

THE SPANISH
ECONOMY

Monthly Report

SMEs

SMEs, KEYS TO RECOVERY

SMEs: cradle of great firms [Page 18](#)

Factors that determine the birth and growth of SMEs

SMEs: cloistered in the local market? [Page 33](#)

The key elements of internationalization: technology, information and alliances

Spanish SMEs and innovation: great expectations? [Page 49](#)

Are Spanish SMEs up to the challenge of innovating?

SMEs: sailing against the wind [Page 69](#)

The credit crunch raises questions as to SMEs' access to financing

Forecast

% change over same period year before unless otherwise noted

	2008	2009	2010	2009				2010	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY									
Gross domestic product									
United States	0.0	-2.6	2.8	-3.8	-4.1	-2.7	0.2	2.4	3.0
Japan	-1.2	-5.2	2.5	-8.7	-5.9	-4.9	-1.3	4.4	1.9
United Kingdom	0.5	-4.9	1.5	-5.3	-5.9	-5.3	-3.1	-0.2	1.6
Euro area	0.5	-4.1	1.5	-5.2	-4.9	-4.1	-2.1	0.6	1.7
Germany	0.7	-4.6	3.0	-6.6	-5.5	-4.4	-2.0	2.0	3.7
France	0.3	-2.2	1.5	0.6	-0.2	-0.4	0.4	1.3	1.7
Consumer prices									
United States	3.8	-0.3	1.7	-0.2	-1.0	-1.6	1.5	2.4	1.8
Japan	1.4	-1.4	-0.8	-0.1	-1.0	-2.3	-2.0	-1.1	-0.9
United Kingdom	3.6	2.2	2.8	3.0	2.1	1.5	2.1	3.3	3.4
Euro area	3.3	0.3	1.4	1.0	0.2	-0.4	0.4	1.1	1.5
Germany	2.6	0.3	1.1	0.8	0.3	-0.2	0.4	0.8	1.1
France	2.8	0.1	1.5	0.7	-0.2	-0.4	0.4	1.4	1.6
SPANISH ECONOMY									
Macroeconomic figures									
Household consumption	-0.6	-4.3	0.1	-5.0	-5.5	-4.2	-2.6	-0.3	2.0
Government consumption	5.8	3.2	-0.2	5.9	4.3	2.7	0.2	-0.2	0.4
Gross fixed capital formation	-4.8	-16.0	-6.7	-15.3	-18.0	-16.4	-14.0	-10.5	-7.0
Capital goods	-1.8	-24.8	0.4	-24.2	-31.5	-25.5	-16.9	-4.8	8.7
Construction	-5.5	-11.9	-9.7	-12.2	-12.0	-11.7	-11.9	-11.4	-11.4
Domestic demand (contribution to GDP growth)	-0.6	-6.4	-1.6	-6.2	-7.5	-6.5	-5.3	-2.8	-0.5
Exports of goods and services	-1.1	-11.6	8.1	-16.5	-15.8	-11.0	-2.1	8.8	10.5
Imports of goods and services	-5.3	-17.8	2.6	-21.5	-22.2	-17.2	-9.2	2.0	8.1
Gross domestic product	0.9	-3.7	-0.4	-3.5	-4.4	-3.9	-3.0	-1.3	-0.1
Other variables									
Employment	-0.5	-6.6	-2.1	-6.2	-7.1	-7.2	-6.0	-3.7	-2.5
Unemployment (% labour force)	11.3	18.0	19.7	17.4	17.9	17.9	18.8	20.0	20.1
Consumer price index	4.1	-0.3	1.6	0.5	-0.7	-1.1	0.1	1.1	1.6
Unit labour costs	4.9	1.0	-0.7	1.9	1.7	0.3	0.0	-0.7	-1.0
Current account balance (% GDP)	-9.6	-5.5	-4.2	-8.6	-4.7	-4.0	-4.7	-6.0	-5.0
Net lending or net borrowing rest of the world (% GDP)	-9.2	-5.1	-3.8	-8.3	-4.2	-3.7	-4.4	-5.3	-4.3
General government financial balance (% GDP)	-4.1	-11.2	-9.5						
FINANCIAL MARKETS									
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	3.3	2.7	3.3	3.5	3.4	3.7	3.5
10-year German bonds	4.0	3.3	3.0	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

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SMEs, keys to recovery

Hard hit by plummeting demand, threatened by globalization, facing unexpected financial difficulties and tackling a regulatory environment that has often been yet another obstacle, the more than three million small and medium-sized firms in Spain have suffered the worst of the crisis. A difficult time in addition to the customary competitive challenges facing SMEs, forcing entrepreneurs to redouble their efforts in order to navigate such rough waters. Because entrepreneurs make SMEs, their commitment and dedication, their view of the market, their management experience, their knowledge of the sector, their ability to take on risk. SMEs represent the entrepreneurial spirit in its purest state.

But the evidence shows that good entrepreneurs are not enough. The environment is also vital. A stable economy, with access to sources of both finances and skilled workers, good infrastructures and a suitable framework of labour, financial and accounting regulations are all essential to creating the right mix for SMEs to be born and grow. Society at large needs to realize and appreciate the crucial role played by SMEs in economic life and the development of shared wealth. Studies have confirmed that, proportionally, small firms create more jobs than large ones. Moreover, the new firms started up generate more competition and also make it easier for large firms to outsource, leading to synergies that enhance the progress and development of the economy in general and society.

Business people, public authorities and economic and social agents must sort out their capacities in order to optimize results. Entrepreneurs, committed to growing the business and striving to take on new challenges, and the rest, provide resources that help to overcome the intrinsic deficiencies of SMEs. In particular, their lower work factor productivity compared with large firms, in general resulting from the sector orientation, capital intensity or economies of scale, among other factors. Moreover, in a world where innovation and internationalization are decisive in economic progress, it's important to recognize that SMEs play a fundamental role. In the case of innovation resulting from big investment in research and development, it's evident that such heights are off limits to SMEs, but when we look at non-technological innovation, their role is key. This is a wide range of innovations that do not come out of the laboratory but result from contact with clients, suppliers and the market; particularly in a world where consumers develop a preference for variety, leading to many different demand niches that can be exploited with the agility and adaptive capacity of small firms.

On the other hand, SMEs must also be capable of taking on the challenge of globalization, although this may seem contradictory to their size, taking advantage of advances in information and communication technologies, establishing strategic alliances and cooperation networks that reduce the effects of economies of scale. Here economic policies (international promotion, providing efficient technological structures) also have a vital role to play.

SMEs were the first to notice the crisis but they will also be the first to bear out the recovery, once again contributing decisively to growth, to creating jobs and to supporting local and regional economies. Their success will be the success of all.

EXECUTIVE SUMMARY

The growth of the euro area comes as a pleasant surprise after a first half of the year hit by financial storms and austerity plans.

Germany drives the euro area and growth forecasts increase.

In contrast with the euro area, figures are disappointing from the United States and China and doubts appear as to whether growth can be sustained...

The euro area firms up its recovery but the United States weakens

The first half of 2010 was marked by the consolidation of the international recovery and the flaring up of new financial storms, this time caused by the sovereign debt crisis. The United States, on the part of advanced countries, and China, on the side of emerging economies, seemed to take the lead and guarantee a definitive exit from recession. Europe, however, was immersed in uncertainty created by the high public deficits of some economies, the doubts regarding the capacity of some governments in the euro area to meet their debt payments, the withdrawal of fiscal stimulus plans and fears that the single currency would not be able to withstand the stress.

The fiercest flames of the euro area's debt crisis had only just been extinguished (thanks to the response of authorities and especially to the publication of the banks' stress tests) when the euro area provided us with a very pleasant surprise. In mid-August the growth data were published for the second quarter of 2010, in which the old continent's economy had progressed by a resounding and unexpected 1.0% compared with the previous quarter, placing the year-on-year rate of change for gross domestic product (GDP) at 1.7%. There have now been four consecutive quarters of growth and, what's more, after the sharp rise recorded, the trend is now clearly positive.

This burgeoning of the euro area has been particularly thanks to the surprising

improvement in the German economy, posting a 2.2% rise quarter-on-quarter, the best figures since the country's reunification. Because of this upswing, the Bundesbank has upgraded its growth forecast for 2010 by more than one percentage point, setting it at 3.0%. These good growth figures have also been accompanied by a significant and no less surprising rise in investment, suggesting that the path taken by the recovery is firm and that the German economy might well have regained all the ground lost during the crisis by 2011.

The rest of the economies in the euro area presented no surprises, however. Growth in France and Italy was 0.6% and 0.4% respectively and, at the tail end of the recovery, were Spain and Portugal, both growing by 0.2%, and above all Greece, which posted a fall of 1.5% and is the only country still in recession.

In contrast to the results of the euro area, the signs of a slowdown appearing in the United States and China have cooled off the favourable expectations produced in the first half of the year. Up to a point, analysts already expected the pace of growth to ease back, both in the case of the United States, due to the gradual disappearance of the fiscal impulse and other temporary factors, and in China, given that, months ago, the government adopted a series of restrictive measures to avoid overheating.

In the case of the United States, second quarter GDP grew by 0.6% quarter-on-quarter. This change in tone of the economy's perceived capacity to recover

is mostly due to three factors. Firstly, the downgrading of GDP for the previous quarters, placing the starting point for the recovery lower than had been believed. Secondly, one of the components downgraded the most is private consumption, a bastion of the US economy. Moreover, most monthly indicators show that the slowdown occurring in the third quarter is quite acute. All this means that the fear of a recessionary and deflationary situation in the American economy has reappeared, although this is still deemed very unlikely.

Indicators for the Chinese economy also reveal a certain deceleration, with the Asian giant's GDP growing by 10.3% year-on-year in the second quarter. The pace of growth is still solid, it's true, but it's 1.6 percentage points less than the figure recorded in the first quarter. Moreover, as in the US, most monthly indicators show a clear slowdown. For example, in July the PMI (purchasing managers' index) fell for the third consecutive month and industrial production and retail sales posted clearly lower rates of growth than for the first quarter.

Given the challenges appearing in this atypical post-financial crisis scenario, the main central banks have once again displayed notable flexibility in the orientation and implementation of their policies. The Federal Reserve (Fed) made use of additional quantitative measures to reinvest the sums from their mortgage bond portfolio maturing by buying up public debt. In this way, the Fed aims to avoid the risk of moving too fast in toughening up its monetary policy, given the fragile state of the economy, which the organization itself has recognized by slightly downgrading its growth and inflation forecasts.

The European Central Bank, however, has taken advantage of the improved

macroeconomic conditions in Europe to virtually stop its public debt purchase programme in secondary markets, as well as slightly reducing the loans requested by financial institutions. Consequently, excess bank reserves in the system have fallen and the one-day interbank interest rate (EONIA) saw a modest but revealing rise. The Euribor interbank interest rate has continued to increase gently, cushioned in August by greater confidence among banks and after the stress tests were published on 23 July.

Trends in the main international stock market indices reflect the shift in concerns regarding global recovery. Fears of a possible double-dip recession for the global economy might continue for some time yet. In the medium term, however, we expect that the continued improvement in corporate profits, the improvement in the state of the financial sector and the fall in sovereign debt yields for countries on the periphery of the euro area will help to push the stock markets up.

The Spanish economy is developing along similar lines to that of Europe, albeit with some important differences. Its economy is still recovering but at a slower pace than the euro area average. In the first half of the year, GDP grew in quarter-on-quarter terms and the year-on-year rate of change has improved substantially, standing at -0.1%, on the point of leaving negative figures. The problems of confidence in international markets due to the knock-on effect of the Greek fiscal crisis have forced the early withdrawal of fiscal stimuli and an intensification of the budget cuts, focusing on expenditure (wages, pensions and public works) and also on revenue (higher value added tax (VAT), among others). The austerity of the public sector, together with private sector deleveraging, might slow up the speed at which the country exits the

...although China continues to grow significantly.

The Fed postpones its normalization of monetary policy.

The Spanish economy follows in the wake of Europe...

**...supported by growth
in household consumption...**

recession but ensures its recovery will continue in the medium term.

Domestic demand, which plummeted at the peak of the crisis, showed signs of being close to stabilizing in the second quarter, now at -0.5 percentage points. One of the main reasons for this improvement has been the growth in household consumption. After seven consecutive months of shrinkage, this grew by 2.0% in year-on-year terms, a figure not seen since early 2008. Although all the components of household expenditure have seen positive growth, of note are consumer durables, up more than 13.0%. This is fundamentally due to purchases being made earlier to avoid the VAT hike in the third quarter. Gross fixed capital formation continued to moderate its year-on-year drop, going from -10.5% in the first quarter to -7.0% in the second, but it still has a long way to go.

The foreign sector is still driving business but this time its contribution to growth was just 0.4 tenths of a percentage point. Exports of goods and services increased their growth, from 8.8% to 10.5%, as the European economy became more dynamic. However, imports also increased their year-on-year growth, from 2.0% to 8.1%.

The improved economic situation is starting to have an effect on the labour

market. Employment, measured in terms of full-time equivalent jobs, has moderated its decline by 1.2 percentage points, while data from the labour force survey point in the same direction. In the second quarter, the number of employed rose by 82,700 people compared with the figure for first quarter. This is the first rise in two years, although seasonal factors have played their part. The figures for those registered as employed with Social Security in July also show an increase but, once seasonally adjusted, this becomes a fall of 27,000 people, so that we still can't say that job losses have stopped.

Together with the improvement in economic activity, the doubts regarding the solvency of the Spanish financial sector have also gradually dissipated. The vast majority of financial institutions achieved the targets for capital agreed by the Committee of European Banking Supervisors. In the third quarter, household expenditure on consumption might fall as a result of purchases made early to avoid the hike in indirect taxes. However, the improved confidence of households, the rise in companies' order portfolios and the drive provided by the foreign sector, thanks to euro area's improved prospects, should maintain and bolster the recovery throughout the second half of the year.

30 August 2010

**...and by the continued
pull of the foreign sector.**

**The deterioration in the
labour market is starting
to ease.**

CHRONOLOGY

2009

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.

July 1 **Rise in the general VAT** rate from 16% to 18%, and the reduced rate from 7% to 8%.

9 The government approves the **reforms of the Savings Bank Governing Body Act**.

22 The Ministry of Public Works specifies its **cuts in public works spending**.

23 The Committee of European Banking Supervisors publishes the results of the **stress tests** on European banks.

AGENDA

September

- 2** Registration with Social Security and registered unemployment (August).
Governing Council Central European Bank.
- 8** Industrial production index (July).
- 10** CPI (August).
- 16** Quarterly labour cost survey (second quarter).
- 21** Fed Open Market Committee
International trade (July).
- 24** Producer prices (August).
- 28** Central government revenue and spending (August).
- 29** HCPI flash estimate (September).
Retail and consumer goods (August).
- 30** Balance of payments (July).

October

- 4** Registration with Social Security and registered unemployment (September).
- 6** Industrial production index (August).
- 14** CPI (September).
- 15** EU HCPI (September).
- 20** International trade (August).
- 21** Governing Council of the European Central Bank.
- 25** Producer prices (September).
- 26** Central government revenue and spending (September).
- 27** Retail and consumer goods (September).
- 29** Balance of payments (August).
Labour Force Survey (third quarter).
HCPI flash estimate (October).
US GDP (second quarter).

INTERNATIONAL REVIEW

United States slows up due to the stock cycle easing off and strong imports.

The national account review confirms the rise in household savings.

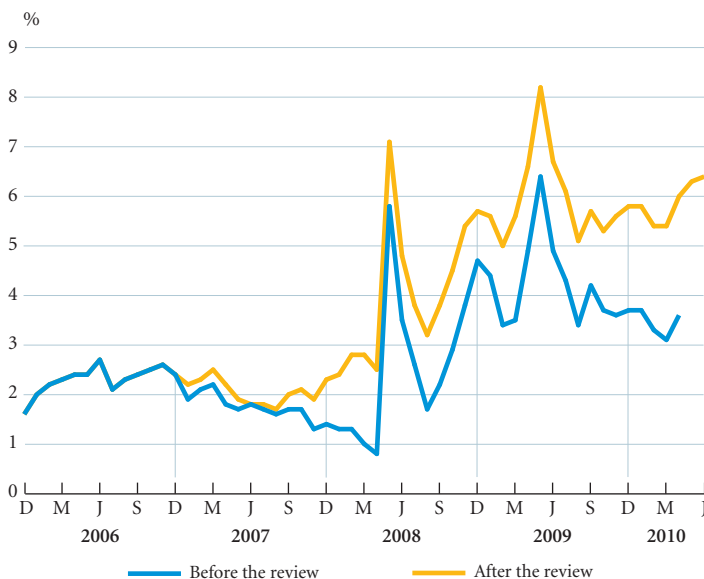
The United States: A tougher reality than expected

In the second quarter, the gross domestic product (GDP) of the US economy grew by 1.6% annualized quarter-on-quarter. The risks inherent in weak growth have therefore gained ground over the risk of inflationary tension. Although base effects took year-on-year growth to 3.0%, it's true that the slowdown compared with the first quarter was greater than expected and the recovery appears to be weaker than what had been anticipated. We have therefore downgraded our growth forecast for 2010 by two tenths of a percentage point to 2.8%.

In addition, July's usual review showed that the starting point for the recovery is lower than what had been first supposed, with an economy that posted zero growth in 2008 and a drop of 2.6% in 2009. The new national accounts for the last three years show a greater slowdown in private consumption that, in turn, is having a significant effect on the household savings rate. In June, household savings reached 6.4% of gross disposable income while, during the last year, it had remained consistently over 5.0%, rates clearly above the figure of 3.0% that had been bandied about before the review and more consistent with the situation

THE UNITED STATES: HIGHER SAVINGS THAN SUPPOSED

Household savings rate as percentage of gross disposable income



SOURCES: Bureau of Economic Analysis and own calculations.

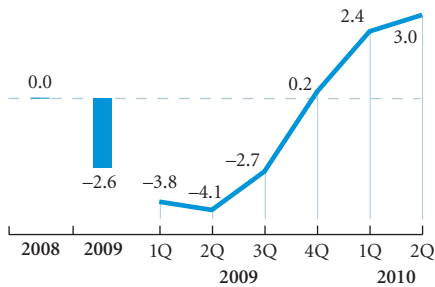
of reducing household debt, the state of the real estate market and continuing high unemployment.

By way of compensation, public consumption has been higher than previously estimated. But it's capital

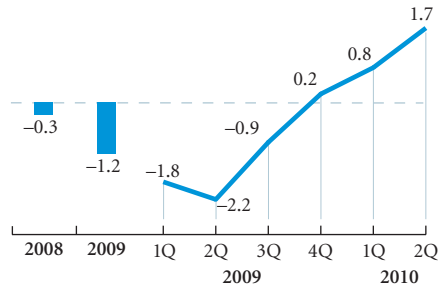
TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms

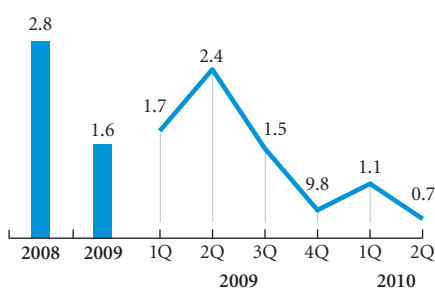
GDP



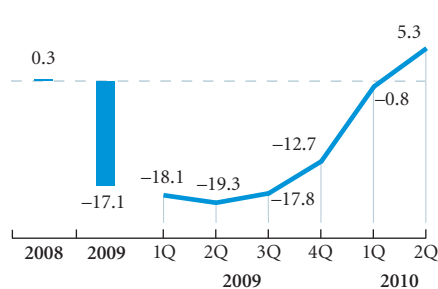
Private consumption



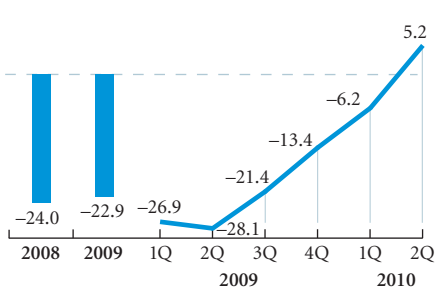
Public consumption



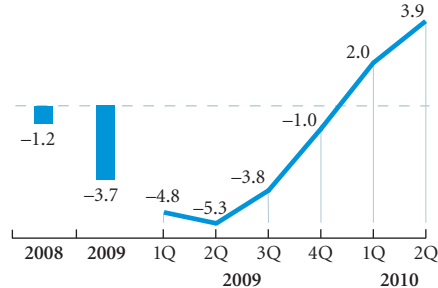
Non-housing investment



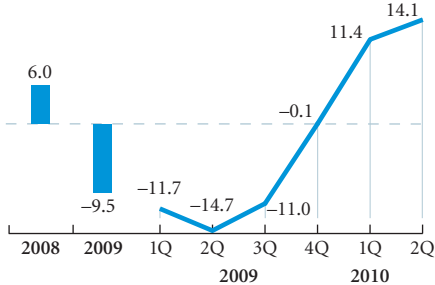
Housing investment



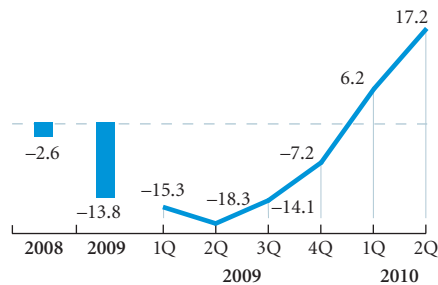
Domestic demand



Exports of goods and services



Imports of goods and services



SOURCES: Bureau of Economic Analysis and own calculations.

Retail sales reflect consumer pessimism.

goods investment that's established itself as the main bastion to the recovery, with a third quarter of solid rises. In the case of residential investment, the second quarter's strong growth was due more to the downgrade in the already weak figures for the previous quarters than to any real recovery in the sector. With regard to the foreign sector, the slowdown in exports went hand in hand with continued pressure from imports, where the sharp upswing in foreign purchases in the second quarter particularly stands out, although this should calm down over the coming months given the weakness of private consumption.

Elaborating on this dwindling consumer appetite, retail sales without cars or petrol saw their fourth consecutive month of weakness in July, with a slight fall of 0.2% compared with June. Discounting the effect of price variations, retail

consumption was 2.9% below the figure posted for December 2007, the level representative of the situation before the crisis. Within this same weak tone, July's Conference Board Consumer Confidence index fell sharply for the second month in a row.

On the supply side, non-financial firms continue to be the most robust part of the recovery, as shown by trends in capital goods investment in the national accounts. However, over the last two months business prospects have gone slightly downhill, although they are still clearly on the optimistic side, with the business sentiment index of the Institute for Supply Management rising slightly to 60.4 points in manufacturing and 60.3 points in services. While the manufacturing situation is consistent with high levels of growth, services, the area concentrating 83.2% of all private employment, are seeing a more modest

Entrepreneurs lose some of their optimism while industry sees slow recovery.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	2Q	July
Real GDP	0.0	-2.6	-4.1	-2.7	0.2	2.4	3.0	—
Retail sales	-1.0	-6.3	-9.9	-7.0	1.9	5.7	6.9	5.5
Consumer confidence (1)	58.0	45.2	48.3	51.8	51.0	51.7	58.2	50.4
Industrial production	-3.3	-9.3	-12.7	-8.6	-3.8	2.7	7.2	7.7
Manufacturing (ISM) (1)	45.5	46.2	43.0	51.4	54.6	58.2	58.8	55.5
Housing construction	-32.9	-38.4	-46.9	-32.0	-14.8	16.5	12.0	-7.0
Unemployment rate (2)	5.8	9.3	9.3	9.6	10.0	9.7	9.7	9.5
Consumer prices	3.8	-0.4	-1.2	-1.6	1.4	2.4	1.8	1.2
Trade balance (3)	-698.8	-374.9	-502.8	-414.5	-374.9	-399.7	-451.5	...
3-month interbank interest rate (1)	2.8	0.7	0.8	0.4	0.3	0.3	0.5	0.5
Nominal effective exchange rate (4)	74.5	77.7	79.6	75.3	72.8	74.8	77.6	76.7

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.

expansion. In line with the improved situation in manufacturing, July's industrial production shook itself out of its lethargy in June and continued to consolidate its recovery, with a general index that has regained 7.9% of the 14.9% it managed to lose during the crisis. Industrial capacity utilization rose to 75.8% of the total, its highest percentage since the end of 2008 but clearly lower than the historic average of 81.0%.

The housing market is still weak in spite of contributing positively to growth in the second quarter. The 546,000 homes started in July, in annual terms, are far from the 1,600,000 homes started in the years before the bubble. Housing sales are not showing much sign of livening up either, with clear declines as from the end of governmental aid. The Case-Shiller index for second-hand house prices rose modestly in April and May,

although still far from showing any clear upward trend, while the confidence index for builders from the National Association of Home Builders fell in July to its lowest level since March 2009. Housing's problem lies in the surplus supply in the market which, in turn, is being boosted by mortgage foreclosures that, in the first quarter, continued at record highs, with 9.5% of all mortgage loans showing delays due to non-payment longer than 90 days.

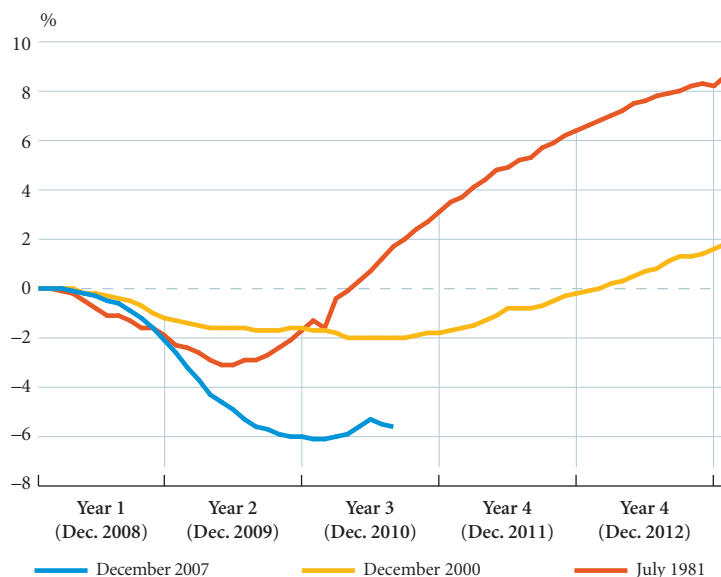
One of the main obstacles to recovery in the housing market continues to be the weak labour market, a situation that looks like lasting until the first half of 2011. 630,000 new jobs were created in the private sector during the first seven months of 2010, a very slow pace to offset the 8.5 million lost in 2008 and 2009. The unemployment rate stood at 9.5% in July while the share of long-term unemployed, who are difficult to

Construction and the housing market are still stuck in the doldrums.

Unemployment stands at 9.5% and the labour market is only recovering slowly.

THE UNITED STATES: THE DETERIORATION IN EMPLOYMENT IS GREATER THAN IN OTHER RECESSIONS

Loss of jobs as percentage of all employed workers at the start of the decline (*)

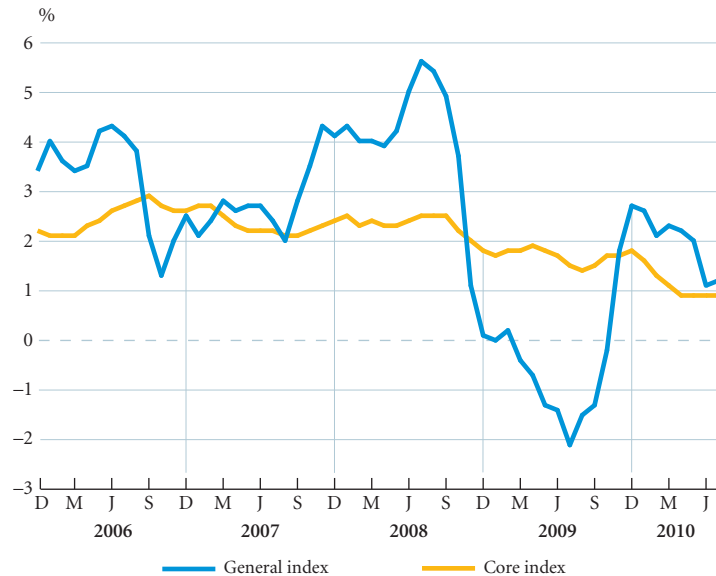


NOTE: (*) The dates in brackets correspond to the last recession (December 2007).

SOURCES: Department of Labor and own calculations.

THE UNITED STATES: STABLE PRICES

Year-on-year change in core and general consumer price index components (*)



NOTE: (*) The core index excludes food and energy.
SOURCES: Department of Labor and own calculations.

The CPI's up 1.2% and core inflation continues rising, by 0.9%.

relocate, has hit a record high of 44.9%. The large number of discouraged workers and those involuntarily working part-time will make it difficult for the unemployment rate to fall significantly as long as economic growth doesn't get any faster.

Prices remain sluggish. The general consumer price index (CPI) for July was up 1.2% year-on-year, while weak consumption and the low utilization of production capacity meant that core inflation rose by 0.9% year-on-year for the fourth consecutive month. The weakness in the housing market has also had an impact here, as the owners' equivalent rent of a primary residence continues to push the price indices down.

Weak consumption is not moderating the trade deficit.

The foreign sector has deteriorated significantly, in spite of domestic demand moderating and the relative stability of oil

prices, thereby slowing up the adjustment started in 2006. Along these lines, June's trade deficit for goods and services was 49.895 billion dollars, 8 billion higher than the previous month and now at pre-crisis levels. The trade deficit excluding oil and its derivatives reached its highest level since 2007 because of products imported from East Asia and, although the bilateral deficit with China is 42.0% of the total, in July the deficit with Japan also increased sharply.

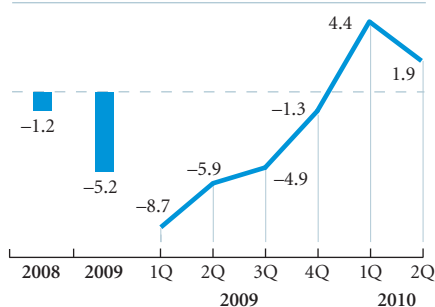
Japan: weak domestic demand rules the day

The Japanese economy grew by 0.4% annualized quarter-on-quarter in the second quarter, a clear slowdown compared with the figure for the first quarter. Year-on-year growth eased back 4.2% to 1.9%. The main cause of this slowdown was weak private

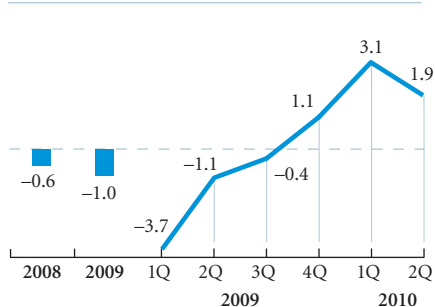
TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms

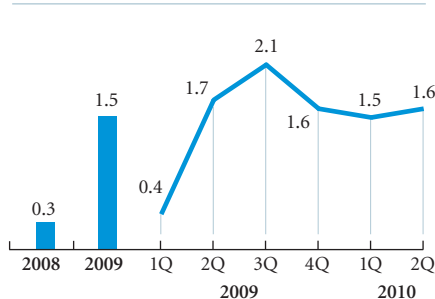
GDP



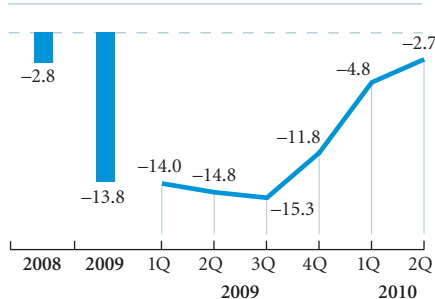
Private consumption



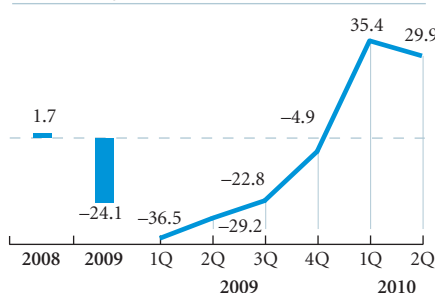
Public consumption



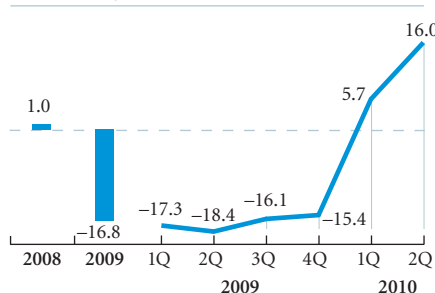
Gross fixed capital formation



Exports or goods and services



Imports or goods and services



SOURCES: Institute of Economic and Social Investigation and own calculations.

consumption, which practically came to a halt after growing in the order of 2.0% in the first quarter thanks to government stimuli.

Capital goods investment and public consumption slowed up while construction lost pace again. For its part the foreign sector continued to contribute positively to growth, albeit at a lower rate than in the first quarter of the year. With these figures, the Chinese economy will

overtake the Japanese economy in 2010, in current terms.

Weak domestic demand, within a deflationary climate, and the burden of heavy borrowing by the public coffers, the highest of all rich economies, have got the better of the energy shown by exports and are taking the Japanese economy to the edge of a double-dip recession. During the first four months of 2010, industry had established itself as a bastion

Japan is slowing up and only grows by 0.4% because of weak domestic consumption.

JAPAN: INDUSTRY'S RECOVERY PUT ON HOLD

Industrial production index



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

The recovery in industry and investment comes to a halt.

of strength and supported the recovery but, after stagnating in May, industrial production fell in June, now 13.1% below

the level of May 2008, at the start of the crisis. Investment prospects also cooled off during this period.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009			2010		
			2Q	3Q	4Q	1Q	2Q	July
Real GDP	-1.2	-5.2	-5.9	-4.9	-1.3	4.4	1.9	-
Retail sales	0.3	-2.3	-2.8	-1.9	-0.7	3.8	3.7	...
Industrial production	-3.4	-21.8	-26.9	-20.5	-5.1	27.1	21.1	...
Tankan company Index (1)	-2.8	-40.8	-48.0	-33.0	-24.0	-14.0	1.0	-
Housing construction	2.5	-27.6	-31.9	-35.9	-20.7	-6.7	-1.1	...
Unemployment rate (2)	4.0	5.1	5.1	5.4	5.2	4.9	5.2	...
Consumer prices	1.4	-1.4	-1.0	-2.2	-2.0	-1.1	-0.9	...
Trade balance (3)	4.2	4.0	1.0	1.8	4.0	6.7	7.4	...
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	102.8	107.5

NOTES: (1) Index value.

(2) Percentage of labour force.

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

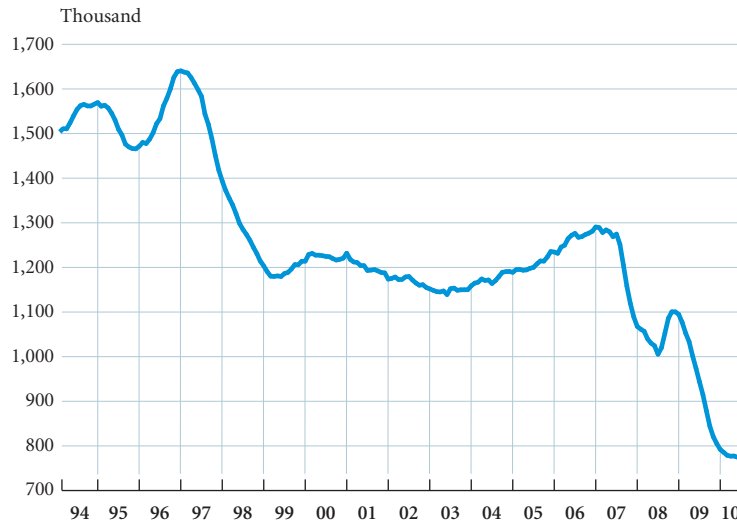
(4) Percentage.

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

SOURCES: OECD, national statistical bodies and own calculations.

JAPAN: CONSTRUCTION DOWN IN THE DUMPS

Number of homes started (*)



NOTE: (*) Moving 12-month figure.

SOURCES: Japanese Ministry of Land, Infrastructure, Transport and Tourism and own calculations.

The real estate market can't manage to pick itself up. In the first quarter of the year, the price of land in the six main cities fell again, accumulating a fall of 16.4% since March 2005. On the other hand, new homes started in June are still at rock bottom, without showing any signs of recovery.

In the labour market, June's unemployment rate saw its fourth consecutive month of rises and reached 5.3%, a moderate rate compared with other economies but close to July 2009's record high. In the case of prices, weak demand continues to encourage deflationary tendencies, which should continue throughout 2011 according to the Bank of Japan's calculations. Consequently, June's CPI posted a drop of 0.7% year-on-year while core inflation, the general index without energy and food, dropped by a more significant 1.5% year-on-year, falling below the level of April 1992.

It's in the foreign sector where the Japanese economy is placing all its hopes, but June's trade surplus fell due to the slowdown in exports, coinciding with the stagnation in industry. Japan's recovery in exports is based mainly on sales to the rest of the Asian continent, in June rising 31.6% year-on-year, higher than the 21.1% in sales to the United States and far from the 9.0% in sales to the European Union. This dependency on exports to Asia, together with weak domestic demand, means that the current possibility of a slowdown in China's growth poses the greatest risk for Japan's economy.

China: growth and moderation, the new Asian double act?

China's GDP grew by 10.3% year-on-year in the second quarter of the year, lower than the 11.9% recorded for the previous quarter. China's growth confirms the strength in Asia, as well as hinting

Land prices continue to fall and construction fails to pick up.

The CPI is down 0.7% and core inflation 1.5%, while unemployment rises to 5.3%.

The trade surplus depends on recovery in East Asia.

China grows a solid 10.3% in the second quarter.

at certain signs of moderation starting to spread throughout the region. Inflation also seems to have eased its growth in most of the continent, with the clear exception of India. In spite of this slight slowdown, no drastic changes are expected in the monetary policies of the different central banks, which some months ago went back to more restrictive measures.

Within this monetary context, the Chinese authorities have adopted several administrative measures to drain off excessive liquidity. In particular, restrictions on new bank lending, which in July stood at 535 billion renminbis, are far below the 774 billion in April and in line with the 7.5 trillion per year set by the central bank. This considerable drop in credit might postpone the expected actions on the interest rate, so widespread in the rest of the continent.

On the other hand, while inflation slowed up in June to 2.9%, in July it picked up and stood at 3.3%. However, this was due to the sharp rise in food prices after the floods affecting the country. So all the evidence available seems to suggest that

this rise will be temporary and that prices will continue the generalised trend to moderate, and we expect inflation to end the year at around 3%. Similarly, house prices rose by 10.3% in July, below the average of 12.2% in the second quarter so that, for the moment, the real estate sector seems to be in for a soft landing.

Most of the business indicators for the months of June and July confirm the combination we mentioned at the start between strength and moderation. Concerning demand, investment in fixed assets was up 24.5% year-on-year in July, slightly below the average of 25.7% in the second quarter. Meanwhile, retail sales rose 14.1% year-on-year in July in real terms, also below the 15.1% of the second quarter.

Among the leading indicators for supply, the purchasing managers' index (PMI) fell for the third consecutive month, reaching 51.2 points in July from the 55.7 points of April. On the other hand, July's industrial production grew 13.4% year-on-year, compared with 16% in the second quarter.

Moderate upswing in July's inflation.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2008	2009	2009		2010		
			3Q	4Q	1Q	2Q	July
Real GDP	9.6	9.1	9.6	11.3	11.9	10.3	–
Industrial production	12.6	12.5	12.3	17.9	19.8	16.0	13.4
Electrical power generation	6.7	6.7	8.0	24.3	24.1	17.8	12.9
Consumer prices (*)	5.9	–0.7	–1.3	0.7	2.2	2.9	3.3
Trade balance (**)	298	197	251	197	149	156	175
Reference rate (***)	5.31	5.31	5.31	5.31	5.31	5.31	5.31
Renminbi to dollar (*)	6.9	6.8	6.8	6.8	6.8	6.8	6.8

NOTES: (*) Average.

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

(***) Percentage at end of period.

Revised figures for GDP growth in 2009 (8.7 versus 9.1 currently).

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

However, this moderation does not seem to have reached China's foreign sector which, totalling 28.7 billion dollars in July, posted the biggest trade surplus of the last 18 months. This was partly due to the slowdown in imports but especially because of strong exports which, with a 38.1% rise year-on-year, surpassed even the most optimistic forecasts and the record reached in July 2008. Once again, the size of the trade surplus and strong imbalance with the United States, around 25 billion dollars, was accompanied by a series of statements from the People's Bank of China repeating their commitment to allow the Chinese currency to appreciate more against the dollar. However, since it was announced at the end of June that the exchange rate would become more flexible, the renminbi has only appreciated a slight 0.4% against the US dollar.

In short, China still enjoys solid growth, as well as seeming to avoid inflationary tensions and the risk of a bubble in the real estate sector. However, domestic consumption needs to play a greater role

in order for the country's progress to become sustainable, something which is still not being observed, particularly compared with the vigorous foreign sector.

Brazil: easing back on the accelerator but not going down a gear

After the spectacular surge of the first quarter of 2010 and its surprisingly dynamic domestic demand, the Brazilian economy is facing a second half of the year marked by elections and a tone of moderation. Although most indicators continue to show signs of expansion, certain restraint can be seen and both the gradual removal of fiscal stimuli and the recent upturn in monetary policy will temper Brazil's economic progress over the coming months. Nonetheless, we still expect growth greater than its potential in the second half of the year and maintain our forecast of 7% for the overall figure for 2010.

The fundamental reason is no other than the steadfast and continued strength of

Industrial production, retail sales and investment continue to grow, although at a slower pace.

The foreign sector, immune to this moderation, posts its biggest surplus in 18 months.

Brazil's facing the second half of 2010 with a moderate tone but is still growing more than its potential.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010		July
			3Q	4Q	1Q	2Q	
Real GDP	5.1	-0.2	-1.3	4.4	8.9	...	-
Industrial production	2.9	-7.3	-8.6	6.2	17.2	14.2	9.8
Consumer confidence (*)	140.4	138.3	141.9	154.2	158.1	154.6	155.2
Unemployment rate São Paulo (**)	13.0	12.8	13.1	11.8	12.3	13.2	...
Consumer prices	5.7	4.9	4.4	4.2	4.9	5.1	4.6
Trade balance (***)	24.8	25.3	26.4	25.3	23.3	19.3	17.8
Interest rate SELIC (%)	11.25	11.25	8.75	8.75	8.75	10.25	10.75
Reales to dollar (*)	1.8	2.3	1.8	1.7	1.8	1.8	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.

Inflationary pressures take a breather while the real continues to pose a risk.

domestic demand, boosted by the robust job market and credit and persistently high confidence among Brazilian consumers in their country's economic development. In July, although gradually slowing up its rate of growth, industrial production continued upwards with a rise of 9.8% compared with the same month last year. Concerning demand, retail sales also surprised again with an extraordinary increase of 10.3% year-on-year in June.

Although, in the first half of the year, this same vigour led to the reappearance of inflationary pressures and fears of the risk of overheating, inflation dropped back to 4.6% in July, thanks largely to the decline in food prices. Nonetheless, and although economic growth is expected to be slower in the rest of the year, the firmness of domestic expenditure and the high installed production capacity utilization (82.7% in June) suggest inflationary pressures will appear again, so we expect at least another rise in the SELIC rate this year.

On the other hand, the upward trend in the reference rate increases the cost of the sterilization carried out by Brazil's central bank in order to slow up the renewed and persistent appreciation of the real. An appreciation with obvious, harmful effects on the foreign flank of demand, which continues to fall steadily. Fortunately, its huge domestic expenditure more than offsets this effect and continues to boost, single-handedly, the Amazon giant's economic progress... for the moment.

Mexico: starting up its second engine

Growth figures for the second quarter of 2010 exceeded the expectations of the consensus. With resounding growth of

7.7%, the Mexican economy posted its second positive year-on-year figures since September 2008 and therefore consolidates its recovery. Supporting these good annual figures, the quarter-on-quarter comparison also posted growth of 3.2% compared with the first quarter of 2010. By component, growth in GDP continues to be mostly thanks to industry, up 7.8% (5.4% in April) compared with the same period a year ago. However, in the period between April and June, both tertiary and primary sectors made a positive contribution, growing by 7.4% and 4.8%, respectively.

So Mexico's recovery continues to look gradual and has been boosted, to date, by foreign demand performing well, fundamentally from the United States. Nonetheless, if the slowdown in growth north of the Río Grande is confirmed, the Aztec economy will soon have to start up its second engine: a domestic expenditure intimidated by the effects of the crisis but that, gradually, is complementing the drive from outside the country's borders.

Leading business indicators certainly point to a gradual reaction by investment and domestic consumption helping the recovery to continue in the second half of 2010, although growth will slow up if exports lose their head of steam, which is likely. Mexican consumer confidence once again exceeded 87 points in July, its highest value since October 2008, encouraged by the improved job market and the gradual recovery in credit.

In the monetary area, and as expected, inflation put an end to the series of decreases started in April with a month-on-month rise of 0.2% in July, the result of higher food and regulated prices.

The recovery progresses in Mexico, dependent on the United States and the revival in domestic expenditure.

Prices revert their downward trend but no inflationary pressures are perceived.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010		July
			3Q	4Q	1Q	2Q	
Real GDP	1.5	-6.6	-6.2	-2.4	4.4	7.7	—
Industrial production	-0.9	-7.0	-6.5	-1.9	5.7	7.5	...
Consumer confidence (*)	92.2	80.5	83.0	78.4	81.5	84.9	87.4
Leading business index	118.0	110.4	110.9	113.4	114.1	116.6	...
General unemployment rate (**)	4.0	5.5	6.3	5.3	5.4	5.2	5.7
Consumer prices	-11.8	0.0	5.1	4.0	4.8	4.0	3.6
Trade balance (***)	-17.3	-4.6	-12.9	-4.6	-1.9	-2.4	-2.2
Official Banxico rate (%)	7.50	6.75	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	10.6	14.2	13.5	13.1	12.3	12.8	12.6

NOTES: (*) Value.

(**) Percentage of labour force.

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

SOURCES: Banco de México and own calculations.

Nonetheless, its annual figure continued to fall (from 3.69% in June to 3.64% in July) so that, in the short term, we still don't expect any changes in monetary policy. This should give an additional boost to domestic expenditure to help it take off once and for all; absolutely vital for when the foreign engine starts to groan.

Widespread rises and oil stable

Oil prices tended to remain stable, fluctuating within a range from 70 to 85 dollars. Consequently, between 20 July and 20 August, the price of crude fell 2.7% to 74.13 dollars per barrel (Brent quality, for one-month deliveries), a minimum drop of 4.7% this year and practically identical to its value one year ago, illustrating its moderate trend over the last twelve months.

The cooling off of prospects for global growth in the last few months has slowed

up even more, if possible, the trend in oil prices. Consequently, by the end of 2010 crude should be around 80 dollars per barrel, somewhat below the level expected two months ago.

The other commodities have mostly increased, the Economist index rising 8.3% between the 20 July and 20 August. The main reason for this upward trend lies in the drought in Russia and the Ukraine, added to the already upwardly mobile tendency of food prices. Wheat, up 36.1%, and barley, with a rise of 14.4%, dominated these increases, while coffee continued to rise after its big gains in May and June. Among metals, of note was iron, appreciating 25.1% after the new quarterly contracts were introduced in April. Nickel, aluminium and copper were also up, the last being affected by the limited capacity of facilities dating from the eighties. For its part, gold continued upwards with rises of 2.8%.

Oil falls 2.7% and drops below 75 dollars per barrel.

Oil slows up its progress due to lower growth.

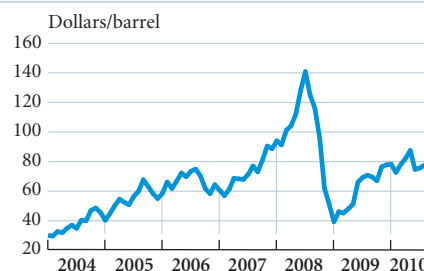
Food prices rise due to the Russian drought and top the widespread increases over the period.

TREND IN VARIOUS COMMODITIES (*)

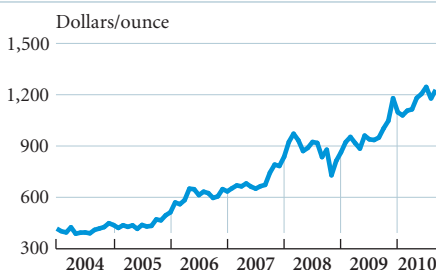
«The Economist» index



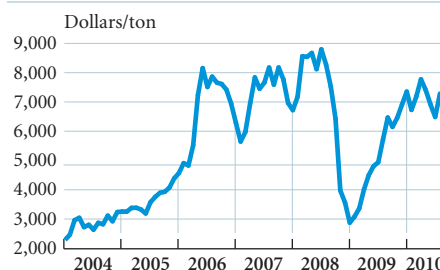
Brent oil



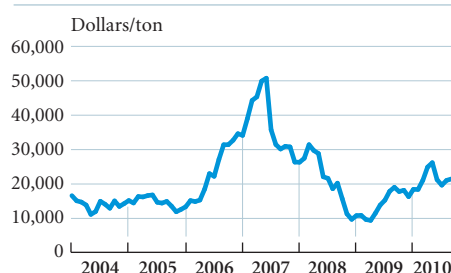
Gold



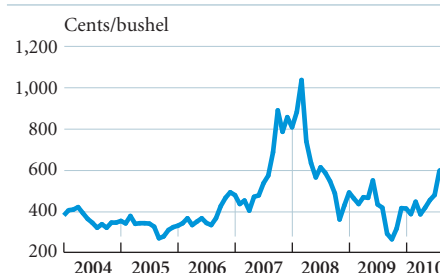
Copper



Nickel



Wheat



NOTE: (*) Figures for last day of month (last date August 20).

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

SMEs: cradle of great firms

The most famous porcelain firm in Spain, and probably the world over, started out as a small business in the region of Valencia. After firing their first plates, tiles and the odd jug in the family courtyard, the Lladró brothers founded their own company to produce classic figurines in the middle of the last century. This firm would grow non-stop, eventually creating a fabulous corporate network and exporting its products to more than a hundred countries.

The Lladró case illustrates the huge potential of a small firm but, nevertheless, not all SMEs complete this journey. In spite of growing more quickly than their larger peers, the vast majority never cross the threshold of 249 workers, the limit that distinguishes a medium-sized firm from a large one. Nevertheless, the value of SMEs

is irrefutable and not merely because of them being a «potentially large firm» but also because of the intrinsic value entailed by their particular weight in today's business world. In Spain, 99.9% of the firms censored are SMEs, contributing more than two thirds of value added and employing more than 75% of the total workforce. Moreover, their format also affords them certain advantages compared with a large firm, such as a greater capacity to adapt to their surroundings and being more dynamic in creating jobs which, in turn, improves the diversification and flexibility of the economy they form part of. Hence the interest, both theoretical and in practice, in understanding what actually determines the birth and growth of a small or medium-sized enterprise.

Economic theory has linked the start-up of small firms to a number of qualities possessed by the entrepreneur and certain conditions in the environment in which the firm is created or inhabits.⁽¹⁾ Classic economists and the Austrian school already recognized the entrepreneur as an individual with special traits: in 1921, Frank H. Knight attributed entrepreneurs with a greater determination and ability to take decisions, secure capital and accept the risk of failure; years later, Schumpeter highlighted their skill in spotting business opportunities and innovating. Over time, new hypotheses have gradually extended this list of skills that supposedly expand the capacity of entrepreneurs to start up a firm, such as experience in the sector and a greater tolerance for uncertainty, as well as other character traits that intensify their motivation to take on the business world, such as a desire for independence or the need for self-realization. It has also been suggested that business is easier to carry out in stable macroeconomic environments, with access to capital and a skilled workforce, better infrastructures and a favourable regulatory framework, among other factors (see the table below for a more exhaustive list).

Empirical evidence notes the influence of the environment on start-ups. The regulatory situation is particularly illustrative: as shown in the graph below, the ratio of new firms per inhabitant tends to be lower in those countries with more regulatory barriers to starting up a business. Unnecessary external barriers (bureaucracy, complex tax regulations, etc.) are particularly detrimental to SMEs as they lead to a higher relative cost, both in terms of time and money, than for a large firm. This makes it difficult not only to start up a company but also to expand it later on.

Growth may be considered as the second big goal of a firm, the first being its survival. In any case, both objectives go hand in hand for small companies: young firms that grow the most are also the most likely to survive. It's therefore no surprise that the literature on business dynamics has invested a lot of effort in understanding why some firms grow and others don't. Although no theoretical consensus has been reached, different hypotheses have been put forward that are based on two broad approaches. The first takes the perspective of the company life cycle (they are born, grow, mature, decline and die) and sees expansion as a natural phenomenon in their evolution; the second, however, sees growth as the result of strategic choice. In both cases, the entrepreneur's attitude and aptitude and the business choices and opportunities provided by the environment are deemed to be as crucial for a company's growth as they were for its creation. But, moreover, new elements come into play that are related, on the one hand, to the attributes and resources of the firm itself (age, size or sector) and, on the other, to how the business is run and the strategic choices made by the entrepreneur.

(1) The universe of SMEs is highly diverse so that, given that most recently created firms are small in size, we are focusing here on the small firm.

FACTORS THAT ENCOURAGE THE START-UP AND GROWTH OF A SMALL FIRM

Factors that encourage start-ups...

...and factors that underpin growth

Entrepreneur	Environment	Company	Strategy
Capacity/Ability:	Demand	Age	Management:
Self-confidence	Macroeconomic stability	Size	Delegating everyday work
Tolerance of uncertainty	Favourable regulatory environment:	Sector:	Planning
Commitment and dedication	Simple tax system	Competition	Manager recruitment
Market orientation	Little bureaucracy	Economies of scale	Information and advice
Open to innovation	Competition	Concentration	Continued training:
Open to new technology	Access to financing	Legal form: limited company	Directors and managers
Knowledge of the sector	Access to new technology	Geographic area of influence	Employees
Management experience	Skilled workers	Shared ownership	Innovation:
Freelance experience	Infrastructures and support services		New products
Family background	Closeness of other firms or partners		Technology
Family and social support	Positive view of the firm		Emphasis on quality and differentiation
Age			Market-oriented:
Education			Positioning
Motivation/Determination:			Adaptation
Entrepreneurial intensity			Client concentration
Desire to grow and take on risk			Exports
Independence			Sources of financing:
Self-realization			External capital
Personal security			Emphasis on quality and differentiation
Social recognition			

SOURCE: Own production.

For some, the key to company expansion lies in the very essence of the entrepreneur-manager and what sets him or her apart from the entrepreneur-owner: commitment to growing the business. According to Clark et al. (2001), the owner's unwillingness to grow is the main internal barrier to the growth of a small firm and the principal reason why most SMEs stagnate and decline.⁽²⁾ For others, the crux lies in the planning, how well the management team matches the size of the business, the continued training of the workforce, the systematization of decision-making and a sufficiently flexible business strategy to adapt to the changing conditions of the environment in terms of competition, market dynamics or technological change. Similarly, getting over barriers of an external nature that slow up growth, such as limited access to additional resources, a market with little potential for expansion or an unfavourable regulatory framework, is put forward as crucial for a firm to achieve sustained growth.

Recently, empirical studies that have attempted to test these hypotheses have focused their attention on a very particular group of small firms known as gazelles or high-growth firms. These stand out because they grow faster than the rest and account for the largest share of net job creation. Although no definite conclusions have been

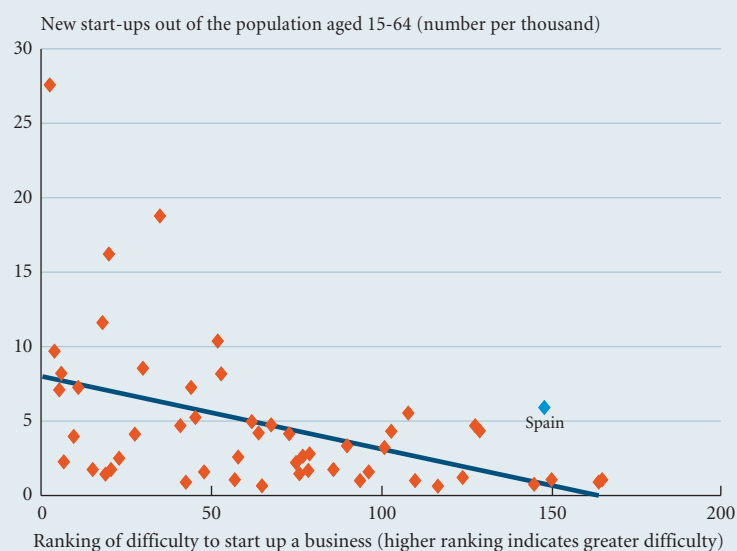
(2) Clark, D., Berkeley, N., Steuer, N. (2001), «Attitudes to growth among owners of small and medium-sized enterprises and the implications for business advice». *International Small Business Journal* 19(3).

reached in this area either, a recent study by the Bank of Spain characterizes this kind of firm in the Spanish case.⁽³⁾ Its findings confirm the existence of huge inertia in terms of business growth: if a firm is a gazelle today, then it's more likely to be one tomorrow as well. Similarly, a young firm is more likely to be a gazelle than an incumbent, so getting rid of barriers to entry would encourage more gazelles to emerge. It also concludes that these firms, in addition to being more productive, also have a higher level of human capital and initial debt, so that making it easier to access these resources should also encourage such firms to develop.

In short, no-one doubts that having a good base of small and medium-sized firms benefits any economy. The SME format is not only the most suitable in certain sectors and circumstances but, moreover, provides dynamism and flexibility, especially in times of crisis. Consequently, if there's the chance to minimize the barriers that stop such firms from being created and growing, then it's worth making the effort. And, in a few years, instead of one Lladró there might be three.

A RELATIVELY UNFAVOURABLE REGULATORY ENVIRONMENT DISCOURAGES THE START-UP OF FIRMS

New start-ups and the difficulty of starting up a business, by country



SOURCES: Own calculations based on World Bank data, WDI (2009) and Entrepreneurship Survey (2008).

(3) López-García, P. and S. Puente (2009), «What makes a high-growth firm? A probit analysis using Spanish firm-level data». Bank of Spain Documento de Trabajo No. 0920.

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EUROPEAN UNION

GDP surprises with strong growth of 1% in the second quarter...

Euro area: signs of strength

Continuing with the general mood before the summer, the euro area's economic situation continued to be crammed with news of some import. The publication of the gross domestic product (GDP) figures for the second quarter, the agreements reached at the Ecofin meeting, the report by the International Monetary Fund (IMF) regarding the euro area's recovery and the publication of the stress tests on European banks are just some of the most important events occurring over the summer. Without doubt, economic news has not taken a holiday.

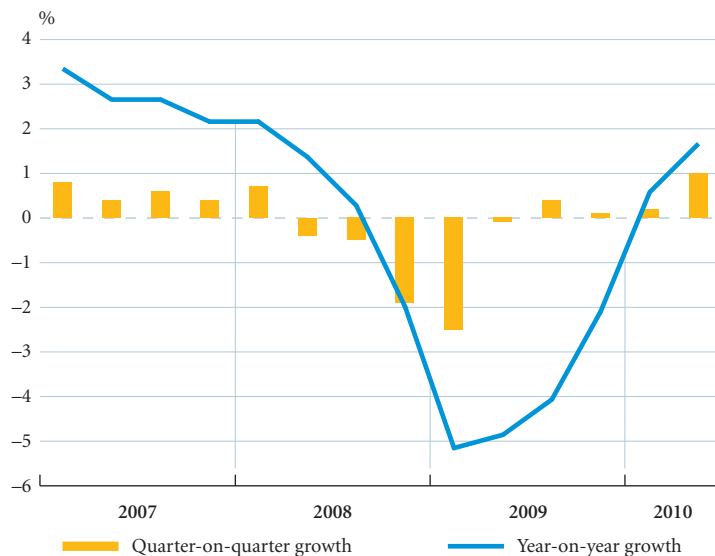
In the second quarter of 2010, the old continent's economy grew by a

resounding and unexpected 1% compared with the previous quarter, placing its year-on-year growth rate for GDP at 1.7%. This has now grown for the last four quarters in a row and, in addition, after the strong growth recorded the trend is now clearly positive.

These growth figures have changed the pessimistic tone of recovery in the euro area. A few months ago, when we compared the pace it was growing at with average growth in the pre-crisis years, the difference was notable. From 1998 to 2008, the average quarter-on-quarter growth in the euro area was 0.6%. That's why the euro area's annual potential growth was around 2% in

SURPRISING INCREASE IN THE EURO AREA'S GROWTH

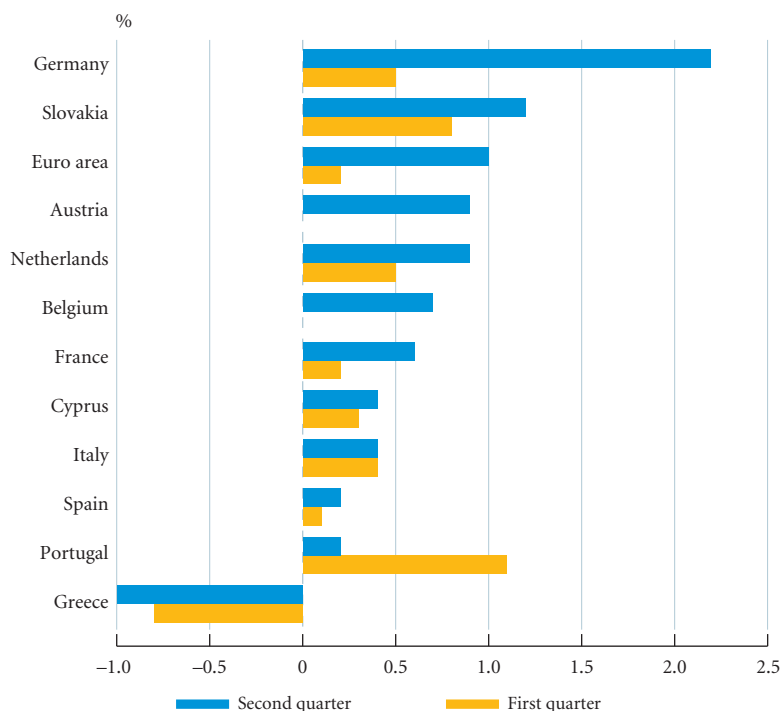
Change in gross domestic product



SOURCES: Eurostat and own calculations.

A RECOVERY AT DIFFERENT SPEEDS

Quarter-on-quarter change in GDP



SOURCE: Eurostat.

general. In the last few quarters, however, the average quarter-on-quarter growth had been around 0.2%. Although this might seem like a small difference, it means that, had this rate of growth continued, GDP would not reach pre-crisis levels for five years, while with an average growth rate of 2% it would only take two years. Hence the importance of the growth figures for the second quarter. Should this rate of growth continue, the pre-crisis level of GDP will be reached in just one and a half years.

But it's not all good news. The return to growth in the euro area is far from homogeneous among the different countries. Germany has provided the biggest surprise, with quarter-on-quarter growth of 2.2%, while France and Italy are growing at a good but less remarkable

pace of 0.6% and 0.4% respectively. Bringing up the rear we find Spain and Portugal with a modest increase of 0.2% and particularly Greece, which has posted a fall of 1.5% and is the only country in the euro area still in recession.

We still don't have the details of the GDP components but monthly indicators suggest that neither of the two fundamental components, consumption and investment, will be behind this big push. Certainly industrial production made strong progress during the second quarter, as did the different indicators for economic sentiment and this could suggest that the growth in investment has been somewhat greater than expected. But the level at which industrial capacity utilization still stands makes any rapid recovery unlikely.

...thanks to the strong push by the German economy.

Investment might provide the odd pleasant surprise...

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010		
			3Q	4Q	1Q	2Q	July
GDP	0.4	-4.1	-4.1	-2.1	0.6	1.7	-
Retail sales	-0.7	-2.3	-2.3	-1.0	0.6	0.5	...
Consumer confidence (1)	-18.1	-24.7	-21.4	-17.0	-16.8	-16.7	-14.0
Industrial production	-1.7	...	-14.4	-7.4	4.9	9.2	...
Economic sentiment indicator (1)	93.5	80.8	84.1	91.9	96.6	99.3	101.3
Unemployment rate (2)	7.5	9.4	9.7	9.8	9.9	10.0	10.0
Consumer prices	3.3	0.3	-0.4	0.4	1.1	1.5	1.7
Trade balance (3)	-1.2	-15.2	-6.3	13.4	26.0	22.2	...
3-month Euribor interest rate	4.6	1.2	0.9	0.7	0.7	0.7	0.8
Nominal effective euro exchange rate (4)	110.6	111.7	112.1	113.8	108.8	103.2	102.5

NOTES: (1) Value.

(2) Percentage of labour force.

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

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

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

...but consumption remains weak.

It's a similar situation with regard to consumption. Confidence indicators are improving, but gradually. Moreover, the situation of the job market and financial system make any fast improvement unlikely. The euro area's labour market, for example, is stuck at high levels of unemployment. In the month of July, the unemployment rate held steady at 10.0%, the same figure since March this year. The consumer price index, a good indicator of consumer tension, remains at a moderate level. In the month of July it rose slightly to 1.7%, after 4 months of remaining stable around 1.5%. However, we don't expect inflationary pressures to increase over the coming months.

Once more the driving force behind growth will more than likely be in the inventory cycle and foreign sector. Exports, for example, pushed forward with 22.8% in the second quarter of 2010 in year-on-year terms.

The IMF points to the need to carry out structural reform.

Naturally, this pace of growth is highly unlikely to continue and, in fact, we are much more likely to see more moderate growth rates in the future. That's why the IMF, in its annual report on the euro area, warns that the pace of recovery in the euro area might be higher if structural reforms were carried out. In general, the IMF recommends fighting on three fronts: competitiveness, fiscal discipline and sorting out the financial sector. The extent of these reforms will largely determine the euro area's potential growth in the medium and long term.

In line with these recommendations, work began on defining some structural reforms at the Ecofin meeting held in July. In particular, the finance ministers of the EU member states tackled the reforms of the regulatory framework for the financial system and the measures to improve fiscal discipline. Next year the Systemic Risk Board is expected to start operations, supervising the stability of the

financial system, as well as the European Semester, a period during which the budgets and structural measures of each country will be analyzed. Both measures could significantly improve the discipline of the financial sector and public sector, but we will have to wait to see the details before evaluating the scope of these reforms.

For the moment, the publication of the stress tests on the banking sector has been a step towards a more transparent economy. This measure had aroused a lot of doubts in some countries but, finally, we can conclude that it has been very positive in terms of dissipating the uncertainty surrounding the strength of the European financial system. It has also helped to identify those banks that need to be recapitalized, improving the stability of the financial system as a whole.

In short, with the publication of the GDP figures for the second quarter, the euro area has provided a show of strength when it most needed one. Moreover, political activity continues to provide clear signs of carrying out structural

reforms to boost the economy's growth potential in the medium and long term. This is undoubtedly very good news and helps to convey a somewhat more optimistic message. But, over the coming months, we'll have to keep a very close eye on the trends in monthly indicators. Although consumer and economic sentiment confidence indices continued to rise sharply in the month of July, it will be very hard to keep up this pace of growth. The pillars on which economic recovery needs to be based, consumption and investment, are still very weak and, with the removal of stimulus measures, may even suffer a slight dip.

The German engine is working at full speed

The main indicators of the last few months hinted at the consolidation of the German recovery in the second quarter of 2010. However, its surprising growth in GDP, 2.2% compared with the previous three months, vastly exceeded all forecasts. This dizzying rise, the highest since its reunification, also raised the year-on-year increase in GDP to 3.7%,

Stress tests show the strength of the European financial system.

This pace of growth is unlikely to continue in the coming quarters.

Germany grows by a surprising 2.2% quarter-on-quarter in the second quarter of 2010...

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010		July
			3Q	4Q	1Q	2Q	
GDP	0.7	-4.7	-4.4	-2.0	2.0	3.7	—
Retail sales	0.0	-2.5	-2.7	-1.8	1.1	0.6	...
Industrial production	-0.1	-15.4	-15.0	-8.0	6.0	12.5	...
Industrial activity index (IFO) (*)	96.8	87.7	89.8	93.6	96.5	101.7	106.2
Unemployment rate (**)	7.8	8.1	8.3	8.1	8.1	7.7	7.6
Consumer prices	2.6	0.4	-0.3	0.4	0.7	1.0	1.2
Trade balance (***)	195.1	140.2	130.9	129.3	140.5	148.4	...

NOTES: (*) Value.

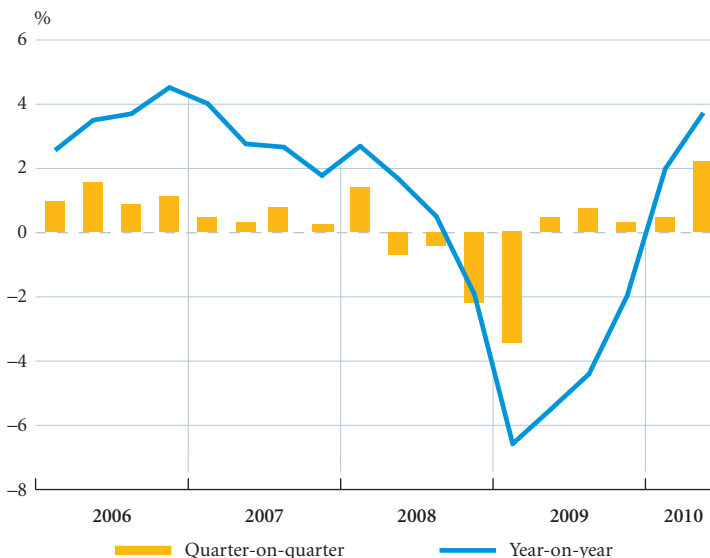
(**) Percentage of labour force.

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

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

STRONG RECOVERY OF THE GERMAN ECONOMY

Change in GDP



SOURCE: German Statistics Institute.

...driven by foreign demand and investment.

placing Germany as the leading player in the European recovery in this period.

As a consequence of this upswing, more befitting a developing than a mature economy, the Bundesbank upgraded its growth forecasts for 2010 by more than one percentage point, placing this around 3%. In spite of the fact that this trend is expected to ease in the coming quarters, by 2011 the German economy will have made up all the ground it has lost since the crisis began.

The breakdown of GDP by component shows investment and foreign demand as the main engines behind this recovery, each contributing 0.9 percentage points to growth. Increased vigour in world trade and the depreciation of the euro, making German products more competitive, boosted German exports, which grew by 24.6% year-on-year in the second quarter of the year. Given that the German products exported need, in turn, components from abroad, imports also

grew by 26.6% in the same period. Nonetheless, the trade surplus increased to 36.2 billion euros, 14.4% above the figure for last year.

This figure once again highlights the German economy's great dependence on the performance of foreign trade flows. Consequently, after the sharp shrinkage in foreign demand in 2009, behind more than two thirds of the German recession, the revival in exports has increased its rate of expansion. However, the United States and China, the main consumers of German products after the European Union, have seen their growth slow up in the last few months. This, and the still weak recovery of some European countries, suggests that foreign demand will be less dynamic in the second half of the year.

Given this easing back of the foreign contribution, domestic demand will determine the extent of the German recovery. On the supply side, after a first

Sharp upswing in industrial activity.

quarter marked by tough weather conditions, the most frequent indicators show business to be picking up strongly. Between April and June, industrial production grew 12.5% year-on-year, the greatest increase in the last forty years. This rise and the improvement in industrial capacity utilization stimulated investment, up by 4.7% quarter-on-quarter in this period.

The performance of this component in the future is uncertain. In spite of industrial orders doing well in June, as well as the IFO index in July, the PMI figures for August show a significant relapse. Growth in investment is therefore expected to slow up in the second half of the year.

For their part, the year-on-year growth in retail sales, 0.6% in the second quarter, is evidence of recovery in private consumption. The sharp rise in consumer confidence in July, boosted by unemployment falling to 7.6% that month, will help private consumption to increase further. This will continue to push German prices up, which grew 1.2% year-on-year in July, far from the negative figures recorded a year ago. Given this context of economic consolidation, consumer prices are expected to go on rising during the second half of the year.

France gradually recovers

In the second quarter, and according to preliminary figures, the French economy grew by 0.6% compared with the previous quarter, higher than the 0.2% posted in the first quarter. Consequently, the year-on-year rise in GDP in this period was up five percentage points, standing at 1.7%. However, in spite of this acceleration in GDP, the recovery is still fragile as it depends largely on fiscal

adjustment policies and the progress made by its trading partners.

A breakdown of the trends in French GDP by its main components shows investment to be finally taking part in the recovery, possibly enhanced by the reform of the local business tax (*taxe professionnelle*), in force as from January 2010. This component grew by 0.9% quarter-on-quarter, for the first time since the beginning of 2008.

On the other hand, private consumption, the typical engine of the French economy, progressed 0.6% during the second quarter, while public expenditure grew by 0.4% and, consequently, domestic demand as a whole was up 0.6%. Regarding foreign demand, the increase in imports was greater than that of exports, resulting in a poorer trade balance. However, the negative contribution of foreign demand to GDP was more than offset by the restocking of firms, which were actually the main source of growth in the second quarter.

An analysis of the most frequent data suggests that French business will continue to recover over the coming months, albeit gently. The economic sentiment of entrepreneurs therefore improved in July, as well as the index for orders. However, industrial production fell that month after a relatively strong June. Similarly, and as expected with the gradual removal of subsidies for vehicle purchases (*prime à la casse*), registrations fell significantly over the last three months. On the other hand, consumer confidence remained stable in July after falling six points during the preceding five months.

These leading indicators have therefore aroused some fears regarding the strength

Higher consumption places German year-on-year inflation at 1.2%.

No change expected for France's austerity plans.

The French economy grows by 0.6% in the second quarter...

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010		July
			3Q	4Q	1Q	2Q	
GDP	0.1	-2.5	-2.7	-0.5	1.2	1.7	–
Domestic consumption	-0.3	0.8	0.3	4.2	1.8	0.3	...
Industrial production	-2.7	-12.1	-11.5	-4.7	4.8	7.4	...
Unemployment rate (*)	7.8	9.4	9.6	9.8	9.9	9.9	...
Consumer prices	2.8	0.1	-0.4	0.4	1.3	1.6	1.7
Trade balance (**)	-50.2	-49.1	-45.4	-41.8	-42.5	-44.3	...

NOTES: (*) Percentage of labour force.

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

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

...boosted by investment and the accumulation of stocks.

of the recovery, so the French economy is expected to progress gradually over the coming months. In fact, according to the International Monetary Fund, the French recovery will be slow, with a 1.4% and 1.6% rise in GDP in 2010 and 2011, respectively, although with a somewhat higher rate than the rest of the euro area given that the country was relatively less hard hit by the recession.

The IMF predicts slow but sure growth for France.

In its report on France in July, this institution also stated that domestic demand would make a stronger contribution to growth, with a little help from the foreign sector in the short term. The report also suggests that France's capacity to grow in the long term will be approximately half a percentage point lower than for the previous decade, due mainly to its ageing population.

Lastly, the improved performance of the labour market should also be noted, as the French economy created jobs again the second quarter. After four quarters of dramatic falls, between the second quarter of 2008 and the first quarter of 2009, the number of salaried employees stabilized, starting to grow as from the third quarter of 2009.

The Italian economy grows by 0.4% quarter-on-quarter in the second quarter.

Italy consolidates its recovery

The recovery of the Italian economy continued at a good pace during the second quarter of 2010, with 0.4% growth in GDP quarter-on-quarter. This figure raises the year-on-year change to 1.1%, the highest increase since 2007. All the evidence seems to suggest that investment and foreign demand held the reigns of the Italian economy in this period, reinforced by a positive contribution from stocks. On the other hand, it is estimated that consumption, both public and private, will remain weak for another quarter.

Supply indicators show an increase in industrial production of 7.6% year-on-year in the second quarter of 2010. This is far behind the levels reached in the period before the recession, keeping industrial capacity utilization low. In spite of this, the end of fiscal incentives in June for replacing obsolete machinery will have brought forward decisions to invest on the part of industry, especially within the current situation of recovery.

Concerning demand, of note is the upswing in exports that, during the

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010		July
			3Q	4Q	1Q	2Q	
GDP	-1.3	-5.1	-4.7	-2.8	0.5	1.1	—
Retail sales	-0.3	-1.6	-1.8	-0.7	-0.4	...	...
Industrial production	-3.8	-18.2	-17.4	-9.3	3.0	7.6	...
Unemployment rate (*)	6.7	7.8	8.0	8.3	8.4	...	—
Consumer prices	3.3	0.8	0.1	0.7	1.3	1.5	1.7
Trade balance (**)	-10.0	-9.9	-8.7	-6.0	-6.9	-12.0	...

NOTES: (*) Percentage of labour force.

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

SOURCES: OECD, national statistical bodies and own calculations.

spring quarter, grew by 18.4% compared with the previous year. The rise in imports, 26.7% in the same period, placed the trade deficit at 5.848 billion euros. This figure was 30.4% lower than that recorded the previous quarter, contributing positively to growth in this period.

Weak consumption may slow up Italy's recovery in the short term. Retail sales continued to fall in April and May, with year-on-year decreases of 0.7% and 1.2% respectively. Moreover, the uncertain performance of the job market and the rise in consumer prices, in July standing at 1.7%, once again stopped consumer confidence from improving this month. With regard to public consumption, the approval of the austerity plan for the next two years, calculated at 25 billion euros, does not suggest any positive contribution from this area in the coming quarters.

All this occurred within a context of political instability due to the governing party losing its support in parliament. This could lead to early elections; a scenario, however, that is not thought to be very likely.

The recovery in the United Kingdom remains firm but might slow up in the second half of the year

In the second quarter of 2010, British GDP increased by 1.1% compared with the previous period, leaving its year-on-year rate at 1.6%. There have now been three quarters of positive rates and this confirms that the British economy is continuing to recover. In the first half of this year, the United Kingdom grew at a rate close to its historic average, although its economic activity remained at levels somewhat lower than the peak reached before the recession.

According to August's Inflation Report by the Bank of England, both the significant stimulus provided by monetary policy and the expansion of international demand and relatively low level of the pound should all help the recovery. However, the fact that some confidence indicators have been less favourable, the strong fiscal consolidation and slow improvement in credit restrictions have led the bank to slightly downgrade its growth forecasts. This institution now expects the growth rate over the coming months to end up being lower than the one recorded in the second quarter.

Foreign demand improves in this period...

...but Italian consumption is still very weak.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009		2010			
			3Q	4Q	1Q	2Q	July	August
GDP	-0.1	-4.9	-5.3	-2.9	-0.2	1.6	-	...
Retail sales	2.2	1.4	2.4	3.0	0.3	1.2	-	...
Industrial production	-3.1	-10.2	-10.5	-6.1	0.0	1.6	...	...
Unemployment rate (1)	2.8	4.7	4.9	5.0	4.9	4.6	4.5	...
Consumer prices	3.6	2.1	1.5	2.1	3.2	3.4	3.1	...
Trade balance (2)	-93.6	-86.6	-83.9	-82.0	-82.2	-84.3	...	...
3-month Libor interest rate (3)	5.5	1.2	0.8	0.6	0.6	0.7	0.7	0.7
Nominal effective pound exchange rate (4)	97.6	73.9	83.7	79.0	80.4	78.2	81.5	82.3

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.

British GDP grows by 1.1% quarter-on-quarter.

In fact, supply indicators suggest a slightly weaker performance. On the one hand, industrial production fell by 0.4% in June, pushing the year-on-year rate of growth to 1.3%. Similarly, total registrations were down 13.2% in July after a year of positive figures. For their part, industry and services confidence indices showed quite erratic results. While the construction business index exceeded the average figure for the pre-crisis period (1999-2007), most business confidence indices fell in the month of July. Within this context, the National Institute of Economic and Social Research estimates that the British economy grew by 0.9% year-on-year in the three months up to July, denoting a certain slowdown in the pace of growth.

On the other hand, the outlook for demand depends largely on the desire of homes and companies to maintain their level of savings. During the recession, household consumption fell by 5% but this seems to have stabilized in the last few quarters. With regard to investment, although companies could increase this due to their relatively high level of

savings, survey data noted a relatively weak volume of orders and under-utilization of production capacity.

With regard to foreign demand, the foreign sector is performing weakly at present in spite of the pound's depreciation. The Office of National Statistics (ONS) estimates that the trade balance has contributed negatively to growth in the United Kingdom over the last three quarters. This is surprising, given the currency's depreciation, and indicates that British firms are finding it hard to redirect their resources towards the production of exportable goods and services.

Looking at the trends in inflation, this fell by one tenth of a percentage point to 3.1%, although still at a level that is quite a lot higher than the Bank of England's target for price stability. In fact, inflation is expected to remain above 2% until the end of 2011, largely due to the further hike in VAT from 17.5% to 20% next January. Moreover, the bank expects firms to pass on almost all the VAT increase to consumers, as this change

The recovery might slow up a little in the third quarter.

The Bank of England expects inflation over 2% until the end of 2011.

in the tax system is expected to be permanent.

Emerging Europe: dynamic at present, uncertain in the future

Over the summer, a negative state of opinion has been developing concerning the outlook for the world economy in the coming quarters. In its most extreme version, this theory believes that the United States will enter a double-dip recession in 2011, dragging the rest of the economies into a new phase of low growth. Nonetheless, the most usual position is to accept an additional but not excessive economic slowdown compared with the rate of growth some months ago as the most likely scenario. If this happens, will emerging Europe be able to weather the storm?

First, we should remind ourselves of the region's overall situation. The most outstanding feature is that emerging Europe is immersed in a dynamic economic recovery. GDP growth data for the second quarter have been clearly positive, in most countries surpassing the available forecasts. Consequently, none of the economies in the area regressed in quarter-on-quarter terms during this period, with Slovakia, Estonia and Lithuania achieving figures above those recorded for the European Union as a whole (1.0% quarter-on-quarter) and the Czech Republic just a little behind them. Lacking the figures for Poland (a clear rise in GDP is expected) and Rumania (the only economy in the region that will probably decline compared with the first quarter), the regional balance in growth terms is, as we have already stated, favourable. Particularly because leading indicators for the third quarter show that the accelerating trend in growth is

continuing in most of the countries (Rumania and Bulgaria are the most notorious exceptions).

To date, this expansion has fundamentally been due to foreign demand and, to a lesser degree, trends in stocks, with consumption and investment still weak. Although trends in household expenditure are varied, indicators such as retail sales suggest that a first group of countries made up of Poland, Hungary and the Czech Republic is the most advanced in terms of their consumption recovering, while the Baltic countries and Rumania continue to be extremely fragile in this respect.

From a financial point of view, inflows of foreign capital have also picked up significantly, funding the expansion, although in May these inflows reflected the increased uncertainty caused by the sovereign debt crisis in the euro area, a situation that eased subsequently. In spite of the recently improved economic vigour, the low degree of production capacity utilization and the already mentioned weakness in domestic demand have contained prices, in turn providing room to manoeuvre for a lax monetary policy. Lastly, the drop in business before the current recovery has notably affected public finances, although the starting point was, in most cases, healthy, so that the levels of public deficit and debt are not alarming.

From this superficial review we can conclude, almost directly, that the region's recovery depends critically on economic and financial trends outside its borders. Specifically, it depends on the notable recovery in foreign demand continuing and on public and private international funding continuing to flow towards emerging Europe. Given the nature of the region's trade and

The worsening global economic outlook raises doubts as to the expansion in emerging Europe.

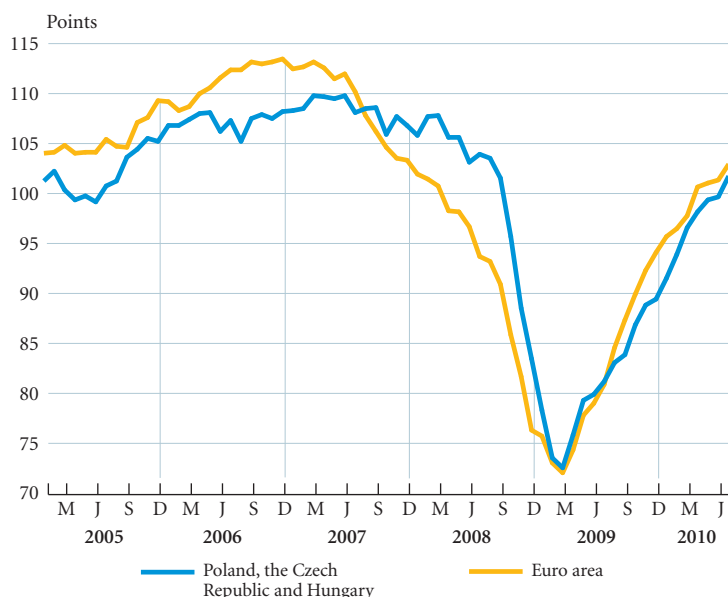
To date, the pace of business has accelerated significantly.

Whether this recovery continues depends on foreign demand and international financing.

The recovery in emerging Europe will largely depend on expansion in the euro area.

EMERGING EUROPE: THE EURO AREA, BASIS OF THE RECOVERY

Index of economic sentiment



SOURCES: European Commission and own calculations.

financial links, in practice both these issues boil down to one: emerging Europe's recovery will only continue, beyond its current inertia, if the euro area avoids a double-dip recession. Should this negative scenario arise, we'll see a rapid drop in activity in these countries. However, if European growth slows up but doesn't go under, this being our main forecast scenario, the region's perspectives will not be affected to any great degree.

One of the aspects that could alter the possible impact of a slowdown (or recession, in an extreme scenario) in Europe is national economic policy and, in particular, how budget policy is handled, given the sensitivity shown by international investors to sovereign debt since last spring. In this area, three general trends can be seen in the region. The first is a budget adjustment that cannot be postponed,

such as the one carried out by the Baltic countries and Hungary, or the one currently being undertaken by Rumania.

A second option is to delay the adjustment. This is the option being taken by Poland, which is benefitting from having been the only European country to avoid recession in 2009, and Hungary. In the Hungarian case, unfortunately, although the decision to relax its fiscal consolidation targets and particularly not to negotiate a new monetary agreement with the International Monetary Fund have broadened the field of play for populist policies, this has been done at the cost of a higher country risk premium and a deterioration in its currency, which will lead to lower growth in the future.

Lastly, the third option is the one being followed by the Czech Republic,

How budget policy is handled continues to attract attention.

undertaking clear fiscal consolidation without direct international financial pressure. Although it's difficult to suggest optimum patterns in this area, given the recent trends in indicators it seems as if the options to consolidate are providing greater returns in terms of lower risk premiums for the countries that have chosen them. Consequently, and returning to the initial question of

the role of national economic policy, fiscal reform is probably an advisable strategy in order to provide a degree of protection for the economies of emerging Europe should the financial storms get worse, or provide them with the margin to implement an expansionary economic policy should business fall off.

Fiscal consolidation might help to provide greater protection against possible monetary disturbances.

SMEs: cloistered in the local market?

In the era of globalization, countries, regions and firms compete in the international arena to get a foothold in the global market and, in spite of their enduring national bias, small and medium-sized firms (SMEs) are not exempt from this globalizing process. The importance of SMEs in the economic environment, together with the benefits of the internationalization phenomenon, invite us to consider the challenges these firms must overcome when they decide to break into a new market, as well as the measures that might help them do so.

According to OECD data, globally, 90% of firms are SMEs. These employ between 50% and 60% of the total workforce and generate around 50% of the goods and services. However, their impact on the development of countries, particularly less advanced ones, goes beyond what these figures suggest. In more backward economies, SMEs tend to be concentrated in businesses that intensively employ women and young people, actively helping to reduce poverty levels.

On the other hand, and from an additional perspective, empirical evidence suggests that internationalization (be it in its most traditional form of trade or via flows of foreign direct investment (FDI) or international collaborations and alliances) fosters economic growth. For SMEs, contact with foreign companies, feedback from new clients and access to larger markets provide them not only with a platform to improve their productivity but also the chance to diversify risk by reducing their dependence on the domestic market.

However, in spite of the importance of internationalization, most SMEs are still cloistered in their domestic market. By way of example, while SMEs account for 50% of global production, their share of manufactured exports lies between 25% and 35%. This disparity is even greater if we look at FDI, where the contribution made by SMEs doesn't even reach 10% of the total.

But why are they less active in international markets? In a few words, SMEs and large companies are poles apart in terms of both their resources and their degree of proficiency. However, both types of firms face the same obstacles and challenges when they decide to go beyond their borders: from greater competition to substantial fixed entry costs, including difficulties related to the adoption of international standards, doubts concerning copyright and political risks, to name but a few.

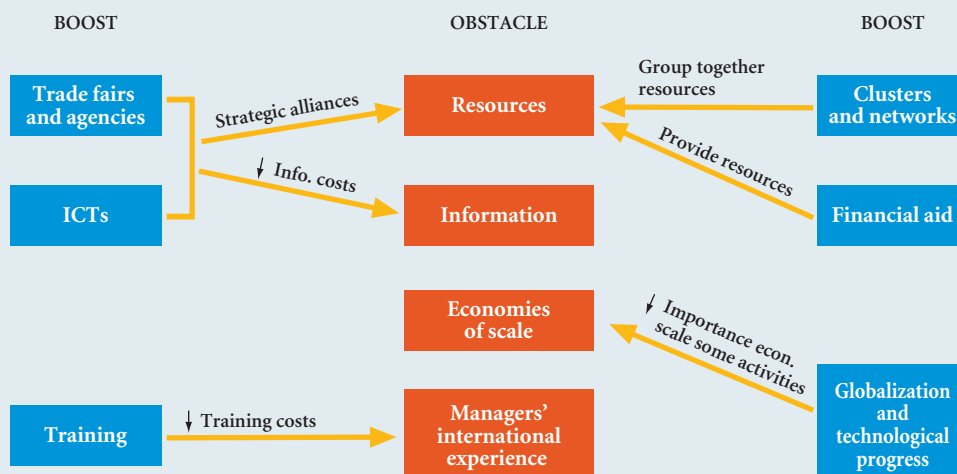
Given these difficulties, large companies enjoy certain advantages related precisely to their size, which they can take advantage of to access international markets. Firstly, they have more financial, human and material resources, all key to developing a strategic internationalization plan as well as to sustain the new market. Secondly, the greater international experience of their managers is another important asset. Moreover, they can also profit from economies of scale and their larger market power. Lastly, their better access to information, together with their capacity to diversify, means that they are less risk averse, something they make the most of to embark upon the road to internationalization, a path that is never entirely free from danger.

Nonetheless, things are changing and company internationalization is starting to spread to SMEs, largely thanks to the advances in information and communication technologies (ICTs). Advances in ICTs have not only reduced the cost of information, making its access more widespread and putting companies on a more equal footing, but they have also helped strategic alliances and networks to spring up, providing SMEs with more resources and knowledge. Consequently, alliances between small and large companies are increasingly more common. These associations allow large corporations to react more swiftly to changes in the market thanks to the greater flexibility afforded by their SME «allies». Similarly, technological changes have also reduced the importance of economies of scale in many activities (see diagram).

Public administrations also play a vital role in the internationalization of SMEs. Promoting trade fairs and support agencies and the good work carried out by commercial offices in embassies can improve access to information and help to identify potential foreign allies. Similarly, encouraging clusters and networks, as well as financial support through, for example, export loans, help to lower the high cost of breaking into foreign markets. All these measures play a part in resolving the various market failures related to the provision of public goods, the existence of coordination problems or asymmetric information problems in credit markets. In particular, public administration actions aimed at spreading information, which is a «public good» aspect of information. Hence, the private sector would invest less than what is best for society.

In short, in spite of the importance of internationalization as a source of economic progress, SMEs still tend to be concentrated in the domestic market. This is due to their lack of resources, experience, information and economies of scale, and due to their higher risk aversion. However, things are changing and advances in ICTs have lessened some of these difficulties. Without doubt, public policies that provide access to information and promote the formation of alliances and networks might spur on the greater expansion of the globalizing phenomenon in SMEs. But the true driving force behind internationalization lies in firms themselves and their managers, aware of the potential offered by a market with global scope.

POLICIES AND ADVANCES IN FAVOUR OF THE INTERNATIONALIZATION OF SMEs



SOURCE: Own production.

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FINANCIAL MARKETS

Monetary and capital markets

The markets' attention is now focused on key signs of a slowdown in the United States and China.

The Fed and the ECB are flexible in their plans to normalize monetary policy

Throughout the summer, the financial markets' attention has shifted from the sovereign debt crisis in the euro area towards the signs of a slowdown in the United States and China, to the extent that there are even fears of a recessionary and deflationary scenario in the US

economy. Up to a point, analysts had already anticipated a slowdown in the pace of growth, both in the case of the United States, due to the disappearance of fiscal stimuli and other temporary factors, and in China given that, some months ago, the government adopted a series of measures to restrict the economy and bank credit in order to avoid unwarranted overheating. The surprise has been the simultaneous

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate(4)	3-month (5)	3-month (5)
		3-month	1-year						
2009									
August	1.00	0.82	1.30	0.25	0.35	0.39	0.50	0.69	0.30
September	1.00	0.75	1.24	0.25	0.29	0.35	0.50	0.54	0.31
October	1.00	0.72	1.24	0.25	0.28	0.33	0.50	0.59	0.34
November	1.00	0.72	1.23	0.25	0.26	0.30	0.50	0.61	0.32
December	1.00	0.70	1.25	0.25	0.25	0.28	0.50	0.61	0.35
2010									
January	1.00	0.67	1.23	0.25	0.25	0.26	0.50	0.62	0.34
February	1.00	0.66	1.22	0.25	0.25	0.25	0.50	0.64	0.36
March	1.00	0.63	1.21	0.25	0.29	0.24	0.50	0.65	0.28
April	1.00	0.66	1.24	0.25	0.35	0.24	0.50	0.68	0.21
May	1.00	0.70	1.26	0.25	0.54	0.25	0.50	0.71	0.13
June	1.00	0.77	1.31	0.25	0.53	0.24	0.50	0.73	0.28
July	1.00	0.90	1.42	0.25	0.45	0.24	0.50	0.75	0.42
August (1)	1.00	0.89	1.42	0.25	0.30	0.23	0.50	0.72	0.34

NOTES: (1) August 27.

(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.

nature and intensity of the economic slowdown in both regions, shifting attention away from the gradual stabilization of the crisis in the euro area and Germany's satisfactory figures.

Consequently, and within a scenario characterized by low volumes of trading typical of this time of year, the most outstanding movements have been seen in the money and bond markets: a notable drop in interest rates in most instruments, both by public and private issuers and for all maturities. The stock markets have seen irregular, lacklustre performance. In currency markets, the dollar has been weak but without any major tension.

The main central banks have once again shown notable flexibility in the orientation and implementation of their policies, given the challenges appearing in the atypical post-crisis financial cycle we're currently immersed in. Consequently, while the Federal Reserve (Fed) helped out via additional measures of a quantitative nature, the European Central Bank put a stop to theirs.

In fact, at its meeting held on 10 August, the Fed decided to delay the normalization of its monetary policy. Specifically, the central bank decided to reinvest the funds from maturities in its mortgage bond portfolio in buying up public debt. In practical terms, this is the equivalent of aiming to keep the level of its balance sheet around 2.3 trillion dollars, which is significantly different from its previous strategy of gradually reducing both assets and reserves, either automatically through maturities as well as through specific measures (reverse repos, term deposits, etc.). In this way, the Fed is hoping to avoid the risk of tightening up its monetary policy too

quickly, given the still fragile economy which the organization itself has acknowledged, slightly downgrading its growth and inflation forecasts.

Investors have accepted the central bank's view and futures markets have therefore decided that the Fed won't raise the reference rate until the end of the coming year and even then very gradually. This has caused the interbank dollar rate to relax significantly, down to levels close to the minimums at the beginning of the year.

The actions taken by the European Central Bank (ECB) are in line with the tentative improvements in financing terms both for governments and banks, particularly in the periphery of the euro area. Consequently, at its meeting on 5 August, the ECB decided to keep the official interest rate at 1%. Jean-Claude Trichet, the ECB President, stated that the recovery was very likely to take root and the risk of recession in the euro area as a whole could be ruled out; however, he stressed that there's still a lot of uncertainty regarding exactly how the economy would grow over the coming quarters. The ECB also acknowledged that the stress tests carried out on the financial sector have lifted a lot of doubts and have played a key role in improving the money markets, while austerity measures and coordination in fiscal policy among member countries are helping to calm tension in the sovereign debt markets.

Within this improved context, the ECB has practically discontinued its programme to buy up public debt in secondary markets, at the same time as the amount of loans requested by financial institutions has fallen significantly. As a result, surplus banking

Yields on bonds drop significantly, while equity's performance is lacklustre.

The central banks show flexibility in implementing their policies to underpin economic recovery.

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

The ECB stops its public debt purchase programme.

reserves in the system have shrunk and the one-day interbank interest rate (EONIA) has undergone a modest but revealing rise. The Euribor interbank interest rate has continued to evolve gently, easing in August given the unexpected slowdown in the global economy, as well as more confidence among institutions after the publication of the stress test results on 23 July.

Public debt markets: sharp fall in yields

In April, when the sovereign debt crisis erupted in the euro area, investors sold off the bonds of those countries whose fiscal consolidation was in doubt, such as Greece, Spain, Portugal and Ireland and took refuge in the debt of countries with high credibility, such as France and especially Germany. This movement led to a huge rise in the spreads between

interest rates for these two groups of countries.

Given this emergency, the European Union and member governments adopted an extensive battery of measures to put a stop to systemic risk (including the creation of a European stabilization mechanism provided with 750 billion euros). As the substance of these economic policy decisions took hold among investors, the crisis was contained. Consequently, since the middle of July, this change in sentiment has led to centre-periphery differentials closing the gap slightly.

It should be noted, however, that spreads have not shrunk equally throughout the different countries in question, nor have pre-crisis levels been achieved. And neither has this decreasing trend been uniform. For example, the announcement of high losses in one of

The measures implemented limit the effects of the sovereign debt crisis in the euro area.

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								
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	2.58	3.05	4.56	4.09	2.93	1.09	3.36	1.48
July	2.67	2.95	4.21	3.95	2.91	1.07	3.33	1.46
August (*)	2.12	2.46	4.01	3.76	2.51	1.00	2.89	1.10

NOTE: (*) August 27.

SOURCE: Bloomberg.

the large Irish banks once again led to tension in the Irish bond differential, so that, by mid-August, the Treasury of Ireland had to offer a yield of 5.38% to sell its issue of 10-year bonds. In the case of Greece, the good news concerning the drop in its fiscal deficit was accompanied by figures showing sharp economic shrinkage, leading to doubts regarding whether the country can withstand this situation for very long. Lastly, confusion concerning the definitive adjustment in Spain's public investment harmed the spread for Spanish debt compared with German bonds.

Although the sovereign risk factor in the euro area cannot be deemed to be neutralized once and for all, its place in the limelight has been taken over by concern about the prospect of lower growth in the United States and China. This concern is the fundamental element behind the additional fall in yields experienced in August and has since spread to the public debt of most countries. In the case of 10-year bonds from the United States, their rate is close to 2.50%. This level is near the record low reached at the end of 2008, namely 2.05%, precisely at the most critical time in the financial crisis caused by the bankruptcy of the North American bank Lehman Brothers. For its part, long-term German debt has already hit record lows, below 2.15% for 10-year bonds.

It seems unlikely that this downward trend in yields will continue over the coming months, for two reasons. The first is that the worst in terms of economic shrinkage in the most important economies is now several quarters in the past and the recent slowdown will be short-lived. Secondly, because the yield levels reached by short

and medium-term bonds are already very close to the nominal minimum of 0%. In the medium term, and as economic data confirm that the slight slowdown in growth is not putting a stop to the recovery, there should be a small upward trend in yields, returning to the levels seen in April this year.

Worsening growth prospects affect the dollar

The currency market has not been immune to the prospects of synchronized slowdown in growth in the United States and China. The most notable consequence has been the fall of the dollar against other leading currencies. For example, although one euro was worth around 1.24 dollars in mid-June, it had quickly reached an exchange rate of 1.33 dollars by the beginning of August. This situation has now partially corrected itself and the euro is now worth around 1.27 dollars. The dollar's depreciation has also been sharp against the Japanese yen, falling 6% since the beginning of June.

Of note in Asia are the progressive movements made by the Chinese authorities to normalize their exchange policy. With the announcement by the People's Bank of China that it would start to operate with other central banks in the cross-border settlement of yuan in Hong Kong and Macao, another step has been taken in freeing up control over the yuan. China will also allow foreign banks to operate in its domestic interbank bond market in order to internationalize its currency. In this way it hopes to extend use of the yuan in the international financial system.

Although the process of reducing interest rate differentials is not uniform.

Concern regarding growth in the United States and China is now the fundamental factor in falling yields.

Doubts concerning growth in the United States drive the dollar's depreciation.

The Chinese authorities create a pilot programme to internationalize the yuan.

EXCHANGE RATES OF MAIN CURRENCIES

August 27, 2010

	Exchange rate	% change (*)		
		Monthly	Over December 2009	Annual
Against US dollar				
Japanese yen	84.7	−3.8	−9.8	−10.4
Pound sterling	0.645	−0.6	−4.3	−5.0
Swiss franc	1.024	−3.6	−1.1	−3.5
Canadian dollar	1.059	2.3	0.6	−2.7
Mexican peso	13.101	3.2	0.1	−1.0
Against euro				
US dollar	1.271	2.2	11.3	11.4
Japanese yen	107.6	−6.2	−23.8	−24.6
Swiss franc	1.301	−5.9	−14.0	−16.8
Pound sterling	0.819	−1.7	−8.2	−7.5
Swedish krona	9.395	−1.0	−9.1	−8.8
Danish krone	7.448	−0.1	0.1	0.1
Polish zloty	3.990	−0.4	−2.8	−3.1
Czech crown	24.76	−1.1	−6.8	−2.9
Hungarian forint	284.3	0.6	4.9	5.2

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

SOURCE: Bloomberg.

Trends remain good in the private bond market...

...although doubts concerning growth in the United States slow up the pace of recovery.

Corporate debt looks solid

Corporate bond markets have continued to perform solidly over the summer months. This can be seen in the aggregate indices, posting very significant rises. The main factor has been the success of the European stress tests, with some Spanish banks performing exceptionally well. Another positive element has been the relaxation and delay in applying the Basel III banking regulations. Within this environment, the banking sector has performed particularly well compared with the rest of the economic sectors.

In fact, since the start of the economic recovery the private bond market has seen very positive trends, both in prices and volumes, compared with the rest of financial assets, satisfactorily overcoming

the different storms that have appeared throughout this period.

For example, during the month of August, the positive trend in corporate bond markets has slowed up but not stopped, due to the already mentioned publication of various indicators that raise doubts regarding the future pace of growth in the United States and China.

In any case, the private bond market has one factor that is key in the current situation: the results of large international firms, which in addition to being highly positive are also being systematically better than expected by analysts. This situation, which has been occurring since the first quarter of 2009, has led to a rapid accumulation of financial resources which, combined

THE POSITIVE TREND HAS SLOWED UP BUT NOT STOPPED

Trends in risk premia for European corporate bonds



SOURCE: Bloomberg.

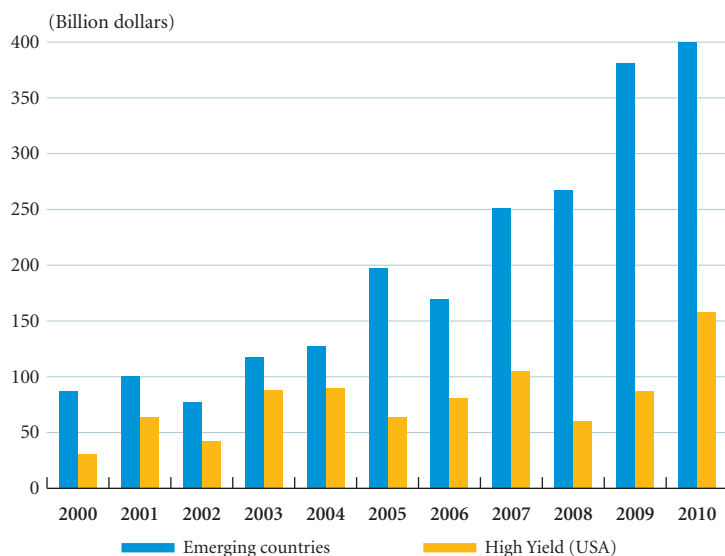
with sluggish investment, results in a strong cash position. Consequently, most of these firms are not under pressure from new financing needs and can even

take advantage of the propitious moment in the private bond market to comfortably refinance their debt at very low interest rates.

The key element underlining the recovery in this market is firms' now healthy financial situation.

ISSUES RESPOND TO THE STRONG DEMAND FOR PRIVATE BONDS

Corporate bond issues



NOTE: (*) Issues accumulated up to 18 August every year.

SOURCE: Bloomberg.

This good performance has spread to the bonds of high risk companies.

Private bond prospects continue to look good.

Stock market indices continue to move laterally.

The strength of the private bond market has also spread to the emerging economies because these offer higher potential growth than developed economies and their companies also issue bonds with more attractive yields. This has been confirmed by the sharp rise in the volume of high risk bonds issued and with the strong growth in flows towards emerging countries, in both cases breaking records.

One notable fact at present, given that markets are highly sensitive to news concerning the credit risk of corporate debt, is that the positive trend is remaining firm in the debt rating for high risk (or high yield) firms, compared with the stability in debt rating of high rating firms (or investment grade) firms.

Within this context, investors are still interested in the private bond market and

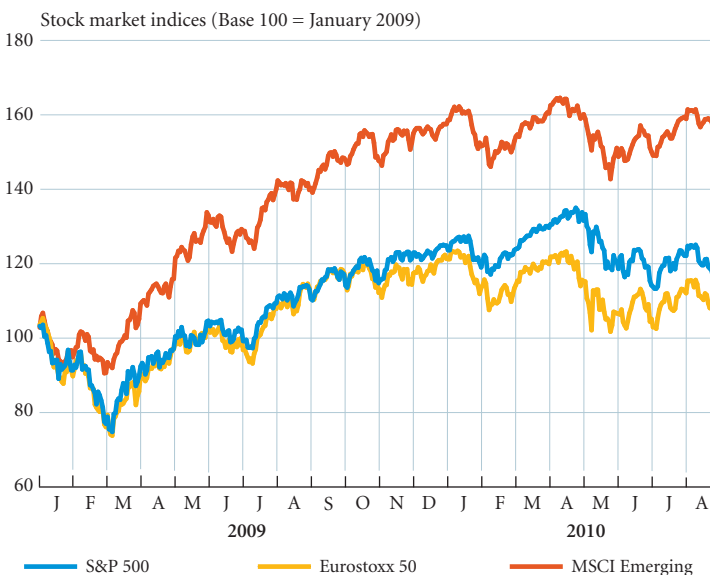
continue to invest apace in this kind of asset, although corporate bond interest rates have fallen to record lows. Given this situation, and attracted by the higher returns offered by high risk bonds, investors have increased their exposure to this segment. The outlook for the corporate bond market is still positive as long as there's no significant change in expectations for economic growth, insofar as the corporate and flow parameters that underlie this trend remain in place.

Stock markets turn their gaze towards the economic cycle

During the summer, the main international stock market indices did not lose the weak, irregular pulse that has characterized them throughout the year. Although July's record lows are now behind them, they haven't managed to

STOCK MARKETS REMAIN INDEFINITE

Trends in the main international stock markets



SOURCE: Bloomberg.

consolidate any upward trend. As has already been noted, improvements due to the handling of the sovereign debt crisis in the euro area have been replaced by concerns regarding growth in the United States and China and the impact this might have on company results in the coming quarters.

As often happens during the summer, activity has been sluggish. Flow indicators continue to show that retail investors are still reluctant to invest in equity, preferring less risky assets such as corporate bonds.

There are three decisive factors that have particularly helped to reduce the high volatility shown by stock markets at the start of July. Firstly, the positive outcome of the stress tests carried out on the European banking sector.

The conclusions of this analysis, carried out on 91 financial institutions, helped to dispel doubts concerning the stamina of the European banking system, showing banks to have a high degree of transparency and solvency in a potentially adverse scenario.

Secondly, the positive outcome of the corporate earnings season for the second quarter, both in the United States and in the euro area. For the sixth consecutive quarter, the corporate profits of the S&P 500 companies were higher than expected by the consensus of analysts, with a 36% rise in profit per share compared with the same period a year ago. Similarly, in the euro area, and although lagging behind slightly, firms' margins have accumulated widespread gains since last autumn, particularly in the industrial sector.

The outcome of the stress tests on the euro area's financial system is key to equity.

Another important element is the good corporate earnings season for the second quarter.

INDICES OF MAIN WORLD STOCK EXCHANGES

August 27, 2010

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
<i>Dow Jones</i>	9,985.8	-5.2	-4.2	4.2
<i>Standard & Poor's</i>	1,047.2	-6.0	-6.1	1.6
<i>Nasdaq</i>	2,118.7	-7.4	-6.6	4.5
Tokyo	8,991.1	-5.3	-14.7	-14.2
London	5,149.1	-4.0	-4.9	5.7
Euro area	2,599.7	-6.1	-12.3	-6.4
<i>Frankfurt</i>	5,906.6	-4.8	-0.9	8.0
<i>Paris</i>	3,463.7	-5.5	-12.0	-5.1
<i>Amsterdam</i>	313.0	-7.4	-6.6	5.4
<i>Milan</i>	19,628.6	-7.2	-15.6	-12.7
<i>Madrid</i>	10,003.2	-6.0	-16.2	-11.9
Zurich	6,133.5	-2.3	-6.3	-0.6
Hong Kong	20,597.4	-1.8	-5.8	1.8
Buenos Aires	2,321.4	-2.8	0.0	30.5
São Paulo	63,867.5	-4.2	-6.9	10.7

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.

Now investors are closely following global growth prospects and their impact on firms.

Lastly, the handling of the sovereign debt crisis in the euro area has led to lower risk aversion by investors regarding equity, compared with the turbulent months from April to June.

This renewed calm in the stock markets was ruffled in the middle weeks of August by the already mentioned publication of unfavourable economic data for the United States and China. This has led to the resurgence of fears of a relapse in the global economy, and

European stock markets have not remained untouched. This situation might continue for some time to come but the probability of a double-dip recession seems faint at present so that, in the medium-term, aspects such as the continuing recovery in corporate earnings, the improvement in the financial sector's situation and the fall in sovereign debt yields for periphery countries of the euro area should help the stock markets to rise.

SPAIN: OVERALL ANALYSIS

Economic activity

Economic activity continues to pick up in the second quarter

After seven months of economic recession in the period 2008-2009, gross domestic product (GDP) grew for the second consecutive quarter in April-June 2010 compared to the previous quarter, according to data published by the National Institute of Statistics. The economic recovery therefore continued, albeit tempered by problems of confidence in international markets due to the knock-on effect of the Greek fiscal crisis, as well as the effects of the gradual withdrawal of the previous year's fiscal stimuli and intensified budget adjustments. On the other hand, these downward forces were offset by

consumption being brought forward due to the rise in value added tax (VAT) in July.

Consequently, GDP grew by 2 tenths of a percentage point compared with the first quarter of 2010, one tenth more than the previous quarter-on-quarter rise. However, the year-on-year rate of change was still negative, namely -0.1%, albeit 1.2 points higher than in the preceding quarter. This improvement was due to a lower negative contribution from domestic demand.

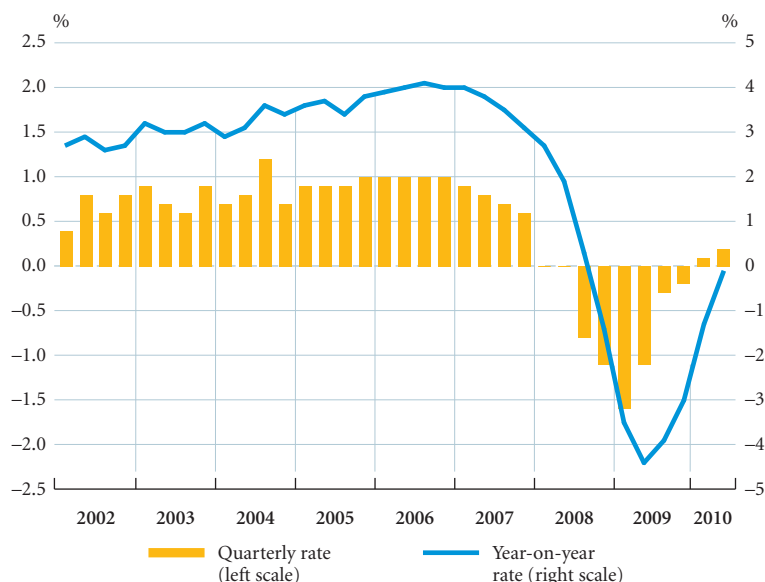
The main component of domestic demand, consumption, still performed well, albeit thanks to transient factors. Automobile sales rose by 35.3% in the

GDP grows by 0.2% in the second quarter compared to the first.

Consumption still continues to perform well in the second quarter, thanks to demand being brought forward before the VAT hike in July.

MODEST GDP GROWTH IN THE SECOND QUARTER

Change in gross domestic product



SOURCE: National Institute of Statistics.

Downward shift in household savings, although high levels are maintained.

second quarter compared with the same period in 2009, largely due to purchases being brought forward before the VAT hike at the beginning of July 2010 and given the end of the direct aid provided by the 2000E plan. Consequently, in July 2010 car registrations slumped by 24.1% compared with the same month a year ago, returning to the levels of 1995.

Another indicator, the production of consumer goods, posted a 2.5% year-on-year rise in the second quarter, 2.1 points more than in the first. Similarly retail sales, which had recorded falls in April and May, achieved year-on-year growth of 1.3% in June. Domestic sales in large firms confirmed the livelier consumption in the month of June, both in goods and services, up 7.6% and 11.7% respectively compared with June last year.

a slight dip in household savings. The savings rate for households stood at 18.5% of disposable income in the last year up to the first quarter, 3 tenths of a percentage point less than in the preceding moving period. Moreover, this trend is likely to continue in the second quarter. However, the level of individual savings remains high due to economic uncertainty and high unemployment, as well as the need for adjustment after the heavy borrowing incurred prior to the economic crisis.

Within a context of surplus production capacity, albeit lower than in preceding months, investment continued to fall but slowed up its decline. With regard to capital equipment, this continued its recovery with a year-on-year rise of 13.0% in imports and, although its production index was down 1.9% in the second quarter, this was half a point less than in the first. Registrations of load-bearing

Investment picks up in capital goods.

As a counterbalance to the upsurge in consumption in 2010 there has been

DEMAND INDICATORS

Percentage change over same period year before

	2008	2009	2009			2010				
			2Q	3Q	4Q	1Q	April	May	June	July
Consumption										
Production of consumer goods (*)	-4.7	-8.2	-9.4	-8.6	-1.7	0.4	3.7	1.6	2.2	...
Imports of consumer goods (**)	-7.7	-6.1	-14.9	-3.4	3.7	-10.8	-0.2	11.8	-2.4	...
Car registrations	-28.1	-17.9	-33.7	-0.6	29.3	44.5	39.3	44.6	25.6	-24.1
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	-25.0	-26.0
Investment										
Capital goods production (*)	-8.8	-22.1	-24.7	-20.2	-10.3	-2.4	-5.8	-1.1	1.3	...
Imports of capital goods (**)	-19.6	-27.0	-35.1	-23.4	-16.9	-1.2	11.1	9.2	19.4	...
Commercial vehicle registrations	-43.6	-40.0	-51.9	-30.8	-7.8	8.5	17.9	30.3	24.7	-7.6
Foreign trade (**)										
Non-energy imports	-4.9	-17.5	-26.8	-13.4	-0.7	10.4	16.7	22.9	14.8	...
Exports	1.9	-9.8	-14.7	-9.6	4.3	17.4	10.5	20.7	13.5	...

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.

vehicles saw a spectacular rise year-on-year of 24.2% in the second quarter, 15.8 points more than in the first, although this was driven by a stimulus plan, falling again by 7.6% in July compared with twelve months before.

With regard to investment in construction, a leading indicator such as apparent cement consumption posted a 12% annual drop, 8.8 points lower than the figure for the first quarter. This slump could be seen to be slowing down in the residential subsector, linked to the brake on falling prices as a result of house purchases livening up. However, apart from greater accessibility resulting from low interest rates and lower prices, this is also because of demand being brought forward due to the VAT hike on new homes and the partial withdrawal of the personal income tax deduction as from January 2011. On the other hand, civil building work continues to be affected by budget cuts.

Looking at the foreign sector, the boost provided by international markets and improved relative prices, helped by the depreciation of the euro, pushed up exports. However, imports also boomed, partly due to the already mentioned earlier purchases to avoid the VAT hike. The foreign sector's contribution to growth therefore fell slightly.

From the point of view of supply, industry continued to recover from the worst crisis of the last few decades with production posting a 2.8% rise year-on-year in the second quarter, 2.6 points more than in the first, driven partly by foreign demand and some stimulus plans. Similarly, electricity consumption was up 4.2% year-on-year in the second quarter, 1.2 points more than in the first.

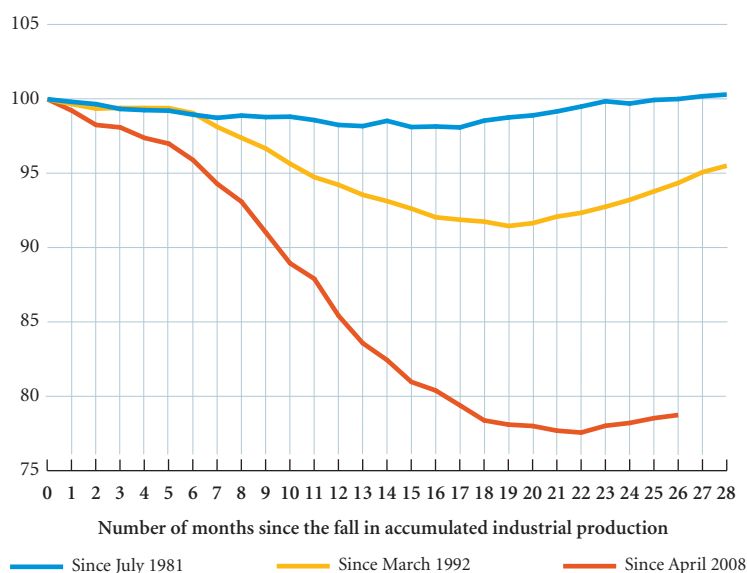
Services performed quite well in general and the number of businesses in the services sector was up 7.1% in June compared with the same month last year.

The decline in residential construction slows up.

Foreign sector contributes less to economic growth.

INDUSTRIAL PRODUCTION RECOVERS FROM THE WORST CRISIS OF THE LAST FEW DECADES

Industrial production index (*)



NOTE: Twelve-month moving average.

SOURCES: National Institute of Statistics and own calculations.

The government reasserts its priority to control the public deficit and approves structural reforms.

Retail, transport and storage and professional, scientific and technical activities were the branches that saw the greatest year-on-year growth. On the other hand, the subsectors of information and communications, administrative activities and auxiliary services and hotels and restaurants all recorded annual drops in billing. Nonetheless, hotel stays rose by 7.2% and tourist entries by 4.5% in July compared with the same month in 2009.

For its part, in the last few months the government has reasserted its priority to

control the public deficit in order to tackle the crisis in confidence in sovereign debt. It has therefore specified the cuts in investment in infrastructures and has also approved labour reforms, as well as starting to restructure the financial system, passing the reforms contained in the Government Body Act and other aspects of the legal system governing Savings Banks. The aim of these structural reforms is to establish a firm basis in order to restore confidence and improve medium and long-term growth prospects.

SUPPLY INDICATORS

Percentage change over same period year before

	2008	2009	2009			2010				
			2Q	3Q	4Q	1Q	April	May	June	July
Industry										
Electricity consumption (1)	0.5	-4.3	-6.4	-2.1	-1.4	3.0	5.8	3.2	3.7	3.3
Industrial production index (2)	-7.3	-15.8	-18.6	-14.6	-5.6	0.3	2.4	3.2	3.0	...
Confidence indicator for industry (3)	-18.0	-31.2	-35.0	-29.0	-24.1	-20.1	-14.3	-15.0	-13.0	-14.0
Utilization of production capacity (4)	80.1	71.2	70.9	69.8	70.6	69.5	71.8	-	-	73.9
Imports of non-energy intermediate goods (5)	-0.7	-21.6	-31.1	-17.1	0.1	26.9	28.4	32.4	24.9	...
Construction										
Cement consumption	-23.8	-32.4	-35.1	-26.4	-16.7	-20.8	-10.5	-11.4	-14.0	...
Confidence indicator for construction (3)	-22.6	-30.6	-35.0	-26.3	-24.5	-24.9	-17.0	-24.0	-32.0	-31.0
Housing (new construction approvals)	-59.4	-58.1	-62.8	-52.4	-45.5	-24.4	-22.9	-12.6	...	...
Government tendering	3.0	-8.2	-8.4	-1.4	-17.0	-50.4	-10.6	0.1	...	...
Services										
Retail sales (6)	-6.0	-5.4	-6.4	-4.5	-2.7	0.7	-1.2	-0.9	1.3	...
Foreign tourists	-2.5	-8.7	-8.2	-7.6	-3.5	0.3	-13.3	1.1	1.7	4.5
Tourist revenue inflows	-0.4	-9.0	-8.0	-9.2	-5.5	0.2	-4.7	1.7	...	...
Goods carried by rail (ton-km)	-7.7	-28.4	-34.9	-32.4	-7.7	4.5	15.5	22.1	25.0	...
Air passenger traffic	-3.0	-8.0	-8.6	-5.1	-0.8	3.5	-8.6	3.0	3.2	3.6
Motor vehicle diesel fuel consumption	-3.8	-5.1	-5.1	-3.0	-2.0	-0.5	-2.1	0.1	...	...

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.

However, the intensified budget cuts might lead to declines in the short-term, added to the impact of purchases being brought forward to the second quarter. In fact, the consumer confidence index has fallen since the month of April, and

the industrial confidence and economic sentiment index both fell in the month of July. Consequently, in spite of foreign markets performing better, economic activity might weaken in the third quarter.

Economic activity might weaken in the third quarter due to the impact of the VAT hike and the budget cuts.

Spanish SMEs and innovation: great expectations?

The belief that the Spanish economy needs a change in model is widely shared. The current economic crisis has highlighted the need to move quickly towards activities of greater added value, improve the country's competitiveness, focus more on international markets, etc. and innovation has a key role to play in all of this. So are we in any position to rely on our capacity to innovate? We know that our country is one of small and medium-sized enterprises (SMEs). We also assume this trait to be a weakness in terms of innovation, whose development depends critically on size, being an activity subject to evident economies of scale. If we think of the stereotypical innovative tasks, what springs to mind is huge investment in research and development, without doubt carried out in laboratories and specific units, perhaps at the company itself, where product innovations are produced. All this appears to be beyond the scope of SMEs.

Fortunately, in the area of innovation the stereotypes are not altogether true. The kind of innovation we have just mentioned is the most classic type, clearly oriented towards technology and science. It's usually closed in nature, i.e. knowledge is generated within the firm or within an exclusive relationship with a group of external researchers (for example, from academia). And although it's often incremental (improvements are gradually introduced in products and business practices), there's also a high degree of radical, disruptive innovation.⁽¹⁾ Seen in this way, innovation is primarily the business of large firms.

However, the world, and innovation along with it, is constantly changing. Breaking with the past, other forms of innovation are becoming increasingly more common. Together with the already mentioned innovation of science and technology, a wide range of non-technological innovation activities is also appearing that are particularly relevant to the service industry. Many of these activities are not created in a laboratory but result from demand, from contact with users, learning from the day to day work. They're not nourished by the exclusive knowledge generated by a firm but also from the flow of ideas and people that circulate freely within their circle (known as open innovation). Finally, and in line with this open, client or user-based innovation, incremental innovation takes on an even greater role, although radical innovation may still occur.

As we were saying, these new ways of innovating are related to economic changes, ones in which SMEs have a lot more to say. SMEs are the great beneficiaries in a world with a growing standard of living and where consumers

(1) The development of disruptive innovation has been dealt with particularly by Clayton Christensen (see, specifically, Christensen, C., 1997, *The innovator's dilemma: when new technologies cause great firms to fail*, Harvard Business School Press, Boston). Concerning the kind of firms that carry out each type of innovation, and although authors such as Baumol (see, in particular, Baumol, W., 2002, *The Free-Market Innovation Machine: Analyzing the Growth Miracle of Capitalism*, Princeton University Press, Princeton) associate large firms with incremental innovation and new firms, many of them small at the beginning, with radical innovation, the fact is that the evidence available is not clear-cut and big differences can be identified between different sectors. By way of example, we should note that almost all radical pharmaceutical innovation has been generated in large firms.

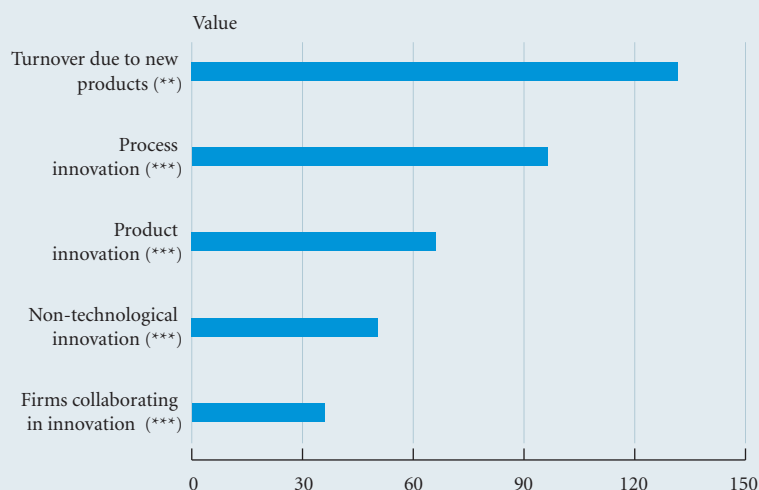
are developing a preference for variety, leading to many different market niches that responsive, swift, user-oriented innovation can exploit. The quickening of product life cycles, big changes in the competitive environment, the emergence of technologies (such as information technologies) that alter a wide range of activities (including reducing efficiencies of scale in many sectors) – all these provide opportunities for smaller, more flexible companies.⁽²⁾

So, the innovative outlook for SMEs is now better than it was decades ago, provided these SMEs are good enough to take advantage of these opportunities. On comparing the innovative performance of Spanish SMEs with those of a group of advanced European countries, we can see that their results are far from those of the best SMEs in terms of product and process innovation (see the diagram below). Neither do Spanish SMEs exhibit high levels of cooperation in innovation. However, and this is an indicator that is of great importance per se, their share of turnover resulting from product innovations is slightly higher than in the case of European SMEs. So although Spanish SMEs are not extraordinarily innovative, they are capable of taking advantage of innovation in terms of billing. This is a critical feature that is often highlighted as essential in assessing the quality of innovative activity in terms of the economic value it creates.

In spite of the favourable prospects offered by the new kinds of innovation, Spanish SMEs are facing notable difficulties in stepping up such activities. The factors mentioned by SMEs in surveys on this issue chiefly

SPANISH SMEs: MODEST BUT PROFITABLE INNOVATION

Average of reference countries = 100 (*), 2006



NOTES: (*) Average of Germany, Austria, Belgium, Denmark, Finland, France, Hungary, Ireland, Italy, the Netherlands, Poland, Portugal, the Czech Republic and Sweden.

(**) Percentage of the SME's turnover generated by the firm's new products.

(***) Number of SMEs innovating in the way mentioned compared with the total SMEs in the country or reference group.

SOURCES: OECD (2010), «SMEs, Entrepreneurship and Innovation», Paris, and own calculations.

(2) Thurik calls these changes the shift from the managed to the entrepreneurial economy (see Thurik, R., 2009, «Entrepreneurship, Economic Growth, and Policy», in Z. Acs, D. Audretsch and R. Strom (eds.), *Entrepreneurship, Growth, and Public Policy*, Cambridge University Press, Cambridge).

mention the lack of financial resources, both those generated by the firms themselves and those available externally.⁽³⁾ This problem is also common to other countries. However, and without underestimating its importance, particularly at a time when access to funding is even more difficult, we should acknowledge that this problem has been perfectly well pinpointed in the innovation policies of the European Union and Spain. Moreover, it's also a problem that occurs particularly in the area of «classic» innovation (technological and closed), presented above. When we move towards the new innovation, open in nature and with non-technological aspects playing a greater part, the fundamental restriction becomes the absence of suitably qualified human resources. The new generations of innovation policies being promoted in advanced countries tend to increasingly attack this problem, although the idea that this is a key limitation has yet to become firmly established.

Spanish SMEs also point to the presence of dominant firms in the market as one of the barriers to innovation and this does not tend to occur equally in other countries. What is common, however, is the belief that the uncertainty surrounding the demand for innovative services and products is an additional barrier. Unfortunately, this feature is inherent in innovating and, in any case, is slightly less important than the problems of financing, human resources and established firms that Spanish SMEs claim to be fundamental.

In short, innovating is difficult, uncertain and requires talent. In spite of these difficulties, however, innovation is an inescapable challenge for our economy and, given their large share in Spanish production, SMEs have a role to play in this area. The comparison with other countries reminds us that the main challenge will be to increase the outcomes from innovation in the form of new products, processes and organisational changes. Once this has been done, the capacity to turn innovation into business, something Spanish SMEs are not so bad at compared with other countries, will probably be a major incentive to firmly establish our firms' commitment to innovation once and for all.

(3) *Community Innovation Survey* by Eurostat (2006).

*This box was prepared by Àlex Ruiz
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Labour market

First rise in employment in two years.

The Labour market is leaving the worst of the crisis behind it

According to figures from the labour force survey (LFS), in the second quarter the number of employed people rose by 82,700 compared with the previous quarter, the first rise in two years, totalling 18,476,900 and thereby easing its year-on-year rate back to 2.5%. However, although this rise in employment is good news, the current fragility of the Spanish economy's recovery means we must qualify our assessment of the figures and wait for the results from the next few surveys before endorsing the trend as positive in terms of creating jobs.

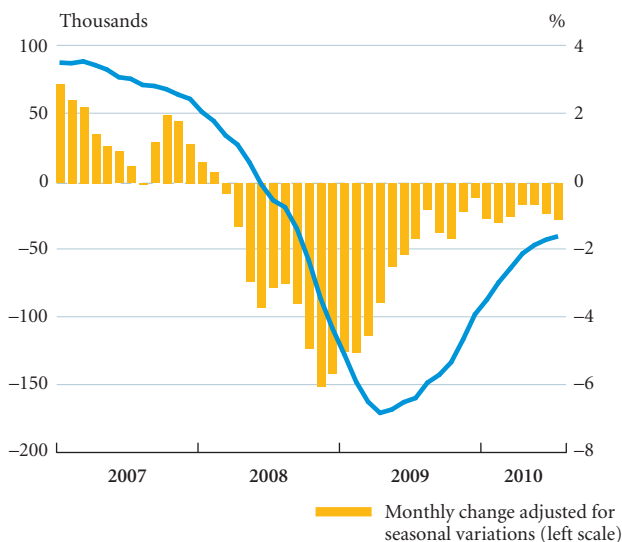
In fact, July's figures for the number of people registered as employed with Social

Security showed a rise of 65,541 but, once seasonally adjusted, this becomes a fall of about 27,000 registrations, so we can't say that job losses have actually come to an end just yet. However, it should be noted that this fall is lower than those recorded in previous months and that the year-on-year drop has eased back to 1.6%, so a change in trend is probably a bit closer.

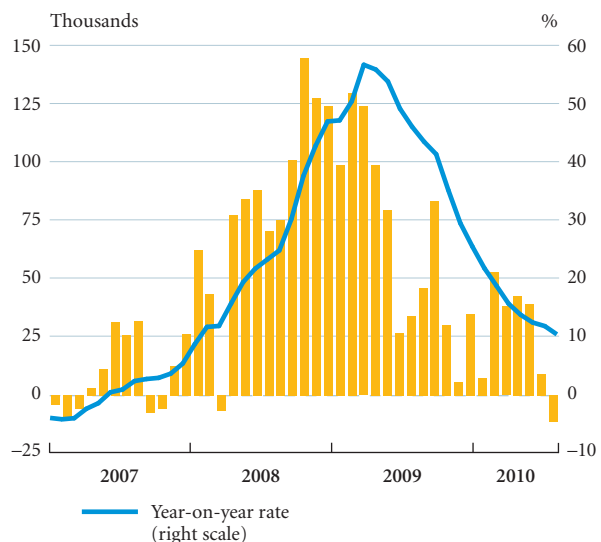
Returning to the LFS, in the second quarter of 2010 we can see that new jobs were concentrated in the male segment, while women continued to lose employment, unlike in previous quarters when men were the most severely affected. This is mainly due to the male predominance in the construction industry, a sector that, for the first time since the recession started, saw a rise in

SLOW REVERSAL IN THE JOB MARKET'S DECLINE

People registered as employed with Social Security



Registered unemployed



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

its number of employed, namely 2.2% quarter-on-quarter. In the second quarter jobs were also created in industry, 0.7%, and in services, 0.6%. However, all sectors continued to post negative figures compared with last year.

Regarding employer type, the LFS reflects the effects of public sector provisions aimed at reducing state-employed workers, as in the second quarter no further jobs were being created in this sector. So, while the private sector

generated 85,500 jobs, the public sector reduced its number by 2,800 workers. In fact, since the recession started, the positive figures for the public sector have contrasted sharply with the extent of job losses in the private sector.

On the other hand, the figures also show that part-time work has had a boost over the last twelve months, as this kind of work saw a 2.0% year-on-year increase, unlike the 3.1% drop recorded for full-time employment. The number of part-

Public sector employment falls for the first time in the second quarter.

ESTIMATED EMPLOYMENT

Second quarter 2010

	No. of employees (thousands)	Quarterly change		Annual change		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	778.2	−57.0	−6.8	−8.4	−1.1	4.2
Non-farm	17,698.7	139.8	0.8	−459.7	−2.5	95.8
<i>Industry</i>	2,618.9	19.1	0.7	−180.5	−6.4	14.2
<i>Construction</i>	1,699.7	36.7	2.2	−222.4	−11.6	9.2
<i>Services</i>	13,380.1	84.0	0.6	−56.8	−0.4	72.4
By type of employer						
Private sector	15,391.3	85.5	0.6	−502.6	−3.2	83.3
Public sector	3,085.6	−2.8	−0.1	34.5	1.1	16.7
By work situation						
Wage-earners	15,363.4	110.2	0.7	−373.4	−2.4	83.1
<i>Permanent contract</i>	11,541.3	8.6	0.1	−224.0	−1.9	62.5
<i>Temporary contract</i>	3,822.1	101.6	2.7	−149.4	−3.8	20.7
Non-wage-earners	3,103.9	−26.9	−0.9	−92.1	−2.9	16.8
<i>Entrepreneurs with employees</i>	1,036.7	−11.2	−1.1	−43.4	−4.0	5.6
<i>Entrepreneurs without employees</i>	1,915.0	2.4	0.1	−33.8	−1.7	10.4
<i>Family help</i>	152.2	−18.1	−10.6	−14.9	−8.9	0.8
Other	9.5	−0.7	−6.9	−2.7	−22.1	0.1
By time worked						
Full-time	15,978.2	35.8	0.2	−516.2	−3.1	86.5
Part-time	2,498.6	46.9	1.9	48.0	2.0	13.5
By sex						
Males	10,333.9	94.0	0.9	−367.0	−3.4	55.9
Females	8,142.9	−11.3	−0.1	−101.2	−1.2	44.1
TOTAL	18,476.9	82.7	0.5	−468.1	−2.5	100.0

SOURCE: National Institute of Statistics and own calculations.

Unemployment increases and stands at 20.1%.

time jobs continued to grow at a faster pace throughout this second quarter, increasing the ratio for this kind of employment by two tenths of a percentage point, to 13.5%.

In terms of geographical area, in the last year jobs were created in the Basque Country and in Navarre, so that these two communities are probably pioneers in the job market's recovery. The rest of the communities posted negative annual rates, particularly the Community of Valencia, Galicia and Asturias.

The labour force estimated by the LFS rose by 115,500 people in the second quarter, a higher figure than the overall growth in employment and therefore leading to a larger number of unemployed, now totalling 4,645,500. As a result, the unemployment rate stood at 20.1%.

In regional terms, the highest unemployment rates could once again

be seen in the Canary Islands and Andalusia, with figures above 27.5%, while at the opposite end of the scale was the Basque Country with the lowest rate, namely 10.4%.

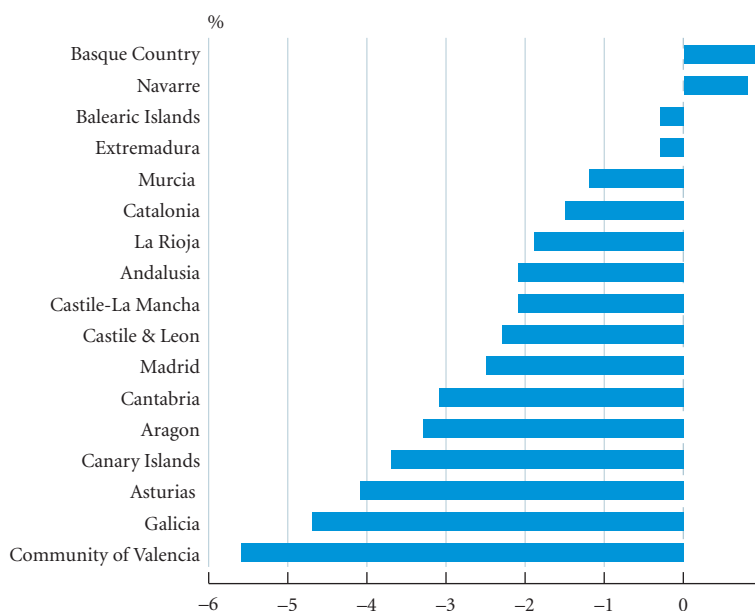
It's also important to note that unemployment continued to rise more sharply among those segments of the population at greater risk. In fact, the number of families with all their members out of work increased last year, reaching a total of 1,308,000. Higher unemployment was also concentrated among those younger than 25, with a rate of 42.1%.

With regard to unemployed people registered with the employment offices, the figures for the month of July were somewhat more encouraging, as shown in the above graph, suggesting that rising unemployment is close to its peak as, for the first time since the crisis began, there has been a fall in the total number of

The rise in unemployment is concentrated among those younger than 25.

THE BASQUE COUNTRY AND NAVARRE ARE THE ONLY COMMUNITIES TO CREATE JOBS IN THE LAST YEAR

Year-on-year change in the level of employment by autonomous community



SOURCES: National Institute of Statistics and own calculations.

ESTIMATED UNEMPLOYMENT

Second quarter 2010

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	2,538.0	−15.7	−0.6	248.9	10.9	54.6	19.7
Females	2,107.5	48.5	2.4	259.1	14.0	45.4	20.6
By age							
Under 25 years	871.1	35.5	4.2	15.9	1.9	18.8	42.1
Other	3,774.4	−2.7	−0.1	492.1	15.0	81.2	17.9
By personal situation							
Long-term unemployment	1,968.3	180.9	10.1	878.6	80.6	42.4	—
Seeking first job	361.8	37.9	11.7	75.2	26.2	7.8	—
Other	2,315.4	−186.0	−7.4	−445.8	−16.1	49.8	—
TOTAL	4,645.5	32.8	0.7	508.0	12.3	100.0	20.1

SOURCE: National Institute of Statistics and own calculations.

registered unemployed, once seasonally adjusted, of around 11,500. However, there is still the risk that, in the second half of the year, the end of the tourist season and the application of the measures contained in the austerity plan will reverse this recovery.

As a result of the trends in unemployment, expenditure on unemployment benefit rose 1.2% year-on-year in June, a much lower rise than the 62.9% recorded at the end of 2009. This slowdown in expenditure is mainly due to the fact that many of those receiving benefit ran out of their entitlement and went on to receive a subsidy payment, which is lower. Nonetheless, the cost of these payments rose to 2.583 billion euros. Within this

context, the Spanish cabinet's approval to extend the aid of 426 euros to those unemployed people who receive no benefit or subsidy for six additional months as from 16 August will help to increase expenditure on this item.

Another consequence of the rising unemployment in the last year has been the higher labour costs of firms resulting from redundancy payments, as shown by the figures from the annual labour cost survey carried out by the National Institute of Statistics. Consequently, while net labour costs were up 3.5% in 2009 compared with the previous year, lay-off costs grew by 42.7% during the same period, so that their contribution to the total cost went from 1.14% to 1.57%.

Expenditure on unemployment payments slows up.

Prices

In July, the CPI's year-on-year rate of change rises 0.4 percentage points to 1.9%, mostly due to the hike in VAT.

Modest impact of the hike in VAT

The year-on-year inflation rate for the consumer price index (CPI) rose 4 tenths of a percentage point in July to 1.9%. This is its highest level since November 2008 but can still be considered moderate. After reaching a record low for the last few decades in July 2009 of -1.4%, inflation in consumer prices tended to rise slightly as oil prices picked up. Over the last few months, improved consumption has also tended to slow up the downward pressure provided by the economic crisis.

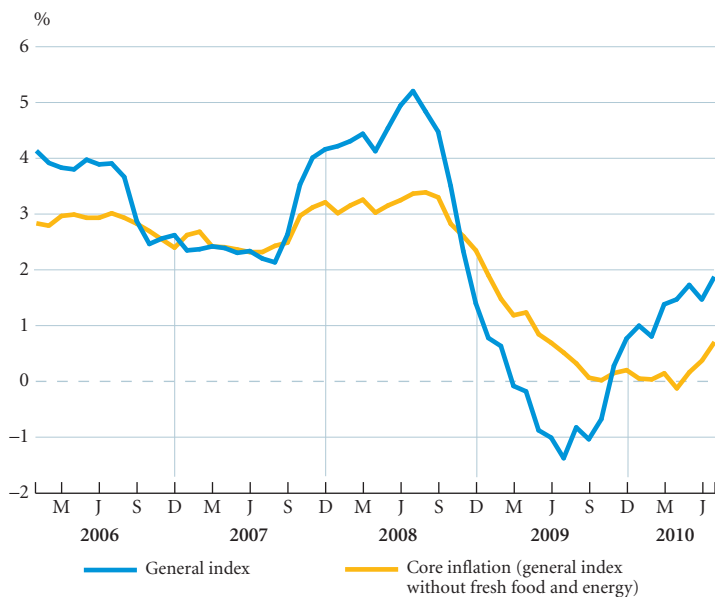
In fact, July's rise in inflation was mostly due to the effect of the hike in the value added tax (VAT) general rate from 16% to 18% and the reduced rate from 7% to

8%, in effect as from 1 July. It should be noted that, under normal economic conditions, the initial impact of this rise in VAT would have been slightly greater, but it was largely absorbed by business margins on the part of producers and distributors.

By component, the greatest contribution to the rise in inflation came from the more stable core or underlying inflation, which excludes fresh foods and energy products. This was up 0.3 percentage points in July, to 0.8% year-on-year, therefore posting positive rates for the third consecutive month and moving further away from the risk of deflation. July's rise in core inflation was basically due to the VAT hike.

SLIGHT UPSWING IN CORE INFLATION

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	0.2	1.0	1.5
July	-0.9	-0.5	-1.4	-0.4	0.6	1.9
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.

Manufacturing products stood at 0.1% below last year's rate and contributed almost 2 tenths of a percentage point to

the rise in inflation's year-on-year rate in July. Half of this contribution came from higher car prices. Services also

Core inflation rises to 0.8% year-on-year.

MANUFACTURING PRODUCT PRICES STABILIZE

Year-on-year change in the price index for industrial goods without energy products



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

July

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2009	2010	2009	2010	2009	2010
By type of spending							
Food and non-alcoholic beverages	107.5	−0.2	0.2	−2.6	−0.5	−2.1	−0.3
Alcoholic beverages and tobacco	136.8	4.3	0.5	12.6	8.6	13.0	8.7
Clothing and footwear	92.8	−11.8	−11.7	−14.6	−14.0	−2.1	−0.2
Housing	116.5	0.3	1.3	0.1	3.5	−0.8	4.3
Furnishings and household equipment	107.1	−0.9	−0.4	−0.3	−0.4	1.2	0.7
Health	96.9	0.0	0.0	−1.5	−0.6	−1.2	−0.4
Transport	109.4	−0.1	0.7	3.6	5.9	−9.5	6.2
Communications	98.8	0.0	0.5	−0.3	−0.5	−0.9	−0.6
Recreation and culture	99.1	0.8	1.6	0.1	0.5	−0.3	−0.7
Education	114.6	0.0	0.0	0.2	0.1	3.8	2.6
Restaurants and hotels	114.1	0.7	0.9	2.0	2.0	1.5	1.2
Other goods and services	111.9	−0.2	0.0	1.6	1.9	2.2	2.4
By group							
Processed food, beverages and tobacco	112.5	0.6	0.1	0.5	0.6	0.9	0.7
Unprocessed food	107.6	−0.1	0.6	−3.4	0.8	−2.7	1.1
Non-food products	107.4	−1.2	−0.6	−0.5	0.5	−1.7	2.2
Industrial goods	102.6	−2.8	−2.1	−2.8	−0.5	−5.3	3.0
Energy products	117.5	0.3	1.1	5.3	9.6	−15.9	11.8
Fuels and oils	114.4	−0.4	0.9	5.0	11.8	−22.5	14.9
Industrial goods excluding energy products	97.3	−3.9	−3.3	−5.5	−4.0	−1.5	−0.1
Services	112.6	0.5	0.8	1.8	1.6	2.1	1.4
Underlying inflation (**)	107.1	−1.1	−0.7	−1.0	−0.5	0.6	0.8
GENERAL INDEX	108.4	−0.9	−0.4	−0.5	0.6	−1.4	1.9

NOTES: (*) Base 2006 = 100.

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

SOURCE: National Institute of Statistics.

Spain's inflation exceeds the euro area's.

contributed 0.15 percentage points to inflation's year-on-year rise, of which 0.05 percentage points corresponded to package travel. The contribution made by restaurants and bars, transport maintenance and repair and telephone services was also slight.

Processed foods, however, deducted almost one tenth of a percentage point from annual inflation, mostly due to tobacco. Nonetheless, this was due to the rise in cigarette prices in June 2009,

in anticipation of the hike in the special tax rate in July 2009.

For their part, energy products contributed one tenth of a percentage point to July's higher year-on-year inflation. This was fundamentally because of the quarterly gas price review and the VAT hike. With regard to the other volatile component, unprocessed food, this contributed almost 0.05 percentage points to the rise in year-on-year inflation, particularly due to the

higher price of potatoes and fresh fruit, which were not affected by the VAT hike as the 4% minimum rate applied to these products remained the same.

The EU harmonized consumer price index also posted a 1.9% year-on-year change in July. Consequently, the inflation differential with the euro area stood at 0.1 points, the same as in June.

Although the VAT hike may continue to have an impact over the coming months, the year-on-year inflation rate might drop slightly in August due to the base effect of energy prices. However, inflation will then rise again slightly.

The increase in wholesale prices slows up in June

Wholesale prices slowed up their year-on-year rise in June thanks to energy, with the annual rate of change for industrial prices falling by 0.6 percentage points to 3.2% in June. Import prices also eased in June but to a lesser extent, namely by one tenth of a percentage point to 10.1% year-on-year, due to the depreciation of the euro. With regard to farm prices at source, in April their annual rate of change stood at 2.8%, half the figure for March. Both market livestock prices and livestock products were 4.6% below their level for the same month a year ago.

Inflation might fall in August, although it will rise slightly afterwards.

Thanks to energy, industrial prices and those of imports ease in June.

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											
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	-0.1	1.5	0.4
March	5.6	2.4	-0.1	0.0	0.5	10.1	7.2	1.2	0.0	4.3	-
April	2.8	3.7	0.1	-0.1	2.4	13.1	8.3	2.1	0.3	6.6	-
May	...	3.8	0.2	-0.1	3.5	12.0	10.2	4.2	1.1	9.9	...
June	...	3.2	0.3	0.1	3.8	8.5	10.1	5.3	1.5	11.4	-

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

(**) Except energy.

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

Foreign sector

Trade deficit up 8.6% year-on-year in the first six months of 2010.

The energy imbalance continues to grow

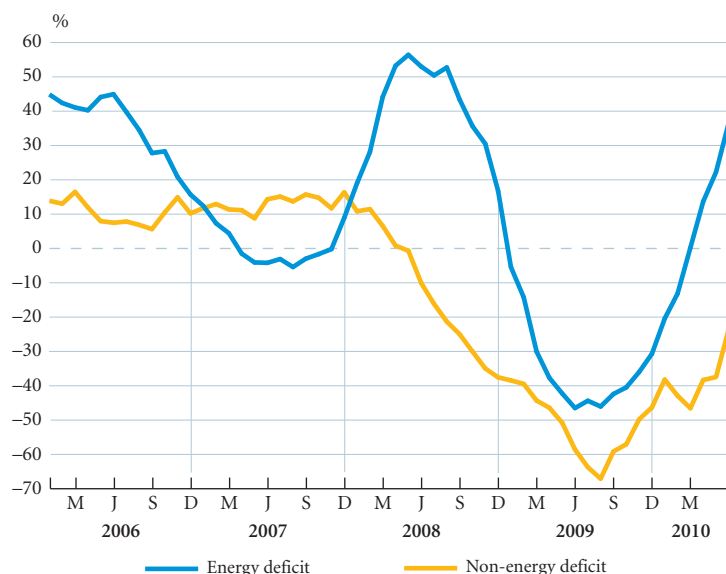
The first half of 2010 closed with an 8.6% growth in the trade deficit compared with the same period a year ago, putting an end to the continual improvements recorded since the end of 2008. This decline took place within a context of significant growth in trade flows from Spain with other countries. Consequently, after the sharp fall in exports in 2009, these increased by 16.3% in the first six months of 2010 compared with the first six months of last year. However, this rise, the largest since 2001, was not enough to offset higher imports, growing by 14.5% in the same period.

As can be seen in the graph below, the greater energy imbalance during the first six months of 2010, up 36.5% year-on-year, was the main reason for the trade deficit's decline in this period, resulting from strong growth in energy imports, up 31.1% year-on-year in the first six months of the year. A rise that, however, was exclusively due to the 27.5% rise in energy prices, while the volume of energy imports rose just 2.5%.

Meanwhile, the rest of imports posted significantly lower year-on-year growth of 11.3%. This can be explained by a rise in the volumes imported, rising to 14.2%, compared with a 2.6% drop in prices for this period. The lower rise in imports allowed the non-energy deficit to

THE ENERGY COMPONENT IS THE MAIN REASON BEHIND THE DEFICIT'S DECLINE

Year-on-year change in the balance of trade accumulated over six months



SOURCES: Ministry of the Economy and own calculations.

FOREIGN TRADE

January-June 2010

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	21,350	31.1	18.4	3,659	9.9	4.1	−17,691	17.1
Consumer goods	28,986	−9.9	25.0	31,034	−1.7	34.6	2,047	107.1
Food	7,186	1.1	6.2	11,912	6.0	13.3	4,726	165.8
Non-foods	21,800	−13.0	18.8	19,121	−6.0	21.3	−2,679	87.7
Capital goods	8,597	2.7	7.4	7,700	24.0	8.6	−897	89.6
Non-energy intermediate goods	57,081	28.2	49.2	47,378	31.3	52.8	−9,703	83.0
By geographical area								
European Union	65,015	9.1	56.0	61,502	14.1	68.5	−3,512	94.6
Euro area	52,142	4.1	44.9	50,713	14.0	56.5	−1,429	97.3
Other countries	51,000	22.1	44.0	28,268	21.4	31.5	−22,732	55.4
Russia	2,831	45.4	2.4	814	17.8	0.9	−2,017	28.8
United States	4,452	−3.5	3.8	3,013	2.5	3.4	−1,439	67.7
Japan	1,850	26.5	1.6	702	22.6	0.8	−1,147	38.0
Latin America	6,635	32.1	5.7	4,564	22.0	5.1	−2,071	68.8
OPEC	10,955	34.6	9.4	3,204	−1.2	3.6	−7,751	29.2
Rest	24,277	18.0	20.9	15,970	32.1	17.8	−8,307	65.8
TOTAL	116,015	14.5	100.0	89,770	16.3	100.0	−26,244	77.4

SOURCES: Ministry of the Economy and own calculations.

continue improving, although more slowly than before, with a year-on-year change of 23.6%.

Far from putting a stop to this situation, the figures for June show a faster increase in the deficit, up to 45.6% compared with the same month in 2009. Should this trend continue, the trade deficit would end up at around 5% of GDP during the second half of the year; a figure that, although far from the maximums reached in 2008, is still very high. However, the economic recovery of some of Spain's main trading partners such as France and Germany and the devaluation of the euro might boost exports over the next few months, readjusting the trade imbalance.

The Eurosystem, the main resource for external financing

This decline in the trade deficit is also reflected in the data available on the balance of payments up to May. According to these figures, the balance of goods saw a negative balance of 18.815 billion euros in the first five months of the year, 1.0% higher than the figure for the same period a year ago. However, the current deficit nonetheless continued to fall over this period, with a 15.0% drop year-on-year. This adjustment was mainly due to the improved deficit for the income balance that, up 38.3% year-on-year, was larger than the drop in the transfer account. The service balance remained practically the same.

June's figures point to further deficit growth.

The current deficit continues to fall in the first five months of the year.

Strong growth in Eurosystem loans to Spanish financial institutions.

An analysis of the monthly figures shows another annual fall in May's income deficit, as a result of lower investment income payouts. This was not enough to prevent a rise in the current deficit, however, its third consecutive increase, highlighting the change in trend recorded for this series. Nevertheless, the external financing needs of the Spanish economy, measured as the sum of the current balance plus the capital balance, continued to fall in May due to the latter performing well.

The composition of financing in May shows that the Eurosystem was the main

source of funding, totalling 42.402 billion euros. This figure, the largest since this institution was set up, is because the sovereign debt crisis has badly affected other external sources of financing. Greater Spanish direct investment abroad and the numerous foreign portfolio divestments during this month lie behind the net outflows of funds recorded for both items. On the other hand, short-term investment (loans, deposits and repos) which, during the period of financial turbulence was one of the main sources of funds, fell by more than 24.210 billion euros in May.

BALANCE OF PAYMENTS

Mayo 2010

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	-18,815	1.0	-45,302	21,154	-31.8
Services					
<i>Tourism</i>	8,502	-1.7	25,890	-1,697	-6.2
<i>Other services</i>	-354	-32.6	-539	506	-48.4
Total	8,148	0.3	25,351	-1,191	-4.5
Income	-9,448	-38.3	-24,661	13,434	-35.3
Transfers	-5,880	23.1	-9,083	-1,040	12.9
Total	-25,995	-15.0	-53,695	32,357	-37.6
Capital account	3,641	76.4	5,634	1,551	38.0
Financial balance					
Direct investment	8,543	-	16,229	31,052	-
Portfolio investment	-9,723	-	29,971	15,878	112.7
Other investment	-7,659	-	-37,731	-95,010	-
Total	-8,839	-	8,468	-48,081	-85.0
Errors and omissions	-4,859	-	-9,779	-9,458	-
Change in assets of Bank of Spain	36,051	-	49,701	25,564	105.9

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

A marked fall in the central government deficit during the first half of 2010

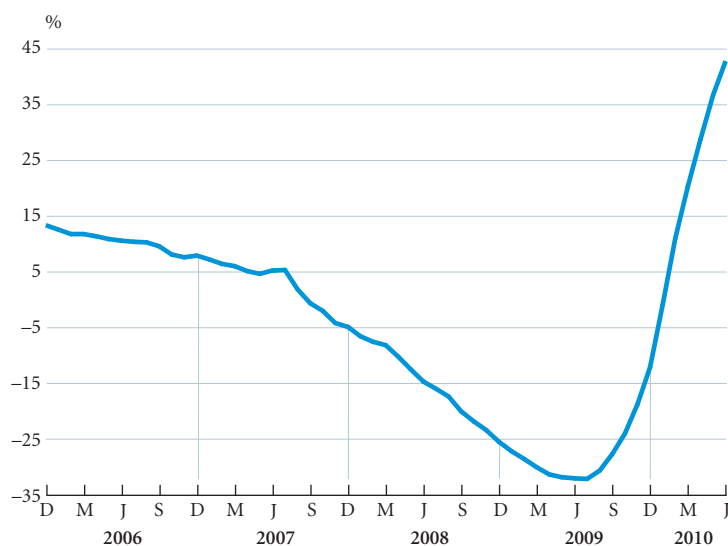
Over the last few months, budget austerity measures have been adopted as part of the Stability Programme in order to reduce the public deficit to 3% of gross domestic product (GDP) by 2013. Consequently, at the beginning of July the government ruled that the maximum percentage of vacancies to be filled in public administration bodies should go from 8% to 5%, except in the Armed Forces, Justice Administration and some other exceptions. The aim of this measure is to stop the wage bill from rising.

Similarly, towards the middle of July the Ministry of Public Works announced a 3.435 billion euro adjustment in its budget resources. It was therefore announced that 32 contracts for new building work would be withdrawn, less than 3% of all those above a million euros. However, 12 of these will be reinstated via public-private collaboration through tenders, and 2 will be put to tender again in order to achieve more efficiency. Moreover, the completion periods for 199 road and railway contracts will be extended. Nevertheless, in August the President of the government, José Luis Rodríguez Zapatero, announced that some of the

The Ministry of Public Works provides details on how its budget resources will be adjusted.

VAT REVENUE IS DYNAMIC IN THE FIRST SIX MONTHS

Homogenous year-on-year percentage change in revenue from value added tax (*)



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

SOURCE: Tax Agency.

Improved consumption and purchases made before the July tax hike boost VAT.

public works affected by the cuts might be reinstated.

A favourable trend has been noted in central government accounts, especially the rise in revenue, thanks to the effect of the measures undertaken and to an improved economic climate. Total income for the central government's coffers rose to 79.235 billion euros in the first six months of the year, a year-on-year increase of 5.8%. For its part, net tax revenue was up 3.5% compared with the first six months of 2009, once adjusted for regulatory impacts and the different rate of returns this year, a figure that almost doubles the accumulated figure up to May and clearly exceeds nominal GDP.

Revenue from direct taxation rose by 1.0% in the first half of the year compared with the same period in 2009. The most significant item, personal income tax, was up 3.6% due to the partial removal of the 400-euro advanced deduction and to the rise in the capital gains withholding rate. Once corrected for these measures and the different return rates, the percentage change is around -2.2%. On the other hand, corporate tax fell by 14.5%.

Indirect taxation recovered strongly and posted a year-on-year rise of 22.6%. Value added tax (VAT) was up 31.3%, this rate being affected by the new monthly refund system and the different rates of returns. The dynamism seen in VAT revenue is evidence of improved consumption, although it also reflects the fact that people have been advancing their purchases in anticipation of the tax

hike on 1 July 2010. Both revenue from domestic sales and imports saw considerable rises. For its part, revenue from special taxes rose by 7.2%.

With regard to expenditure, the austerity measures adopted are starting to have more impact. The central government's total non-financial payments were up 3.6% year-on-year in the period January-June but compare favourably with the 14.5% rate for the accumulated figure up to May. Current spending rose 7.9% compared with the first six months of 2009. The highest rise year-on-year was for financial costs, up 23.0% due to higher debt. Current transfers rose 7.3%, particularly because of the advances made to autonomous communities, established in the new financing system. Accumulated current expenditure on goods and services was up 3.2% and on personnel 2.4% after the public employee wage cuts in June 2010.

Capital payments were down 17.1%. Of these, real estate investment fell by 6.2%, in spite of a 2.4% rise in civil investment. For their part, capital transfers decreased by 22.7%.

Because of these trends in revenue and expenditure, the central government had a non-financial cash deficit of 30.794 billion euros up to June, a year-on-year drop of 16.4%. On a national accounts basis, i.e. according to the rights and obligations recognised, the central government's net borrowing totalled 29.765 billion euros, an annual fall of 24.7%. Regarding GDP, financing needs came to 2.83%, compared with 3.76% in the first half of 2009.

The austerity measures adopted are starting to have a greater impact on expenditure.

Financing needs fall by 25% up to June compared with the same period in 2009.

Savings and financing

The fall in private sector debt eases off

In the second quarter, financial institutions slightly toughened up their conditions to supply financing, especially because of the difficulties they experienced in accessing wholesale markets due to the Greek fiscal crisis, according to the corresponding Bank of Spain survey. Demand remained weak, although the housing segment picked up. The average interest rate for credit transactions stood at 3.19% in June, very close to the minimum for the last few decades recorded in the month of May.

Within this context, in May and June the deleveraging slowed up of firms and

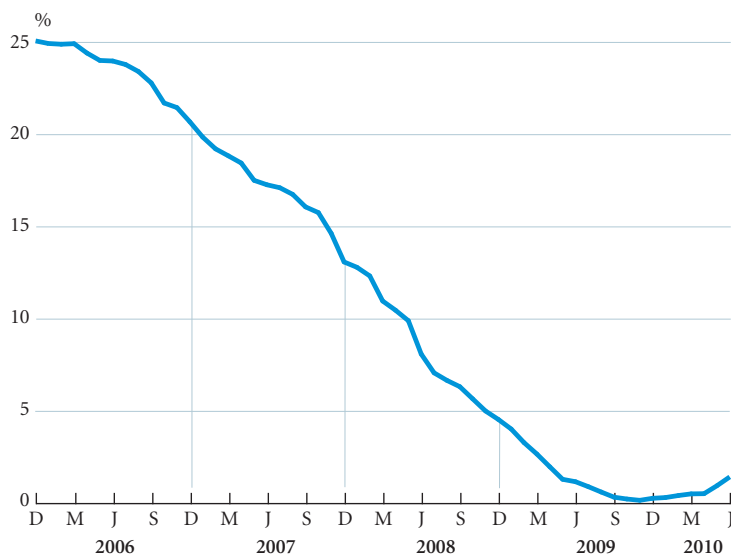
households, which had reached high levels of debt before the 2008-2009 recession. Consequently, private sector financing recorded a 0.8% year-on-year decrease in June, albeit almost one point lower than the figure two months earlier.

Financing to firms also moderated its fall over the last few months. Consequently, in June this showed a year-on-year decrease of 2.1%, although 8 tenths of a percentage point less than in April. This change was due to loans by resident institutions, which slowed up their decline, and the speeding up of fixed income security issues, up 48.7% compared to June 2009. However, foreign loans shrank by 4.9%.

Private sector financing records a 0.8% year-on-year fall in June, almost one point lower than the figure for April.

HOUSEHOLD FINANCING FOR HOUSING LIVENS UP

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



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

SOURCE: Bank of Spain.

FINANCING OF NON-FINANCIAL SECTORS (1)

June 2010

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,213,938	488	-0.8	78.7
Non-financial corporations	1,301,893	-8,544	-2.1	46.3
<i>Resident credit institution loans</i> (3)	902,040	-14,317	-3.4	32.1
<i>Securities other than shares</i>	66,138	9,884	48.7	2.4
<i>External loans</i>	333,715	-4,111	-4.9	11.9
Households (4)	912,045	9,033	1.0	32.4
<i>Housing loans</i> (3)	684,922	6,370	1.4	24.4
<i>Other</i> (3)	224,416	2,592	-0.2	8.0
<i>External loans</i>	2,707	70	4.5	0.1
General government (5)	598,371	38,724	19.0	21.3
TOTAL	2,812,310	39,213	2.8	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.

Upswing in mortgages to buy housing, partly due to demand being brought forward given the expected tax hike.

In June, the balance for household financing continued its recovery noted over the last few months and posted a year-on-year rise of 1.0%, compared with an annual fall of 0.3% in December. The boost came particularly from housing loans, up 1.4% on the same month in 2009.

The rise in mortgages can be explained by the reduction in the effort required to secure a mortgage, given the fall in house prices and low interest rates. The one-year Euribor, the most widely used reference for this market segment, stood at 1.37% as a monthly average in July, 16 basis points above the record low of March 2010 but still below inflation, suggesting a negative real interest rate. In the first few weeks of August, the 12-month Euribor continued its slight upward trend and reached 1.42% by the end of the third week. Also of influence was the fact that demand was brought

forward due to the rise in value added tax for new homes as from 1 July 2010, as well as the partial removal of the deduction in personal income tax as from January 2011.

With regard to non-performing loans, in June the rate for credit institutions as a whole eased off and stood at 5.3%, one tenth of a percentage point below its level two months previously and returning to the level of mid-1996. However, financial institutions have continued to increase their provisions to tackle the upward trend in default. By type of institution, this rate stood at 5.3% for banks, 5.3% for savings banks, 4.1% for credit cooperatives and 10.1% for financial credit establishments.

On 23 July, the Committee of European Banking Supervisors (CEBS) published the results of the stress tests carried out

The default rate for credit institutions eases off in June.

on 91 European financial institutions. The institutions taking part from each country account for at least 50% of its banking sector. However, in the case of Spain, and in an exercise of maximum transparency, all listed Spanish banks were tested, as well as all savings banks.

These stress tests confirmed the solidity of the Spanish banking sector. The vast majority of the 27 Spanish institutions and groups analysed passed the target level for capital agreed by the CEBS (6% of Tier 1 capital, 50% more than the minimum required by international regulations). "la Caixa", the largest Spanish savings bank, posted 8.5% for its Tier 1 ratio in an adverse scenario and 7.7% with the additional impact of sovereign debt, one of the highest rates of all Spanish institutions. However, in order to comply with the Ecofin agreement that no institution would see its Tier 1 ratio fall under 6% as a result of the most adverse scenario, a further four Spanish savings bank groups, which do not form part of the largest institutions, will have to increase their equity by 1.835 billion euros, although today their capital rates greatly exceed 6% of the Tier 1 ratio.

Within this context, the new Savings Bank Act, established by Royal Decree-Law 11/2010 of 9 July, allows these institutions to secure funds in the top quality capital market and to get ready to tackle the reform of the international financial system regulations, which will require financial institutions to have more and better quality capital. In accordance with the new Government Body Act and other aspects of the Savings Bank regulations, these institutions will be able to keep their status and issue shares with voting rights limited to 50% of their assets, or alternatively they will

be able to pass on their financial business to a bank owned by them and manage their welfare work through a foundation. They'll also be able to become a foundation, giving up all their business as a credit institution to a bank in which they have a holding. Moreover, the Board must comprise at least 50% professionals and may not include elected political positions.

With regard to general government finances, the public debt measured according to the Excessive Deficit Procedure at the end of the first half of the year rose to 19.0% compared with twelve months before. However, a slowdown can be seen, since in October 2009 this was advancing at an annual rate of 35.2%. The government's austerity programme has helped towards this slowdown in public debt. The restrictive measures taken by the government and the structural reforms announced have also helped to lower the risk premium for Spanish public debt. Consequently, the differential between Spanish 10-year government bonds with German bonds for the same period went from 221 basis points in mid-June to around 180 in the fourth week of August.

Slight growth in bank deposits

The average return on bank deposits in June reached its highest level since July 2009, standing at 1.37%. This rise was due to the higher yield from term deposits and temporary transfers.

The rise in yield for term deposits is in line with the slight increase in the one-year Euribor, but it also demonstrated the interest of institutions in financing themselves via customer deposits, given the difficulties in accessing international

Stress tests confirm the solidity of the Spanish banking sector.

The new Savings Bank Act changes the model for Spanish savings banks.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

June 2010

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	265,362	2,627	1.0	7,434	2.9	18.7
Savings deposits	213,778	5,986	2.9	14,961	7.5	15.1
Term deposits	714,394	-5,618	-0.8	-16,149	-2.2	50.4
Deposits in foreign currency	22,425	410	1.9	-3,417	-13.2	1.6
Total deposits	1,215,958	3,405	0.3	2,828	0.2	85.8
Other liabilities (*)	201,369	-11,761	-5.5	-16,004	-7.4	14.2
TOTAL	1,417,326	-8,356	-0.6	-13,176	-0.9	100.0

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

SOURCES: Bank of Spain and own calculations.

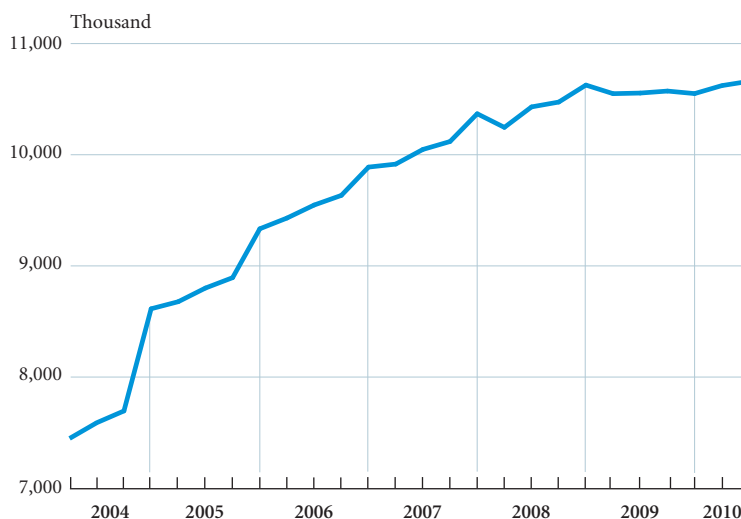
Pension fund assets up 5% in the last twelve months.

markets after the outbreak of the Greek fiscal crisis. However, an improvement was noted after the results of the stress tests were published for European banks and savings banks. Consequently, at the end of the first half of the year, private sector deposits were slightly up year-on-year by 0.2%, unlike their 0.7% fall year-on-year in April 2010.

At the end of the second quarter, the volume of assets for pension funds rose to 82.388 billion euros, a 5% rise compared with the same month last year. The number of participant accounts increased by 1% annually, up to 10,646,477, setting a new record. The average weighted annual yield was 3.4% at one year and 5.2% at twenty years, greatly exceeding inflation.

PENSION FUND PARTICIPANT ACCOUNTS SET RECORD HIGH

Number of pension fund participant accounts



SOURCE: Inverco.

SMEs: sailing against the wind

The business sector, for either SMEs or large firms, is crucial for economic growth. After all, a country's capacity to generate wealth and employment depends on business being healthy. Throughout the last few years this sector has been sunk in a deep recession in most developed countries, but the crisis has had a significantly more virulent effect on SMEs than their larger peers. Taking the Spanish case as an example, between 2007 and 2009 the number of SMEs fell 10.1%, much further than the 3.4% recorded for large firms. This greater vulnerability has reopened the debate about the weaknesses of SMEs and most particularly their financing difficulties.

Although the definition of an SME covers a highly heterogeneous group of firms, making any attempt at generalization much more difficult, they do share certain traits that set them apart from large firms and affect their ability to secure external funding. Their smaller size and the higher cost of professionalizing their financial management limit their access to the capital markets (by issuing corporate debt or through the stock market). This makes bank loans the primary source of financing for SMEs.

Moreover, there are two aspects that affect SMEs significantly in terms of financing: higher risk assessment costs and a higher probability of default. With regard to the first aspect, since financial management is less sophisticated among SMEs and up-to-date financial information is less readily available, lenders are forced to incur additional costs to determine a firm's solvency. With regard to the second aspect, their size restricts their ability to diversify, both geographically and across sectors, leading to a higher concentration of risk. Because of this assessment-risk issue, financing conditions for SMEs are usually stricter than for larger firms, both in terms of interest rates and the guarantees required.⁽¹⁾

But small and medium-sized firms have encountered an important increase in their financing needs during the latest economic recession. Consequently, according to the European Central Bank (ECB), 19% of SMEs saw funding as their second biggest problem during the last six months of 2009.⁽²⁾ A higher proportion than the one reported by larger firms.

There are various reasons as to why it's more difficult for SMEs to secure financing. This can be partly explained by the different use of funding. In the case of SMEs, a high proportion of the funds secured are used to finance their working capital (for example, through lines of credit), increasing their vulnerability in times of less liquidity, as recently. Furthermore, the financial turmoil that started at the end of 2007 affected the banking sector's borrowing capacity. As a result, financial institutions were forced to toughen up their credit standards, particularly in 2008 according to the ECB.⁽³⁾ Lastly, deteriorating economic conditions weakened the solvency of many firms, hence their capacity to borrow also worsened.

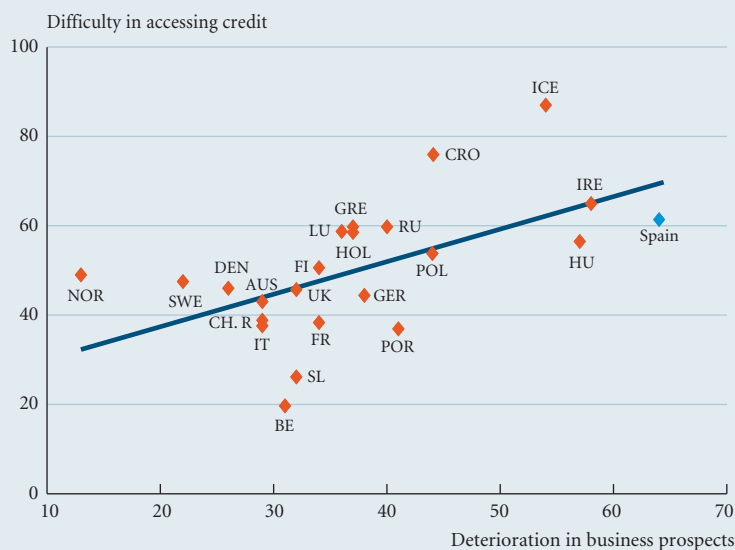
(1) Beck, T. *et al.* (2008), «Bank Financing for SMEs around the World: Drivers, Obstacles, Business Models and Lending Practices», World Bank Policy Research Working Paper.

(2) Survey on the access to finance of small and medium-sized enterprises in the Euro Area.

(3) The Euro Area Bank Lending Survey.

FOR SMEs, THE WORSE THEIR BUSINESS PROSPECTS, THE HARDER IT IS FOR THEM TO ACCESS CREDIT

Percentage of SMEs



SOURCE: Flash Eurobarometer 2009.

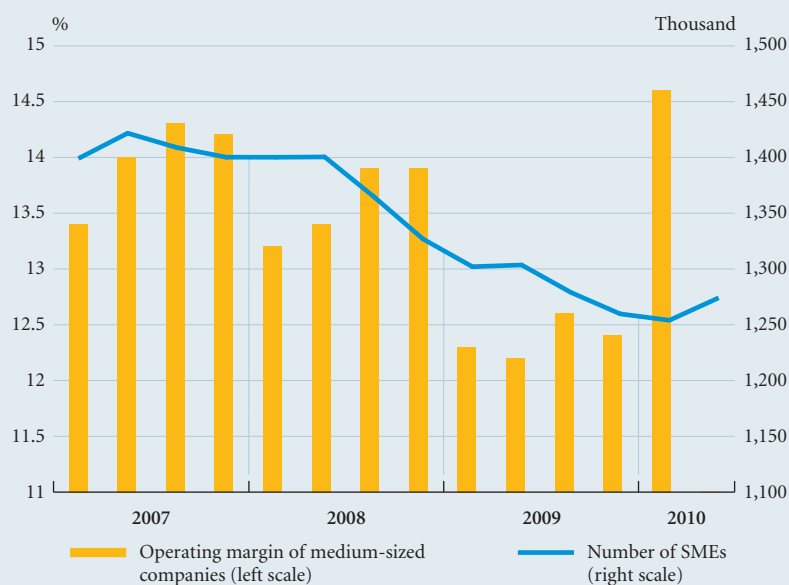
All these factors worsened the situation for SMEs even more. In addition lower optimism regarding their future growth made it more difficult for them to access credit, and vice versa. The above graph, for example, shows that, in those countries where the business prospects for SMEs deteriorated more sharply (Spain, Hungary, Ireland and Iceland), financing difficulties were greater.

It's no surprise that, given this scenario, most governments have implemented measures to improve financing conditions for SMEs. Among the most frequently used are direct lines of credit to finance exports or innovation projects, bank credit guarantees given to firms and improvements in SMEs' liquidity (reducing taxes and shortening payment delays for public procurement). This stimulated credit to small and medium-sized firms to a certain extent, although it wasn't enough to completely open up the traditional financing markets.

However, in the same way that the deterioration in economic outlook worsened the situation in the sector, the current economic turnaround may be salutary. In this respect, the strong growth being recorded in the euro area, Spain's main trading partner, and particularly the recovery of the Spanish economy per se will come as a breath of fresh air for SMEs. In fact, some available indicators regarding the operations of small and medium-sized firms in Spain have already started to show a change in trend. Thus, in the first half of 2010, there was a net increase in the number of SMEs after two and a half years of continual falls. At the same time, figures from the Central Balance Sheet Data Office, published by the Bank of Spain, show a slight improvement in operating margins for medium-sized firms during the first quarter of 2010.

SPANISH SMEs SHOW SIGNS OF RECOVERY IN 2010

Operating margin (*) of medium-sized companies and number of SMEs



NOTE: (*) Gross value added less personnel costs over production value.

SOURCES: Social Security and the Bank of Spain's Central Balance Sheet Data Office.

In spite of small and medium-sized firms having embarked upon the road to recovery, in March this year 85.3% were still encountering difficulties in securing financing.⁽⁴⁾ Without a shadow of a doubt, it won't be at all easy for financial conditions to get back to normal. The likely tightening up of banking regulations, for example, might slow up this process. However, the Spanish economy's gradual return to growth allows some room for optimism.

(4) According to the survey by the High Council of the Chambers of Commerce.

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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



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