NUMBER 337 • JULY-AUGUST 2010

THE SPANISH ECONOMY

Monthly Report

SOCIAL WELFARE, ECONOMIC PROGRESS AND HAPPINESS

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2008	2009	2010	2009				2010	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast						Forecast
Gross domestic product									
United States	0.4	–2.4	3.0	–3.3	–3.8	–2.6	0.1	2.4	3.3
Japan	–1.2	–5.3	2.5	–8.6	–6.0	–4.9	–1.4	4.2	2.5
United Kingdom	0.5	–4.9	1.4	–5.3	–5.9	–5.3	–3.1	–0.2	1.1
Euro area	0.5	–4.1	1.0	–5.2	–4.9	–4.1	–2.1	0.6	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	1.8	–0.2	–1.0	–1.6	1.5	2.4	1.9
Japan	1.4	–1.4	–0.9	–0.1	–1.0	–2.3	–2.0	–1.1	–1.0
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	1.4	1.0	0.2	–0.4	0.4	1.1	1.5
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						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	–15.2	–6.7	–14.9	–17.0	–16.0	–12.9	–9.9	–6.9
Capital goods	*–1.8*	*–23.0*	*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	1.6	0.5	–0.7	–1.1	0.1	1.1	1.6
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						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	3.6	2.7	3.3	3.5	3.4	3.7	3.5
10-year German bonds	4.0	3.3	3.1	3.1	3.4	3.3	3.2	3.2	2.8
Exchange rate									
$/Euro	1.48	1.39	1.30	1.30	1.36	1.43	1.48	1.38	1.27

Social welfare, economic progress and happiness

Contents

The pursuit of happiness is a constant in the individual and collective history of human beings and this is confirmed by a wealth of popular refrains and sayings. Even the United States Declaration of Independence placed the pursuit of happiness among the rights of man. 25 centuries ago, Aristotle also established the pursuit of happiness as the aim of his philosophical ethics. But what does happiness consist of? There can be many different answers: pleasure, wealth, fame or power; or an intellectually rewarding life, the practice of virtue or helping others. Or a combination. The menu is long and highly varied and we are therefore faced with a totally subjective concept that is difficult to apprehend.

That's why it might be surprising that economics, the dismal science as defined by Thomas Carlyle, is also devoted to happiness. Richard Layard, one of the great references in this debate, defines the determining principles of our personal satisfaction or subjective happiness: family relations; a stable, rewarding job; community and friends; health; individual freedom; personal values and, of course, financial situation. Money is one of the components of happiness but it is in no way a determining factor. Of course we are referring to «normal» situations. Privation and poverty are hardly compatible with a satisfactory personal state. But once our basic needs have been met, money becomes secondary; or not, because it can be seen that comparing ourselves with our peers sets off a mechanism that alters our subjective perception of what we take to be «basic needs». If we earn more money or our car is more expensive than our neighbour's, we will probably feel more satisfied, and vice versa. If a country has a higher per capita income than its neighbour, it will also feel more satisfied. Comparisons also have an effect in terms of time. A rise or cut in wages, as well as losing or getting a job, affect individual happiness because we compare them with our previous situation. But the principle of adaptive expectations is also true, i.e. increases in wealth only have a temporary, limited effect on our happiness and we individuals adapt to almost any situation, be it better or worse.

In any case, comparisons, albeit odious, are also important when evaluating happiness or personal or collective satisfaction. But how can our degree of happiness be measured? One way is by directly asking citizens for their personal, subjective opinion, let's say on a scale of 0 to 10. This provides interesting information but it's difficult to extract applicable conclusions, given the variability between what each person understands as happiness. Another way is to use objective indicators that define what is understood by the state of social welfare, such as life expectancy, level of education, the unemployment rate, etc. But it's complicated to get the right combination of indicators for the desired purpose, bringing us back to the initial situation of subjectivity. What would make it a lot easier would be if one of the macroeconomic indicators, in particular gross domestic product (GDP) per capita, could give us an adequate view of the state of social welfare. This idea is rejected, often vehemently, because GDP does not include aspects such as health, air purity or joy of living. However, it's also true that, in general, GDP has a close correlation with the objective variables of social welfare, and that economic progress plays a key role in improving this. Money isn't everything but, as the saying goes, it certainly helps.

EXECUTIVE SUMMARY

Fiscal adjustment takes centre stage

The G20 agrees to halve public deficit by 2013.

The uncertainty caused by the euro area's sovereign debt crisis has monopolized a large part of the economic news in the last few months but European institutional initiatives have managed to ease the tension to a certain extent. Both the European Central Bank (ECB) and Ecofin (Council of Economic and Finance Ministers of the European Union) have adopted effective measures against the crisis. At the G20 meeting held at the end of June, leaders from the main economies gave out a clear signal when they adopted the firm commitment to halve public deficit by 2013.

The main European powers present their austerity plans.

But where political activity is more intense is in the epicentre of the debt crisis: the euro area. Last month the European Stabilization Mechanism was approved which, together with the contribution from the International Monetary Fund, places 750 billion euros at the disposal of countries with liquidity problems. This agreement has been key to reducing some of the tension in the markets, while the national policies to contain public deficit that have been subsequently announced have also been of great importance. After publicizing those of Spain, Portugal and Greece, this month has seen the big European powers joining the fiscal containment movement.

The European Council is also taking measures to reduce uncertainty...

One of the most eagerly awaited and largest plans has been the German one, raising as much expectation as controversy. The package presented by German chancellor Angela Merkel plans to save the public coffers close to 80 billion euros between 2011 and 2014. This package affects the vast majority of public spending items, with the exception of education and research. These measures will help to gradually reduce the public deficit to 3% of gross domestic product (GDP) by 2013 and place the structural public deficit for the German economy below 0.35% as from 2016, a requirement recently added to the Constitution. According to detractors, the problem with these measures is that they don't stimulate Germany's domestic demand, so that the traditional driving force of Europe may, in the short term, find it difficult to take up the position of economic leader that so many require of it.

The path taken by the rest of the European powers is similar. The package announced by David Cameron was also eagerly awaited, as the United Kingdom's deficit has climbed to 11% of GDP. The new prime minister expects to reduce this figure to 1.1% of GDP in the next five years by saving around 50 billion euros a year, fundamentally through cuts in public spending. France, which plans to reduce its deficit by 100 billion euros in three years, will do so with an equal contribution from spending cuts and revenue. The plan presented by Italy is more modest, 24 billion euros between 2011 and 2012, in spite of the country having one of the highest levels of public debt in the euro area.

Another example of just how hard the European political machinery is working are the agreements reached by the European Council. Heads of state and government of the different member states agreed to introduce a new tax on the financial sector whose revenue will help to set up a fund to tackle future financial crises with more conviction. It was also agreed to publish the stress tests for the main banks in the euro area and to improve the standards for budget discipline and macroeconomic surveillance for the region.

All this has helped to ease the tension in international financial markets but the situation is far from being normal. In fact, instability has continued to be the overriding tone during the last few weeks, with an incipient but promising improvement in the second half of June. The main focus of tension is still the sovereign debt crisis in the euro area but other factors have also played their part, such as the nasty surprises in some economic activity indicators in the United States, the probable tightening up of monetary policy in various emerging countries and the incessant and occasionally confusing flow of news regarding financial regulatory reform.

In the United States, the recovery is still consolidating after a first quarter of strong growth but belief is growing that the expansion will enjoy modest growth rates. Indicators for the last few weeks point towards a scenario of less growth than first suggested by the data for the first quarter. Consequently, risks of deflation and of maintaining an aggregate demand that is weaker than expected are increasing. Non-financial firms continue to be the strongest point in the expansion, supported by notable increases in corporate profits in the first quarter and by business sentiment that remains at levels constant with robust growth.

...but the situation is still far from normal.

The breakdown of GDP in the first quarter for the euro area has also toned down any optimism. The reason is that the two forces that drove growth in the second quarter were the accumulation of stock and a rise in public consumption, while the pace of recovery in private consumption and investment, the pillars on which the recovery must be based, is still very weak.

The counterpoint is still being provided by the main emerging countries. From China's 11.9% growth year-on-year in the first quarter of 2010 to the 8.6% of India, the other giant of the region, including the progress made by Singapore (15.5%), Taiwan (13.3%), Hong Kong (8.2%) and Korea (8.1%), among others, the recovery is tightening its grip in emerging Asia. The most recent data for China, for the month of May, confirm this recovery. Proof of this is the renewed energy of exports and the sturdiness of investment. Given this upsurge in trade and perhaps bowing to US pressure, on 19 June the People's Bank of China made a statement concerning the expected flexibilization of the exchange rate, announcing that the controls that keep the renminbi interest rate practically fixed against the dollar would be relaxed. However, we will have to wait some time to appreciate the repercussions of this measure, which does not seem to suggest any sudden changes at first sight. The most likely situation is that the Chinese currency will very gradually appreciate against the US currency.

However, the main emerging countries continue to show signs of strength.

The situation of the Spanish economy is following in the wake of the euro area's recovery. After seven quarters of recession, activity posted positive growth

The Spanish economy continues to expand in the second quarter.

The European Commission invites Spain to specify more fiscal containment measures.

Labour reform comes into force and should help to create jobs in the long term.

The restructuring of the financial system is making progress and reforms are planned for Social Security and certain production sectors.

in the first quarter of 2010 and the few economic indicators available for the second quarter generally point towards this recovering trend continuing. However, the economic sentiment index halted its upturn in May, probably due to the unfavourable trend in the financial markets that month and the budget adjustment measures announced by the Spanish government.

In this respect, in mid-June the European Commission assessed the Spanish government's plans to correct its excessive public deficit, together with those presented by a further eleven European countries. Although it believed that the decisions taken by the Spanish executive to adjust its budget for 2010 were sufficient, it invited the government to specify additional measures up to 1.75% of GDP for 2011 in order to ensure the target is reached of a public deficit of 6% of GDP that year. The extent of cuts recommended by the Commission is a little higher than that defined by the government in its May package, as the Spanish government's forecast for GDP growth in 2011 is above the figure projected by the European Commission.

Moreover, as a complement to the budget adjustment package in May 2010, it has also been announced that the government and some autonomous communities are planning tax hikes to help reduce the public deficit. Although most of these hikes have yet to be defined, they appear to point towards tax on higher income brackets.

Within this context, the International Monetary Fund carried out a diagnosis of the Spanish economy, highlighting its key problems, such as the labour market, the bursting of the real estate bubble, the budget deficit, little growth in productivity and a weakened banking sector. Its recipe, apart from fiscal consolidation, included reforms in the labour market, in the pension scheme and financial system.

Over the last few months, economic policy has been used to implement a series of regulations that attempt to tackle the challenge of achieving a sustained recovery. The labour reform came into force at the end of June with the aim of reducing the dual nature of the job market, the division between employees with permanent contracts and those with temporary contracts, and to help firms adjust their economic conditions, also establishing subsidies for hiring people from those segments of the population most severely affected by unemployment. The idea is to implement the necessary conditions to facilitate business investment and thereby create jobs at a time when the outlook is improving, in an economy that is suffering from a very high level of unemployment.

A great deal of progress has also been made in another key aspect: the restructuring of the financial system. The number of savings banks will be cut to less than half those existing at the start of the process, either by mergers or by two direct interventions by the Bank of Spain. The Fund for Orderly Bank Restructuring has played a key role in this process.

The reform process does not stop there, as it is also planned to amend the regulations on savings banks, organizations that cover around half the national banking system, to raise the retirement age, to improve the adjustment between Social Security contributions and benefits, to carry out reforms in the energy sector, etc. The aim is to get the economy once and for all on the road to recovery, ensuring sustained improvement in productivity.

30 June 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**.
June	**17**	The European Council decides to publish the **stress tests** for the main European banks, to levy a **new tax on banks** and improve the **budget discipline and macroeconomic standards**.
	22	The Spanish parliament **approves a Decree-Law with urgent measures to reform the labour market**, proposed by the government.
	26	One year after the Fund for Orderly Bank Restructuring (FROB) was set up, the Bank of Spain considers the **process of restructuring savings banks** in Spain to be almost complete.
	27	The **G-20** summit decides to halve the deficits of advanced economies by 2013.

AGENDA

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).

August

3 Registration with Social Security and registered unemployment (July).
EU industrial production index (June).
5 Industrial production index (June).
Governing Council Central European Bank.
12 CPI (July).
13 GDP flash estimate (second quarter). EU GDP flash estimate (second quarter).
16 EU inflation (July).
17 Foreign trade (June).
25 Producer prices (July).
26 Quarterly national accounts (second quarter).
27 Retail and consumer goods (July).
30 HCPI flash estimate (August).
31 Government revenue and expenditure (July).

INTERNATIONAL REVIEW

The United States: more moderate expansion

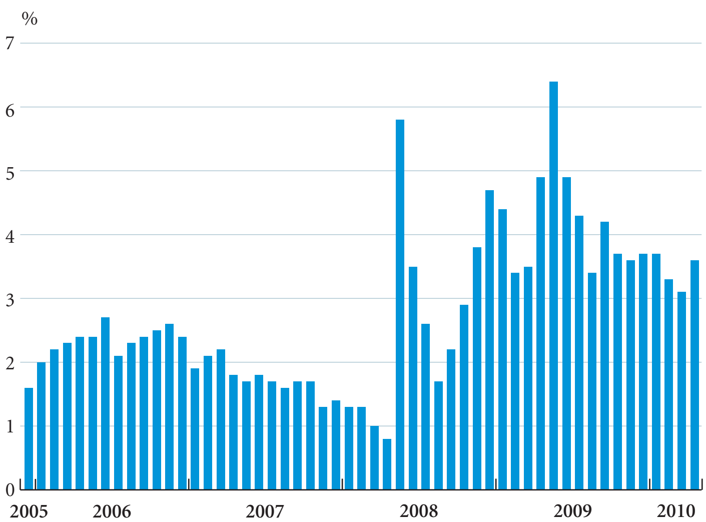
The United States grows by 2.7% and is looking at a modest recovery.

With a gross domestic product (GDP) that grew by 2.7% in the first quarter of 2010 in annualized quarter-on-quarter terms, the recovery is still consolidating but belief is growing that the expansion will enjoy modest growth rates. Economic decisions are often a question of accepting the lesser of two evils. On his return to Ithaca, Ulysses passed through a strait where he had to choose between getting close to Scylla, an inflationary monster with several heads, or next to Charybdis, a deflationary hole that would swallow up anything approaching it. The Scylla of the US economy today is a public deficit that reached 10.9% of GDP in the first quarter of 2010. Charybdis is the risk of growth being too small, with a 9.7% unemployment rate and a real estate market that's still in the doldrums.

Indicators for the last few weeks point towards a scenario of less growth than first suggested by the data for the first quarter. The inflationary risks of Scylla have therefore lessened somewhat, while those of Charybdis have increased due to the weakness of aggregate demand. During the last quarter of 2009 and the first of 2010, private consumption reacted upwards to offset the privations brought by households' greater risk aversion at the end of 2008 and beginning of 2009. But the latest

THE UNITED STATES: RISK AVERSION AND SAVINGS

Household savings by percentage of disposable income



SOURCES: Bureau of Economic Analysis and own calculations.

indicators point towards a return to normality, with private savings offsetting most of the increase in public deficit and with prices continuing to show their most moderate face.

April's national accounts indicate a slowdown in consumption. In the first quarter of the year, the rise in consumption absorbed 80% of the 89 billion dollar rise in households' disposable income during the period. However, the scenario changed completely in April, as the entire 64 billion dollar growth in disposable income went to savings. Confirming that the urge to consume is calming down, retail sales without cars or gasoline dropped off in May compared with April, putting an end to nine consecutive months of rises. The year-on-year increase was still positive, at 4.7%, but shows signs of slowing down. Automobile sales also slumped after two months on the up.

Consumption is slowing down after a nine-month upswing.

On the supply side, non-financial firms continue to be the strong point of the expansion. First quarter company profits were up 31.0% year-on-year, overtaking the pre-crisis level of December 2007. Within a general tone of sustainability, the business sentiment index of the Institute for Supply Management only saw minute changes in May. Manufacturers dropped slightly to 59.7 points, while services advanced to 61.1 points. Although the last few months have not seen notable advances, in accordance with the moderate line being following by the economy as a whole, the current levels are typical of strong expansionary phases. Industry might be the clearest exponent of a recovery that is consolidating at the same time as confirming its modest nature. Industrial production increased 7.2%

Entrepreneurs are looking at higher profits and remain optimistic.

UNITED STATES: MAIN ECONOMIC INDICATORS

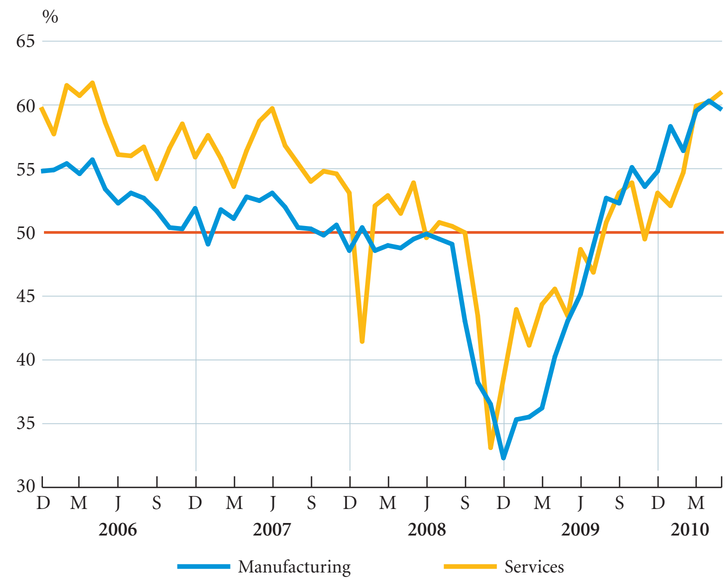
Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
Real GDP	0.4	–2.4	–3.8	–2.6	0.1	2.4	–	...
Retail sales	–1.0	–6.3	–9.9	–7.1	1.9	5.7	9.0	6.9
Consumer confidence (1)	58.0	45.2	48.3	51.8	51.0	51.7	57.7	63.3
Industrial production	–2.2	–9.7	–12.9	–9.4	–4.7	2.3	5.2	7.6
Manufacturing (ISM) (1)	45.5	46.2	43.0	51.4	54.6	58.2	60.4	59.7
Housing construction	–32.9	–38.4	–46.9	–32.0	–14.8	16.5	38.2	7.8
Unemployment rate (2)	5.8	9.3	9.3	9.6	10.0	9.7	9.9	9.7
Consumer prices	3.8	–0.4	–1.2	–1.6	1.4	2.4	2.2	2.0
Trade balance (3)	–698.8	–374.9	–502.8	–414.5	–374.9	–399.7	–411.6	...
3-month interbank interest rate (1)	2.8	0.7	0.8	0.4	0.3	0.3	0.3	0.5
Nominal effective exchange rate (4)	74.5	77.7	79.6	75.3	72.8	74.8	75.4	78.4

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: ENTREPRENEURS BELIEVE IN THE RECOVERY

ISM index level (*)



NOTE: (*) A level of 50 means there are as many optimistic as pessimistic responses.
SOURCES: Institute for Supply Management and own calculations.

Construction and housing prices still sluggish.

year-on-year in May, while industrial capacity utilization reached 74.7%. In both cases, the levels are halfway between the recent record lows and the pre-crisis situation.

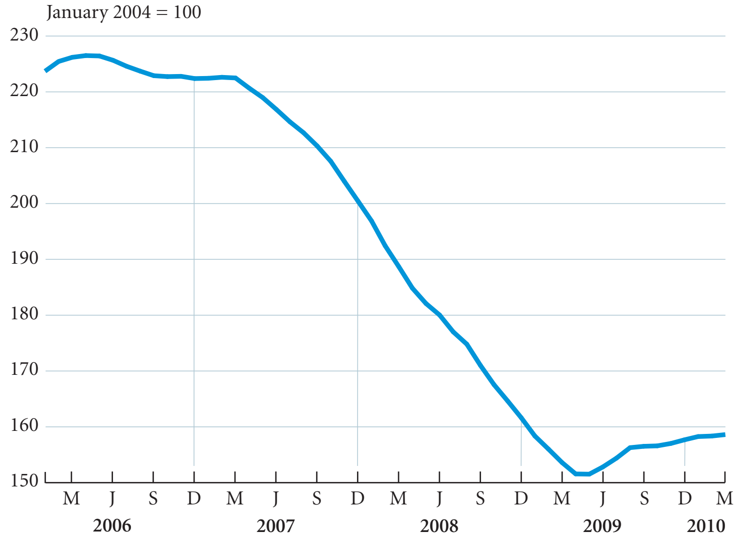
The real estate market is still weak and might take longer than expected to play its part in the economy's growth. On the supply side, the 593,000 homes started in May represent a drop compared with April and are still a tiny fraction of the 1,600,000 homes started in the years prior to the bubble. So the timid recovery of the previous two months has been halted and it can be seen that, in the housing sector, life is tough without the public stimuli that ended in April. Oversupply and mortgage foreclosures continue to be a burden that is also affecting prices. The Case-Shiller index for second-hand house prices was up in March by 0.2% compared with the previous month, seasonally adjusted, so that the accumulated rise since August 2009 is a skimpy 1.0%, 0.5% discounting inflation. So while San Francisco and San Diego continue with their recovery, areas as significant as Chicago, New York and Detroit have yet to touch bottom.

Unemployment stands at 9.7% and won't fall until 2011.

The labour market is still in a weak situation that will continue throughout 2010, in spite of the 431,000 net jobs created in May, mostly in the public sector. So while more than 8.4 million jobs were lost in private employment in 2008 and 2009 as a whole, half of the 982,000 net jobs created in 2010 can be put down to the public sector. The unemployment rate fell slightly from 9.9% to 9.7% but the high proportion of long-term unemployed, more difficult to relocate, and the large number of discouraged and involuntary part-time

THE UNITED STATES: HOUSING, A RECOVERY YET TO ARRIVE

Case-Shiller index for housing prices (*)



NOTE: (*) Series seasonally adjusted for the ten most significant areas as a whole.
SOURCES: Standard & Poor's and own calculations.

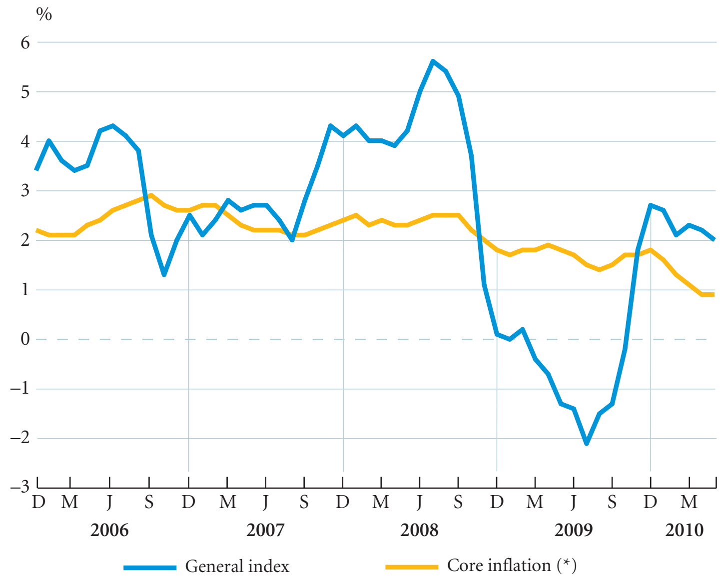
workers will make it difficult for unemployment to fall significantly until economic growth speeds up.

Moderate inflation continues to be in line with the low utilization of production capacity. Prices have

The CPI is up 2.0% while the underlying CPI remains at 1.0%.

THE UNITED STATES: STABILITY IN PRICES

Year-on-year change in the consumer price index



NOTE: (*) Core inflation excludes food and energy.
SOURCES: Department of Labor and own calculations.

The strong dollar weakens exports.

therefore left room for policies to boost demand, as well as confirming that, at present, there are more risks entailed by the weak demand than by inflationary tensions. In May, the general consumer price index (CPI) fell compared with the previous month for the second time running, seasonally adjusted. The year-on-year change was 2.0%, lower than the 2.2% of April. Without the effects of oil, prices would not have fallen but the situation continues to be lax, as shown by the trends in core inflation, the general index without food and energy, which rose 1.0% year-on-year.

The foreign sector will find it difficult 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. The trade deficit for goods and services in April was 40.285 billion dollars, a similar level to March. But this remained stable thanks to the fall in value of crude imports. Consequently, the trade deficit excluding oil and its derivates fell by close to 800 million dollars due to exports suffering from the stronger dollar, although this did not interrupt the medium-term corrective trend that, since the first quarter of 2006, has taken the non-oil deficit from 3.9% to 1.3% of GDP.

Japan: exports and public debt

Japan grows 5.0% thanks to exports.

Japan's GDP was up 5.0% annualized quarter-on-quarter, lessening the risk of a relapse in activity for 2010 as a whole. However, domestic demand still needs to be sorted out, as four of these five percentage points of growth were due to the boost provided by exports. Regarding the outlook for 2011, caution is the name of the day in

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
Real GDP	–1.2	–5.3	–6.0	–4.9	–1.4	4.2	–	...
Retail sales	0.3	–2.3	–2.8	–1.9	–0.7	3.8	4.9	...
Industrial production	–3.4	–21.8	–26.9	–20.5	–5.1	27.1	25.8	...
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	0.5	...
Unemployment rate (2)	4.0	5.1	5.1	5.4	5.2	4.9	5.1	...
Consumer prices	1.4	–1.4	–1.0	–2.2	–2.0	–1.1	–1.2	...
Trade balance (3)	4.2	4.0	1.0	1.8	4.0	6.7	7.3	...
3-month interbank interest rate (4)	0.8	0.6	0.6	0.5	0.5	0.4	0.4	0.4
Nominal effective exchange rate (5)	86.6	98.6	95.7	97.0	99.6	101.1	99.0	103.7

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.

an economy that continues in deflation with a public debt of more than 200% of GDP and an ageing population.

Its sovereign debt, mainly in Japanese hands, has been relatively well respected by the markets with a 10-year reference interest rate hovering around a contained 1.3%. A rate that, however, does not seem so favourable when compared with the downward trend in prices. Naoto Kan, the new prime minister, wants to put a stop to this problem of government debt by raising taxes and cutting costs but it won't be an easy route to take. The 5% projected rise in sales tax will have to wait at least a couple of years, pending the end of deflation and stronger domestic demand as, in 1997, this tax was already raised from 3% to 5% and the economy ended up in a recession.

The latest supply indicators show the strength of the industrial sector, more closely related to exports. In April, industrial production remained as dynamic as it had been in March and recovered two thirds of what had been lost between May 2008 and February 2009. However, the outlook for investment worsened in April, with machinery orders losing part of their upswing in March, both in purchases for the domestic market and also in investment demand by exporters.

There are still no signs of recovery in the housing market. New homes started in April showed no change compared with March and continue 35.8% b low the average for 2006, the year before the crisis in construction. A situation similar to that of sales in the Tokyo area.
The outlook for the labour market is no more promising, with an unemployment rate that, in April,

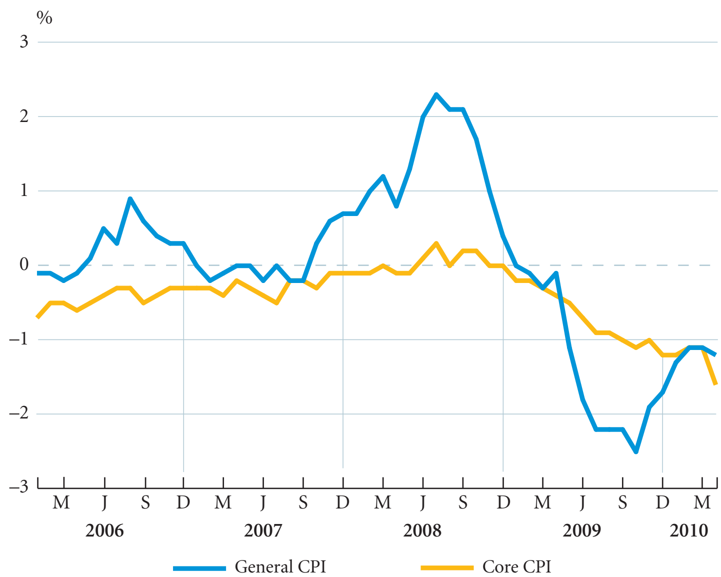
The reduction in government debt will have to wait until the end of deflation.

Industry continues to creep towards its pre-crisis levels.

Housing is still weak and unemployment reaches 5.1%.

JAPAN: CORE DEFLATION HASN'T HIT BOTTOM YET

Year-on-year change in the consumer price index



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

The CPI is down 1.2% while core inflation falls by 1.6%.

continued to rise to 5.1% and with the net loss of 300,000 jobs.

Regarding prices, weak demand has exacerbated the deflationary trends that, according to the Bank of Japan, will probably continue until early 2012. Consequently, although the CPI in April fell by 1.2% year-on-year, core inflation, the general index without energy or food, dropped 1.6% year-on-year, the biggest drop since the indicator came into existence, leaving prices at the levels of the first quarter of 1992.

Sales to the rest of Asia, particularly to China, are driving Japanese exports.

Recovery is strongest in the foreign sector. April's trade surplus slid back slightly compared with March due to the upswing in imports. But exports recovered from their weak performance in March and approached their robustness of January. April's exports stood at 57.8% above the average of the first quarter of 2009, their weakest period. The rise in sales to Asia is behind two thirds of the improvement and sales to China a quarter of the improvement. In contrast, the combined contribution of sales to Europe and the United States hardly goes to make up a fifth.

Expansion is confirmed in emerging Asia.

China: consolidating expansion

From China's 11.9% growth year-on-year in the first quarter of 2010 to the 8.6% of India, the other giant of the region, including the progress made by Singapore (15.5%), Taiwan (13.3%), Hong Kong (8.2%) and Korea (8.1%), among others, the recovery is tightening its grip in emerging Asia. Although partly due to the minimums reached a year ago, their recent growth figures caught most people by surprise.

May's data confirm such a recovery. Proof of this is the renewed energy of exports and the sturdiness of investment. In particular, the trade surplus improved to 19.5 billion dollars in May after a deficit of 7.2 billion in March and April's modest surplus (1.7 billion). This clear improvement is due to the spectacular rise in exports that, with growth close to 50% year-on-year, are about to reach the record high of July 2008. Imports continued on the up with a year-on-year rise of a similar size to exports.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
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	16.5
Electrical power generation	6.7	6.7	–0.4	8.0	24.3	22.6	22.2	19.9
Consumer prices (*)	5.9	–0.7	–1.5	–1.3	0.7	2.2	2.8	3.1
Trade balance (**)	298	197	296	251	197	150	138	145
Reference rate (***)	5.31	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	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.

Given this upsurge in trade and perhaps bowing to US pressure, on 19 June the People's Bank of China announced a change in their exchange rate regime that will increase the renminbi exchange rate flexibility, ending its de facto peg to the dollar. However, we will have to wait some time to see the repercussions of this measure, even though no sudden changes are expected. Most likely, the Chinese currency will appreciate very gradually against the US currency.

In this context, domestic demand was still strong, with retail sales up a resounding 15.1% year-on-year in May in real terms. Investment in fixed assets rose 25.8%, close to April figure and still not showing any clear signs of a slowdown in spite of the different measures applied to cool off the real estate sector and limit credit. Meanwhile, credit has started to show signs of moderation, in May the granting of new credit rose to 637.5 billion yuan, lower than the 771 billion in April, so that we predict a slowdown in investment over the coming months.

Leading supply indicators also seem to suggest a certain slowdown, although they are still strong. Industrial production grew significantly by 16.5% year-on-year in May, albeit below the average for the first four months of the year (19.3%). The purchasing managers' index (PMI) was still above 50 points, the boundary between recession and expansion, but slid from its 55.7 points in April to 53.9 in May.

Regarding prices, the risk of overheating is still hovering over the Asian giant. In particular, inflation climbed up to 3.1% in May, above the government's average annual target of 3%, although this is still a consequence of base effects and food. Similarly, housing prices extended their upward trend and rose 12.4% year-on-year, once again revealing a possible bubble in this sector. However, we mustn't forget the tenacity of the Chinese authorities, who have promised to cool off the property market and whose new measures have already started to affect sales.

In conclusion, although China continues to show the vigour that has astonished us so much during the global crisis, certain hints of moderation are starting to be seen. Nevertheless, this is good news given the danger of overheating. Regarding the external sector, the announcement concerning the flexibilization of the exchange rate is another step forward in correcting the high Chinese surplus.

Brazil: full steam ahead

With 8.9% growth year-on-year in the first quarter of 2010, 2.7% compared with the previous quarter, Brazil is confirming its place as one of the driving forces behind recovery. These figures do not only exceed the expectations of the consensus but also its potential growth rate, i.e. the rate considered compatible with a non-inflationary environment, estimated at between 4.5% and 5%. This has aroused fears of overheating in the leading Latin American power and we should therefore not be surprised at the fast reaction of Brazil's central bank, raising the SELIC rate in June another 75 basis points to 10.25%. The minutes of the last COPOM meeting also predict further increases this very summer... and not just in temperature.

What is definitely continuing to rise is domestic demand, undoubtedly the

Business indicators continue to progress strongly, although some moderation seems to lie ahead.

Inflation reaches 3.1% in China. Possible overheating?

Brazil's economy grows by 9% in the first quarter of 2010.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
Real GDP	5.1	–0.2	–1.7	–1.3	4.4	8.9	–	...
Industrial production	2.9	–7.3	–11.6	–8.7	6.2	17.3	16.7	...
Consumer confidence (*)	140.4	138.3	128.4	141.9	154.2	158.1	152.1	152.9
Unemployment rate São Paulo (**)	13.0	12.8	13.9	13.1	11.8	12.3	13.3	13.3
Consumer prices	5.7	4.9	5.2	4.4	4.2	4.9	5.3	5.2
Trade balance (***)	24.8	25.3	27.5	26.4	25.3	23.3	20.8	21.7
Interest rate SELIC (%)	11.25	11.25	9.25	8.75	8.75	8.75	9.50	9.50
Reales to dollar (*)	1.8	2.3	2.0	1.8	1.7	1.8	1.7	1.8

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.

Domestic demand at the helm.

main engine of the Brazilian recovery. Up 9.3%, consumption continues its relentless climb and confirms its resistance to the progressive withdrawal of public aid. Nonetheless, investment took pride of place in the first quarter of the year, boosted by gross fixed capital formation that grew an extraordinary 26% year-on-year, its best result in fifteen years. Albeit to a lesser degree, public expenditure also made a contribution, 1.8% year-on-year (5.5% in the previous quarter). So the only heading that continues to deduct from growth is foreign demand, in spite of both exports and imports recovering their positive year-on-year rate: the former up 21% and the latter 32% compared with the first quarter of 2009 (see the graph below).

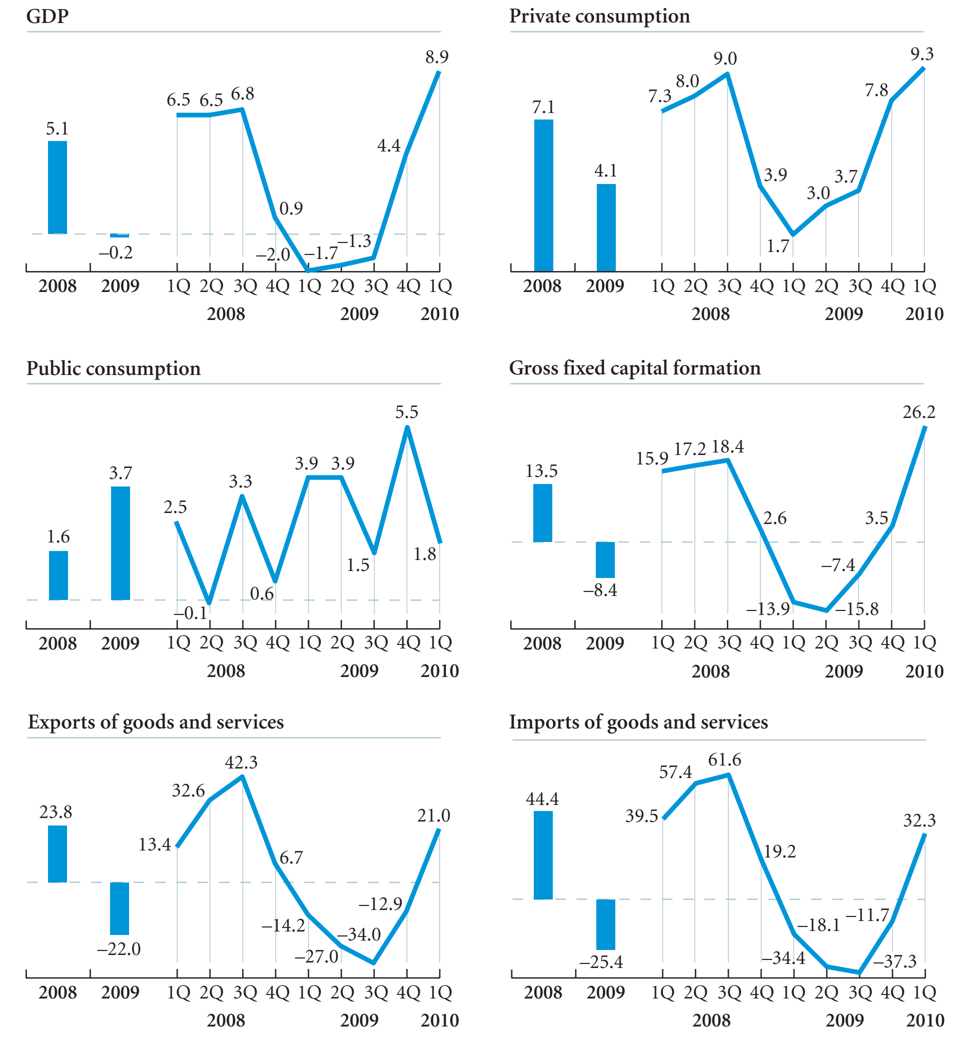
Fears increase of the Brazilian economy overheating.

The latest figures from leading indicators continue at levels befitting strong expansion, although pointing towards slight moderation. In April, installed industrial capacity utilization remained stable at around 82%; industrial production grew by 16.7% and retail sales pushed forward with 9% compared with the same period a year ago, albeit 3% less than in March. Inflation also took a breather in May (5.2% compared with 5.3% in April), remaining within the targets set for this year and 2011 (4.5% ±2pp).

Given this scenario, and following the general trend, we have upgraded our growth forecasts for Brazil in 2010 and 2011 to 7% and the 5%, respectively. Nonetheless, the action taken by the Brazilian economic authorities will be decisive both in terms of channelling the sustainability of growth in the medium and long term and also in safeguarding the current cycle of excessive inflationary pressures. Pressures that, should their risks come about, may put a stop to what is becoming Brazil's definitive economic resurgence. Sometimes taking your foot off the accelerator in time can be highly beneficial... particularly if you run the risk of wrecking the engine.

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms



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

Mexico: a slow awakening

In the first quarter of 2010, the Mexican economy finally came to grips with growth, posting its first year-on-year rise since September 2008. The latest figures from the National Accounts system, broken down by demand component, confirm what we had already suggested in the last issue: a Mexican recovery nourished by the upsurge in foreign demand and a domestic market that still refuses to completely awaken from the daze caused by the crisis.

Investment is the only heading still in negative terrain, down 1.2% compared with the first quarter of 2009, although it is also gradually easing back on its decline. The trend in public

In Mexico, domestic demand refuses to shake off its sluggishness.

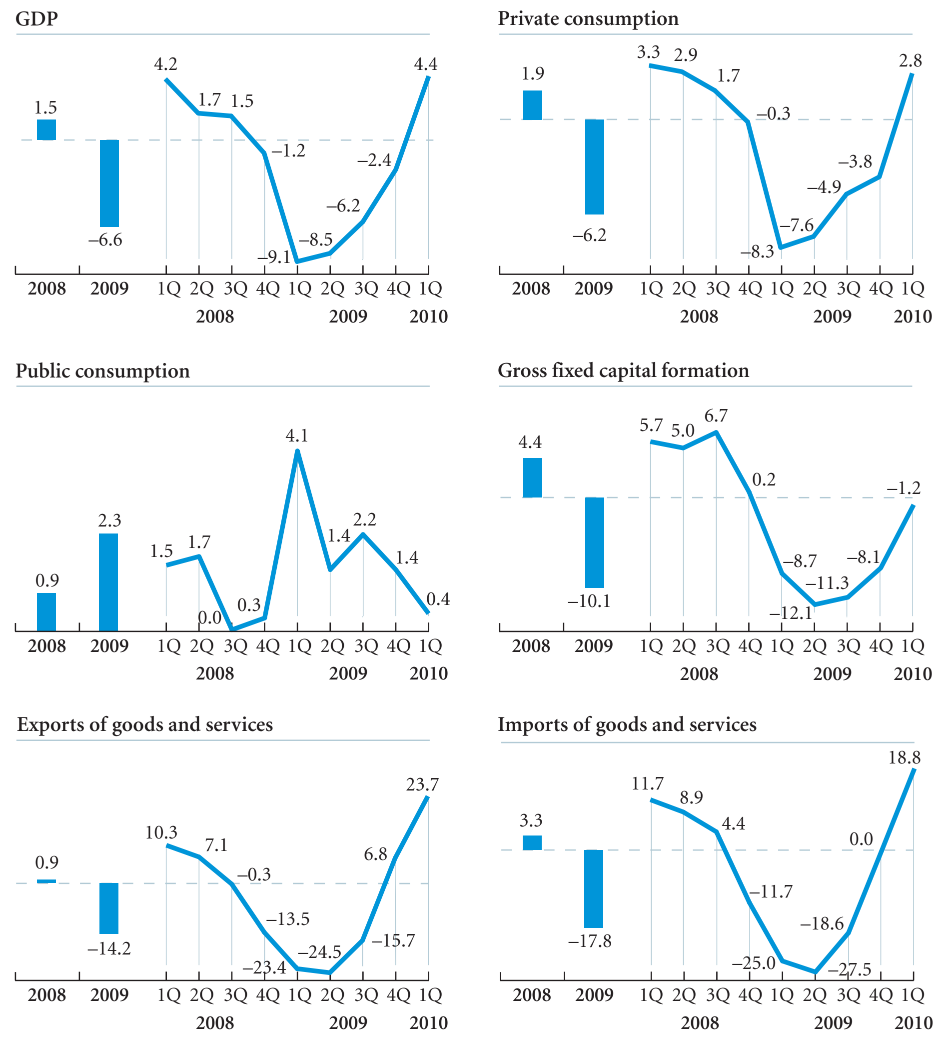
Recovery looks to be very gradual.

consumption is also moderating but in this case it was upwards, growing 0.4% year-on-year during the same period. Private consumption, however, provided more certain signs of recovering its tone, up 2.8% year-on-year. A tone that, in the case of exports and imports, is no longer of recovery but of full take-off, with double digit growth of 23.7% and 18.8% respectively.

Concerning the future, leading indicators for activity point towards a prolonged, gradual recovery. With regard to demand, retail sales dropped once again in April (1.1% compared with March and 0.1% compared with the same month last year) and have yet to establish sustained growth. With regard to supply, installed industrial capacity utilization is already at 80.3%, a reflection of the boost provided by manufacturing industry, the main beneficiary of strong exports. Nonetheless, both industrial and manufacturing production, although

TREND IN MEXICO'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Banco de México and own calculations.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
Real GDP	1.5	–6.6	–8.5	–6.2	–2.4	4.4	–	...
Industrial production	–0.9	–7.0	–9.5	–6.5	–1.9	5.7	5.4	...
Consumer confidence (*)	92.2	80.5	80.5	83.0	78.4	81.5	82.5	84.6
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	5.4	...
Consumer prices	–11.8	0.0	6.0	5.1	4.0	4.8	4.3	3.9
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	4.50
Mexican pesos to dollar (*)	10.6	14.2	13.2	13.5	13.1	12.3	12.2	12.9

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

growing by 5.4% and 9.1% year-on-year respectively in April, suffered slight drops compared with the previous month, a sign of the relative moderation of growth in the United States.

Within this context, and given that inflation fell in May to 3.9%, Banxico opted not to make a move in June and kept its reference rate at 4.5%. This confirms our forecast of interest rate stability, at least until year-end; without doubt, an additional incentive for domestic demand to shake off its sluggishness.

The effects of financial instability die down

Oil prices are returning to their upward trend before the sovereign debt crisis. After having fluctuated between 90 and 70 dollars per barrel, crude embarked on its climb towards 79.50 dollars per barrel (Brent quality, for one-month deliveries). Consequently, between 20 May 2010 and 21 June, oil rose 11.6%, slightly above the level at the start of the year and 18.2% more expensive than at the end of June 2009.

Crude up 11.6%, coming close to 80 dollars per barrel.

So, after the storms in the euro area and the dollar's appreciation, we are returning to the main scenario characterized by a recovery led by emerging economies that use commodities more intensively. This should push oil up towards moderate growth and leave it within the price range of 80-85 dollars per barrel by the end of the year.

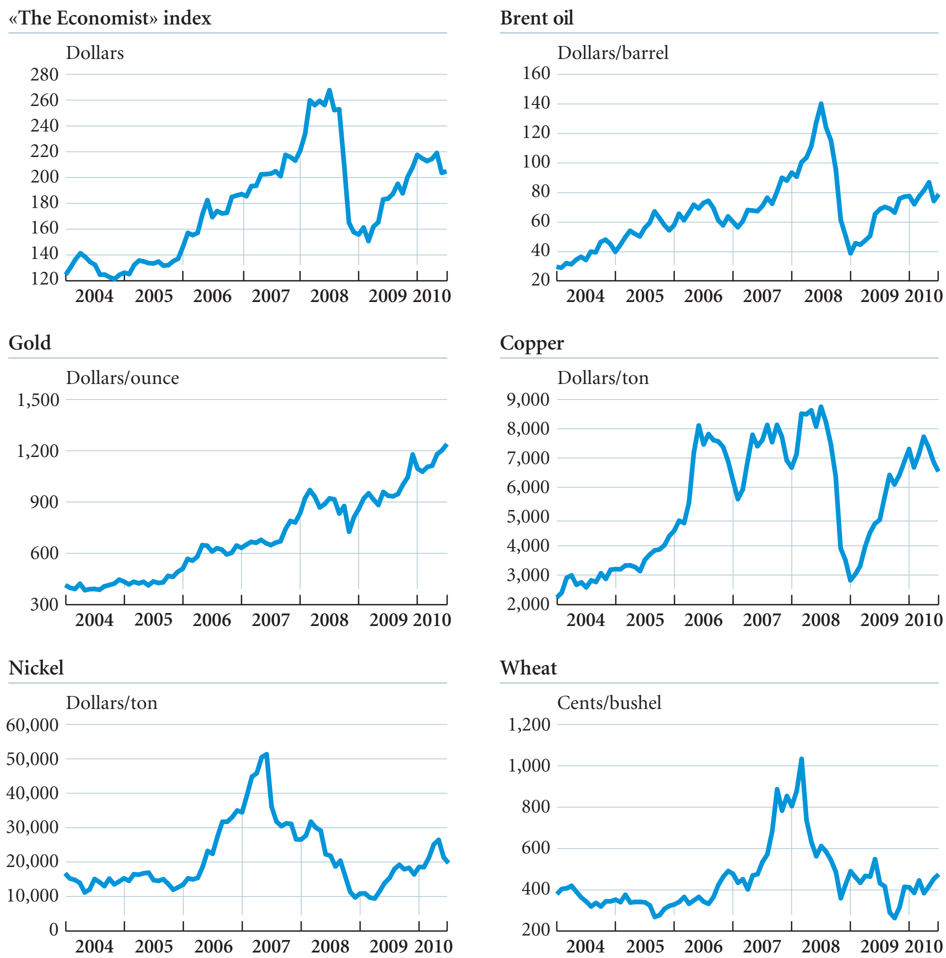
The recovery led by emerging economies boosts oil.

The other commodities also recovered their May losses but only in the second week of June, leaving the balance of the last 30 days at quits. Consequently, the Economist index rose an unappreciable 0.6% between 20 May and 21 June. This recovery varies among metals. Gold continued to gain ground, accumulating gains of 24% in the current year, while precious metals followed in its wake after the losses of the previous month, particularly palladium, up 16.0%. But base metals

Precious metals and coffee lead the recovery in commodities.

are somewhat slow to follow, with nickel and aluminium far from their pre-correction levels. In foods, of note is the rise in coffee, with Arabic setting a record for the last two years. Tea was the opposite to coffee, down 19.8%.

TREND IN VARIOUS COMMODITIES (*)



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

Money can't buy you happiness... Or can it?

According to Woody Allen «money doesn't make you happy... but it produces such a similar feeling that only a real expert can spot the difference». To date, not even the most daring of experts have managed to resolve the dilemma, proving the filmmaker's great insight. Either that... or he very closely follows the debate about the relationship between wealth and happiness. A debate that, in 1974, Richard Easterlin rescued from the annals of economics and set within a question: if we were all richer, would we be happier?

First off, the overwhelming majority of us would expect a decisively affirmative answer, and this is reflected in the surveys. On being asked about the circumstances that most influence our personal satisfaction (or subjective happiness), the answer almost always includes finances. Sir Richard Layard, one of the great references in the debate in question, coined the term «the big seven» to refer to the key determining factors of happiness: family relationships; stable, rewarding work; community and friends; health; personal freedom; personal values, and, of course, the financial situation.

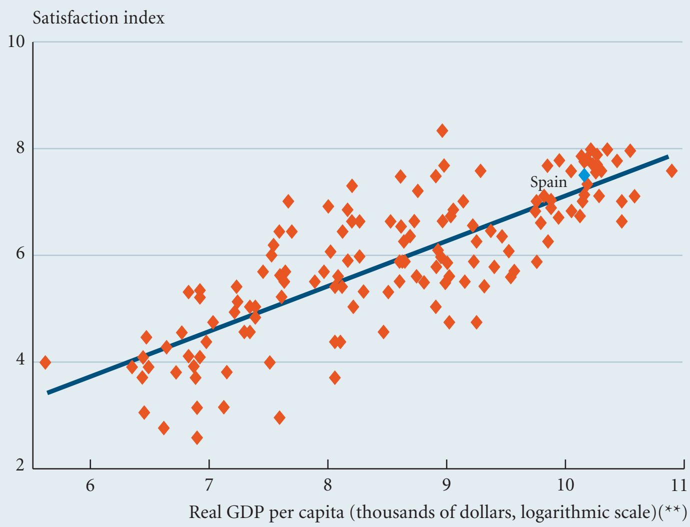
However, the same polls suggest that money is not the factor that most affects our lives, not by a long chalk. On a scale of 10 to 100, marital separation reduces our welfare by 8 points and losing our job or physical deterioration by 6, while the loss of a third of our family income only takes away 2 points. So the direct impact of changes in income on happiness seems to be modest, especially compared to the impact achieved by family circumstances, unemployment or health.

A broad sector of the academic literature subscribes to this thesis. Among its staunchest supporters are Sir Layard and Easterlin himself who, in his influential article of more than a quarter of a century ago, revealed a series of apparently contradictory findings that still arouse debate today and that led him to discount the permanent influence of wealth over happiness.[1]

On the one hand, when we compare individuals from the same country at a specific point in time, the data indicate that greater wealth leads to greater satisfaction; in the United States, for example, among top earners (the top 25% of the distribution), 45% consider themselves to be «very happy»; however, 33% of the poorest

RICH COUNTRIES ATTAIN A HIGHER DEGREE OF SATISFACTION (*)

Relationship between the degree of satisfaction and per capita income



NOTES: (*) The sample contains 141 countries in 2005.
(**) GDP per capita in thousands of dollars in terms of PPP or purchasing power parity. In the case of Spain, for example, GDP per capita in current dollars totalled 26,033 in 2005, the equivalent of 27,367 dollars in PPP and, in logarithmic terms, 10.2.
SOURCES: World Gallup Poll (2006)I; World Development Indicators (2009) and own calculations.

(1) Easterlin, R. (1974), «Does Economic Growth Improve the Human Lot? Some Empirical Evidence», in P. A. David & M. W. Reder (eds.), *Nations and Households in Economic Growth: Essays in Honour of Moses Abramowitz*. Academic Press, NY.

quartile feel the same way. However, the size of the effect is estimated as decisively modest: a 10% rise in per capita income would lead to a rise of about 0.1 on a scale of 10.

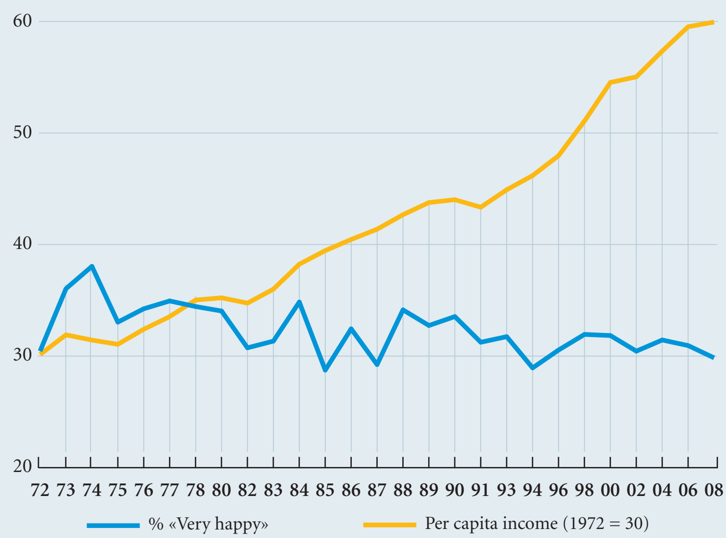
A comparison between countries also reveals a positive relationship between per capita income and the acknowledged level of happiness. Although Easterlin rejected this hypothesis at first, a wealth of new data corroborates that the inhabitants of rich countries generally live more satisfied lives than those in poor countries (see the graph below). At the same time, an international comparison rules out the existence of an income threshold after which higher income no longer leads to satisfaction, although it can be seen that a rise in income entails less satisfaction the higher the per capita income.(2)

Contradictions arise when these findings are compared with trends in the wealth-happiness link over time. Most studies conclude that the level of happiness in a specific country practically doesn't change in the long term, no matter how much richer its citizens become. The paradigmatic case is the United States, where the average satisfaction has remained stable since the middle of the 20th century, while per capita income has increased markedly (see the graph below). How can this be reconciled with the fact that, year after year, the wealthiest North Americans proclaim themselves to be happier than their less fortunate fellow citizens? Hence Easterlin's famous paradox: when people progress compared with their neighbour, they are happier, but when a whole society gets richer, they aren't.

According to Easterlin, this paradox can be explained if we look at the findings through the right glasses: privation and poverty damage happiness to a large extent but, once the basic needs have been covered, what leads

THE UNITED STATES: INCREASINGLY RICHER BUT... NOT HAPPIER

Percentage of «very happy» respondents in the United States and per capita income



SOURCES: Global Social Survey, BEA and own calculations.

(2) Note that the graph above uses logarithmic scales and therefore reflects the nature of this relationship.

to satisfaction is not absolute income but relative and the effect of income in absolute terms is merely transitory at best. The logic behind this is psychological in origin. The human mind lacks an internal gauge to assign value to all goods or conditions, so that it resorts to comparison as its usual method of valuation. In the case of income, we value this more highly when it is greater in quantity compared with two barometers: what those close to us receive (social comparison) and our income yesterday. In the retrospective comparison, we should note that individuals eventually adapt to almost any situation and, in the case of a rise in income, this adaptation involves an upgrade in their demands and aspirations: the more we earn, the more we aspire to earn (adaptive expectations). This theory (the hedonic treadmill) explains why an increase in wealth only has a temporary and fleeting impact on happiness.

From this perspective, social comparison explains why we feel more satisfied if we earn more money than our fellow citizens or the neighbouring country. On the other hand, when the economy prospers, both the social and the retrospective «bar» is higher so that, within a context of economic growth, an increase in income does not have a permanent effect on happiness. At most, it leads to transitory improvement until our aspirations adjust completely to the new circumstances. This explains the human tendency to remain at a relatively stable level of happiness.

Nonetheless, other hypotheses have also been put forward, such as the one claiming that wealth has contributed to happiness since the Second World War but its effect has been offset by a deterioration in the rest of the determining factors, particularly harmony in personal relationships. A recent article has also added fire to the debate by defending, with new findings, that happiness does not only depend on relative income but also and particularly on absolute.(3) Their thesis claims that higher pay allows additional aspirations to be satisfied (intellectual, etc.) beyond the basic needs so that, when an economy grows, happiness also grows. Easterlin himself has not taken long to refute these conclusions, arguing that the timescale used is too short and that the relationship identified merely captures the temporary impact of income on happiness.

In short, experts are still divided among those who rule out the permanent influence of income on happiness and those who disagree. Nonetheless, no-one denies that greater wealth leads to greater and better opportunities. It's a question of choosing those opportunities that give us greater and longer lasting enjoyment and, at the same time, of intelligently managing emotions, as far as possible avoiding the trap of relativity and a senseless «keeping up with the Jones's». Moreover, even if it had no direct effect on happiness, economic improvement does involve advances in other determining factors, such as health or personal freedom. Woody Allen also mentioned that: «Money can't buy you happiness, but it can buy you a better class of misery». Definitely another great insight.

(3) Wolfers and Stevenson (2008), «Economic Growth and Subjective Well-Being: Reassessing the Easterlin Paradox», Brooking Papers of Economic Activity.

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

EUROPEAN UNION

Euro area: reforms underway

The European Council takes measures to dispel uncertainty.

After an April stuffed with news of huge economic and political significance in the euro area, the month of May has been somewhat calmer. But only somewhat, as the political machinery continues at full throttle in an attempt to get economic recovery back on the right track and reduce instability in the markets.

The most notable events are the agreements reached at the European Council's meeting. Heads of state and government from the different member states agreed to introduce a new tax for the financial sector, whose revenue will be used to create a fund to tackle future financial crises with more conviction. Moreover, this proposal was also taken to the G20 summit held in Toronto at the end of June to convince the rest of the countries to follow suit. This is of the utmost importance as, if they don't, it could make European banking less competitive at an international level.

It approves a bank tax and announces the publication of the stress tests...

The European Council also agreed to publish the results of the stress tests being carried out by the central banks of each country on their main banks. The aim of this is to put a stop to growing uncertainty regarding the solvency of some countries' financial systems in the European Union (EU). The stress tests analyze the capacity of each bank to withstand a worsening in economic conditions. The announcement that the test results would be published has been interpreted as a sign that the financial system is healthy and has therefore managed to lessen the pessimistic tone of the last few weeks.

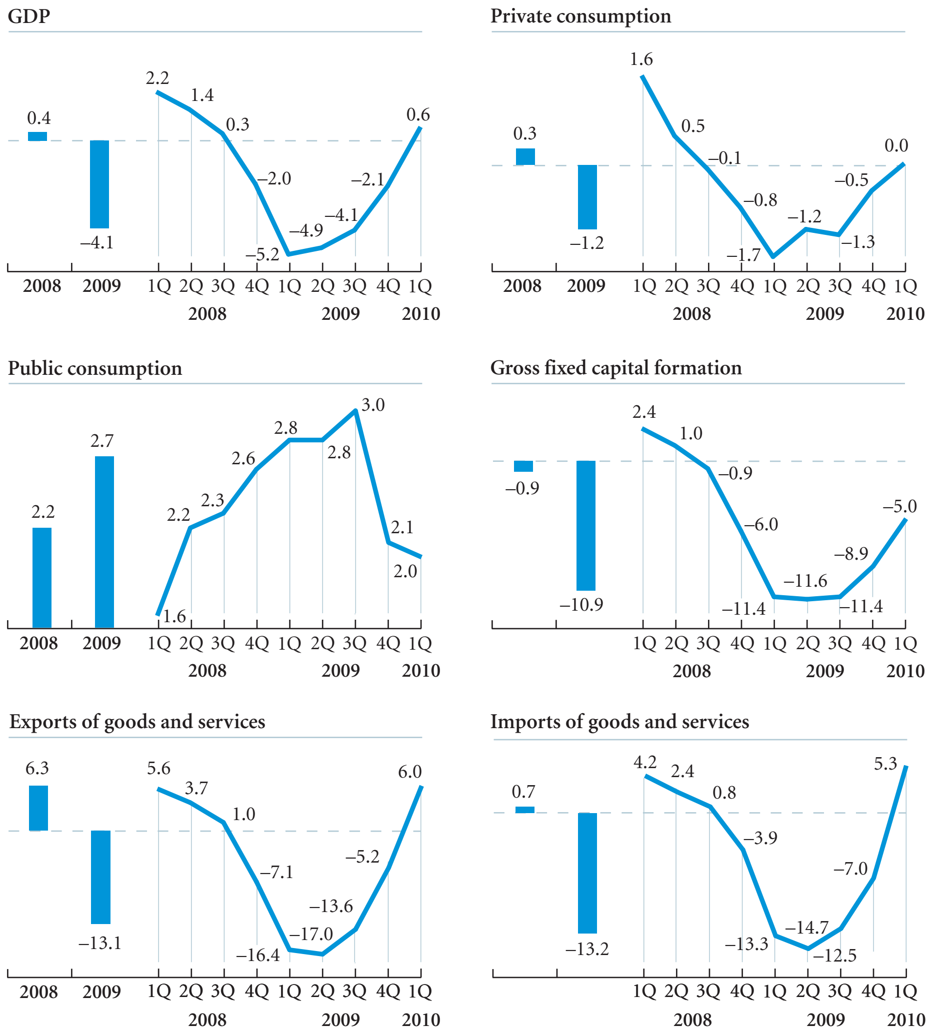
...and better standards regarding budget discipline.

The last big point on which the European Council's meeting focused concerned the standards for budget discipline and macroeconomic surveillance of the euro area. The main European leaders want to rule out any further doubts regarding an EU member state's ability to repay its public debt in the future. That's why another priority is the introduction of budget reforms to ensure the short-term solvency of public accounts, although this may weaken the desired economic recovery. Those countries that had generated most doubts, namely Greece, Portugal and Spain, have already presented tough fiscal adjustment plans and, for the moment, the premium for their sovereign debt has moved away from the record highs reached in the month of May, although it's still at very high levels.

With regard to news strictly related to the economic situation as a whole, throughout May the breakdown was published of the gross domestic product (GDP) of the euro area by component. The European statistics office, Eurostat, confirmed that the euro area grew by 0.2% quarter-on-quarter in the first quarter and raised its growth estimates for the last quarter of 2009 by one tenth of a percentage point, placing this at 0.1%. However, although these figures suggest that the recovery is well on track, the breakdown by component makes us

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCES: Eurostat and own calculations.

tone down our optimism. The reason is that the two forces that drove growth in the second quarter were the accumulation of stock and the rise in public consumption. Private consumption fell again by one tenth of a percentage point compared with the previous quarter and its year-on-year rate of change has stagnated. Neither is investment's rate of recovery at all encouraging, falling by 1.1% compared with the previous quarter and leaving the year-on-year rate of change at –5.0%.

Both the recovery in private consumption and in investment are being very slow but they are following the pattern set out by our series of forecasts. What did come as a surprise was the trend in the foreign sector, with its negative contribution to growth in GDP.

The pace of recovery in exports did not ease up, advancing 2.5% in quarter-on-quarter terms, eight tenths of a percentage point more than in the last

GDP components for the first quarter reveal just how weak the recovery is.

Improvement in private consumption is still very slow.

Exports keep on growing...

...but imports surprisingly rise.

quarter of 2009. But imports grew by no less than 4%, close to three percentage points more than the previous quarter.

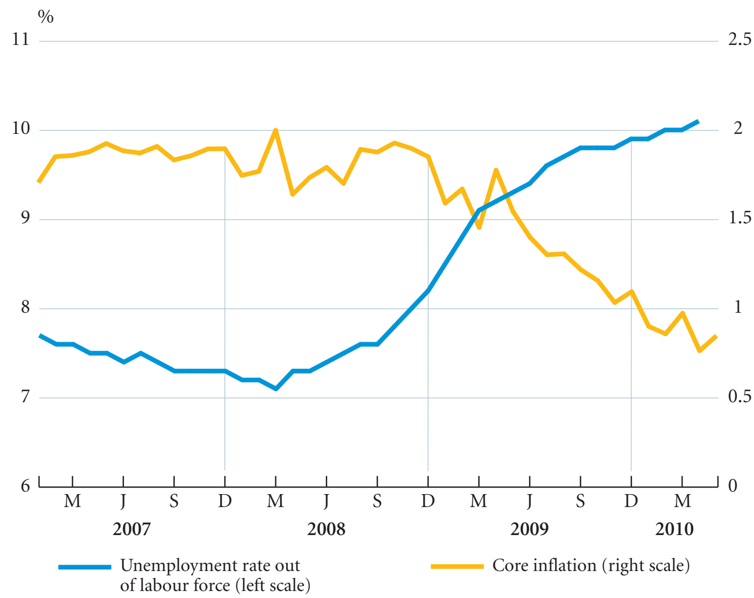
This strong upswing in imports is partly due to a recovery in stocks, so that we believe the growth rate will ease slightly in the coming quarters, following a similar recovery pattern to that of private consumption and investment. With regard to these two components, leading indicators continue to suggest that the second quarter will still be quite weak in tone. Retail sales slumped significantly again in April, suggesting that consumption has yet to embark on a solid recovery process. Data on consumer confidence point in the same direction, given the large drop in the month of May. The most worrying, however, is that confidence is stabilizing at very low levels, far from values compatible with expansion.

The trend in prices is also a clear reflection of the weak demand. The harmonized consumer price index (CPI) is visibly positive in trend. In the month of May, inflation stood at 1.6% but this is fundamentally due to the upswing in the energy component. Trends in core inflation, a more accurate representation of the state of demand, continues with a clearly downward trend in spite of the fact that, in May, it recovered one tenth of a percentage point and stood at 0.9%. The decline in the labour market, still not providing any good news, is undoubtedly one of the main reasons. In April, the unemployment rate rose by one tenth of a percentage point and stood at 10.1%. Although it's true that, in the last few months, the pace of this deterioration has notably slowed up, it still doesn't seem to have peaked yet.

With regard to investment, the pace of the recovery in industrial production is

WEAK DEMAND CONTINUES TO IMPEDE THE RECOVERY

Indicators for inflation and unemployment



SOURCES: Eurostat and own calculations.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
GDP	0.4	–4.1	–4.9	–4.1	–2.1	0.6	–	...
Retail sales	–0.7	–2.2	–2.6	–2.2	–0.9	0.3	–1.7	...
Consumer confidence (1)	–18.1	–24.7	–27.9	–21.4	–17.0	–16.8	–15.0	–17.8
Industrial production	–1.7	...	–18.8	–14.6	–7.7	4.6	9.6	...
Economic sentiment indicator (1)	93.5	80.8	75.6	84.1	91.9	96.6	100.6	98.4
Unemployment rate (2)	7.5	9.4	9.3	9.7	9.8	10.0	10.1	...
Consumer prices	3.3	0.3	0.2	–0.4	0.4	1.1	1.5	1.6
Trade balance (3)	–1.2	–14.1	–30.5	–5.0	15.1	27.0	29.2	...
3-month Euribor interest rate	4.6	1.2	1.3	0.9	0.7	0.7	0.6	0.7
Nominal effective euro exchange rate (4)	110.6	111.7	111.0	112.1	113.8	108.8	106.1	102.8

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.

still excellent. In April, the year-on-year change reached 9.6%, a record high. However, the low utilization of production capacity, estimated at 75.5% for the second quarter, means that this will not be immediately translated into higher investment. In fact, we don't expect this to grow until the second half of the year.

In short, the underlying course taken by the European economy is good. Moreover, we can expect the uncertainty that was assailing it to gradually dissipate over the coming months since, finally, European leaders seem to have started up the machinery to carry out the necessary reforms.

Germany presents its guidelines for budget adjustment

After several months recommending greater fiscal austerity to those governments with a high public debt, the German chancellor Angela Merkel decided to set an example by announcing a budget adjustment plan at the beginning of June. According to estimates by the German government, this will entail savings for the public coffers of close to 80 billion euros between 2011 and 2014, equivalent to a little more than 3% of GDP.

This package affects most public expenditure items except for education and research. Of note are the cuts in social spending, with reductions in long-term unemployment benefit and the disappearance of child benefit for those on unemployment benefit. Other portfolios affected are infrastructure and defence; for the latter, a cut of 40,000 people is predicted in the number of employees. The wage cut for civil servants is along the same lines, namely 2.5% in 2010, as well as reducing the number of public employees by 10,000 over the next four years. Moreover, in terms of revenue, new taxes have been created on air traffic, nuclear power stations and fiscal transactions.

The improvement in the industrial production index continues at a good pace.

The German government approves a savings plan totalling 80 billion euros...

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
GDP	1.0	–4.9	–5.8	–4.8	–2.2	1.5	–	...
Retail sales	0.0	–2.3	–1.9	–2.5	–1.8	–0.1	...	...
Industrial production	–0.1	–15.9	–19.2	–15.6	–8.5	5.3	13.2	...
Industrial activity index (IFO) (*)	96.8	87.7	84.7	89.9	93.5	96.5	101.6	101.5
Unemployment rate (**)	7.8	8.2	8.3	8.3	8.2	8.1	7.8	7.7
Consumer prices	2.6	0.4	0.3	–0.3	0.4	0.7	1.0	1.2
Trade balance (***)	195.0	140.2	140.4	131.0	129.5	140.6	148.3	...

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.

...which will reduce the structural public deficit to 0.35% in 2016.

According to the government's calculations, these measures will gradually reduce the public deficit, reaching 3% in 2013 (more than two percentage points lower than the forecast for 2010) and place the German structural deficit below 0.35% as from 2016, a requirement recently added to the Constitution. This is all part of the German government's aim to set a course that must be followed by its European peers in order to sort out the deteriorated public accounts of their countries and thereby strengthen the stability of the European economy.

However, approval of this package has aroused a lot of resentment from outside Germany's borders. Those inside Germany criticize the fact that most of the burden falls on the most disadvantaged, without specifically tackling the highest income brackets, while the opinions given in the rest of the European countries have been more severe. According to these, the austerity plan ignores petitions to stimulate German domestic demand, as well as making it difficult for the rest of the European countries to finance their debt, jeopardizing growth in the European economy.

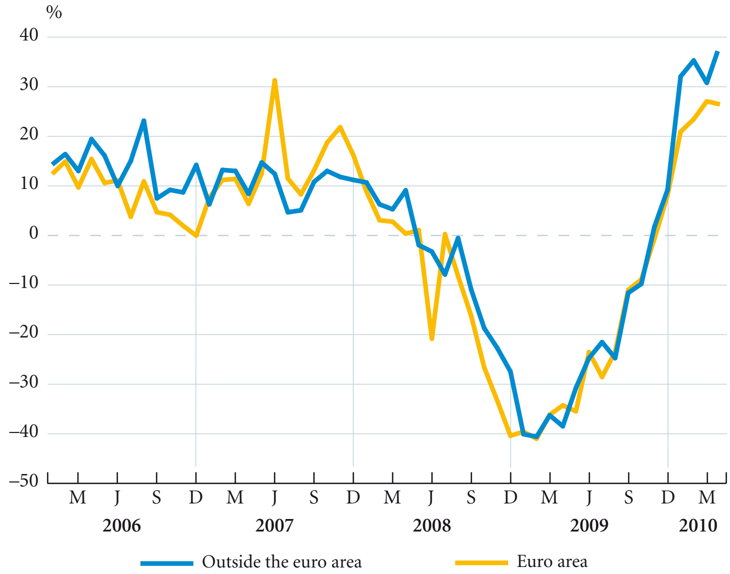
The Bundesbank upgrades its growth forecasts for 2010 to 1.9%.

With regard to the German economy, these public spending cuts will keep domestic demand weak. According to the breakdown in GDP, this contributed negatively, for the third consecutive time, to first quarter growth in 2010. Moreover, the sharp rises in imports in this same period led to stocks becoming the main factor of growth. However, the economy is expected to recover significantly in what remains of the year, boosted by investment and the foreign sector. Consequently, the Bundesbank upgraded its growth rate for 2010 by half a point, raising it to 1.9%.

An analysis of the most frequent indicators shows clear improvement in industrial activity in April, with month-on-month growth in industrial production and orders of 0.9% and 3.3% respectively. Of note in this last case, as can be seen in the graph below, is the strong recovery in orders from outside the euro area, the result of growth in

INDUSTRIAL ORDERS FROM OUTSIDE THE EURO AREA BOOST INDUSTRIAL ACTIVITY

Year-on-year change in the industrial orders index by origin



SOURCE: German statistics institute.

emerging countries and of the depreciated European currency. Consequently, in the second quarter of the year, the IFO index for economic sentiment and industrial capacity utilization will reach levels that suggest an upswing in investment for this period.

The weakness shown by the euro in the last few months also led to further growth in German exports that, in April, rose by 19.3% compared with the same month last year. It was trade with countries outside the euro area that boosted exports, up by 31.6% in this period. Consequently, April's balance of trade increased 40.1% compared with the same month in 2009.

This strong foreign demand contrasts with weak German private consumption. Consequently, in spite of a gradual improvement in the unemployment rate, in May only one tenth of a percentage point above the minimum reached in the last expansionary period (7.7%), retail sales were down 0.5% month-on-month in April. Figures that, together with the slump in consumer confidence in May, do not suggest a recovery in consumption in the short term.

Private consumption remains weak.

Given this scenario, it will be necessary to wait for the results of the second quarter to determine whether the growth predicted by the Bundesbank might be achieved by the German economy. Something that, should it occur, would relieve the political damage suffered by the German coalition government since it was formed in October 2009.

France announces a plan to sort out its public accounts

Following the savings trend of European governments, the French prime minister, François Fillon, announced on 12 June a reduction in the deficit of 100 billion

France to reduce its public expenditure by 45 billion over three years.

The government plans to raise the retirement age from 60 to 62.

euros over in three years. With this measure, the French government expects its deficit to go from 8% of GDP to 3% by 2013. Sorting out the public accounts has therefore become more important in the process of reactivating the French economy.

The plan is designed so that both items, spending and revenue, contribute equally. A cut of 45 billion euros in public spending has therefore been planned, plus the cancellation of tax exemptions totalling 5 billion.

With regard Social Security costs, of note is the bill to reform the pension system, presented to the Cabinet on 13 July. Its main point is the gradual raising of the retirement age from 60 to 62 years by 2018. The proposal also adds two years to the retirement age in other groups with a lower legal age and makes the conditions for private employees and civil servants more similar. The government also proposes to raise the tax on high incomes by 1% in order to fund the pension system. To contain Social Security costs, it has also been established that the increase in health spending will not exceed 3% in 2010 and will gradually fall to 2.7% in 2013.

On the other hand, the central government also expects to collect an additional 35 billion from the improved economy and 15 billion from withdrawing reactivation measures. However, these calculations include an optimistic growth rate in GDP of 2.5% annually in the period 2011-2013, so that the amount actually collected might end up being lower. This, together with the fact that the estimates are based on a relatively low interest rate, raises doubts as to whether the deficit will ultimately reach 3% in 2013. The French government's adjustment plans therefore need the recovery to consolidate and, although most of the data point towards this happening, there are some factors that might slow up the process.

From the point of view of supply, leading indicators on the whole suggest that the economy is continuing to reactivate, albeit at a moderate pace. After three months of rises, industrial production fell by 0.3% in April, placing the year-on-year rate of growth at 7.9%. However, the results from business surveys in May are optimistic in general and it is therefore estimated that production will start to grow again. The INSEE indicators for economic sentiment of the manufacturing industry were up by

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
GDP	0.1	–2.5	–3.2	–2.6	–0.4	1.2	–	...
Domestic consumption	–0.3	0.8	–0.1	0.2	4.1	1.8	1.1	1.9
Industrial production	–2.4	–12.0	–15.5	–11.5	–4.7	4.5	7.9	...
Unemployment rate (*)	7.8	9.5	9.4	9.7	9.9	10.0	10.1	...
Consumer prices	2.8	0.1	–0.2	–0.4	0.4	1.3	1.7	1.6
Trade balance (**)	–50.2	–48.7	–52.8	–45.0	–41.3	–42.0	–42.4	...

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

one point, coming close to their long-term average. For its part, the Bank of France's business climate index for the services sector increased by two points, although the equivalent index for industrial business was down one point.

In spite of the moderation in consumption, both private and public, foreign sales might give demand a break. In this respect, exports grew by 1% in April, standing at 17.6% year-on-year, two points higher than the rate for imports.

French exports grow by 1% in April.

Lastly, demand is expected to be boosted by investment, as suggested by entrepreneurs interviewed in May. The tax reforms on local activity (*taxe professionnelle*) might also help this process, in force as from January 2010. In fact, the prime minister also remarked, in the aforementioned speech, that the government's other main aim to guarantee a solid recovery was to stimulate investment.

Italy joins the austerity plans

In the first quarter of 2010, Italy returned to growth with a 0.4% rise in GDP quarter-on-quarter, generated by the foreign sector and investment. This recovery put an end to a 2009 in which the Italian economy recorded a severe slump of 5.1%. In spite of this, and in spite of having one of the largest public debts, Italy was less affected than others in the south of Europe by the sovereign debt crisis. This, however, has not stopped Italy from having to join the main European countries and present, in the last week of May, a package of budget adjustments estimated at 24 billion euros between 2011 and 2012.

Most of the initiatives contained in this plan are based on cutting public expenditure. Among these measures, of particular importance is the recruitment of fewer civil servants in the public sector and the wage freeze for civil servants for three years, as well as cuts in local government funds and pharmaceutical spending, raising the retirement age and combating tax evasion. According to the government's calculations, applying these measures would leave the public deficit at 2.7% of GDP in 2012, more than two percentage points below the figure expected for 2010.

Italy announces spending cuts totalling 24 billion euros.

However, there is the risk of implementing the budget adjustment

Implemented too soon and it might weaken economy.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
GDP	–1.3	–5.1	–6.1	–4.7	–2.8	0.5	–	...
Retail sales	–0.3	–1.6	–1.8	–1.8	–0.6	–0.4	...	...
Industrial production	–3.8	–18.2	–23.1	–17.4	–9.2	3.1	7.8	...
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	1.4
Trade balance (**)	–10.0	–9.9	–11.7	–8.7	–6.0	–6.9	–9.2	...

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

Industrial activity picks up in Italy.

measures too quickly and weakening the incipient recovery of the Italian economy, once again bringing its growth rates close to zero.

An analysis of the data available in the second quarter of the year shows differing trends between demand and supply indicators. The former indicate weak private consumption. The unemployment rate grew again in April and, according to the estimates of the Italian statistics institute, it equalled the levels reached in 2001. This might have affected the relapse of consumer confidence in May to its 2009 level, mainly due to the pessimism of future expectations. Only foreign demand showed signs of growth, with a year-on-year rise in exports in April of 15.2%. This was not enough, however, to generate a trade balance surplus, due to the higher increase in imports, namely 18.3% in the same period.

VAT will go up from 17.5 to 20% in 2011 in the United Kingdom.

It therefore seems that industrial activity will take over the reins of economic growth during this period. Along these lines, year-on-year growth for industrial production in April was 7.8%. Similarly, industrial confidence in May improved again for the ninth consecutive month, suggesting further growth in investment in the second quarter.

The United Kingdom presents its austerity plan

On 22 June the British government announced its new general budget project that aims to adjust the public deficit over the next five years. This plan hopes to improve credibility in the compliance of public finances and therefore aims to reduce the GDP debt ratio by the tax year of 2015-2016. The Office for Budget Responsibility also started operations, an independent body responsible for making forecasts for the economy on which the budgets are based.

In its project, the government undertakes to cut the current deficit of 11% of GDP to 1.1% in five years, which would put

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	0.5	1.3	2.2
Industrial production	–3.1	–10.5	–12.0	–10.9	–6.1	0.5	2.1	...
Unemployment rate (1)	2.8	4.7	4.7	4.9	5.0	4.9	4.7	4.6
Consumer prices	3.6	2.1	2.1	1.5	2.1	3.2	3.7	3.4
Trade balance (2)	–93.7	–86.7	–88.7	–84.0	–82.2	–82.4	–82.8	...
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. Higher values imply currency appreciation.
SOURCES: OECD, Bank of England, ONS, European Commission and own calculations.

the debt in terms of percentage of GDP at 67.4% by the end of this period. This goal is expected to be achieved by means of an annual budget adjustment of 40 billion pounds. Applying the 80:20 rule advocated by the Tories, 77% of this amount will be achieved by cutting public spending and the rest with tax hikes.

Among the measures to cut spending, of note is the two-year wage freeze for civil servants earning more than 21,000 pounds and the 11 billion pound cut in aid to families with children, to those buying a home and invalidity benefit. With regard to revenue, VAT will be raised from 17.5% to 20% in January 2011. On this same date a bank tax will also come into force, applicable to financial institutions operating in the United Kingdom, be they British or foreign, whose liabilities exceed 20 billion pounds, without including minority deposits and TIER 1 capital. The rate proposed will be 0.04% in 2011 and 0.07% in 2012. On the other hand, other taxes will be reduced in order to boost business initiative, such as Corporate Tax, going from 28% to 24% in four years.

These accounts have been produced based on the assumption that the United Kingdom's economic activity will grow less than that established in the budgets by the previous government. In particular, the Office for Budget Responsibility estimates that GDP will grow by 1.2% this year, 2.3% next year and 2.8%, 2.9% and 2.7% in the following three years.

Regarding the British economy, supply variables show some improvement in general. Although industrial production fell 0.3% in April, moderating its year-on-year rise to 2.1%, industrial confidence surveys rose sharply in May. On the other hand, demand is improving, albeit gradually, largely thanks to household consumption performing well. In fact, although consumer confidence fell in May, retail sales were up 0.6% that month, placing the year-on-year growth rate at 2.2%. The fact that the labour market is also showing signs of recovery is creating good expectations for trends in private consumption. Registered unemployment in May fell by more than 30,000 people and thereby accumulated four months of reductions.

The Office for Budget Responsibility estimates that GDP will grow by 1.2% in 2010.

Lastly, inflation dropped by four tenths of a percentage point to 3.3% and core inflation also fell by two tenths of a percentage point, standing at 3.0%. Although the increase in prices remains at a level that is quite a lot higher than the Bank of England's price stability target, they are expected to have reached their peak and fall gradually to a level slightly lower than at the start of 2010.

Inflation finally falls by four tenths of a percentage point to 3.3%.

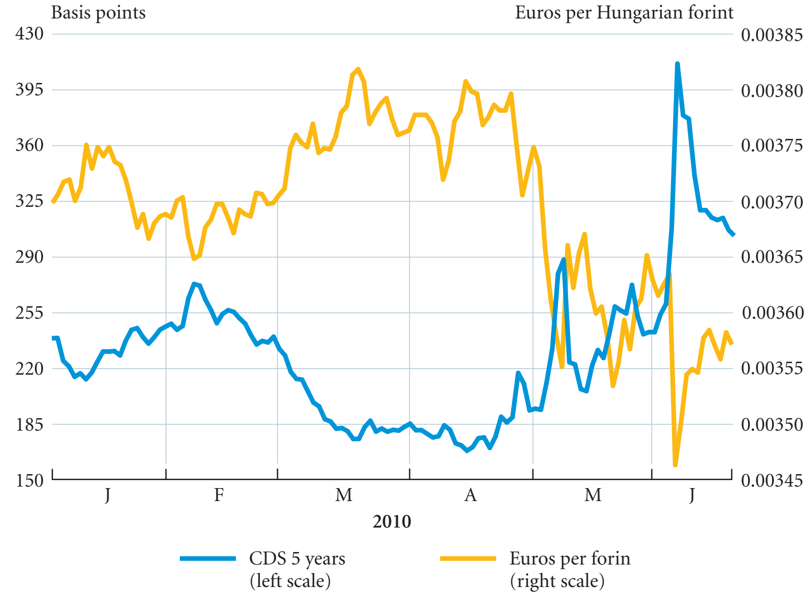
Emerging Europe: Hungary, the region's weakest link?

«It's clear the economy is in a very serious situation». This statement, made on 4 June by Péter Szijjártó, spokesman for the Hungarian government, together with other statements on the possibility of defaulting on its sovereign debt and doubts concerning the accuracy of its public sector figures, sank the forint to a record low for the last year, as well as causing country-risk to rocket, affecting the stock market (of Budapest and many European markets) and weakening the single currency. Certain financial circles started to see Hungary as «the new Greece». The financial markets had been exhibiting slightly less confidence in the government for the last few days as the prime minister, Viktor Orbán, the clear winner in the elections last April, had

The Hungarian government sets alarm bells ringing by comparing its budget situation to that of Greece...

IN HUNGARY, ALMOST A RETURN TICKET TO AND FROM UNCERTAINTY

Value



SOURCE: Thomson Reuters Datastream.

...although a subsequent denial and adoption of a traditional adjustment programme calm down investors.

unsuccessfully sounded out the European Commission about the possibility of relaxing the public deficit target for 2010 approved in the Stability and Growth Programme, equivalent to 3.8% of GDP.

After financial reprisals, and once the markets had closed, Mihály Varga, leader of Orbán's cabinet and former finance minister, stated on 5 June that the comments of the days before had been unfortunate and that the government would keep to its budget target. Throughout the week, the government would provide more details on this fiscal commitment. The measures finally announced included cuts in public spending (fundamentally by cutting civil servant wages) and a global rise in taxes (resulting from combining a future single income tax of 16% and applying a temporary tax on bank activity). Since then, the underlying trend has been to reverse the strong slump of the first few days of June, although the damage has not been completely repaired.

The budget situation is not alarming, although 2010's public deficit is above the official target of 3.8% of GDP.

Ultimately, was it all a (financial) storm in a (political) teacup? The answer is not completely. The actual budget figures up to April indicate that the forecast for the 2010 public deficit (the aforementioned 3.8%) is clearly optimistic. After accounting for a series of costs related to public corporations and local entities, the government has acknowledged an additional deficit in the order of 1% of GDP. This is a coherent figure which, in part, had been taken as read. Consequently, for example, the European Commission itself, in its forecasts in spring, gave a public deficit figure of 4.1%. Nonetheless, the additional adjustment measures announced by Viktor Orbán are the equivalent, according to the executive's own estimates, of 1%-1.5% of GDP. This would allow the now recognized additional deficit to be absorbed.

The budget figures actually provide further relevant information. First, they confirm that, after three years (from 2007 to 2009) of spending being stable at 50% of GDP, the assumption contained in the Stability Programme that this can be lowered by an additional point in 2010 and two more in 2011 is not very likely. But, on the other hand, revenue might perform better than expected. The figures for activity show an economy that is strongly recovering from a strong recession in 2009. In the first quarter, GDP grew by 0.9% quarter-on-quarter, clearly reflecting notable expansion. The different indicators for the second quarter tend to confirm that activity is growing, particularly due to good export performance. This will mean that, in all probability, growth in 2010 will be greater than expected and, consequently, tax revenue. All this within a context of a not too excessive public debt, in the order of 80% of GDP, if the forecasts for 2010 and 2011 hold true.

Given this situation, is there a risk of extreme financing? Not in our opinion. According to the figures available, the maturities for sovereign debt in 2010 total 10.3% of GDP, which, added to a public deficit that could be around 5% of GDP, leads to net borrowing for the government of around 15% of GDP. The government forecasts assume issues equivalent to 12% of GDP, which would entail a financial shortfall in the order of 3% of GDP. Given that Hungary has assured international financial aid (the International Monetary Fund and European Union, fundamentally) equivalent to 6% of GDP in 2010, this safety margin of 3% of GDP should be enough to sustain investor confidence.

With these figures, we can convincingly argue that Hungary is not Greece. Rather Greece could be Hungary if the former's economy manages to overcome the hurdles of the next few years. It was no coincidence that Hungary started to strongly adjust its budget situation in 2006, increasing the public deficit to 9.3% of GDP. In one year, this imbalance reached 4.9%, afterwards falling in 2008 to 3.8%. Even during the worst recession in practically two decades, its public deficit only reached 4.0% in 2009.

In short, the Hungarian episode is a reminder of how difficult it is to handle political communication when the two main targets of this communication, namely citizens and markets, are very apprehensive and edgy. It's never easy to combine the mindset of citizens (a target that sometimes requires a stronger tone in order to stress the dangers of political inaction) with investor confidence, always resentful of any sudden changes in course or strident announcements that alter the existing scenario. The Hungarian politicians found such communication hard to handle but we must remember that, after making basic errors in form, the situation is now back on track.

There is enough of a safety margin to guarantee the financing of the public deficit and debt maturities for this year.

The Hungarian situation is radically different from Greece's.

In any case, the Hungarian problem is due to how communication with citizens and investors is handled.

FINANCIAL MARKETS

Monetary and capital markets

Instability sets the tone for international financial markets

The European Central Bank and European Union avoid a systemic crisis.

Instability continued to be the dominating tone in international financial markets over the last few weeks with an incipient but promising improvement in the second half of June. Obviously the main focus of tension was the sovereign debt crisis in the euro area but other factors have also played their part, such as the nasty surprises in some economic activity indicators in the United States, the probable tightening up of monetary policy in various emerging countries and the incessant and occasionally confusing flow of news regarding financial regulatory reform.

In spite of significant measures adopted at a European level, the risks are still considerable.

The European Central Bank (ECB) has taken on an important role in putting a stop to the debt crisis, modifying the sequence of its «exit strategy» and implementing an emblematic programme to buy up public and private bonds. The Federal Reserve (Fed) has helped the ECB in this task by reinstating the swap lines to provide European banks with dollar liquidity, as well as moderating its declarations concerning monetary policy. These actions have helped to avoid a system-wide crisis in the interbank market, although there are still remarkable dysfunctions in some of this market's segments. The measures adopted both by European bodies (of note being the creation of the European Stabilization Mechanism) as well as by member states (particularly the ambitious budget consolidation programmes) seem to be helping to contain the extent of the crisis.

But the risks are still considerable and, from now on, what will be crucial is the determination and resolve shown by authorities in applying the many different measures of economic policy announced and, largely dependent on this, a return to a sufficiently confident climate on the part of private agents and international investors. Satisfactory progress on these fronts would greatly benefit corporate bond and equity markets, allowing them to pick up again on the basis of foundations that continue to be favourable. However, the outlook for the euro, severely punished over the last few months, does not seem to provide much potential, beyond a possible technical recovery should the fear disappear of the extreme scenario of disintegration of the euro area. As a result, the combination of fiscal and monetary policies in the region points towards interest rates remaining low for a long time, at least compared with those in the United States.

The ECB and the Fed show themselves to be flexible, given the uncertainty

The ECB keeps its official interest rate at 1%.

In the press conference after the meeting of the ECB's Governing Council, where it was decided to keep the official rate at 1.0%, Trichet maintained a neutral tone regarding the monetary policy to maintain full flexibility within a context of «unusually high uncertainty». Moreover, and as expected, Trichet did not provide details regarding the nationality of the debt nor of the final total of government bonds bought in the programme. However, the institution announced that, up to 11 June, it had accumulated 47 billion euros in sovereign bonds. The importance of this programme can be seen in the ECB's communication, as the paragraph referring to monetary policy starts by explicitly mentioning «financial stability», going on to claim that the programme is totally in line with the institution's mandate. Without doubt, the measures taken are crucial to ensuring the debt crisis does not take on a systemic dimension.

Trichet highlighted three points in the section on liquidity provision for banking markets. Firstly, he explicitly mentioned the «malfunctioning» of the money markets, a situation observed in the high demand for liquidity and, on the other hand, in the greater use of deposit facilities. Secondly, he felt that the fact that the dollar liquidity line was not being used was a sign that the situation is not as serious as in 2008. Lastly, he confirmed that the decision was unanimous to maintain the conditions of full allotment and a fixed 1.0% rate for the 3-month tenders to be conducted on 28 July, 25 August and 29 September.

The ECB management projections were presented in the macroeconomic section. The range of growth expected for 2010 was revised upwards to 0.7%-1.3%, mainly reflecting the likely improvement in domestic demand. Regarding the projected inflation, the institution also upgraded its range to 1.4%-2.2%, to include the rise in commodity prices, increased due to the euro's depreciation. Moreover, the ECB does not rule out further increases in inflation in the second half of the year.

In the United States, the Fed is keeping on course for standard and non-standard monetary policy, although, as stated by governor Ben Bernanke, it is closely watching how events develop in Europe.

In the section on standard monetary policy there are no changes in the benchmark rate, staying at 0.25%, or in the language of the communication. Regarding non-standard policy, the Fed started the first of the three operations it will carry out to test the functioning of term deposits, one of the instruments it will use when it decides to drain surplus reserves from the financial system. Consequently, on 14 June the central bank sold 1.152 billion dollars in 14-day term deposits at an interest rate of 0.27%. The second deposit auction will be held on 1 July, with a 28-day maturity. Lastly, on 12 July there will be the last auction of deposits, with a term of 84 days.

A counterpoint to the monetary leniency adopted by the ECB and the Fed is being provided by the monetary authorities of some emerging economies and by other countries closely dependent on them. Consequently, throughout the month of June, we saw the Banco Central do Brasil, the Reserve Bank of New Zealand, the Banco de the República de Perú and the Bank of Canada increase their official rates to 10.25% (+75bp), 2.75% (+25bp), 1.75% (+25bp) and 0.5% (+25bp), respectively (one hundred basis points, bp, equal 1%). These countries all need to adjust monetary policy to the good performance of their

The ECB maintains flexibility to be able to act easily within a context of high uncertainty.

Trichet confirms that the reserve bank will grant all the liquidity required.

The Fed moderates its tone in interest rates but continues to adjust the instruments it will use when the time comes to drain off surplus reserves.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate(4)	3-month (5)	3-month (5)
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)	1.00	0.66	1.24	0.25	0.35	0.24	0.50	0.68	0.21
May	1.00	0.70	1.26	0.25	0.54	0.25	0.50	0.71	0.13
Junio (1)	1.00	0.73	1.29	0.25	0.54	0.24	0.50	0.73	0.19

NOTES: (1) June 18.
(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.

The ECB will continue to support the financial system to prevent tension in bank financing.

economies and thereby avoid inflationary tensions.

On both sides of the Atlantic, the volume of interbank operations continues to be very low and this is why the interbank interest rates do not suitably reflect the tensions that still underlie the global financial system. The US interbank curve has risen around 7 basis points on average and its gradient (the difference between the 12-month and 1-month rates) has risen by 5 basis points, whereas the interbank curve of the euro area continues to record very modest rises of around 2 basis points on average.

The measures implemented in Europe avoid the collapse of the government bond market.

Government bond markets: systemic risk is avoided

The month of June started with strong risk aversion, reflected in higher volatility that severely affected European government bond markets. Investor uncertainty was translated into notable pressure on the yield demanded from the sovereign debt of various countries in the south of the euro area. Given this panorama, the European Union took a series of urgent measures, in particular specifying the details of the European Financial Stability Facility, the cornerstone for the programme

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								
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	2.66	2.92	4.26	4.14	3.28	1.27	3.58	1.54
June (*)	2.71	3.14	4.76	4.01	3.29	1.23	3.53	1.56

NOTE: (*) June 17.
SOURCE: Bloomberg.

christened the «European Stabilization Mechanism», approved in May for a total of 750 billion euros.

ECOFIN also agreed to strengthen the statistics office, Eurostat, so that it can audit the official statistics of member states. From now on the European Union will also review the budgets from the different countries that go to make up the European Union, examining the main hypotheses underpinning their public accounts, such as growth forecasts, inflation and their main aggregates. All these measures, together with those implemented by the ECB, have calmed the situation and avoided the risk of a split in the euro area, reducing investor risk aversion.

As can be seen in the above table, in May and June investors took refuge in the public debt with the highest credit quality, specifically that of Germany and of the United States, and strong demand pushed up prices and forced down the yields on these assets. In the euro area, the public debt differential between 10-year Spanish and German bonds reached 220 basis points. But in mid-June the situation seems to have relaxed, albeit tentatively, thanks to the aforementioned measures. These have been crucial for the euro area's periphery countries to be able to issue public debt on the primary market, reasonably well received by investors although they have had to offer higher yields, in line with those listed on secondary government bond markets. But the important thing is that these states have been able to place, through primary markets, the amounts they need to renew the maturities of public debt and finance high public deficits.

Investors take refuge in German and US public debt.

To place their debt, the Treasuries of periphery countries have had to offer higher yields.

As the economic actions reveal their effectiveness, the differentials between Germany and periphery countries should fall.

In the United States, the figures for the reduction in public deficit have given a boost to the performance of US sovereign debt, which has also benefitted from the safe haven effect during these months of risk aversion. At present, US government bonds continue to enjoy the confidence of international investors but, as yet, the risk of crisis cannot be completely eliminated and it would be advisable for the government to do its homework and gradually reduce its huge fiscal deficit.

The euro picks up after its strong depreciation against the dollar.

In the medium term, the implementation of the economic policy measures approved by the different governmental institutions should reduce the situation and correct the magnification of interest rate differentials experienced by those countries perceived as more vulnerable to default risk.

The dollar takes a break

The euro's exchange rate with the dollar speeded up its depreciation in May and early June, even breaking through the psychological barrier of 1.20, as on 7 June one euro was being exchanged for just 1.19 dollars. This reflected the sovereign debt crisis in the euro area. But as from the second week of June the euro managed to recover its rate of 1.24 dollars per euro thanks to two factors. The first was the supply of dollars available to European commercial banks through the ECB loan mechanism using the Fed swap line. The second factor was

EXCHANGE RATES OF MAIN CURRENCIES

June 17, 2010

	Exchange rate	% change (*)		
		Monthly	Over December 2009	Annual
Against US dollar				
Japanese yen	91.3	–1.4	–1.9	–4.9
Pound sterling	0.675	2.3	–9.1	–10.7
Swiss franc	1.113	–1.6	7.0	3.0
Canadian dollar	1.023	–0.9	–3.0	–10.6
Mexican peso	12.551	–0.4	–4.3	–6.9
Against euro				
US dollar	1.239	0.0	13.5	11.1
Japanese yen	113.1	–1.4	–17.7	–18.0
Swiss franc	1.379	–1.7	–7.6	–9.2
Pound sterling	0.836	–2.4	–6.0	–1.7
Swedish krona	9.588	0.3	–7.0	–14.1
Danish krone	7.439	0.0	0.0	–0.1
Polish zloty	4.070	1.2	–0.7	–11.3
Czech crown	25.74	0.8	–2.7	–3.8
Hungarian forint	279.1	0.5	3.1	–1.1

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

that people stopped talking, in economic debate, about the euro disappearing, a scenario that, after the measures implemented by the European Union, can probably be ruled out.

This correction in the sharp depreciation experienced by the euro against the dollar since December last year might remain over the coming weeks but, in the medium term, the interest rate differential between the United States and the euro area should favour the dollar.

On the other hand, the US Secretary of the Treasury, Timothy Geithner, in a speech prepared for an audience with the US Senate Committee on Finance, stated that a more flexible yuan is extremely important for the world economy. On 19 June, China answered by announcing greater flexibility in the official exchange rate of its currency and this decision was welcomed by both Washington and the IMF.

The United States continues to pressurize China to appreciate the renminbi.

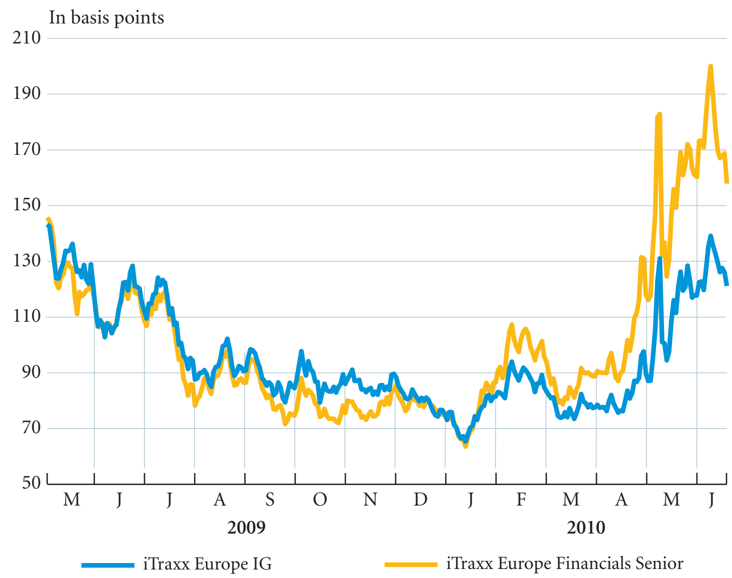
Signs of improvement in corporate debt

After two months of sharp decline in private bond markets, with falling prices in indices, loss of funds and a drastic drop in issuance, in the second half of June there was a promising recovery in activity, especially for countries in the centre of the euro area, while in periphery countries to the south the market is still waiting for sovereign risk to stabilize in order to start up issues again. However, periphery countries continue to be left out of the improvement in activity, even in covered bonds, a sector where they had been the most active in recent years.

Notable recovery in activity in central European countries.

TRENDS IN RISK PREMIA IN EUROPE

Risk indicators



SOURCE: Bloomberg.

The financial sector has benefitted most from the ECB's expansion of liquidity.

Once again, action by central banks has been decisive in the recovery of private bond markets and particularly the management by the ECB which, with the announcement of extraordinary liquidity provision measures, has encouraged a rapid rise in issues in the euro area.

Also, once again the financial sector has benefitted most from the central banks' expansion of liquidity. This can be seen in the strong reactivation of bond issues by highly solvent financial institutions and the incipient reduction in risk premia. The central banks' commitment to keep the discount window open for commercial paper also offers the chance to issue bonds to other institutions with a lower credit quality.

Firms with high quality ratings take advantage to issue debt.

For its part, the non-financial corporate sector, and specifically public service firms with high quality ratings (electricity, gas, water, concessionaries, etc.) are taking advantage of market improvements to increase the number and volume of new issues. Geographically, the firms leading this recovery also belong essentially to the group of countries in the centre and north of Europe, where sovereign credit risk is still at a very moderate level.

The rest of the higher risk sectors and especially issuers catalogued as high yield are waiting for the market to consolidate its gains and offer them the chance to get medium and long-term financing. In this respect, the sentiment of European mutual fund managers is shifting once again towards a more positive view in the medium term and the latest surveys suggest that these agents intend to increase their portfolios by buying high risk bonds.

In short, it seems that the stabilization of financial risks is encouraging private and institutional investors to aim their portfolios towards private bonds, increasing their proportion of high yield bonds. The effectiveness of the measures adopted by central banks and governments to reduce sovereign debt risk has been fundamental in restructuring activity in the private bond market.

Stock markets appreciate the efforts made

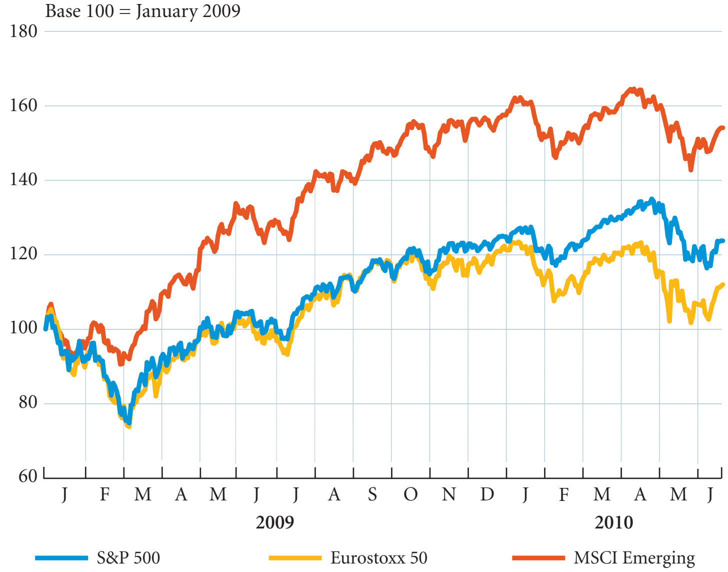
Stock markets slowly get going again, subject to regional and sector differences.

During the month of June, the main stock market indices varied in their performance, albeit ending up with a positive monthly balance in most cases. Although the focus of tension is still on the European sovereign debt crisis, the importance of other factors, such as the pace of economic growth and monetary policy actions, are leading to differences in equity markets both at a regional and sector level. On the one hand, the US and emerging country stock markets have managed to recoup the year's average gains thanks to their economic cycles continuing to improve. On the other hand, the indices for the euro area, in spite of having improved since their annual minimums and supported by the actions of governments and the ECB, are still far from the maximum levels of the year.

Such disparity can also be seen from a sector point of view. Of note is the financial sector which, although being the driving force of the markets in previous quarters, has differentiated itself from the rest as it has been more severely affected by the tensions of the last few months. There are three reasons behind this situation: (i) direct exposure to the public debt of countries with difficulties, (ii) future tightening of financial regulations and (iii) financing difficulties in capital markets for organizations from countries with high

TRENDS IN THE MAIN INTERNATIONAL STOCK MARKETS

Stock market indices



SOURCE: Bloomberg.

INDICES OF MAIN WORLD STOCK EXCHANGES

June 18, 2010

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*10,434.2*	*–0.7*	*0.1*	*22.0*
Standard & Poor's	*1,116.0*	*–0.4*	*0.1*	*21.5*
Nasdaq	*2,307.2*	*–0.4*	*1.7*	*27.6*
Tokyo	9,995.0	–2.4	–5.2	3.0
London	5,276.1	–0.6	–2.5	23.2
Euro area	2,738.8	1.5	–7.6	13.4
Frankfurt	*6,230.6*	*1.2*	*4.6*	*28.8*
Paris	*3,687.7*	*1.9*	*–6.3*	*15.5*
Amsterdam	*336.3*	*1.6*	*0.3*	*32.6*
Milan	*20,643.9*	*1.6*	*–11.2*	*7.3*
Madrid	*9,909.2*	*2.9*	*–17.0*	*5.6*
Zurich	6,474.9	0.1	–1.1	20.4
Hong Kong	20,286.7	1.7	–7.3	14.1
Buenos Aires	2,314.5	6.0	–0.3	51.3
São Paulo	64,540.9	6.1	–5.9	26.8

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

The financial sector diverges from the rest due to uncertainty.

deficits, as in the case of Spanish organizations.

Of note is the specific case of the oil spill by the British company BP in the Gulf of Mexico, which has led to its share price falling nearly 50%, although this has not affected the rest of the firms in the energy sector to the same extent.

Values in equity portfolios: socially responsible investment

Socially Responsible Investment (SRI) is a strategy whereby, in addition to the traditional financial parameters of profitability and risk, investors also include other criteria in their portfolio selection decisions that are related to firms' values in moral, ethical, social, environmental or corporate governance terms. SRI arose from the belief of some investors that you can obtain «something else» in addition to economic-monetary returns when financing certain business projects. In this respect, it is presented as philanthropic behaviour that can stem from different motivations, which we will look at.

In practical terms, through SRI investors hope to directly or indirectly influence firms to adopt practices that uphold and promote Corporate Social Responsibility (CSR). Obviously, individuals and businesses being interested in investing in projects that contribute to the development of good causes is not new; however, it has been over the last 10 or 15 years that the social responsibility movement has truly consolidated its position. Both the volumes handled and the institutional grid around SRI have developed noticeably, in the United States and in Europe. For example, firms that wish to voluntarily include criteria in their business decisions that promote CSR now have institutional frameworks of reference, such as the Equator Principles, the United Nations Global Compact and the recent Principles for Responsible Investment created under the auspices of the United Nations.[1] Based on these principles and criteria, specialist organizations have appeared that assess the degree of social responsibility of different firms, rating them and producing rankings. Several stock market indices have been produced based on these ratings, listing firms with a high degree of respect for social responsibility. Lastly, these indices serve as a benchmark for numerous mutual and pension funds and any investors with a penchant for SRI.

SRI's remarkable development in practical terms contrasts with the meagre treatment received by its financial theory. Both analyses of portfolio selection decisions and also of asset valuation usually omit the ethical and moral factors highlighted by SRI. Some have tried to extend or complement the classic model of portfolio selection initially proposed by Markowitz, but they have not managed to create a sufficiently solid and tested body of theory. According to Bénabou and Tirole (2010),[2] individuals' growing interest in SRI is due to complex, interdependent motivations. Firstly, people are moved by «genuine altruism»: we all want to do good. Secondly, some motivations are actually economic; for example, the greater probability of collaborating with charitable works if the contribution is tax deductible or if lower fees are charged for managing an SRI fund. Lastly, given that what we do define what we are like, people are concerned with their social image and, we mustn't forget, self-esteem. For its part, at a business level CSR can be basically due to two views. The first is where firms adopt a long-term perspective to maximize gains, so that shareholders position themselves in such a way as to stop directors succumbing to the temptation to take decisions that are

(1) www.unpri.org.
(2) R. Bénabou and J. Tirole, «Individual and Corporate Social Responsibility», Nota di Lavoro 23.2010, Fondazione Eni Enrico Mattei, 2010.

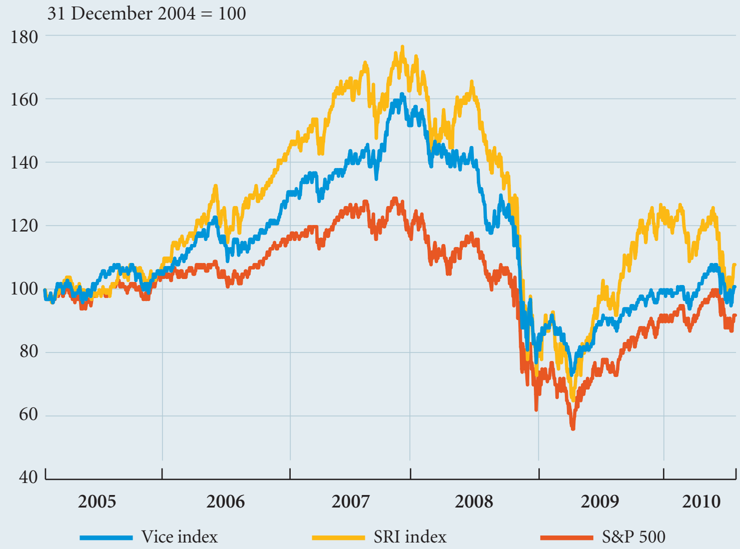
too focused on the short-term, which might lead to social costs that would harm the company in the long term. The second view is called «delegated philanthropy»; in short, when information or transaction costs are high, investors can use companies as an effective instrument for channelling the individual demands of social responsibility.

From a practical view of SRI you can amalgamate the purely financial with the social commitment emanating from agents. To this end, investors pre-select investments based on an exclusive or negative analysis (negative screening), on positive criteria (best in class) or on a combination of the two. Negative screening generally involves ethical criteria, i.e. those sectors or firms will be excluded that are related to activities against the investors' beliefs or values (nuclear weapons, pornography, child exploitation or violation of human rights, etc.). Using the best in class method, firms are pre-selected that, in each sector, perform best within the framework of what is socially responsible, the environment, transparency, commitment to their mission and society, but also with a subsequently assessment of the financial aspect.

The question that comes to mind for an ordinary investor is: in terms of monetary returns, does being socially responsible have a high cost or price? In principle, the answer is not necessarily a clear or resounding «yes», as frequently and dogmatically claimed by some studies or investors. Obviously the reply will depend on how each investor defines «doing good» and therefore on the assets or firms selected under the SRI strategy and, if applicable, the anti-SRI strategy (which some call «sin» or «vice» investing). The graph shows the trends in three representative assets of different social responsibility strategies in recent years for the United States. At first glance, none of them appears to be evidently superior. Unfortunately, thorough empirical studies don't reach any conclusive findings either, being highly dependent on the sample period, the geographical area or the statistical techniques used. It is no surprise, therefore, that this issue is surrounded by controversy.

S&P 500 *VERSUS* ALTERNATIVE INVESTMENT STRATEGIES

Stock market index



SOURCE: Bloomberg.

On one side of the debate, some controversial studies claim that an investor cannot achieve the dual goal of being virtuous and prosperous since these are opposing objectives.[3] Along the same lines is the argument that environmental and social stereotypes run the risk of being marginalized from decisions if investors cannot see how such factors can be financially materialized. A study carried out by Dupre, Girerd-Potin and Kassoua (2003),[4] on European companies, gives a none too optimistic view of the future of SRI, as the authors maintain that investors must not expect to gain in the long term if they decide to include SRI-related criteria, since financial sacrifice increases as investors' «ethical appetite» grows. In line with this stance, Fabozzi, Ma and Oliphant (2008)[5] present some striking findings. The authors document that investing one dollar in 1970 in a portfolio made up of «sinner firms» would have had an annual return of 19% up to 2007, while a standard portfolio would have provided an annual return of 7.9%.

On the other side of the debate are those who support a long-term socio-economic view, claiming that SRI can no longer be considered as an exotic strategy but a profitable and valid alternative. Consequently, Meir Statman (2007)[6] offers a more positive point of view of SRI. In his study, Statman compares the DS 400[7] and the S&P 500 indices for the period 1990-2006, concluding that SRI reported marginally higher returns (0.04%), although not statistically different, to those that could have been obtained by a standard portfolio. Although this evidence does not tilt the balance towards SRI, it does encourages investors to see it as an alternative that would allow them to maintain their returns at the same time as supporting firms that promote sustainability in different social aspects or economic areas (doing well while doing good).

(3) Wesley Cragg and Benjamin J. Richardson, «Being Virtuous and Prosperous: SRI's Conflicting Goals», SSRN 1463936, 2009.
(4) Denis Dupre, Isabelle Girerd-Potin and Raghid Kassoua, «Adding an Ethical Dimension to Portfolio Management», SSRN 394101, 2003.
(5) Frank J., Fabozzi, K. C., Ma and Becky J. Oliphant, «Sin Stock Returns», The Journal of Portfolio Management, Vol. 35, No. 1, Autumn 2008.
(6) Meir Statman, «Social Responsible Investments», Working Paper, Santa Clara University, 2007.
(7) Index made up of socially responsible firms, constructed by KLD Research and Analysis.

This box was prepared by Eduardo Pedreira Collazo
Financial Markets Unit, "la Caixa" Research Department

Economic activity

Modest progress in economic activity

The economy posted positive growth in the first quarter of 2010 after seven quarters of recession and the few economic indicators available for the second quarter generally point towards this recovering trend continuing. However, the economic sentiment index halted its upturn in May, probably due to the unfavourable trend in the financial markets that month and the budget adjustment measures announced by the Spanish government.

Consumption has continued to grow in the last few months but unevenly. The production of consumer goods rose 3.4% in April compared with the same month the year before, above the 0.6% posted in the first quarter, but retail sales decreased 1.1% in April compared with twelve months before. Nonetheless, personal equipment recorded a year-on-year rise of 1.9% and household equipment 1.6%.

Automobile sales were still strong in May with a year-on-year increase of 44.6%. However, this dynamic rise was influenced by demand being brought forward in anticipation of the end of funds available for direct aid from the Plan 2000E, as well as the expected hike in value added tax in the month of July.

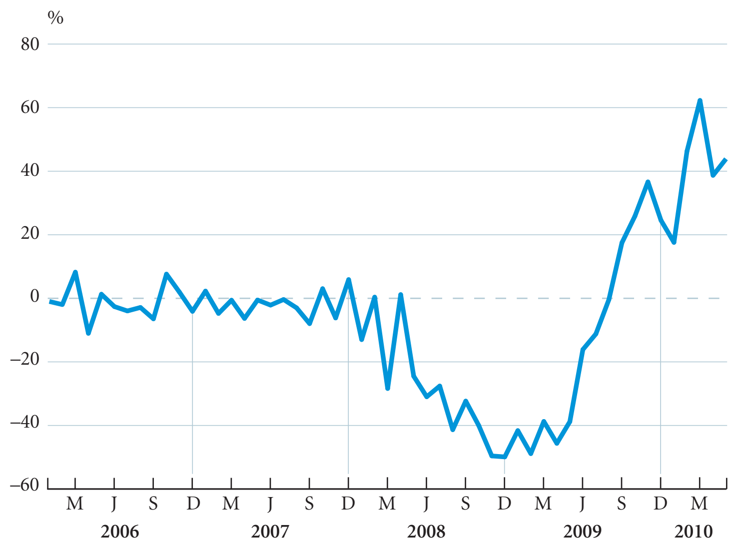
Domestic sales in large consumer goods and service firms were up 0.6% in April

The economic sentiment index halts its upward trend in May.

The production of consumer goods improves in April but retail sales fall compared with twelve months ago.

CAR SALES RISE THANKS TO THE PLAN 2000E

Year-on-year change in vehicle registrations



SOURCES: ANFAC and own calculations.

Registrations of load-bearing vehicles perform well.

compared with the same month in 2009, a slowdown on previous months and both goods and services posted smaller year-on-year rates than the previous month. Meanwhile the consumer confidence index, after having recovered in April, slumped again in May to a level not recorded since May 2009, as a result of an edgier economic climate.

Investment in capital goods continued to be somewhat weak overall, with production of capital goods down 5.5% in April compared with the same month the previous year, a larger drop than the one recorded in the first quarter. Domestic sales of equipment and software in large firms were also down 5.2% in April compared with the same month last year, interrupting three consecutive months of annual rises. On the other hand, registrations of load-bearing vehicles continued to perform well, with a year-on-year rise of 30.3% in the month of May.

The boost provided by foreign demand supports industrial growth.

Regarding investment in construction, a leading indicator such as apparent cement consumption fell by 11.0% in April-May compared to a year earlier. However, this rate is half that recorded in the first quarter, indicating a slowdown in the decline, although the confidence indicators for construction slid downwards again in May, reaching the same level as the end of 2009.

From the point of view of supply, industrial production enjoyed moderate growth in April, 2.4%, compared with the same month last year. The highest year-on-year rise was in intermediate goods, up 8.0%, this being largely boosted by foreign demand.

DEMAND INDICATORS

Percentage change over same period year before

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
Consumption								
Production of consumer goods (*)	–4.7	–8.2	–9.4	–8.6	–1.7	0.6	3.4	...
Imports of consumer goods (**)	–7.7	–6.1	–14.9	–3.4	3.7	–10.8	–0.2	...
Car registrations	–28.1	–17.9	–33.7	–0.6	29.3	44.5	39.3	44.6
Credit for consumer durables	3.6	–11.5	–14.1	–10.8	–9.1	–5.6	–	...
Consumer confidence index (***)	–33.8	–28.3	–28.0	–20.7	–20.0	–18.2	–19.6	–24.0
Investment								
Capital goods production (*)	–8.8	–22.1	–24.7	–20.2	–10.3	–2.3	–5.5	...
Imports of capital goods (**)	–19.6	–27.0	–35.1	–23.4	–16.9	–1.2	11.1	...
Commercial vehicle registrations	–43.6	–40.0	–51.9	–30.8	–7.8	8.5	17.9	30.3
Foreign trade (**)								
Non-energy imports	–4.9	–17.5	–26.8	–13.4	–0.7	10.4	16.7	...
Exports	1.9	–9.8	–14.7	–9.6	4.3	17.4	10.5	...

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

However, industry confidence indicators slipped slightly in May after improving in previous months and growth in goods orders also slowed up in April.

With regard to construction, the residential segment was still adjusting due to oversupply, with this continuing to push down prices. Nonetheless, there were signs of greater activity, partly because of demand being brought forward in anticipation of the hike in value added tax in July and the partial withdrawal of the tax deduction for buying homes in January 2011. Consequently, in April the number of home purchases recorded a year-on-year rise for the fourth consecutive time, according to data from the National Institute of Statistics.

In April, the number of service sector businesses grew by 1.9% compared with the same month in 2009, meaning that the growth rate is slowing up. Retail trade and transport were the best performing branches over the last twelve months, whereas information and communications, administrative activities and auxiliary services recorded falls of over 5.0%. For its part, the hotel and restaurant sector decreased by 1.5% compared with a year ago. Passenger air traffic picked up in May, increasing 3.0% compared with the same month last year after an 8.6% drop in April, affected by problems due to the temporary closure of quite a few airports because of ash from an Icelandic volcano.

Passenger air traffic picks up in May.

Another sign of improvement in the overall economy was the rise in the number of new businesses set up in April compared with the same month the year before, up 4.1%. However, capital subscribed in the month was 9.7% lower than the figure for April 2009 and the number of companies increasing their capital fell by 4.4% compared with twelve months ago. Similarly, there were

MODERATE GROWTH IN INDUSTRIAL PRODUCTION

Year-on-year change in the general industrial production index (*)

NOTE: (*) Adjusted for work calendar differences.
SOURCE: National Institute of Statistics.

The International Monetary Fund's Managing Director expresses his confidence in the prospects for the Spanish economy after the measures taken by the government.

7.0% more companies wound up. On the other hand, unpaid negotiable instruments were down 34.4% in April compared with the same month last year, helped by strict risk control. Consequently, the proportion of unpaid to matured negotiable instruments continued to fall, reaching 4.0%.

Towards the end of May, the International Monetary Fund carried out a diagnosis of the Spanish economy, highlighting the following as its key problems: the poor performance of the labour market, the bursting of the real estate bubble, a large budget deficit, excessive debt in the private sector and abroad, little growth in productivity and a weakened banking sector. Its recipe, apart from fiscal consolidation, included reforms in the labour market, in the pension scheme and financial system.

Since then, and in addition to pushing forward with the budget consolidation, in mid-June the government also passed labour reforms and has continued to restructure the financial system.

Within this context, at the end of the third week of June the International

SUPPLY INDICATORS

Percentage change over same period year before

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
Industry								
Electricity consumption (1)	0.5	–4.3	–6.4	–2.1	–1.4	3.0	5.8	3.2
Industrial production index (2)	–7.3	–15.8	–18.6	–14.6	–5.6	0.4	2.4	...
Confidence indicator for industry (3)	–18.0	–31.2	–35.0	–29.0	–24.1	–20.1	–14.3	–15.0
Utilization of production capacity (4)	79.5	69.2	69.5	68.5	69.9	69.0	–	70.9
Imports of non-energy intermediate goods (5)	–0.7	–21.6	–31.1	–17.1	0.1	26.9	28.4	...
Construction								
Cement consumption	–23.8	–32.6	–36.0	–26.4	–16.7	–20.8	–10.5	–11.4
Confidence indicator for construction (3)	–22.6	–30.6	–35.0	–26.3	–24.5	–24.9	–17.0	–24.0
Housing (new construction approvals)	–59.4	–58.1	–62.8	–52.4	–45.5	–24.4	...	...
Government tendering	3.0	–8.1	–8.4	–1.4	–16.7	–50.2	...	...
Services								
Retail sales (6)	–6.0	–5.4	–6.4	–4.5	–2.7	0.7	–1.1	...
Foreign tourists	–2.5	–8.8	–8.2	–7.8	–3.5	0.3	–13.3	1.1
Tourist revenue inflows	–0.4	–9.0	–8.0	–9.2	–5.5	0.2	...	...
Goods carried by rail (ton-km)	–7.7	–28.4	–34.9	–32.4	–7.7	4.5	15.5	...
Air passenger traffic	–3.0	–8.0	–8.6	–5.2	–0.8	3.5	–8.6	3.0
Motor vehicle diesel fuel consumption	–3.8	–5.1	–5.1	–3.0	–2.0	–0.6	...	...

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

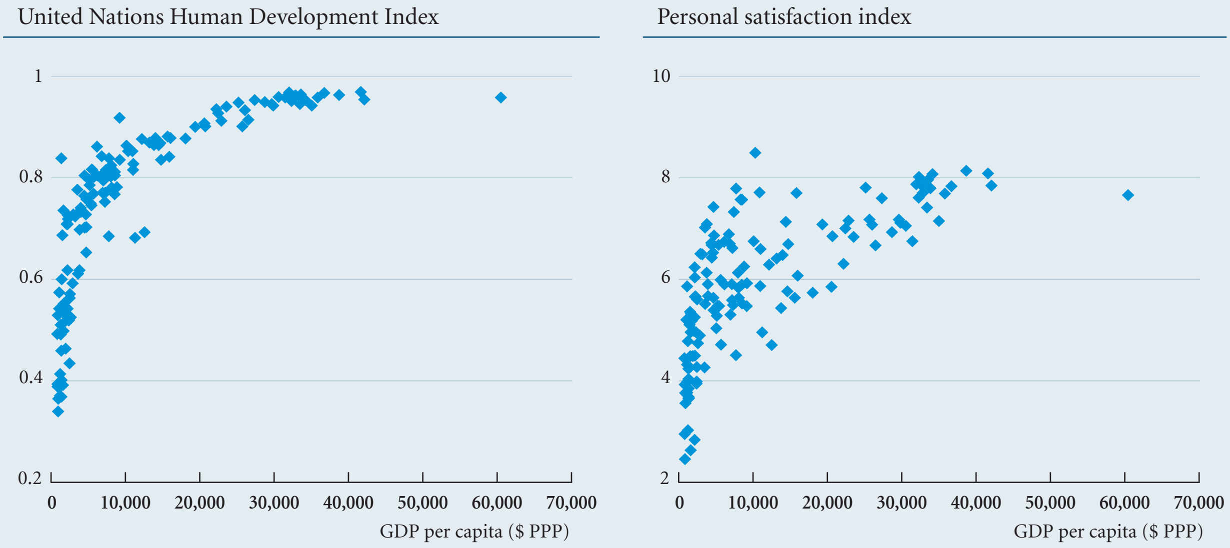
Monetary Fund's Managing Director, Dominique Strauss-Kahn, met with the President of the Spanish government, José Luis Rodríguez Zapatero, the former stating that the measures taken by the Spanish government are «decisive and crucial», that «they are laying the foundations for future growth» and expressing his confidence in the prospects for the Spanish economy.

Is GDP a measure of happiness?

Gross domestic product (GDP) is the most usual way of measuring economic activity and its pace of growth is used to evaluate a country's standard of living or development. If we divide it by the number of inhabitants, we get an indicator, GDP per capita, that frequently assesses the relative economic level of a country or region. However, does GDP adequately measure the progress and welfare of a society? As it stands, the efforts aimed at resolving the devastating oil spill in the Gulf of Mexico entail a rise in GDP. The same thing happens with reconstruction work after an earthquake or with an increase in the police force to prevent terrorism. Even Simon Kuznets, the Russian-American economist who created the US national account system, once warned his country's Congress about the inappropriateness of using GDP to measure the welfare of a nation.

Many initiatives exist to find alternative ways of measuring a society's progress and welfare and their proposals point in three directions: correcting existing GDP by broadening its focus towards the social or environmental dimension (for example, the United Nations Human Development Index or the Genuine Progress Indicator of the organization Redefining Progress); producing other indicators based on objective variables that are not directly related to economic growth, such as the Calvert-Henderson quality of life indicators, and using subjective measures of welfare, including concepts such as satisfaction and happiness.

INCOME LEVEL AS AN INDICATOR OF WELFARE IS LESS APPROPRIATE IN RICH COUNTRIES



SOURCES: United Nations (2009), «Human Development Report»; Abdallah S., Thompson S., Michaelson J., Marks N. and Steuer N. (2009), «The (un)Happy Planet Index 2.0. Why good lives don't have to cost the Earth»; and own calculations.

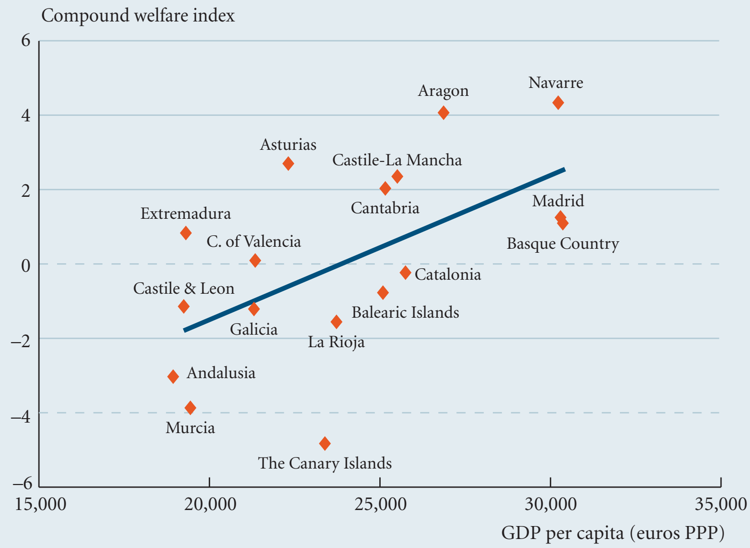
This box evaluates to what extent, in practice, the findings provided by GDP differ substantially from those that can be obtained using other indicators. To this end, we will carry out three exercises. The first compares the per capita income of each country with the aforementioned Human Development Index (HDI), covering life expectancy and income level. To calculate the HDI we first need to create sub-indices for each of its components, choosing minimum and maximum values. These are 85 and 25 years of age for life expectancy at birth, 100% and 0% for the two education components (adult literacy rate and gross enrolment rate) and 40,000 and 100 dollars for GDP per capita in purchasing power parity (PPP). The HDI is calculated by averaging its three main components.

The second exercise compares GDP per capita with a more subjective measure of welfare, namely a personal satisfaction index constructed by the New Economics Foundation. This variable comes from questionnaires where respondents rate how happy they are with the state of their lives on a scale of 0 to 10.

From the first two exercises we can see that GDP approximates, reasonably adequately, a society's progress when the comparison is very global and includes highly diverse zones of wealth. As seen in the graphs above, rich countries are, in effect, to be found in the higher bands of welfare, be it in purely income terms or in terms of less economically-based variables. However, this positive association between GDP and the rest of the indicators becomes less reliable as income levels increase. This suggests that, among the richest regions, a combination of welfare indices or a personal satisfaction assessment is probably a better way to express a population's degree of standard of living.

GDP AND WELFARE LEVEL: A REASONABLE RELATIONSHIP

Welfare and GDP per capita by autonomous community



NOTE: The compound welfare index is constructed using the following indicators: i) average number of pupils per teacher (Ministry of Education); ii) percentage of adults who feel their health is good or very good (Life Conditions Survey); iii) percentage of households that get to the end of the month without difficulty (Life Conditions Survey); iv) satisfaction in the workplace (ECVT, Ministry of Labour); v) number of crimes per 1,000 inhabitants (INE); vi) total greenhouse gas emissions per km² (Ministry of the Environment). Each indicator is standardized by subtracting the mean and dividing by the standard deviation. The index is the sum of the individual indices. Data from 2008.
SOURCES: INE, Ministry of Education, Ministry of Labour, Ministry of the Environment and own calculations.

This is what the third exercise aims to do. Here we compare the GDP per capita of the autonomous communities in Spain, all of them with relatively high levels of wealth in global terms, and a summary indicator of welfare based on the criteria of Stiglitz, Sen and Fitoussi.(1) We include six dimensions in this indicator: health, education, work, social capital, environment and security. For them to be comparable, the GDP per capita of each region has been standardized with the relative purchasing power indices.

The above graph shows that the correlation between both measures continues to be positive although relatively weak. We must particularly bear in mind the degree of subjectivity involved in this kind of system, as the choice of indicators can notably affect the final outcome. For example, Navarre would lead the social welfare ranking, even exceeding the ranking it would have for its high GDP, thanks to the good health of its population, the low number of households with difficulties and a good environmental situation. On the other hand, Madrid's welfare is somewhat lower than its corresponding rank for its high GDP per capita due to work satisfaction indicators, while the environmental component has significantly lowered the Basque Country's ranking. Among those autonomous communities with lower purchasing power we should note Extremadura, whose welfare would exceed the level corresponding to its per capita income due to the low number of crimes per inhabitant and low pollution.

We must insist that the construction of welfare indices can lead to results that do not appropriately reflect the reality, due to many different factors: availability of data, suitability of the variables, number of variables used, methodology, etc. The exercise carried out in this box is therefore purely illustrative. But, in general, the results are not significantly different from those provided by GDP per capita. That is why, pending better statistical instruments and used with due caution, GDP per capita continues to be a reasonable way of measuring the welfare of nations.

(1) Stiglitz, J. E., Sen, A. I., Fitoussi, J. P. (2009), «Report by the Commission on the Measurement of Economic Performance and Social Progress», http://www.stiglitz-sen-fitoussi.fr/in/index.htm.

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Labour market

Labour market reform comes into force

Reduction in duality and facilities to secede from the collective agreement, the key aspects to labour reform.

On 22 June, the Spanish parliament approved the Royal Decree Law on urgent measures to reform the labour market. This is a series of modifications that, although without effect in the short term, should help to create jobs in the medium and long term once the necessary conditions are in place for the economy to revive and grow. In broad terms, the reform includes measures that make it easier for companies to adjust their workforce, increase the flexibility of the workday and help to separate wages from collective agreements. It also introduces changes both to the groups eligible for rebates and to career guidance measures.

This reform's success will depend on the extent to which it is ultimately implemented and this is largely dependent on the speed and confidence of companies in the different processes, particularly regarding dismissals and changes in the workday or wages for economic reasons.

MAIN MEASURES OF THE LABOUR REFORM
Permanent contracts
– More specific details concerning the causes for the 20-day objective dismissal system.
– Encouragement of employment promotion contracts with 33 days severance pay for unfair dismissal.
– Fogasa will pay 8 days of the severance pay.
– As from 2012, creation of a Capitalization Fund to finance part of the dismissal.
Temporary contracts
– Limited duration of works or service contracts to 3 years, extendable by 12 months.
– More difficult to give successive temporary contracts.
– Severance pay goes from 8 to 12 days.
Separation from the collective agreement
– Greater facilities to secede from the agreement if it jeopardises the firm's economic stability.
– Bargaining period is limited to 15 days before going to an arbitrator.
Reduction in the workday to adjust employment
– Workday can be cut by 10% to 70% for economic reasons.
– Rebate in social security contributions is raised from 50% to 80% if there is training.
– Bargaining period is limited to 15 days before going to an arbitrator.
Rebates for young people (16-30) and those over 45
– Higher amount for women.
– Valid until the end of 2011.
Career guidance measures
– Job agencies are extending their role as collaborators for the Public Employment Services.

Labour reform is being tackled within a still precarious situation for the labour market, as confirmed by the number of people registered as employed with Social Security and the registered unemployed for the month of May. Data on the total number of people registered as employed point towards the impending end to job losses. In this month, there was a drop in employment of 11,400, seasonally adjusted (an increase of 113,237 people in gross terms). The fall in employment was less than in the preceding months and helped to moderate the year-on-year rate at 1.9%. By sector, although all had higher numbers of employed in gross terms, improvement was concentrated in services, as this was the only sector where employment grew once the figures had been seasonally adjusted. The services sector has therefore been generating employment for the last seven months.

The year-on-year rate of fall in employment has eased, now at 1.9%.

By gender, the fall in the year-on-year employment rate decreased both for women and men, standing at 0.3% and 3.2%, respectively. Self-employment also increased for the third consecutive month, moderating its year-on-year drop to 3.0%. The total number of salaried people also grew in May, so that its rate of fall decreased by two tenths of a percentage point, standing at 1.7%.

On the other hand, according to the labour situation survey for the first quarter of 2010, job losses in the last twelve months were relatively more intense in small firms (centres with

EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	April	May
Persons registered with Social Security (1)								
Sectors of activity								
Industry	*2.1*	*–10.6*	*–11.5*	*–11.5*	*–10.0*	*–7.2*	*–5.4*	*–4.9*
Construction	*–10.3*	*–23.1*	*–25.4*	*–22.0*	*–18.9*	*–16.4*	*–13.6*	*–13.0*
Services	*1.7*	*–2.6*	*–3.1*	*–3.0*	*–2.1*	*–0.8*	*–0.1*	*0.2*
Job situation								
Wage-earners	*–0.7*	*–6.0*	*–7.0*	*–6.2*	*–4.6*	*–2.8*	*–1.9*	*–1.7*
Non-wage-earners	*0.4*	*–4.8*	*–5.0*	*–5.3*	*–4.9*	*–4.0*	*–3.3*	*–3.0*
Total	**–0.5**	**–5.8**	**–6.7**	**–6.0**	**–4.6**	**–3.0**	**–2.1**	**–1.9**
Persons employed (2)	**–0.5**	**–6.8**	**–7.2**	**–7.3**	**–6.1**	**–3.6**	**–**	**–**
Jobs (3)	**–0.6**	**–6.7**	**–7.2**	**–7.2**	**–6.1**	**–3.6**	**–**	**–**
Hiring contracts registered (4)								
Permanent	–14.3	–31.0	–35.3	–28.6	–22.5	–11.9	–7.6	–0.8
Temporary	–10.4	–13.5	–17.8	–9.4	–2.1	3.7	6.0	7.3
Total	**–10.9**	**–15.5**	**–19.9**	**–11.4**	**–4.3**	**2.0**	**4.6**	**6.5**

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

Small firms lose more jobs.

fewer than 50 workers) with a 6% fall in the number of employed. The drop in employment in medium-sized firms (from 50 to 250 workers) was 1%, and in large firms, 2.3%.

In May, the number of contracts recorded increased by 6.5% year-on-year, contrasting with the 19.8% fall in the total number of contracts recorded for the same month a year ago. Figures also show that the adjustment in employment is concentrated in temporary contracts, up by 7.3% in the last twelve months, whereas permanent contracts still recorded a negative year-on-year rate of 0.8%.

Registered unemployment is up 12%.

With regard to registered unemployment, although the number fell by 76,223 people to a total of 4,066,202, this figure becomes a rise of 52,200 once it is seasonally adjusted, as in the previous month. Nonetheless, the year-on-year rate of increase stood at 12.3%, significantly lower than the 53.8% recorded the same month a year ago.

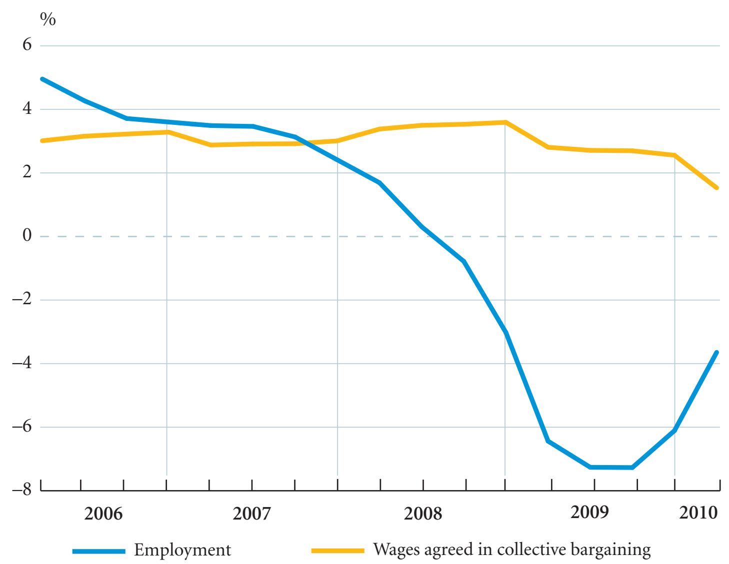
The drop in registered unemployment in gross terms was widespread in all economic sectors, with the highest fall in services. Unemployment also fell for both sexes in the month, and in all autonomous communities, particularly in the Balearic Islands, Asturias and Catalonia.

Labour costs reflect the adjustments in the labour market

The labour cost per worker and month of firms increased by 1% in the first quarter of 2010 compared with the same period a year ago. This rate is the lowest in the history of this statistic and contrasts with the 4.1% rise recorded in the first quarter of 2009. Adjustment in labour costs has therefore finally arrived, after two years of economic recession.

WAGES TAKE THEIR TIME TO RESPOND TO LABOUR MARKET CONDITIONS

Year-on-year change in employment and wage indicators



SOURCES: National Institute of Statistics and own calculations.

The slowdown in labour costs is due to the brake on wage rises, whose year-on-year rate of growth stood at 1.9%, lower than the 4.6% of a year ago. It was also helped by the non-wage component, down 1.1% mainly thanks to the lower cost of severance pay.

On the other hand, in 2009 the increase in higher labour costs than wages in the collective agreement can be put down to severance pay obligations. This reveals the potential importance of dismissal conditions, especially in terms of compensation, for companies' labour costs. Within this context, the clarification of what is meant by objective causes for dismissal is fundamental to the labour reform as, in this case, severance pay costs are lower.

With regard to the labour cost per hour, this was up 2.1% in the first quarter of 2010, higher than the cost per worker, due to the 1% drop in the number of effective hours of work.

Lastly, we should also note that, for the first time, labour costs per hour grew less in Spain than the average for the European Union. According to Eurostat, the rise in labour costs per hour worked in Spain in the first quarter of 2010 was 2.0% year-on-year, below the European average of 2.2%.

Labour costs per worker grow 1% year-on-year in the first quarter of 2010.

WAGE INDICATORS

Percentage rate of change over same period year before

	2008	2009	2009			2010
			2Q	3Q	4Q	1Q
Increase under general wage agreements (*)	**3.6**	**2.5**	**2.7**	**2.6**	**2.5**	**1.4**
Wage per job equivalent to full-time work (**)	**6.1**	**3.8**	**4.2**	**3.3**	**3.1**	**2.0**
Quarterly labour cost survey						
Wage costs						
Total	5.1	3.2	4.1	3.1	2.7	1.9
Industry	*4.8*	*2.1*	*2.4*	*2.0*	*2.5*	*2.8*
Construction	*6.3*	*5.2*	*5.8*	*4.9*	*5.3*	*1.9*
Services	*5.0*	*3.2*	*4.3*	*3.2*	*2.5*	*1.6*
Average wages per hour worked	4.9	5.3	9.8	3.9	5.3	2.9
Other labour costs	4.1	4.3	3.5	3.9	1.9	–1.1
Work day (***)	0.2	–2.1	–5.1	–0.9	–2.4	–1.0
Farm wages	**5.1**	**2.6**	**4.0**	**0.3**	**2.8**	**–**
Labour cost in construction	**5.7**	**4.7**	**4.3**	**3.7**	**3.6**	**3.1**

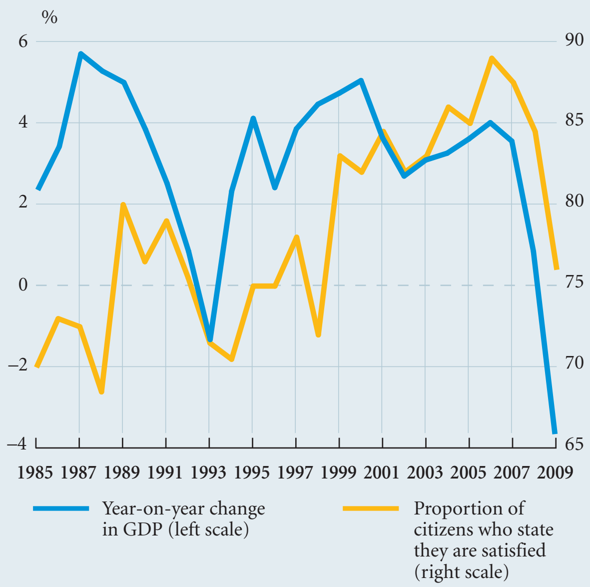
NOTES: (*) Does not include wage revision clauses. Cumulative figures.
(**) Quarterly National Accounts: data adjusted for seasons and public holidays.
(***) Effective hours worked per worker per month.
SOURCES: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture,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

Smiling's more difficult when the economy doesn't smile

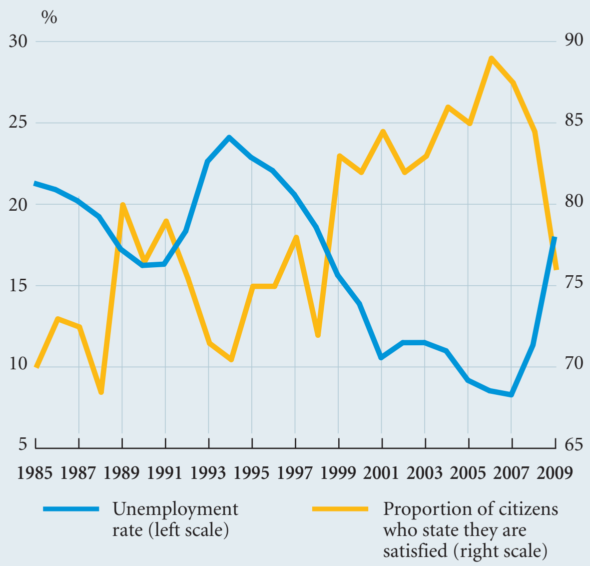
The great recession affecting the world economy in 2008 and 2009 has left behind a long list of victims and its impact on GDP and employment is relatively well-known. What isn't so clear, however, is its effect on welfare or happiness, a concept that's much more difficult to measure. Although economic cycles evidently alter our happiness, very few efforts have been made to determine to what extent we are affected.

THE HAPPINESS OF THE SPANISH, AT THE MERCY OF THE ECONOMIC CYCLE

Economic growth and happiness index in Spain



Unemployment and happiness index in Spain



SOURCES: European Commission and INE.

A study some years ago by Di Tella *et al.* (2003)[1] analyzes the relationship between the main macroeconomic variables and European citizens' degree of personal satisfaction measured through the Eurobarometer surveys. They conclude that a decline in GDP certainly affects happiness but GDP alone does not explain the acknowledged loss of welfare resulting from an economic crisis (see the left-hand graph above). The non-pecuniary effects of economic cycles seem to be highly significant. In particular, a decline in economic activity involves job losses and higher uncertainty, involving a psychological cost that can diminish people's happiness even more than a loss of income. According to estimates by the aforementioned study, we would be willing to give up 3% of our annual income in exchange for avoiding the insecurity brought about by a typical recession in which unemployment goes up by 1.5 percentage points.

Unemployment certainly looks like being very costly for happiness: work doesn't only provide us with an income but also meaning for our lives, as it allows us to develop our creative drive and feel we are contributing to society.

(1) Among the references used in producing this box, of note are Di Tella, R., MacCulloch, R. and A. Oswald (2003), «*The Macroeconomics of Happiness*», *The Review of Economics and Statistics*, vol. 85 (4), p. 809-827 and Clark, A. (2003), «*Unemployment as a Social Norm: Psychological Evidence from Panel Data*», *Journal of Labor Economics,* vol. 21 (2), p. 323-351.

That's why losing your job does not only involve an immediate pecuniary cost, due to the wages you no longer get, but also leads to a loss of self-esteem and social ties, factors that have a notable influence on our state of mind. Moreover, losing a job can also entail an unrecoverable loss of part of the productive potential if workers had developed specific skills and aptitudes that cannot be transferred to another job.

However this influence occurs, studies highlight the notable impact of an economy's propensity to create or destroy jobs on happiness (see the right-hand graph above). It is estimated that job loss reduces the probability of reporting positive satisfaction levels by 20%, and that the additional damage to welfare caused by unemployment, beyond the loss of income, is equivalent to half the annual income lost. Moreover, it's not just the people who lose their job who suffer, but also those who continue working but have to face a greater risk of unemployment and therefore live under more uncertain and unstable circumstances. Nonetheless, some findings suggest that the higher the unemployment rate, the less unhappy the unemployed feel. It appears that, within a context of high unemployment, the stigma attached to being unemployed is much less than within a context of low unemployment, and this more than offsets the greater difficulty in finding another job.

The importance of unemployment for welfare suggests that expansion and recession in economic activity has a lopsided effect on happiness. This is largely due to the fact that an expansion in GDP typically leads to a gradual decline or stabilization in the unemployment rate, while a recession tends to be associated with greater job losses and a sharper rise in unemployment.

The case of Spain illustrates this phenomenon: between 2000 and 2008, real GDP grew 27.6% in accumulated terms while unemployment fell by 2.5 percentage points, to 11.3%. In 2009, however, a 3.6% drop in GDP led to an increase of 6.7 percentage points in the unemployment rate. This can help us to understand why the proportion of citizens who state they are satisfied with their lives fell in 2009 to the levels of 1998. Although these traits can be seen in other developed countries, they are less intense. Last year, the GDP of the main industrialized economies fell on average by 4.2%, while unemployment increased 2.1 percentage points.

On the other hand, it has been shown that, at an individual level, we place much more importance on a loss, be it pecuniary or personal, than to a gain of equal size. So, for example, the loss of satisfaction reported by a fall in income of 2,000 euros is, in general, greater than the improvement involved in an equivalent rise in wages. This phenomenon, known as «loss aversion», also partly explains the asymmetry observed in the economic cycle's impact on welfare, whether this cycle is in an expansionary or recessionary phase.

In short, an economic crisis exacts a cost on welfare that goes beyond the loss involved in a fall in GDP and loss of income. Unemployment makes us particularly unhappy; not only those who lose their jobs but also those who are afraid of losing them. That's why undertaking measures to minimize job losses could have an appreciable effect on the welfare of society. Since the recession started, Spain has dropped six positions in the European Union's happiness ranking. To regain its pre-crisis level, the unemployment rate has to fall by around 10%-11% in the next five years. Until then, we won't be able to say the recession has ended; at least not in terms of happiness.

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

Prices

Consumer price inflation stands at 1.8% in May and the upward push is not coming from energy products...

...but from core inflation, up 3 tenths of a percentage point to 0.2%, leaving behind its lowest level of the last few decades.

Inflation continues to rise but remains at a moderate level

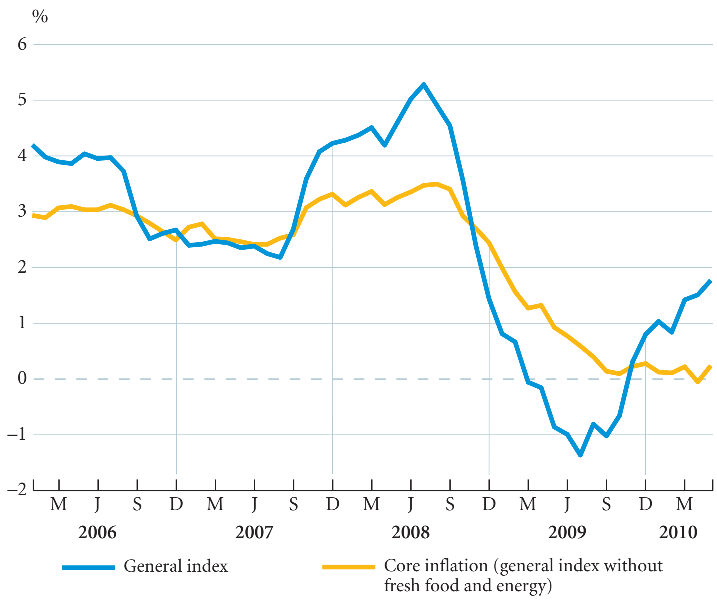
In line with what was expected, the consumer price index (CPI) continued to rise in the month of May. The monthly increase was 2 tenths of a percentage point, bringing the year-on-year rate of change to 1.8%, 3 tenths of a percentage point more than in the previous month. It therefore stood at 2.6 points more than twelve months before, when the inflation rate was negative. Unlike previous months, inflation was not boosted by the energy component.

Almost all the rise in inflation in May resulted from the most stable core of prices or underlying inflation, which excludes the most volatile elements, namely unprocessed food and energy products. Core inflation rose 3 tenths of a percentage point in May to 0.2%, leaving behind its lowest level for the last few decades in April. This increase was partly due to the end of the effect of Easter being early this year compared with last year. All three groups that make up core inflation saw rises in May, although their percentage change remains low.

The upswing in non-energy industrial goods contributed one tenth of a percentage point to the year-on-year rise in inflation in May. Nonetheless,

CORE INFLATION IS POSITIVE AGAIN

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

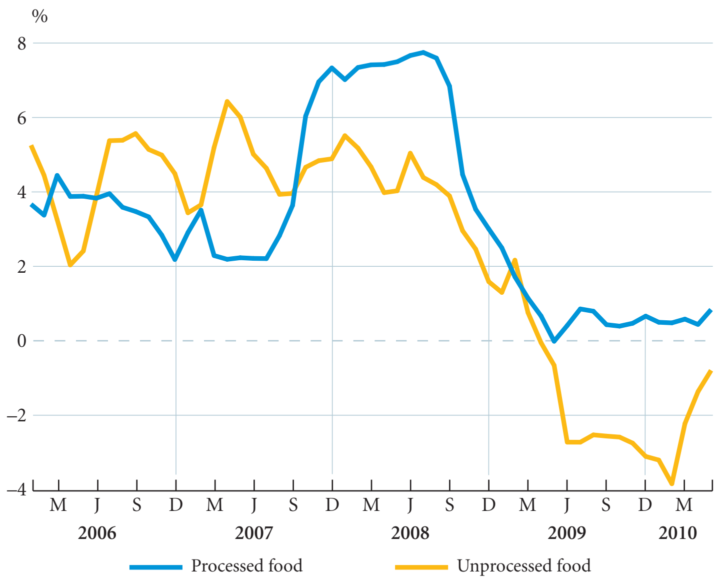
CONSUMER PRICE INDEX

	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	0.2	0.8	1.8
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.

SLIGHT UPSWING IN FOOD PRICES

Year-on-year change in the food price index



SOURCE: National Institute of Statistics.

the percentage change of the price index for this group was –1.1%, a result of the pressure from strong competition in international markets.

Services as a whole also contributed around one tenth of a percentage point to inflation’s year-on-year increase in May. The percentage change in their

Food helps to push up inflation in May.

prices over the last year was 1.0%, 2 tenths of a percentage point more than the lowest level for the last few decades, recorded the month before. The greatest impact came from package trips and, to a much smaller degree, hotels.

Also of note was the contribution to inflation's rise made by processed food, whose prices were up 0.9% over the last twelve months, 4 tenths of a percentage point more than in April.

Fresh foods also contributed to the rise in inflation but to a smaller degree. Their prices fell in May by 0.8% compared with the same month last year, but 6 tenths of a percentage point less than in April. The impact from potatoes, pulses and fresh vegetables, fruit and chicken was remarkable. On the other hand, the other erratic component of the CPI, energy products, had a slightly negative effect on general inflation as their year-on-year rate fell by 0.3 percentage points to 16.4%.

CONSUMER PRICE INDEX BY COMPONENT GROUP

May

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2009	2010	2009	2010	2009	2010
By type of spending							
Food and non-alcoholic beverages	107.0	–0.5	0.0	–2.0	–0.9	–0.8	–1.4
Alcoholic beverages and tobacco	129.7	0.0	0.0	3.5	3.0	3.9	12.1
Clothing and footwear	105.7	1.6	2.0	–2.4	–2.1	–1.5	–0.5
Housing	115.2	–0.1	0.3	–0.6	2.3	0.8	3.8
Furnishings and household equipment	107.4	0.3	0.2	0.6	0.0	1.6	0.2
Health	96.9	–2.1	–0.7	–1.5	–0.6	–0.9	–0.4
Transport	108.9	0.8	0.5	1.4	5.4	–9.1	7.9
Communications	98.4	–0.2	0.0	–0.1	–0.9	–0.7	–1.2
Recreation and culture	96.9	–1.5	–0.6	–1.2	–1.7	0.0	–1.7
Education	114.6	0.0	0.0	0.2	0.1	3.9	2.6
Restaurants and hotels	112.8	–0.1	0.0	1.1	0.9	2.1	1.0
Other goods and services	111.7	0.0	0.2	1.7	1.7	2.7	2.1
By group							
Processed food, beverages and tobacco	111.3	–0.4	0.0	–0.7	–0.5	0.0	0.9
Unprocessed food	106.5	–0.5	0.0	–2.6	–0.2	–0.6	–0.8
Non-food products	108.1	0.1	0.3	0.2	1.2	–1.1	2.1
Industrial goods	105.1	0.4	0.7	–0.7	1.9	–4.6	3.3
Energy products	*116.8*	*0.9*	*0.7*	*0.6*	*8.9*	*–15.3*	*16.4*
Fuels and oils	*114.2*	*1.2*	*0.9*	*–0.4*	*11.6*	*–22.8*	*20.9*
Industrial goods excluding energy products	*100.8*	*0.3*	*0.6*	*–1.2*	*–0.6*	*–0.8*	*–1.1*
Services	111.4	–0.3	–0.1	1.1	0.5	2.6	1.0
Underlying inflation (**)	107.6	–0.1	0.2	0.0	–0.1	0.9	0.2
GENERAL INDEX	**108.7**	**0.0**	**0.2**	**–0.1**	**0.8**	**–0.9**	**1.8**

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

The harmonized consumer price index with the European Union also posted a 1.8% year-on-year change in May. The inflation differential with the euro area therefore widened to 0.2 points, with inflation in the euro area standing at 1.6%. However, the core inflation differential continued to be favourable to Spain.

In June, inflation is likely to fall a few tenths of a percentage point. However, it will then rise again due to increases in the rates for value added tax as from July, although it seems that part of this impact will be absorbed by company margins, given the weak demand. Consequently, year-end inflation might remain at a moderate level.

Rise in wholesale prices

In April, the year-on-year inflation rate for wholesale prices continued to rise, reflecting the increase in commodity prices over the last year, although this has slowed up in the last few months. Industrial prices therefore rose 3.7% compared with April 2009, 1.3 points more than in the previous month. The main boost came from gas and metal products. Meanwhile, for the first time since August 2008 farm prices at source recorded a positive annual increase, in February posting a rise of 1.0% compared with twelve months earlier.

In June, inflation is likely to fall some tenths of a percentage point, although the VAT hike as from July will push it up again.

Farm prices at source posted a positive annual increase in February for the first time since August 2008.

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											
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	–11.5	2.0	2.2	–7.1	–
August	–14.8	–5.5	–0.9	0.3	–7.7	–11.5	–9.9	0.6	2.0	–7.4	–0.6
September	–14.0	–5.4	–0.7	0.4	–7.6	–11.5	–9.3	–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	–3.2	–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	0.7	–1.9	–
2010											
January	–5.5	0.9	–0.5	–0.3	–0.9	6.3	3.4	–0.9	0.1	0.2	–
February	1.0	1.1	–0.6	0.0	–0.4	6.8	4.7	–0.4	–0.2	1.5	0.4
March	...	2.4	–0.1	0.0	0.5	10.3	7.2	1.2	0.0	4.4	–
April	...	3.7	0.1	–0.2	2.4	13.5	7.8	2.0	0.5	6.6	–

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

Foreign sector

The trade deficit stops shrinking

Trade deficit up 38% year-on-year in April.

April's trade deficit totalled 5.004 billion euros, 37.6% higher than the figure recorded for the same month in 2009. This imbalance, the third for the year, was caused by the year-on-year growth in exports, which was lower than the growth in imports, of 10.8% and 16.6% respectively. The accumulated deficit during the first four months of 2010, with a 1.6% drop year-on-year, remained practically unchanged compared with the same period the previous year, far from the significant reductions recorded throughout 2009.

Given this scenario, we should ask what reasons lie behind this slowdown in the correction of the trade imbalance, as well as the possible trends for the balance of trade in what remains of the year.

FOREIGN TRADE

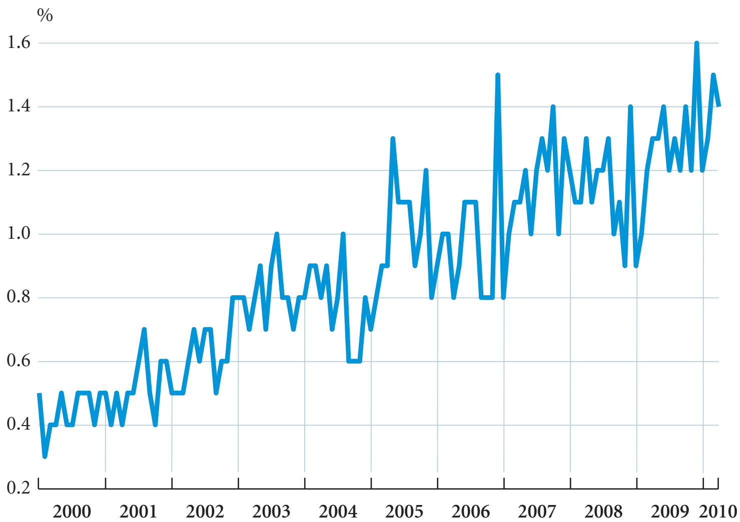
January-April 2010

	Imports			Exports			Balance	
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	Export/ Import rate (%)
By product group								
Energy products	13,690	24.9	18.3	2,156	4.5	3.8	–11,533	15.8
Consumer goods	18,792	–14.8	25.1	20,563	–1.4	35.9	1,771	109.4
Food	*4,566*	*–0.9*	*6.1*	*7,956*	*5.3*	*13.9*	*3,390*	*174.2*
Non-foods	*14,226*	*–18.5*	*19.0*	*12,608*	*–5.3*	*22.0*	*–1,619*	*88.6*
Capital goods	5,598	–3.2	7.5	4,590	14.0	8.0	–1,009	82.0
Non-energy intermediate goods	36,642	25.3	49.0	30,045	28.1	52.4	–6,597	82.0
By geographical area								
European Union	41,839	5.8	56.0	39,675	11.9	69.2	–2,165	94.8
Euro area	*33,796*	*1.2*	*45.2*	*32,697*	*11.8*	*57.0*	*–1,100*	*96.7*
Other countries	32,882	15.3	44.0	17,679	18.4	30.8	–15,203	53.8
Russia	*1,504*	*14.2*	*2.0*	*510*	*15.8*	*0.9*	*–994*	*33.9*
United States	*2,861*	*–10.9*	*3.8*	*1,876*	*–1.5*	*3.3*	*–985*	*65.6*
Japan	*1,220*	*26.1*	*1.6*	*471*	*25.4*	*0.8*	*–749*	*38.6*
Latin America	*4,204*	*24.1*	*5.6*	*2,881*	*17.8*	*5.0*	*–1,323*	*68.5*
OPEC	*7,226*	*33.1*	*9.7*	*2,060*	*–1.5*	*3.6*	*–5,166*	*28.5*
Rest	*15,867*	*11.7*	*21.2*	*9,882*	*28.7*	*17.2*	*–5,986*	*62.3*
TOTAL	**74,722**	**9.8**	**100.0**	**57,354**	**13.8**	**100.0**	**–17,368**	**76.8**

SOURCES: Ministry of the Economy and own calculations.

EXPORTS TO CHINA GAIN SHARE

Percentage exports to China out of total



SOURCES: Ministry of the Economy and own calculations.

Of note among the main factors behind this change in trend is the expansion in the energy deficit, up 38.8% year-on-year in April, due mainly to the rising price of energy goods. Moreover, unlike over the last two years, the trade deficit's non-energy component also increased its imbalance by 35.9% in the same period. This was due, on the one hand, to a gradual rise in imports, particularly in consumer durables, and on the other to the 12.2% fall in exports from the car industry year-on-year, resulting from the end of stimulus plans for buying vehicles in the main European countries.

The non-energy deficit widens after shrinking for more than two years.

This last event shows the potential effect on exports of the new measures of fiscal adjustment approved by the main European governments. It's therefore possible that the demand for goods on the part of Germany, France, United Kingdom, Portugal and Italy, which accounted for 54% of Spanish exports in 2009, will fall as these austerity plans are put in place. Given this scenario, and with the depreciation of the euro, Spain should take advantage of the situation and increase its export share to countries outside the euro area, something which, as can be seen in the above graph, is already happening with China.

The income balance maintains the drop in the current deficit

The latest data available on the current account balance for March places the deficit at 4.334 billion euros, 34.6% lower than the figure recorded in the same month a year ago. However, unlike in previous months, this adjustment was fundamentally the result of a fall in the income balance deficit of 54.7% year-on-year. This sharp drop in income deficit can be explained by the reduction in investment income payments. Moreover, in this same period, both the current transfer and services balance improved, neutralizing the deterioration in the commercial deficit.

Current deficit down 35% in March.

Portfolio investment continues to fall while short-term financing increases.

An analysis of the accumulated data for the last twelve months shows, in March, a 45.5% reduction in the current deficit compared with the same period a year ago, placing it at 52.541 billion euros. This figure is equivalent to 5.0% of GDP, moving away from the record high of 10.6% reached in June 2008. The rise in the capital account surplus placed financing needs at 47.77 billion euros, equivalent to 4.6% of GDP, a similar level to that reached in 2004.

With regard to financial flows, a further reduction was posted in the month of March in net portfolio investment, of 1.757 billion euros. This figure, although lower than the net outflows of 18.036 billion euros of the previous month, was the result of capital withdrawals by foreign investors due to a greater lack of confidence regarding the stock market and sovereign bond market trends. On the other hand, short-term financing, which had fallen sharply over the last few months, rose again in March with a net inflow of 5.844 billion euros.

BALANCE OF PAYMENTS

March 2010

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change: Absolute	Annual change: %
Current account balance					
Trade balance	–10,842	–14.0	–43,275	32,113	–42.6
Services					
Tourism	*4,412*	*–0.3*	*26,186*	*–1,478*	*–5.3*
Other services	*79*	*–*	*37*	*1,434*	*–*
Total	4,491	13.3	26,223	–44	–0.2
Income	–6,338	–37.6	–26,026	13,055	–33.4
Transfers	–4,750	45.8	–9,463	–1,238	15.1
Total	**–17,439**	**–20.9**	**–52,541**	**43,885**	**–45.5**
Capital account	**1,678**	**72.2**	**4,771**	**537**	**12.7**
Financial balance					
Direct investment	11,513	–	19,939	37,117	–
Portfolio investment	–10,923	–	26,716	–7,233	–21.3
Other investment	16,561	–27.2	–2,614	–38,501	–
Total	**17,150**	**–15.3**	**44,041**	**–8,618**	**–16.4**
Errors and omissions	–4,535	–	–9,621	–7,008	268.2
Change in assets of Bank of Spain	3,146	–	14,004	–26,540	–65.5

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

Fall in public deficit accumulated up to May

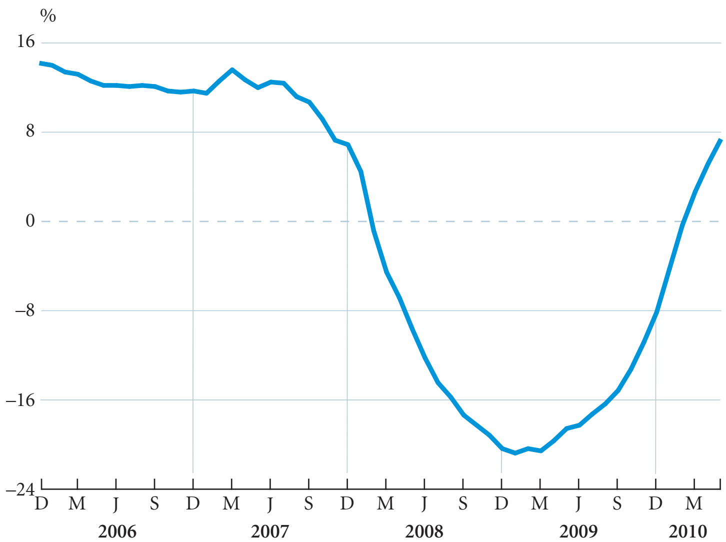
In mid-June, the European Commission evaluated the Spanish government's plans to correct its excessive public deficit, together with those presented by another eleven European countries. Although it felt that the decisions taken by the Spanish government to adjust the budget for 2010 were adequate, they were asked to specify measures totalling 1.75% of gross domestic product (GDP) for 2011 in order to actually achieve the public deficit target of 6% GDP in that year. The extent of the cuts proposed by the Commission is a little higher than that defined by the government in its May package, namely 1.5% of GDP, as the Spanish government's forecast of 1.3% growth in GDP in 2011, which was downgraded at the end of May, is higher than the projection by the European Commission.

At the end of May, the government reduced the central government's non-financial spending limit on a national accounts basis to 150,056 million euros for 2011, a drop of 7.7% on 2010, in homogeneous terms. Moreover, as a complement to the budget adjustment package of May 2010, it has also been announced that the central government and some autonomous communities are preparing tax hikes to help reduce the public deficit. Although most of these rises have yet to be defined, they seem

The government cuts the 2011 central government spending limit by 7.7% and prepares tax hikes to reduce its public deficit.

TAX REVENUE PICKS UP

Homogeneous year-on-year percentage change in tax revenue (*)



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

The gradual recovery in the overall economic situation and restrictive fiscal measures help to reduce the public deficit.

to point towards taxing higher income brackets.

With regard to the trends in central government accounts, the gradual recovery in economic activity and the effect of the first fiscal measures to reduce the public deficit have had a favourable effect. Consequently, there was a notable upswing in revenue in the first five months of 2010. In treasury terms, i.e. according to the monetary flows actually recorded, total tax revenue for the central government rose by 2.4% in the period January-May compared with the same period the previous year and compared with an annual drop of 13.9% in 2009.

Improved consumption and higher rates for special taxes lead to a rise in indirect taxation.

Revenue from direct taxation increased by 0.2% compared with the period January-May 2009. Personal income tax, the main type of tax, rose by 3.6% thanks to higher employment withholdings, up 4.4% year-on-year, especially due to the effect of partially eliminating the early deduction of up to 400 euros as from January 2010. Withholdings from investment fell 15.7% and from leases and mutual funds, 1.8% and 25.9%, respectively, while corporate tax was down 18.1%. This decrease mostly reflects the slump in corporate profits.

For their part, indirect taxes shot up by 16.4% compared with the first five months of 2009. Revenue from value added tax was up 21.9%, due both to improved domestic sales and imports, influenced by higher demand before the tax hike in July 2010, as well as to the end of direct aid for buying cars.

The public deficit falls 6% in the first five months of the year, now at 1.8% of GDP.

Special taxes also saw a year-on-year increase of 4.8%.

With regard to non-financial central government payments, these rose by 14.5% in the period January-May compared with the same months the previous year. Under current spending, the greatest relative increase was in transfers, up 28.2% due particularly to increased payments to the State Employment Service to cover unemployment benefit and to the advances to autonomous communities as a result of the new financing system. Interest payments rose by 26.5% and staff costs by 5.6%, while current expenditure on goods and services fell 0.1%.

With regard to capital costs, real estate investment decreased 3.2% year-on-year due to the fall in military expenditure, while civil costs rose by 6.6%. For their part, capital transfers were down 29.8%.

Given the trends in revenue and payments, the central government recorded an accumulated non-financial deficit of 22.878 billion euros, 19.8% higher than the figure for the same period in 2009. However, on a national accounts basis, i.e. according to the rights and obligations recognised, which provides a more reliable view of the trends in accounts, the central government's non-financial resources rose by 15.6%, while expenditure increased 9.0%. The central government's net borrowing therefore fell by 5.7% compared with the period January-May 2009, standing at 1.79% of the gross domestic product.

Savings and financing

Private sector deleveraging continues

Interest rates for bank loans and credit to firms and households continued to slide downwards in general in April, the drop partly reflecting the weakness in demand. This fact, together with stricter financial conditions on the supply side, meant that private sector financing continued to adjust, which had reached very high levels in the last expansionary phase of the economic cycle. Consequently, financing to firms and households posted a 1.4% year-on-year decrease in April, 3 tenths of a percentage point more than the figure for March.

This slight acceleration in the adjustment was due to non-financial firms, whose financing fell by 2.5% relative to April 2009, half a point more than in the preceding month. This drop can be put down to loans; both domestic, which fell 4.7% year-on-year, and foreign, down 2.0% in the last twelve months.

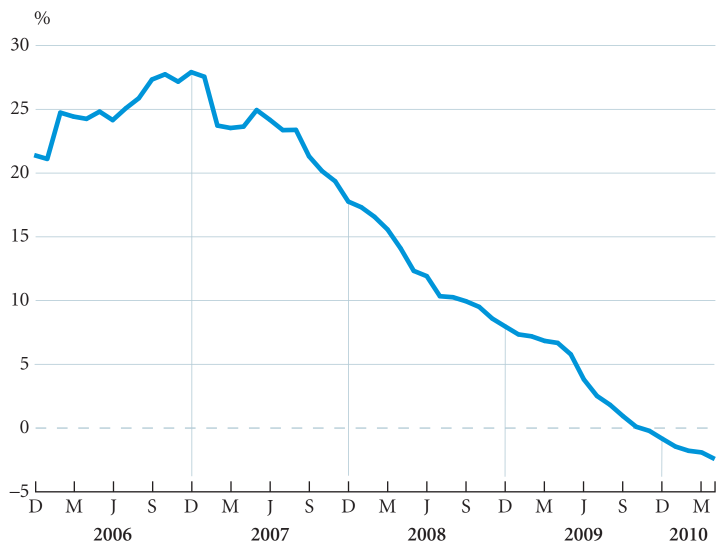
By sector, with data up to the end of the first quarter of 2010, the credit balance was below the level of a year ago in all large groups, although with appreciable differences between them. Construction continued to show the greatest shrinkage, 11.9% year-on-year, albeit lower than three months earlier. Credit for the primary sector was down 6.9% compared with the first quarter of 2009, but this rate was five points higher than the previous quarter. However, credit to industry sharpened its year-on-year

Adjustment continues in private sector financing, which had reached very high levels in the last phase of the expansionary cycle.

Construction suffers the greatest shrinkage in credit.

SLUMP IN COMPANY FINANCING

Year-on-year change in financing for non-financial firms



SOURCE: Bank of Spain

FINANCING OF NON-FINANCIAL SECTORS (1)

April 2010

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,204,982	–9,983	–1.4	79.3
Non-financial corporations	1,304,619	–7,313	–2.5	46.9
Resident credit institution loans (3)	*904,637*	*–11,721*	*–4.7*	*32.5*
Securities other than shares	*63,851*	*7,597*	*39.5*	*2.3*
External loans	*336,131*	*–3,188*	*–2.0*	*12.1*
Households (4)	900,364	–2,670	0.2	32.4
Housing loans (3)	*678,987*	*416*	*0.4*	*24.4*
Other (3)	*218,654*	*–3,173*	*–0.5*	*7.9*
External loans	*2,723*	*87*	*6.0*	*0.1*
General government (5)	577,103	17,454	20.3	20.7
TOTAL	**2,782,086**	**7,471**	**2.4**	**100.0**

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

Slight upswing in loans to households.

decline to 6.0%. Credit to services was also down but to a lesser extent, to a year-on-year decrease of 0.8%. Within this segment, credit to property developers fell by 0.4% in the last twelve months.

The balance of loans to households seems to have bottomed out, picking up slightly in April. Consequently, after having posted a 0.3% annual fall last year, it rose by 0.2% in April compared with the same month last year.

This upswing was due to housing, whose loans increased by 0.4% relative to twelve months before. This was helped by the smaller effort required to buy a house since interest rates are so low and prices have fallen. In fact, the one-year Euribor, the index for most mortgages, hit a record low of 1.22% in March, rising very slightly to 1.23% in April and 1.25% in May as a monthly average, continuing to rise slightly to 1.29% in the fourth week of June. Also influential was the fact that demand was brought forward in anticipation of the higher value added tax rate as from July, as well as the partial withdrawal of tax deductions in January 2011.

Reduction in non-performing loans for buying housing with a mortgage.

After having taken a break in the month of March, the bad debt rate for financial institutions as a whole once again rose in April, reaching 5.5%, one point more than a year earlier and returning to the level of 1996. However, non-performing loans vary substantially depending on the type of asset in question. The bad debt rate for housing mortgages stood at 2.7% at the end of the first quarter, one tenth of a percentage point less than a year earlier. On the other hand, the bad debt rate for financing consumer durables stood at 7.7%, 3 tenths of a percentage point more than twelve months before. The bad debt rate for real

CREDIT TO PRIVATE SECTOR BY PURPOSE

First quarter of 2010

	Balance (*)	Change this year		Change over 12 months	
	Million euros	Million euros	%	Million euros	%
Financing of production activities					
Agriculture, livestock raising and fishing	22,791	–332	–1.4	–1,681	–6.9
Industry	149,302	–2,897	–1.9	–9,604	–6.0
Construction	126,374	–4,064	–3.1	–17,140	–11.9
Services	686,630	1,029	0.2	–5,380	–0.8
Total	**985,097**	**–6,264**	**–0.6**	**–33,805**	**–3.3**
Financing to individuals					
Acquisition and renovation of own home	655,570	1,004	0.2	4,075	0.6
Acquisition of consumer durables	47,716	–1,557	–3.2	–2,845	–5.6
Other financing	107,956	–2,145	–1.9	1,296	1.2
Total	**811,242**	**–2,697**	**–0.3**	**2,527**	**0.3**
Financing to private non-profit institutions	**5,372**	**–151**	**–2.7**	**247**	**4.8**
Other unclassified	**25,278**	**–926**	**–3.5**	**–3,713**	**–12.8**
TOTAL	**1,826,989**	**–10,039**	**–0.5**	**–34,745**	**–1.9**

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

estate activities was 10.9%, 3 points more than at the end of the first quarter of 2009.

However, the restructuring of the Spanish financial system has speeded up over the last few months, particularly affecting all the savings banks as well as some banks. The 45 savings banks that existed at the end of 2009 will soon become 19 once the integration process that is currently underway is completed, through Institutional Protection Systems or mergers.

Although, in the words of the governor of the Bank of Spain, Miguel Fernández Ordóñez, the restructuring has been imposed to «adapt to the new reality in which the financial sector will have to operate in the near future», «the sector as a whole is in a healthy position» and the Bank of Spain proposes to publish the results of the stress tests for Spanish banking institutions so that the markets can realize this.

Stress tests show the Spanish financial sector to be in good health.

With regard to general government financing, its rate of growth continued to slow up in April. Debt rose by 20.3% in the last twelve months up to April but this rate is clearly lower than the 35.2% posted in October 2009.

However, greater uncertainty in international markets led to a rise in the risk premium for Spanish sovereign bonds. The yield differential of the central government's 10-year bonds compared with German bonds for the same period increased to 221 basis points in mid-June, a record since the euro was launched in 1999.

Rise in the risk premium for Spanish public debt.

Bank deposits also shrink

The balance of bank deposits in the private sector posts a year-on-year drop for the first time since 1997.

The return on bank deposits, unlike credits, continued to increase in April, thereby squeezing bank margins. In fact, the average rate for deposits rose to 1.36%, 6 basis points more than the previous month although 22 basis points below the rate of twelve months earlier. This upswing in bank deposit yields in the last few months is mostly due to stronger competition.

However, the balance of deposits in financial institutions for firms and households continued to slow up in April, reaching a 0.7% drop year-on-year, the first since 1997. It should be noted that there was also a drop in bank deposits in the private sector for the euro area. However, the fall in Spain was lower than the fall in credits, so that the gap between credits and deposits continued to close up, as part of the overall adjustment of the Spanish economy. On the other hand, dependence on foreign financing is therefore also falling, this becoming relevant in May and June due to the difficulties encountered by Spanish banks to borrow abroad because of the debt crisis in several European countries also spreading to Spain.

All types of mutual funds achieve positive annual yields in spite of the negative trend in the markets in May.

Aggressive competition between bank deposits, the unfavourable trends in financial markets and the uncertainty regarding possible changes in taxation drove mutual funds down in May. Net withdrawals therefore stood at 3.729 billion euros in this month. Withdrawals particularly affected more conservative funds, such as mixed short-term Euro bonds and monetary funds, but there were net inflows in some types, such as guaranteed fixed income, US equity and international fixed income. Mutual fund assets consequently fell month-on-month by 3.5%, totalling 152.667 billion euros, a drop of 5.7% compared with May 2009.

Nonetheless, all the categories of mutual funds had positive annual yields at the end of May, with an average yield of 2.5%, albeit with a large spread. Emerging market equity led the ranking with 35.3%, while the money market recorded an average yield of 0.5%.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

April 2010

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	252,597	–10,138	–3.9	9,197	3.8	18.3
Savings deposits	203,870	–3,921	–1.9	19,234	10.4	14.8
Term deposits	706,052	–13,959	–1.9	–31,274	–4.2	51.1
Deposits in foreign currency	21,975	–40	–0.2	–4,927	–18.3	1.6
Total deposits	**1,184,494**	**–28,059**	**–2.3**	**–7,770**	**–0.7**	**85.8**
Other liabilities (*)	**196,009**	**–17,120**	**–8.0**	**–23,514**	**–10.7**	**14.2**
TOTAL	**1,380,503**	**–45,179**	**–3.2**	**–31,284**	**–2.2**	**100.0**

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

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July-August 2010

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"la Caixa" GROUP: KEY FIGURES

As of December 31, 2009

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**

Design, page make-up and printing: www.cege.es - Ciutat d'Asunción, 42 - 08030 Barcelona D. L.: B. 21063-1980 ISSN: 1134-1920