (%)	11.25	11.25	9.25	8.75	8.75	8.75	9.50
Reales to dollar (*)	1.8	2.3	2.0	1.8	1.7	1.8	1.7

NOTES: (*) Value.

(**) Percentage of labour force.

(***) Cumulative balance for 12 months. Billion dollars.

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

confirm this initial assessment, they will also confirm the candidature of the biggest Latin American power to join a new league: that of a double-digit recovery, the exclusive terrain of the Asian dragons to date.

This information arrives just days after the government announced its intention to make additional cuts to the 2010 budget, and that the country's highest monetary authority had raised the Selic rate by 75 basis points. Both plans aim to gather forces to slow up the indisputable upsurge in domestic demand and to thereby prevent the Brazilian economy from overheating. This risk needs to be taken into account, also considering the exorbitant growth rate of the latest inflation figures: namely 5.3% in April. A figure that does not violate the target set (4.5% \pm 2) but does suggest a trend that demands caution.

And so it should. In spite of the fact that some of the inflationary pressure is expected to be temporary, and that the pace of economic growth in what remains of the year is expected to be

slower (both due to the base effect and also to the recent trend in the purchasing managers' index), the latest leading data on activity continue to point towards expansion in domestic expenditure and greater pressure on installed production capacity. In March, use of this capacity reached 82.4%, while industrial production continued its heady progress with 18.6% growth compared with the same month last year. With regard to demand, retail sales also surprised again with an extraordinary rise of 15.7% year-on-year, boosted by a labour market that, in just four months, has created almost the same number of jobs as in the whole of 2009 (close to a million).

In summary, although the external side of demand continues to decline and suffer from the persistent strength of the real, the whirlwind of domestic expenditure continues to threaten the economic progress of this Amazonian giant with the risk of overheating. In this respect, the determined reaction of the Brazilian economic authorities given

Brazil's central bank estimates that economic activity will have grown by almost 10% in the first quarter of 2010.

Leading indicators for activity point towards the pace of growth easing off but there's still a risk of overheating.

these risks is reassuring, as it reaffirms their determined commitment to macroeconomic stability. A commitment that has won Brazil a place among the main engines of global recovery and that neither the government nor the opposition are prepared to dispute, not even with the presidential elections coming up in October. President Lula made this very clear: «Brazil is a serious country and this is a one-way ticket».

Mexico: recovery at half throttle

The growth data for the first quarter of 2010 were better than expected by the consensus. Up 4.4%, the Mexican economy has posted its first year-on-year positive figure since September 2008 and is consolidating its recovery. By components, the rise in GDP continues to come mostly from industry, growing 5.4% compared with the same period a year ago, this in turn being boosted by the economic recovery in the United States. Tertiary activities also

contributed with a growth of 3.8%, while primary activities fell 1.5% in real terms due to the drop in agricultural production.

In spite of the good annual data, the quarter-on-quarter comparison showed a slight decline of 0.3% compared with the last quarter of 2009, indicating a gradual, moderately paced recovery. Although this decline is slight and might be partly due to the end of the «cash for clunkers» programme on the other side of the border, the root of the problem lies in an obvious fault in the Aztec recovery: a set-back in its second engine, domestic expenditure. Although foreign demand, fundamentally from the United States, continues to boost industry and especially a car industry whose foreign sales rose by 74% between January and March, Mexican investment and consumption are still hesitant. Gross investment in fixed capital fell by 2.3% year-on-year in February, while retail sales continued to grow, 2.3% year-on-year in April, but

Mexico consolidates its recovery but it still depends on the boost provided by the United States.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010	
			2Q	3Q	4Q	1Q	April
Real GDP	1.5	-6.6	-8.5	-6.2	-2.4	4.4	-
Industrial production	-0.9	-7.0	-9.6	-6.5	-1.9	5.7	...
Consumer confidence (*)	92.2	80.5	80.5	83.0	78.4	81.5	82.5
Leading business index	118.0	110.4	108.4	111.0	113.3	113.9	...
General unemployment rate (**)	4.0	5.5	5.2	6.3	5.3	5.4	...
Consumer prices	-11.8	0.0	6.0	5.1	4.0	4.8	4.3
Trade balance (***)	-17.3	-4.7	-15.9	-12.6	-4.7	-2.6	-2.6
Official Banxico rate (%)	7.50	6.75	4.75	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	10.6	14.2	13.2	13.5	13.1	12.3	12.2

NOTES: (*) Value.

(**) Percentage of labour force.

(***) Cumulative balance for 12 months. Billion dollars.

SOURCES: Banco de México and own calculations.

still haven't taken off, particularly in consumer durables.

With regard to the future, everything points towards a gradual acceleration in the recovery thanks to the continuity of the economic drive in the United States and the gradual revival of domestic demand. Industrial production was up 7.2% in March, its highest year-on-year increase in 4 years, and manufacturing production rose 13%, boosted by the revival in demand for cars and domestic appliances in the United States. The leading index for economic activity, IGAE, continued to advance in March, both in annual and monthly terms, due mainly to the renewed push by the tertiary sector. Similarly, Mexican consumer confidence reached 82.5 points in April, largely encouraged by the improved job market.

Surprisingly, inflation fell in the fourth month of the year so that, in the short term, we still don't see any change in the monetary policy. This might encourage domestic expenditure and shake it out of its lethargy once and for all. When all's said and done, no matter how open an economy is, it will always be a twin-engine.

Risk aversion brings widespread declines

Oil prices, after having come close to the threshold of 90 dollars at the end of April, were affected by the unrest in the debt markets and by a growing aversion to risk, resulting in them falling to

71.26 dollars per barrel (Brent quality, for one-month deliveries). Consequently, between 20 April and 20 May 2010, crude lost 16.5%, also partly due to the appreciation of the dollar, up 8.5% compared with the euro.

The fragile expectations for economic recovery in the euro area and doubts regarding sovereign debt affected all commodities in general. As financial markets are gradually starting to get back to normal, and the recovery is still on track in the emerging countries and the United States, crude should regain ground and might end the year within the range of 80-85 dollars per barrel.

The rest of commodities were not immune to the effects of risk aversion. Consequently, the Economist index fell 8.1% between 20 April and 20 May. The biggest drops were to be seen in metals, where risk aversion was in addition to profit-taking after the strong appreciations of the last few months. After having reached their highest value since 2008 at the end of April, most metals saw an adjustment in price that resulted in them accumulating losses during the month. Nickel was down 22.4%, aluminium 17.5%, copper 15.1%, palladium 22.7% and platinum 11.6%. Given its status as a safe haven, gold avoided such a decline and was up 4.2% for the month as a whole, after reaching a record high on 13 May. With regard to foodstuffs, which had risen less, the drops were not so widespread. Wheat posted gains while sugar was the most affected, down 10.7%.

The slow revival in domestic demand moderates growth rates.

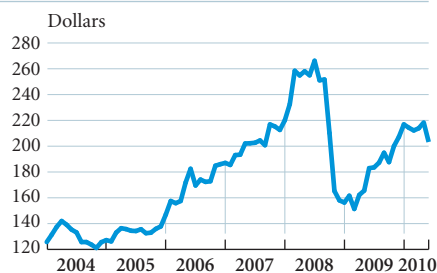
Crude falls 16.5% due to higher risk aversion in the markets.

With the return to normality, oil might reach over 80 dollars by year-end.

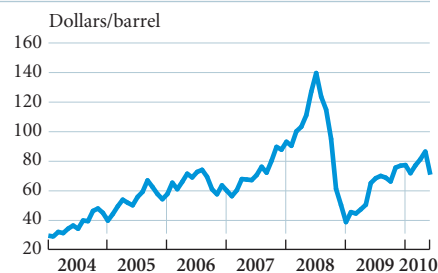
Metals suffer from increased risk aversion and profit-taking.

TREND IN VARIOUS COMMODITIES (*)

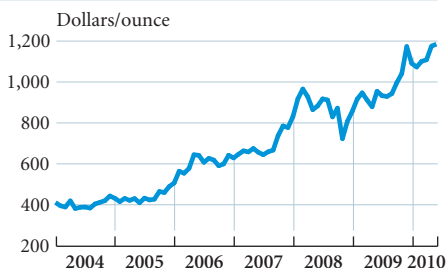
«The Economist» index



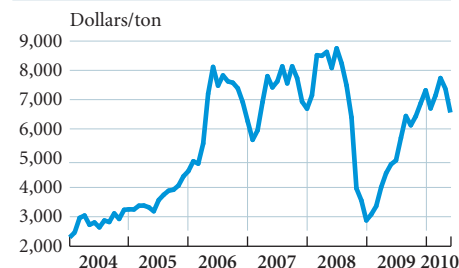
Brent oil



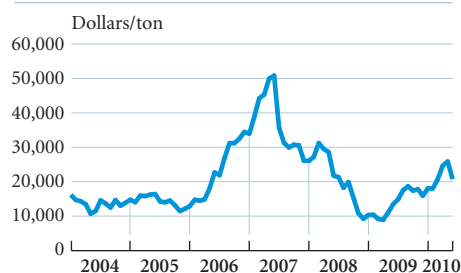
Gold



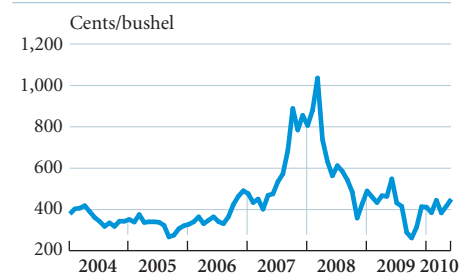
Copper



Nickel



Wheat



NOTES: (*) Figures for last day of month (last date May 20).

SOURCE: «The Economist», Thomson Reuters Datastream and own calculations.

Towards tomorrow's economy

In 1905, Einstein put an end to the Newtonian belief that time was universal, absolute and exactly identical everywhere. His Special Theory of Relativity demonstrated that, if we were capable of flying at the speed of light, the future could be... a tourist destination. Unfortunately, he also proved that such speed could not be reached, so we'll have to resort to alternative methods to answer the question that concerns us: Which economic sectors are facing the future with the best prospects?

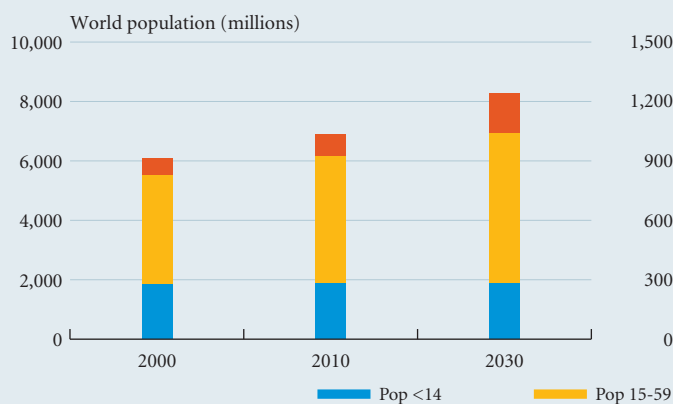
The first clue concerning the future paths to be taken by our economies is provided by the «broad trends», a series of changes in the world's socioeconomic balance that will determine the global future in the coming years. Three trends stand out among these far-reaching developments: the growth and ageing of an increasingly

urbanized population; the upsurge of the emerging economies; and the pressure on natural resources and the environment (see the graph below).

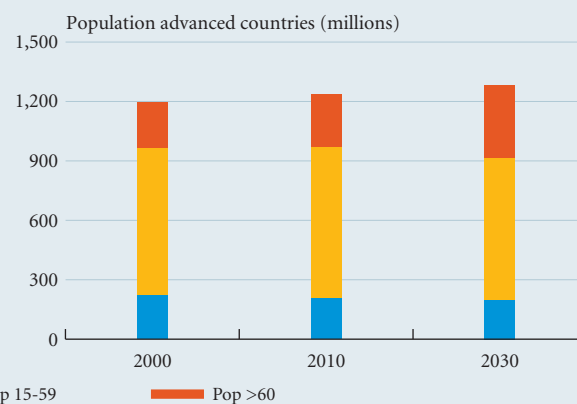
The UN estimates that the world's population, almost 7 billion people in 2010, will reach 9 billion by the middle of the century. This growth will also be accompanied by a higher degree of urbanization (from 50% of the world's population in 2010 to 59% in 2030) and progressive ageing (the median age will increase from 29 to 34 in 2030). Nonetheless, this combined trend conceals a notable heterogeneity between regions. While developing countries will be mainly responsible for the population and urban growth, the most advanced countries will see a greater reversal in their population pyramid: in 2030, their median age will reach 44 and more than 20% of their population will be over 65.

BROAD TRENDS THAT WILL DETERMINE THE GLOBAL SCENARIO OF THE FUTURE

Population growth...

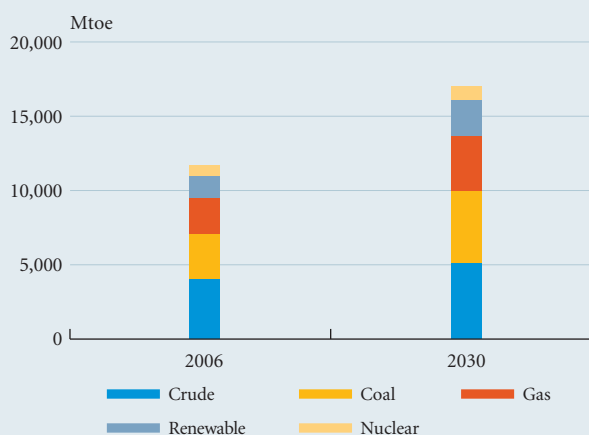


...and ageing in rich countries



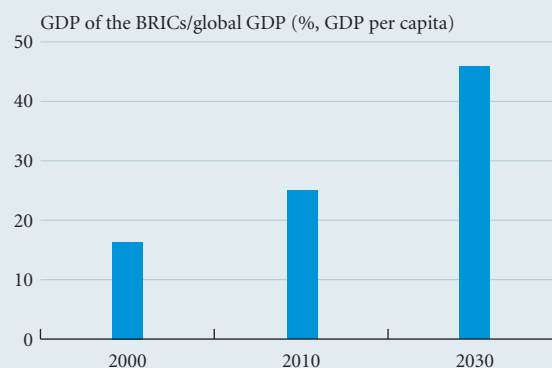
SOURCES: UN, Population statistics division and own calculations.

A rising demand for energy



SOURCES: OECD, IEA 2008 and own calculations.

Greater weight for emerging countries



SOURCES: Economic Intelligence Unit and own calculations.

This demographic change will contribute to another of the big global transformations: the rise of emerging economies. Lower production costs and a series of favourable policies have shifted the focus of manufacturing and, recently, some services towards Eastern Europe, East Asia and Latin America. The bulk of the evidence available on this matter suggests that this shift will continue so that, as shown in the graph above, the economic weight of these regions will increase. Most estimates state that the GDP of the BRIC countries (Brazil, Russia, India and China) will account for almost 50% of the world economy by 2030 and will have achieved the proportion of the G7 by the middle of the century. If the current trend persists, China might become the second world economy by 2025.

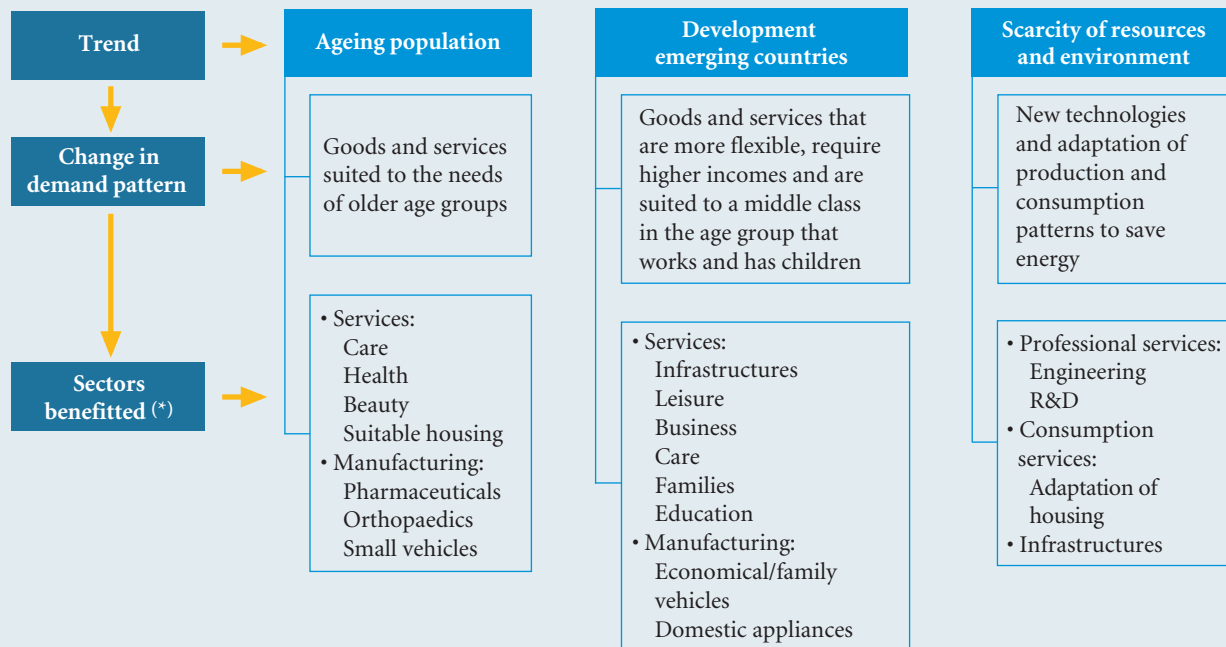
Although the breakneck speed of growth of these economies is positive in many different dimensions, there are also doubts as to the sustainability of the pattern of growth and its subsequent increasing pressure on the environment and strategic resources: water, food and especially energy. More than three quarters of the world's energy consumption currently comes from fossil fuels; with limited, non-renewable reserves and production systems that emit huge amounts of CO₂. Should we continue along this path and using current technologies, the Intergovernmental Panel on Climate Change (IPCC) estimates that, by the end of the century, emissions related to energy consumption might even have doubled the levels of 2000, entailing an average rise in temperature of between 2 and 6 °C and resulting in severe climate change and irreparable damage to the environment. That's why greater awareness of these risks on the part of society and the progressive reduction of fossil fuel reserves are expected to encourage investment in renewable and less polluting energy sources. If this doesn't happen, or if no substantial progress is made, the contribution of renewable sources to energy consumption will continue to be very limited: in 2030, this would increase one percentage point compared with the current rate of 13% (10% biomass and waste, 1% hydroelectric, 1% other).

Having outlined the profile of the new socioeconomic scenario in the medium term, the next step is to predict how this will affect consumption patterns and production structures. A priori, and at a global level, the sectors benefitting most from the broad trends described will be those aimed at meeting the needs of a richer, older society more demanding in terms of energy, ecology and technology (see the graph below).

When someone reaches retirement age, the share of income allocated to certain items (housing, food in the home, health, transport and personal care) increases, while it decreases in others (particularly items related to work, such as clothing, footwear and meals outside the home). That's why, in rich countries, sectors aimed at improving quality of life at later stages in life, such as pharmaceuticals and care services, have a bright future ahead of them. At the same time, the development of the emerging countries, with greater economic and demographic growth, a relatively younger population and a rising middle class, will provide new business opportunities in sectors serving the population segment that is at working age and that has children (clothing, housing, leisure, education, family transport, etc.) and in sectors aimed at meeting the higher demand for infrastructures (construction, engineering, financial services), the latter also being boosted by progressive urbanization and greater demands for energy. Similarly, we would also expect greater ecological awareness to stimulate demand in sectors involved in energy savings (adapting homes, etc.) or in improving the sustainability of the ecosystem (biotechnology, R&D, etc.).

In short, there are several sectors with great prospects for the future if they manage to take advantage of the opportunities. The dilemma facing some is whether the economic authorities, given these trends and the overpowering need to reactivate growth, should become more proactive in developing these sectors. This «picking winners» strategy, however, has turned out to be complex and with little guarantee of success.

THE BROAD TRENDS BRING ABOUT NEW CHALLENGES BUT ALSO NEW OPPORTUNITIES



NOTE: (*) Analysis not exhaustive.
SOURCE: Own calculations.

Moreover, data show that what determines the differences in productivity between countries is not so much the different sectors that go to make up their respective economies but rather their greater efficiency overall compared with that of their rivals. In other words, it's not so important to specialize in a leading sector as to have leading competitive firms within each sector.⁽¹⁾ However, achieving this greater competitiveness requires a flexible institutional framework that encourages innovation and rewards talent. And this is something that concerns the economic authorities: establishing a suitable playing field for firms to grow and compete in the global market, successfully adapting to the new requirements.

Our economies have already set off on their journey to the future. Albeit not at the speed of light, the tides of change are advancing relentlessly and making sure we're among the first to arrive at the next station will require a substantial collective effort. If institutions level out the field, firms take a leading position in innovation and strategy and people provide the talent and hard work, then the journey will be a successful one.

(1) See, for example, «How to compete and grow: A sector guide to policy», McKinsey Global Institute, 03/2010.

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EUROPEAN UNION

The bailout plan for Greece doesn't manage to calm the markets...

...and forces different countries in the euro area to take historic measures.

The euro area: historic measures in exceptional times

The month of May has been packed with far-reaching economic events in the European Union that will have repercussions both in the short and long term. The bailout plan for Greece approved by the different countries of the euro area and the International Monetary Fund (IMF), together with the extraordinary measures for economic austerity taken by the Greek government, were not enough to convince the markets. The risk of default on Greek debt remained high and fuelled fears that other countries in the euro area, such as Portugal, Ireland, Spain or Italy, might go down the same path. Given such a

turbulent scenario, the finance ministers from the different countries of the euro area held an urgent meeting and took drastic measures to stop the panic from spreading. The outcome of this meeting was the creation of a European stabilization mechanism provided with 750 billion euros. A more than impressive figure that, initially, managed to reduce the downward slide of the capital markets.

These funds are available for those euro area countries that might have problems of liquidity and take the form of loans or lines of credit. A third will be provided by the IMF, while the rest will be provided by the different member states according to their share in the European

THE EURO SUFFERS FROM RISING UNCERTAINTY

Euro-dollar exchange rate



SOURCES: Thomson Reuters Datastream and own calculations.

Central Bank. Lastly, the European Commission will extend the allocation to help countries with balance of payments problems of 50 billion euros to 110 billion euros, making this available to all EU countries, not just those that do not form part of the euro area. This will be carried out by issuing bonds guaranteed by the European Commission's budget.

Moreover, the European Central Bank (ECB) has also started to directly buy up the public debt of the different member states of the euro area. This is also historic, as to date the ECB had been totally opposed to taking such measures due to the inflationary risk involved. However, Jean Claude Trichet, the head of the ECB, justified this not as aid for those states with problems but as a measure to restore normality in the financial markets. He also announced that the operations to buy public debt would be neutralized by issuing fixed-

term deposits. Another remarkable fact is the international support received by the measures taken, particularly from the United States. One example is the reopening of the swap lines between the Fed and the ECB to ensure liquidity in the financial system.

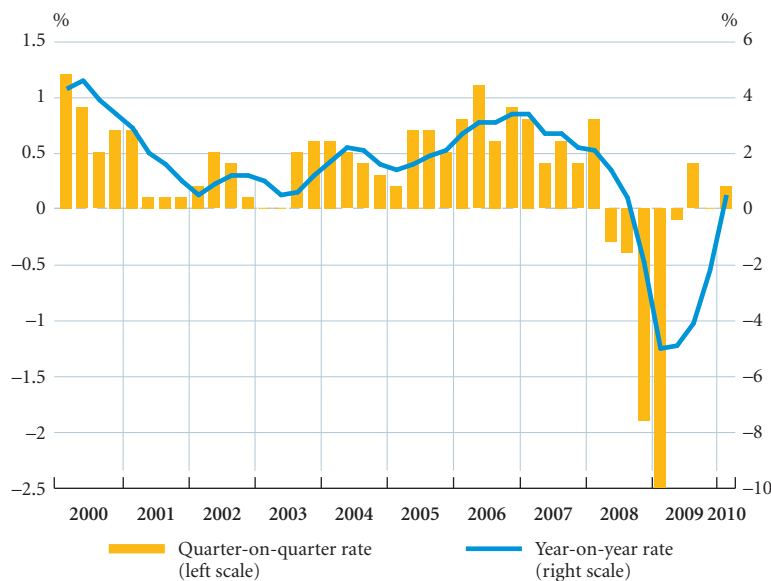
All these measures are in addition to the speeding up of fiscal consolidation policies, particularly in those countries where the risk of contamination is greater. This was precisely one of the points that most concerned the IMF and the European Commission, and they stated as such in their respective publications on the economic outlook of the euro area. For the moment, Portugal and Spain have already presented new measures to accelerate their public deficit reduction and other countries will probably follow suit over the coming months. Germany, for example, will not carry out the tax cuts promised by its chancellor, Angela Merkel, and the

The ECB buys up public debt.

There are concerns about the effects of withdrawing fiscal stimulus measures.

THE RECOVERY CONTINUES AT A GOOD PACE

Change in GDP in the euro area



SOURCES: Eurostat and own calculations.

The new decisions partly achieve their goal but the markets are still jittery...

recently elected British prime minister, David Cameron, has already announced that reducing public deficit is one of his priorities.

The response to the battery of decisions announced was highly positive, particularly by the financial markets. Proof of this is the historic upswing in the stock markets on Monday, 10 May, the day after the announcement. But the markets soon became nervous again. Firstly, because there has only been a general announcement of the extent and type of measures planned to be taken. It remains to be seen whether they will ultimately be adopted, as some require the approval of each country's parliament and, above all, the details of each measure have yet to be specified.

At present, the risk of default has eased slightly, so that part of the goal has been achieved. But this is taking its toll: the depreciation of the euro. Economic uncertainty, which remains very high,

together with the unexpected turnaround in the ECB's policy, have sunk the euro in record time, falling to 1.22 dollars when its exchange rate against the dollar was around 1.35 just two months earlier.

But we mustn't forget that a weak euro is not such bad news as it will help the foreign sector to continue boosting economic recovery. In fact, once again, the data on the economic recovery have been relegated to second place, in spite of the fact that, throughout the month of May, the gross domestic product (GDP) of the euro area was announced for the first quarter of 2010. This grew by 0.2% compared with the previous quarter, so that the year-on-year rate of change has now reached positive figures and is at 0.5%. Although the progress being made by the European economy seems somewhat weak, particularly when compared with the figures presented by the United States, it is good to see it clearly in positive terrain again. We must

...and the euro takes a dive.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010	
			2Q	3Q	4Q	1Q	April
GDP	0.5	-4.0	-4.9	-4.1	-2.2	0.5	-
Retail sales	-0.7	-2.2	-2.6	-2.2	-1.0	-0.2	...
Consumer confidence (1)	-18.1	-24.7	-27.9	-21.4	-17.0	-16.8	-15.0
Industrial production	-1.7	...	-18.8	-14.5	-7.6	4.3	...
Economic sentiment indicator (1)	93.5	80.8	75.6	84.1	91.9	96.6	100.6
Unemployment rate (2)	7.5	9.4	9.3	9.7	9.8	10.0	...
Consumer prices	3.3	0.3	0.2	-0.4	0.4	1.1	1.5
Trade balance (3)	-1.2	-13.5	-30.1	-4.1	15.9	29.1	...
3-month Euribor interest rate	4.6	1.2	1.3	0.9	0.7	0.7	0.6
Nominal effective euro exchange rate (4)	110.6	111.7	111.0	112.1	113.8	108.8	106.1

NOTES: (1) Value.

(2) Percentage of labour force.

(3) Cumulative balance for 12 months. Billion euros.

(4) Change weighted for foreign trade flows. Higher values imply currency appreciation.

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

remember that the quarter-on-quarter change in the last quarter of 2009 stood at a modest 0.0%.

The figures for growth in the first quarter have been in line with our forecasts, so that we still expect 1.0% growth in GDP for the year as a whole. To achieve this, over the coming quarter the pace of growth will have to continue at least at its current rate and speed up a little during the second half of the year. Something that seems quite plausible if we take the high frequency indicators as our guide. The recovery in industrial production is still notable, as well as that in the different indices of business confidence and economic sentiment. Demand, which has been finding it a little more difficult to climb out of its slump, may start to make progress over the coming months. Retail sales, for example, recorded a positive percentage change quarter-on-quarter in the month of March and consumer confidence,

although at quite a slow pace, is still also on positive ground.

The basic trend in the European economy is good and clearly positive, but uncertainty has increased again considerably. The measures announced should be defined soon and implemented quickly. This is fundamental to return to the path of economic growth. Both the recovery in the labour market, which is still at a standstill, as well as in investment, which is just starting, depend on the expectations of future growth and the confidence that different authorities manage to convey.

The foreign sector revives the German economy

As has been seen, uncertainty regarding the Greek government's solvency has raised doubts concerning the stability

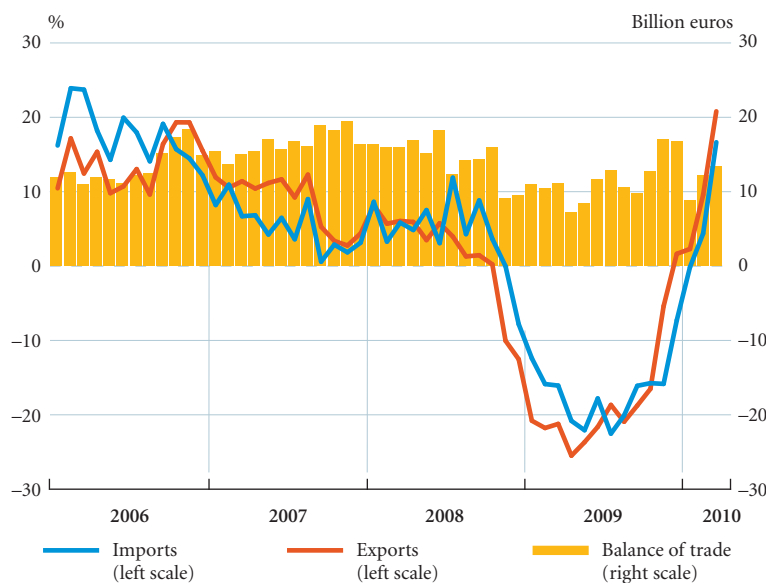
In any case, the economy continues to recover...

...although it's very fragile and might be affected by rising uncertainty.

German GDP grows by 0.2% in the first quarter of 2010.

GROWTH IN EXPORTS BOOSTS THE GERMAN ECONOMY

Year-on-year change in trade flows and monthly balance of trade figures



SOURCES: Deutsche Bundesbank and own calculations.

Private consumption doesn't manage to take off.

of the euro area over the last few months. Given this threat, the countries within the monetary union designed a bailout plan for the Greek economy that would, in turn, stop any possible spread to other European economies. This bailout plan stumbled against the hesitance of the German government that, fearing reprisals by its electorate, would have preferred to postpone its approval until after the elections in the state of North Rhine-Westphalia.

Pressure by the financial markets did not permit such a delay, which may have contributed to the severe lesson given to Angela Merkel's party in the regional elections. Consequently, the two parties that form the coalition government lost their majority in the upper chamber of the German parliament (Bundesrat). This will make it difficult for the chancellor to take decisions, something that was unthinkable when she confirmed her position just eight months ago.

However, such disruption caused by the Greek debt crisis has not masked the positive trends in indicators that, in spite of the adverse weather conditions in the

first quarter, showed improvement in the German economy. German GDP grew by 0.2% quarter-on-quarter in this period, better than the decline predicted by analysts. This, and the upgrade of data for the previous quarter, placed the year-on-year change at 1.5%, the first increase since mid-2008.

Although we do not have a breakdown of GDP by component, the monthly data point towards the foreign sector as the main engine for the German economy in this period. This is reflected in the above graph, which shows a 20.7% rise in exports year-on-year in March, its highest growth since 2000. During the same period, imports also recorded significant growth, namely 16.5%. The depreciation of the euro and the rise in Asian demand will sustain exports during the second half of the year. These, however, will have a slower pace of growth, the result of the slowdown in intra-European trade, which currently accounts for 70% of German exports.

This improvement in foreign demand was not emulated by private

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010	
			2Q	3Q	4Q	1Q	April
GDP	1.0	-4.9	-5.8	-4.8	-2.2	1.5	-
Retail sales	0.0	-2.2	-1.9	-2.4	-1.8	-0.3	...
Industrial production	-0.1	-15.9	-19.2	-15.6	-8.5	5.2	...
Industrial activity index (IFO) (*)	96.8	87.7	84.7	89.9	93.5	96.4	101.6
Unemployment rate (**)	7.8	8.2	8.3	8.3	8.2	8.1	7.8
Consumer prices	2.6	0.4	0.3	-0.3	0.4	0.7	1.0
Trade balance (***)	195.0	140.2	140.4	131.0	129.5	140.7	...

NOTES: (*) Value.

(**) Percentage of labour force.

(***) Cumulative balance for 12 months. Billion euros.

SOURCES: Eurostat, European Central Bank, European Commission, national statistical bodies and own calculations.

consumption. In March, retail sales equalled the record lows of 2007, with a 1.6% fall month-on-month. This figure is actually quite surprising, particularly considering the improvement this year in consumer confidence and in the unemployment rate, which fell to 7.8% in April. These indicator trends suggest an upswing in private consumption in the short term, albeit moderate due to the uncertainty regarding the labour market and inflation. The latter stood at 1.0% in April, boosted by higher crude prices.

In spite of stagnant private consumption, the recovery in foreign demand has revived German industry, heavily oriented towards exports. So both production and industrial orders picked up strongly in March, with month-on-month growth rates of 4.0% and 5.7%. However, this did not stop both series from remaining at the same level as 2005, far from the record highs achieved before the financial crisis hit.

It's no surprise that, given the upswing in industrial activity, the IFO index for economic sentiment rose again in May, now at levels similar to those of 2008. This, and the recovery in industrial

capacity utilization, will mean that investment can once again contribute to growth in the German economy in 2010, after a year and a half of year-on-year falls.

However, this expected recovery in investment and the foreign sector will not stop the Germany economy's growth from being below its potential in 2010. Unlike what happened over the last two years, public expenditure will not contribute positively to growth. The high German fiscal deficit, which will exceed 5% this year, and the expected lower tax revenue in the future, will force the government to take further measures to reduce its deficit. In spite of this budget adjustment plan still not being known, everything points towards the tax cuts announced during the election campaign not actually being implemented.

France increases its efforts to control its public accounts

The recession and fiscal stimulus measures adopted to revive the economy have aggravated budget imbalances. In 2009, France's public deficit was 7.5%

The German government must take further measures to adjust its budget.

The French government undertakes to cut its deficit to 3% before 2013.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010	
			2Q	3Q	4Q	1Q	April
GDP	0.1	-2.5	-3.2	-2.6	-0.4	1.2	-
Domestic consumption	-0.6	1.0	0.6	-0.1	4.3	1.8	1.1
Industrial production	-2.4	-11.8	-15.2	-11.3	-4.7	3.9	...
Unemployment rate (*)	7.8	9.5	9.4	9.7	9.9	10.1	...
Consumer prices	2.8	0.1	-0.2	-0.4	0.4	1.3	1.7
Trade balance (**)	-50.2	-48.7	-52.8	-45.0	-41.4	-42.2	...

NOTES: (*) Percentage of labour force.

(**) Cumulative balance for 12 months. Billion euros.

SOURCES: OECD, Eurostat, INSEE, European Commission and own calculations.

French GDP grows by 0.1% in the first quarter of 2010.

of GDP and total debt grew to 77.6% of GDP. Moreover, in 2010 the public deficit is expected to reach a record figure of over 8% of GDP. As in other, highly indebted countries, the French government acknowledges the need to control finances more thoroughly and thereby calm the markets. It therefore proposes to reduce its deficit to 6% in 2011, 4.6% in 2012 and 3% in 2013.

With this very aim in mind, on 20 May the French president, Nicolas Sarkozy, announced his intention to introduce, in the constitution, a new reform aimed at controlling the deficit: as from the next general elections in 2012, the government will set a five-year target for the structural public deficit and the Constitutional Council will ensure that it is met. This initiative will be subject to consultation by the political parties in June and the executive will then put forward a constitutional bill.

Another area implemented by the French government to improve its public accounts is pension reform. On 16 May the minister for Employment, Eric Woerth, presented a memorandum to the trade unions proposing to increase the length of time for employment. This would be done by either raising the legal retirement age, currently at 60, or by increasing the period to pay social security contributions.

With regard to the pace of recovery of the French economy, data from its National Accounts system show a 0.1% rise in GDP in the first quarter, so that there have now been four consecutive quarters with positive figures for quarter-on-quarter growth in France. Although this 0.1% rise is lower than the figure recorded in the preceding quarters, possibly due to adverse weather conditions, most indicators suggest

that this will improve in the second quarter.

From the point of view of supply, of note is the strong recovery in industrial production in the month of March, advancing 6.2% year-on-year. For their part, the surveys can be interpreted positively in general, although they are divergent. According to the Bank of France's Annual Report published on 10 May, the business climate index for the services sector rose by two points, standing at 95 points, while the equivalent index for industrial business fell by two points. Based on the trend in activity indicators, the same report predicts moderate progress in activity over the coming months and estimates a 0.5% growth in French GDP in the second quarter of 2010.

From the perspective of demand, a breakdown by component of French GDP shows that exports are performing well, growing by 3.9% in the first quarter of 2010, greater than imports, which rose by 2.0%. The fact that many European countries are experiencing economic difficulties might slow up this favourable trend in foreign sales, as Europe accounts for two thirds of all French exports. However, the depreciation of the euro might offset this, facilitating trade with non-EU countries and thereby taking advantage of the dynamism of the emerging economies. This was precisely one of the aims of the French president's visit to China last April.

With regard to private consumption, normally the engine for French growth, the data point to total stagnation in the first quarter of 2010. The outlook for the second is somewhat better, in spite of the fact that household consumption fell a little in April. For its part, public expenditure only increased by one tenth

The government plans to reform pensions.

Exports take over from consumption as the engine for growth.

of a percentage point and, unlike private consumption, it's not expected to rise over the coming months, in fact quite the opposite.

Investment, the other component of domestic demand, fell in the first quarter of the year, albeit more moderately. However, surveys on business investment decisions show a more favourable profile for 2010. In effect, the entrepreneurs interviewed in April predict a 6% rise in investment, particularly in electronic equipment and machinery.

In summary, although the recovery in economic activity in France slowed up a little in the first quarter of 2010, indicators point towards stronger growth for the second quarter. However, there are risks of decline due to the problems of excessive debt in a large number of European countries.

Italy: public accounts don't hamper a return to growth

The Italian economy was growing again in the first quarter of 2010, with a 0.5% rise in GDP compared with the previous quarter. This figure, better than analysts'

estimates, and the upgrade in the last data for 2009, raised the year-on-year increase in GDP to 0.6%, its first positive figure in two years. However, trends in high frequency indicators are not completely in line with this upswing, suggesting a certain weakness in the recovery.

Regarding demand, retail sales for the first quarter were down 0.4% compared with the same period in 2009, at levels similar to those of 2005. Moreover, the rise in unemployment in April, estimated to be close to 8.8%, and the low consumer confidence do not suggest signs of private consumption getting stronger in the short term. In April, inflation grew by one tenth of a percentage point, to 1.5%, partly boosted by higher crude prices, although still at a historically low level.

Foreign demand didn't contribute to growth in the Italian economy either in this period. In spite of the 9.2% rise year-on-year in exports in the first quarter of the year, the trade deficit increased again compared with the previous quarter.

That's why the only signs of recovery in the first quarter of 2010 came from the

Italian GDP grows again in the first quarter.

Industrial production progresses in the first few months of 2010.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010	
			2Q	3Q	4Q	1Q	April
GDP	-1.3	-5.1	-6.1	-4.7	-2.8	0.6	...
Retail sales	-0.3	-1.7	-1.9	-1.9	-0.7	-0.4	...
Industrial production	-3.8	-18.2	-23.1	-17.4	-9.2	2.9	...
Unemployment rate (*)	6.7	7.7	7.6	7.9	8.2	...	-
Consumer prices	3.3	0.8	0.8	0.1	0.7	1.3	1.5
Trade balance (**)	-10.0	-9.1	-11.2	-7.4	-4.9	-5.3	...

NOTES: (*) Percentage of labour force.

(**) Cumulative balance for 12 months. Billion euros.

SOURCES: OECD, national statistical bodies and own calculations.

The Italian government will present a budget adjustment plan.

supply side. Industrial production posted further growth in the first quarter of the year, distancing it from the minimum reached in March 2009. The upswing in industrial confidence and orders in April suggests this trend will continue over the coming months. Investment is therefore expected to make a positive contribution in the first half of 2010, particularly if industrial capacity utilization grows slightly.

In spite of the good news of the recovery in GDP, the Italian government must act to sort out its battered public accounts, with a debt close to 115% in 2009. This is a matter of priority in the European Union because of the instability caused by the mismatched fiscal situations of the different governments. That's why the Italian executive is studying a budget adjustment plan similar to those presented by other European countries. This would include measures such as raising the retirement age, reducing the number of public employees, repealing

some fiscal benefits and combating tax evasion, among others. It is estimated that all these measures could lead to savings of 24 billion euros for the central government's coffers over two years (slightly lower than 2% of Italian GDP).

The United Kingdom: the new government takes over the reins of the economy

After the elections on 6 May, the first Liberal-Conservative coalition in history took over from the Labour government. The new government has inherited an economy in serious difficulties with a huge fiscal deficit, 11.5% of GDP in 2009. The recently formed coalition must therefore get to work without delay.

Although any coalition raises doubts as to the capacity for agreement, for the moment the new British government has presented a unanimous front. In fact, the

The Liberal-Conservative coalition forms a new British government.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
GDP	0.5	-4.9	-5.9	-5.3	-3.1	-0.2	-	...
Retail sales	2.2	1.4	0.2	2.5	3.0	0.8	1.7	...
Industrial production	-3.1	-10.2	-11.7	-10.7	-5.9	0.0
Unemployment rate (1)	2.8	4.7	4.7	4.9	5.0	4.9	4.7	...
Consumer prices	3.6	2.1	2.1	1.5	2.1	3.2	3.7	...
Trade balance (2)	-93.7	-86.7	-88.7	-84.0	-82.2	-82.2
3-month Libor interest rate (3)	5.5	1.2	1.4	0.8	0.6	0.6	0.7	0.7
Nominal effective pound exchange rate (4)	97.6	73.9	77.0	83.7	79.0	80.4	78.2	79.1

NOTES: (1) Percentage of labour force.

(2) Cumulative balance for 12 months. Billion pounds.

(3) Average for the period.

(4) Index weighted for foreign trade flows (January 2005 = 100). Higher values imply currency appreciation.

SOURCES: OECD, Bank of England, ONS, European Commission and own calculations.

recently elected prime minister, the Tory David Cameron, and his deputy, the Liberal-Democrat, Nick Clegg, announced the priority of sorting out the public accounts. To this end, a new urgent proposal will be presented on 22 June.

Both parties have also agreed to apply their fiscal austerity plan this very year, with cutbacks totalling 6 billion pounds. Moreover, the new chancellor of the exchequer, George Osborne, announced the creation of an independent office to control the budgets, the Office for Budget Responsibility. This body will independently carry out forecasts of the economy and public accounts and will take part in the urgent adjustment of the budget. Similarly, the chancellor of the exchequer also announced his intention to lower company tax and simplify the rules governing the setting up of foreign firms in the United Kingdom. Another measure was the raising of the minimum tax threshold for individuals to 10,000 pounds.

With these changes, the government is attempting to boost the British recovery started in the last quarter of 2009. After the 0.3% rise in GDP in the first quarter of 2010, indicators suggest a somewhat higher increase in the second. Consequently, industrial production in the month of March increased by 1.9% year-on-year, the first positive rate since March 2008. Most of the confidence surveys also showed an advance, except the consumer survey, which recorded a decline. Similarly, retail sales grew by 0.2% in the month of April, leaving behind the large drop in January caused by strong snowfalls.

On the other hand, inflation in the month of April was higher than

expected, standing at 3.7% year-on-year, forcing the governor of the Bank of England to give an official explanation of the reasons why this rate had exceeded 3%. Among the main reasons, he mentioned the following: the restoration of value added tax (VAT) at 17.5% in January, after 13 months at 15%; the rise in energy prices; and the passing on to the end price of more expensive imported components due to the pound's depreciation.

In spite of the pound's fall in value implying a loss of confidence by the markets in the British economy, it also has a positive side if it helps to boost exports. However, for the moment, the performance of foreign sales, although rising, has been less than would have been expected given the extent of the currency's depreciation. In fact, imports in March rose more than exports, thereby increasing the trade deficit.

Although fiscal consolidation is vital to establish the confidence of the financial markets concerning the capacity of the British government to pay back its debts, this also has a negative effect on growth prospects in the short term. Most have therefore slightly downgraded their growth forecasts for 2010. In fact, in its Inflation Report for May 2010, the Bank of England includes, in its forecasts, the risks of decline caused by the plans to reduce public expenditure and the problems of Greece and other highly indebted countries. The Report therefore estimates a year-on-year growth in GDP in the United Kingdom of around 1.5% year-on-year in the second quarter of 2010. Nonetheless, this would be the first positive year-on-year rate in six quarters, quite a lot higher than the 0.2% drop recorded in the first quarter.

An independent office is set up to control budgets.

Inflation stands at 3.7% year-on-year in the month of April.

The year-on-year growth in GDP might be positive in the second quarter.

Emerging Europe confirms that its expansion is speeding up.

For the moment, the engine of the recovery is the foreign sector.

Emerging Europe: a clear recovery, in spite of financial storms

Emerging Europe is consolidating the scenario of recovery that has been expected for the last few months. With the data from the first part of 2010 already published, it can be seen that the pace of activity has accelerated. The results in terms of GDP growth in the first quarter were positive and, in general, better than expected. Among those countries for which data are available, the strong quarter-on-quarter advance of Hungary and Slovakia are particularly of note. Even in those countries where GDP is still falling, such as Romania or Lithuania, the drop turned out to be less than expected. The trend in the economic sentiment indices available for the second quarter suggests that the upswing in activity continued in April.

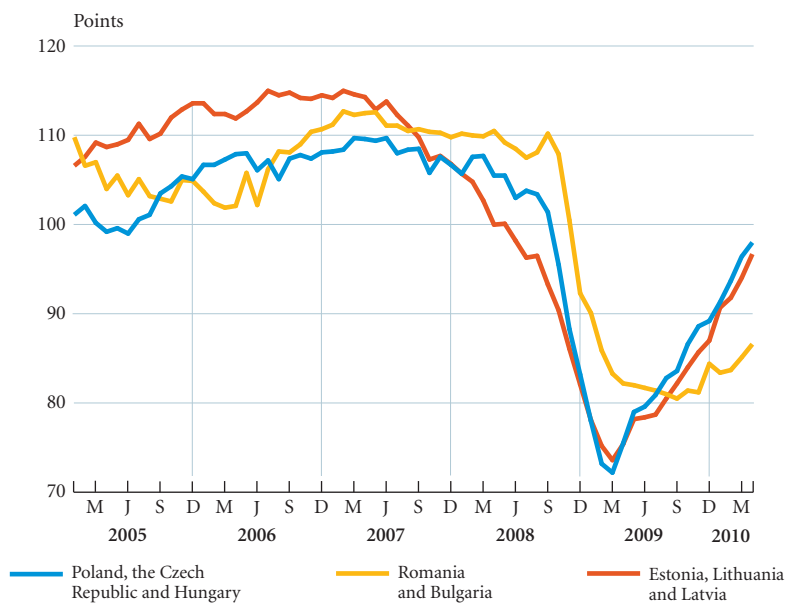
What pattern of growth are the economies of emerging Europe showing?

Although we do not have a breakdown by component provided by the National Accounts system, the trends in indicators suggest that domestic demand is still listless in most of these countries and that the lion's share of the recovery is thanks to the foreign sector. This situation is particularly severe in Romania, an economy that, due to the strong adjustment in public accounts, is undergoing one of the worst slumps in domestic demand in the region. According to estimates produced by the Institute of International Finance, its domestic demand will have fallen, in year-on-year terms, by the order of 4% in the first quarter.

Together with Romania's present weak activity, the new package of austerity measures recently announced by the government, with the core measures of cutting civil service wages and pensions, will probably lead to lower growth than expected.

EMERGING EUROPE IS HEADING FOR RECOVERY

Economic sentiment index



SOURCES: European Commission and own calculations.

On the other side of the scale we find Poland. The bulk of the evidence available suggests that, should 2009's trends continue, the country's private consumption will most probably have remained in expansion in the first quarter. In this case, the Institute of International Finance estimates that domestic demand as a whole might have achieved year-on-year growth of approximately 4%, above the modest growth figures forecast by the institution for the Czech Republic and Hungary.

Within this context, the main engine for activity in the region comes, as mentioned before, from the foreign sector. Here we are faced with a twofold favourable situation that affects the trade balances of the region's countries. Firstly, improvement in the main export countries (in particular, the euro area) is contributing to a notable recovery in the pace of exports. In addition, the weak push provided by domestic demand is ensuring that imports grow at a slower rate than sales abroad. The cases of Hungary and the Czech Republic are paradigmatic of this situation.

Everything therefore seems to be going as expected: in 2010 most of the economies should have left the severe recession of 2009 behind them, this expansion continuing into 2011. However, concerns about the region have grown over the last few weeks. The reason, totally unrelated to the zone's internal dynamics, is the risk of hypothetical contamination from the Greek sovereign debt crisis. Should this factor downgrade the forecasts for activity?

For the moment, the answer is «no», due to three different aspects. Firstly, because of the lessons that can be learned from the tense period of May per se. First off, we should point out that the extent to which these financial tensions were passed on was clearly contained, far from the worsening situation exhibited by Greece and other economies. Moreover, the current levels of country-risk indicators are, in all the zone's economies, lower than those last January.

A second factor that offers peace of mind is that the public account situation in emerging Europe is notably better than in many of the euro area's members. The volumes of debt to be issued in 2010 are relatively small, even in countries such as Poland and Hungary, with a slightly more exposed budget situation. In short, we are far from the more usual scenarios of unwilling budget adjustments seen at other latitudes.

Lastly, and from a broader perspective, we should remember that the key economies for emerging Europe in terms of financial exposure and international trade (in particular, Germany) have not seen any worsening in their recovery forecasts. In summary, we should conclude that the episode of contamination was contained, that the fiscal foundations are reasonable and that the relevant economic environment remains in line with the expansion coordinates outlined months ago. Three reasons, albeit still closely scrutinizing the financial trends in the Union, for expecting emerging Europe to grow over the next two years.

Poland has an atypical pattern, as its consumption is keeping its head above water.

The budget situation of emerging Europe is reasonably solid.

Financial tensions have ended up with a limited spread which does not alter the positive outlook for the region.

Innovation performance: cross-country comparison

For modern economies, the ability to convert technological knowledge into growth is one of the most important factors in improving their competitiveness. This is a complex process and assessing how countries develop and market their discoveries is no easy task. Designing indicators for innovation performance is therefore of great interest as it can guide countries in terms of their policies to stimulate investment and development. These indicators are also useful for assessing whether the economic cycle is having an effect on the creation of ideas, particularly within the context of the current crisis.

With this aim in mind, since 2001 the European Commission has published the European Innovation Scoreboard (EIS), an instrument to illustrate the degree of innovation of the EU27 Member States and other countries. In general terms, this study focuses on producing the Summary Innovation Index (SII), calculated using indicators that summarize seven dimensions required for progress, in turn grouped into three blocks.

The first block includes drivers of innovation that are external to the firm: the creation of knowledge or human resources and the financing of projects. For example, it contains variables such as the ratio of doctorate graduates, participation in life-long learning, public R&D expenditure and the ratio of firms with broadband access. The second group focuses on business initiative: company investment and private expenditure on R&D, IT or innovation; linkages (the degree of collaboration between innovative SMEs or the number of publications); and the production of copyright (patents, trademarks and designs). The last group quantifies the output of firms' activity: the total innovation products, such as the ratio of SMEs introducing product, process or organisational innovations and the ratio of firms that manage to reduce their labour or energy costs thanks to innovation; as well as the economic effects (sales, employment and exports).

What do these indices reveal about the countries' attitude towards innovation? The graph below shows the correlation between countries from the innovation index and their annual growth according to the findings from the EIS 2009. It should be noted that the index refers to an earlier period as it uses variables gathered during 2006, 2007 and 2008. An analysis of the spread of data allows us to group the economies according to their ability to generate innovation: innovation leaders, followers, moderate innovators and catching-up countries. In turn, the countries' growth in innovation performance is classified into three dimensions: growth leaders, moderate growers and slow growers.

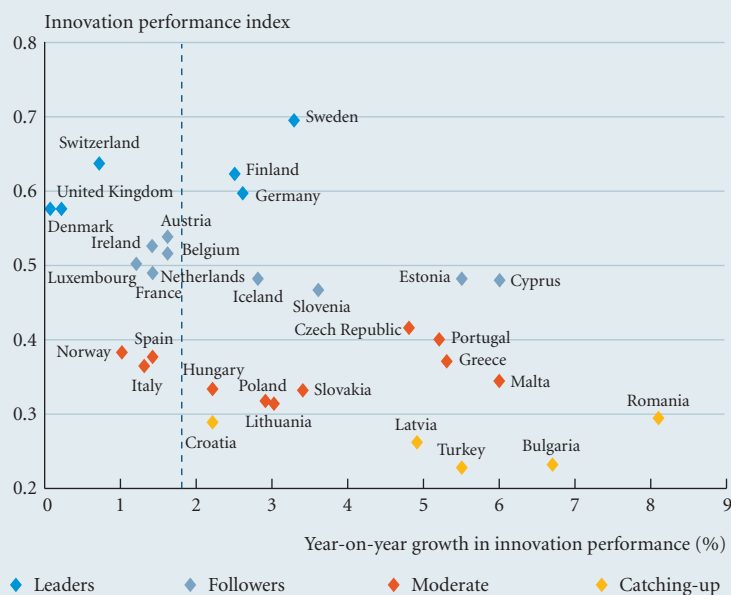
According to this study, Denmark, Finland, Germany, Sweden, Switzerland and the United Kingdom lead the ranking with values that are quite a lot higher than the average for the EU27 member states. However, they have varying speeds of growth; while Germany, Finland and particularly Switzerland are improving their ability to innovate, Denmark and the United Kingdom are showing signs of slowing up. The case of Japan and the United States has not been dealt with here but a previous study places both countries among the leaders.

In the group of innovation followers are states with an index slightly above the average. Although most have moderate growth rates (Austria, Belgium, Cyprus, Estonia, France, Ireland, Luxembourg and Holland), there are some reservations about the good rates enjoyed by Cyprus, Estonia, Iceland and Slovenia.

Moderate countries are below average in terms of their innovation. Among these, the cases of Italy, Norway and Spain come as some surprise, as their growth is also slow. This suggests that these countries should possibly review their policies and invest more in those areas that would improve their ability to innovate.

NOTABLE CONTRAST BETWEEN COUNTRIES IN TERMS OF INNOVATION CAPACITY

Innovation performance index (2006-2008)



NOTE: The dotted line shows the innovation performance and growth for EU27 countries.

SOURCES: European Innovation Scoreboard 2009, INNO METRICS and own calculations.

In the Spanish case, its lower innovation performance than the EU27 average is mainly due to its weak business initiative, in investment, linkages and the production of copyright. On the other hand, its relative strength lies in its ability to finance projects and the economic effect of its innovation. Over the last five years, business investment has made a positive contribution to the rate of innovation growth thanks particularly to the 12% increase in private credit and 13% in innovation expenditure. However, human resources, linkages and the overall number of innovation products fell compared with the EU27 average.

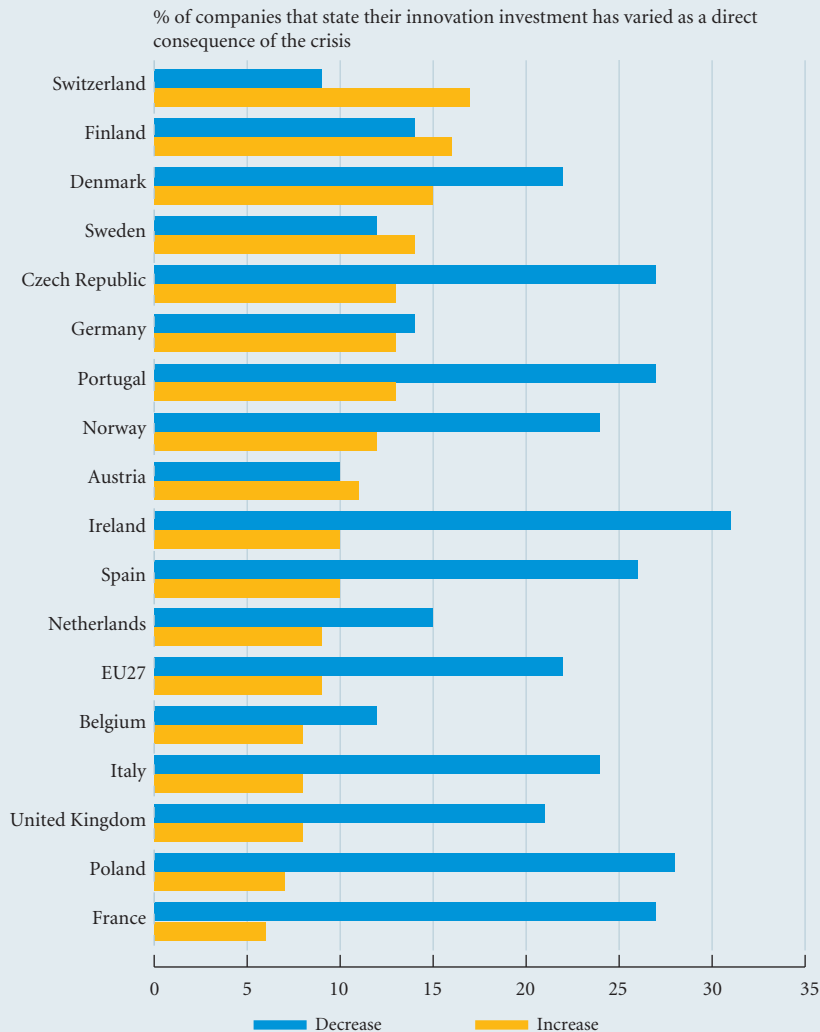
The rest of the moderate countries, mostly from emerging Europe, are increasing their innovation index either gradually (Hungary, Lithuania, Poland, Slovakia) or more quickly (the Czech Republic, Greece, Malta and Portugal). These findings therefore point towards a certain gradual convergence in the innovation levels of some countries.

The last group of countries, the catching-up group, develop their technological knowledge very gradually and are below the EU27 average (Bulgaria, Romania, Latvia, Turkey and Croatia). Of particular note is Croatia's bad performance due to its equally low rate of growth in innovation attitude.

So the innovation index is clearly useful for informing the respective countries on their performance regarding the development of innovations. However, it does not help to assess whether the current recession has modified innovation practice as it does not cover the most recent period. To this end, we can use the Innobarometer survey of 2009, produced in April 2009 by the Gallup Organization for the European Commission. The survey asks companies with more than 20 employees about their investment plans. This

questionnaire also asks direct questions about whether they have varied their innovation expenditure due to the slump in the economy as from mid-2008. The results show that 22% of innovative firms reduced their level of expenditure on innovation, a figure that is quite a bit higher than the 9% recorded in the period 2006-2008. This suggests that the economic crisis has had a significant effect on investment in this area.

TOTAL EXPENDITURE ON INNOVATION FALLS DUE TO THE CRISIS



SOURCES: Innobarometer 2009 and own calculations.

However, not all countries reacted in the same way. In fact, some firms took a more radical stance and used this recession as an opportunity to invest in innovation. The case of Switzerland is of note, where only 9% of its firms reduced their expenditure compared with 17% that increased it. In Finland, Sweden, Germany and Austria, the proportion of firms that increased or decreased their expenditure was similar. In the rest, the number of firms that reduced their level of spending on innovation was higher than those that increased it,

taking a more defensive attitude. The findings of the Innobarometer 2009 also indicate that the most innovative firms tended to cut back less on their expenditure on innovation, so that they might be less affected by the current recession.

In summary, an analysis of innovation performance shows that there are notable differences between economies. Given the importance of technological progress for well-being in general, these findings show the need for the so-called moderate countries (and the catching-up countries) to review their investment strategies in innovation. Similarly, the data show that the process of convergence has slowed up somewhat as a result of the crisis, as it is precisely the less innovative countries that have seen the biggest cuts in expenditure in this area.

*This box was prepared by Maria Gutiérrez-Domènech
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FINANCIAL MARKETS

Monetary and capital markets

The ECB buys bonds and sterilizes, while the Fed moves forward in its exit strategy

As already happened in April, in May investors' attention focused on the strong tensions concerning Greece's sovereign debt and the potential negative implications if its spread to other countries was not contained in time. For this reason, the markets expected that, on 6 May, the day of the meeting of the Governing Council Central European Bank (ECB), some measure or pronouncement would be announced aimed at normalizing the functioning of the markets. However, the reserve bank communicated that it was maintaining its official rate at 1% and its president, Jean-Claude Trichet, stated that they had not discussed the possibility of intervening in the markets by buying up government bonds.

In the post-meeting press conference, Trichet added that the European Central Bank's non-standard monetary policy would remain unchanged in all its aspects. Moreover, the ECB president stressed that market trends were no obstacle to continuing with the gradual withdrawal of monetary stimulus.

Regarding the economic perspective, the ECB gave a more positive view of the recovery in business, supported by global growth and foreign trade. On the other hand, although Trichet said that inflationary pressures were expected to remain contained in the euro area, he also stated that there was a risk of

importing inflation due to rising commodity prices.

On 7 May, the high uncertainty and volatility reigning in the markets led to a spectacular fall in the price of Greek sovereign debt, which also infected the public debt of Spain, Portugal, Ireland and Italy, albeit to a lesser extent. This resulted, on Monday 10 May, in an unprecedented coordinated effort, with the governments of the euro area together with the ECB announcing a series of measures aimed at safeguarding the region's financial stability.

Among the different measures, of note is the ECB's decision to start buying up government and private bonds to ensure the markets function properly. Trichet also announced that liquidity resulting from bond purchases would be re-absorbed via fixed-term deposits. In this respect, on 18 May the ECB carried out a tender for deposits in which it accepted 16.5 billion euros at a marginal interest rate of 0.29%, thereby counteracting the total amount of bonds purchased up to 17 May.

Other measures taken by the ECB affected the agenda for refinancing operations at three and six months and dollar liquidity. Firstly, on 12 May, another 6-month tender was carried out at a rate fixed at the average minimum bid rate of the weekly tenders, allotting 35.688 billion euros among 56 commercial banks. Secondly, the 3-month tenders, which will be carried out in May and June, will once again adopt a full

The ECB sees the outlook as positive for business but is more cautious about inflation trends.

The ECB keeps its official interest rate at 1%.

The ECB's buying of bonds is being complemented by deposit tenders to sterilize the liquidity resulting from these operations.

allotment procedure and a fixed interest rate of 1%. Lastly, the ECB resumed the swap line in dollars with the Federal Reserve (Fed) to provide financial institutions in the euro area with dollar liquidity.

On the other side of the Atlantic, the most interesting news regarding the Fed was related to its non-standard monetary policy, and in particular fixed-term deposits. The central bank has communicated that, in mid-June, it will start to test, on a small scale, the functioning of the term deposit facility. This is one of the instruments that will be used by the institution when it starts to drain excess reserves from the financial system. The test will consist of auctioning five operations, at a fixed

interest rate and a maximum term of 84 days.

There have been no substantial changes in its standard monetary policy. At least this was implied by the latest statements given by the Fed governors of Dallas and Minnesota, Richard Fisher and Narayana Kocherlakota, respectively. Both governors presented a positive view of business but always indicating that the monetary authority believes it is still too early to raise the official rate.

The latest financial incidents have increased disparity in the behaviour of interbank markets in the euro area and United States. The US interbank curve has risen 16 basis points on average (100 basis points are 1%), and its slope

The United States' greater financial stability can be seen in the trends in its interbank curve.

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						
2009									
June	1.00	1.10	1.50	0.25	0.60	0.46	0.50	1.19	0.33
July	1.00	0.89	1.36	0.25	0.48	0.41	0.50	0.89	0.41
August	1.00	0.82	1.30	0.25	0.35	0.39	0.50	0.69	0.30
September	1.00	0.75	1.24	0.25	0.29	0.35	0.50	0.54	0.31
October	1.00	0.72	1.24	0.25	0.28	0.33	0.50	0.59	0.34
November	1.00	0.72	1.23	0.25	0.26	0.30	0.50	0.61	0.32
December	1.00	0.70	1.25	0.25	0.25	0.28	0.50	0.61	0.35
2010									
January	1.00	0.67	1.23	0.25	0.25	0.26	0.50	0.62	0.34
February	1.00	0.66	1.22	0.25	0.25	0.25	0.50	0.64	0.36
March	1.00	0.63	1.21	0.25	0.29	0.24	0.50	0.65	0.28
April	1.00	0.66	1.24	0.25	0.35	0.24	0.50	0.68	0.21
May (1)	1.00	0.69	1.25	0.25	0.48	0.25	0.50	0.70	0.04

NOTES: (1) May 20.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-10-08 (3.75%), 6-11-08 (3.25%), 4-12-08 (2.50%), 5-03-09 (1.50%), 2-04-09 (1.25%), 7-05-09 (1.00%).

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

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

(5) Interbank rate.

SOURCES: National central banks, Bloomberg and own calculations.

Risk aversion increases in government bond markets.

(the difference between the 12-month and 1-month rate) has risen by 9 basis points. This behaviour does not seem to be due to financial tensions but rather to the United States being at a later stage in the recovery cycle.

On the other hand, the apparent stability of the interbank curve for the euro area, which has only risen 3 basis points on average, occurs within a context of a market with certain operational problems. In this respect, the ECB's emergency measures to provide liquidity reveal a lack of confidence among the financial institutions of the euro area. This situation suggests that the slight upward trend in yield, which was expected for this market a few months ago, will take a bit longer to materialize.

The approval of the Greek bailout plan is complemented with the creation of a stabilization fund in the European Union.

Government bond markets: a rush for quality

During the month of May, the rise in risk aversion in the euro area's government bond markets became extreme. The greater uncertainty regarding governments' ability to meet public debt payments, such as Greece, Portugal or Spain, significantly widened the differentials between Germany and these countries.

Investors, gripped by the fear of default or restructuring, transferred their money towards the government bonds of countries such as the United States and Germany, considered to be a safe haven when panic reigns supreme, such as in the last few weeks.

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
2009								
May	3.59	3.95	4.29	4.48	3.46	1.49	3.75	2.41
June	3.39	3.73	4.13	4.43	3.53	1.36	3.69	2.32
July	3.30	3.57	3.85	4.16	3.48	1.42	3.80	1.97
August	3.26	3.54	3.78	4.08	3.40	1.31	3.56	2.03
September	3.22	3.54	3.81	4.02	3.31	1.30	3.59	1.99
October	3.23	3.53	3.79	4.07	3.38	1.42	3.62	2.02
November	3.16	3.42	3.75	4.02	3.20	1.27	3.52	1.84
December	3.39	3.59	3.98	4.14	3.84	1.30	4.02	1.90
2010								
January	3.20	3.46	4.12	4.12	3.58	1.33	3.91	2.00
February	3.10	3.40	3.86	4.00	3.61	1.31	4.03	1.90
March	3.09	3.42	3.82	3.98	3.83	1.40	3.94	1.88
April	3.02	3.29	4.03	4.02	3.65	1.29	3.85	1.78
May (*)	2.74	2.99	4.10	3.97	3.31	1.27	3.63	1.60

NOTE: (*) May 20.

SOURCE: Bloomberg.

The approval on 2 May of the bailout plan for Greece, totalling 110 billion euros, initially appeared to stop the situation from spreading to the rest of the peripheral countries. But this green light for the plan didn't manage to calm the markets for long. One example of the state of nerves could be seen in the differential between Spanish and German bonds with 10-year maturity which, since 23 April, has widened from 0.83% to a maximum of 1.64% recorded on 10 May.

Given the serious turn taken by events, and the sharp rise in volatility in financial markets, the European Union adopted a significant fund of financial aid for members in difficulty. This consists of the creation of a stabilization mechanism provided with 750 billion euros. Moreover, as has already been mentioned, the ECB undertook to buy government bonds to unblock some markets.

The extent of these measures had a calming effect and managed to slightly reduce the differentials between Germany and the peripheral countries, although still at levels higher than those before the crisis erupted. Thanks to its status as an asset safe haven, German debt with a 10-year maturity has slipped below 3%, at the end of May offering a yield of 2.74%.

Movement was also intense in the United States treasuries. While the economic data continue to endorse a slight improvement in this country's economic situation, 10-year US bonds, which offered a 3.65% yield at the end of April, were only providing a return of 3.31% one month later. This lower yield reflects the significant tensions experienced in international financial markets and the strong demand for North American

Treasury bonds, in which investors decided to take refuge.

On 19 May, the Federal Financial Supervisory Authority in Germany (BaFin) announced that, as from that date and up to 31 March 2011, it was banning naked short sales of debt securities of euro area countries. It has also banned uncovered credit default swaps (CDS) in which the underlying asset is a government bond of a euro area country, if it is not the owner. CDS are similar to insurance against default risk for the underlying asset on which the product has been taken out. BaFin justified this measure by referring to the extraordinary volatility of debt securities of countries from the euro area, which is jeopardizing the stability of the financial system.

Government bond markets are still highly volatile and the next few weeks will be very important in recovering stability after the significant measures announced, both at the level of the European Union as a whole and also in the various countries that are carrying out budget adjustments. We cannot rule out some moment of tension during this period. But in the medium term, and as the economic data continue to confirm global economic growth, the differential between Germany and the peripheral countries will tend to stabilize and even decrease within a slightly upward context of the yields offered by sovereign debt.

The euro is still tending to lose value

The other financial asset that has suffered severely at the hands of the volatile markets has been the euro. In the midst of extreme statements by numerous international economists

Investors take refuge in the government bonds of Germany and the United States.

Germany bans the naked short-selling of EU government bonds.

In the medium term, and as tensions ease, the differentials between the debt of Germany and peripheral countries should decrease.

The euro depreciates significant during the month of May.

EXCHANGE RATES OF MAIN CURRENCIES

May 20, 2010

	Exchange rate	% change (*)		
		Monthly	Over December 2009	Annual
Against US dollar				
Japanese yen	90.9	−2.6	−2.4	−4.4
Pound sterling	0.700	−7.5	−13.2	−10.3
Swiss franc	1.149	7.0	9.9	4.2
Canadian dollar	1.062	5.9	0.8	−7.6
Mexican peso	13.029	6.2	−0.5	0.1
Against euro				
US dollar	1.235	8.1	13.8	10.4
Japanese yen	112.2	−11.6	−18.7	−16.5
Swiss franc	1.419	−1.2	−4.6	−6.9
Pound sterling	0.864	−1.2	−2.6	−1.2
Swedish krona	9.745	1.4	−5.2	−7.5
Danish krone	7.442	0.0	0.1	0.0
Polish zloty	4.178	7.1	1.8	−4.1
Czech crown	25.91	2.4	−2.0	−2.8
Hungarian forint	282.5	6.4	4.3	2.3

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

SOURCE: Bloomberg.

The different stages in the economic cycle of the United States and the euro area favour the dollar.

and investors, who were even setting a date for the disappearance of the single currency, the European Union has decided, in the words of the EU Commissioner for Economic and Monetary Policy, Olli Rehn, that «we shall defend the euro whatever it takes».

But in spite of all the measures taken, the euro has accelerated its depreciation against the dollar, started at the end of November last year when one euro was worth 1.50 dollars. It is currently worth 1.23 dollars, depreciating approximately 8% in the last month alone.

Two factors can explain the violent movement experienced by the euro. Firstly, economic fundamentals have boosted the dollar. In other words, the differences in growth perspectives and interest rates between the United States

and the euro area have led to the dollar appreciating against the euro. In such an environment, it's normal for the demand for dollars to increase in detriment to the euro, in order to acquire North American financial assets, both fixed income and equity.

Secondly, the higher perceived sovereign risk in periphery countries of the euro area has led to intense movement in the portfolios of international investors. Hedge funds, for example, have increased positions that benefit from a depreciating euro and investors have reduced the proportion of assets in euros to contain the risk in their investment portfolios.

Although the continuation of the economic fundamental factors that favour a depreciation of the euro will continue to encourage such movement, after the

Institutional investors have increased positions that benefit from a depreciating euro.

recent exceptional intensity we cannot rule out the euro appreciating in the short term, at least partially. For this to happen, the decisions taken by the European Union must help to restore confidence in the project of the single currency.

The sovereign debt crisis in Europe is hindering corporate debt

As already mentioned, the sovereign debt crisis of several countries in the euro area has become a crisis of confidence in the euro or, put another way, the inability of the European Union to manage economic and financial imbalances. As a result, risk premia have substantially risen in the private bond market.

Once again, the financial sector is the most affected and the risk premia of some institutions have widely exceeded the maximums recorded in the Lehman Brothers crisis. On the other hand, risk premia have risen notably in large firms

and sectors with regulatory risk, such as energy, telecommunications, etc. and those exposed to public investment. In general, firms with high debt levels are suffering a highly significant deterioration in their net lending and are facing notably more expensive credit.

Logically, firms located in those countries causing this financial instability are suffering from much more expensive and, of course, much more scarce credit in international markets.

In the last few weeks, this uncertainty has jumped from Europe to the United States and has even reached some emerging markets. The high yield bond market, representative of those firms most sensitive to trends in the economic cycle, has ended up suffering more sharply from the effects of contamination.

The negative effects for capital markets are also being felt in the activity of the venture capital market in the United

The sovereign debt crisis hits private debt, particularly financial institutions.

The crisis reaches the high yield bond market and threatens to paralyze the deleveraging of venture capital funds.

TRENDS IN RISK PREMIA IN EUROPE



SOURCE: Bloomberg.

Rating agencies confirm the different expectations for American and European firms.

States which, taking advantage of the high level of liquidity in the markets in the years before the crisis started, got into debt by buying firms with great financial leveraging. The debt that must be refinanced over the next few years totals 2 billion dollars.

Within this uncertain environment, there has been a rapid fall in activity in Europe with a drastic reduction in new issues and a drop in transactions in secondary markets. The volume of business remained stable in most sectors in the United States, but in the last few weeks there has been a fall in activity in the primary market, although no excessive reduction in the level of operations has been seen in the secondary market.

Credit rating agencies, distanced from the turbulence of the markets, offer a very clear portrait of the trends, with a notable improvement in the ratings of corporate debt in the United States;

unlike those of the euro area, where the positive to negative rating ratio has been moving at the lowest levels in the last ten years.

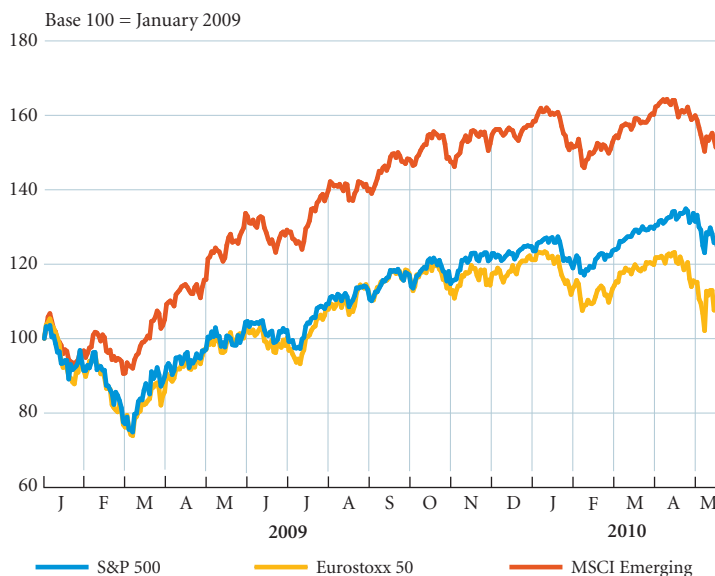
Doubt reigns supreme in the stock markets

Equity has performed negatively during the month of May. The uncertainty generated by the sovereign debt risk of some euro area countries has clearly contaminated equity markets, although with varying intensity. The European markets have suffered the biggest drop with monthly reductions of close to 10%. Meanwhile, the repercussions are less severe in the US and emerging country stock markets thanks to the good performance of their economies, as shown by their improved business margins. But the effects of the crisis are filtering through to equity via the depreciation of the euro's exchange rate.

Stock markets crumble due to concerns resulting from the sovereign debt crisis.

TRENDS IN THE MAIN INTERNATIONAL STOCK MARKETS

Stock market indices



SOURCE: Bloomberg.

Risk aversion has been reflected in the sharp increase in volatility of the stock market indices, accompanied by institutional investment flows fleeing from equity towards other, lower risk alternatives.

Equity investors appear to be greatly concerned about the financial sector, only comparable with the situation experienced in 2008 with Lehman Brothers, and due to two aspects. Firstly, the European sovereign crisis has increased uncertainty regarding financial institutions, since they have around 10% of their national government's debt on their balance sheets and also hold debt from other countries in the euro area. And, secondly, the debate is still raging in the United States on how to regulate the financial system, the proposal being to redefine the operational rules in order to protect the sector from further crises.

In the last few days, Germany has made an unexpected about-turn regarding the financial markets. Given the strong volatility in the German stock market, the German financial market supervisory body has imposed a temporary ban (until 31 March 2011) on «naked» sales of shares of the country's top ten financial institutions.

In spite of this scenario today, the medium term outlook for equity is still good, thanks to the recovery in economic activity. But in the short term, given the highly vulnerable financial markets and the lack of confidence in the measures being implemented by politicians on both sides of the Atlantic, there may still be a period of erratic movements within a context of high volatility.

Upswing in the volatility of equity markets and risk premia.

Germany bans short selling in order to protect the euro.

INDICES OF MAIN WORLD STOCK EXCHANGES

May 20, 2010

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
<i>Dow Jones</i>	10,444.4	-6.1	0.2	24.0
<i>Standard & Poor's</i>	1,115.1	-7.6	0.0	23.4
<i>Nasdaq</i>	2,298.4	-8.1	1.3	33.0
Tokyo	10,030.3	-8.0	-4.9	7.3
London	5,192.2	-10.2	-4.1	16.2
Euro area	2,641.8	-11.5	-10.9	6.2
<i>Frankfurt</i>	5,998.6	-4.2	0.7	19.0
<i>Paris</i>	3,534.1	-12.2	-10.2	7.0
<i>Amsterdam</i>	323.1	-8.9	-3.6	21.3
<i>Milan</i>	19,882.0	-14.6	-14.5	-3.1
<i>Madrid</i>	9,541.9	-15.6	-20.1	1.6
Zurich	6,403.4	-6.4	-2.2	16.2
Hong Kong	19,545.8	-9.6	-10.6	11.8
Buenos Aires	2,178.4	-10.2	-6.1	40.5
São Paulo	59,689.3	-13.9	-13.0	16.5

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

SOURCE: Bloomberg.

Venture capital, a step forward

The presence of Private Equity funds (PE)⁽¹⁾ and particularly Venture Capital funds (VC)⁽²⁾ is frequently mentioned as one of the factors associated with the great dynamism of certain firms and business sectors, such as biotechnology. On the whole, the empirical evidence seems to support this observation, albeit with significant nuances and exceptions. Moreover, the predominant idea that this better performance is a consequence of the active role played by PE/VC funds is questioned by some, who wonder whether this cause and effect relationship might actually be in the other direction; i.e. whether the real reason is that PE/VC funds are successful by choosing those sectors that are going to grow more quickly. Whatever the case, it is still useful to examine the businesses these funds currently wish to invest in. Will these be the sectors of the future?

Firstly, we should highlight the differences, in business model terms, between general Private Equity funds and «pure» Venture Capital funds. PE funds aim to restructure mature firms with inefficient management practices that often lack a suitable competitive strategy. For their part, VC funds usually focus on pioneering sectors with high growth potential and a great capacity to generate positive externalities for the economy. VC funds represent the type of financial intermediation that is most strongly related to the dynamism of entrepreneurial firms, such as start-ups, particularly in high technology industries such as biotechnology, information technology (IT) and energy technology, although they are also present in some traditional, mature areas.

VC funds stand out due to three basic characteristics. First, they are vehicles of financing for pioneering firms finding it difficult to get external funds, given that their collateral is not material and sources of financing are based on the credibility of their projects. Second, the managers of these funds amass the necessary qualifications and experience that make it viable to transform a «business project» into a «reality» by correctly assessing and financing the risks. Third, the fund's promoter also plays a role in its management, in addition to the main investor.

There are many studies⁽³⁾ that analyse the economic and social impact of the presence of PE and/or VC funds, based on trends in parameters such as revenue, employment, investment and profit at a business and sector level. The figures show, remarkably clearly,⁽⁴⁾ that firms with PE/VC fund involvement perform better than the rest of the firms in the same sector. In general, improvements are also detected⁽⁵⁾ in the performance of sectors in which PE/VC funds are more present, both in terms of growth rates and also in productivity, without weakening stability. The most usual conclusion in these studies is that the management carried out by the funds improves the productivity of the firms in question, thereby stimulating the rest of the sector and raising competitiveness. However, the nature of the statistical techniques used in these studies means that we cannot rule out, as has been mentioned earlier, the possibility that this cause and effect relationship is actually the other way round, so that «the merit» of PE/VC funds would not lie in them improving management but in selecting the right firms and sectors to invest in.

(1) Financial activity that consists of providing capital in the form of equity to firms that are not quoted on the stock exchange.

(2) This is a sub-group of Private Equity that is different because the capital is provided to business projects at an early or embryonic stage.

(3) See, for example, the review in EEAG/Cesifo Report 2009, Ch. 3, «Private Equity».

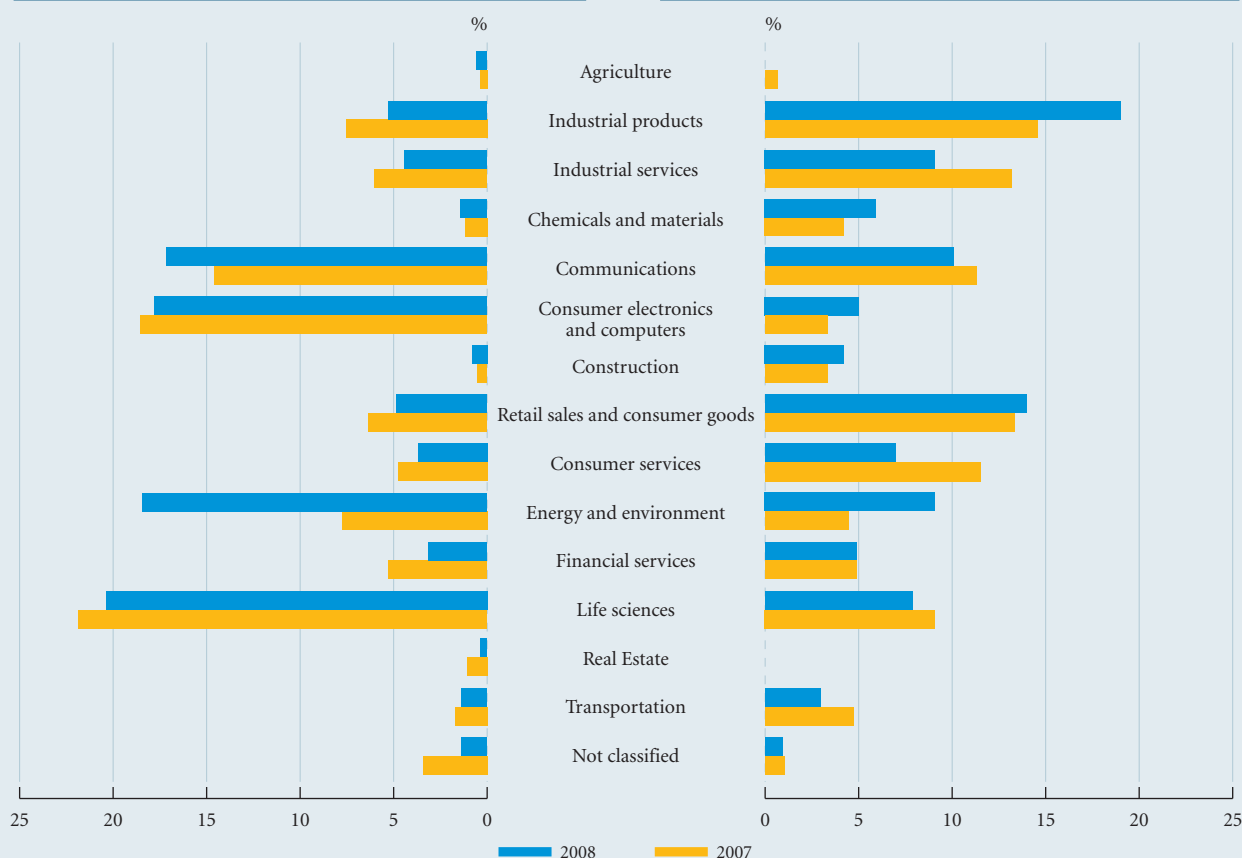
(4) See, for example, Bloom, Sadun and Van Reenen (2009) «Do Private Equity-Owned firms have better management practises?», in *Globalization of Alternative Investments Working Papers* Volume 2, World Economic Forum USA, 2009.

(5) See, for example, Bernstein, Lerner, Sorensen and Stromberg (2010) «Private Equity and Industry Performance», Working Paper 10-045, Harvard University, 2010.

INVESTMENT BY SECTOR

«Pure» Venture Capital

«Traditional» Private Equity



SOURCE: European Ventura Capital Association (EVCA).

From the point of view of profitability and value creation for investors in the PE/VC funds, the results differ notably depending on the type of fund, the geographical area they act in and the timescale of the investment. On the whole,⁽⁶⁾ the returns obtained historically by PE/VC funds are higher than those of most financial assets, partly because they also efficiently manage the market cycles, taking advantage of times of low interest rates and abundant liquidity. The yield for funds in the United States is normally higher than for European ones, due to the greater development and specialization of the US fund industry and its apparently more highly skilled managers. The venture capital business started in the United States in the eighties, in the aeronautics, astronautics and defence sectors. Later on in the nineties, activity grew sharply, reaching a peak in 2000 with the spectacular TMT boom (technology, media and telecommunications). On the other hand, these instruments developed later in Europe and the volume of investment has been significantly lower than that of the United States. In spite of this, the results achieved have also been highly positive.

(6) See, for example, Kaplan and Schoar (2005) «Private Equity Performance: Returns, Persistence and Capital Flows», Journal of Finance, August 2005.

Arriving at the present day, PE/VC funds enjoy very positive growth forecasts. Firstly, because the firms in which these funds invest have handled the crisis better than the rest thanks to a stronger financial structure. Moreover, PE/VC funds, especially in the United States, have relied on the greater experience of their managers and their advantageous sector-based specialization to increase their share of the financial markets. This means there are reasons to think that, as of today and after the economic recession, firms with PE/VC fund involvement represent a particularly attractive potential investment. This state of affairs, together with this kind of firm's historical link with innovation, has led many governments to promote different policies supporting these activities, even taking part in creating and financing some «pure» VC funds. In addition, public administrations also offer favourable regulatory and fiscal frameworks to concentrate these funds in sectors singled out as strategic. At present, regulatory bodies are fervently developing industries related to clean, renewable energy sources, as well as biotechnology research.

This is why, together with the original vocation of VC funds to invest in pioneering and innovative industries, the gaze of venture capital managers will be fixed on these sectors for the next few years,⁽⁷⁾ in contrast to the meagre possibilities offered by mature businesses such as construction or agriculture. Similarly, the specialization of these funds by geographical area is displacing investment flows from the United States and Western Europe towards the emerging economies. Entrepreneur funds can create firms in any location at a global level and choose the place where the conditions are favourable and the human skills competitive. In this respect, South East Asia and, in particular, China and India, offer the best opportunities.

(7) See Deloitte (2009) «Global Trends in Venture Capital, 2009 Global Report», as well as the EVCA Yearbook, 2009.

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SPAIN: OVERALL ANALYSIS

Economic activity

Consumption and the foreign sector drive growth

After seven quarters of recession, the economy started to grow in the first quarter of 2010, posting an increase in gross domestic product (GDP) of 0.1% compared to the previous quarter, according to data from the National Accounts system of the National Institute of Statistics. This recession has been the worst for the past few decades and was longer than the previous recession of 1992-1993, lasting five quarters. It was also slightly more intense, as the accumulated drop in GDP was 4.6%, compared with 1.7% previously.

However, the year-on-year rate of change of GDP was still -1.3% in the first quarter of 2010, although up 1.8 points compared with the fourth quarter of 2009.

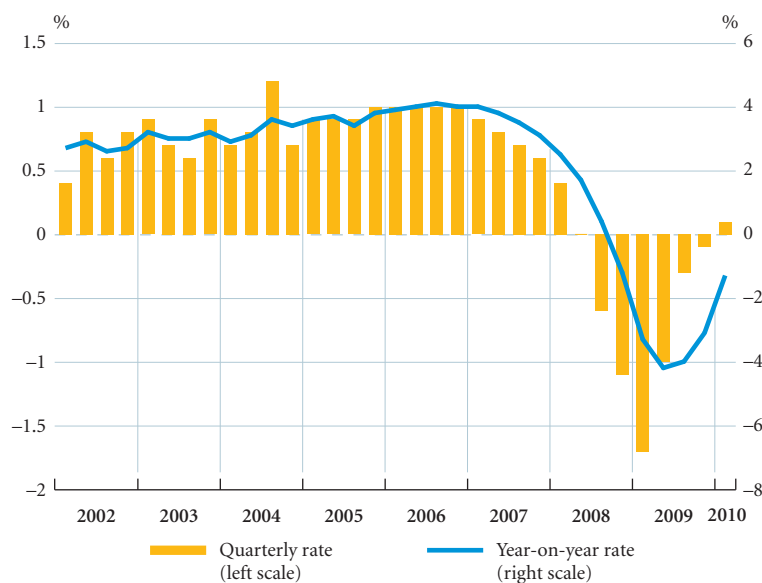
Domestic demand continued to improve in the first quarter of 2010, reducing its negative contribution to the year-on-year growth in GDP by 2.8 points to -2.5 points. The contribution made by foreign demand was positive for the ninth consecutive quarter but fell by one point to 1.2 points.

Household consumption livened up and posted quarter-on-quarter growth for the second time in a row, although its

The accumulated drop in the 2008-2009 recession was 4.6%, compared with 1.7% in the previous 1992-1993 recession.

THE ECONOMY COMES OUT OF SEVEN QUARTERS OF RECESSION

Change in gross domestic product

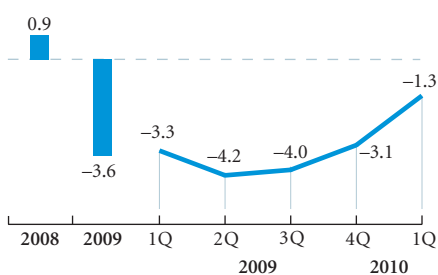


SOURCE: National Institute of Statistics.

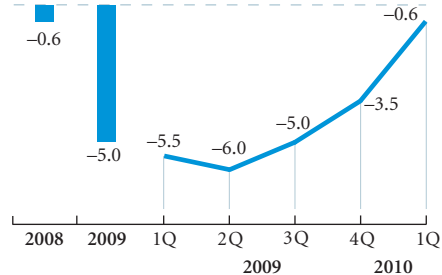
TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)

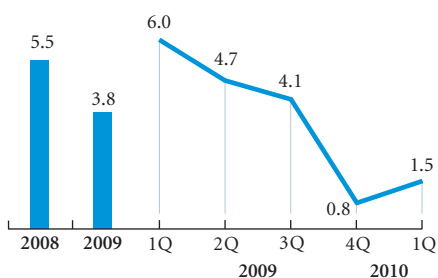
GDP



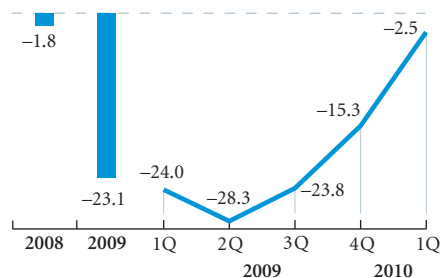
Household consumption



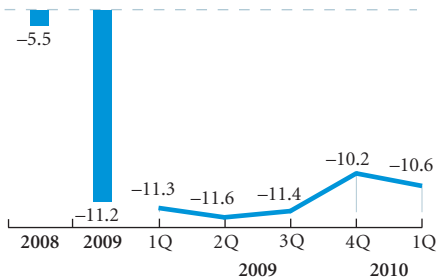
Public consumption



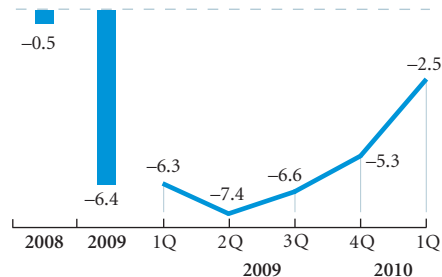
Investment in capital goods



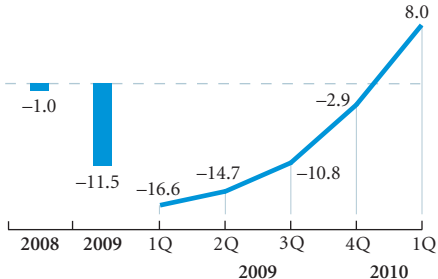
Construction investment



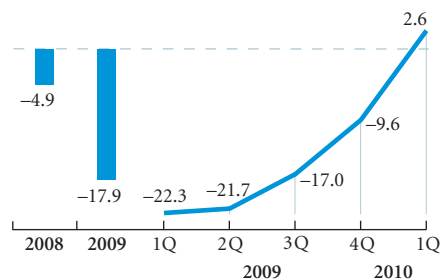
Domestic demand (**)



Exports of goods and services



Imports of goods and services



NOTES: (*) Data adjusted for seasonal and calendar effects.

(**) Contribution to GDP growth.

SOURCE: National Institute of Statistics.

year-on-year rate of change continued negative, namely -0.6%. This upswing was in line with the trend in disposable income. The wages of salaried workers reduced their decline to 1.2% year-on-year in nominal terms thanks to the slowdown in the drop in employment to 3.6%. In the first quarter, of note is the vitality of spending on durables and, to a lesser degree, on food, while the rest of the components were below the levels of a year ago.

Expenditure on public consumption picked up in the first quarter with a year-on-year increase of 1.5%, 7 tenths of a percentage point more than the previous quarter. There were rises both in the wages of public administration employees as well as in purchases of goods and services and the social transfer of products acquired in the market to supply families directly.

In April, car sales continued at a good pace thanks to direct aid from the Plan 2000E. They were also helped by demand being brought forward due to the expected hike in value added tax in July 2010 and the impending end of the total amount of aid available. Consumer confidence also picked up in April after falling in the previous two months.

Investment was still hindered by low production capacity utilization and falling corporate profits. Overall, its year-on-year rate of change rose 3 points to -9.9%. This attenuation came particularly from capital goods and to a lesser extent from other products, such as mining and oil prospecting and software. Investment in machinery was 3.8% below that of the first quarter of 2009, while investment in transport material was at the same level as twelve months ago.

On the other hand, investment in construction fell 10.6% in year-on-year terms, 4 tenths of a percentage point more than the previous quarter. This decline was due to infrastructure works, so that construction other than housing fell 2.8% compared to a year earlier, with an annual rise of 2.4% in the fourth quarter. With regard to investment in housing, this continued to be affected by the real estate crisis and posted a 20.7% drop year-on-year. However, this fall was 3.8 points less than that recorded three months earlier. Similarly, housing transactions picked up by 9.7% year-on-year in the first quarter, encouraged by the low interest rates, lower prices and by demand being brought forward due to the hike in value added tax in July and the partial withdrawal of the tax deduction in 2011.

Apparent cement consumption, a leading indicator, also continued to moderate its decline in April. However, confidence in construction was worse than in March.

With regard to foreign demand, both the exports and imports of goods and services grew compared with the first quarter of 2009, something that had not occurred since the first half of 2008, but the progress made by exports was greater than imports. The push by exports was driven by the improvement in the situation of foreign markets, especially in the European Union. The rise in both cases is due to goods, as services continued with negative annual change rates.

From the point of view of supply, of note is the improvement made by industry, whereas there was a decline in agriculture, affected by the bad weather conditions in the first three months of the year.

Upswing in consumer confidence in April.

Investment is leaving behind the worst moments of the recession.

Both exports and imports posted positive year-on-year rates of change.

**Confidence improves,
as well as new orders
in industry.**

The gross value added of the secondary sector fell by 3.1% compared with the first quarter of 2009, but 7.4 points less than in the previous quarter. The energy subsector posted a 0.3% year-on-year rise after five quarters of decline. Other dynamic branches were the manufacture of motor vehicles and metallurgy. Moreover, the confidence in industry continued to improve in April and new

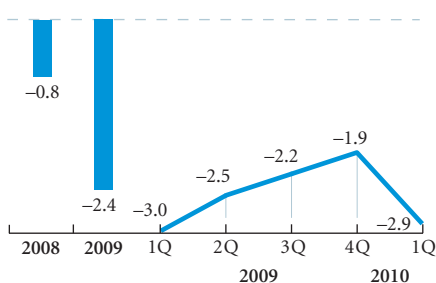
orders rose by 13.6% in March compared with the same month the previous year.

Private services suffered a 0.7% drop compared to the same quarter the previous year but this fall was 1.1 points less than the previous quarter. The most dynamic branches were in retail trade. At the opposite end of the scale were information and communication

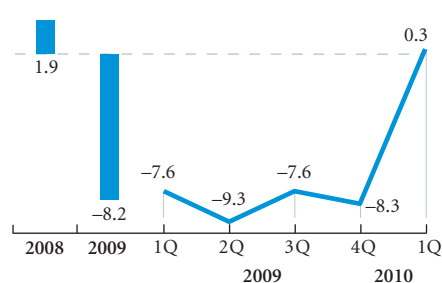
TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)

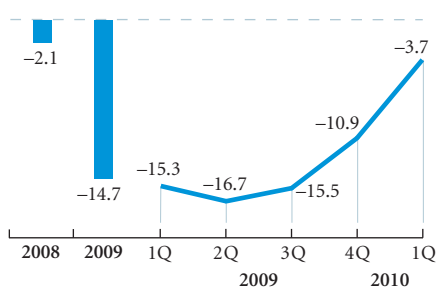
Agriculture



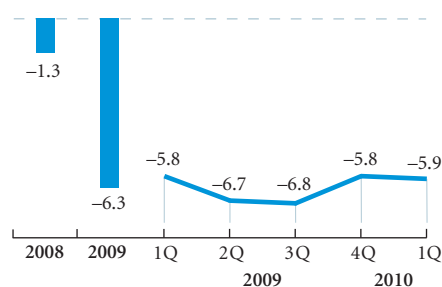
Energy



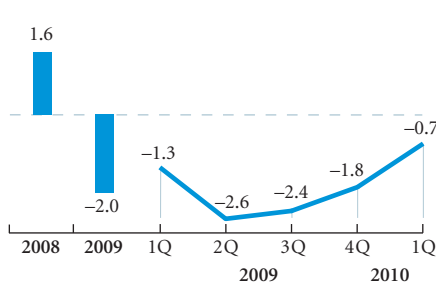
Industry



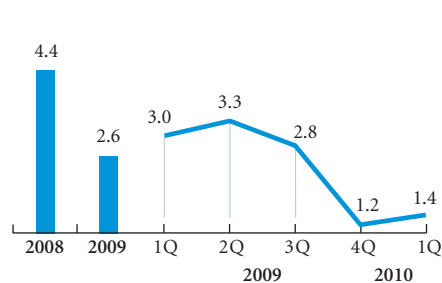
Construction



Market services



Non-market services



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

technologies, as well as corporate services.

As a consequence of the trends in GDP and employment, apparent labour productivity continued to slow up with a 2.4% year-on-year increase, 8 tenths of a percentage point less than in the fourth quarter of 2009. Given that the slowdown in wages was less, unit labour costs picked up slightly to 0.1%, nonetheless 3 tenths of a percentage point below the implicit deflator of the economy.

Another sign of the economy's improvement was that the number of unpaid negotiable instruments fell by 35.9% in the first quarter compared with the same period the previous year,

helped by stricter risk controls. Similarly, the number of firms in receivership fell by 4.1% year-on-year in the period January-March, whereas the number of new companies set up rose by 1.1% in the first three months of the year, compared with twelve months before.

The few indicators available for the second quarter point towards a continuation of this revival in the economy. However, the package of restrictive budgetary measures approved by the government in the third week of May, involving a further reduction in the public deficit of half a point of GDP in 2010 and one and a half points in 2011, might slow up the economic recovery slightly.

Productivity slows up.

Drop in the number of firms in receivership and rise in the creation of new firms.

Beyond bricks and mortar: the medium-term outlook for sectors

Construction played a key role in the last expansionary cycle of the Spanish economy. Its intense growth not only raised its share of GDP but, being an activity with a powerful knock-on effect, it also generated strong synergies of growth in other sectors of the economy. Once the recession hit, the tables turned and the sharp brake on property has affected the rest of its associated sectors. Moreover, the sovereign debt crisis means that the fiscal stimuli implemented to slow up the slump in demand will now have to be withdrawn sooner, damaging the perspectives for growth in domestic demand. However, the capacity of emerging countries to recover (China, Brazil, India, etc.), together with the United States exiting its recession, have meant that the foreign sector is one of the areas that is boosting demand in a large number of European countries.

All these disturbances have been added to an economy that is in a complicated phase of the cycle, but it is estimated that the worst is now behind us. Within this state of affairs, one of the questions most often asked concerns the economy's capacity or potential for growth in the next expansionary phase. More specifically, which sectors will «drive» business, assuming that the role played by construction and the property market in the previous phase will not be repeated.

Answering this question requires an analysis and prediction that is beyond the scope of this box. However, one way of providing an initial examination of growth potential at a sector and branch level of activity is by drawing up a taxonomy of these according to the destination of their sales. The criterion used to make this division is based on a future scenario in the medium term defined in accordance with the aforementioned parameters, i.e. construction and the property market will continue to be depressed, domestic demand will recover slowly and the greatest opportunities for growth will occur in export markets, preferably towards non-EU countries. We can therefore distinguish five groups of sector, using information available from the input-

output tables for the Spanish economy produced by the National Institute of Statistics. This statistical instrument lists an economy's total supply of goods and services with their destination, distinguishing between production and imports and differentiating between intermediary consumption and end demand, in turn dividing the latter into its different components, i.e. end consumption, capital formation, exports, etc. This information helps relations between sectors to flourish and provides great insight into an economy's production and demand structure.

In accordance with the criteria described, the first group is made up of those sectors most oriented towards exports and less dependent on construction activities, therefore the best positioned sectors, whose share of the total value added would be a little more than 17% (the data correspond to 2005, the last input-output table available). Here we find important sectors of the Spanish economy such as chemicals, agriculture and stockbreeding, car manufacture, machinery and mechanical equipment manufacture, textiles, clothing and footwear, electronic equipment, computing and office material.

We can then define a second group made up of sectors that have little or no dependence on construction and are not very oriented towards exports, although a large number of these have the potential to increase their exports. These go to make up more than 27% of the total value added and, most importantly, they include the activities of the food, beverage and tobacco industries. Here we also find corporate services, wholesale trade and distribution of fuel, publishing and graphic arts, furniture, financial brokering and insurance, etc.

A DIVERSIFIED ECONOMY IN SECTOR TERMS

Sector groups by share of total value added

Public services and other non-tradeable services: 29%

Public administration and defence
Education
Health
Domestic and personal services

Not very oriented towards exports and highly exposed to construction: 25%

Construction and property
Production of metal products
Cement, lime and plaster
Wood and cork
Recycling

Oriented towards exports and highly exposed to construction: 2%

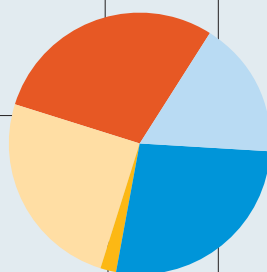
Metallurgy
Manufacture of machinery and electrical material
Ceramics and glass

Oriented towards exports and not very exposed to construction: 17%

Chemicals and plastic materials
Hotels and restaurants and tourism
Agriculture and stockbreeding
Manufacture of motor vehicles
Machinery and mechanical equipment
Refining and nuclear fuels
Air, space and marine transport
Paper
Textiles, clothing, leather and footwear
Electronics, computing and office machinery

Less oriented towards exports and not very exposed to construction: 27%

Food, beverages and tobacco
Wholesale trade and fuel
Financial broking and insurance
Land and rail transport
Publishing and graphic arts
Furniture
Research and development



SOURCES: INE and own calculations.

The third group is made up of sectors that are highly dependent on construction but also oriented towards exports, a circumstance that should allow them to at least partially offset the adjustment taking place in the property market. These are metallurgy, machinery and electrical material, as well as ceramics and glass. This is the smallest of the groups, as it hardly achieves 2% of the value added.

In fourth place would be those activities strongly linked, directly or indirectly, with construction and the property market and not very oriented towards exports, these being in the worst position. In addition to these two sectors, the group also includes the manufacture of metal products, cement, lime and plaster, wood and cork and recycling. These go to make up 25% of the value added for the year 2005, a year when these activities were on the rise, so that their relative weight will have fallen appreciably after the adjustment that has taken place to date.

Lastly, we have also defined a group made up of services offered by the public authorities or non-exportable market services, such as domestic services and those related to people, with a share close to 30% of the total economy.

This classification bears out the fact that the adjustment in the property market, whose effects in terms of growth are certainly relevant, is nonetheless limited in scope, since around three quarters of the economy has few direct or indirect links with construction. Moreover, the exporting core of the economy has an important weight that, although it won't make up for the decline in the property market, it will have the capacity to pull with it a large part of the rest of the sectors in the market, as well as possibly being reinforced by other activities whose export potential has not been fully exploited. It should be noted that, within this core, we find traditional industrial sectors that are not usually taken into account when debating the «sectors of the future» (motor vehicle industry, textiles, chemicals, food, etc.) but whose capacity to support growth and create jobs means they must be included in any development strategy. The key lies in those sectors with growth potential being within a suitable regulatory, financial and fiscal environment and in them being able to take on the tough international competition, orienting themselves towards those activities where they can maximise their profits and growth.

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Labour market

700,000 jobs lost in the last 12 months.

The decline in the labour market has yet to bottom out

The labour force survey (LFS) data confirm that job losses did not stop during the first quarter of 2010. In the last twelve months, the number of employed fell by 696,600 people, 3.7% year-on-year, reaching a total of 18,394,200. Although the rate of decline is lower than the 6.4% recorded in the same quarter a year ago, these figures do not point towards an impending end to the decline in the job market, as ratified by data from Social Security registrations.

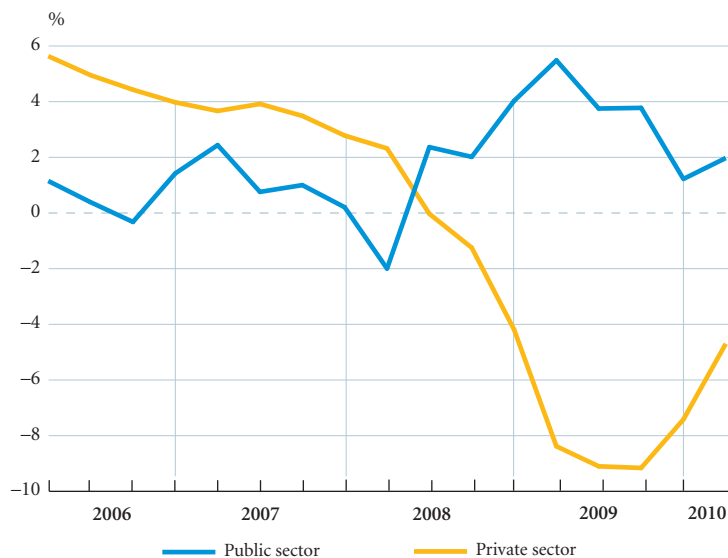
The number people registered as employed with Social Security in April doesn't bode well for the prospects of the second quarter either. Although the

total number of registrations rose by 53,852, the seasonally adjusted figure shows a fall of approximately 13,000. However, it should be noted that this drop is lower than those recorded in previous months, so that the data for April are less negative.

Returning to the LFS, in the first quarter of 2010 it can be seen that job losses were once again higher among men than women, with a year-on-year fall of 5.5% and 1.3%, respectively. This is mainly due to male employment predominating in those sectors most severely hit by the crisis, namely construction and industry. In relative terms, the sector that continues to get rid of most jobs was construction, down 15.9% year-on-year. The fall in industry in the last year was

THE PUBLIC SECTOR CONTINUES TO CREATE JOBS IN THE RECESSIVE STAGE

Year-on-year change in estimated employment



SOURCES: National Institute of Statistics and own calculations.

also significant, namely 10.4%, affected by weak demand. On the other hand, job losses were much less severe in services, at 0.6% year-on-year.

On the other hand, the LFS confirms that employment trends are very different depending on the type of employer. While, in the first quarter of 2010, the private sector saw 274,400 jobs lost, the public workforce rose by 22,700 workers. In relative terms, the rate of job losses in the private sector therefore stood at 4.7% year-on-year whereas the

total workers employed by public authorities and corporations grew by 1.9% in the last twelve months. Within this context, we should remember the plan to reduce the number of public sector workers in the period 2010-2012 contained in the Public Function Agreement between the government and the trade unions. According to this agreement, the total number of jobs offered will not exceed 15% of the replacement rate, except in Justice, Health, Education and others.

The public sector continues to create jobs while planning to lower its wages.

ESTIMATED EMPLOYMENT

First quarter 2010

	No. of employees (thousands)	Quarterly change		Annual change		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	835.2	52.6	6.7	−2.6	−0.3	4.5
Non-farm	17,558.9	−304.4	−1.7	−694.1	−3.8	95.5
Industry	2,599.8	−81.1	−3.0	−300.3	−10.4	14.1
Construction	1,663.0	−139.7	−7.7	−315.0	−15.9	9.0
Services	13,296.1	−83.6	−0.6	−78.8	−0.6	72.3
By type of employer						
Private sector	15,305.8	−274.4	−1.8	−755.6	−4.7	83.2
Public sector	3,088.4	22.7	0.7	58.9	1.9	16.8
By work situation						
Wage-earners	15,253.2	−239.4	−1.5	−589.8	−3.7	82.9
Permanent contract	11,532.7	−73.7	−0.6	−284.6	−2.4	62.7
Temporary contract	3,720.5	−165.7	−4.3	−305.2	−7.6	20.2
Non-wage-earners	3,130.8	−9.8	−0.3	−109.7	−3.4	17.0
Entrepreneurs with employees	1,047.9	−3.1	−0.3	−52.4	−4.8	5.7
Entrepreneurs without employees	1,912.6	−18.1	−0.9	−43.5	−2.2	10.4
Family help	170.3	11.4	7.2	−13.8	−7.5	0.9
Other	10.1	−2.6	−20.5	2.8	38.4	0.1
By time worked						
Full-time	15,942.4	−232.8	−1.4	−725.5	−4.4	86.7
Part-time	2,451.7	−19.0	−0.8	28.8	1.2	13.3
By sex						
Males	10,239.9	−200.7	−1.9	−591.0	−5.5	55.7
Females	8,154.2	−51.1	−0.6	−105.7	−1.3	44.3
TOTAL	18,394.2	−251.7	−1.3	−696.6	−3.6	100.0

SOURCE: National Institute of Statistics and own calculations.

The adjustment in employment particularly affects young people on temporary contracts.

This rise in employment in the public sector also contrasts with the commitment to speed up the fiscal consolidation plans of the Spanish government. In fact, one of the fiscal austerity measures announced last 12 May consists of reducing public sector wages by 5% on average as from June 2010, and freezing them in 2011.

On the other hand, total salaried employment fell by 3.7% year-on-year. The adjustment fell harder on workers with temporary contracts, with a drop of 7.6%, higher than the fall of 2.4% recorded for employees with a permanent contract. The temporary employment rate therefore fell to 24.3%. For their part, non-salaried workers have also been affected by the economic crisis, seeing a 3.4% drop in jobs in the last twelve months. The number of employers was down 4.8% year-on-year, a higher rate than the 2.2% drop recorded by the self-employed.

With regard to the job format, data show that the decline in employment is more concentrated in full-time jobs. While this group fell by 4.4% compared with the previous year, part-time employment, which is more flexible, rose 1.2% year-on-year. However, it should be noted that jobs were also lost throughout this first quarter, 0.8% among part-time work. So the ratio of part-time employees grew by 0.08 percentage points in the first quarter, to 13.3%.

By age group, the number of employed is falling in all segments except those of 50 to 54 years of age, the drop being sharpest among younger workers. Also of note are the appreciable increases in employment among women aged over 50, probably due to domestic work. However, employment is falling in all age

groups among men, except in those aged between 35 and 39.

According to the LFS, the estimated labour force rose for the second consecutive quarter. The falling trend of the preceding quarters has therefore been halted, as a result of discouragement due to the difficulty in finding a job, typical of recessionary periods. This increase in activity is due to the net incorporation of women, as the male share in the labour market fell. One possible explanation might be the fact that, under the current circumstances, women have a better chance of finding employment in services.

The unemployment trend is the result of the behaviour of the labour force and employment. The larger total labour force offsets the relief provided by the fall in labour market share for the unemployment rate. However, the most important factor behind the rise in the total number of unemployed in the first quarter of 2010 has been job losses. In this period the number of unemployed rose by 286,200 to a total of 4,612,700. Consequently, the unemployment rate stood at 20.0%, the highest since the first quarter of 1995. By gender, unemployment increased more among men than women, with an unemployment rate of 20.0% and 20.2%, respectively, both rates therefore continuing to come closer together.

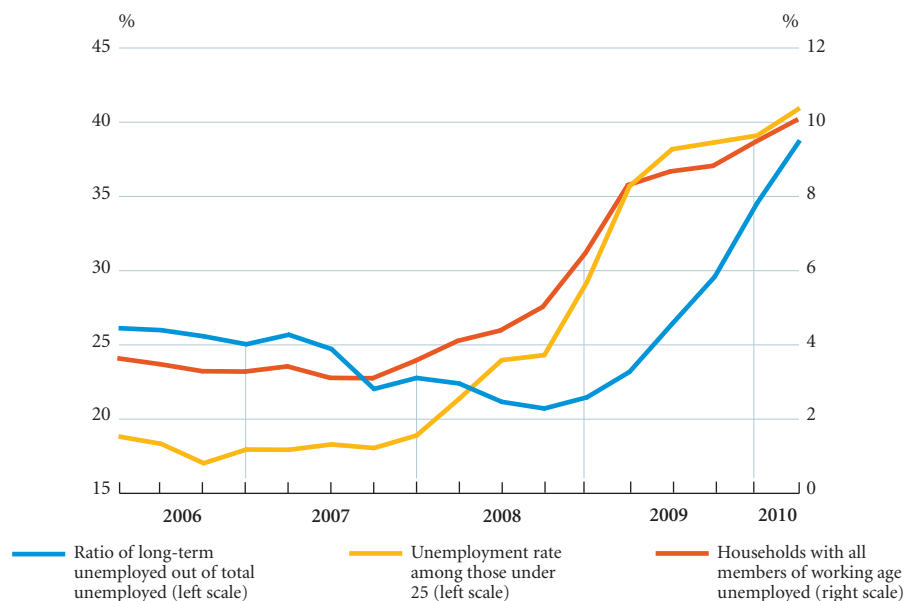
It is worth noting that unemployment is still growing more sharply in those groups at greater risk in society. In fact, unemployment among those aged under 25 reached 40.9% last year. Similarly, the ratio of households where all the members of working age are unemployed continued to increase, standing at 10.1%. We should also add

The labour force halts its decline this quarter.

Unemployment stands at 20.0%.

UNEMPLOYMENT CONTINUES TO RISE IN THE HIGHER RISK GROUPS

Unemployment trends in different groups



SOURCES: National Institute of Statistics and own calculations.

the rise in the overall number of long-term unemployed, now accounting for 38.7% of the total. This group of unemployed is particularly worrying because they tend to have more difficulty in finding a job even once the economic cycle picks up.

With regard to geographical differences, in the last 12 months no autonomous community posted a rise in employment. In fact, in this period all saw increases in unemployment except for the Basque Country. The highest unemployment rates were to be found in the Canary Islands and Andalusia, with rates above 27%. On the opposite side of the scale,

the lowest unemployment rate was recorded in the Basque Country, 10.9%.

Lastly, the figures for registered unemployment at the employment offices in April don't point towards an end to rising unemployment in the second quarter of 2010 either. Although registered unemployment fell by 24,188 people to 4,142,425, the seasonally adjusted figure shows a rise of close to 63,000. However, the pace of growth in unemployment does seem to be slowing up as, in the month of April, the year-on-year rate was 13.7%, quite a lot lower than the 55.9% recorded in the same month a year ago.

In 10.1% of households, all members of working age are unemployed.

The Basque Country is the autonomous community that is least affected by rising unemployment.

Prices

The year-on-year inflation rate rises one tenth of a percentage point in April to 1.5%.

First drop in core inflation in decades

Inflation continued to rise slightly in April, reflecting the trends in oil prices and the euro. Consequently, the year-on-year rate of change for the consumer price index (CPI) stood at 1.5% at the end of the first four months, one tenth of a percentage point more than the previous month and 1.7 points more than twelve months earlier, when the economy was in recession.

In effect, the main group behind this rise in inflation in April was fuels and oils, up 21.3% in the last twelve months, almost 4 percentage points more than in the previous month. In April, the greatest

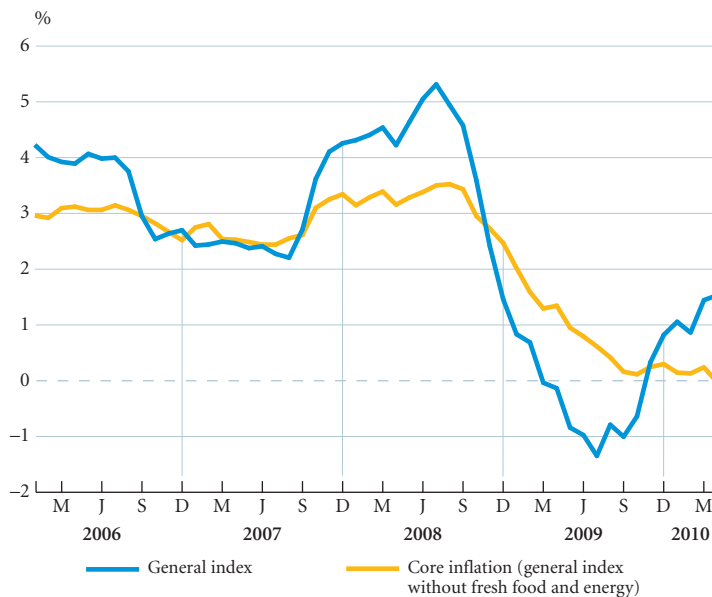
push upwards actually came from the quarterly revision of gas prices.

The other volatile component of the CPI, fresh foods, also helped to boost inflation, although to a much smaller extent, going from an annual rate of change of -2.2% in March to -1.3% in April. The biggest contribution to this increase came from potatoes and chicken, although their year-on-year rates of change were still negative.

Although the CPI's movement in April was in line with what had been expected, the main surprise was provided by underlying inflation, the most stable core of inflation that excludes unprocessed

CORE INFLATION HITS ITS LOWEST LEVEL FOR THE LAST FEW DECADES

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

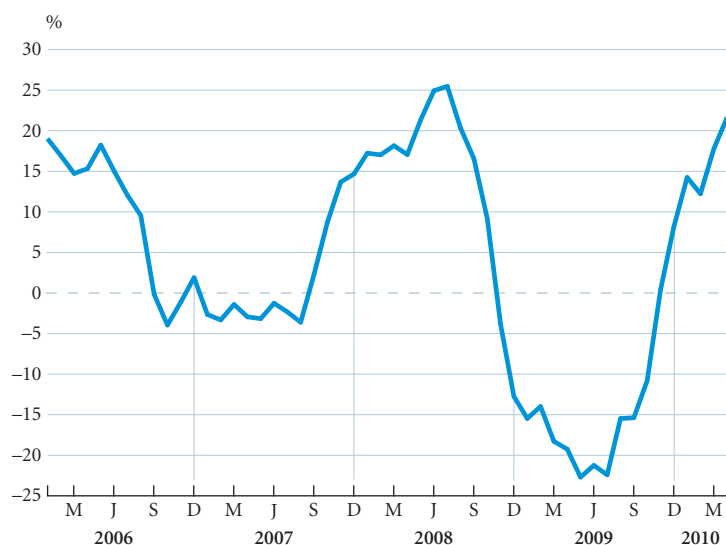
CONSUMER PRICE INDEX

	2009			2010		
	% monthly change	% change over December 2008	% annual change	% monthly change	% change over December 2009	% annual change
January	-1.2	-1.2	0.8	-1.0	-1.0	1.0
February	0.0	-1.2	0.7	-0.2	-1.2	0.8
March	0.2	-1.1	-0.1	0.7	-0.5	1.4
April	1.0	-0.1	-0.2	1.1	0.6	1.5
May	0.0	-0.1	-0.9			
June	0.4	0.3	-1.0			
July	-0.9	-0.5	-1.4			
August	0.3	-0.2	-0.8			
September	-0.2	-0.4	-1.0			
October	0.7	0.3	-0.7			
November	0.5	0.8	0.3			
December	0.0	0.8	0.8			

SOURCE: National Institute of Statistics.

THE RISE IN FUELS AND OILS BOOSTS INFLATION

Year-on-year change in fuels and oils prices



SOURCE: National Institute of Statistics.

foods and energy products, which fell 0.3 percentage points and stood at -0.1%. This was the first time it had seen negative figures in the last few decades. It should be noted that this drop

has been influenced by a calendar effect, as Easter was earlier this year compared with 2009. However, the low level of core inflation also reveals the listlessness of consumption.

Core inflation stands at -0.1%, its first negative figure for many decades.

CONSUMER PRICE INDEX BY COMPONENT GROUP

April

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2009	2010	2009	2010	2009	2010
By type of spending							
Food and non-alcoholic beverages	107.1	−0.3	−0.1	−1.4	−0.9	−0.1	−1.9
Alcoholic beverages and tobacco	129.6	0.0	0.0	3.5	2.9	4.0	12.1
Clothing and footwear	103.7	9.4	9.5	−3.9	−4.0	−1.7	−0.9
Housing	114.8	−1.4	0.7	−0.5	2.0	1.6	3.4
Furnishings and household equipment	107.2	0.5	0.3	0.3	−0.3	1.8	0.2
Health	97.6	0.3	0.0	0.6	0.1	0.7	−1.7
Transport	108.4	1.4	1.5	0.7	4.9	−7.5	8.3
Communications	98.4	0.0	−0.9	0.1	−0.9	−0.5	−1.3
Recreation and culture	97.5	1.4	−0.2	0.3	−1.1	1.6	−2.5
Education	114.6	0.0	0.0	0.2	0.1	3.9	2.6
Restaurants and hotels	112.8	0.6	0.5	1.3	0.9	2.4	0.9
Other goods and services	111.5	0.2	0.2	1.7	1.5	2.8	1.9
By group							
Processed food, beverages and tobacco	111.3	−0.2	−0.4	−0.3	−0.5	0.7	0.5
Unprocessed food	106.5	−0.4	0.5	−2.0	−0.3	0.0	−1.3
Non-food products	107.8	1.3	1.4	0.1	0.9	−0.4	1.9
Industrial goods	104.4	2.1	2.7	−1.1	1.2	−3.7	3.0
Energy products	116.0	0.3	2.7	−0.3	8.2	−12.4	16.7
Fuels and oils	113.2	0.4	3.7	−1.6	10.7	−19.3	21.3
Industrial goods excluding energy products	100.2	2.7	2.7	−1.4	−1.2	−0.7	−1.5
Services	111.4	0.6	0.1	1.4	0.6	3.1	0.8
Underlying inflation (**)	107.4	1.2	0.9	0.1	−0.2	1.3	−0.1
GENERAL INDEX	108.4	1.0	1.1	−0.1	0.6	−0.2	1.5

NOTES: (*) Base 2006 = 100.

(**) General index excluding energy products and unprocessed food.

SOURCE: National Institute of Statistics.

Inflation differential with the euro area remains slightly positive.

Processed foods slowed down one tenth of a percentage point, recording a year-on-year increase of 0.5%. This drop can mostly be explained by the fall in milk prices, down 8.7% year-on-year.

The slowdown was greater in services, whose annual rate of change fell half a point to 0.8%, its lowest for several decades. The main downward pressure came from package holidays, whose prices fell slightly compared with an increase in April 2009. Other services,

such as telephony, also contributed to the slowdown.

The harmonized consumer price index with the European Union saw a year-on-year increase of 1.6% in April, 0.1 percentage points more than the previous month. Consequently, the inflation differential with the euro area remained slightly positive. However, the differential for core inflation was negative, by more than half a point.

With regard to trends in inflation over the coming months, a slight increase is likely in May, whereas the effect of the higher value added tax will be noted in the second half of the year. However, weak consumption and strong competition in international markets will tend to contain prices, so that year-end inflation will be close to the upper limit for the euro area as a whole, namely 2%.

Wholesale prices reflect the rise in commodities

In March, wholesale prices continued their upswing of the last few months, which in turn reflects the rising trend in most commodities in the last year.

Consequently, the general index for industrial prices rose 2.4% in the last twelve months, almost 5 percentage points more than in March 2009. Most of the components recorded rises, particularly energy goods. However, consumer goods posted a slightly negative year-on-year rate of change and capital goods held their prices at the same level as last year.

Even higher was the 7.2% year-on-year rise in import prices, affected by the depreciation of the euro over the last year. For their part, the prices of farmers' output in January continued to post an annual drop of 5.5%, as the higher decrease in animal products was offset by a smaller reduction in agricultural prices.

Inflation is likely to be moderate over the coming months.

The depreciation of the euro contributes to the higher rise in import prices.

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 (**)	
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	1.6	-3.2	-1.9	-5.6	3.0	2.6	-1.2	1.5
March	-7.1	-2.5	-0.4	1.3	-4.3	-5.0	-6.9	2.6	3.1	-2.7	-
April	-7.7	-3.4	-0.8	1.2	-5.5	-6.8	-7.4	2.5	3.1	-3.7	-
May	-15.1	-4.4	-1.1	1.1	-6.3	-9.8	-9.9	1.8	2.5	-5.5	0.2
June	-17.2	-4.9	-1.3	0.9	-6.9	-10.1	-10.8	1.3	2.4	-6.0	-
July	-17.9	-6.7	-1.3	0.5	-7.8	-16.0	-11.4	2.0	2.3	-7.1	-
August	-14.8	-5.5	-0.9	0.3	-7.7	-11.5	-9.8	0.6	2.1	-7.4	-0.6
September	-14.0	-5.4	-0.7	0.4	-7.6	-11.5	-9.2	-0.5	1.7	-7.6	-
October	-12.2	-4.3	-0.7	0.2	-6.3	-8.4	-7.2	-2.1	1.0	-6.7	-
November	-9.3	-1.8	-0.6	0.2	-4.6	-0.7	-3.1	-3.1	0.5	-5.4	-0.2
December	-5.5	0.4	-0.5	0.1	-2.7	6.3	1.9	-1.0	0.8	-1.9	-
2010											
January	-5.5	0.9	-0.5	-0.3	-0.9	6.3	3.4	-0.9	0.2	0.2	-
February	...	1.1	-0.6	0.0	-0.4	6.8	4.7	-0.5	-0.2	1.4	0.4
March	...	2.4	-0.1	0.0	0.4	10.3	7.2	1.1	-0.1	4.3	-

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

(**) Except energy.

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

Foreign sector

Trade deficit stops shrinking and widens by 17% in March...

The energy deficit slows up the correction of the trade imbalance

The outbreak of the worldwide economic crisis at the end of 2008 resulted in a squeeze on trade at an international level. Spain was not spared from this situation and saw a significant fall in its exports in the following months. However, it was imports that fell more sharply, intensified by a slump in domestic demand and falling oil prices,

thereby allowing a 46.7% correction in the trade deficit in 2009.

The recovery in the global economy and the stabilization of Spain's macroeconomic situation have led to this reduction in the trade deficit coming to an end, which in March was 17.4% higher than one year ago. This increase, the second of the year, took place within a context of 21.4% and 20.6% rises year-on-year in exports and imports,

FOREIGN TRADE

January-March 2010

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	9,979	20.5	18.1	1,510	−5.4	3.5	−8,469	15.1
Consumer goods	13,979	−17.7	25.4	15,840	2.7	37.1	1,861	113.3
Food	3,325	−2.8	6.0	5,984	6.1	14.0	2,660	180.0
Non-foods	10,655	−21.4	19.3	9,856	0.8	23.1	−799	92.5
Capital goods	4,086	−5.8	7.4	3,367	9.7	7.9	−719	82.4
Non-energy intermediate goods	27,050	25.1	49.1	22,013	28.6	51.5	−5,036	81.4
By geographical area								
European Union	30,757	4.9	55.8	29,633	13.6	69.3	−1,124	96.3
Euro area	24,745	−0.4	44.9	24,513	14.4	57.4	−231	99.1
Other countries	24,337	11.1	44.2	13,098	17.8	30.7	−11,240	53.8
Russia	1,180	22.2	2.1	367	11.0	0.9	−813	31.1
United States	2,133	−13.7	3.9	1,382	−5.1	3.2	−751	64.8
Japan	906	23.6	1.6	338	23.4	0.8	−568	37.3
Latin America	3,006	18.4	5.5	2,213	21.3	5.2	−792	73.6
OPEC	5,267	24.7	9.6	1,490	−4.9	3.5	−3,778	28.3
Rest	11,845	8.0	21.5	7,307	28.9	17.1	−4,538	61.7
TOTAL	55,094	7.5	100.0	42,731	14.8	100.0	−12,364	77.6

SOURCES: Ministry of the Economy and own calculations.

respectively. Consequently, the National Accounts data place the accumulated deficit for the last four quarters at similar levels to those of 2009, slightly above 4% of GDP.

But what is the reason for this change in trend? A breakdown of the trade deficit shows that the energy deficit widened by 43.5% year-on-year in March. The recovery in oil prices since the start of 2010 has increased the value of energy imports, offsetting the 19.1% improvement in the non-energy deficit. All this meant that more than 70% of March's imbalance was energy-related (60% if we consider the accumulated figures over the last twelve months). Also of note in March is the fall in vehicle exports abroad, after several months of these being the leading exported good.

The trade deficit is expected to reduce slightly throughout 2010, in particular

if we take into account the loss in value of the euro compared with the world's main currencies. In spite of the strong concentration of Spanish exports within the single currency area, this depreciation is reviving trade relations with other countries. Exports to non-euro area countries rose by 26.4%, particularly to the rest of Europe, Latin America and Asia, these being the zones with the highest increases.

New external financing falls

According to the National Accounts figures published by the National Institute of Statistics, the adjustment in the current deficit was lower in the first quarter of 2010. The final balance of Spanish operations accumulated over the last four quarters was 50.561 billion euros, equivalent to 4.8% of GDP.

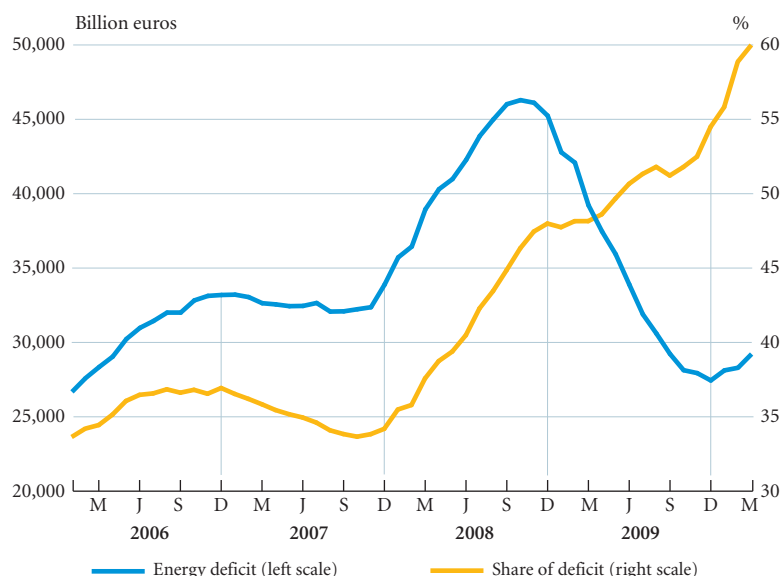
A figure that, as with the trade deficit, is not very far from the figure recorded

...boosted by the energy deficit.

Current deficit falls to 4.8% of GDP.

THE GROWTH IN THE ENERGY DEFICIT SLOWS UP THE CORRECTION IN THE TRADE DEFICIT

Accumulated energy deficit last twelve months and percentage out of total deficit



SOURCES: Ministry of the Economy and own calculations.

Foreign portfolio investment falls.

in the previous quarter. Similarly, financing needs stood at 4.3% in the same period, four tenths of a percentage point lower than the previous period.

The data from February's balance of payments confirm the slowdown in this adjustment. During the first two months, the accumulated current deficit fell by 15.1% compared with the same period in 2009, a significantly lower figure than those of the preceding months. In this period, the reduction in the trade deficit led the adjustment in the current imbalance, supported by a further

reduction in the income balance deficit and a slight surplus in the balance of services. On the other hand, the transfer balance once again slid back for the third consecutive month.

With regard to financial flows, in the month of February there was a reduction in net portfolio investment of 18.036 billion euros. This lower portfolio investment was offset by the lower direct investment by Spain abroad, totalling 7.351 billion euros. On the other hand, short-term financing increased in February after more than a year of reductions.

BALANCE OF PAYMENTS

February 2010

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	-7,188	-23.9	-42,781	36,966	-46.4
Services					
<i>Tourism</i>	2,755	-1.2	26,165	-1,806	-6.5
<i>Other services</i>	-66	-47.2	-443	1,209	-73.2
Total	2,689	0.9	25,722	-597	-2.3
Income	-4,592	-27.1	-28,138	9,539	-25.3
Transfers	-4,015	70.6	-9,633	-898	10.3
Total	-13,105	-15.1	-54,830	45,010	-45.1
Capital account	1,466	148.7	4,944	747	17.8
Financial balance					
Direct investment	10,902	-	14,305	29,793	-
Portfolio investment	-9,166	-	29,578	14,293	93.5
Other investment	10,716	16.8	5,122	-53,885	-91.3
Total	12,453	17.5	49,005	-9,800	-16.7
Errors and omissions	-2,184	-	-8,044	-7,076	-
Change in assets of Bank of Spain	1,370	-39.3	9,578	-26,624	-73.5

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

SOURCES: Bank of Spain and own calculations.

Public sector

New austerity measures to speed up the reduction in the public deficit

As part of an extraordinary meeting of the European Union's ministers of the economy and finance (Ecofin), held on 9 May, the Spanish minister of the Economy and Taxation, Elena Salgado, announced a new package of austerity measures to reduce the public deficit further. The aim for 2010 is therefore 9.3% of gross domestic product (GDP) and 6% of GDP for the following year, 0.5 and 1.5 points below the forecast in the 2009-2013 Stability Programme, respectively. This intensification of the effort to reduce the public deficit is necessary in order to restore the confidence of international markets.

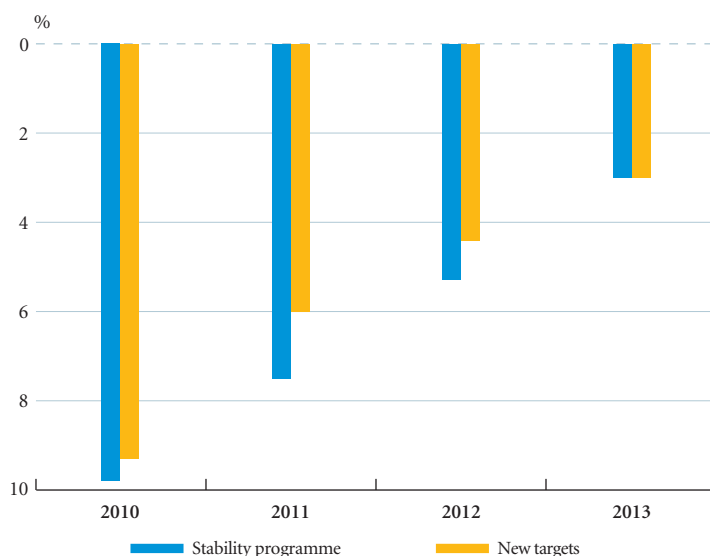
These additional measures were subsequently made more specific. The most important in terms of the volume they represent are a reduction in state public investment and the average cut of 5% in civil service wages as from June 2010, as well as the wage freeze for 2011, with a higher cut for members of the government and other senior positions.

Also notable are the suspension of the review of pensions for 2011, except for non-contributory and minimum pensions, and the elimination of the benefit for new-born babies of 2,500 euros as from 1 January 2011. Moreover, additional savings of 1.2 billion euros are expected to come from the autonomous communities and local bodies.

Cuts in public investment, reduction in civil servant wages and frozen pensions, among other adjustment measures.

THE SCHEDULE FOR REDUCING THE PUBLIC DEFICIT HAS BEEN BROUGHT FORWARD

Deficit of the general government in terms of GDP



SOURCES: Ministry of the Economy and Taxation and own calculations.

The gradual improvement in business and some fiscal measures have led to a certain improvement in revenue.

The central government's net borrowing is 15% up year-on-year in the first quarter.

Other measures in the package are: the reduction between this year and the next of 800 million euros in official development aid, the reduction of expenditure on drugs by lowering the price of medicines excluded from the reference price system, the suppression of backdated payments of dependency benefit to the date the application was presented in the case of new applicants, and the elimination of the temporary system for partial retirement contained in Act 40/2007.

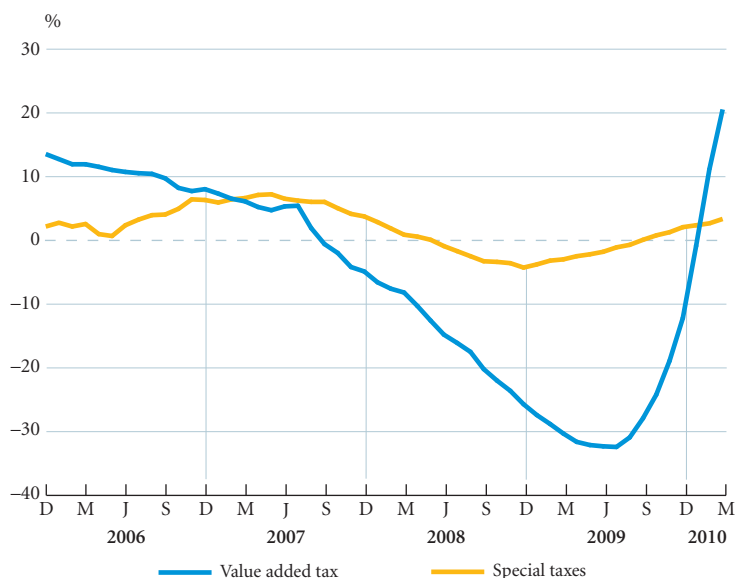
With regard to trends in the central government's accounts, the weakness of the economy overall continues to have a negative effect, although the gradual improvement in business and some fiscal measures taken with regard to withdrawing stimuli have helped to

improve revenue to a certain extent. Consequently, in the first quarter, total non-financial income for the central government fell by 1.9% compared with the same period the previous year, but compares favourably with a drop of 13.9% for 2009 as a whole.

Revenue from direct taxes in the period January-March totalled 20.804 billion euros, a 0.5% drop year-on-year, while the revenue from indirect taxes reflects the improved consumption and investment, posting a year-on-year rise of 2.2%. As a result of the trends in revenue and payments, on a national accounts basis, i.e. according to the rights and obligations recognised, the central government's net borrowing in the first quarter totalled 8.908 billion euros, 15.2% more than in the same period last year.

UPSWING IN INDIRECT TAXES

Homogeneous annual rate of change in revenue (*)



NOTE: (*) From the centred twelve-month moving average.
SOURCE: Tax Agency.

Savings and financing

Slight rise in household financing

Within a context of very low interest rates and the exit from the recession, in the last few months the adjustments in private sector financing have tended to slow up. Consequently, the overall balance of financing for non-financial firms and households fell by 1.0% in March compared to a year earlier, but one tenth of a percentage point less than the previous month.

The fall in financing to non-financial firms eased off, with the overall balance falling by 1.9% in March compared with twelve months earlier, the same rate as the month before. Loans from resident financial institutions fell by 4.2%

compared with March 2009. Similarly, bond issuance picked up and rose 32.2% in the last twelve months, 2.8 points more than in the previous month. However, foreign loans stagnated compared with a year earlier.

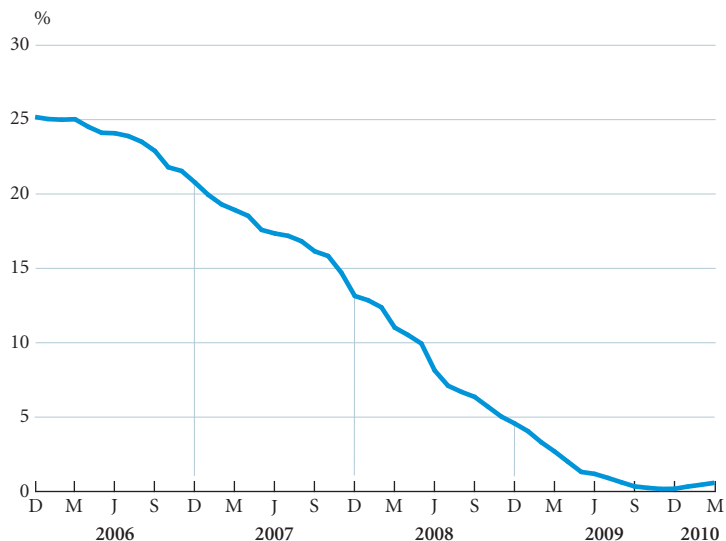
Trade credit, aimed at financing the working capital of firms, continued to slow up its decline, recording a year-on-year change rate of -17.9% in March, 3.7 points more than in February. This slowdown in the drop in trade credit is in line with a certain improvement in economic activity. On the other hand, financial leases, related to investment, were down 16.2% year-on-year in March, 0.3 points more than in the previous month.

Private sector financing falls 1% in the last twelve months up to March.

The squeeze in trade credit slows up.

SLIGHT UPSWING IN HOUSEHOLD FINANCING FOR HOUSING

Year-on-year change in household financing for housing (*)



NOTE: (*) Includes non-profit institutions providing services to households.

SOURCE: Bank of Spain.

FINANCING OF NON-FINANCIAL SECTORS (1)

March 2010

	Balance	Change this year	Change over 12 months	%
	Million euros	Million euros	% (2)	share
Private sector	2,205,932	-9,046	-1.0	79.3
Non-financial corporations	1,305,801	-6,153	-1.9	46.9
<i>Resident credit institution loans (3)</i>	<i>907,540</i>	<i>-8,841</i>	<i>-4.2</i>	<i>32.6</i>
<i>Securities other than shares</i>	<i>60,065</i>	<i>3,811</i>	<i>32.2</i>	<i>2.2</i>
<i>External loans</i>	<i>338,196</i>	<i>-1,123</i>	<i>0.0</i>	<i>12.2</i>
Households (4)	900,131	-2,892	0.2	32.3
<i>Housing loans (3)</i>	<i>679,254</i>	<i>1,347</i>	<i>0.5</i>	<i>24.4</i>
<i>Other (3)</i>	<i>218,175</i>	<i>-4,305</i>	<i>-0.5</i>	<i>7.8</i>
<i>External loans</i>	<i>2,701</i>	<i>65</i>	<i>5.6</i>	<i>0.1</i>
General government (5)	576,553	16,903	23.9	20.7
TOTAL	2,782,485	7,858	3.3	100.0

NOTES: (1) Resident in Spain.

(2) Year-on-year rates of change calculated as effective flow/stock at beginning of period.

(3) Include bank off-balance-sheet securitized loans.

(4) Include those non-profit institutions serving households.

(5) Total liabilities (consolidated). Liabilities among public administrations are deducted.

SOURCES: Bank of Spain and own calculations.

The default rate eases off in March.

With regard to household financing, this continued to pick up slightly in March and posted a year-on-year change rate of 0.2%, its second consecutive annual growth figure. This trend can be partly explained by the record low for the 12-month Euribor in March, to which most mortgages are linked, and a certain revival in the housing market, partly due to demand being brought forward because of the rise in value added tax in July and the partial suppression of the tax deduction as from 2011. For its part, the 12-month Euribor increased very slightly in April, standing at 1.225% as its monthly average. In the first few weeks of May, the 1-year Euribor continued to rise slightly, standing at 1.26% in the fourth week of the month.

The rest of loans to individuals continued to moderate their fall. They therefore presented a year-on-year change rate of -0.5% in March, 3 tenths

of a percentage point more than in the previous month.

On the other hand, non-performing loans took a break in March. In this month, the default rate for financial institutions as a whole fell by one tenth of a percentage point to 5.3%. Overall, this was 1.1 points above the level of a year earlier.

With regard to public financing, this continued to slow up, although in March it still grew by 23.9% compared to a year earlier. It should be noted that, at the end of April, the credit rating agency Standard & Poor's downgraded the Spanish sovereign debt rating in the long term by one notch to AA and gave it a negative outlook, although the agencies Moody's and Fitch kept it at the highest rating. This downgrade led to a slight increase in risk premium for public debt and the 10-year differential with German government

Public financing slows up.

bonds widened slightly. At the end of the first week in May, uncertainty increased in the markets and the differential rose to 1.7 points, the highest since the euro was launched. However, after the announcement of a package of measures by the European Central Bank and the euro group to safeguard the euro area's fiscal and financial stability, the differential narrowed to 1.1 points the following week. Nonetheless, it then rose again to 1.6 points in the fourth week of May, as tensions in the debt markets did not disappear, and on 28 May the agency Fitch also downgraded Spain's sovereign debt rating by one notch.

On the whole, total financing to resident sectors halted its decline and posted a rise of 3.3% in March compared with the same month the year before. This represents an increase of one tenth of a percentage point compared with February.

Modest growth in bank deposits

Yields on bank deposits rose slightly in March due to the movements by some entities to gain market share. Consequently, the average interest rate for term deposits for individuals stood at 2.19%, 15 basis points above the rate of one month earlier, although 2 basis points below that of December 2009. However, the low level of economic activity meant that the slowdown in bank deposits as a whole hardly varied, up 0.3% compared with a year earlier, 7 tenths of a percentage point less than in February. Nonetheless, the gap between credits and deposits continued to widen, yet another element in the adjustment of the Spanish economy.

Both on-demand deposits and savings deposits moderated their rate of growth.

However, savings deposits saw the greatest expansion year-on-year, namely 12.5%, showing savers' preference for liquidity given the economic uncertainty and rising unemployment. On the other hand, foreign currency accounts slowed up their decline, probably due to the expectations generated by the euro's depreciation over the last few months. In March, this balance fell by 22.1% compared with twelve months earlier but was 2.3 points less than the previous month.

Competition for bank deposits and the volatile financial markets continued to harm investment funds in April. Mutual fund assets fell by 2.123 billion euros in April to 158.271 billion, a year-on-year decrease of 2.3%. This monthly drop is due particularly to net withdrawals of 1.349 billion euros, basically from the most conservative categories, such as short-term fixed income and monetary funds. However, the number of mutual fund participants rose by 16,802 in April to 5,675,764, a figure that represents a 1.0% increase over December.

Yields suffered from the weakness of fixed income and European equity in the month, but the average annual yield stood at a significant 4.1%. All kinds of mutual funds managed to achieve annual gains, led by the emerging markets with 54.4%.

For their part, real estate funds remained practically stable in April, with assets totalling 6.333 billion euros and 81,498 participants. However, they posted an annual drop of 4% and 14%, respectively, because of the property crisis.

Regarding pension funds, the balance of their assets totalled 85.325 billion euros at the end of the first quarter, with a

The risk premium for long-term sovereign debt hits its highest level since the euro was launched, but then falls.

Competition for bank deposits and the volatile financial markets lead to further net withdrawals from mutual funds.

Average annual yield stands at 4.1%.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

March 2010

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	258,660	-4,075	-1.6	12,826	5.2	18.5
Savings deposits	204,365	-3,426	-1.6	22,740	12.5	14.6
Term deposits	709,209	-10,803	-1.5	-25,813	-3.5	50.6
Deposits in foreign currency	22,161	146	0.7	-6,304	-22.1	1.6
Total deposits	1,194,395	-18,158	-1.5	3,449	0.3	85.3
Other liabilities (*)	206,495	-6,634	-3.1	-21,926	-9.6	14.7
TOTAL	1,400,890	-24,792	-1.7	-18,477	-1.3	100.0

NOTE: (*) Aggregate balance according to supervision statements. Includes asset transfers, hybrid financial liabilities, repos and subordinated deposits.

SOURCES: Bank of Spain and own calculations.

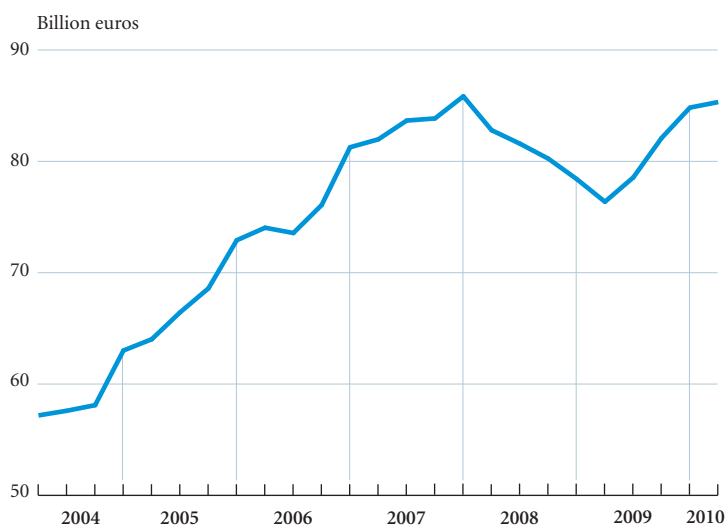
Pension funds achieve an average annual yield of 11%.

year-on-year rise of 11.7%. Contributions during the first quarter of 2010 were 7.5% lower than those of the first quarter a year earlier, but net contributions were higher, as payouts were 20% down. The average annual yield for pension funds was 11.0%. Over the last twenty years, the average yield for pension funds has been 5.5% annually, clearly above inflation for the period.

Revenue from insurance premiums also declined in the first quarter of 2010, 3.8% compared with a year earlier, totalling almost 15.790 billion euros. The biggest drop was in life insurance, however, namely 5.9%. Among the non-life branches, some such as health enjoyed favourable trends, with an annual increase of 4.4%. However, others more closely related to economic and

PENSION FUNDS CONTINUE ON THE UP

Total assets in pension funds



SOURCE: Inverco.

industrial activity continued to be affected by the overall lethargy and their premiums fell by 8.8% year-on-year.

Rise in financial wealth of households in 2009

Bank deposits continued to be the main financial asset for savers in 2009, accounting for 42.2% of the total. However, their share fell by one tenth of a percentage point, growing a little less than assets as a whole.

The equity portfolio was up 5.2%, both due to gains and also share purchases. However, there were net sales in investment funds, albeit much lower than those recorded in 2008.

After having recorded their first drop for the last few decades, insurance products

picked up again in 2009 and posted their highest annual increase, namely 5.5%. In this way, their share of the total rose to 15.0%, 3 tenths of a percentage point more than in the previous year.

On the other side of the household balance sheet, financial liabilities continued to slow up, posting an annual drop of 0.7%, the first for the last few decades. Most of this is made up of loans, accounting for 125.4% of gross disposable income, 2.3 points less than the previous year.

Lastly, the net financial wealth of families, defined as their financial assets minus their financial liabilities, grew by 9.4% in 2009 after suffering the greatest fall of the last few decades in 2008. It therefore reached 802.100 billion euros, 76.3% of the gross domestic product.

Insurance picks up in 2009 and posts its highest annual increase in household assets.

Household debt posts its first annual fall of the last few decades in 2009.

NET HOUSEHOLD FINANCIAL WEALTH (*)

	2009			Annual change		Change over 5 years	
	Million euros	Structure as %	%/GDP	Million euros	%	Million euros	%
Financial assets							
Cash	92,986	5.3	8.8	769	0.8	23,684	34.2
Deposits	738,579	42.2	70.3	24,968	3.5	267,363	56.7
Instruments other than shares	45,603	2.6	4.3	-498	-1.1	14,282	45.6
Shares and participations in mutual funds	556,741	31.8	53.0	27,297	5.2	7,832	1.4
Insurance premium reserves	263,393	15.0	25.1	13,622	5.5	54,448	26.1
Other	54,754	3.1	5.2	-3,992	-6.8	10,121	22.7
Total	1,752,056	100.0	166.7	62,166	3.7	377,730	27.5
Financial liabilities							
Loans	906,505	95.4	86.2	-6,280	-0.7	364,582	67.3
Other	43,450	4.6	4.1	-413	-0.9	-5,463	-11.2
Total	949,956	100.0	90.4	-6,693	-0.7	359,119	60.8
Net financial wealth	802,100	-	76.3	68,858	9.4	18,612	2.4

NOTE: (*) Includes non-profit institutions serving households.

SOURCES: Bank of Spain and own calculations.

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FINANCIAL ACTIVITY		Million euros
Total customer funds		237,799
Receivable from customers		178,026
Profit attributable to Group		1,510
STAFF, BRANCHES AND MEANS OF PAYMENT		
Staff		27,505
Branches		5,326
Self-service terminals		7,951
Cards (million)		10.3
COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2010		Million euros
Social		356
Science and environmental		62
Cultural		55
Educational and research		27
TOTAL BUDGET		500



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